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School of Optimal Governance

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Honorable President of the USA
Honorable President-elect of USA
Honorable Vice President-elect Joe Biden
Honorable Speaker Nancy Pelosi
Honorable Senator Harry Reid
Honorable Senator John McCain
Honorable House Member Barney Frank
Honorable Chairman of Federal Reserve

Sub: An Optimal Strategy to Revive Economic Boom with Enormous Profits to Taxpayers.

I. A Sagacious Interest Rate Policy

There used to be a tacit policy of the US Congress to ensure that mortgage interest rates did not exceed the Fed Funds rate by more than about 2.5%. I have read about the U.S. Congress raising voice whenever this policy was transgressed by banks. The 2.5% premium is sufficient to cover debt service and earn a fair return on equity capital invested in financial institutions. This policy is not only sound in terms of fairness, it is also central to the crisis we are facing now.

A fair lending rate is at the heart of the historical struggle between creditors and debtors. Creditors have a tendency of collecting usurious interest rates from debtors. When the system of usury reaches the extreme that the debtors can no longer bear, the system breaks down.

The U.S. Congress has perhaps followed, sagaciously even if subconsciously, the tacit rule of making the lending rate equal to the Fed Funds Rate plus 2.5% to prevent the system from breaking down.

The system broke down because the tacit policy was not followed since 2002. I tried my best but failed to get a floating rate mortgage loan linked to the Fed Funds rate in 2003, 2004 and 2007. I was offered only rates linked to a funky LIBOR. I knew that the banks would manipulate the vast majority of borrowers through an index like LIBOR that they, not the US Congress, could control.

A few bankers have usurped the enormous power of a democracy by rendering the Congress and the vast majority (the borrowers) powerless. The bankers have destabilized the system and brought financial ruin even for themselves.

II. An Optimal Strategy to Restore the Sagacious Interest Rate Policy

The financial crisis can be completely reversed to pave the way for a new economic boom if we adopt the above sagacious tacit Congressional policy via two sound principles, which have been already embraced by

the current administration:

1. Cutting the interest rate for lending to financial institutions to 0-.25 percent. This would alleviate the pain of financial institutions that had borrowed at low rates from Japan and USA during the low interest rate regime in 2002-03 to invest in risky real estate and stocks. The financial institutions can now borrow new money from taxpayers at much lower rates than the low prevailed during 2002-03 to repay their higher interest rate loans. But the financial institutions are still stuck with the risky assets.

2. Investing taxpayer funds (TARP or whatever else) in form of equity only in the sound financial institutions. The prevailing logic is that the taxpayers will lose if the government infuses funds to financially tottering banks which cannot deliver banking service due to mismanagement. I am stating this as a principle accepted by the current administration. I argue later how this logic is specious, as it does not make the "principle of infusing taxpayer funds as equity in healthy banks" optimal for taxpayers.

The above principles should pave the way for an urgent new optimal strategy:

Refinance all existing mortgage holders in good standing at the Fed Funds rate plus 2.5% with no closing costs and for the full amount of the mortgage loan balance, with no regard to property value, through Fannie Mae and Freddie Mac even if other banks reciprocate. The loan-to-value is immaterial for all prime mortgage holders who are current, paying their monthly dues in full. The proposed strategy of refinancing mortgage loans of prime households is very different from the currently floated proposals for helping subprime home owners avoid foreclosure or for inducing potential home buyers to purchase homes through government decreed lower fixed mortgage interest rate of 4.5%.

1. The optimal strategy is not costly to taxpayers because it is based on a fair floating interest rate, unlike the current proposals. This strategy is not a giveaway to any existing mortgage holder in good standing because the floating rate being offered is a fair rate in the current low rate environment. The proposal of offering a lower fixed mortgage interest rate to replace a higher fixed rate held by existing home owners is costly to taxpayers. Because the strategy is fair to taxpayers and mortgage holders, many existing mortgage holders with fixed interest rates may not necessarily revert to the fair floating rate proposed here.[1]

2. This strategy will still earn fair returns on the investments taxpayers make in Fannie Mae and Freddie Mac because of the premium of 2.5% over cost of funds to these institutions. At such premium, banks have historically demonstrated profitability.

3. This strategy will release most mortgage holders out of the current doldrums due to uncontrollable LIBOR linked interest rates.

4. This strategy will cost taxpayers little except the closing costs. The cost is less than the stimulus checks mailed out by the current administration.

5. This strategy will retain for Fannie Mae and Freddie Mac the flexibility of collecting higher interest

[1] My household has a 6% fixed rate mortgage loan. It is not clear for us if we would benefit from the rule I am proposing here because we may be more interested in a lower fixed rate mortgage loan.

rates from home owners when inflation resurfaces again. The fixed 4.5% mortgage interest rate contracts envisaged by many thinkers will fail to accomplish such flexibility and will cost taxpayers dearly when inflation resurfaces. Besides, government induced demand for housing through lower mortgage interest rate will unduly expand supply in relation to the true underlying demand as happened during 2003-2005.

6. The new strategy will create no new money that is the main cause of inflation and erosion of living standards of the vast majority. New money effectively robs prosperity of people who work hard and prop the whole system. The effective producers are pillars of a society who feed and secure the rulers as well as the lethargic and the poor. A democratic government representing the best interest of the vast majority should never follow policies that undermine the effective producers who form the vast majority and who prop national competitiveness and prosperity.

7. The new strategy will thwart moral hazard by discouraging households to give up their homes during a time when the property value falls below the mortgage loan amount. It will encourage household to meet their mortgage payment obligations even during rough times. No bank would like to hold real estate that does not generate incomes.

8. The new strategy will face no political opposition because it is consistent with the principles already followed by the current administration.

The overwhelming justification for the new strategy as an <u>urgent necessity</u> to restore the sagacious (non-usurious) interest rate policy establishes an optimal role for national mortgage lenders, like the GSEs of Fannie Mae and Freddie Mac. The GSEs were created after the Great Depression to avert a recurrence of a financial crisis of the type we are now experiencing. The GSEs were unfortunately forced by the government to buy a vast amount of usuriously created liar loans, option ARMs and LIBOR ARMs to yield windfall profits for private mortgage originators and private middlemen bankers by burdening the taxpayers. The private beneficiaries in fact destroyed the capitals of the GSEs and then blundered in pushing for elimination of the GSEs. The maneuver to eliminate GSEs panicked investors worldwide to scale back lending in the US, which has made the Federal Reserve the lender of the last resort. This process has hurt the creditors more severely than the vast majority of effective producers of globally competitive goods and services. This is what I had prognosticated since 2003-05. This is why I have been stressing that the best interests of even the creditors would be served only if the effective producers remain prosperous and stable, not cannibalized by usury.

I had earlier proposed for infusing equity from taxpayer funds to a national commercial bank (by creating one) and to the existing national mortgage banks (Fannie and Freddie) to facilitate direct lending to businesses and households at reduced interest rates. Infusing TARP funds as equity capital in healthy banks was better than buying toxic bank assets. But it was a very inefficient use of taxpayer funds because it could not effect direct lending to businesses and households at reduced rates, as I had argued earlier. The healthy private banks that received more equity capital from taxpayers resorted to the same old tactics of causing capital market volatility to usurp wealth from investments in pension plans and mutual funds that hurt taxpayers all along. Giving away taxpayer funds to the private banks was thus a very suboptimal strategy for taxpayers. I hope the remainder of taxpayer funds held in form of TARP is not misused and is, instead, infused to national mortgage banks or a new national commercial bank if one is created.

I see immense prosperity amid stability only if the above optimal strategy is followed. I also see that the

government will be willy-nilly forced to follow the above optimal strategy, maybe after more pain to society, if not immediately. This government would eventually be forced to infuse fresh massive capital to restore the optimal role for the GSEs to serve the best interest of taxpayers.

III. Value of the Proposed Strategy to Taxpayers

Suppose that:

(a) $350 billion is infused as equity capital to Fannie Mae and Freddie Mac.
(b) The current average mortgage rate is 7.00%.
(c) $10 trillion of outstanding mortgages are refinanced at 2.75%.
(d) The difference between lending rate and cost of funds to banks (lenders to prime households) is approximately equal to the difference that will prevail under the proposed strategy. The tax revenues earned by the government from the lending institutions will thus be unaffected, approximately.

Then:

(a) The interest rate reduction will be 7.00-2.75 = 4.25% on $10 trillion or $425 billion per year. This amount will increase income tax collected by IRS by about 33% or approximately $141 billion.[2]
(b) The sales tax accruing to state and local governments from increased household spending will also rise, leading to stimulation of economic activity and more tax revenues to IRS.
(c) Taking a conservative estimate of about $150 billion of increase in annual government tax revenues due to the new strategy, the present value of this annual cash flow series at 2.75% discount rate corresponding to the risk of refinancing is approximately 150/.0275 or about 5455 billion in present value accruing to taxpayers.
(d) The present value of the proposed strategy to taxpayers is 18 times higher than the TARP funds of $350 billion that may be needed now to prime up equity in Fannie Mae and Freddie Mac.
(e) The benefits of the low interest rate environment should accrue to the vast majority as well as to the government that safeguards prosperity amid stability of the nation.
(f) There is no jugglery in this win-win strategy.

How should the equity capital infusion to Fannie and Freddie be priced?

(a) Fairly, it should be equal to a price per share of common stock that will prevail after the new capital is infused. No one knows this *ex post* price now.
(b) But the *ex ante* price in anticipation of a government takeover of the GSEs or about $6 per share of common stock that prevailed before the conservatorship was announced is fairly low for taxpayers to not grumble.
(c) The common stock price of Fannie Mae and Freddie Mac has dropped to less than $1 per share after announcement conservatorship, obviously because the government announced a *de facto* price of $1 per share through warrants without clarifying the role of GSEs unambiguously.
(d) The proposed strategy will surely benefit the risk-takers who bought millions of shares dumped after the government conservatorship was announced. The risk-takers will benefit only if others are willing to accept the government's pricing of capital infusion and believe in a fair return in terms of dividends on their investments at the price government sets.

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[2]Let's not bring up the issue of curtailing the current mortgage interest deduction because doing so will unnerve the productive households reeling under erosions in their incomes and savings.

(e) Private capital should be allowed to buy directly at the same price at which that the government infuses new capital so that the GSEs receive both private capital and taxpayer funds to grow as public-private partnerships with a charter to lend mortgage loans at Fed Fund rate plus 2.5% to credit-worthy prime borrowers.
(f) In fact, the profitability under this charter will facilitate a selloff of the government equity stake to private parties to make the GSEs privately owned but publicly traded mortgage companies operating under the new charter.

IV. Positive Externality

If GSEs begin to refinance the prime households, the creditors of such households will face a serious choice: deposit the cash from repaid loans at 0-.25% in a Federal Reserve Bank or accept the GSE terms to modify the loans made to the prime borrowers at the proposed Fed Funds rate plus 2.5% for the full outstanding loan amount irrespective of the value of the home.

Since only prime borrowers will be refinanced under the proposed strategy, all existing creditors will most likely accept a relatively low-risk lending at the proposed terms. In this case, taxpayers will not need to fund GSEs with any significant amount as the existing creditors refinance the prime households at reduced rates. This will create a new low mortgage rate environment that will raise property values and entice new home buyers. The homebuilders and home sellers as well as the banks with subprime assets will then benefit enormously. There will be no pressure on the dollar to go down as little new money will be needed to be created. The new savings by prime households will boost confidence to increase spending that will raise demand and production and job growth.

V. Negative Impact of Monetary Expansion

Continual expansion of money supply for employment growth since the Great Depression has landed the economy in a trouble. Continual monetary expansion causes severe underemployment due to erosion of the value of income and decimation of household assets, leading to financial depression of households.

Most of the currently planned $1 trillion stimulus will be very inefficiently wasted; it may create jobs but not efficiently due to government involvement. The government should concentrate on boosting the quality of education, research and development for new energy, training of displaced workers and other infrastructure projects that private enterprise is incapable of doing. Excessive government involvement saps national competitiveness.

Excessive monetary expansion in the same of employment creation, per se, should be avoided to stem the downward pressure on the dollar. Savings by the prime households under the strategy proposed here will rather flow efficiently to investments needed by the society.

VI. Making Banks Profitable

Banks play an important role in a society: transfer funds efficiently from the savers to the borrowers. To perform this function, banks do not need to trade derivatives which are financial securities derived from fundamental securities like stocks and bonds. Most derivatives can be replicated by a portfolio of the fundamental securities. Why should banks then trade derivatives? Banks have been lately steeped in the

business of creating trading derivatives like credit default swaps (CDS). The face value of CDS outstanding now is about $54 trillion. A CDS is a put option designed to insure the debt contracts. It can be replicated by the underlying debt and treasury securities.

Only if the market price is consistently different from the fair value of a security will the trader make profits. Derivatives like CDS have created excellent profit opportunities for banks as the following example illustrates.

An Example of Profits and Derivative Trading

A bank holding company (BHC) funds a mortgage loan of $100 at 10.5% per year to receive $10.5 annually. The BHC then plans to create a Trust (a legally valid, firewalled subsidiary) with equity capital of $10 infused from the parent company and debt funding raised from outsiders. The equity in the Trust enhances the credit quality. The bank cajoles a rating agency to obtain AAA rating for commercial paper (a form of debt) to be issued by the Trust at an expected yield of 7%. The AAA-rating makes the commercial paper attractive to the investors at a time when the U.S. Treasuries of equal maturities yield about 4%. Due to the yield expectations for AAA-rated bonds, the investors will immediately fund or pay the Trust $100 for every $7 promised in interest payment per year over time in future. The Trust can pay the $10.5 annual mortgage payment to the commercial paper investor so that the latter funds the former 100x10.5/7 or $150. The Trust books a gross profit of $50 equal to the difference between the $150 received from investors and $100 paid to the mortgagor. The Trust transfers to the BHC a net profit of $40 which is equal to gross profit of $50 minus the $10 of equity capital received from the parent BHC. The BHC pays out its profit of $40 as executive bonus, and retains all the risk in the Trust and in the BHC. The taxpayers are forced to bear this risk in case of any problem in future because the BHC is too big to fail and holds federally insured deposits in its banking subsidiaries.[3]

As the quantum of commercial papers grows in the capital markets, investors become a bit worried. Investors then demand guarantees for the default of the papers. The BHC then creates a CDS (debt insurance contracts) to sell it to the commercial paper investors for a price. The BHC sells the CDS and the underlying debt as a package to the investors. The BHC books as profits the difference between the selling price and the theoretical value of the CDS. This is in addition to the profits booked from selling the AAA-rated debt. The BHC's calculation of profits from CDS defies the real world method of realization of profits (that I emphasize in my classes) as equal to the selling price minus the real cost of the item sold. The real cost of a CDS created by a BHC remains unknown until the commercial papers issued to the investors actually default or the BHC goes bankrupt. But the BHC books the unrealized profits based on the theoretical costs of CDS contracts it sells. The BHC is interested in generating short-term profits to pay bonuses to executives.

To generate growth in profits and personal bonus, bankers have mispriced the CDS. Otherwise, the CDS issuers like American International Group would not have melted down due to the CDS obligations. A lower CDS selling price entices investors to buy the underlying commercial papers. The bankers might have also lowered their theoretical value of CDS to book higher profits. A lower theoretical value of the CDS enhances the BHC's booked profits and bonuses for the executives.

The BHCs have thus generated fictitious profits usuriously by piling up all the residual risk in their financial institutions to be borne by taxpayers eventually. The have succeeded because of the environment they have

[3] http://www.pro-prosperity.com/Citizens%20Publishing/TableOfContents.pdf

established:

(a) The fictitiously generated but unrealized profits can be paid out as executive bonus without any objection from government regulators.

(b) The residual risk in the Trust and the BHC can be left for the taxpayers to bear without any objection from the government regulators.

(c) Taxpayers can be blackmailed at the time of systemic financial meltdown because the government has to replenish the depleted BHC kitty to pay off the federally insured bank deposits.

(d) Bankers can depute their proxies as government policymakers to scare the Congress to bailout the BHCs that are too big to fail.

The large bank executive incomes thus stem from manipulation of taxpayers, not any ingenuity or innovation in banking services.

VII. Optimal Bank Regulation Strategy

To serve the best interest of taxpayers, a two-stage optimal strategy should be adopted.

First stage:

1. Restrict the pay of any bank executive to at most ten times of the average pay of all other employees of the bank. The multiplier "ten" is tentative, inspired by the president's compensation being about ten times of the average household income. The Congress has the power restrict bank executive compensation because all banks and financial institutions have either received direct assistance or are indirectly protected due to the federal guarantee of deposits or under the too big to fail policy. This executive compensation policy will (i) make banks profitable sooner than later, (ii) stop the incentives for the executives to cook up profits, and (iii) induce executives to work long-term in the bank by generating higher employee wages. Other aspects of optimal executive compensation are available in a different paper.[4]

2. Do not accept policy recommendations of the bank executives or their proxies without independent analysis to serve the best interest of taxpayers.

Second stage:

1. Adopt safe banking policy to eliminate the moral hazard associated with the federal deposit guarantee and with the tacit too big to fail policy.[5]

2. Do not create new fiat money except for development of critical infrastructure is necessary to provide the incentives for innovation and production of globally competitive goods and services.

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[4] http://www.pro-prosperity.com/Research/OptimalCEOCompensation.pdf
[5] http://www.pro-prosperity.com/Research/moralhazard-safebanking.pdf

As discussed earlier, continual creation of new fiat money to overcome economic weakness has caused, in the long run, severe underemployment due to inflation and erosion of household assets. Creation of new money is inefficient when the funds reach people who do not build new capacity to produce globally competitive goods and services.

For example, the new money created during the last cycle for war gravitated inefficiently to contractors and then perhaps to leveraged hedge funds. Many of these hedge funds were decimated due to forced liquidation. The new money did not build up capacity for globally competitive goods and services to enhance national competitiveness.

The Keynesian philosophy of continually increasing government spending to avert recessions can backfire in the long run as it can permanently cripple the economy due to erosion of national competitiveness measured by large trade deficits and weak currency.[6]

Fiat money in an economy is a translation of labor. Creating and wasting fiat money amounts to devaluation of labor which props the value of money.

The gargantuan stimulus package being contemplated now can also lead to inefficiency and wastage and not necessarily enhance national competitiveness.

As a matter of optimal rule, the government should undertake only those programs that private entrepreneurs cannot undertake and provide incentives for every program that private entrepreneurs can themselves execute to enhance national competitiveness, that is, for production of globally competitive goods and services such as renewable energy, technology, broadband, efficient healthcare, competitive production of medicine at lower costs, etc.

With profound regards,

Sankarshan Acharya

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[6] http://www.pro-prosperity.com/Fallacy-of-Keyensian-Economic-Philosophy.html

The following plan unveiled by President-elect Barack Obama and the Federal Reserve's plan to buy back GSE debt are consistent with the strategies proposed above.

Obama unveils economic stimulus plan

Agence France-Presse
Washington, January 03, 2009

US president-elect Barack Obama on Saturday unveiled a broad proposal to boost job growth and the troubled American economy, a top priority for the incoming administration.

"Economists from across the political spectrum agree that if we don't act swiftly and boldly, we could see a much deeper economic downturn that could lead to double digit unemployment and the American Dream slipping further and further out of reach," Obama said in his weekly radio address

"That's why we need an American Recovery and Reinvestment Plan that not only creates jobs in the short-term but spurs economic growth and competitiveness in the long-term."

For several weeks Obama's economic team have been in talks over its recovery plan. The negotiations were almost wrapped up before Christmas, vice-president elect Joe Biden said in an interview.

To revive the world's largest economy, struggling amid global financial turmoil, Obama said "the number one goal" of his plan was to create three million jobs -- 80 percent them in the private sector.

"To put people back to work today and reduce our dependence on foreign oil tomorrow, we will double renewable energy production and renovate public buildings to make them more energy efficient," Obama added.

He also called for "long-term investments," such as infrastructure building, updating the American healthcare system and building "21st century" learning institutions, on top of "direct tax relief to 95 percent of American workers."

"This plan must be designed in a new way -- we can't just fall into the old Washington habit of throwing money at the problem," Obama said, calling for "strategic investments," "vigorous oversight and strict accountability" and "fiscal responsibility."

Obama will meet with key congressional leaders on Monday to finalize the multi-billion-dollar economic stimulus plan Democrats hope to pass shortly after he takes office on January 20, officials told AFP.