Utility of Wealth, Policy and Governance

Sankarshan Acharya*
University of Illinois at Chicago

Abstract

A barometer of success of a democracy is economic freedom, as opposed to bondage, which can be measured only by net assets of voters. Democratic governments surprisingly do not measure net household assets, making it impossible to know if the majority enjoys economic freedom. Any simmering depression due to economic bondage of the majority – that is entitled to rule in a democracy – can suddenly transform into a catastrophe like great global depression. Democratic governments should adopt optimal policies to maximize individual utility of wealth while minimizing the social cost stemming from individual actions.

1. Introduction

In a pure dictatorship one individual promotes his own interests, even when doing so undermines others. A pure democracy, however, vests equal opportunity on all to promote their interests. A hybrid democracy is between a pure dictatorship and a pure democracy. A hybrid democracy is characterized by a few groups of individuals promoting their interests, even by hurting the majority interest. The few groups of individuals may be politicians, bureaucrats or their constituent special corporate interests, or the military and defense contractors.

Policies in a democracy are enacted by representative lawmakers elected by voters, who are citizens above certain age. Elected lawmakers serve for fixed terms. They can enact laws that benefit themselves and a few special corporate interests and hurt the interests of the majority. Even if the majority deciphers the fine prints in such laws, it cannot easily organize protest rallies or sue the lawmakers to stop enactment of the laws. The majority may choose a different group of lawmakers during the next term. But the new lawmakers may be no different in its approach to enact laws that benefit themselves and a few corporate interests while hurting the majority.

The laws in hybrid democracies will benefit only a few special interests including lawmakers while hurting the majority interest. Only when a catastrophe like the Great Depression unfolds does the voting majority search for clues in the bad laws hurting its interests and then devise new rules to enhance its welfare. But they may have little help from the special groups controlling the media or talking heads like the economists.

No one yet knows which public policy, if any, caused the Great Depression. Is it because the data necessary for at least post mortem analysis are never recorded, maybe deliberately?

The majority may sometimes detect and repeal bad policies afterwards. But the special interests and their political patrons will have prospered irrationally at a huge cost to the majority, by devising and using favorable laws whose deleterious effects on the majority could be deciphered, if at all, only afterwards.

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* This paper comprises of ideas based on the author's research starting in 1988. The paper was verbally composed without mathematics in 2003 and major revisions were made in 2007.

In a hybrid democracy, the majority may simply chase a mirage of equal opportunity to enhance their prosperity. Even the few special corporate and political interest groups cannot escape the catastrophic effects of policies that lead to global depression, global warming, environmental pollution, riots and nuclear proliferation.

How have the humans reached such a predicament?

Individuals maximize their utilities of wealth to make decisions, subject to constraints imposed by public policies promulgated by the government. A government representing the interests of such individuals chooses optimal public policies by maximizing the aggregate utilities of individuals. This is the current hybrid democratic government policy paradigm. It seems rational, at first blush, for individuals with finite lives. But this paradigm may eventually hurt the collective human welfare, cause social instability and stifle the efficacy of democracy in begetting equal opportunity for all. Sporadic riots, global depression, global warming, nuclear proliferation, depletion of ground water, pollution of surface water and environmental degradation can be attributed to this seemingly rational, but truly irrational paradigm.

The current hybrid democratic government 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 minimizing the cost to humanity of individual utility maximizing actions. The current economic paradigm, 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.

Most research in economics present positive theories to justify market behavior based on the current paradigm. But there is ample evidence that the market is acting like a herd, not rationally. How else would one justify NASDAQ stock index rising to 5000 and then falling to 1100 in a year? The current paradigm leads to herd behavior, by being oblivious of deleterious outcomes arising from such behavior like the Great Depression or banking panics and runs. The truly rational public policy paradigm strikes a balance between utility of wealth and potential social instability.

To enhance long run welfare of humanity, democratic governments must be responsible to design laws based on the truly rational 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 has resulted in hybrid democracies with government policymakers adopting 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 individual utility maximization paradigm may unduly accentuate self-serving behavior to undermine collective welfare. This year's 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.

The rest of this article argues how the individual utility maximization paradigm can lead to the recurrence of a devastating Great Depression. We then propose policies to enhance stability amid prosperity of humanity in a democratic world.

2. Examples of Undermining Human Welfare

Individual actions chosen to maximize wealth can badly degrade collective social welfare and then undermine individual prosperity and liberty. The current paradigm presumes that when an individual maximizes own utility of wealth, it enhances others' utilities of wealth. This presumption is obviously not correct. Maximizing own utility of wealth can lead to actions that each individual may construe to be optimal but is harmful to the majority in a society. This is illustrated in the following examples.

2.1 Groundwater Depletion

Each individual may optimally [under the current paradigm] extract ground water from an independent bore-well when the community where he lives cannot guarantee good water supply. But if every individual drills a separate bore-well, the ground water level in the geographical location of the community can recede. This can harm every individual living in the community. Ancient civilizations have perished due to deterioration of collective welfare stemming from individually optimal courses of action. The paradigm of individual utility maximization with no regard to collective social welfare is contradictory and very often harmful.

2.2 Nuclear Proliferation

Now consider maximization of (utility of) wealth of each individual nation. Wealth can be protected only by establishing security. To enhance safety of a nation against possible bombing by others, the individual utility of wealth maximization paradigm will prescribe for the nation to optimally make its own nuclear bombs. But if every nation piles up nuclear bombs to point at others, then all the bombs may explode accidentally. This will then hamper the utility of each individual nation. The paradigm that prescribes for an individual nation to maximize its own utility is thus self-contradictory.

2.3 Squandering Oil Reserve and Increasing Pollution

Take the case of oil consumption and automobile production. It is optimal for companies to produce as many automobiles as they can as long as they earn profits. It is optimal for individuals to live as independently from each other as possible. These individually optimal courses of action can lead to widespread human habitation and an unsustainably large number of automobiles. Such individually optimal human behavior imposes serious constraints on dwindling sources of oil and on an increasingly polluted environment Humans used to living in relative seclusion and comfort can suddenly discover deterioration of their collective welfare. The paradigm of individual utility maximization is thus self-contradictory.

2.4 Social Welfare and Instability

What is construed to be individually optimal – based on own utility maximization with no regard to deterioration of social welfare resulting from actions chosen by such utility maximization paradigm – may indeed be suboptimal for the individual. It is suboptimal for an individual to remain oblivious of the adverse impact of his individual choices on the welfare of the society where he lives. Our truly rational paradigm accounts for any disutility of social instability on individual wealth or prosperity. The optimal course of action for an individual stemming from this paradigm balances social instability with individual prosperity. This optimal action indeed restores a balance between myopically observable individual prosperity and farsighted cost of social instability.

2.5 Tax Policy

It may appear to be optimal to pay little tax to the government because doing so appears to enhance individual prosperity. But this may be myopic. Individuals should not be oblivious of the adverse impact on their own welfare of an undermined social infrastructure due to lower taxes or because of wealth concentrated in a few households. Any rise in the probability of social instability can dilute expected individual prosperity.

To balance social stability with individual prosperity, the wealthy may on own volition rationally (optimally) prefer to pay higher taxes than what they can consider expedient otherwise (myopically).

But how would one know that there is myopia in, say, the current tax policy of USA? It is impossible to say if the current tax policy of USA is suboptimal or irrational unless we have data on undermining of social stability due to this policy. If the number of individual households with declining prosperity (net assets) is increasing, then social stability is correspondingly deteriorating. It is, therefore, absolutely essential to measure net assets of individual households over time. The author has already proposed to the White House and Senators to measure household net assets data. Only such data over time can allow a society to fathom the degree of social instability and if stability is deteriorating under the veneer of growth in gross domestic product.

2.6 Transcending myopia for long-run prosperity

Abraham Lincoln brilliantly transcended the standard political strategy of simply representing myopic interests of voters to achieve long run prosperity and stability for the United States of America. When a mostly agrarian American economy was benefiting immensely from slavery, Lincoln saw wisdom to abolish it. Lincoln transcended the myopic interests of his constituents. He led America to an era of equal opportunity. His leadership induced inflows of talents and capital to the USA to make the nation as powerful as it is today.

Lincoln saw how liberty wangled away from people was sapping USA internally. He corrected the malaise to alleviate the looming threat to the union. His leadership begot nonpareil prosperity for USA as inflows of monetary and human capitals from abroad fostered wealth protected by equal opportunity and liberty.

3. Policies to Avert Recurrence of Great Depression

Lincoln's contribution to democracy and freedom is nonpareil. But his task was easier because the slavery (bondage) then was based on color. The current threat to democratic stability is due to potentially severe financial bondage of American households stemming from deterioration of their net assets and negative 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. Democracies do not collect such data currently. But we need this data to ascertain if financial bondage is increasing, in order to devise remedial policies.

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 own financial stability and prosperity likewise. Then a democratic government representing people should measure net assets that every household considers paramount. Why are the democratic governments worldwide not measuring the net household assets to learn if net assets of the people they serve are growing or deteriorating? I have no answer. I have made a proposal to prominent U.S. Senators and President Bush to measure net assets of individual households as a barometer of social prosperity and stability. Senator Barack Obama has responded positively to the proposal. America should lead the world to govern by truth disseminated to all citizens in its nonpareil, though impure, democracy. Growth in gross domestic product camouflages true prosperity, namely, net assets as judged by every household.

The remainder of this section argues that a great depression, maybe globally, can happen even in an era of low unemployment, and outlines some remedial policies to circumvent potential threat to democracy.

3.1 Genesis of and Triggers of Great Depression

What makes households feel secure? Is it growth in gross domestic product (GDP) or their own net assets? In general, households feel financially secure only when their net assets are positive and growing. Currently, we cannot tell if the net assets of the vast majority of households in USA or any other democracy are growing. It is because the government does not record data on net assets of individual households. Net income of American households has become zero. The net income will likely be very negative for the vast majority of households.

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. I define <u>underemployment</u> by 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 if net assets deteriorate due to prolonged severe underemployment of a vast majority of households. The government cannot collect data on underemployment. But growth in net assets of households-data on which can be collected-subsumes the effects of unemployment and underemployment on the Great Depression.

The current low unemployment statistics are not very useful and further money injection is futile if net assets of a vast majority of households have been declining due to severe underemployment. A prolonged period of high unemployment (negative net income) deteriorated the net assets of a vast majority to cause the Great Depression. A prolonged underemployment (negative net income) can also lead to decimation of net assets of the vast majority to trigger Great Depression. Repeated money injections so far may have brought us to a stage at which any further injection is perhaps futile.

Government officials mention that net negative income of households has been lately buttressed by increases in the market values of stocks. But this seems to be grossly incorrect. It is because the vast majority that is languishing by negative net income has lost trillions of dollars of net assets due to the stock market debacle of 2000-2001.[†] As a result, they have little left over stocks to gain much from current market price appreciation to make up for massive losses they have suffered. Any assertion that stock price appreciation is supplanting negative net incomes of the vast majority can be verified by only having the data on net assets of individual households.

Officials should have no hesitation to agree with my proposal for the government to collect data on net assets of individual households because (i) net assets are considered paramount by everyone in American democracy and (ii) policymakers need to know if the rising market price of stocks has been buttressing negative net incomes of the vast majority. We cannot, of course, create the past data on net assets of individual households because they have not been documented. But we should record such data now on for current and future policy directions.

A deterioration in net assets of households and negative household income due to severe underemployment of the vast majority over a prolonged period may very likely lead to a recurrence of the Great Depression, despite nearly full employment effected by continual money injection. The policy based on just the unemployment and inflation data is half-baked at best. Prolonged severe underemployment amid low unemployment and low inflation can result in negative net incomes to decimate net assets of the vast majority for the Great Depression to recur.

Declining net assets and negative net incomes (due to unemployment or underemployment) of the vast majority of households are true harbingers of a Great Depression. Low unemployment, low inflation and growth in gross domestic product can mask the true harbingers of a Great Depression. Current levels of high employment, low inflation and good GDP growth may not reveal deterioration of net assets due to prolonged periods of negative net incomes wrought by severe underemployment of the vast majority.

Zero net income for the U.S. economy would only mean negative net income for the vast majority who are net borrowers of about $38 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

[†] 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).

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 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 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 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 and 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 in devising optimal rules.

3.2 Optimal Regulatory Policies

The current financial balance across the U.S. households may be very unstable. Of about $38 trillion of debt owed by corporate firms, households and government, roughly about $4 trillion is lent by foreigners including China and Japan. The net positive asset holders within USA have thus created and extended a credit of $34 trillion as debt to the vast majority of other households who are the net borrowers. Pension fund savings are held in form of equity of highly leveraged companies, some of which like Enron and MCI-World Com have wiped out hundreds of billions of dollars. Such uneven credit-debit balance may lead to unwarranted social instability that can seriously undermine democracy.

Existing U.S. rules of law permit usurious wealth transfer from the multitude to fewer and fewer households.[‡] Reforming these rules of law is necessary to prevent the Great Depression from recurring. Only those types of regulatory reforms which will enhance the stability and prosperity of the vast majority of households should be made. The following reforms are needed:

1. Collect data on net assets of individual assets every year with tax returns. The Internal Revenue Service now has the authority to collect such data when it wants. Households routinely provide such data to lenders at the time of borrowing. If the vast majority of households are required to provide such data, there should be no problem in mandating such data collection.

2. Ban pre-Great Depression era short selling of financial securities, especially, when it leads to breech of trust between customers and their brokerages and between mutual funds and the mutual fund company's BOD-managed hedge funds.[§] The existing rules provide unequal opportunity and undue advantage to a very small minority of brokerages and mutual fund companies, as compared to the multitude of others who do not hold stocks or invest passively in mutual funds.

3. Enforce that hedge funds including brokerages, investment banks and mutual fund companies report their long and short positions in all securities, especially those in which they have more than 1% of all the outstanding shares. It is important that the brokerages, investment banks and mutual fund companies each consolidate their holdings across all hedge funds which they manage directly and indirectly through affiliates in USA and other countries and islands to report their holdings on a consolidated basis. The Security and Exchange Commission already has a rule that requires holders of more than 5% of all outstanding shares of a security report the same to government. But this rule does not apply to hedge funds that can create many accounts each holding less than 5%, while the fund holds more than 5%. The existing rule does not require a filing for short positions. Reducing the limit to 1% and bringing both short and long positions under the purview of the SEC rule will enhance transparency and contain clandestine wealth transfer.

4. Mandate that market makers and their investment banks, brokerages and clearing houses report their own as well as their affiliates' short and long positions in inventory accounts. The inventory accounts are like any individual account. Keeping large positions in inventory accounts secret creates lopsided opportunities for such account holders. Inventory account holders are large brokerages who also act as clearing houses for the exchanges and can thus see other individual account holders of securities of interest.

[‡]How the existing rules are being exploited for wealth transfer schemes is analyzed in a book: *Prosperity: Optimal Governance, Banking, Financial Markets, Global Trading and Exchange Rate*, Citizens Publishing, October 2005 (http://www.pro-prosperity.com/Citizens%20Publishing/Abstract.htm). 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).

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[§] See my memo entitled, "To Ban Short Selling" sent to the U.S. Congress, dated March 1, 2005, available in this link: http://www.pro-prosperity.com/USCongress030105.html.

5. Adopt the <u>safe banking</u> principle which will eliminate the current system of permitting large regulated banks to hold capital market operations within subsidiaries protected by legal structures known as firewalls. Such subsidiaries have played havoc by hiding their operations like in the case of Enron and MCI-WorldCom. Taxpayers have usually borne the burden to protect large federally insured banks by the government's tacit, preemptive too-big-to fail policy. Weakly capitalized banks usually make risky bets due to the moral hazard problem associated with firewalled subsidiaries.[**] The safe banking policy reform calls for deregulation of banks and institution of strictly safe banks (that invest only in Treasury securities) in which the risk-averse, panic-prone individuals can hold deposits. Prevention of banking panics will obviate regulation of other banks which will operate like the current investment banks under the control of debt and equity holders. Until the safe banking law is enacted, universal banks (which are currently regulated) should be required to maintain the minimum required regulatory capital based on consolidation across all subsidiaries including off balance sheet bankruptcy-remote entities like trusts, master trusts and conduits of the type that led to fiasco at Enron and MCI-WorldCom.[††]

Such policy reforms will level the playing field for individual wealth creation under equal opportunity which is necessary for democracy. Otherwise, lopsided wealth transfers will financially sap the majority so badly that they will likely enact irrational policies after capturing power democratically. Irrational policies will stifle innovation and weaken society that can lead to dictatorship.

4. **Optimal governance to enhance competitiveness**

Competitiveness of a country can be measured by the net exports and foreign exchange reserves. To achieve a goal of prosperity amid social 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 (source of depression and un-competitiveness) that underlies the fever. Continual application of antipyretics has debilitated 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:

[**] The author has predicted in a paper, "Safe Banking," *Journal of American Academy of Business*, August 2003 the bursting of mortgage debt subsidiaries of banks, that has unfolded now (http://www.pro-prosperity.com/Research/Safe%20Banking.pdf).

[††] When I was on a mission from Federal Reserve (as an economist assigned to devise bank capital requirements based on public rating of bank assets, as required by the U.S. Congress) I had noticed at Citicorp that they had grossly abused the minimum bank capital requirement policy through firewalled subsidiaries.

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.

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 has been 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.

The Federal Reserve Board should not be confused about the currently observed downward sloping yield curve and rising commodity prices, because the abundance of money with the *ineffective* and the current system of governance are the reasons for the "conundrums." The current state of U.S. households (in terms of net assets) is more depressing than the Japanese to support any rate of interest more than 0.5%.

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.[‡‡]

5. **Optimal Mandate for a Central Bank**

The Central Bank (CB) can use only two monetary instruments: interest rate and new money infusion.

Has, for example, the CB of the U.S. (Federal Reserve Board) used these instruments effectively to enhance American competitiveness and prosperity? A universal barometer of prosperity is household net worth. No government agency collects data on net worth of <u>all</u> individual households. But the net worth of a majority of households must be declining badly, if savings are negative for prolonged periods. Competitiveness can be measured by the foreign exchange reserves and net exports. The CB has been really ineffective in improving the quantitative measures of prosperity and competitiveness.

Should the CB simply contain price inflation and unemployment? Price of labor (wages) for the vast majority has not inflated, but the price of everything else has gone up to generate negative savings. Keeping people in jobs is important to contain depression and instability. Low unemployment must, therefore, be a wise goal of any nation. But what if even full employment cannot check depression due to declining prosperity of a majority of households? If the majority of American households has been experiencing depression due to the CB's manipulation of monetary instruments, then the goal of full employment is redundant, if not vacuous.

It behooves the lawmakers, therefore, to measure the real source of depression: declining net worth of each household. The tax agency (Internal Revenue Service) and the lenders are now authorized to collect data on any targeted household's assets and debts. A new law to collect such data for <u>all</u> households is equitable in a democracy. More importantly, though, such a law will allow policymakers to learn whether a widespread depression is simmering under the veneer of GDP growth. An ostrich-like approach to not gather the information needed to reform policy is detrimental to national <u>stability</u>, <u>prosperity</u> and <u>competitiveness</u> of a democracy.

[‡‡] 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.

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 CB achieve these goals–not some flaky targets like inflation and unemployment–by collecting all necessary data.

Whenever billions of dollars are infused or the interest rates are manipulated, the vast majority of households gets taxed/robbed with higher prices (except wages) and lower net worth.[§§] It is comforting that the current Federal Reserve Chairman has said in a speech in 2003 (when he was a governor) the interest rate volatility has real deleterious effects on economy.

The Federal Reserve now seems to be aspiring for a stable interest rate policy. But what is the correct rate of interest? The Federal Reserve has suggested in 2003 that households should prefer adjustable rate loans. This may have led to a depression in the housing and banking sectors. Equally seriously, it has resulted in distrust of the home mortgage debt investors in Wall Street and in the U.S. Financial System. Distrust in the system of governance will retard inflows of human and monetary capitals to USA. It is the equity, justice and trust in the system of governance that led to "exporting of America" to induce capital inflows, triggered by a farsighted president's abolishing of slavery. Now the vast majority is financially bonded by the current system of governance in which the investors have lost trust. This is a colossal loss of American competitiveness.

A small interest rate of 0.5% for a similarly depressing Japan should amply demonstrate that the current U.S. rate in unsustainable. The scheme of borrowing at 2% from depressed Japanese households to lend at 6-9% to equally precarious American homeowners, facing eroding income and net worth, is simply not sustainable.

The Central Banking policy on interest rate, inflation and unemployment is really redundant for achieving the national goals of stability, prosperity and competitiveness. The mandate for a Central Bank should accordingly be reformed to achieve the national goals.

5. Conclusion

Democracy can maintain social stability only if the system of governance can foster equal opportunity for enhancement of individual wealth based on perseverance, talent and skills. The majority wields power to formulate rules in a democracy. It is, therefore, important that to ensure growth, not decay, in wealth of the majority. Otherwise, there may be social instability leading to dictatorship and irrational rules. Growth in wealth tends to keep individuals psychologically stable.

The government can foster equal opportunity only through rules that maximize individual wealth while minimizing the social cost stemming from individual actions. In this regard, certain policy reforms are necessary to contain lopsided wealth transfer, which is possible under the current rules providing unequal advantage to a few by sacrificing the interests of the majority.

The role of a government is to enhance competitiveness of a country, avert potential depressions and achieve prosperity amid stability. This can be done only by letting money flow at drastically lower interest rates to the real producers of globally competitive goods, services, ideas and creativity.

[§§] This is what I wrote in a memo to the Federal Reserve in June 2001.