

# OPTIMAL GOVERNANCE FOR PROSPERITY AMID STABILITY

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**Abstract:** This paper defines *Country* as the effective producers of globally competitive goods, services and ideas in a politically defined nation; the *Country* contributes to prosperity, security and stability of a nation. We present (i) a new paradigm to determine optimal rules of governance by which individuals can maximize the utilities of their net worth (prosperity), but not undertake collective actions that cause instability like global depression or warming<sup>1</sup> and (ii) new measures of prosperity of the *Country* to presage and avert potential financial depressions, and (iii) examples of specific rules of governance of banks like safe central banking to foster a *free market economy* in which no agent can impose prohibitive moral hazard risk on the *Country*. A *free market economy* disallows blackmailing of the *Country* by agents who take risky bets to generate private benefits if the bets succeed and extort bailout by the *Country* when the bets fail.

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<sup>1</sup>Such balancing or tradeoff is the hallmark of economic models that determine optimal choices.

## 1. INTRODUCTION

This paper presents a new paradigm or philosophy of *optimal governance (rule) for prosperity amid stability* (OGPS) which allows individuals to maximize the utilities of their net-worth (prosperity) without causing social instability like global depression or warming. The OGPS paradigm is founded on a general equilibrium dynamic programming model which obtains the *first-best (efficient) resolution* of the financial moral hazard problem inherent in the prevailing paradigm.<sup>2</sup> The model represents the real-world dynamic game among the leveraged firms with potentially asymmetrically informed stakeholders maximizing their net-worth while the government ensures free markets and trading with a constitutional rule to protect the net-worth generated by the players through trading and arbitrage pricing in equilibrium. The goal of *first-best policies* is to beget first-best status for principals (citizens) of a society.<sup>3</sup> During and after the 2008 financial catastrophe, the U.S. Congress has adopted major first-best policies that have emerged from this model, namely, (i) offering safe central government banking facility to \$3.5 trillion of previously uninsured money market funds and bank debts, and (ii) requiring the bank holding companies to have minimum capitals on a consolidated basis.

The dynamic programming model underlying the OGPS paradigm subsumes Chichilnisky's (2011) concepts on sustainability by according importance to the present and future. The dynamic game underlying the OGPS paradigm is like Ketola's (2011) chess among firms, households and a government. The stability in the OGPS paradigm is indeed the economic equilibrium in a long-run dynamic game among these players while a free market values their risky securities by arbitrage. The economic equilibrium in short-run or temporal models may not necessarily ensure stability or long-run sustainability. Coco and Ferri (2010) address the issue of organizational structure where a larger body of stakeholders including shareholders can make financial institutions stable. Such stakeholders are subsumed by the not-for-profit government minimizing its costs of monitoring all firms including banks within the game underlying the OGPS paradigm. In particular, we obtain first-best (efficient) policies for long-run sustainable resolution of the problem of financial moral hazard. We discuss how the prevailing financial moral hazard game has subverted the Federal Reserve's econometric forecasting model for inflation and seriously misled the interest rate policy. Such subversion is consistent the conclusion of Ozdemir and Tuzunturk (2009) that higher macroeconomic performance in terms of sustainable growth cannot be accomplished through inflation targeting alone. The crux of the recent financial meltdown is multi-leveraging via the bank holding company structure. A BHC can raise return on consolidated holding company equity by ten-fold by decimating the capital to one-tenth of the required minimum under the bank foreclosure law enacted in the Federal Deposit Insurance Improvement Act of 1991. This is consistent with the recent findings by

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<sup>2</sup>This model was first mimeographed at the Board of Governors of the Federal Reserve System, Washington, D.C. in 1991. Some results stemming from this model have appeared in *Safe Banking* (Acharya, 2003) and *Safe Banking to Avoid Moral Hazard*. This model with new results have formed a new paper "*Economically Efficient Constitutional Governance*," which is available at <http://www.pro-prosperity.com/Research/moralhazardliberty.pdf>

<sup>3</sup> See Acharya, S. (2011), "Begetting first-best efficient status for principals," at [http://www.pro-prosperity.com/Begetting%20first-best%20status%20for%20principals%20\(citizens\).html](http://www.pro-prosperity.com/Begetting%20first-best%20status%20for%20principals%20(citizens).html)

Stubelj and Dolenc (2009) that profits from the trading portfolio of a bank have not changed significantly in 2007 (compared to 2005 and 2006), but ROE and ROA surprisingly increased in 2007.

The OGPS is fundamentally different from the prevailing paradigm (PP) which sets second-best rules that maximize the net-worth of a few agents without any regard to prosperity amid stability of society. The PP is prone to cause (i) social instability, (ii) transgression of constitutionally mandated free market economy and (iii) trampling of freedom of individuals. How? Consider the prevailing system of governance (rules):

1. Individual wealth or credit is stored in terms of fiat money whose supply is controlled by a central bank, e.g., the U.S. Federal Reserve.
2. A group of agents (robber barons) form a charter for the central bank–Federal Reserve Act of 1913–to create fiat money only for them at a lower rate of interest to lend the same money to the government at a higher rate.
3. The agents bribe the government (through political contributions) to make this central bank charter as the law for the *Country*.
4. The *Country* is the group of non-banker individuals who produce globally competitive goods and services to prop the fiat money created by the central bank.
5. The *Country* saves its maximized net-worth or wealth or credit in terms of fiat money in bank deposits guaranteed by the government or in stocks and bonds.
6. The agents again bribe the government to enact trading rules to permit them to use the government guaranteed bank deposits and new fiat money created by the central bank to actively trade with the *Country* of passive investors.
7. The agents collect hefty compensations by transferring the wealth of the *Country* stored in the banks.
8. The central bank periodically audits to ensure that banks have more assets than owed to the *Country* as per the bank foreclosure law enacted by the government.<sup>4</sup> The bank foreclosure law ensures that banks have about 8% more assets than the credits owed to the *Country*. But the central bank permits bankers to transgress the bank foreclosure law through the bank holding company structure like in the following example: A bank starts with \$8 of capital and \$92 of government guaranteed debt. It has the minimum required capital of 8% under the bank foreclosure law. The bank then becomes a bank holding company with one subsidiary bank and \$100 in assets of the parent company. The parent company transfers all of its assets, equal to \$100, to its subsidiary bank. For the subsidiary bank, the transferred \$100 becomes equity. The subsidiary bank is allowed to

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<sup>4</sup>The bank foreclosure law passed as Federal Deposit Insurance Corporation Improvement Act of 1991 is based on research, Acharya, S. and Dreyfus, J.F. (1989), “Optimal Bank Reorganization Policies and Pricing of Federal Deposit Insurance,” *Journal of Finance*.

raise another \$1150 of government guaranteed subsidiary bank debt. The subsidiary bank thus meets the minimum capital ratio of 8% or  $100/(100+1150)$  as required under the bank foreclosure law. But the holding company's consolidated capital is now diluted to 0.8% or  $8/1250$ , which is one-tenth of the minimum required under the bank foreclosure law. Dilution of the minimum required capital to one-tenth raises the return on consolidated holding company capital to ten-fold or 1000% of that of the non-holding company bank. The U.S. central bank has permitted such transgression of the bank foreclosure law until 2008.

9. The central bank continually creates new money on the back of the *Country* to give it to the bankers to make up for their periodic losses (shortfalls in capital) at the banks while allowing the trading and compensation game.
10. The bankers appoint chaired banking professors as experts to publish in journals controlled by the bankers only those research articles which support the above game set up by the agents and reject and penalize academic scholars who write first-best (efficient) policies to resolve the above system of financial moral hazard to beget first-best status for the *Country*.
11. The articles published in the controlled journals become the wisdom infused by the decree of the academy in the minds of every student including the elected representatives of the *Country*. The media controlled by the agents broadcast that without such academic wisdom no one can improve net-worth. The academy concurrently instills another dose of wisdom that every rational individual maximizes his net-worth and that individuals so deemed as irrational do not have a desirable status in the *Country*.

This above prevailing paradigm (PP) will obviously fail, exactly as I have presaged in my first-best policy research presented to the US Federal Reserve since 1991 and to the US Congress since 2003.<sup>5</sup> The Congress found in its 2011 Financial Crisis Inquiry Commission report that the agents, academic experts and government regulators have failed and their failure caused the manmade (avoidable) financial catastrophe of 2008, which is worse than the Great Depression according to the Federal Reserve.<sup>6</sup> The PP is inconsistent with the *free market economy* like that mandated by the American constitution. The PP is predicated on blackmailing of the *Country* by agents who take risky bets to generate private benefits if the bets succeed and extort bailout by the *Country* when the bets fail. The PP imposes serious moral hazard restrictions and cost on a *Country*'s economy and is, thus, inconsistent with the constitution.<sup>7</sup>

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<sup>5</sup>See Acharya, S. (2003), "Warning to US Congress in 2003 on the Current Home Mortgage Debt Debacle," available at <http://pro-prosperity.com/Global%20Economy%20Chatterbox/Warning-USCongress-In-2003-On-Home-Mortgage-Debacle.html>

<sup>6</sup> See Acharya, S. (2011), "Begetting first-best status for principals (citizens)," a memo to the US President and Congress, available at <http://pro-prosperity.com/Begetting%20first-best%20status.html>

<sup>7</sup>A mathematical model, comprising a general equilibrium theory on efficient resolution of moral hazard in which the Safe Banking Policy is a unique equilibrium, is in Acharya, S. (2007), "Efficient Resolution of Moral Hazard Due to Arbitrage Trading, Risk Premium, Volatility and Capital Structure" available here: <http://www.pro-prosperity.com/Research/EfficientResolution.pdf>.

Wealth or net-worth or credit is the repertoire of hard work of people in a *Country*. The goal of governance of a *Country* should, therefore, be to adopt only those rules which preserve wealth of the *Country*. This goal is necessary to keep the political economy of the country stable. I have argued since 2003 and the US Congress has accepted in 2008 the first-best rule of *safe central banking* as necessary to preserve wealth of a *Country* and constitutionally mandated free market economy. Had the second-best policy promoting agents realized the impending failure of the PP on time, the first-best safe central banking policy could have been adopted at least in 2003, if not earlier, to preemptively (a) avert the financial meltdown of 2008, (b) preserve trillions of dollars of lost wealth, (c) retain millions of jobs, and (d) avoid the anxiety of dysfunctional governance due to loss of tax revenues.

*We the people* have dreamt of a *Free Market Economy* in 1787 and the research here provides a path (OGPS) to realize the common dream.

Political leaders have often repeated during crises, “ask what you can do for your *Country*.” This idea was coined even before President John F. Kennedy uttered it in a public speech. Senator John McCain has recently launched a “*Country First*” campaign. President Barack Obama has called for community involvement to uplift the *Country* from the present crisis. If leaders emphasize working for the *Country* and voters respond positively, it is perhaps a profound notion. Political leaders have not, however, articulated what they mean by *Country*.

Rationally, “*Country*” should be the vast majority of effective producers of globally competitive goods, services and ideas. This definition underlies a fundamental truth that only the effective producers can make a nation prosperous and stable and that only they can feed and protect the rulers as well as the poor and the laggards. If we stray from this fundamental truth, there will be utter confusion and deterioration in the core strength of a nation. No democracy can afford to adopt a different definition of *Country*.

What one should do for the *Country* can thus be ascertained by those actions and policies that fulfill the *common longing* of the vast majority of effective producers. A common longing is individual *prosperity amid stability* of society. A democracy should have a referendum to resolve the issue of common longing.

The novel philosophy or paradigm of service to the *Country* is called here *Optimal Governance for Prosperity amid Stability* (OGPS). Optimal governance is defined as an environment (rules) which lets individuals maximize the utilities of their net worth (prosperity), but not to undertake actions which collectively cause calamities like global financial depression or warming. This philosophy is fundamentally distinct from the existing paradigm of governance on the following counts:

1. The current economic paradigm of governance is based on maximization of utility of wealth of a representative agent like in an academic model or a lobbyist in the real world.
2. The OGPS philosophy is based on the growth or decay in net assets (prosperity) of the *Country*, not of some representative agent or lobbyist. The *Country* is the true source of power in a democracy. The OGPS philosophy is necessary for sustenance of democratic

capitalism in a nation. Communism saps the strength of a *Country* because it enforces equal pay without incentives for individual perseverance. Maximum prosperity is possible under capitalism. But, in the prevailing system of governance, capitalism can lead to financial bondage of a democratic *Country*, social instability and ultimate erosion of everyone's individual prosperity.

3. The OGPS philosophy is predicated on serving the best interests of the *Country*. This philosophy is fundamentally distinct from the existing theory of governance that serves the best interests of some representative agent or lobbyist.
4. The OGPS paradigm is original. If it were not original, then we would have observed the following:
  - a. The governments and thinkers in at least the developed democracies would be already measuring net assets (prosperity) of every individual household to determine any deterioration in net assets of the *Country*. Uncontrollable deterioration in net assets of the *Country* leads to financial depression and catastrophe like that witnessed during the Great Depression of 1920's and the Great Recession of 2008. Presaging such depression is supremely important to every nation. Yet, no nation currently collects data on net assets of every individual household in the *Country*. Nations are thus unable to determine optimal preemptive rules of governance 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 stemming from the current paradigm of serving the agents. Recording data on net worth of individual households as the barometer of prosperity of the vast majority, say the middle 90%, is not only desired by the *Country* but also necessary to have early warnings about impending depressions.
  - b. The custodians of a nation, relentlessly pursuing for enhancing their own net worth, would not have swayed their *Country* to accept government-hooded GDP growth statistics as barometers of prosperity. Only recently, has the US President stated how the values of credit default swaps have been added to the U.S. GDP growth, while the *Country* remains depressed under the veneer of such rosy economic growth statistics.
  - c. At least the developed countries would have set early warning measures to detect the onset of a wide-spread depression. After circulation of the OGPS philosophy and after presentation of some of its ideas at the Hong Kong Monetary Authority in August 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. The U.K. Prime Minister Gordon Brown has echoed the need for stability in a column in Washington Post in October 2008 and sought to establish an early warning system to avert financial depression. The governments of China or U.K. have not yet stated, though, if they would measure net assets of every individual household in their countries to establish an early warning system. The US Federal Reserve Chairman has recently expressed, however, the necessity of incorporating stability in decision making.

The current global economic crisis simply illustrates that the *Country* has not been well served by the prevailing paradigm of governance. In the wake of path-breaking industrialization of America, markets crashed badly in the 1860's leading to destitution of the vast majority with ensuing unrest. In the aftermath of major inventions like telecommunication, radio and television, markets crashed again in 1929 leading to the Great Depression that left very few financially unscathed. The current technological advancements mark the steepest progress humans could conceive of with peta bytes of data transmitted per second through broadband telecommunication networks and with supercomputers of the bygone era available in a compact form for barely five hundred dollars. Yet, the *Country* is passing through a severe depression due to bankruptcy of households as well as bankers.

The current financial depression is unfortunately trivializing the unprecedented technological advancements made by humans around the world. How does a depression follow unprecedented breakthroughs in technology? Bankers channel the savings of people for investment in stocks of promising technology companies. Bankers see the flow of funds through the system they control. They see how very few investors sell such promising stocks. Bankers respond to the demand for stock and create shares through naked short-selling to fetch astronomical prices to suck up passive retirement savings of the *Country*.<sup>8</sup> Bankers also underwrite shell companies in the hot technology sectors to short-sell those shares to the *Country* lured by hype in agents' controlled media. Bankers watch when the *Country* exhausts its savings. They then use their controlled media to trumpet rumors about the same shell companies whose stocks they sold short at exorbitant prices. They then downgrade the ratings of the stocks. Prices collapse. The *Country* once lured to buy promising stocks at exorbitant prices panics to sell the stocks for pittance to the naked short-sellers. Bankers make windfalls as the *Country* goes bankrupt and the economy is depressed.

How did the custodians respond to the American financial crisis soon after it unfolded? As soon as they recognized the collapse of the banking industry in 2008, they aptly created about \$3.2 trillion for the banks who had gambled away federally insured deposit funds and lost the trust of the *Country*. The guardians thus allowed irresponsible and reckless bankers to refinance their debts at about 0% by printing money fictitiously. The *Country* still pays 6-9% interest on loans. Ironically, the *Country* props everyone including the bankers and the custodians. The *Country* also backs the money created by the guardians. Yet, the guardians create money freely for the same irresponsible and reckless bankers who destroy the *Country*'s hard-earned wealth. The Federal Reserve Act is obviously not serving the *Country*. How do the custodians serving the *Country* allow a Federal Reserve System (twelve privately controlled Federal Reserve Banks) to lend money created on the back of the *Country* to a bunch of reckless banker-gamblers, who have decimated (i) the wealth of the *Country*, (ii) the banks' equity capitals, and (iii) the trust of investors everywhere? The money at 0% on the name of the *Country* is not passed on at low rates to the prime households in the same *Country* who prop everyone else!

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<sup>8</sup> Selling borrowed shares short also violates the corporate law. Suppose that a company has 1 million shares issued and outstanding, which are owned by investor "A" in brokerage house "B". Suppose that "B" borrows the 1 million shares from "A" to sell the same short to another investor "C." Then the number of shares outstanding effectively rises to 2 million shares (contrary to corporate law that 1 million shares remain outstanding) with one million issued through short-selling by "B." "A" may not lend the shares to "B" to sell short. "A" may also lend first and then recall the shares that can hurt the short-seller badly. In the case of naked short-selling, no recall is possible and so it is very dilutive.

The responses of the guardians (US Congress) to the financial meltdown of 2008 may sound sheer helplessness. But they have adopted two major first-best policies I have pursued with them since 2003: safe central banking and minimum consolidated capital for bank holding companies. Their actions are consistent with my OGPS philosophy.

The remainder of the paper is devoted to specific optimal rules of governance within the new OGPS paradigm as well as consistent actions undertaken by various nations around the real world as a result of communication with authorities. Section 2 presents the formulation of a safe central banking policy in equilibrium within a free market economy that is consistent with the American constitution. Section 3 focuses on determination of the interest rate within a free market economy. Section 4 deals with how the pervasive greedy creed (maximization of net-worth) may have led to perpetuation of the prevailing paradigm causing continual depressions around the world. Section 5 is devoted to concluding remarks.

## 2. SAFE BANKING NEEDED FOR FREE MARKET ECONOMY

An optimal rule for governance of banks should be based on a tradeoff between the bankers' prosperity and instability due to systemic failure in banking caused by the strategies of the bankers to enhance their prosperity.

Competition breeds efficiency in production of goods and service. But competition in the banking industry may induce banks to pay higher interest rates to attract government insured deposits to facilitate bankers to take greater risk to generate higher bonus for themselves, if not returns for stockholders. Such competition can enhance prosperity of bankers and bank equity holders. 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 of inefficiency 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 up to a limit. The government can adopt a bank foreclosure rule to ensure that banks maintain minimum

capitals. But if these rules are not enforced properly (due to holding company structures, as discussed earlier), most the banks can fail at the same time, as it happened in 2008. The current global banking crisis is due to a systemic failure due to financial moral hazard.

A general equilibrium model shows that free markets with arbitrage pricing of securities and without government deposit insurance can efficiently resolve the moral hazard problem in the banking industry.<sup>9</sup> The equilibrium in this model consists of *safe central banking* without the current Federal Reserve Act and without the Deposit Insurance Corporation in USA. *Safe central banking* offers every household and firm (not just banks) an option (a) to hold their safe assets (deposits) in a *safe central bank* which invests only in government securities and (b) to invest the remainder of their savings in potentially risky *universal banks* with no guarantee of the government. The *universal banks* will be free to maintain any capital structure, invest in any risky asset and face no government oversight or guarantee against failure. Only well-capitalized *universal banks* will, thus, succeed in equilibrium once the *safe central banking rule* is adopted by the government. No bank will have federal deposit insurance or a too-big-to-fail guarantee by taxpayers and Congress. This equilibrium will have no moral hazard risk for taxpayers. The *safe central banking rule* is closest to the *true free market economy* enshrined in the first ever written constitution, that of the United States.

This *safe central banking rule* is consistent with the OGPS philosophy.<sup>10</sup> The government will no longer insure deposits in any bank. The *safe central bank* 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 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. Bankers with little capital can no longer advantage from government-sponsored moral hazard due to deposit guarantee, once such guarantee is eliminated. Bankers 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 central banking rule* is adopted, regulators will need to monitor only the *safe central bank* to ensure that it invests in the safest government securities and has adequate capital.

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

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<sup>9</sup> See Acharya, S. (2010), "Economically Efficient Constitutional Governance," available at <http://pro-prosperity.com/Research/moralhazardliberty.pdf>

<sup>10</sup> 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>.

The *safe central banking policy* will be at least as good as the current 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 US Federal Reserve had to provide safe central banking by guaranteeing the previously uninsured money market funds and bank debts to stop the domino of panics and runs in 2008. What is additionally needed for enactment of the *equilibrium safe central banking rule* is to repeal the Federal Reserve Act of 1913 and the FDIC created via the Glass-Steagall Act of 1933, and to enact a new Safe Central Banking Act which offers no federal guarantee of bank deposits, but an option of central banking to every household and firm.

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 has cost U.S. taxpayers trillions of dollars and millions of jobs. 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*. The government deposit guarantee and the Federal Reserve Act are antithetic 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 only optimal rule of bank governance available to a *Country* to achieve *prosperity amid stability*.

**Real-world developments:** I first submitted my safe banking policy proposal to the U.S. Congress in March 2003.<sup>11</sup> 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 experts then concluded that the banks were safe and sound, despite my vivid illustrations to the contrary.

It is widely accepted now that the principal cause of the current banking failure is the multi-leveraging through off-balance sheet firewalled subsidiaries created by bank holding companies

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<sup>11</sup>Acharya, S. (2003): "Warning to US Congress in 2003 On Current Home Mortgage Debt Debacle," available at <http://www.proprosperity.com/Global%20Economy%20Chatterbox/Warning-USCongress-In-2003-On-Home-Mortgage-Debacle.html>

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 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.<sup>12</sup> 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 in 2003. But the 2008 financial market meltdown has virtually forced them to offer *safe central banking* to previously uninsured money market funds and bank debts. The U.S. government, during the 2008 financial market meltdown, also infused new capital equal to \$700 billion in several 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 central banking policy* - by insuring every bank liability except equity. But this extreme measure will still perpetuate the current government-sponsored moral hazard, causing enormous future losses to taxpayers and thus undermine prosperity of the *Country*. The current state of governance is inconsistent with my new paradigm of *optimal governance for prosperity amid stability*. The only way to achieve *prosperity amid stability* is by fully implementing my safe central banking policy.

### **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 rules to govern the price of credit are, therefore, needed to achieve *prosperity amid stability* of the *Country*.

#### **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

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<sup>12</sup>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*.

credits. Monetary economics was perhaps born then. Philosophers like Aristotle and Plato have advocated for zero rate of interest. Prophet Mohammed afterwards enunciated a new religion based on zero interest rate (riba-free economy) and on equality of all humans. The Church later adopted a philosophy of zero interest rate being good for humanity.

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 to set the price of credit based on the principles of demand and supply of modern economics. As someone who pledges allegiance to the 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.<sup>13</sup>

The ancient religious scripts offer no room for amendment. They were propagated as sacrosanct documents for governance of the human behavior. The humans have been indoctrinated in their religious dogmas, when they are young with little 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.<sup>14</sup>

The field of financial economics has considered beliefs about uncertain states of nature as the necessary components for pricing. Pricing of the credit should thus depend on how beliefs are formed universally.

The price of credit set by the top creditors or by their representatives (the central banks) may be unsustainable, leading to instability and wide-spread financial meltdown of the *Country*. The resolution of the current crisis depends on the price of credit set optimally from the point of view of the *Country*, not just the enhance prosperity of the top creditors.

### **3.2 Usurious price of credit**

The modern constitution allows for its amendment based on the latest human wisdom and democratic discourse. Most countries have adopted such constitutions. But the current financial crisis has raised doubts about whether rules adopted are constitutional and capable of begetting *prosperity amid stability* of a *Country*. Such doubts have unfortunately emboldened even people to challenge the governments. Reforming the prevailing financial system is necessary to remove doubts about the efficacy of the constitutional democratic governance. This may be daunting because the current financial meltdown seems to be rooted in an unsustainably high (usurious) price of credit.

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

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<sup>13</sup> See Acharya, S. (1995-2011), “A Unifying Philosophy of Governance,” available at <http://proprosperity.com/Research/A%20Unifying%20Philosophy%20of%20Governance.pdf>

<sup>14</sup> Acharya, S. (1995-2011): *A Unifying Philosophy of Governance*, available on the internet at: <http://www.proprosperity.com/Research/Universal%20Religion%20and%20God.pdf>

on retaining the real value of accumulated credit, not on whether the rate is usurious or whether the rate is optimal from the point of view of the *Country*.

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 used by the central banks are not very useful in determining the optimal interest rate.

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 deem optimal. This also means that the cost of credit is too high to be sustainable.

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

1. The CEOs of federally insured banks can lend credit (obtained from government insured bank deposits and Federal Reserve lending) 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 of the *Country*.
2. If the credits available at federally insured banks are instead channeled to real activities, the lending rates of interest would be much lower than they have been.
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 indicate.

The above reasons imply that the price of credit can be unsustainably usurious. The following observations indicate that the price of credit in the U.S. had been usurious before the financial meltdown.

**Real-world developments:** 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.”<sup>15</sup> 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. Investment banks are primarily 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 tottered before the Federal Reserve Board made them bank holdings companies to lend new money. Yet, the era of highly leveraged bets against pension plans, mutual funds and retail investors based on mega borrowing of 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 calls from many Federal Reserve Governors and Presidents to keep the rate that high or for even to raise it further.

In the wake of my memos, the Federal Reserve has cut the rate of interest drastically and then lowered it to 0-.25%. But lowering the benchmark rate does not make credit available at lower rates to the *Country*, the businesses and households where real economic activity flourishes. The Federal Reserve is, therefore, creating new money by buying mortgage backed securities used by government secured enterprises like Fannie Mae and Freddie Mac and even U.S. Treasury Securities.

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<sup>15</sup>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 faced by the *Country* is still usuriously high. To cut interest rate on lending to the *Country*, the government has no option but to decree by Congressional fiat:

1. To lend directly grass-root borrowers (businesses and households) 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. The government should also adopt a long-term policy of safe central 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.

**Real word 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 had announced some measure of debt relief to households. Top economists are now openly advocating debt write-downs and refinancing of mortgages at lower rate mortgage for borrowers who have not defaulted even when their home values fell below the mortgage loans outstanding.<sup>16</sup>

## 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 lent more and more risky mortgage loans.

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<sup>16</sup> See Feldstein, M (October 12, 2011), "How to stop the drop in home values," New York Times, at <http://www.nytimes.com/2011/10/13/opinion/how-to-stop-the-drop-in-home-values.html>

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 have been lent only to the prime borrowers, as per arguments of many pundits and economists, to avoid reckless lending. This means that the prime borrowers should have been choked with all the debt at lower and lower interest rates. But then growing credits lent as debts would have eventually burdened the prime borrowers to make them 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* in the *Country*. They piled up debt as their incomes and savings eroded beyond their control. So, a root cause of the crisis is an explosive growth and accumulation of credits by a few top policymakers and allied creditors who control the Federal Reserve's interest rate policy and the powerful media propagating a myth about historically low interest rates. The usuriously accumulated credits have been loaned back to the *Country* of prime producers. The prime producers have propped the economy, while facing a stealthy erosion of their incomes and savings to become 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 also 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.<sup>17</sup>

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<sup>17</sup>Acharya, Sankarshan (2005), "Prosperity: Optimal Governance, Banking, Capital Markets, Global Trade, and Exchange Rate," *Citizens Publishing*.

*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 being 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. This system 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-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 WW-II and were not defeated 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 bills on 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 and green for the posterity. This strategy will automatically defeat, nonviolently, the philosophy of terrorism and obscurantism.

## 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 gauge 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 gauge 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.<sup>18</sup> 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.

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

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<sup>18</sup>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).

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.

**Real-world actions undertaken:** This section was the theme of several memos available on the internet at [pro-prosperity.com](http://pro-prosperity.com) sent to the U.S. President, presidential candidates and ranking Senators.

Both the presidential candidates in the last 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.<sup>19</sup>

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 has been 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 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.<sup>20</sup>

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<sup>19</sup> Acharya, S. (2008): “Sub-optimality of Short-Selling,” available at <http://www.pro-prosperity.com/Research/Sub-Optimality%20of%20Short%20Selling.pdf>.

<sup>20</sup> 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>

## 5. CONCLUSION

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This paper has argued that a free market economy and democratic capitalism can maximize the *prosperity amid stability* of a *Country*, defined by the vast majority of effective producers. The first ever written constitution (of America) mandates a free market economy which has become the dominating ethos, making the *Country* prosperous and powerful.

I have argued that a free market economy can be ensured only if restrictions imposed on taxpayers due to moral hazard in the banking industry can be eliminated. I have showed that my safe central banking policy can efficiently resolve financial moral hazard and foster a free market economy. I also presented several optimal rules of governance within a free market environment to enhance competitiveness and prosperity of the *Country*.

I also presented actions undertaken by authorities in various countries in the world to promote prosperity and stability and democratic capitalism, following communications of ideas presented in the paper. These consistent actions lend immense support to the new philosophy and optimal rules of governance presented in the paper.

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 to 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.

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