Sub-Optimality of Lending Taxpayer Money to Hedge Funds

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Abstract

This paper deals with an urgent and potentially catastrophic hot-button issue, which currently bedevils central banks and governments globally. The evolving financial market meltdown and a potentially looming global depression are very worrisome to policymakers. Sporadic riots have surfaced due to rising food prices. This paper pins down the underpinnings of such meltdown and depression. It presents and argues for a specific optimal policy to avert an escalation of the current dire situation: stop lending of taxpayer funds to hedge funds.

Taxpayer funds refer to the reserves held by a central bank or federally insured deposits made in the commercial banks. This letter argues that the government's decision to lend such taxpayer funds to hedge funds is financially suicidal for the vast majority of investors-taxpayers. This argument is very pertinent to the current hot debate about how, if at all, to regulate hedge funds.

Introduction

The trading activity of an investment bank is as highly leveraged as most hedge funds. Hedge funds usually borrow taxpayer funds to trade in financial securities, commodities and other assets. Hedge fund trading may be construed as a market mechanism to beget fair prices of assets efficiently. But when a stock index like NASDAQ doubles in a year to 5000 and then falls 75% in another year, one cannot support a hypothesis that the market is able to determine the fair price as, for example, the discounted expected value of future dividends.

Rationally, the market appears to be a game in which hedge funds play with individuals and fund managers.

Commercial banking activity is also highly leveraged. But it provides an immense service to society by taking short-term deposits and debts to lend on long-term to homeowners for living and to corporations for job creation. The theory of financial intermediation justifies correctly the role and existence of commercial banks. The commercial banking activity of investment banks is likewise a noble service to society.

This paper is not about the commercial banking activity. It focuses on the hedge fund activity of investment banks and universal banks and other individuals and institutions. After the repeal of the Glass-Stegall Act, commercial banks have formed firewalled subsidiaries to trade like hedge funds. Such firewalled subsidiaries are created legally on paper as bankruptcy remote entities, which are like limited liability companies, but are reported as off balance sheet items to avoid scrutiny of the Security and Exchange Corporation.

If a hedge fund trades with its own or privately borrowed funds, it should be its business like any other business activity. This paper is not about private funding or borrowing of hedge funds. It is about the government allowing hedge funds to borrow taxpayer funds, either directly from the central bank or indirectly from federally insured deposits of commercial banks. This paper argues that lending taxpayer funds to hedge funds is tantamount to financial suicide by taxpayers.

Sub-optimality of Lending Taxpayer Funds to Hedge Funds

Just visualize that a bunch of hedge funds borrow taxpayer funds to trade securities held by taxpayers. The gain to hedge funds from such trading is a loss to taxpayers. After trading for such gains, some hedge funds may no longer generate further gains. A few hedge funds may thus collapse. A hedge fund's collapse shows that the fund could no longer wangle wealth of the vast majority of other taxpayers-investors. The vast majority of taxpayers-investors will not, optimally, bail out a collapsing hedge fund or lend more taxpayer funds to the remaining hedge funds.

Well-connected hedge funds tend to obtain huge amounts of credits at the lowest possible interest rate from the federally insured deposits held in commercial banks or reserve funds held by the central bank. Such credits are essentially taxpayer funds. The vast majority of investors-taxpayers do not have any power to set the cost of these funds. A common presumption is that the central bank will act in the best interest of the vast majority of investors-taxpayers in setting the optimal rate of interest on taxpayer funds.

This paper is not about any mistakes or criticisms of the interest rate policy of the Federal Reserve. It is about the government or central bank policy of lending taxpayer funds to hedge funds at the lowest possible interest rate, because such lending hurts the interest of the vast majority of investors-taxpayers.

Hedge funds deploy the taxpayer funds borrowed at the lowest possible cost to trade in the direction of sentiments to exaggerate either the rise or the fall in the price of certain assets. The direction of trading is accentuated by media driven panic and euphoria among the vast majority of taxpayer-investors.

Availability of cheap credit to hedge funds has been primarily responsible for price bubbles like in the Japanese and NASDAQ securities. Bubbles and bursts permit better informed and better connected hedge funds to garner taxpayer funds at the lowest possible interest rate to squeeze the wealth of retail traders, smaller hedge funds and the passively invested mutual funds and pension plants. The retail traders and smaller hedge funds have a decisive disadvantage as they cannot borrow taxpayer funds cheaply and have to pay higher rates of interest on their margin borrowings made from broker-dealers. Such lopsided cost of trading eventually forces many smaller hedge funds and retail traders to lose their capitals.

Most small and medium retail traders in the U.S. probably lost their capitals in the wake of bursting of the NASDAQ stock price bubble. The upper middleclass perhaps lost their savings in the following years. Now even larger hedge funds are losing their capitals or have stopped borrowing to trade.

At this juncture, it is natural for the remaining large hedge funds to trade on long side in the market for commodities through media propaganda and on short side financial securities held by the majority of passive investors. As a result, prices of commodities, especially of food, are rising through the roof while financial securities are falling off the cliff. This is causing panic among the vast majority of people and their governments worldwide. Riots for food are now being feared.

One can thus envision miseries for the vast majority of humanity around the world wrought by the "need" of a few hedge funds to earn higher returns on trades than the cheapest rate of interest on their enormous borrowing of taxpayer funds - insured deposits and Federal Reserve funds.

Borrowing insured deposits is possible for hedge fund owners who are connected to commercial banks, directly and indirectly. Most hedge funds are run by the executives of the commercial banks and have no problem in getting massive credits from taxpayer funds. When the Federal Reserve lowers the interest rate due to economic recession, the hedge funds have the opportunity to borrow taxpayer funds cheaply.

The repeal of Glass-Stegall Act opened the door widely for many hedge funds to operate as firewalled subsidiaries of large universal banks which combine commercial banking, security trading and investment banking. The hedge fund managers – top executives of financial firms – must have had enormous sway over the government to repeal the act, which was enacted to avoid a recurrence of the Great Depression by dissociating commercial banking from security trading and investment banking. The Glass-Stegall Act stemmed from a correct belief that the performance of commercial banking, security trading and investment banking under the same management led to the Great Depression.

The proponents for repealing the Glass-Stegall Act asserted that the Great Depression would not recur when the advanced financial and information technologies are applied in universal banks. There was no data to support such assertion, when the act was repealed or even now. The efficiency in execution of financial transactions, possible due to advanced information technology, would rather precipitate a recurrence of the Great Depression, which may now spread globally.

The main point of this paper is that taxpayers will not optimally allow their funds–held either by the Federal Reserve or by federally insured commercial banks–to be borrowed by hedge funds. The vast majority of investors-taxpayers would rather not lend their funds to the hedge funds to prevent the latter from creating enormous leverage to depress the asset holdings of the majority or to raise the price of commodities like food and oil needed for existence.

Shouldn't the representatives of the vast majority of taxpayers-investors in a democracy act in the best interest of the latter? The most respected lawmakers of the most important and responsible nation like USA should lead in repealing the practice of lending taxpayer funds to hedge funds. We hope that this letter and the following numerical example will unambiguously convince the lawmakers to formulate a policy to never lend taxpayers' funds to hedge funds.

A Numerical Example

In this example, hedge funds borrow taxpayer funds and sell securities held by the vast majority of investors-taxpayers short. The price of those securities drops as a result. The hedge funds make profits by covering their positions as panicking investors-taxpayers sell. The panic is created by excessive short positions taken by the hedge funds ahead of a slightly pessimistic outlook. The example illustrates that when the vast majority of investors-taxpayers lose 50%, the government gains 16% in taxes and interest on funds lent and the hedge funds gain 34%.

- Suppose the vast majority of investors-taxpayers buy $1 worth of securities in mutual funds using their savings.

- The hedge funds sell those securities short with massive leverage using funds borrowed from taxpayers over a period of, say, 4 months.

- Suppose that the price of those securities drops 50% to \$0.5. The vast majority of investors-taxpayers panic and sell at \$.5 for a loss of \$0.5.

- The hedge funds make \$0.5, pay 3% interest for the days they borrowed the taxpayers' funds and pay 30% tax on the gain. Hedge funds use other ruses to pay much less tax than 30%.

- The government gains .3x.5 = \$0.15 in tax.

- The interest cost to hedge funds is \$0.01.

- Then the government in behalf of taxpayers gets \$0.01 + \$0.15 = \$0.16 in interest and tax.

- The hedge funds make a net profit after taxes \$0.5 - \$0.16 = \$0.34.

- The vast majority of investors-taxpayers lose \$0.5, which is transferred to government in taxes and interest equal to \$0.16 and to the hedge funds as net profit of \$0.34.

The economy benefits little as a result of the game played by hedge funds. But the shorting game and trading on short-side eventually makes the vast majority of investors-taxpayers panic. When the vast majority continually loses its savings in pension plans and mutual funds and pile on debt for survival, the economy falls into a financial depression. During the periods of the game, the total income of the economy can still grow. Such economic growth based on incomes hides the wealth transfer from the vast majority of taxpayers to a fringe of hedge fund owners. Lending taxpayers' money to hedge funds is thus financially suicidal for the vast majority of investors-taxpayers. Another letter by the author shows that the short-selling practice is not only illegal by the Corporation Act, but also suboptimal for society.

Conclusion

In a democratically free society, individuals should have the freedom to pursue whatever trades they wish to undertake. But should the government, that represents the vast majority of people, allow a small fringe of hedge funds to frame rules and procedures to borrow taxpayer funds to depress financial prosperity of the vast majority? The answer is clearly no.

The argument that systemic risk will spread throughout the economy if a failing hedge fund is not bailed out is specious. A highly leveraged hedge fund fails when it can no longer squeeze wealth from taxpayers. Not bailing out leveraged hedge funds will thus have no further adverse impact on taxpayers. Not bailing out weak hedge funds and not lending to the rest would rather have a decisively positive impact on the wealth of the vast majority of taxpayers and prevent a recurrence of the Great Depression.

Furthermore, hedge funds do not produce globally competitive goods and services that enhance national exports and currency. They make the vast majority of taxpayers-investors lose. It is, thus, not optimal for the vast majority or a democratic government either (a) to lend taxpayer funds to hedge funds or (b) to bail out the faltering ones.

Taxes on hedge fund trading profits are used up by a bureaucracy that does not detect the best interest of taxpayers or lawmakers to fund pet projects that do not enhance national competitiveness defined by higher net exports and stronger currency. The gains to hedge funds and decision makers come with huge losses to the vast majority of a nation, pushed to financial depression. The decision makers should optimally trade off their short-term gains against the long-term adverse impact on them due to financial depression leading to riots by the majority.

The gains to the fringe are credits created as debt laden on the majority. The majority of effective producers of globally competitive goods and services basically lose their savings, remain indebted, and face the brunt of rising prices. This unstable inequity in prosperity is due to the lopsided rules and procedures (like lending taxpayer funds and short-selling) crafted by hedge fund managers and enacted by lawmakers.

Lending taxpayer funds to hedge funds is perhaps the primary reason for the imbalance in massive credits piled by a few households, held as debt on the vast majority, globally. Such imbalance has led to financial and social instability everywhere. Potential riots and mass default on the credits due to such imbalance cannot be ruled out. Such events occurred during the Great Depression. They are <u>not</u> optimal even from the point of view of the few hedge funds that pile up enormous credits, indolently, by foisting lopsided laws on the majority. Lending taxpayer funds to the hedge funds or taxpayer bailout of failing hedge funds should, therefore, be optimally discontinued.