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# A Comprehensive Economic Stimulus for our Failing Economy

Sarah R. Anderson
*Gettysburg College*

Steven T. Ferraro
*Gettysburg College*

Jeffrey D. Greenlaw
*Gettysburg College*

Justin E. Holz
*Gettysburg College*

David H. Krisch
*Gettysburg College*

***See next page for additional authors***



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Anderson, Sarah R.; Ferraro, Steven T.; Greenlaw, Jeffrey D.; Holz, Justin E.; Krisch, David H.; Koury, Jonathan M.; Kuznicki, Jamee L.; McNamee, Stephen M.; Ryckbost, Jeffrey D.; Saeger, Kristi L.; Smith, Andrew L.; Sprague, Daniel B.; Willaurer, Ryan; Wills, Timothy D.; and Wood, Benjamin B. (2009) "A Comprehensive Economic Stimulus for our Failing Economy," *Gettysburg Economic Review*: Vol. 3, Article 4.
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# A Comprehensive Economic Stimulus for our Failing Economy

**Abstract**

This paper presents a comprehensive plan to fix the ailing American economy, through a five-step approach. First, the Federal Reserve must continue to broaden the scope of monetary policy, by purchasing and selling long-term securities. Manipulating expectations through FOMC statements is another tool at the Federal Reserve's disposal. Secondly, the government must enact fiscal stimulus to stabilize the economy in the short and medium runs, through investment in infrastructure projects, green technology, fusion technology, and science education. Additionally, the new fiscal policy must tackle the mortgage meltdown, which is weighing down the entire economy. Third, the regulatory system must be changed to reduce the likelihood of another financial collapse, starting with the nationalization of the ratings agencies. Ratings should be updated faster, with a numeric grading system rather than the pre-existing letter grades. Fourth, our globalized economy insures that a coordinated globalized response is necessary to recover. Global cooperation to reduce inflation and avoid protectionist policies is vital. Finally, the American bailout policy must be made clear, only giving bailouts to companies that are sound but financially strapped and those that are too big to fail.

**Keywords**

failing economy, Federal Reserve, FOMC, monetary policy, global economy, weak market, market collapse

**Authors**

Sarah R. Anderson, Steven T. Ferraro, Jeffrey D. Greenlaw, Justin E. Holz, David H. Krisch, Jonathan M. Koury, Jamee L. Kuznicki, Stephen M. McNamee, Jeffrey D. Ryckbost, Kristi L. Saeger, Andrew L. Smith, Daniel B. Sprague, Ryan Willaurer, Timothy D. Wills, and Benjamin B. Wood

# A COMPREHENSIVE ECONOMIC STIMULUS FOR OUR FAILING ECONOMY

***Sarah Anderson, Steven Ferraro, Jeff Greenlaw, Justin Holz, David Krisch, John Koury, Jamee Kuznicki, Stephen McNamee, Jeff Ryckbost, Kristi Saeger, Andrew Smith, Danny Sprague, Ryan Willaurer, Tim Wills, Ben Wood***

**ABSTRACT**

This paper presents a comprehensive plan to fix the ailing American economy, through a five-step approach. First, the Federal Reserve must continue to broaden the scope of monetary policy, by purchasing and selling long-term securities. Manipulating expectations through FOMC statements is another tool at the Federal Reserve's disposal. Secondly, the government must enact fiscal stimulus to stabilize the economy in the short and medium runs, through investment in infrastructure projects, green technology, fusion technology, and science education. Additionally, the new fiscal policy must tackle the mortgage meltdown, which is weighing down the entire economy. Third, the regulatory system must be changed to reduce the likelihood of another financial collapse, starting with the nationalization of the ratings agencies. Ratings should be updated faster, with a numeric grading system rather than the pre-existing letter grades. Fourth, our globalized economy insures that a coordinated globalized response is necessary to recover. Global cooperation to reduce inflation and avoid protectionist policies is vital. Finally, the American bailout policy must be made clear, only giving bailouts to companies that are sound but financially strapped and those that are too big to fail.

## I. Introduction

Often heralded as the most dominant economy in modern history, the American economy has reached a critical point. The real economy is faltering at an alarming pace. We have witnessed the bursting of the housing market bubble, rising unemployment, and just last quarter saw output decline substantially. Deflationary pressures have now set in, making real interest rates appear higher, further curtailing investment. To no surprise, the National Bureau of Economic Research has officially declared us in a state of recession since December 2007.

Taking the recession from a downturn to an economic catastrophe has been the financial crisis. The true risk levels of many securities, such as mortgage-backed securities, were not known, causing financial institutions to severely misprice their assets. As foreclosure rates increased and the value of mortgage-backed securities fell, many financial institutions were left grasping for cash. The overleveraging that took place magnified the existing problems. We have witnessed the failure and rescue of financial institutions we thought "too big to fail", such as Bear Stearns, Freddie Mac and Fannie Mae, AIG, Lehman Brothers and Citibank. The interconnectedness of the major financial corporations, and the fear of more bank collapses, froze the credit markets. Although the government stepped in with a $700 billion package, the credit markets remain in disarray. Now, with our government having a substantial stake in the economy, the financial crisis has taken on even greater importance. The lack of available credit worsened the situation companies found themselves in with the ongoing recession.

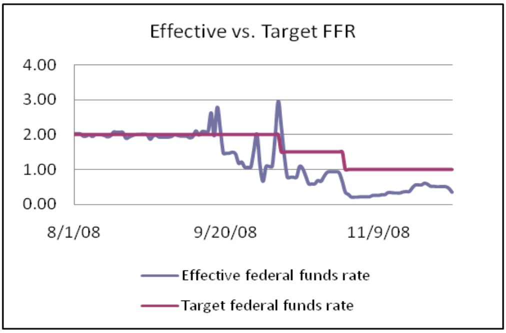
Dramatic and forceful responses are needed by all sectors of the government to combat the economic tribulations we face. The 2008 Macroeconomic Policy Senior Seminar at Gettysburg College compiled a collection of essays on a variety of economic categories that strive to give policy makers a guide to escape the mess we face. Monetary policy has entered a new horizon, as the target federal funds rate is below a quarter. The future will entail nontraditional methods aimed at a more expansionary policy and methods of altering expectations. President-elect Obama is promising a massive fiscal policy response to inject large amounts of money into the economy, looking to stabilize job loss get the economy turning again. Global trade may be a vital solution to these problems, as the world has become increasingly globalized. A unified response from different sectors of the world may be appropriate. Based on the financial mess, regulation and bailout policy must be reanalyzed. Poor regulation has been widely accepted as a cause of this crisis and bailouts give bring forth major questions which need to be answered. Our senior seminar presents these essays to tackle the economic crisis through a comprehensive approach from all angles of the world economy, as inactivity or too narrow a response by the government is not an option.

**II. Entering a New Frontier: Monetary Policy**

The U.S. economy is currently in a recession, while still experiencing the effects of the greatest financial crisis since the Great Depression. Traditional monetary policy has been ineffective in combating the problems that have arose and stimulating the real economy, forcing the Federal Reserve to take exotic actions. The Federal Reserve has and should continue to conduct monetary policy through a broader lens, no longer deciding on only the target federal funds rate but instead making broad moves toward expansionary or contractionary monetary policy. Important on the Federal Reserve's agenda must be to use its public statements to influence such things as inflationary expectations and the risk premium. Despite the importance of the short term needs of the economy, it is vital for the Federal Reserve to keep in mind long term issues, such as its independence from the Treasury and future inflation.

Traditional uses of monetary policy have proven to be ineffective at the present time, as the Federal Reserve has exhausted its use as a method of manipulating aggregate demand. In January of 2008, the funds rate was as high as 4.25%. In less than a year, the Federal Reserve made historic changes, dropping the target federal funds rate to between a quarter and zero percent. Never before in America has the target federal funds rate been so low. There is effectively no room for the Federal Reserve to lower the target rate, making traditional manipulation of the target federal funds rate nonexistent.

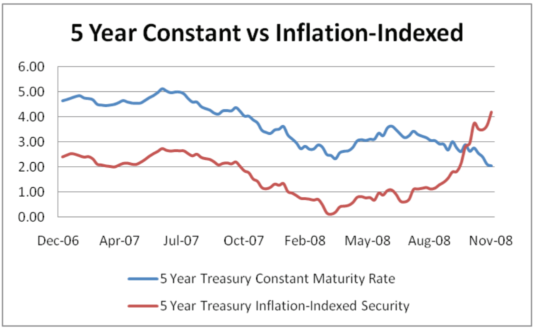
Furthermore, the effective funds rate has begun to deviate from the target rate, because of the large risk premiums and financial uncertainty in the current economy. Even before this latest rate




cut, when the target federal funds rate could be lowered somewhat further, the effective federal funds rate could not have gotten much lower. We can no longer rely on the funds rate to get us out of the recession, which has induced a state of panic.

The most recent rate cut most likely will not instill confidence in financial markets, due to the fact that the effective funds rate is no longer closely tied to the target rate and the fact that the funds rate was already approaching the zero bound. Additionally, the reduction in the funds rate will make little difference in manipulating long term risky interest rates, because it will do nothing to alter expectations on risk. The impression that the Federal Reserve has run out of weapons in which to fight the current crisis, may be given due to the most recent cut.

Decreasing the risk premium must be a top priority for the short term. One way the Federal Reserve can continue to reduce risk is through its FOMC statements. Bernanke's erratic use of exotic monetary policy has called his credibility into question, putting excess importance on those critical statements. For example, the current financial crisis has likely reached its lowest point, as credit markets are slowly beginning to function once again. Thus, the Federal Reserve can publicly say with confidence that it does not foresee any major bank failing in the future, but if one does then it will



guarantee its survival. The Federal Reserve has basically enacted such a policy (Citibank), but it has not stated it clearly. This would have the effect of increasing interbank lending, as lenders will be less concerned about the possibility of bank failure and the loss of their loaned funds. FOMC statements can play an important role in calming fears that are influenced by media outlets and politicians alike.

Another realm in which FOMC statements can affect short term policy is through inflation expectations. The Federal Reserve, through issuing statements showing a strong commitment to keeping interest rates low, can raise inflation expectations which could help in lowering the real interest rate. Currently there are fears concerning deflation in the economy, which has not been seen in America since the Great Depression. The graph below shows that the markets are anticipating deflation over the next five years. Convincing the public that deflation will not occur could be a method of enticing people to spend their money.

Another action the Federal Reserve can take, despite limitations, is to attack the term premium through conducting open market operations to purchase long term securities. Purchasing long term securities will increase the price of these assets, which will drive down interest rates. Lowering interest rates will help relieve pressure on companies looking to invest, which would provide a stimulus to the economy and promote growth. If it becomes necessary, the Federal Reserve could even purchase mortgage-backed securities to prop up mortgage prices and help banks, or they could continue to buy equity in banks to keep them afloat. All of these actions in the short-term strive to reduce the amount of unemployment.

Once these immediate concerns are resolved, monetary policy needs to focus on our long run objectives. The Federal Reserve must closely monitor the state of the economy in the following years to make sure that our current aggressive expansionary policy does not lead to long term inflationary pressures. As businesses begin to recover, the amount of money that has been injected by reducing the Federal Reserve's balance sheet must be contracted. Allowing the money to remain in the economy too long could create a system where businesses are dependent on liquidity injections from the Federal Reserve. Additionally, we do not want to remove the money too quickly, which could render banks unable to make loans and exacerbate the already weakened financial system.

As we move forward another consideration for long term policy is the relationship between the Treasury and the Federal Reserve. Historically there has been a wall of independence between the two entities. For example, the 1951 Accord was put in place to reestablish the independence of the Federal Reserve from the Treasury, after Truman and the Treasury tried to strong arm Chairman Eccles of the Federal Reserve into keeping interest rates low in order to better finance government debt. Currently the Federal Reserve and the Treasury share the same objectives, which will be convenient with Geithner as Treasury Secretary. However, in the future if their objectives no longer coincide their close relations may hinder the Federal Reserve's ability to act independently of political pressures. Once this crisis has subsided, the Federal Reserve and the Treasury must sever their ties as soon as it is feasible to do so.

The Federal Reserve is in a historic period, as it enters a horizon it has never reached – a zero percent target federal funds rate. Although Bernanke has written extensively on financial crises and what to do at the zero bound, what waits before him is unchartered territory. The actions taken by him and the Federal Reserve over the next few months and years will be revolutionary, essentially writing a new chapter in Monetary Policy textbooks. The Federal Reserve must act aggressively to foster an expansionary monetary policy, though it remains without traditional tools, while keeping in mind the long-run consequences that may result.

## III. A New Government Agenda: Fiscal Policy

The current global financial crisis has thrown the United States and much of the world into crisis. While the exact depth of recession is not yet known, it is becoming obvious that the country is facing its worst economic problem in recent history. This paper attempts to present recommendations for the United States government in regards to short term and long term fiscal policy measures that could be adopted to mitigate the effect of this crisis on the United States. We propose creating a massive fiscal policy package that will pump money into the economy in the short and medium run to help stabilize the economy from the shocks that the financial system has caused. We propose investing large amounts of capital into infrastructure projects, green technology, fusion technology, and science education. In addition to these conventional fiscal spending measures, we include suggestions for fixing problems that are more closely associated with the current slowdown. These measures address the foreclosure problem that is threatening American's homes.

The first part of our plan, which all the others are predicated on, is short-term deficit spending. To pull the nation out of recession, output and consumption must rise. To do this, a fiscal stimulus must be introduced which pumps money into the economy in a way that encourages consumption spending. At the current time, we believe the agent best able to spend the money in an efficient way would be the United States government. We do not believe that simply mailing rebate checks to families would be as effective since people will be more likely to pay off bills and debt than consume new goods and services. We have explored many different ideas about requiring the tax payers to spend the money within a short period of time and restricting them from paying off bills but this seems too difficult. We believe that telling the public that they can't pay off debt with the check they are sent would be cruel, considering that many of them need help paying off their debt. While we are aware of the problems associated with a large national deficit, we believe that the country must spend money to pull itself out of the recession. For the time being, therefore, the United States should not concern itself with the federal deficit until GDP growth is positive. Once this happens, the country can begin to pay off its large debt and must drastically change the tax code in a way that would allow the government to get out of debt.

We recommend making $400 billion available to be used on infrastructure projects over the next year. This money will be used to cover all forms of infrastructure including roads, bridges and highways as well as electric and hydro infrastructure. In addition to the use of this money at the national level, states can apply for funding for projects that they have on their books. Two independent commissions should be set up to allocate the money to the states. The first commission should be set up under the department of transportation and the second under the department of energy. States can apply for funds for anything that would fall under conventional infrastructure projects. For example New Jersey plans to spend $2.8 billion on transportation improvements next year which could be covered by this part of our plan. This plan in New Jersey is expected to create 26,000 jobs over the next year. By the federal government paying for these plans the state governments would be better able to balance their budgets.

We believe that government spending must focus on infrastructure because transportation and communication are incredibly important to growth in all parts of the United States economy. Currently, the nation's roads and bridges suffer from neglect and lack of support from the taxpayer. Rolling brownouts are still a problem in some highly populated parts of the country, and the means through which we power our cities are extremely outdated. We need to immediately begin building new roads and bridges, as well as better water and electric systems. This will create new jobs and improve efficiency in both the short and long-run. Over the next ten years even more money will need to be spent on infrastructure with many estimates ranging from $800 Billion to $1.2 trillion.

In order to maintain the proud history of technological innovation the United States has had we propose spending $100 billion on developing green technology. In regards to energy, we must strive to create energy sources that are green and do not require the consumption of oil or coal. Likewise, we must not focus on energy sources, which create large amounts of waste. Green energy, which includes wind and solar power, must be the top priority.

We propose allotting $10 billion for developing nuclear fusion as a power source. This builds more specifically off our Green energy plan. We must expand our efforts to harness nuclear fusion, which promises to be an incredible source of energy in the future. It is important that the United States lead the world in the creation of green energy, as we believe that the economic benefits of controlling the green technology market are immense.

A large portion of our fiscal policy focuses on health care. We believe that America's health care system is extremely lacking when compared to the rest of the world. Millions of Americans are not covered in the case of illness or injury. The average American is much less healthy than many citizens of other nations with lower standards of living. The government must provide health care to all citizens. We propose creating a national healthcare agency that will be placed under the Secretary of Health and Human services. The creation and organization of such a new national health care system may be expensive to implement but we believe it to be necessary. We will spend money ensuring that every American is covered under a national health care policy. For these policies to be implemented we are allocating up to $100 billion. The true nationalization will take a bit longer, but we believe it will increase efficiency in the industry. Restructuring this system will be extremely expensive in the short run, but investing in this project will create many jobs and stimulate the economy overall. Also in the long run this program may save taxpayers money since they will not need to pay the ever increasing private sector health care costs. Since, health care costs for the United States totaled $2.16 trillion in 2007, we only allocated less than 5% to reframe the system.

We are also proposing large increases in educational spending over the next year at the federal level. We propose a $10 billion dollar program to encourage students to study math, science and engineering. While we will offer economic benefits for studying science in the higher levels of education, we recognize that the impetus must come from the bottom. In this sense, we will use money to encourage young children to study science. If we can make science fun and interesting to kids at a young age, we believe that they will continue this passion through high school and into colleges and universities then finally into the work force.

We propose creating a government taskforce aimed at stabilizing the housing market by serving as an arbitrator between lenders and borrowers who are in foreclosure. The arbitration will be binding for the borrower and the lender. The government taskforce will negotiate mortgage replacement loans, which will split the loss from falling home values equally between borrowers and lenders. What this will do is prevent lenders from entering foreclosure because they would lose more money by doing so. Under this program, lenders will only lose half of the difference between what they are owed and what the home is valued at in the market, instead of somewhere between 20 and 50% of the debt, which has been the case with recent foreclosures. It will also create positive equity for borrowers who have found that they owe more than their home is worth. This plan will split the loss from falling home values between lenders and borrowers so that each party accepts 50% of the difference between home value and mortgage debt outstanding. This will be done by requiring banks to write down 50% of this difference. Then, borrowers will take a loan from the government amounting to 20% of the remaining mortgage debt outstanding, up to some yet to be determined dollar amount, at a lower interest rate. Borrowers will use this loan to pay down 20% of their mortgages. This way, their outstanding mortgage debt will be less than their home's value, in most cases, and borrowers will again have positive equity in their homes. This will also benefit lenders as the loans will be used to pay off large portions of the mortgages they hold. This will effectively lower the interest rate being paid by borrowers and ultimately make foreclosure a poorer option. Such a program would strengthen the financial sector, stabilize the subprime debt crisis, slow the rate of foreclosure, and ease the burden of borrowers' mortgage debts. We believe this would go a long way to help the economy recover and the financial sector regain liquidity.

We also propose giving the Commerce department up to $50 billion to spend on small business investment. This money will be allocated to help owners cover start up expenses which they could not otherwise find funding for. Priority of funding will be given to the best business plans and applications will be thoroughly reviewed so that the money is not just being gambled on unpromising endeavors. The commerce department shall spend the money as quickly as good ideas present themselves.

This package will require a total of $620 billion to be spent over the next year. Our ten year plan will include $1 trillion for infrastructure, $500 billion for green technology, $200 billion for national health care, $50 billion for developing nuclear fusion, and $50 billion to encourage education in the sciences. This ten-year plan requires the spending of $2.8 trillion over the period. This combination of a large short-term stimulus and a prorated ten-year spending policy will result in the creation of new jobs, the expansion and increased efficiency of the economy through infrastructure building, and a better standard of living for nearly all Americans.

As previously stated, we understand the extreme volume of our fiscal plan, and realize that there are costs in running up a large federal deficit. We maintain that the deficit must increase in the short run in order to help the economy, but also offer some alternative sources of funding for these projects. Our first source of funding would be the implementation of a federal gas tax. This tax will encourage green technology and discourage the use of inefficient SUVs and similar vehicles. The tax will give several billion dollars to the government and allow us to pay off our deficit once we have emerged from recession. Our second proposal for creating revenue is to nationalize health insurance. Doing this will save billions of dollars every year on administrative costs that goes to HMOs and insurers. We recognize that though nationalizing health care does increase government spending, it will cut costs for society. Third, we propose a major change in income taxes after we get out of the recession. Income taxes will have to rise since they make up such a large portion of government revenue. Finally, we will let the Bush tax cuts expire which we believe will raise revenue in the future.

## IV. Making Sure the Past Does Not Repeat: Regulatory Policy

In the midst of the current economic crisis, a number of faulty regulations within our financial system have surfaced. We suggest adopting new regulations to address the failures of the rating agencies, mortgage industry, and capital requirements of all financial institutions. In addition, to solve the complexity accompanied with this globalized financial turmoil, there is a need to adopt an International Securities and Banking Regulatory Agency.

In order to eliminate all credit rating bias, the entire industry must be nationalized. Rating agencies, in their current establishment, have an incentive to give ratings that make financial institutions happy. This unnatural ratings inflation has made investing less transparent, contributing to the situation we are currently in. Having a government rating institution, with a uniform credit rating standard, would instill confidence among all investors that know their rating agencies have no ulterior motive. With a clear and objective set of standards for what constitutes a certain rating, the added transparency will allow firms and investors to optimally evaluate their risk portfolios.

Recent massive losses in the collateralized debt obligations market have exposed the need for rating agencies to frequently update their assed ratings. Credit Suisse, for example, issued $340.7 million of collateral debt obligations that resulted in losses of approximately $125 million despite having a AAA rating from Standard & Poor's, Fitch Group, and Moody's. In response, the rating agencies asserted that their ratings constitute only a "point-in-time" analysis and which does not guarantee the validity of their rating at any point in the future. This example shows the need for constant reevaluation and updating of credit ratings on a quarterly basis at a minimum.

It is also important to consider, however, the effects of downgrading a firm's credit rating. In some cases, large loans to companies include clauses that state if the company's rating falls below a certain level than it must immediately repay its loan in full. These clauses were essential in the collapse of many companies, for example Enron. Since the collapse of Enron, the Securities and Exchange Commission (SEC) required every public company to disclose if they have taken out a loan with similar terms. It is essential that credit ratings are reevaluated regularly and if a company has debt that is affected by its rating then it must be taken into account in an initial evaluation. To help reduce the panic that ensues from a drop in ratings, a 1 to 100 rating system should be used in place of the old letter grade rating system.

As a government institution, rating agencies must not charge fees to debt issuers, which would eliminate the conflict of interest that the agencies might have to provide inflated ratings to the debt issuers that are paying them. It is also essential that the methodology used by the rating institution be a matter of public record. Making the rating methodology public will not only allow investors to better understand the risk associated with a certain rating, but it will also cause investors to pay more attention to the underlying fundamentals of the securities that they hold.

The subprime mortgage crisis has exposed the shortcomings of subprime lending. With little to no down payments being made on houses via non-traditional loans, subprime borrowers[7] secured mortgages for homes they were unable to afford. When the housing market collapsed, mortgage defaults and foreclosures skyrocketed. The mortgage industry now faces questions of how it has contributed

7 Borrowers with a heightened perceived risk of default, usually with a credit score lower than a specific level

to the current mess and what can be done to solve these issues. In our opinion, the following measures must be taken:

Instead of the former subprime mortgage lending practices, a different form of mortgage lending must be encouraged by subsidizing homeownership through the establishment of a down payment matching program similar to those used by many European Nations. This would help those who formally using traditional subprime mortgage lending. The government would match dollar for dollar the down payment on mortgages up to 20% of the house value, depending on income levels. Borrowers with lower income levels below $50,000 would qualify for a match of the full 20%, while higher income levels would qualify for matches on a decreasing percentage of the home's value. Through this program, homebuyers would have an incentive to obtain a higher down payment, reducing the number of subprime loans made. This strategy promotes homeownership in a way that reduces overall risk.

An additional method to discourage lending to subprime borrowers is to use a broader, more comprehensive set of eligibility factors for potential borrowers. Stringent requirements must be put in place regarding mortgage eligibility for potential homebuyers. We propose establishing a set of minimum qualification which establishes multiple factors that deliver a more complete image of the borrower—rather than simply a credit score which include: education, disciplinary history and work history. Also, lenders should be made to obtain proof of a borrower's income before making a loan. These requirements would force lenders to pay closer attention to a borrower's ability to repay.

The Fair Mortgage Practices Act (FMPA) should be signed into law. This act calls for all mortgage lenders to require a license and would set up a national registration system. It entitles the simplification of disclosures, making loan terms more transparent to borrowers. The FMPA limits prepayment penalties for certain introductory adjustable-rate mortgages (ARMs) and requires a creditor to establish, in connection with a subprime mortgage transaction, an escrow or impound account for payment of taxes and hazard insurance. The passing of the FMPA will help balance the playing field between mortgage originators and borrowers.

For the subprime mortgages that do occur, require that subprime borrowers complete a seminar on homeownership prior to obtaining a loan. These courses would be offered for no charge by state governments (with federal funding) and open to all potential homebuyers. Loan-based incentives would be given to homebuyers (specifically first-time homebuyers) conditional on completion. A strong emphasis must be placed on homebuyer education in order to inform borrowers of the risks of buying a home.

In an effort to arrest the increasing number of mortgage defaults and to stabilize housing prices, the federal government should implement a program of mortgage replacement loans. These loans would offer all homeowners with mortgages the opportunity to replace a fifth of their existing mortgage (up to some dollar limit) with a government loan. Unlike most mortgages, these government loans would be full-recourse loans that would have to be repaid regardless. They would carry a substantially lower interest rate than the individual's mortgage, thereby making it easier to make payments and prevent default.

These recommendations will lead to a sounder mortgage industry in which subprime mortgages, defaults, and foreclosures are scarce.

The banking industry has long based asset reserve and capital requirement systems on rating agency modeling. The disclosure of risk to potential investors, while providing enormous amounts of opportunity over the short term, has substantially increased the amount of risk taken on by investors in the dark about many of the banks' long-term and unrealized capital held apart from their disclosed core capital reserves (Tier 1 capital). The opaque information available on financial institutions regarding their remaining long-term capital reserves (Tier 2 and 3) is unknown to private market participants and regulators.

The Basel Committee on Banking Supervision (2006) defines Tier 2 and Tier 3 capital as consisting of five types of reserves: undisclosed, revaluation, general loan-loss, hybrid debt capital instruments, and subordinated term debt. Undisclosed reserves are unpublished reserves by institutions similar to published Tier 1 core capital reserves that have passed through the profit loss account, but lack proper transparency. The revaluation reserves are assets that the financial institution recalculates based on estimated current values instead of their historical value.[8] Financial institutions that own an asset with an unrealized loss or gain constitute the general loan-loss delimited Tier 2 category of reserves. Hybrid debt capital instruments are assets that combine certain characteristics of equity and certain characteristics of debt such as cumulative preference shares.[9] Tier 3 capital consists only of subordinated term debt instruments issued to outside buyers which pay a fixed maturity and are unable to absorb losses except in liquidation. This instrument is used to raise short-term capital to cover market risks such as losses incurred by mortgage backed security holdings.

The lack of previous regulation to require institutions to disclose Tier 2 and 3 reserves increased the incentive to take riskier positions in hopes of greater potential profits during boom-times. The SEC further exacerbated this risk taking in 2004 by allowing the five largest financial institutions to have debt-to-net capital leverage ratios of 40 to 1 as opposed to the previous limit of 12 to 1. This over-leveraging and subsequent losses formed Special Investment Vehicles which allowed institutions (such as Citibank) to hold risky assets like subprime mortgage backed securities off their books to give the appearance of financial health. The creation of SIVs and over-leveraging by banks were a direct result of the lack of transparency of their long-term Tier 2 and Tier 3 assets. Any reform of banking regulation must include an unconditional disclosure of *all* assets by institutions to investors and regulators.

8 An example of this type of reserve would be a security or other asset which changes value

9 Cumulative preference shares are equity shares which ensure a payment of a missed dividend for a future date

The solution to all of the sub-topics explored is the founding of a new International Securities and Banking Regulatory Agency (ISBRA). The focus of this new ISBRA would include the regulation of international markets and ensuring investment standards across international borders. Such a solution exists for international aid, war, and politics but the globalization of financial markets has yet produced proper oversight of the formation of complicated derivatives across sovereign national economies. Long-term stability in the interconnected globalized market cannot be achieved without the formation of an ISBRA like institution.

**V. Solutions for a Global World: International Trade Policy**

The increasing amount of economic interdependence since the end of World War II and the subsequent creation of modern financial institutions and trade agreements requires that the recent financial crisis be dealt with on an international scale. Such an approach is necessary in order to promote worldwide stability and prevent the situation from escalating to levels unforeseen since the Great Depression. Regulatory, monetary, and fiscal actions taken by each nation now will have an ultimate effect on the terms of trade and future conditions of the worsening financial situation; therefore, all issues must be addressed with universal cooperation. Below are four policy recommendations directed toward all participants of the international economic system, without regard to developmental status or particular share of the global market.

The implementation of any new or extensive protectionist measures must be avoided by all nations participating in trade at this time of financial crisis. The economies of developing nations must be taken into special consideration to uphold the current world economic order and maintain relative stability within the international system. Any implementation of new or further regulations and barriers to trade would have a negative effect on the growth rate of such economies, consequently escalating the crisis to unprecedented levels. The consequences of additional protectionist measures can be prevented as long as they are addressed now.

The World Trade Organization strongly advises that governments do not attempt to protect their domestic industries that potentially could be affected by the crisis. The latest WTO Agenda for Doha Development rounds calls for "special and differential treatment" to be given to countries that lack key financial institutions, like governmental agencies and central banks free of corruption, which are necessary in order to maintain overall economic stability. It also calls for a dramatic decline in agricultural subsidies and import barriers, as has each Agenda since 2001. The most recent 2008 rounds request developed nations to see to a 50% or higher reduction in import tariffs; while asking developing nations to open up by at least 33% within the next two years. Prior agreements formed after the 1994 round are causing a conflict of interest with these suggestions, due to their allowance of safeguards in response to the decision to replace quotas and other barriers with strictly tariffs. Lastly, it is recommended that the WTO work to take full precautionary measures to monitor all countries involved in international trade agreements, with particular attention given to those that hold a large share of the world market.

The best example of the problems associated with protectionism during a financial downturn occurred during the Great Depression. From 1929 to 1932, world trade declined tremendously due to a number of factors; the increase in both tariffs and nontariff barriers significantly influenced the decline. For example, the United States' Smoot-Hawley Act of 1930 alone produced serious repercussions for the entire world system. The Act no longer allowed for easy entry by foreign competitors into U.S. agricultural markets and placed tariffs on tens of thousands of previously imported goods. Entry was difficult for some products; for others it was nearly impossible. Smoot-Hawley encouraged other nations to generate additional regulations on imported goods, specifically agriculture, which ultimately led to the considerable decline in the world market and individual economies' balance sheets. Smoot-Hawley also reduced the United States' role as a major world creditor by prohibiting the issuance of new loans and discontinuing previous loans, upon which other economies had become dependent to finance their trade deficits. This reduction in available credit also contributed to the decline in world trade; therefore it is recommended that actions similar to those promoted by Smoot-Hawley be averted.

Independence among the executive board of the IMF from being involved in individual government agendas is important as well as an expansion of its lending capacity. It is important to ensure that Amendments to the Articles of the Agreement on which the Fund was founded will ensure more transparency, independence, and accountability of the Executive Board, and not that the members do not focus on their respective home country's national interests. These amendments should include making the Executive Directors accountable for their decisions. If they are pursuing private government agendas, an Interim Committee should be able to step in and remove the Executive Director from his or her position. If the IMF were more independent from political and sovereign influence, financial institutions would have a better opportunity to understand the true risks facing them, as there would be no political pressure clouding their view of risk.

Currently the IMF has a lending capacity of $250 billion, which would not be sufficient for an emerging market in financial need. An increase in the IMF lending capacity to at least $700 billion is necessary to help liquidity-strapped countries that are suffering from the spillover of the financial crisis. Asian governments must be incorporated in the restructuring of the IMF to expand its lending capacity because these countries have the financial backing that is needed. Incorporation of China and other emerging economies to the fund's board will help expand the lending capacity and loosen the stigma associated with borrowing from the IMF.

Latin America has felt the spillover of the U.S. financial crisis. As the recession worsens in the U.S., export revenues and foreign direct investment (FDI) will decline in Latin America. The UNCTAD (U.N. Conference on Trade and Development) reported that for the first six months of 2008 international transactions were down 29% as compared to the same period in 2007. In addition, they reported that FDI decreased by 10% for 2008. The World Bank revised its growth estimates for Latin America in 2009 from 4.2 percent to between 2.5 and 3.5 percent in light of the U.S. recession. This spillover effect is due to the shrinking of global credit and the decline in commodity prices. If the crisis continues, export industries dependent on the U.S. textile, steel and other mineral imports will see a decrease in the U.S. demand, and therefore a decrease in their exports. Increased lending capacity of the IMF is important for struggling nations that will be hurt by the decrease in the U.S. imports and FDI.

The reality of bankruptcy is evident in the financial crisis therefore the establishment of an International Bankruptcy Court to deal with international cooperation and the liquidafication their assets is needed. Mexico and Venezuela will be hurt by the decline in U.S. imports because of their dependence on external consumption. Venezuela depends on exporting its crude oil to the U.S. as it is one of the only countries that can refine their oil. The lower prices of petroleum may spark a decline in demand for Venezuelan oil exports. Venezuela was affected by the financial breakup of Lehman Brother's assets—among other countries. Since Lehman Brother's was an international financial institution, when it went bankrupt, regulators in each country froze its assets in the home country branch to protect the small investors within the country causing a global credit crunch and stock market crash. The global credit crunch and stock market increased the fear that no banks were safe and interbank lending seized up. However, international bankruptcy laws differ across countries and therefore the liquidation of asset position and returning assets to the creditors is extremely difficult and timely. Lehman Brothers is an example of how an international system to deal with the bankruptcy of international financial institutions is needed to avoid the moral hazard dilemma and governments being forced to bail them out.

Initially established in response to the 1970s' oil supply crises, the annual Group of 8 (G8) summit meetings have proven useful in theory and practice in the past. However, in the event of the recent financial crisis, the original framework is now outdated and inefficient in its current form. The full potential of the Group is not being met due to the absence of valuable input from all regions of the world, and it highly recommended that new seats be added or prior seats be replaced.

Within the current system, emerging market economies such as nations in Asia and Latin America are not represented, and neither is Africa. The European Union, on the other hand, offers a single representative when the summit is held outside of their jurisdiction; two when its member-nations act as host. The immense size and power of the EU market requires more than one contributing voice to accurately present its position to the forum. Global representation, in terms of a more regionally balanced set of participating delegates, will help the IMF better understand world crises from a more well-rounded prospective, helping them create a more effective agenda for addressing its relevant issues in the future.

The increasing significance of these relatively new markets has a direct effect on global conditions. The prospect of a worsening recession or worldwide state of economic depression calls for full participation. The 1999 introduction of the Group of 20 (G20) summit meetings allows for industrial and developing nations to come together to discuss international finance and economic concerns, but the size of the forum generates some concern over the effectiveness of their efforts. Therefore, adjustments to G8 will be presumably more beneficial and productive in structural nature.

The existence of a wide range of political and economic systems within countries engaged in trade requires that international objectives be met by a heterogeneous plan of action, in which all G8/G20 members regulate accordingly with respect to their individual system. It is not recommended that a single monetary or fiscal approach be agreed upon amongst all nations, but rather a spectrum of adjustments be pursued in order to reach the common goal.

An international commitment to fighting inflation will help ensure that excessive bubbles do not occur in the future. As the U.S. consumption is decreasing, imports decrease as well. Foreign governments will be tempted to inflate their currency and build up U.S. reserves. This may have worked for China in the short-run, as now they are in a position to protect themselves from the global credit crunch and the foreign capital flight, although it is monetary practices like that which help create bubbles and the eventual demise of the current financial system. Current account surpluses or deficits are a good monetary tool to cope with shocks in the finance and investment; however, the massive trade imbalances only would worsen the crisis.

To ensure that these excessive booms and busts do not occur in the future the IMF should regulate the exchange rates of countries to represent their true market value. Countries that peg their currencies must commit to adjusting their interest rates to target keeping inflation low. Countries such as China would need to float their exchange rate in order to be able to increase interest rates if there was a threat of high inflation. This would not work unless there was international commitment to coordination, especially among trading partners. Along with targeting inflation, each country should look at its financial situation to help balance the international financial system. Countries such as China and Germany should coordinate fiscal stimulus, however countries such as the U.S. and the U.K. should refrain from large fiscal stimulus packages that could offset and possible worsen the international financial imbalance.

The U.S. must lead the global economic response out of the financial turmoil that ensued from the financial and housing bubbles. It must make push for reforms to the IMF to create independence, accountability and transparency that will increase the lending capacity of the IMF. The G8 should expand to include Asian and Latin American markets. Reforms to the Work Bank are encouraged to set a standard for international bankruptcy laws. The U.S. should avoid protectionism measures at all costs to ensure that there is no greater spillover effect to other countries. The WTO should monitor countries to ensure that no new protectionist measures are implemented. Countries should be committed to low inflation and a flexible exchange rate.

**VI. What is Worth Saving?: Bailout Policy**

Government money should go to companies with sound business models that have proven to be profitable and efficient in the past but are in desperate need of money for survival. This is the case with the banking industry. Many of the banks have been very profitable in the past (if not too profitable from the excessive risk taken on) but their assets have dramatically decreased in value while their liabilities remain very high. An injection of cash can bring their assets and liabilities back to equilibrium, allowing them to function properly. Breaking up a big conglomerate company such as Citigroup is a dangerous proposal and one that should be generally avoided as the sections a company often rely on each other for support and provide diversification. Taking a sector of the business away will cause problems even in the previously healthy segments.

Despite our support for bailouts of certain industries, we believe that using taxpayer money for private companies should be avoided whenever possible, as it will create a moral hazard problem by allowing companies to take on excessive risk knowing that they will not be allowed to fail by the government. Bailouts must come with stipulations to avoid these problems. Our solution to this problem is both simple and complex.

First, we suggest that one of the requirements of bailout money is the immediate firing of the CFO or CEO. The reason for this perceivably harsh decision has its basis in simple business class teachings. Hypothetically speaking, let's say one day the CEO or CFO of a regular publicly owned company was to walk into the board room and explain to its members that they needed to give him a blank check or the company would fail. I would suggest that nearly every company's board would demand the immediate firing of the CFO and in many cases they would go after the CEO as well. Furthermore, the idea that the board would then sit down and listen to the proposed idea of the CFO is clearly absurd. Yet, the United States government has done exactly that thus far. They have allowed these companies' CEOs to walk into Congress and ask for large sums of money without showing any signs of structural change within their companies. Yet, if one of the requirements of bailing a company out involved the dismissal of one of the company's chief officers it would begin to solve the problem of "moral hazard." Practically speaking, if the chief officers of these large public companies know that their jobs are on the line if the companies are forced into this type of bailout situation then we believe these individuals will act more responsibly and take fewer risks. The firing of the CFO or CEO of a company also signals an enormous commitment to change that the general taxpayer can see. This helps to reestablish the government and the general public's trust in a company's commitment to change and eventual ability to become profitable in the future. Cases will arise where companies in crisis have replaced their management, leaving new executives to save the failing company. The new officer or officers seeking the bailout may be able to keep their jobs if it is determined by the task force that they were not responsible for the current position of the company and are in fact the right people for the job post bailout money and requirements.

Our second requirement of companies who are seeking a government sponsored bailout is their submittal to a third party review board. This review board or task force would be temporary and compiled only in necessary situations, like the current crisis. More specifically, the review board would consist of a group of individuals outside of Congress who would go over and review the finances and the application of the business model of any companies who are seeking bailout money. This board would be appointed by members of congress and would work with congress to determine which companies are appropriate candidates for a bailout. When you are dealing with large amounts of taxpayers' money, the elected officials should have the final say. We are suggesting, however, that this board consist of members outside of Congress who are much more knowledgeable in the workings of various businesses in specific industries. The Treasury department is filled with highly capable men and women who are extremely familiar with the financial markets and private firms. For example, as secretary, Hank Paulson has previously worked for Goldman Sachs. When it comes to other industries, however, such as car manufacturing, lawmakers are not the best suited to evaluate and allocate money to best support the industry. In this scenario, there would need to be a specialized review board for each bailout case. This would ensure that every company would have people on their review board who are extremely familiar with their industry and business model. This second stipulation would make the entire process seem more credible to the general public and also point out the obvious flaws in each company's business, making the use of the bailout money as efficient as possible.

Unfortunately, not just companies that do not have enough money in the short term are in need of a government bailout. Ailing businesses turn to the government with varying degrees of necessity. One situation in which bailouts are a necessary evil is when a company is too big to fail. In other words, if the company is allowed to fail it will have ramifications for the entire industry, which has the potential effect of causing major long term damage to the macroeconomy. The big three auto-manufacturers are an example of this. If one of these auto giants is allowed to fail it has the potential to start a chain reaction that will bring down the entire auto industry. One estimate is that there will be three million lost jobs in 2009 if there is a 50% decline in the U.S. auto production.[10] This

10 Hight, 2008

number includes not only the workers for the big three auto-manufacturers, but also workers at companies that supply the big auto companies. Additionally, if these auto companies go under there is a chance that their retirees will not receive the full pension that they rely on, making the stress on the macroeconomy, and in particular aggregate demand, even greater. In our current economic state, on the verge of one of the biggest recessions in recent history with unemployment already at 6.5%, this collapse could be catastrophic, deepening and prolonging the recession.

In a similar circumstance in 1980, Chrysler was given a bailout through the Chrysler Loan Guarantee Act. This loan was paid back in three years, seven years before the scheduled deadline. This shows that bailouts of this type have been successful in the short and medium run in the past. The overall goal, however, should be to ensure that these companies never have to be bailed out again. For this to happen there needs to be some significant changes in these companies and perhaps U.S. policy. First, the third party review board and new management must work with the United Auto Workers union to make concessions in its members pay and benefits. This restructuring of benefits should focus on the overly generous pension plans that these companies offer. It is extremely unproductive for these companies to be paying such large amounts to workers that they no longer employ. While we recognize that these workers are entitled to those benefits, some compromise must be worked out to restructure the benefits to ensure that the companies can compete and do not fail. Additionally, one policy that the U.S. Government may need to consider is a socialized medical plan. The big three auto companies, as well as many other U.S. companies that employ unionized workers, have very comprehensive health plans that represent huge costs. These substantial costs make it hard for U.S. companies to compete internationally with companies that do not have such comprehensive health coverage plans. Another policy that the U.S. Government may want to consider is leveling gas prices by utilizing a floating gasoline tax. This would stabilize the demand for fuel efficient autos, eliminating the large swings in demand that can occur when oil prices are allowed to fluctuate wildly. (Hight, 2008) This policy of a gasoline tax, however, would be best if implemented after the economy has recovered from its current recession.

On Friday December 12th, both General Motors and Chrysler failed to secure a government bail-out. Although we had suggested that it was in our economy's best interest to bail-out these firms that are "too large to fail," congressional Republicans obviously disagreed. Ideally, the plan to bail-out these firms would have used a completely different source of funds to provide the $14 billion bailout that GM and Chrysler were seeking. Ironically, the plan had the support of the Democrats and the White House yet President Bush's own party would not side with him on the matter, and the result could be disastrous.

GM and Chrysler came to Congress this month pleading that the government bail them out. The two giants of the auto industry claimed that if the government did not temporarily bail them out they were within weeks of running out of funds that they needed to continue to operate. Here we are a few weeks later and both of these companies have been refused the requested bailout money and are on the steps of bankruptcy. This leaves President Bush with two options: let the automakers fail or bail them out with TARP money. Unfortunately, neither option seems very pretty. Allowing these large companies to fail would leave a significant portion of the work force unemployed. In addition, the ripple effect of these two companies' collapse could hurt the economy in ways we haven't imagined. On the other hand, bailout money from TARP would have a terrible effect in the long run. Under the guidelines of TARP, these companies would not be forced to adhere to any of the guidelines we had set out for them earlier in our proposal. In addition, these companies would not be forced to restructure or remove any of their chief officers. Essentially, by using TARP money, we would literally be "throwing taxpayers' money at the problem."

The fallout from Congress' decision was almost immediate. After Congress refused to bail-out GM and Chrysler on Friday, rumor had it that President Bush has already put in motion the decision to tap into the $700 billion bailout money congress had set aside for the failing financial industry. TARP or the Troubled Asset Relief Program is controlled by the Treasury Department who also voiced a strong opinion in favor of tapping into the remaining money was a stopgap help for the automakers. In a statement released Friday by the Treasury stated, "because Congress failed to act, we will stand ready to prevent an imminent failure until Congress reconvenes and acts to address the long-term viability of the industry."[11]

Ultimately, it seems that there is little anyone can do to prevent President Bush or the Treasury from tapping into the remaining funds left in TARP. However, it is essential for our future economic well being that when Congress reconvenes on January 6, 2009 that they immediately address the issue of using TARP money to bailout GM and Chrysler. Hopefully, the conditions under which these two companies are allowed to access these funds will have a limited lifespan which will expire at some time in January. This would allow Congress to re-examine, under a new administration, how it plans to handle bailouts for automakers in the long run. Hopefully, at this January meeting Congress will come to its senses and agree that using separate funds to bailout these companies under stricter conditions (as we have proposed) is a necessity.

11 Isidore, Chris. "Treasury bailout targeted for big 3." CNNMoney.com. December 14, 2008.