Citizens for Development

Dr. Sankarshan Acharya
Chairman
sacharya@pro-prosperity.com

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To: Mr. George W. Bush
President of the United States of America
White House, Washington, D.C., NW

Cc: Federal Reserve Chairman Alan Greenspan
SEC Chairman William Donaldson
Treasury Secretary John Snow

Subject: **Enhancing American Competitiveness**

Dear President Bush,

This is from someone who has contributed to American competitiveness through optimal regulations for banks[i] and security markets.[ii]

- My recent proposal on safe banking, sent to the Senate Banking Committee, has perhaps led to the Fed testifying before Congress and holding an academic conference on the issue.[iii]

- I have also reported to the SEC in 2001 about potentially suspicious trading between mutual funds and their principals that has ultimately led the Congress to implement new regulations in 2003 to ban trading between mutual funds and their principals.

- The basic idea underlying the latest Basle Accords (2003) on accounting for bank loan loss reserves was first proposed by me, as a Fed economist, in memorandum that was widely circulated among all concerned senior Fed officials.[iv]

- I have also reported to the FBI on the day of WTC bombing about a suspicious news report that appeared in the web edition of a prominent Pakistani English newspaper about the Capitol being attacked indicating that somebody there might have known the targets before the sad event. This news report was subsequently removed from the website after the fourth plane crashed in Pennsylvania.

In the best interest of the vast majority of Americans, I feel impelled to write to you a few suggestions that are beyond the purview of any federal agency to act on:

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- American Ponzi game of forever printing more and more promissory notes to fund operations and debt service cannot be sustained any longer.

- Gravest problems facing the U.S. are entirely internal, stemming from disparity in household wealth (net worth). There is a potential danger of some "al Qaeda" kind of revolt shaping within the U.S.A. unless preemptive steps are taken.

- Growth in household net worth, not gross domestic product, should be used as a barometer of social prosperity. Per-capita net worth of an absolute majority of households, reckoned from the bottom, should be tracked and announced periodically.

- The disparity between lenders' and borrowers' net worth must have widened dramatically. This may be seething under the veneer of American GDP growth. This issue bedevils most nations.[v] But America must lead the way in correctly gauging social prosperity.

- It is usurious lending of the 6th century that led Prophet Mohammed to pander to the growing disenchantment among borrowers through a new religion named "Islam" with twin precepts of zero interest rate and equality of all humans.[vi]

- The mission of the Federal Reserve Board needs to be transparently defined and executed.

- New policy measures are needed to maintain the status of the U.S. as the best nation on earth.

These issues are discussed below under three sub-sections: problems looming in the U.S. horizon, reforms needed to enhance social prosperity, and concluding remarks.

I. Problems looming in the U.S. horizon

The U.S. cannot sustain a process of borrowing (both manpower and capital) from the rest of the world to use the proceeds in warlike ventures in order to control resources that the rest of the world also needs for survival. The U.S. imports a net $700 billion of real merchandise and services from the rest of the world and borrows an extra $400 billion primarily to fund a bureaucracy that appears to be oblivious of problems facing the vast majority of Americans.

The United States is still the very best place on earth to live. But its well being is being threatened by camouflaging of the truth from vast majority of Americans that their true well being – household net worth – has perhaps eroded beyond repair. Even during the peak of NASDAQ bubble in 2000, I was telling my students that the American prosperity was a bubble waiting to burst, that NASDAQ should be around 2200, and that there would be massive job losses. When they asked what the solutions were, I would tell them that in the short-run the U.S. government, with a goal of remaining the sole superpower, would deploy its military might to take over middle-east oilfields to choke China and India because it cannot bomb Beijing or New Delhi, the future juggernauts.

Lectures on options and futures and fixed income derivatives and concepts of valuation and trading that I have been teaching are meaningless unless students remain aware of external forces that subdue such concepts to the background, making even the best hedge fund (Long Term Capital) managed by Nobel Prize winners in finance perish. My students now write to me how prophetic I was. I do not believe I was not prophetic at all. Crude oil then was priced at one-fiftieth (now one-tenth) of the price of artificial drinks like Coke and Pepsi. The concept of supply and demand determining price does not apply to a natural commodity like oil because its supplier (God?) is absent from the equation.

Saudi Arabia alone has pumped out more than $1 trillion worth of its oil since Gulf War-I, but is still a very indebted nation with massive unemployment. Where did the Saudi oil revenues perish? Most of it went to American defense contractors and the rest was nibbled away by Wall Street where the Saudi rulers hoard their wealth. These facts (not religious fanaticism) should explain why most of those who rammed into Wall Street and Pentagon were Saudi nationals.

Just examine a hypothetical scenario that USA becomes the only country with a command over all global natural resources. Can we then solve the American problems? In this scenario the rest of the nations will be enslaved, at least economically, and most Americans will be driving super limousines and bigger SUVs. The current consumption of 25% of global oil supply will eventually swell to 100%. At some point there will be no oil left and the unbridled consumption habits will automatically perish a powerful society, unless new sources of energy replacing oil emerge. The rest of the nations with consumption habits sinking to Stone Age can survive in this hypothetical scenario. Thus, search for alternatives to oil and conserving existing global natural resources should be our priority.

Suppose again that the above hypothetical scenario of America becoming the supreme power becomes a reality and scientists invent good alternatives to oil before oilfields go dry. Then also the declining wealth of an absolute majority of Americans and growing unemployment can rage them like the angry Saudis to commit unexpected shocks within the country. No one knows whom the raged Americans may target. But any target will likely be symbols of freedom that we cherish and are trying to establish elsewhere.

Out of the total debt (is it $10 trillion household debt plus $8 trillion Federal government debt?), foreigners have lent about $2.5 trillion. The rest of the lenders are from within USA. How many Americans have acquired such huge surplus to lend and how did they acquire it? The disparity between lenders and borrowers within USA must have grown very wide and is perhaps seething within. It is akin to the dangerously iniquitous economic disparity situation that Prophet Mohammed had exploited. He succeeded in pandering to the growing disenchantment against usurious lending and against the claims by some humans as being superior to others. Any discontentment, if brewing within, may spread under some other religious nomenclature to engulf societies everywhere. The U.S. is perhaps the only country that can undertake preemptive reforms to nip any such rage that may be budding under the veneer of American GDP prosperity.

II. Reforms Needed to Enhance Social Prosperity

A pursuit of dominating the world will unlikely help in solving underlying problems. The penultimate American problem is entirely internal. Let me jot down some policy reforms needed to serve the best public interest of the vast majority of Americans:[vii]

1. **Mission of Federal Reserve.** Fed should outline its goal, especially, how it is helping the vast majority of Americans through its interest rate policy which is explicitly stated as fighting inflation. If so, the Fed must explain why it is scared about deflation. The Fed expresses such fear of deflation from time to time, contrary to its explicitly stated goal. Is the Fed confused?

2. **Fed actions contrary to its mission:** In the absence of an unambiguously stated mission, let's assume that Fed is supposed to (i) regulate money supply through interest rates – to raise or [lower] the rate when inflation is expected to rise [or fall] – and (ii) facilitate the inter-bank payment system.

   What has Fed done lately with respect to mission (i)? During 1999 inflation was absent and deflation was the issue, but Fed raised interest rates, apparently to punish the stock market. Is it a goal of the Fed to control stock markets? Looking at Fed's unambiguous signal that it did not like rising stocks in 1999-2000, major investment banks established massive short positions and began trading on short side. Due to serious losses in portfolios of mostly passive investors, consumer sentiment dipped, businesses cut their investments and outsourced their jobs. How did this help the vast majority of Americans? Would the financial markets not self-adjust without the Fed dangling a dagger of higher interest rates, when deflation was the issue?

3. **Unwarranted outcomes of Fed actions**: The dramatic turn of events – consumer pessimism, corporate investment cutbacks and outsourcing triggered by higher interest rates – has subsequently forced the Fed to cut interest rates significantly to undo its mistakes. What did the Fed volte-face accomplish? Household debt mounted to $10 trillion and Federal debt to $8 trillion in addition to record levels of debts of state and local governments. Debt has choked households as well as their governments. Now, Fed and Administration are bragging about record high homeownership at reasonable household payments. What is missing from these sanguine talks is that the so-called home ownership is mostly vacuous at best because there is hardly any equity in those homes. House prices have been perhaps rigged up by banks' assessment experts to lend more to households that tend to toil to avoid default till they perish. The vast majority of households are perhaps being undercut by outsourcing, lower pay, and higher costs of education of children and health care.

4. **Social goal.** Every society aims for higher real wages and lower prices. The real per-capita wage is almost stagnant in USA for last three decades. Real wage has perhaps fallen precipitously for the vast majority of Americans, especially, after factoring in the steep rises in health care costs and college tuition. Why is the Fed then worried about falling prices (deflation) that is welcome to the vast majority of households languishing with declining real wages?

5. **GDP growth is a false measure of household well being.** The growth in gross domestic product is a meaningless barometer of social prosperity, i.e., of economic well being of the vast majority of Americans, contrary to the propaganda of most economists. For example, if some household's income rises to $100,000, while the cost of everything it depends on has risen from 80% to 100% of income, will the household be happier? The current inflation measure does not account for astronomical rises in healthcare, education and housing costs.

The real-GDP growth based on such inflation statistic is a false indicator of household prosperity that is deafeningly being broadcast everywhere to cool down the vast majority. For example, suppose that WalMart makes a product in China for $3 to sell to American households for $10, which is less than the prevailing price of the same product a year ago. Then the inflation-adjusted GDP grows by at least $7. But does this GDP growth help an average American household? No. The premise of GDP growth as a barometer of social prosperity is patently fallacious. Yet, the Fed does nothing to correct it.

6. **Household net worth growth is a true measure of well being.** It is the growth in net worth of a household that only can calibrate the progress in economic well being of a society. Let the Fed and Treasury make it a requirement for all individual households to file, during tax returns, data on their net worth. Households already supply most such data to mortgage lenders, local property tax departments, and even to IRS when demanded.

   The Fed's current survey, based on a small sample of 4000 households, is grossly inadequate and incomprehensible as it deletes – or it does not collect such data on – almost all outliers like the top 100 richest households.

   The point is why should a less useful attribute of the economy like the GDP growth be assiduously measured based on all households while a more relevant measure of economic well being, namely, net worth growth be based only on a very biased sample of households. Is it to suppress the real depression in household net worth of the vast majority that the Fed does not want to be known? Each individual household knows the decline or rise in its own net worth, but does not know the status of net worth for the vast majority.

   In a democracy, it is very important and prudent that the vast majority knows the truth about collective growth in their net worth, so that it can enact policy reforms. Otherwise, seething internal discontentment, if any, may suddenly burst open in the form of an unanticipated local "Al Qaeda" shock to the U.S. well being to render currently waged external wars irrelevant.

7. **Ban short-selling of financial securities**. How is perpetuation of short-selling of financial securities beneficial to society? Short-selling seems to be the mother of all evils afflicting the financial markets and is perhaps as rampant now as it was during Great Depression. Why should someone (short-seller) be allowed to borrow somebody else's asset to sell it in the market with an explicit purpose of depressing the price of the asset to induce the owner of the asset to sell it at losses?

   Financial assets, unlike real assets, are held only for price appreciation and dividends. If Pizza Hut discounts its pizza price, consumers flock to eat discounted pizzas. But when the financial asset's price falls, people get nervous and desist from buying whereas those that hold the asset develop a fear to sell it off at losses. Big brokerages in Wall Street exploit this psychology and short-sell even against their own clients' holdings.

   There are automatic programs brokerages use to offer shares for short-sale against their own clients' holdings. If financial markets were rational, we would not have had 5000 for NASDAQ and 1100 a year later. Such huge volatility is due to the propensity of brokerage houses (especially large ones) to push prices higher [or lower] by submitting fake block bids [or asks] when they see too many less endowed short-sellers [or holders] of a security. This causes heavy volatility with the more endowed brokerages (with capital and ability to espionage for new information) loot through their market makers and hedge fund proxies. In particular, more endowed brokerages (market makers and specialists) observe the order flow that is unobservable to others and use their hedge funds as proxies to perform unlawful trading.

Banning short-selling would go a long way in serving the best interest of the vast majority of Americans. The argument of vested interests of Wall Street that short-selling provides liquidity is a camouflage for their amoral activities. I have observed and written (not published) about many sly strategies that market makers employ to transfer wealth from naïve mutual fund investors.

III. Concluding Remarks

To conclude, here is what I believe should be done to serve the best interest of the vast majority of Americans:

a) Enact preemptive policy reforms to win any internal simmering war within USA.

b) Publish periodic growth in per-capita net worth of the absolute majority of households reckoned from the bottom. An absolute majority in a democracy has the power of vote to change the course of their government. Keeping this barometer of social stability latent can cause undesirable unanticipated shocks to the system and threaten the interests of all.

c) Do not raise the rate of interest even if inflation mounts for quite some time. Keeping interest rate lower than the rate of inflation will make the real rate negative and effectively cut the massive debt. This is necessary because every dollar borrowed has been lent from a surplus generated by selling at significantly higher prices than production costs including wages. This means productive workers have been paid less than warranted and the profits so generated have gravitated to workers in the form of debt.

   If current debt is too high, the lending amount is equally high too. But the amount lent has come from profits which must have, therefore, been usurious. Prices of products charged to consumers must have been too high and wages paid to the vast majority of productive Americans must have been too low to generate usurious profits and massive lending to consumers and productive workers. At least a part of the debt must have been due to wages that vast majority of productive workers forfeited due to producers' control over their jobs and wages.

   It is not a question of fairness raised here. It is an issue of the very viability of capitalistic democracy. Let's not forget the Great Depression era unbridled (laisez faire) capitalism which led to the vast majority losing faith in banking. The ensuing banking panics and runs culminated in establishment of the Fed and federal guarantees of bank deposits. This has made banking stable. But we have been facing systemic losses due to moral hazard associated with government insurance of deposits which has already cost taxpayers about $300 billion in failed bank bailouts during 1989-91. See the attached paper on safe banking for needed reforms.

Laisez faire capitalism has now taken an uglier form: usurious profiting from and lending to the productive majority which is reeling under a mountain of debt. Let's maintain hope that this does not lead to social instability. But we should undertake policy reforms to preempt any such possibility.

d) Cut wages of all government employees by at least 25% to help alleviate deficit problems.

e) Drastically cut spending including on wars which will unlikely engender any further inflows of human and monetary capital to American shores.

f) Work towards a borderless world within the existing visa regulations and policing of boundaries. Talented people cannot produce their best when they are huddled with unproductive free-riders. China practices a system of work permits (a form of visa) that prohibits people from moving to a city without a work permit.

g) Abolish patent rights and patenting offices. All major inventions came out of human inquisition, not due to pecuniary inducements. Patents allow only a few (capitalists) to enrich themselves by exploiting the vast majority (consumers) including inventors. A democratic government must work for the majority and not grant patents. In a patent-less regime only efficient producers will survive. Efficiency in production is vital for human development.

With best regards,

Sankarshan Acharya
Citizens for Development

Citizens for Development is a public service entity seeking no public funding to (i) promote human development without jeopardizing environment, (ii) formulate rational policies for governance and economic development of humans while maintaining the integrity of environment, (iii) operate within the ambit of existing laws and the constitution, (iii) pursue vigorously for repealing irrational laws, procedures, policies and systems, (iv) target no one personally while rejuvenating the collective pride of all citizens, (v) search for optimal, not necessarily the ideal, solutions to human problems, and (vi) strive for deployment of latest human wisdom to devise rational rules, laws, procedures and systems for governance and progress of society.

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[i] Sankarshan Acharya is a graduate of Indian Institute of Technology and holds Ph.D. in Business Finance from Northwestern University. He has served as a financial economist working on American competitiveness and optimal bank regulation at the Board of Governors of the Federal Reserve System (USA). His works have been adopted in the U.S. banking law. He was an adviser to the Board of Directors of the Federal Deposit Insurance Corporation (USA) and served as Chief Industrial Engineer in private industry in India. He has taught corporate finance, options and futures markets and fixed income securities markets in New York University, University of Illinois, and Hong Kong University of Science and Technology, and managerial economics at the National Institute for Industrial Engineering (Mumbai).

[ii] In 2001 I had written to the Fed and SEC Chairman that Fed should not have raised interest rates when the economy was experiencing deflation, not inflation, during 1999. I had also warned that the Fed would be forced to lower interest rates dramatically to rescue a sinking economy and to thwart plummeting consumer sentiment. I had reported, what I could infer

from security markets, about clandestine transfer of wealth from mutual funds to top investment bankers and mutual fund company principals. I got several feedbacks from middle rungs of the SEC, but Chairman Harvey Pitts at the time would not let the investigation proceed. I had offered my pro bono service if the SEC could help in obtaining proprietary data from trading houses. I had gathered such insights from my own experience in financial markets. It was painful to observe mutual fund investors losing trillions of dollars. New SEC Chairman afterwards proposed and the Congress implemented new regulations in late 2003 to ban trading between mutual funds and their principals and levied billions of dollars of penalty on defrauding investment bankers. Also the basic ideas underlying the latest Basle Accords (2003) on accounting for bank loan loss reserves was first proposed by me, as a Fed economist, in memorandum that was widely circulated among all concerned senior Fed officials.

[iii] See the attached short paper, "Safe Banking,"
[iv] See the references cited in the paper, "Safe Banking," as well as the letter to Fed and SEC.

[v] I was invited in August 2003 to present a paper on "exchange rate dynamics for developing economies" at Hong Kong Monetary Authority and People's Bank of China during my sabbatical at Hong Kong University of Science and Technology. I could not visit Beijing due to SARS, but presented at HKMA as follows:

- Beijing's low fixed yuan-dollar exchange rate has been immensely successful in (i) neutralizing the imperial game of currency manipulation because the yuan is calibrated to dollar in the domain of US Federal Reserve, and (ii) making China a manufacturing hub to create millions of jobs for Chinese.
- But the costs of decreeing a low yuan-dollar exchange rate are: (a) potentially brewing social instability due to widening wealth disparity between a few foreign exchange earners (exporters and expatriates) and the rest, and (b) possibly a latent explosion of non-performing bank loans. These points are explained below.
- Low yuan value results in creation of more fiat money than necessary in a few private accounts belonging to exporters and expatriates. Excessive money held in bank deposits leads to suboptimal lending, which results in non-performing bank loans.
- Only the Chinese authority can research if social discontentment is brewing and if non-performing bank loans are exploding, since data are not available to public.
- Based on the above research, only the Chinese authority should determine the yuan value by trading off job growth against banking and social instability.
- Yuan is, de facto, trading at a higher value than the official 8.27 yaun per dollar because of the possibility of default in bank deposits of exchange earners. This poses a potential danger of bank run and panics, decimating the confidence of international investors in yuan and Chinese economy.
- Bank runs and panics would erase any hope of making yuan a reserve currency of the world. Making yuan a reserve global currency should be a major Chinese strategy to undo the imperial game of currency manipulation and economic subjugation.

Within a few weeks of my talk, the Chiefs of Hong Kong Monetary Authority and the People's Bank of China met to establish a new bank regulatory authority to monitor non-performing bank loans. Then in a few months China has infused $70 billion to recapitalize bank equity. A year after my talk, many Chinese in Shanghai are withdrawing vast sums from their banks in sacks for lending to borrowers directly.

[vi] Incidentally, my only religion is rationality.
[vii]Well, Fed officials have not liked some one born in India to advise them anything on paper, though behind closed doors they would not hesitate to pump me with remarks like "you are the best expert in the world on bank regulatory policy," "no one but you can tackle this difficult problem," "just tell your ideas, without laboring hard to write memos," and so on. I am an individual of unquestionable integrity, and innately so since childhood. I hope no Fed official will impugn such integrity by saying that they did not make such flattering comments to me behind closed doors. It is not possible to buy me for any price, except to serve the best interests of public. This can be easily ascertained by enquiring everywhere I lived, studied or worked in India and USA. As an example, I once led a project on setting bank capital standards based on public ratings of banks assets as proposed in a pilot study by the US Congress. In the concluding paper, I wrote rationally in the best interest of taxpayers that the current costly government examination of banks be eliminated after public rating agencies are mandated to rate bank assets. FDIC has already shown in a study that government examinations carry no new information unknown to public and that banks were rated higher just before unprecedented banking failures in late 1980's. The Fed officials profusely praised my paper, but asked me to expunge remarks on eliminating government examination before they could submit it to Congress. I did not relent. Instead, I asked them to write their own memo without my remark.