Prosperity amid Stability

A New Economic Paradigm for Democratic Capitalism

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Abstract

I have pursued in the real world for adaptation of a new economic paradigm to choose optimal rules of governance by which individuals can maximize utilities of their net worth (prosperity), but not cause instability like global depression or warming.[1] Communism denudes social strength because it enforces equal pay with no incentive for individual perseverance. Maximum prosperity is possible under capitalism. But without optimal rules of governance capitalism, even under democracy, can financially bondage the vast majority, cause instability and ultimately erode individual prosperity. My rational inference based the steps undertaken globally, following my communication on optimal rules for *prosperity amid stability*, shows a robust ulterior support for this paradigm. I present a few major optimal rules: on exchange rate policy beyond the purchase power parity, safe banking to avoid systemic moral hazard, containing usurious credit growth, and the price of credit. I also list pertinent actions undertaken by leaders globally, consistent with the optimal rules communicated to them through memorandums.

Introduction

What is the fundamental distinction between my theory and the existing theory of governance?

1. The current economic system (rules) of governance is based on maximization of individual utility of wealth of a representative agent. That the representative agent often happens to be a lobbyist (as opposed to an ideal agent modeled by the existing theory) is not the basis of originality in my paper.

2. My theory of optimal governance is based on the growth or decay in net assets (prosperity) of the vast majority of households who (not some representative agent) control the power in a democracy. My theory is vitally necessary for stable democratic capitalism. This is a fundamental truth that has been now uncovered and that cannot be gainsaid.

3. My theory of optimal governance serves the best interests of the vast majority. This is fundamentally distinct from the existing theory of governance that serves the best interests of some representative agent.

4. If my theory were not original, the governments of at least the Western countries would be already measuring net assets (prosperity) of every individual household to determine any deterioration in net assets of the vast majority of households. Such deterioration is the basis of household financial depression that leads to a wide-spread depression. No country currently collects data on net assets of every individual household, let alone the governance of the country (through preemptive economic policies) by balancing (economically trading off) between (i) enhancement of individual prosperity and (ii) social instability due to deterioration in net assets of a vast majority of households.

5. Why would a country not monitor the onset of a wide-spread household depression, if my theory were already available before I circulated it in 2003? Well, after circulation of my theory and after presentation at the Hong Kong Monetary Authority in 2003, the Chinese government has taken certain steps towards stability by revaluing its currency by 22% from 8.3 yuan per dollar to 6.84 yuan per dollar. Prime Minister

[1]Such balancing or tradeoff is the hallmark of economic models that determine optimal choices.

Gordon Brown has echoed in October 2008 to establish an early warning system to avert financial depression. The governments of China or UK have not yet stated if they would measure net assets of every individual household in their countries to establish an early warning system. But the US Federal Reserve Chairman has recently admitted the necessity of incorporating stability in decision making.

6. The reader is invited to enlighten about any previous theory on prosperity amid stability for governance of nations based on growth and decay in net assets of every individual household in a country.

Like any other fundamental theory (e.g., utility theory), my theory of "*prosperity amid stability for democratic capitalism*" is not a policy or a policy position. But like other fundamental theories, my theory can be used as a basis of analysis to develop, for example, an optimal exchange rate policy. My theory is thus a novel theory of governance that is fundamentally different from existing theories and is important for governance of humanity. Some specific optimal policies based on this theory are presented below.

1. Optimal Exchange Rate Policy beyond Purchase Power Parity

The new paradigm of *prosperity amid stability* can be adopted to determine the optimal exchange rate of an economy like that of China, beyond the standard purchase power parity (PPP). The PPP tells that the relative prices of a standard basket of goods and services in two countries determine the exchange rate between their currencies.

The new paradigm is necessary for a country like China to determine, beyond PPP, the optimal value of its currency Yuan in terms of dollar, euro or yen by trading off the benefit of employment growth, possible by depressing Yuan, with banking and social instability associated with a very low value of Yuan.

A low enough currency value attracts global business enterprises to create new jobs in a country. But by keeping the currency value too low, the country creates excessive money for its exporters and expatriates. Excess money in the system induces banks to relax standards for lending to frivolous projects yielding little returns. Growth in frivolous lending is likely to increase the quantum of nonperforming loans which may lead to instability in the banking system. The excess money, created due to lower currency values, for a small segment of national population will likely result in wealth disparity leading to social instability. The optimal exchange value of a currency should thus be determined by balancing growth in jobs (prosperity) with rising social and banking instability.

To know if the Yuan value is too low or too high, the Chinese government has to provide the data on nonperforming loans of banks and survey satisfaction of its citizens to gauze if banks and the society are turning unstable.

Consistent actions undertaken: I presented the new paradigm with the idea of an optimal rule for exchange rate on August 14, 2003 at the Hong Kong Monetary Authority. I was also slated to present it at the People's Bank of China but could not visit Beijing due to SARS. After presenting the theory, I stated that only the Chinese authorities could know based on their confidentially held bank data if the amount of nonperforming loans was growing explosively and that only a Chinese survey could establish any growing disgruntlement due to wealth disparity.

The events in the wake of my HKMA presentation suggested that the Chinese authorities monitored both the nonperforming bank assets and wealth disparity. Within a few weeks of my presentation, the Chiefs of Hong Kong Monetary Authority and People's Bank of China met to grant more power to a newly established bank regulatory authority to monitor nonperforming bank loans, as per press reports. Then in a few months China infused about $70 billion to recapitalize its major banks before making them public.

It seems that China's unpublished but potentially explosive growth in nonperforming bank loans alarmed the Chinese authorities in order to take preemptive actions of recapitalizing their banking industry. President Hu of China has been expressing serious desires about narrowing of the wealth gap to avert social tensions, after my presentation in HKMA. The July 2005 decision to link Yuan to a basket of currencies instead of just to the dollar appears to be a step towards fulfillment of his desires to contain wealth disparity.

Here is another signal of China's acceptance of the paradigm of *prosperity amid stability*. The Chinese government once dispatched a top official - who was visiting the U.S. on the Department of State leadership program - to meet with me on October 26, 2006 in my Chicago office for a discussion on optimal rules of governance of financial markets. The Chinese government authorities had followed on my earlier advice on optimal bank regulation and exchange rate. I gave a copy of my book, *Prosperity*, to the Chinese official. This book mentions how China can become a superpower by adopting *democratic capitalism*. Then, wow, the Chinese President and ministers broached the idea of grass-roots democracy in China as per press reports of December 3, 2006.[2] This shows that China too is interested in *democratic capitalism.* China now follows a single party rule with leaders elected within the party based on the ability to resolve social problems and national agenda. Internal party elections have produced all engineers among the top ten leaders, the current and immediate past presidents of China. Engineers at the helm have perhaps made China the top manufacturing hub of the world. Engineers have not climbed to lead other countries, to the best of my knowledge.

2. Safe Banking to Avoid Moral Hazard

Competition breeds efficiency in production of goods and service. But completion in the banking industry may induce banks to pay higher interest rates to attract deposits to take greater risk with a hope to generate higher returns for stockholders. Such competition can enhance prosperity of stockholders. But some banks operating in such a competitive environment can fail. The failure of a bank can erode the trust of investors in the entire banking system. Erosion of trust in banking leads to social instability due to panics, runs and potential depression. The society thus needs optimal rules to govern banking to enhance *prosperity amid stability*.

The government started insuring bank deposits after the Great Depression to restore stability and to contain systemic risk due to banking panics and runs. But the government guarantee of deposits created two new problems due to moral hazard: (i) excessive risk taking by banks with insured deposits and (ii) excessive regulation to monitor insured banks.

Moral hazard in the banking industry imposes nontrivial costs on taxpayers. Excessive risk taking by government insured banks involves bailing out the failed ones. This may impose potentially higher costs *ex post* than the deposit insurance premiums the government may collect *ex ante* from banks. The banks pass on their deposit insurance costs to taxpayers by charging higher interests on loans or by paying lower interest rates on deposits than feasible otherwise. Taxpayers also bear the burden, directly, of regulatory agencies and, indirectly, as banks pass on the audit costs to customers.

The cost to taxpayers can be very large if the problem of moral hazard becomes systemic with several banks failing simultaneously, despite government insurance of deposits. The current global banking crisis is due to a systemic failure stemming from moral hazard. An optimal rule for governance of banks should thus be based on a tradeoff between individual prosperity due to competition among banks and instability due to systemic failure in banking.

An optimal bank governance rule based on the model of *prosperity amid stability* is to discontinue government insurance of deposits from all banks and to charter differently *safe banks* and *universal banks*. The *universal banks* can invest in risky assets and not face government regulation or intervention. The *safe banks* can invest only in riskless government securities and maintain a minimum required capital as a percent of assets that is monitored by the central bank. The *universal banks* are the same as the current financial institutions like JP Morgan and Chase, Bank of America and Citigroup that offer under a single roof commercial banking, investment banking, insurance, and brokerage services. To achieve prosperity *amid stability*, universal banks will neither be insured nor regulated. They can continue to invest in any risky or riskless assets they choose to serve the best interests of their stakeholders and their own reputation and stability.[3]

Under the optimal safe banking rule, the government will no longer insure deposits in any bank, safe or universal. The newly chartered *safe banks* will attract panic-prone depositors. If all panic-prone depositors become customers at *safe banks*, the possibility of systemic banking panics and runs will be contained. The *universal banks* will

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[2] Acharya (2007): "Grass-roots Democracy in China," available on the internet at http://www.pro-prosperity.com/China/Grassroots%20Democracy%20In%20China.html
[3] Acharya, S. (2008): "Safe Banking to Avoid Moral Hazard," *Journal of Risk Management in Financial Institutions,* available on the internet at http://www.pro-prosperity.com/Research/moralhazard-safebanking.pdf.

continue to serve all types of investors including the big risk-takers. The amount of capital in relation to size and risk of assets will determine the success and stability of a *universal bank* by attracting and retaining investors. Banking entrepreneurs with low capital can no longer start a bank to take advantage of any government-sponsored moral hazard risk taking based on insured deposits, once such insurance is eliminated. The entrepreneurs have to perform well and maintain sufficiently high capital to operate as going concerns, lest private investors will not deposit or invest their savings or lend debt funds. Once the safe banking policy is adopted, regulators will need to monitor only the *safe banks* to ensure that these banks invest in the safest government securities and have adequate capital.

Investors depositing in *safe banks* will thus have a total guarantee of their deposits, not through insurance, but because of these banks' investment in only the safest assets. The government will require the *safe banks* to maintain a minimum positive threshold capital to prevent unscrupulous managements from paying themselves excessive pays and perquisites to erode the safe investments below the amount of deposits. The *safe banks* will thus be quasi-government financial institutions chartered to contain banking panics which erupt when deposits of panic-prone households are not protected by safest investments of their deposits.

The proposed safe banking policy, with all deposits in *safe banks* fully protected, will be at least as good as the current system of partial government deposit guarantee. More importantly, a safe banking policy will obviate the enormous systemic moral hazard risk and cost of government monitoring and regulating of all banks.

The Federal Deposit Insurance Corporation currently offers the federal deposit guarantee up to a maximum of $250,000 at all banks. This would no longer be necessary if the safe banking policy is implemented. The current system of partial deposit insurance in all FDIC-insured banks has proven to be enormously costly to taxpayers. Despite deposit insurance, the U.S. taxpayers lost an estimated $300 billion to rescue the failed Savings and Loans institutions in the early 1990's. This was systemic moral hazard cost due to the policy of deposit guarantee. The current banking crisis can cost the U.S. taxpayers at least one trillion dollars because the deposit guarantee has created systemic moral hazard. The massive sums infused to rescue the economy will only make the dollar cheaper and Americans poorer. The policy of government deposit guarantee has brought neither prosperity for the vast majority, nor stability for the country. This guarantee is antithesis of the new paradigm of *prosperity amid stability*.

A study by the FDIC shows that government monitoring of insured banks carry little new information. The U.S. Congress had therefore mandated within the FDIC Improvement Act of 1991 to have public rating agencies rate bank assets and to set bank capital and deposit insurance norms based on such ratings. But public ratings agencies have been criticized continually for goofing up in their ratings because they are paid by the bond issuers. If banks pay for ratings of their assets to public rating agencies and regulatory standards are based on such ratings, then taxpayers may bear more burdens in future than they have faced in the past. The public ratings based bank regulation, with the government deposit guarantee remaining intact, is also antithesis of the paradigm of *prosperity amid stability*.

The safe banking policy proposed here thus seems to be the best optimal rule of bank governance available to taxpayers to achieve *prosperity amid stability*.

Consistent actions undertaken: I first submitted my safe banking policy proposal to the U.S. Congress in March 2003.[4] Following the receipt of my 2003 memo on the necessity of safe banking, the U.S. Congress had indeed sought testimonies from the Federal Reserve Board and a system-wide conference on safety and soundness of the banking system. But the regulators and economists around the world then tacitly concluded that the banks were safe and sound, notwithstanding my vivid illustrations to the contrary.

It is widely accepted now that the principal cause of the current banking failure is multi-leveraging through off-balance sheet firewalled subsidiaries created by bank holding companies to take unsustainably risky bets without sufficient equity capitals on a consolidated basis. I have observed first-hand since 1994, when I was still serving at

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[4]Acharya, S. (2003): "Warning to US Congress in 2003 On Current Home Mortgage Debt Debacle," available at http://www.pro-prosperity.com/Global%20Economy%20Chatterbox/Warning-USCongress-In-2003-On-Home-Mortgage-Debacle.html

the Federal Reserve Board, how the bank holding companies have rampantly multi-leveraged to violate the minimum bank capital rules, sometimes with as little as one-tenth of the required capital on a consolidated basis.[5] This is crux of the problem I have pointed out in my memos to the members of the U.S. Congress to urge them to consider the safe banking proposal.

The U.S. lawmakers obviously did not adopt my safe banking policy proposal, when it was submitted. But the current financial market meltdown has virtually forced them to create some form of *safe banks*, willy-nilly. The U.S. government was forced recently to insure the previously uninsured money market funds that faced severe runs in the wake of the failure of Lehman Brothers. These government-insured money market funds have now become my *safe banks*.

The U.S. government during the current financial market meltdown has also infused new capital equal to $125 billion in nine national banks, guaranteed inter-bank lending among them and insured all debt and deposits in the entire banking system. Such deposit and debt guarantees are extreme safety measures taken to restore the rapidly eroding trust in the banking and monetary system.

The U.S. has thus veered towards the extreme end of my proposed safe banking policy - by insuring every bank liability but equity. But this extreme measure will still perpetuate the current government-sponsored moral hazard, causing enormous future losses to taxpayers and thus undermine prosperity. This is inconsistent with the new paradigm of *prosperity amid stability*.

The only way to achieve *prosperity amid stability* is by fully implementing my safe banking policy, which would now mean mandating (i) an elimination of government-sponsored moral hazard by discontinuance of the federal guarantee of all banks and money market funds, and (ii) formal establishment of money market funds or other banks as *safe banks*.

3. Usurious Credit Growth as a Determinant of Interest Rate

An economy sets the price of labor (mental and physical) by monetary units. Everything including material is ultimately delivered through labor. The price of labor is the source of creation of both debt and credit in an economy. The amount of debt always equals the total credit balance in an economy. This price of credit (rate of interest) is crucial to solve the current credit crisis optimally to achieve *prosperity amid stability*. Policies based on greed or fear will be suboptimal and only escalate the current crisis.

It is obvious that the net creditors in an economy are able to accumulate more monetary units than they need and the net debtors are unable to receive as many monetary units as they need. The surplus credit is loaned as debt at a price of credit which is set by creditors through the banking and monetary system. The debtors are prone to think that the price of credit is too high while the creditors may not lend even when the price is high. Optimal government policies are, therefore, needed to achieve *prosperity amid stability*.

3.1 Epochal nature of the current credit crisis

The tussle between the debtors and creditors is not new. The first documented tussle occurred sometime in 500 B.C. when a Hindu Lawmaker Vashistha proposed a low interest rate on credits. Monetary economics was perhaps born then. Philosophers like Aristotle and Plato have also advocated for zero rate of interest. Prophet Mohammed afterwards enunciated a new religion based on zero interest rate and on equality of all humans. The Church later adopted a philosophy of zero interest rate being good for humanity.

[5] The minimum bank capital rules were based on research on optimal bank reorganization and pricing of deposit insurance. See Acharya, S. and J. F. Dreyfus (1989): "Optimal Bank Reorganization and Pricing of Deposit Insurance," *Journal of Finance*.

The humans have perhaps become wiser over time to adopt the first ever written democratic constitution founded on the principle of "*we the people are created equal*" with nonpareil monetary rules for the price of credit based on the principles of demand and supply of modern economics in the U.S. As someone who pledges allegiance to democratic constitutional rules of governance everywhere, I see the ancient religious tomes starting from the Gita to the Bible and then to the Quoran as scripts on governance of humanity akin to the modern constitution.

The ancient religious scripts offer no room for amendment. They were propagated as sacrosanct religious documents for governance of the human behavior. The humans have been indoctrinated in their religious dogmas while young without the maturity to think or judge. But after attaining adulthood, many humans have questioned the sacrosanct rigidity of their religious beliefs. I have found that the thought process behind beliefs about the unknown is common to all fields of discourse like religion, science, mathematics, engineering and economics. I have unified this process in a new script with a view to achieving *prosperity through unity amid stability*.[6]

3.2 Usurious price of credit

The modern constitution leaves a scope for its amendment based on latest human wisdom and democratic discourse. Most countries have adopted this system. But the current financial crisis has raised doubts about whether this system is capable of begetting *prosperity amid stability* for the vast majority. Such doubts have unfortunately emboldened the obscurants steeped in their ancient religious dogma to wage a terrorist war against the constitutional rules of governance.

Resolving the current financial crisis is necessary to remove doubts about the efficacy of the constitutional system of democratic governance. A resolution is needed urgently to contain terrorism and obscurantism. This is daunting, though, because the current financial meltdown seems to be rooted in an unsustainably high (usurious) price of credit, but what is usurious may be unclear.

Economists may argue endlessly for or against a rate of interest using economic indicators like inflation, manufacturing activity, unemployment and even stock markets. They may even come to a unanimous conclusion on the rate of interest. But their conclusion is invariably predicated on retaining the real value of the accumulated credit, not on whether the rate is usurious.

Usurious interest rates over a prolonged period can eventually lead to financial meltdown, economic agony, riots, social chaos and maybe Great Depression. Such catastrophic events ultimately force the creditors to face default or preemptively grant debt reliefs and accept a much lower rate of interest. In such circumstances, the economic indicators are not very useful.

My argument about whether the current rate of interest is usurious is based on the distribution of surplus credit in a democratic society. The current distribution of credit in America should show, if factually documented, that the vast majority that wields democratic power has negative net credits or positive net debts, while a small fringe of households have accumulated vastly positive credits. This means that the price of labor of the vast majority has been substantially less than that a democracy can sustain.

A few top creditors can rig up the price of credit by fooling the Federal Reserve Board's model based on economic indicators:

1. The CEOs of federally insured banks can lend credit to leverage their privately-held hedge funds. Using the power of leverage, the hedge funds can rig the markets to wangle wealth from the passive pension plans and mutual funds.

2. If the credits available at the federally insured banks are instead channeled to real activities, the lending rates of interest would be much lower than they have been.

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[6]Acharya, Sankarshan (2006)*: Universal Religion and God*, available on the internet at: http://www.pro-prosperity.com/Research/Universal%20Religion%20and%20God.pdf

3. The U.K. Prime Minister Gordon Brown writes in a column on Washington Post on October 17, 2008 that the European leaders have agreed to "root out the irresponsible and often undisclosed lending [that is] at the heart of our problems." The bank CEOs have apparently made "undisclosed lending" of government insured deposits from their banks to pump leverage into their privately-held hedge funds to cause severe market volatility to wangle wealth from pension plans and hedge funds. This should be "irresponsible" because the world is at the brink of a financial depression.

4. Heavily leveraged hedge funds can also rig up the prices of commodities to create an illusion of inflation to pressure the Federal Reserve to keep the rate of interest high. This means the true equilibrium rate of interest in reality is less than the rate decreed by the Federal Reserve.

5. The Federal Reserve has always acted to preserve and enhance the real value of credit through a policy of keeping the interest rate above the rate of inflation. This policy invariably leads to higher rate of interest than a democratic monetary policy will enforce.

The above reasons imply that the price of credit has been unsustainably usurious.

Consistent actions undertaken: That the price of credit (interest rate) has been usurious is indicated by the fact that the government seems to have recently counseled the federally insured banks to not lend to hedge funds, following my memos dated November 17, 2007 and April 9, 2008 to the U.S. President, Senators, Federal Reserve Chairman and Treasury Secretary. One memo is entitled "A More Effective System of Governance to Enhance Competitiveness" and the other "Lending Taxpayer Funds to Investment Banks and Hedge Funds is Suicidal for Taxpayers."[7] Both the memos emphasize how privately-held hedge funds take federally insured bank deposits to make highly leveraged bets to ruin the pension plan and mutual fund savings of taxpayers for self-aggrandizement.

The current market meltdown accelerated after the restriction of credits from federally insured banks to hedge funds including investment banks which are mega hedge funds. Bear Stearns failed in March 2008 and was absorbed by JP Morgan and Chase. Thereafter, Lehman Brothers collapsed. Merrill Lynch was forced to merge with Bank of America. Goldman Sachs and Morgan Stanley have become bank holdings companies. Yet, the era of highly leveraged bets against pension plans, mutual funds and retail investors based on mega borrowing federally insured deposits cannot end until the safe banking policy is adopted for *prosperity amid stability*.

The current tight credit condition and lack of trust is primarily between the federally insured banks and the leveraged hedge funds and former investment banks that still operate as usual in the capital markets. The government imposed credit restriction has forced deleveraging of the hedge funds through liquidation of their holdings.

Credit tightening has also forced the hedge funds and investment banks to unwind their long positions on commodities leading to a precipitous fall in prices of oil and metals. Now top creditors are craving to buy the Treasuries yielding as low as 0%. Before the restriction of federally insured credits to hedge funds, I had suggested lowering the benchmark Fed rate to about zero when indeed the Fed's model was indicating 5.5%, with vociferous support from many Federal Reserve Governors and Presidents for keeping the rate that high or for even raising it further.

In the wake of my memos, the Federal Reserve has cut the rate of interest drastically and is now coming under market pressure to lower the benchmark rate of interest even below its current 1.5%. Maybe it should. But lowering the benchmark rate does not make credit available at lower rates to the grass-root borrowers, the businesses and households where real economic activity flourishes.

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[7]The contents of several memos including the one dated November 17, 2008 have been merged to a paper which is available at http://www.pro-prosperity.com/Research/UtilityWelfareDemocracy.pdf. The memo of April 9, 2008 is available at: http://www.pro-prosperity.com/Lending-IB-HF-Suicidal-Taxpayers.html. I will be happy to send any memo if requested.

3.3 Optimal Price of Credit to Avert Depression

The current financial meltdown shows that the effective lending rate is still usuriously high for the grass-root borrowers. To cut interest rate on lending grass-root borrowers, the government has no option but to decree by Congressional fiat:

1. To lend directly grass-root borrowers at lower rates.
2. To grant debt relief to grass-root borrowers.

These are urgent policy tools needed to maintain a non-usurious lending rate, as I have written to the U.S. Treasury Secretary, Federal Reserve Chairman and Senators. Competing private banks will automatically lower their lending rates once the government steps in. This will likely boost borrower confidence and revive economic activity. We should also adopt a long-term policy of safe banking to avoid moral hazard, as detailed earlier.

The current financial crisis seems epochal, rooted in a dogma to create credit usuriously and to set an unsustainably high price of such credit. Policymakers who have aggrandized vast credits and allied top private creditors have wielded this dogma to control the government and destiny of the country.

The current crisis can be resolved only by the constitutional principle of liberty for the vast majority via optimal sustainable (non-usurious) growth and price of credit. The issue here is neither fairness nor the mighty being right. It is a matter of optimal democratic governance to maintain social stability and to obviate chaos and incivility.

Consistent actions undertaken: I wrote a memo on the twin urgent policy tools, direct lending and debt relief, first to the U.S. Treasury Secretary on November 12, 2007 and then to ranking U.S. Senators and the Speaker on October 2, 2008. The U.S. government has announced these two measures on October 6, 2008. Even the Republican presidential candidate Mr, John McCain has announced some measure of debt relief to households.

4. Greedy Creed and Depression

I argue in this section that the root cause of current financial market meltdown is *greedy creed* propagated through a dogma of maximizing the utility of own net-worth without caring for the instability wrought by individual actions.

Let’s first ascertain dispassionately if the following could be the fundamental causes of the current financial market meltdown:

1. Fannie Mae and Freddie Mac took more and more risky mortgage debt.
2. Banks and insurers did not have adequate capital to write (short-sell) financial securities like debt, equity, and derivatives like credit default swaps.
3. Regulators were lax in monitoring financial institutions closely enough.
4. The Security and Exchange Commission did not monitor markets closely enough.
5. Deregulation as a model for trickle-down prosperity did not work.
6. Debt holders (households, corporations and government) have been irresponsible to live beyond their means by borrowing.

Consider a *hypothetically rosy scenario*: Fannie, Freddie and other federally insured banks did not engage in risky lending to irresponsible sub-prime borrowers and always held sufficient capitals under strict regulatory supervision.

Where would the growing credit have gone in this rosy scenario, given that the total credit in an economy must equal the total debt? The growing credits should and would have gone to only the prime borrowers, as argued by the elite: the pundits, economists, journalists, politicos and think tanks. The non-elite would also agree with this view. We thus have a unanimous agreement that the prime borrowers should have been choked with all the debt at lower and lower interest rates. But then the growing debt burden would have eventually made the prime borrowers sub-prime.

In reality, the vast majority of mortgage debt holders were considered prime due to a historically low average rate of default of about one percent. The growing credit thus flowed to the prime home mortgage borrowers at lower and lower rates of interest. *The prime borrowers have been the prime producers***.** They piled up debt as their incomes and savings eroded beyond their control. The explosive rate of credit growth and concentration shows that top policymakers and allied creditors have usuriously eroded the prime producers' incomes and savings for self-aggrandizement of credits. The usuriously usurped credits have been loaned back to the prime producers. The prime producers have propped the economy, but the stealthy erosion of their incomes and savings has made them financially shaky and sub-prime.

4.1 The Fundamental Problem Underlying the Current Crisis

The policymakers and allied creditors have for decades wielded their power to grow their credits by usurping both incomes and savings of the prime borrowers who are indeed the prime producers of globally competitive goods and services. The prime borrowers/producers have been ultimately jolted. They have lost trust in this financial system. This is a prelude to a lasting depression because the usurpers can no longer bank on the shaky props: the prime producers who have become sub-prime.

The government-reported high productivity simply depicts an increasing workload on the prime producers during unaccounted off-regular hours. The high productivity has not increased net worth or financial strength of the prime producers. The increased productivity (or growth in GDP) has gravitated to a few net creditors.[8]

It is not the economy, stupid. The economy has grown rather vigorously since 1993 or so. Yet it has taken the U.S. and the world to the precipice of Great Depression II. The true refrain for a democratic, capitalistic economy should be: *it is the usurious credit growth, stupid*.

I believe that the chieftains and custodians of the economy genuinely want to protect, as they too cherish, the *democratic capitalistic system of governance*, which is now challenged by the financial market meltdown. They would not deliberately undermine the prime producers who prop this system of governance. They must be more worried than the rest. The fundamental reasons for the usurious growth in credit must, therefore, be the following:

1. *Greedy creed*, instilled by college education which hammers very talented human brains with a credo of maximizing (the utility of) own net-worth or wealth or market value. This greedy creed makes the minds nonchalant and oblivious of common good because they remain immersed or mired in an unsustainable dogmatic behavior. It is not sustainable because the process of usurious usurpation eventually takes the top players (bankers and policymakers) into an inextricable prisoners' dilemma of the type they are facing today.
2. *Overconfidence* punctuated by military superiority due to nuclear power.

The greedy creed unfortunately drove the chieftains at the investment banks, the hedge funds, the Federal Reserve and the SEC to protect the interests of a few. This drive has willy-nilly killed the real economy, continually.

In a way, the greedy creed at these institutions was successfully exploited by the inflexible Chinese exchange rate policy that offered little room to game through trading and forced the Chinese workers to work for pittance. The greedy creed lured the elite to short-sell the workers in the developed world to establish shops (by going long in the workers) in China and other parts of the developing world. My courses on arbitrage pricing over the last ten years at the University of Illinois have invariably emphasized how this wage-labor arbitrage has enriched a few in Wall Street and its patrons in Washington at a huge expense to the prime producers on the Main Streets, globally. Short-

[8]Acharya, Sankarshan (2005), "Prosperity: Optimal Governance, Banking, Capital Markets, Global Trade, and Exchange Rate," *Citizens Publishing*.

selling the productive workers in the developed world has effectively pruned the roots of the trees (the prime producers in USA and Europe) that offered fruits and shades to the rulers, the poor and the unproductive lots in Wall Street as well as Main Street.

The U.S. recovered from the Great Depression due to a decisive victory in WW-II and then entered an era of prosperity and stability. While this is factually true, the underlying forces of recovery are immigration of talents and willingness of the defeated nations to work under American suzerainty. The reasons for why the U.S. is now facing a potential decline in prosperity are emigration of trained talents and unwillingness of the peoples that did not join and were not defeated in WW-II to work under American suzerainty. The war then was not the motto of the U.S. Americans were provoked by an unjust war and were drawn into it as liberators and were widely eulogized as good Samaritans. The subsequent passage of civil liberties made America a nonpareil destination for talents around the world to immigrate and flourish, making the nation the envy of the world. It is, therefore, not the war, per se, that should be end goal of the U.S.

The ulterior goal must be *prosperity amid stability*, as it was in the wake of WW-II.

4.2 Equity and Liberty

The philosophy of greed (due to enunciation of the economic theory of maximizing own utility) and invincibility (due to invention of nuclear bombs) should give way to the true *founding principles of America: equity and liberty* within the nation and elsewhere in the world. Equity does not refer to quota or entitlement. Equity refers to:

- Equitable flow of money to the effective producers of globally competitive goods and services.
- Stopping surreptitious trading games in Wall Street tacitly supported by rulers and government agencies to usurp income and savings of the effective producers.

Only the effective producers can feed and protect the weak, poor and the rulers. A nation or the world cannot afford to undermine the effective producers. China paid little to its effective producers, but used the surplus to expand its weak infrastructure and manufacturing base. But the U.S. engaged in usurious credit growth for a few by clandestinely undermining the income and savings of the effective producers.

Capturing of the oilfields in the middle-east by engaging and defeating the rest of the world could have brought prosperity through copious supply of oil for Americans. Even if feasible, this could not be a long-term optimal strategy because it would only dwindle the global oil supply faster, maybe after making the Americans a little more obese and a little less productive. The optimal strategy is to search for optimal rules for democratic, capitalistic governance that would tap the inexhaustible power of human mind to discover renewable sources of energy and to keep the earth cool for the posterity. This strategy will automatically defeat, nonviolently, the philosophy of terrorism and obscurantism. Military strength is still necessary, but it should be jointly maneuvered by the peoples following and espousing the philosophy of democratic capitalism.

4.3 Reforming Greedy Creed

Talented humans have been trained to behave myopically to serve short-term self interests. They maximize the utilities of their wealth to make decisions, subject to constraints imposed by public policies adopted by government. A government representing the interests of such individuals chooses optimal public policies by maximizing the aggregate utilities of individuals. This policy paradigm *seems rational*, at first blush, for individuals with finite lives. But it may eventually harm the collective human welfare, cause social instability and not beget equal opportunity for all.

The current policy paradigm ignores how individual utility maximizing actions can undermine collective human welfare in future, if not immediately. It can also degrade utilities of individuals in future, if not now. Government policies should not be, therefore, predicated only on individual utility maximizing efforts.

A *truly rational public policy paradigm* should maximize aggregate individual utilities of wealth while restraining the cost to humanity stemming from individual utility maximizing actions. The current economic paradigm of maximizing individual utilities of wealth propagates a myth about what the humans should consider as rational. It panders to and promotes the baser temptation of humans to focus on individual utilities of wealth.

To enhance long run welfare of humanity, democratic governments must be responsible to design laws based on the *truly rational public policy paradigm* and tell the truth about the long-run adverse effect of pandering only to immediate human desires.

A Nobel Memorial Prize on Economics has been awarded to the utility maximization theory. This prize must have contributed to promotion of models and policies based on individual utility maximization. Propagation of such models must have accentuated the self-serving individual behavior, and thereby blinkered a democratic government's role in enhancing collective welfare of humanity. This must have resulted in laws to serve special interests at a huge long run cost to the majority.

Long run human welfare can be promoted only through worldwide awareness–with efforts of governments, media and academia–about how the individual utility maximization paradigm may unduly accentuate self-serving behavior to undermine collective welfare. The Nobel Peace Prize on global warming will certainly help in spreading the truth about the adverse impact on humanity of the individual utility maximizing actions.

4.4 Freedom from Financial Bondage and Depression

President Abraham Lincoln's contribution to democratic freedom is nonpareil. But his task was rather easy because the slavery (bondage) then was based on color. The current threat to democratic stability is due to a potentially severe financial bondage of American households facing deterioration of their net assets and net income. Financial bondage is colorblind and maybe harder to eradicate. Households with negative net income, due to increasing costs of living and stagnant incomes, are piling up debt and forfeiting their financial liberty. It is perhaps a potent simmering threat to democratic stability. To gauze the degree of such threat, if any, we need data on growth or decay in net assets or wealth of households that are not currently collected by democracies.

Political leaders, hedge fund managers, lawmakers, economists and everyone else with rational thinking considers net assets as the best gauze of their financial prosperity and security, judging from their own actions to enhance their net worth. That is how they seem to measure the stability and prosperity of their own households. It is not unreasonable to presume that every other household too tries to enhance its financial stability and prosperity likewise. Then a democratic government representing people should measure net assets that every household considers paramount.

Growth in gross domestic product camouflages true prosperity, namely, net assets as judged by every household. A great depression, maybe globally, can happen even with low unemployment.

Economic insecurity of a household stems from declining net assets and negative net income. It may result from prolonged periods of unemployment or severe *underemployment*, defined as zero or negative net income. Economic insecurity of a vast majority over a prolonged period may lead to a recurrence of the Great Depression.

The prevailing belief that the Great Depression was due to high unemployment and credit squeeze has led to a policy of low unemployment through continual money injection. Continual money injection may have already created severe underemployment. The Great Depression can recur as the net household assets may have deteriorated due to prolonged severe underemployment.[9] Low unemployment, low inflation and growth in gross domestic product can mask the *true indicators* of Great Depression: declining net assets and negative net incomes.

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[9]Robert Kiyosaki estimates that the vast majority of American households lost $7 to 9 trillion in last five years due to financial predators (http://finance.yahoo.com/columnist/article/richricher/1212, November 14, 2006).

Zero net income for the U.S. economy would only mean negative net income for the vast majority who are net borrowers of about $42 trillion credit in the financial system. The current latent underemployment-indicated by the negative net income of the vast majority of households-is obviously due to unfettered money injection over the decades following the Great Depression.

A fear that credit tightening triggered the Great Depression has perhaps led to the prevailing policy wisdom for continual money injection during periods of economic weakness. But continual money injection has perhaps brought us to severe underemployment or negative net income. At the same time deterioration of net assets of the vast majority may be taking place irrespective of the current monetary policy. This shows that the current monetary policy may not safeguard against recurrence of the Great Depression.

The only insurance against recurrence of the Great Depression is to arrest the deterioration of net assets of households of the vast majority, whether or not such deterioration is due to high unemployment or severe underemployment. But to think of such insurance, we must first record periodically the data on net assets of individual households and monitor this statistic for at least the middle majority, say 75%. We have to then pin down all major factors that can cause deterioration in net assets including unemployment and underemployment.

Suppose in the absence of data that net assets of a vast majority of households have deteriorated over some time. This cannot be only due to a prolonged period of underemployment of the vast majority of households. The prime latent factor for deterioration of net assets of the vast majority is perhaps the current system of governance predicated on pre-Great Depression era policies that have been foisted by hedge funds to wangle wealth from a vast majority. This system of governance basically recycles most of the created money as credits to a few households.

Despite benevolent intentions of money injection, the vast majority continues to be robbed because the prevailing system of governance may not be serving the best interests of the vast majority. It is true that the vast majority wields voting power to change policies in a democracy. But the current system of governance does not generate, let alone disseminate, information on net assets of individual households for the vast majority to propose rational amendments to existing policies.

In spite of low unemployment, the vast majority is now facing the brunt of rising prices, declining net income and perhaps eroding net assets. The problem facing the U.S. households is not due to China accumulating foreign currency reserves or the low value of Yuan. The problem is most likely the current system of governance (policies) designed to wangle wealth of the vast majority of American households.

The U.S. has to rectify its current system of governance for the sake of *prosperity amid stability* of a beautiful democratic country and thereby lead the world for the betterment of humanity everywhere. One should salute great American leaders like Abraham Lincoln who have correctly veered the destiny of a great democracy. I believe that the current leadership too on a bipartisan manner can visualize the real malaise and devise optimal rules.

Consistent actions undertaken: This section was the theme of several memos available on the internet at pro-prosperity.com sent to the U.S. President, presidential candidates and ranking Senators.

Both the presidential candidates in the current election have unequivocally stated that Wall Street greed is responsible for the financial market meltdown. Senator John McCain has even stated that the SEC has permitted illegal trading in Wall Street. The Security and Exchange Commission has banned short-selling of financial securities, which I have argued as illegal and suboptimal.[10]

The Federal Reserve Chairman has explicitly stated in his testimony on October 15, 2008 to consider "financial stability" in monetary policy. This is a path breaking development because the Fed's model on interest rate was based on economic indicators-like unemployment, manufacturing activity, and inflation-not financial instability.

How to measure financial instability of an economy? In my memos to the U.S. Federal Reserve Chairman and top government leaders, I have proposed "growth in net assets of the vast majority of households (middle 75%)" as a

[10] Acharya, S. (2008): "Sub-optimality of Short-Selling," available at http://www.pro-prosperity.com/Research/Sub-Optimality%20of%20Short%20Selling.pdf.

relevant measure of financial stability of an economy. Eroding net assets depresses households financially. The depression spreads throughout the economy if a vast majority of households erode their net assets to become financially unstable. I hope the central banks around the world will measure net assets of households and use it as an indicator of financial stability while setting the interest rate.[11]

5. **Optimal Governance and Competitiveness**

Competitiveness of a country can be measured by the net exports and foreign exchange reserves. To achieve *prosperity amid stability*, the country must enhance its competitiveness while averting a potential depression. Governments have used two policy instruments-money injection and interest rate-to accomplish this goal. But such instruments have not helped a country like USA, judging by the measures of competitiveness.

The U.S. economy is beset with continual liquidity-credit crises and potential depression, which are being preempted by new money injection and interest rate reduction. These policy instruments have basically served as antipyretics to contain a relapsing fever without really treating the ailment underlying the fever, namely, the root cause of depression and un-competitiveness. Continual application of antipyretics debilitates the economic patient, the U.S. economy.

The system of governance needs to be more efficient in letting money at reduced interest rate flow to the *effective* producers and exporters of globally competitive goods, services, ideas and creativity. The U.S. economy will exhibit higher inflation and face threats of depression *if* money continues to flow to the *ineffective*, those who are unable or unwilling to produce globally competitive goods, services, ideas and creativity. How the money now flows to the *ineffective* is illustrated below:

1. When regulated banks ail, the central bank injects new money to stem the systemic risk of banking panic. But some banks reach the brink of failure primarily because of excessive executive pays in comparison to bank earnings. By injecting new money, the central bank funds excessive pays of *ineffective* executives.

2. Politicians continually create new money by borrowing for their pet schemes. Most of this new money is almost freely passed on to their *ineffective* constituents.

3. When governments increase borrowing to fund new tax cuts, the borrowed funds flow freely to taxpayers. Those taxpayers, who merely hoard their tax savings as credits by lending back to government or other borrowers, are rendered *ineffective*.

4. The current law allows creation of mutual fund companies with BOD members floating their private hedge funds to trade collusively with subordinate fund managers to reap mutual benefits at a cost to taxpayers-investors in those funds. This law makes American talents *ineffective*.

5. The current law permits hedge funds to borrow (with equity-to-debt ratio of 1:20) from federally regulated banks to take huge bets to deflate stock prices temporarily to cause panic for investors-taxpayers. The law permits the Federal Reserve to pump new money to save the federally regulated banks which are construed to be too big to fail. The law permits such banks to form firewalled subsidiaries to borrow massively from federally regulated banks to take bets designed to make taxpayers lose portfolio wealth and bear the brunt of higher prices due to federal monetary infusion. Such laws make American talents *ineffective*.

6. The education, health, defense and government sectors have *effectively* propped up the U.S. by inducing continual inflows of human and monetary capital. They have *effectively* exported America's security, education and healthcare. These sectors may be amassing hoards of credits less effectively now. They may have reached points of diminishing returns. They need reform.

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[11] Acharya (2007): "Policies to Avert Recurrence of Great Depression," available on the internet at http://www.pro-prosperity.com/Severe%20Underemployment%20Can%20Trigger%20Great%20Depression.html

A more *effective* system of governance will be based on reforms of laws that will permit the flow of money at lower rates to the *effective*. As money continues to flow disproportionately at lower rates to the *ineffective*, the trade imbalance grows, currency depreciates, inflation soars, standard of living falls, social instability surfaces and depression looms. The only solution is to let money flow to the *effective* at drastically lower interest rate.

Lower interest rates do not necessarily lead to higher inflation as the case of Japan should illustrate amply. The abundance of money with the *ineffective* is the source of inflation. This money produces little, but takes huge bets to raise the prices of consumable goods. Such bets would be limited in a more *effective* system of governance that makes money flow to the *effective*, as in China.

The *ineffective* in the U.S. could take huge highly leveraged bets because their collaterals of mortgage backed securities were valued higher due to higher interest rates. But the Federal Reserve was raising interest rates simply in response to rising commodity prices, quite like administering antipyretics to contain fever without diagnosing and treating the underlying ailments. The households could no longer support the rising interest rates, as indicated by unprecedented housing foreclosures.

Only the *ineffective* will desire to raise the interest rate and to keep the current system of governance unchanged. They will even lobby through generous political contributions and induce talking heads through largesse to spread the myth about the rectitude of their paradigm. It is their *dharma* to hoard credits *ineffectively*.

The *dharma* of a government is to enhance competitiveness of a country, avert potential depressions and achieve *prosperity amid stability*. This can be done only by reforming the current system of governance and by letting money flow at drastically lower interest rates to the *effective*: real producers of globally competitive goods, services, ideas and creativity.[12]

The lawmakers cannot gainsay that *stability*, *prosperity* and *competitiveness* should be the primary national *goals* of any progressive democracy. They should, therefore, optimally mandate that the central bank achieve such goals, not some flaky targets like inflation and unemployment–by collecting all necessary data.[13]

Consistent actions undertaken: I had first communicated on “Enhancing American Competitiveness” to the U.S. President on January 31, 2005 with copies to Federal Reserve Chairman and prominent Senators.[14] I have thereafter followed up on the policy issues in several memos to President Bush and Congressional leaders.

Consistent with many direct and tacit policy implications made in my memos, President Bush has (i) created a budget heading on American Competitiveness, (b) campaigned for energy independence, (c) conceived and consummated a new strategy of friendship with India by even diluting nuclear nonproliferation norms, (d) appointed an expert on the Great Depression as the Chairman of the Federal Reserve Board, (e) withheld plans on bombing Iran,[15] (f) even changed course to coddle the scientific community by speaking at Stanford, and (g) even created a White House website on exercise to reduce obesity. The Yale University president startlingly revealed in a Bloomberg TV interview that Congressional pressure motivated the top private universities to not charge tuition to students from the middle-class families, as announced a few days after the receipt of my memo to the Congress on this topic.

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[12]The U.S.-India collaboration to contain the rise of China smacks of the adage: misery loves company. India is beset with an essentially similar problem of money gravitating to the ineffective people. The difference between the systems of governance in India and USA is that no law is necessary for the former and laws are designed by the latter to achieve the same goal: to let money flow to the ineffective.

[13]Acharya, S. (2005): “Prosperity: Optimal Governance, Banking, Financial Markets, Global Trading and Exchange Rate,” *Citizens Publishing*, (http://www.pro-prosperity.com/Citizens%20Publishing/Abstract.htm).

[14]Acharya, S. (2005): “Enhancing American Competitiveness,” memorandum to President Bush available on the internet at http://www.pro-prosperity.com/USPresident013105.html. This memo is based on “Prosperity: Optimal Governance, Banking, Capital Markets, Global Trade and Exchange Rate,” *Citizens Publishing*.

[15] Acharya, S. (2006): “Winning a War on Terrorism Non-violently,” available on the internet at http://www.pro-prosperity.com/WinningTerrorismWarNonviolently.html

President Bush has now convened a meeting of the global leaders to set rules of governance globally with a view to preserving democratic capitalism. I am truly humbled about having set the trigger everywhere to enhance national competitiveness, needed for *prosperity amid stability* around the world.

6. Conclusion

Only democratic capitalism can maximize *prosperity amid stability*. This inference is based on actions that followed my communication with the global leaders, consistent with the proposed optimal rules. This proves resiliency of a democratic system of governance. All the credit goes to the people's representatives for appreciating the necessity of the *paradigm of prosperity amid stability* for preserving democratic capitalism. This makes me confident that a democracy can maintain long-run social stability and foster equal opportunity to enhance individual wealth based on perseverance, talent and skills.

Leveraging of privately-held hedge funds based on government guaranteed bank deposits has caused massive losses to taxpayers through all forms of moral hazard in government, banking, capital markets and global trade. But only a democracy could heed missives from even an insignificant taxpayer as long as they are articulated to serve the best taxpayer interest. Only a democracy could force the gargantuan deleveraging of mighty hedge funds and investment banks in the best interest of the vast majority.

The majority wields power to formulate optimal rules in a democracy. It is, therefore, important that a democratic government ensures growth, not decay, in wealth of the majority. Otherwise, there may be social instability leading to dictatorial or irrational rules. Growth in wealth keeps individuals financially stable. The household wealth of the prime producers cannot be allowed to decay because only they can feed and protect the poor as well as the rulers.

The government should enhance competitiveness of a country, avert potential depressions and achieve *prosperity amid stability*. This can be done only by letting money flow effectively at drastically lower interest rates to the real producers of globally competitive goods, services, ideas and creativity. This would necessitate reforming many lopsided rules that were designed to transfer wealth from the vast majority to a few.