The Liberal Financial Order in Crisis: Analysis of the Rescue Plans and the Reform of the International System

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I. The Genesis of the Crisis

The current financial crisis originated in the years 1999 – 2007 as a result of a combination of several factors. The first was the extraordinary boom in the housing market, in particular in the United States, where the overhang in the supply of housing opened up for financial institutions the possibility of extending vast numbers of mortgages at attractive rates.[1] The second was the historically low interest rates put in place by the major Central Banks, the third, the accelerated pace of financial innovations in the context of rampant deregulation. And last the virtual disappearance of the inflation fear on the screens of Central Banks. This latter is no doubt the contribution of the extra ordinary growth of cheap Chinese imports in all world markets and the healthy growth of productivity in almost all the economies. While the last two factors are background ones, the first four are directly linked to the current crisis.

The demand for housing equity during the last decade and a half was a historical high in every major country. In the United States the number of housing units sold in 2005 reached a peak of 1,283,000 as compared to an average of 609,000 in 1995-2000. More than 6 million units were sold in the five years up to 2006.[2] This expansion in household equity constituted a major increase in the wealth and disposable capital of the household. In turn, this wealth effect sustained the levels of household consumption and fueled the remarkable growth of the US economy in the 15 years preceding 2007. However, such an expansion in real estate equity would not have taken place had it not been for the availability of cheap mortgages made possible by the rather loose monetary policies of the US from 2001 to 2004, and the consequential low interest rates.

Banks and other financial institutions operating under less and less regulation and global liberalization fed the housing boom with mortgages containing initial grace periods of up to three years, minimal down payments and low initial interest payments to be adjusted later on to market reference rates. Furthermore, so many of these mortgages were extended to borrowers ordinarily considered non credit- worthy or, at the very least, borrowers who incurred debts beyond their capacity to pay back. But in so doing, the lenders observed the old rule that the higher the risk, the higher is the reward. Thus came to be the subprime mortgage market; a market whose borrowers could only pay back their

debt if the rate of increase of housing prices continued to outstrip the rate of debt service so that they can refinance these loans or sell the houses at big profits.

To keep the funds revolving, the lenders sold these loans to pools which repackaged them in the form of leveraged bonds guaranteed by these same mortgages. The door was therefore opened to financial institutions, in particular investment banks, to buy these lucrative financial products without regard to the low quality mortgages underpinning them and without a proper understanding of the risks involved in these leveraged papers. As long as the housing bubble lasted, i.e. house prices growing by higher than the percentage service of the debt, the market for these leveraged bonds kept going and growing.

Naturally if banks and other lenders had extended the mortgage loans under the old conditions of mortgage lending, they would have had to hold them on their books and eventually would have run out of funds. But starting in the late 1980`s, financial innovations made it possible for mortgage lenders to unload their loans to pools, which can transform these personalized, non negotiable obligations into derivative securities guaranteed by the mortgages. The amalgams of mortgage loans have the statistical predictability of large numbers (see the discussion in section II bellow). Two major institutions in this respect are the US public institutions Freddie Mac and Fannie Mae, who bought the biggest chunk of these mortgages and then repackaged them into papers giving the illusion that they are government backed.

In the global financial markets, the circulation of these securities was associated with scant evaluation of their risk, no consideration of the leveraging involved and an oblivion regarding their potential illiquidity when so many banks and other financial institutions held them and might have to liquidate them at the same time. The investment managers thus fell into the trap of the fallacy of composition, so well known in the history of the real bill lending theory.[3] The non transparency of these new instruments and their massive quantum even trumped the rating agencies. Like a herd, the Banks simply followed each other buying these lucrative securities and garnering up in the process big profits on their income statements while hiding the eventual risks as contingent liabilities.

After the crisis erupted, the IMF estimated the size of these securities at more than $ 945 billion, while Goldman Sachs put them at more than 1.0 trillion. [4]In September, the IMF revised its estimate to $ 1.4 trillion. [5]

There were many culprits: the greedy banks and other financial institutions with their irresponsible and uninformed behavior, the equally greedy borrowers, the absence of appropriate regulations covering all the financial institutions and the lacunae of vigilant supervision at both the states and federal levels, the non regulated and non transparent character of the financial innovations, the failure of the rating agencies to do their job and finally the loose monetary policy of the Greenspan era in the years 2001-2004, which were accompanied by looser regulations and encouragement of housing acquisition.[6]

II. The crisis unfolds

The crisis erupted in 2006, the first year in which prices declined. By August 2007 the annual decline exceeded 7%. The unsold inventory of houses was thirty nine percent higher in 2007 than a year before.[7] Naturally, housing price decline rendered refinancing mortgages at higher interest rates rather difficult. The financial institutions, which for long goaded the borrowers to take on mortgages they could not afford, now turned into parsimonious bankers. It should be recalled that in 2005 the Federal Reserve started to tighten monetary policy and raised interest rates seven times in one year. These hikes were of course carried through to the sub prime mortgages, all of which were on floating rate. Gradually, mortgage borrowers came to realize that unless they can borrow or refinance, they could not carry on with their debt. At the higher interest rates, the capital value of so many mortgages started to exceed the resale value of the house. This opened the door on defaults and foreclosures. In the process, banks started to classify sub-prime mortgages as non performing assets. The leveraged mortgage bonds and other derivatives which were previously prized now became risky and balance sheets became vulnerable. The crisis of the banks started in the US and then, in the environment of global markets, spread to banks balance sheets all over the world. As of the middle of 2007, banks came to realize the gravity of the risks of their balance sheet assets and they started to feel the pinch of capital inadequacy. This was soon reflected in retrenchment on lending.

Concurrently, as the US economy and other economies teetered on the edge of recession, the stock markets all over the world turned bearish. In the second half of 2007 and so far in 2008 (October), between a quarter and two fifths of the value of assets on the world stock exchanges has been wiped out. More ominously, since March 2008, major investment banks and major integrated global banks and other financial institutions have been threatened with collapse unless they can get huge injections of capital or be bought by solvent banks. Citibank, the US` biggest bank, got $27 billion injection from foreign sovereign funds and UBS, the world fifth biggest bank, got $ 37 billion capital injection from similar sources. Other banks, in less egregious cases, rushed to raise their capital in order to write down or off, billions of dollars of leveraged mortgage- based paper. However, not all banks were successful in their rush to raise capital. The market dried up in the face of Bear–Stearns last March. The US Federal Reserve had to step in to lend against collaterals and extend loan guarantees to Bear-Stearns. The situation was saved by Chase-Morgan who acquired the bank for $10 a share. Merrill- Lynch, the second largest investment bank in the US, had better luck; the Bank of America bought it for a bargain price. On top of these banks, Freddie Mac and Fannie Mae, the two giants of mortgage pools, holding more than $550 billion of mixed quality mortgages, were saved from collapse and bankruptcy by The US authorities putting them into conservership.

At any rate, the financial crisis was not stemmed at that. In September, the market faced the imminent collapse of Lehman Brothers, another century old institution; it was not successful in either borrowing or finding a buyer. The Fed and the Treasury this time shrank from stepping in for reasons of cost, lack of authorized resources and ideology. Hence, Lehman applied for protection under Chapter 11 of the bankruptcy act. Lehman's

collapse sent severe shocks in all the stock markets. On Monday and Tuesday, 15 and 16, of September, the NYSE lost more than 900 points (more than 8% of its capitalization), and similar percentage losses were recorded in the other stock exchanges all over the world; in the global market all stock markets seem correlated. [8] As the week of September 15 started out, AIG, the world largest insurance group, with a global network covering bank insurances, insurances of retirement plans, protection of construction contracts, covers for health insurance schemes and various other asset protections, revealed that it needs a staggering $ 85 billion to be saved. Once again, in view of the world wide repercussions and the direct threat posed to the safety of the financial system, the Federal Reserve came to the rescue. This time, and that is a historical first, it rescued a financial institution both outside banking and outside its control; surely a precedent in the annals of monetary policy.

The fear that has gripped investors and manifested itself in the volatile and depressed stock exchanges was still not broken by all these dramatic rescues. Stock markets seemed to reason that the basic underlying problem in the housing market remained untreated. Despite the announcements on Wednesday 17 September of a hurried pooling of $85 billion by the world biggest banks to aid banks in need for refinancing and mobilizing a fund of $ 180 billion by the major world Central Banks, stock markets still nosed down in Europe and Asia on Thursday amidst rumors that Morgan-Stanley and Goldman-Sachs, the two remaining independent US investment banks, were looking for buyers. By that time it had become clear that the ad hoc approach was not tracking. Late in the day, a rumor spread that the US Federal government was at last considering a direct attack on the underlying problem by establishing a Resolution Trust Company (RTC) on the model used by the US at the time of the great depression, with sufficient resource to acquire and liquidate most of the non performing mortgages. Indeed, during the weekend, President Bush announced his intention to set up a $ 700 billion agency to deal with the underlying problems. The Thursday rumor had an electrifying effect; on Thursday and Friday, all the stock markets went up in unison. [9]

The crisis spread swiftly to Europe. The Bank of England took over the illiquid assets of Northern Rock, a major mortgage bank. At the behest of the Bank of England, Lloyd Bank agreed to purchase HBOS the mortgage giant which owns the Halifax Bank and the Royal Bank of Scotland, two institutions that teetered on the edge. At the end of September, Bradford and Bingley, another big bank, was taken over by the Bank of England. After unfathomable dithering, the British government announced on October 8 an $ 87 billion in bank capital injections and credit support facilities up to $420 billion. [10] On the continent, October saw the Belgian and Dutch governments taking action to save Fortis, a big mortgage bank. In October, the Germans had to step in to save Hypo-Real Estate, the mortgage giant, by extending $ 48 billion. On the fifth of October, Germany announced that it will guarantee all individual saving deposits in all its banks.[11] So did Ireland, Greece, Austria, Denmark and Iceland.

III. The Liberal Financial Model in a Global Economy

The current global crisis might mark the end of an era in the history of financial capitalism. The prevailing model of deregulated, liberal and open financial capitalism was ushered in the mid 1980`s with the coming to power early in the decade of Mrs. Thatcher in the UK and President Reagan in the US. This model was no doubt given impetus by the manifest success of open market economies and the concomitant manifest failure of the state controlled ones. While that is not a cause and effect situation, the margin of empirical difference was undeniable. The growth of financial flows world wide together with the growth of international trade and transnational corporation investments and other Foreign Direct Investments (FDI) were superior to the growth of national incomes every where.[12] The economies which opened themselves on this new brave world stood to reap rich benefits and the evidence of the difference in the performance persisted for a decade. Therefore, many observers came to the conclusion that the liberal open model was the only successful choice on the menu.

The US offered the most successful example of this model in application. And of all the US economic institutional set up, the financial system was the most performing and most esteemed. The global trend was therefore to copy the American model and push liberalization and globalization to the limits. Hence, the world witnessed a gathering wave of deregulation and globalization in the second half of the 1980s, which accelerated in the 1990s and came to ruling the roost thereafter.[13] In the US, the protestations of non bank financial institutions against regulatory barriers in their face coupled with the rather stagnant performance of commercial banks in the 1990`s convinced the US Congress and Administration to overhaul the financial legislation and do away with the barriers erected by the Glass-Stiegel Act of the depression era, removing in the process the distinctions between banks and other financial intermediaries and institutions. [14] At the end of the second term of the Clinton Administration, the President signed into law the Gramm-Leach-Bliley Modernization Act of 1999, thereby removing distinctions among financial institutions.[15]

The act allowed banks to make themselves supermarket banks, grouping under the same institutional roof retail and wholesale banking, investment banking and other intermediary financial services. This is more or less the European system, but with less regulations. In the global era, this soon turned into global banking. However, banks were not the only beneficiaries of this liberalization. Other financial institutions previously not as regulated as the banks, jumped also on the band-wagon and started offering diversified financial services on a global scale. The stage was therefore set for the double digit annual growth of the financial industry.

This growth was propelled by the multiplicity of financial innovations offering a bewildering variety of financial products, the increased securitization of the financial industry, and thanks to the revolution of information and communications, the global consolidation of banks. Among these innovations was the coming to age of derivative products, whose market is estimated by the IMF in excess of $22 trillion, and who

account for 22 % of bank income. Such products can be treated as off balance sheet items carrying contingency risk, which yield income but do not burden capital as long as they continue to be performing assets.

The innovations retouched also mortgage loans. In the late 1980`s Merrill-Lynch and Michael Millikan at Drexel Bank transformed mortgage loans from personalized assets with non predictable flows into derivative paper based on the statistical properties of large number samples: predictable inflows and outflows and standardized uniform sample characteristics.[16] This was carried into new heights by Fannie Mae and Freddie Mac, which specialized in gathering mortgage pools involving tens of thousands of underlying primary contracts, then repackaging them into leveraged bonds guaranteed by the underlying loans. To neuter the papers taint of origin, they came to be known as "Structured Financial Vehicles". These papers were sold to financial buyers all over the world.

It should be remembered that the underlying mortgages came from banks, which were regulated and non bank institutions, which were much less regulated and supervised. The pools enabled the banks and the other lending institutions to unload their loans. In the pools, the loans were mixed and nobody could access their differentiated risk and thus price the constructed derivatives in relation to their true risk. Had stricter regulation and more realistic risk evaluation standards been applied, the circulation of the resultant derivative securities would have been attached to differentiated risk rating in respect of the issuer: prime papers, essentially issued by regulated banks, and the sub prime papers issued largely by non regulated lenders. In all probability, this risk segmentation would have limited their quantum and reduced their circulation in the global financial markets. This should explain why banks were oblivious to risk and running billions of dubious oblique assets all over the world.

Does the crisis mark the end of the liberal financial model and a return to regulations and national financial markets?

On the twenty second of September, 2008, Morgan Stanley and Goldman-Sachs, the two last remaining independent investment banks, announced that they are applying to the Federal Reserve to operate under its umbrella as bank holding companies. That certainly signals the end of investment banking as Wall Street came to know it. But investment banking is essential for underwriting securities, arranging mergers and acquisitions, extending financial services and advice as well as for financing big projects. Those functions will remain and continue to be performed by institutions which call themselves banks but not Investment Banks. What is likely to emerge is a reasonably supervised and regulated structure, which will continue to operate globally. President Sarkozy of France was speaking for most when he said in the European summit of the four biggest economies on October 4, 2008, the reform needed is to bring about an entrepreneurial capitalism and not a speculative one. Perhaps the future system will be a market based multi standard banking system, some of which is more regulated than the other, but all of which is largely safe and global.

The crisis threw into sharp relief the indispensability of the state role in a market economy as a regulator, a last resort provider and a custodian of the financial markets and people savings. For years, the role of the state has been deprecated and in the belief that whatever it does should be considered suspect and, if needed, a necessary evil. The maxim of President Reagan that the state was not the solution, rather, the problem, was elevated to a self evident truth. Even the instances of market failure, long established in economic theory, became heretical tenets in the policy councils of many states following the Anglo-Saxon model. The excess of the liberal model infused the political discourse, in particular in the US. President Reagan's simplistic reductions; cut the taxes, reduce government spending, deregulate the markets, open the boarder, spend beyond your income and borrow if you need, became the prevalent creed in US politics and much admired elsewhere. The globalization of the economies added to that in three major ways: it reduced the role of the state and eroded its fiscal base while increasing its fiscal obligations in furnishing the warewhithals for a country to enter the global market and to cope with the victims of globalization. On the other hand, globalization set a model of macroeconomic policies that came to be considered the only valid one. Thus, policy making became a practice in emulation. Finally, globalization fostered the notion that in the global economy all agents have the same motive: making private profit. Consequently the role of the state is to facilitate that. The crisis has closed the Reagan era and brought forward the realization that markets are too important to be left operating on their own.

V. International Norms for Financial Regulation and Bank Supervision: Reforming the International System

In the light of the above, it would be reasonable to say that the global financial crisis would not have occurred with the ferocity we have witnessed if proper banking and other financial regulations were in place.

For a number of years, the risk of derivative securities and other instruments of structured finance along with other contingent liabilities have been under intensive consideration by the Bank of International Settlements (BIS) in Basil, Switzerland. [17] The BIS produced two financial conventions: Basel I in 1988, and Basel II, in 2003. Basel I has been incorporated into the regulations of about 100 countries, while Basel II is still under consideration. Along side this work the Basel Committee on Banking Safety (BCBS) added a great deal to the understanding the work and prudential management of banks and the rules for their regulation. It proposed norms for estimating risk and measuring capital adequacy in the new global environment. It also covered norms for best practice for banks and international markets. The BCBS proposed examples of standardized accounting norms for bank and financial auditing and supervision and developed agreed methods for estimating asset value. It also established modalities for supervision and bank examination. Over recent years, the BIS has additionally become a major centre of data gathering and dissemination.[18]

The work of the BIS and the BCBS furnishes good basis for revamping the regulatory system in the US and for making sure that such an overhaul is done on world wide scale.

The salient features of a possible new system which incorporates the lessons of this crisis can be summarized as follows:

- Uniformity of international standards: the surest bank behavior is to exploit differences and gaps in regulations. In the current global market, this means that no regulations are enforceable if they are not done on a global scale. Similarly, nation states would accrue unfair advantages if they adopt different standards than their partners. In October, 2008, Ireland and Greece gave 100 % insurance cover for deposits in their banks, a move that immediately was contested by other EU members and matched within two days by Germany, Austria and Denmark.

- The new regulatory system must cover all financial institutions, be it banks or non banks. The aforementioned European summit promised to submit to an international conference a comprehensive scheme for a college of supervisors of all institutions.[19]

- In line with the recommendations of the BCBS report, the new System may consider the proposed measures to strengthen prudential oversight of banks and other financial institutions and adopt best practice modes.

- The new system must establish common international models for asset risk valuation. The BCBS considered three asset risks: market, credit and operational. It devised rules for weighing various asset risks and relating them to bank capital adequacy ratios, thereby setting the regulatory auditing standards.[20] .

The new system should strive to establish common financial accounting standards for examining, auditing and supervising all financial institutions.

- In view of the gross negligence of the rating agencies in the lead to this crisis, the new system should factor in changes in the role and uses of credit ratings and in the standards applied by these agencies in their work.

- Put in place agreed modalities to strengthen the responsiveness of authorities to systemic risk; and set robust arrangements for dealing with stress in the international financial system. In this context, given the enormous size of consolidated banks, there should be provisions for means to enable the oversight authorities to burst finance bubbles as well as procedures for resolution of insolvency of big, system affecting institutions. [21]

- Establish an internationally standardized system for data definitions, gathering and electronic dissemination to all participants and to the public at large.

While the BIS forum has been quite active over the last ten years, the IMF and other international financial and monetary organs have been notable for their passive presence. In a global economy with global financial markets, an international authority is essential for solving and dealing with any global problem. Resolving the current crisis is

impossible by the lone action of the US. Yet, the prevailing international monetary system has no such locus of authority. The IMF from its inception has had no bank of last resort function and no resources of its own to create international liquidity in order to cope with large scale crisis. The international reserve system it runs is essentially a pool of sovereign contributions of national currencies, dominated by the major reserve currencies and subject to the sovereign control of their governments. The IMF`s surveillance functions under Article IV, are essentially limited to balance of payments issues.[22] It is therefore expected that, contrary to all logic, it be irrelevant in the current crisis. However, the BIS forum cannot substitute for the IMF because its membership is limited to the ten major countries plus Switzerland. More importantly, none of the results of its work are mandatory on member states, let alone other countries. It takes no leap of imagination to conclude that international monetary reform should be a major item on any intergovernmental future agenda.[23] President Sarkozy of France and other heads of states said that much in the current session of the UN General Assembly which coincided with the crisis. In the years since the Washington Consensus, the IBRD and the IMF have become unconditional advocates of deregulation, openness and market liberalization.[24] Their policy recommendations emphasizing unfettered openness and liberalization, proved ineffective in foiling the Asian crisis of 1998, and in some cases, like Malaysia, irrelevant.[25] Worst, they could neither predict nor stop the crisis.[26] Thereafter, the importance of these institutions and their relevance to a global financial system was dwarfed by the size and the availability of private and regional lending institutions. It is now only countries with no market access or access on onerous terms and conditions that resort to them. Consequently, their relevance has been put in question.[27] In the aftermath of the current crisis, the role of these institutions and their philosophy must be reconsidered. While it is unrealistic to expect that they will ever substitute for national authorities as banks of last resort[28], they can be very helpful and effective if they move in concert with the BIS to provide a true international forum for international coordination in areas of regulations, practice standards and bank data reporting. They can also break new grounds if they make themselves loci of advanced warning of system crisis and the forum of coordinated response. This is precisely what the October meeting of the IMF council produced: agreement to coordinate a common action by all member states to deal with crisis. In addition, the EU member states are now on record that they will be bronging up with US and other countries, including major emerging economy countries the question of reforming the international monetary system. A considerable literature on international monetary reform has developed over the past three decades with a wealth of ideas and proposals.[29] Unfortunately, international monetary reform has been a taboo topic for the US over much of the last three decades.

V. Analysis of the Rescue Plans: Issues at Stake

Ultimately, the viability of any financial rescue plan depends also on what happens in the real economy. An economy in recession is one in which the recovery of the financial system is difficult; the value of banking and other financial assets is positively correlated to the level of macroeconomic activities. On the other hand, the recovery of an economy

depends on the health of the financial system and its ability to extend credit; it is indeed a circular dilemma.

There are now several rescue plans, the most important of which are the US recue plan, the British rescue plan and the variety of plans announced by other members of the EU. European officials outside the UK were quite slow to react; most of them thought that the crisis is essentially confined to the US and the UK. As they realized that the crisis is global, they started to float various ideas: the Dutch Prime Minister suggested a plan of $450 billion for Europe financed by a percentage of the GDP of the EU members. Similar thoughts were attributed to French Officials. On October 4, President Sarkozy hosted the heads of governments of the four largest economies in an emergency meeting on the crisis. This meeting produced agreement to take coordinated but independent national action by the members as they see fit. It called for an international conference in the form of a G.7 meeting and a meeting of the heads of states of Europe to look into the situation. It was revealed that the European Central Bank has established a swap line with the US Federal Reserve of $240 billion to deal with system action and that the European Investment Bank has laid $40 billion of loan facilities for small and intermediate businesses. The Europeans announced that five proposals for revamping the regulatory system will be presented to the College of Regulators in short time. They also petitioned the E.U. to wave the Treaties restrictions on budget deficit limits. [30]

Meanwhile, the US Treasury rescue plan, whose first draft was rejected by the House, was approved by the Senate in a second draft which attached to it both tax reduction provisions and an increase in limits of deposit insurance by the FDIC to $ 250 000. In essence, the US government rescue aims initially at breaking the fear factor by assuring depositors and financial investors. Next, reestablishing confidence in the banking system by removing from balance sheets the Troubled Assets, as defined by the Treasury, so that banks and other financial institutions can utilize the funds received to resume their lending, especially, inter-bank lending. The rescue is embodied in the Emergency Economic Stabilization Act of 2008 (hereinafter EESA), which must enter into application the day after it became law on 2 October, 2008. The EESA faces and will try to answer a host of technical, economic and political issues.

An Over Riding Issue:

The first and foremost issue is whether the Rescue Plan is needed and justifiable at all. Many conservatives do not condone shielding firms from market discipline. During the week of negotiating the EESA, no alternative plans came up; there were suggestions to allow private insurances to do the job. However, such suggestions are not viable at this juncture and their time-line would be disastrous. Populists do not approve shackling tax payers with the cost of the mistakes of highly paid financial executives, and do not, despite all evidence, connect the crisis on Wall Street with the functioning of the real economy and the safety of public savings and pensions. Whatever are the merits of these positions, the economic facts require action to stave off many potential disasters to the US and the world economies. The Economist, basing itself on IMF estimates, put the

total outlays of the rescue plans at 7% of the GDP of the countries involved, whereas the damage to the economies would amount to 16%.[31] Obviously, modern economies cannot operate with locked up financial markets. The cost of not acting is therefore greater than acting. Moreover, the rescue plans seem to be structured in a way -see bellow- that might recuperate tax-payers' money.

The Technical Issues:

The EESA creates a troubled asset relief program (TARP), under the supervision of the Secretary of the Treasury (Secretary) to establish vehicles to purchase, hold and sell troubled assets. The law provides for two approaches to deal with troubled assets: purchasing them from the institutions holding them (section 101) and/or extending guarantees to cover such assets (section 102).[32] This is surely a preferable market solution, but it takes time to work out and is less direct than the EESA. It can be argued that two more avenues are authorized under the EESA and are, in our opinion, more effective. The first is to extend loans or guarantees on loans to recapitalize the banks with attached conditions regarding: bank restructuring, loan recapitalization and provisions on foreclosures. The second avenue is to buy the stocks of the institutions in trouble, i.e. inject capital directly. This is more powerful than purchasing troubled assets in that it implies under the prevailing capital adequacy norms a 1 to 11 leveraging, that is, for every dollar capital a possible $ 11 credit. Injecting capital is the essence of the UK approach and is more direct than just buying troubled assets. This idea, according to press reports, was discussed but rejected in Washington. After meeting the Finance Ministers of the G.7 in Washington on October 10, Secretary Paulson indicated that he is studying such an idea. As a historical precedent, Sweden nationalized its banks in 1991 and got out of its crisis in record time.

If the Treasury acquires stocks, they should be non-voting stocks and there should be clear sunset rules to avoid government going into the banking business. To safeguard the tax- payers' money, warrants on non voting bank preferred stocks can be issued or equity for debt swaps can be made a part of the plan.

Regarding the pricing of troubled assets, it should be borne in mind that the financial institutions involved have not collapsed. Therefore, their assets are worth something between their book values and fire-sale values. Unlike the RTC experience of the depression years, the assets involved have values unknown by the markets. Therefore, one of the first tasks of EESA is to authorize the Secretary of the Treasury to find a mechanism for defining and acquiring troubled assets and establishing a market price for them. This cannot be done without differentiating their risks and categorizing them accordingly. If the Treasury were to price the troubled assets too high, there would be undue gain for the banks and other institutions. If on the other hand, the price were too low, that would discourage healthy but affected banks form participation in TARP and harm its successful conclusion. It would in addition encourage private bidders to purchase such assets at low prices thereby accrue private benefits from the Treasury rescue. Most likely, the price would be determined by setting up a reverse- biding

auction, i.e. one buyer and many sellers. Assets of the same risk would then undergo a market price discovery through these auctions. To be realistic in setting prices, the Treasury should calculate a reference benchmark via the method of marking to the market. That means capitalizing at acquisition the value of the future cash flows of a security. Care must be taken however, to estimate the probabilities of scenarios of mortgage payment in the context of scenarios of the macroeconomic conditions and the conditions of the institutions; otherwise, it would be Enron type of marking to market all over again. The Secretary is to report in 45 days of the entry into effect of EESA, to the Congress on the mechanisms and valuation methods adopted.[33]

Another problem is to effect the acquisition in a way that stops unnecessary foreclosures. If the price was high, the underlying problem for the house owners will not be resolved. If the price was low, both the institutions involved will suffer and the non defaulting borrowers will bear a moral hazard penalty. The EESA provided for a variety of relief measures based on capitalizing mortgages at the present value of a loan to the tax-payers. The provisions amount to refinancing and restructuring the troubled loans of those who are willing to continue holding them. Presumably, to avoid adventurous demands, the Secretary was given leeway to have such requests examined by officials he appoints. There are in this respect forbearance provisions to keep people in their houses while the process is engaged.

Another technical hurdle is to choose assets to be unloaded. The troubled mortgage assets were estimated by Secretary Paulson at only 5% of total mortgage assets.[34] Providing level playing field for all banks implies that all institutions should be included. With two months already into the crisis, banks and other financial institutions are now in a position to present the Secretary with the assets they consider troubled. It goes without saying that the Secretary would appoint experts independent of Wall Street and the involved banks, to help him delimit his choice.

The available empirical knowledge regarding the size of the assets still outstanding on the books- without capital write-offs- is estimated at $760 billion for US institutions.[35] Perhaps this explains why the EESA came at $700 billion: an initial authorization to the Secretary of $ 250 billion with $100 billion extra placed under the authority of the President and the remaining $350 billion subject to congressional approval. At the insistence of conservative legislatures, the EESA provided in section 102 for guarantees of insurance for institutions preferring to shore up themselves in this way. In the short run, this paper holds that this alternative is not practical and would only be viable in a limited number of cases. But if the EESA succeeds and seems to be properly functioning, this extra avenue would be very helpful in providing, in the intermediate run, a market solution to a part of the problem, thereby sparing to that extent, the tax payers.

The Economic Issues:

It is remarkable indeed that the US Treasury was caught in the crisis without preparation, without policy forethought and with no inkling about the state of the economy and its

finances. Secretary Paulson first proposal was a sorry three page paper which proposed granting him absolute and unfettered power to spend $ 700 billion buying his former colleagues' assets. The rescue package that emerged is by no means a great plan. However, it is detailed, flexible, supervised and politically attuned. And it was the only plan on the table.

The first economic issue is the scope of the monetary intervention and that of the fiscal one. Monetary intervention directly affects inflation and interest rates and thus the dollar exchange rate, and in the process, the balance of payments. It is likely that in the short term, the dollar might be boosted if the action plan is successful. However, in the long term, there would be little doubt that it will weaken. The inflationary consequences will first appear in commodity prices, including food-staffs and gold, and perhaps oil. The fiscal action affects the US budget deficit and therefore, the gap between US national investments and savings as well as the size of the US public debt. This, in turn, affects adversely the long run dollar exchange rate and the Balance of Payments. Expanding the size of the public debt to $11.2 trillion augers future tax increases and shifting the burden to future generations. There is in addition, a very important problem of economic efficiency: if the market was not allowed to penalize the derelict institutions, how can one be sure that their behavior will change and their inefficiencies removed? The best way is for the Secretary to demand of participants restructuring as a quid pro quo for help when he deems that warranted. At any rate, even under the best conditions, the financial system will not fully recover for some time. One is in effect looking in the immediate aftermath of the rescue for only unlocking the system and resuming lending.

If within a few days of the entering into effect of the EESA, the financial system does not resume inter- bank and other lending, the authorities every where must be prepared to intervene in a more direct and forceful way. For example, they may consider extending guarantees on all inter-bank lending, or even create, for a short period, a clearing house run by the Central Bank for inter- bank lending. They may also announce that as an exception to the discount policy, they would grant access to the Central Bank windows for discounting loans to bank customers. Still another avenue is to allow Central Banks to make, under certain conditions, direct loans to businesses and/or extend short term guarantees for such loans. Another avenue is to authorize the Central Bank to purchase business debt papers, such as Commercial Papers and other high grade money market instruments whose market has dried up. This step is already decided by the US Federal Reserve, which additionally doubled the size of its discount window funds.

To enhance confidence, many countries including the US, have increased substantially their bank deposit insurance coverage. To avoid beggar thy neighbor practices, this measure should be coordinated internationally. In sum, four types of direct policy actions on the financial –monetary front are called for: a direct removal of troubled assets, a direct injection of liquidity and guarantees, a direct capitalization through guarantees or purchasing stocks and a direct treatment of the mortgage- housing problem. In this context, the rescue plan might not, in the short run, have impact on this market. Hence, the Treasury might consider while holding the troubled assets to proceed to recapitalize, restructure and modify every mortgage loan in which the capital value exceeds the resale

value of the property, provided that the loans are not taken up at their book values.[36] For other troubled assets, the provisions of EESA described above, should suffice. After the market stabilizes, these mortgages can be sold gradually in the market to financial buyers.

Beyond these immediate finance problems, there is the underlying macroeconomic recessionary condition of the US and other economies. The circularity between economic performance and the health of the financial system would call, in our judgment, for a global stimulatory action. In the October meeting of the IMF, it was agreed to take such actions and, further, the IMF was instructed to extend financial help to countries affected by the rise in food and other commodity prices. As regards the US economy, it is commonly agreed that a stimulatory package is in order. With the exception of the export sector, the investment and consumer sectors are experiencing significant expenditure shrinkage. The available data show investment spending shrinking since July after a modest increase in the second quarter. Data on economic indicators show that consumer spending, accounting for two thirds of total spending and long the stable main stay of the US economy declined 3.15 % from May to August.[37] In the production sectors, with the exception of the export sector, energy and some services, all other sectors are experiencing relative decline. Leading the list is the construction sector: house prices have declined by 16.3% in September 2008 over a year before, and housing starts declined by 6.2% in August on top of 12.4% in July.[38] The orders for products of the manufacturing industries experienced the lowest levels in six years going down by 5.5 % in July and August. The car industry expects declines in sales ranging from 15 % to 30% over the previous year sales. The Industrial Production Index declined 111.51 in June to 110.3 in August.[39] Many consumer related service industries such as insurance and, of course, the financial service industry are in decline. The data show also that unemployment hit 6.1 percent, a six year high on Tuesday 23 September. In nine months so far this year, 750,000 workers have lost their jobs. Thus, by any yard-stick, the US economy, after a good performance in the second quarter, is heading into recession in the third quarter. With the combined effects of the crisis and an expected deceleration in exports, the decline should accelerate in the fourth quarter. Therefore, the case for a stimulus has become persuasive. According to our calculations, the size of the necessary fiscal stimulus is at least $ 200 billion. Coming on top of all other fiscal commitments, it would be essential to have an iron clad commitment to restore fiscal balance within a sensible period. The package should have direct spending elements in view of their short propagation lag and their superior multiplier effect. The first that comes to mind is the infrastructure projects planned already either by the Federal Government or by state and local governments. Another element is to lengthen the period of drawing benefits by laid off workers and tax breaks to small businesses hiring workers. However, even with that, the data since 1972 indicate that the average length of global recessions has been 12 months as compared with 6 months when confined to the US. This would imply that even with a fiscal stimulus, the recovery of the US economy would take place some two to three quarters after EESA enters into effect.

Monetary stimulus, in view of the above proposals about more aggressive action, and the outlays already committed, is underway. The Federal Reserve and other Central Banks

should reconsider their anti inflationary stances as commodity prices have declined over the last two months. Central Banks should act in a coordinated way, and kick off that with a coordinated rate cut. A part of the economic decisions must be designing and installing a new system of regulations for banks and other financial institutions such as insurance companies and non depository institutions, which are currently outside the purview of the Federal Reserve. In the global setting, this has to be done with international cooperation.

The international work discussed in section IV. should furnish good basis in this respect. However, The BIS work should be recast into an exercise of re- examining the architecture of the International Monetary system.[40]

The Political Issues:

The political problems are also manifold. First of all there is a cross economic one concerning the security of tax payers' money. The US government and tax payers are potentially out of $ 650 billion for the rescue operations in place. The EESA will add immediately $ 250 billion followed if needed by another $ 100 billion. Consequently, the Congress put into the EESA provisions requiring the involved institutions to issue in favor of the Treasury both warrants for none voting preferred stocks in the firms, and promises to pay the difference (if positive) between the realized value of the asset and the Treasury purchase price. Such stocks would be offered without dilution of capital. If most institutions recover, it is possible that the US tax-payers might get their money back and hopefully garner a profit.

The control and oversight authority over the disbursement and the disposition of the assets is a major political issue; will that be vested solely in the Treasury Secretary or another entity. The initial proposal of the Treasury gave the Secretary an absolute and final power subject to no review by any body and granted him immunity vis-à-vis any challenges before the courts. The EESA of 2008 changed that and created a Stability Oversight Board (SOB) composed of five members including the Secretary, the Chairman of the Fed., the Housing Secretary, the Chairman of SEC and the Director of the FHFA, under an elected Chairman who turned out to be the Chairman of the Fed. The Secretary reports periodically to the SOB, which in turn reports to the US Congress.[41]

There is as well a problem of national resource allocation in all of this: is the rescue of the derelict institutions a better choice than spending the tax-payers' money elsewhere, for example, on the decaying US physical infrastructure, on investment in health care, in education and research and in developing a new ecological technology reducing the demand for carbon fossils fuels? Many would argue that the alternative is a better investment. Another political problem is the potential benefits accruing from the rescue to bank stock- holders and bank executives at the public expense. Many voices are heard asking for limits on salaries and bonuses for departing executives in the rescued institutions and a maximum on salary increases. According to representative Brad Sherman of California, the President initially wanted to place a limit of one million a

year; an astonishing figure.[42] The EESA places two limits: for the institutions taken over a limit of $ 400,000, and for those on their own there would be no tax deduction on the salaries and golden parachutes. In the same vein, the European rescues, for example in France and in the UK, provide strict limits on compensation together with penalties on the management of institutions seeking help.

The case for fiscal and monetary stimuli is also convincing in the large European Union countries. But, if all that is not done with international coordination, the world would head towards global inflation and unacceptable pattern of external deficits.

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[1] For a detailed discussion of the US housing market see Luci Elise, The Housing Meltdown: Why Did It Happen In The US, BIS Working Papers no 259, September, 2008. [2] The statistics are forming Wikipedia, US Housing Bubble. [3] The fallacy of composition refers to the observation that real bills guaranteeing bank loans have little market if all banks proceed to liquidate them at the same time. See any standard money and banking text on the real bill theory and the fallacy of composition, for example, F.S. Mishkin, The Economics of Money, Banking and Financial Markets, McGraw-Hill, international edition, eighth edition, Ch.16, p.420. 2008. [4] IMF, Global Financial Stability Report Washington DC, April, 2008...See also the story in the International Herald Tribune, April 8, 2008 on the estimate of 1.2 billion made by Goldman Sachs. [5].The Economist, October 11.2008," When Fortune Frowned, A Special Report on the World Economy", p.4. [6] In 2002, the HOUSE Democrats brought to the attention of Allan Greenspan, the Fed Chairman, the dangers of the behavior of the unregulated mortgage lenders and asked for putting up regulations. According to Congressman Barney Frank, the Chairman refused the idea of regulating markets; interview on CNN, 20 September, 2008.. [7] Wikipedia, Op. Cit. [8] Idem for data on stock market developments of the respective days. [9] The most widely observed stock index, the Dow Jones Industrial of New York, recouped close to 800 points and the CAC- Quarante of Paris soared 9.6 % of its value, whilst the London FT-100 gained 5.6 % on Friday. In Frankfurt, the DAX gained 3.9 %. The Asian markets were more impressive: the Hang-Sang recorded 9.6% gain and the Nikkei 3.8 %. See; www.Reuters/finance/economic, Friday, September 19, 2008. [10] Forty four billion of this amount will go to support the capital of eight endangered banks and the rest for other possible use if and when necessary. [11] The International Herald Tribune, October 6, 2008. [12] UNCTAD, World Investment Report, Geneva, 2007, and .1997. [13] See UNCTAD, Globalization and liberalization, Geneva, 1996, Chapter I; UNCTAD, "Global financial integration and related domestic liberalization policies", in Globalization and Liberalization: Effects of International Economic Relations on Poverty, New York and Geneva, 1996. Michael Sakbani, a Re-examination of the Architecture of the International Economic System in a Global Setting: Issues and Proposals, UNCTAD, Discussion Paper, no. 181, PP.5-7. [14]

The Glass-Steigle act established fire walls between commercial banks and other financial institutions in order to remove conflict of interest and financial pyramiding, which was rampant in the prior decade. [15] See the analysis of the act known as the Gramm-Leach-Bliley Modernization Act of 1999, in Mishkin, Op.Cit. Ch.10, pp. 268- [16] For an entertaining narration of this innovation and the personae involved, see, Michael Lewis, Liar's Poker, Penguin, New York, 1990. [17] BCBS, The New Capital Accords, GIS, April, 2004; Andrew Cornford; "Basel II; Vintage 2003", Journal of Financial Regulations and Compliance, (12 /1), February 2004. [18] Idem, The Basel Committee's Proposal For Revised Capital Standards, G24 Discussion Paper Series, no. 3. [19] Andrew Cornford, Basel II, The Revised Framework of June 2004; manuscript, 2005. [20] Idem, Basel II at a Time of Financial Peril, TWN Global Economy Series, March 2008. [21] Ibid. [22] BCBS, International Convergence of Capital Measurement& Capital Standards; A Revised Framework Comprehensive Version, BUS, Basel, 2006. [23] The last systematic exercise in IMS` reform was the work of the C.20 in 1972-1974. The report of the C 20 was approved by all IMF members except the US and Germany. Two more partial attempts were effected in 1981 and 1993 to no results. For a review of the C 20 and IMS reform in general, see Michael Sakbani, " International Monetary Reform: Issues and Proposals", UNCTAD, Trade and Development; No.6, 1985, pp.172-194. See also John Williamson, Failure of International Monetary Reform, Nelson, 1979. [24] Joseph Stiglitz, the Nobel laureate, is a leading critic of the Washington Consensus. The WC represents the collective views of many economists, gathered around the Bretton Woods institutions as to what should be the correct model of economic policies. Briefly, it consists of following liberal market policies opened on the world along with full liberalization of the financial sector and full acceptance of globalization. Stiglitz and others like him do not agree that the liberal model followed by the IMF and the World Bank, is applicable in every case, and in the same way. On this view, it is argued that country specific circumstances and the complexity of the development process would call for nuanced and multi dimensional paradigms suited to the particularities of various countries. In particular they disagree with the Consensus regarding the role of government and the unadulterated application of the liberal model. See J. Stiglitz, Globalization and its Discontents, Norton and Company, N.Y, 2002. Doni Rodrik, of Harvard University, expresses amazement as to how the IMF can still maintain a one –fit-all model, now that we begin to understand how and why things work in some countries but not in others. See Doni Rodrik, "Governing the Global Economy: Does one Architectural Style Fit All?" In The Brookings Institution Trade Policy Forum, Conference on Governing the Global Economy**,** Harvard University, April, 1999. [25] Ethan Kaplan and Doni Rodrik, Did the Malaysian Capital Controls Work?, Harvard University, J. F. school of Government, February 2001. [26] See Michael Sakbani, "The International Economic System under Globalization: System Problems and Reform Proposals in the Monetary System", International Development Economic Studies (IDEAS), January 2006, part ii, governance of international flows. [27] George Soros," Avoiding a Breakdown", Financial Times, London, 31 December, 1997. Also, I*dem*, The Crisis of Global Capitalism**,** the Public Affairs Press, N.Y. 1998 [28]See Stanley Fischer, "On the need for an international lender of last resort ", The Journal of Economic Perspective, 13(4), pp.85-104. [29] See Michael Sakbani, Op. Cit., Reform Proposals, part II, pp.10-23. [30]For the full text, see: http://www.politsite.com/act.pdf, [31] The

Economist, Op. Cit., p.4. [32]Ibid. pp.6 -8. [33] Ibid, section 102, p.10. [34] This is the estimate made by the US Secretary of the Treasury in the Senate hearing on Tuesday 23 of September 2008. [35] The Economist, Op.Cit., p.4. [36] This idea was raised by Senator Hillary Clinton in her primary campaign. At the time, the cost to the Government of this proposal was seen prohibitive. However, now that EESA provides $ 700 billion, the price is no longer untenable. [37] Data from US Economic Statistics Administration, Economic Indicators, 2 October, 2008. [38] US Census Bureau; data announced on September 30, 2008. [39] Board of Governors statistics as released by the Reserve Bank of St. Louis, Economic Indicators. September, 2008. [40] For a review of the issues in international monetary reform see Michael Sakbani, (IDEA and UNCTAD, 2006); Y.Akyuz, ed., Reforming the Global Financial Architecture, UNCTAD, Geneva, 2001.; J.Eatwell and Lance Taylor, Global Finance at Risk: the Case for International Regulation, the New Press, N.Y.,2000. [41] The ESAA of 2008, http://www.politsite.com/act.pdf , section105, pp.20-23. [42] Interview with Lou Dobbs, CNN, Friday, 26 September, 2008.

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