Public Lending to Private Hedge Funds is Inefficient, Unstable, Unconstitutional and Unanimously Disagreeable

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Abstract: Public funds include federally insured deposits held under the custody of private banks, central bank loans and taxpayer funds. The principal finding of this paper is that lending such public funds through a private banking system to private hedge funds allied with the banks is inefficient, unstable, fundamentally unfair (unconstitutional) and unanimously disagreeable. This finding is akin to the unanimously agreeable safe central banking policy (Acharya, 1991-2016) which, in dynamic general equilibrium, (a) eliminates federal guarantee of bank deposits, (b) offers every business enterprise and household an option to keep in the central bank any part of its deposits it wants to be held absolutely safely, (c) completely deregulates all private banks without any privilege to rob public or private wealth like too-big-to-fail or too-big-to-be-jailed status or the power of market making and clearing. Safe central banking is the only way to make private banks responsible to hold sufficient capital to attract uninsured private deposits like the trading houses currently do. The private banks will then have complete freedom to lend their uninsured deposits to private hedge funds. The Volker Rule (NYT, January 30, 2010), incorporated in the Dodd-Frank Act of 2010, is an infeasible and unworkable band-aid for the moral-hazard driven systemic robbery of wealth creators wrought by the government-ordained private banking custody of public funds. The established systemic moral-hazard problem can be efficiently and constitutionally resolved only through unanimously agreeable safe central banking. Current proposals on overhauling of Fannie and Freddie made by various pundits of systemic robbery amount to a gargantuan amount of public lending to private hedge funds and, hence, inefficient, unstable, unconstitutional and unanimously disagreeable.

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[1]The first draft of this paper with a different title was dated November 17, 2007, which is still available as Acharya (2007), cited as one of the references. I am immensely thankful to an anonymous referee for numerous useful suggestions on the first version of the paper and to Benjamin Carney for his comments on presentation of this draft. This revision is dated March 31, 2016. The author is solely responsible for any remaining error or lapse in presentation. The author, Dr. Sankarshan Acharya, is Director of the Research Center on Finance and Governance. He also teaches at the University of Illinois at Chicago.

1. Introduction

This paper (since 2007 when its first draft was widely circulated),[2] continues to be at the epicenter of transformation of USA from its currently established system of robbery of enterprising wealth creators - which I have proved as inefficient, unstable, fundamentally unfair (unconstitutional) and unanimously disagreeable - to an antithetic system which is unanimously agreeable and which attains within a general dynamic equilibrium model as efficient, stable and fundamentally fair or constitutional (Acharya 1991-2016).

Public events show that the findings of this paper have dismayed and unnerved top global leaders like never before. Steps taken by the U.S. government in 2008 to undo the "undisclosed" and "unaccounted" lending of public funds to private hedge funds precipitated the looming and inevitable financial crisis of 2008. This crisis was worse than the Great Depression, according to the Federal Reserve, as it involved a run on previously uninsured bank debt and money market funds totaling $11.3 trillion.

Acharya (2003a, 2003b and 2005) narrates how (a) the Great Depression would recur due to highly leveraged bank holding company shenanigans underlying public lending to private hedge funds, and (b) why safe central banking proposed in these papers - with analytical foundation laid out in an original paper mimeographed at the Board of Governors of the Federal Reserve System in 1991 (Acharya 1991-2016) - would be necessary to preemptively avert the crisis. The U.S. government indeed adopted an ad hock safe central banking policy in 2008 to stem the domino of crashing markets and panic runs in uninsured funds (Acharya 2011). The U.S. government has not yet enacted into law, though, the safe central banking policy in toto attained in general dynamic equilibrium in Acharya (1991-2016).

Here is a brief summary of the public events that vindicate the findings of this paper:

- After the first version of this paper was widely circulated among members of U.S. Congress, President Bush and Presidential candidate Obama in November 2007, the US Treasury Secretary publicly demanded that leveraged financial institutions raise sufficient capital or face shut down.

- Many top financial institutions were indeed shut down starting early 2008 due to their failure to raise sufficient capital.

- The remaining banks, though, were heavily laden with toxic mortgage backed assets (backed by liar loans), which were fictitious securities artificially created for short-selling (Acharya, 2012). The banks that were not shut down were also not sufficiently capitalized due to the toxic assets in their books.

[2] See Acharya (2007a).

- The US government enacted *Emergency Economic Stabilization Act of 2008*, signed into law on October 3, 2008, to create $700 billion of public funds under Troubled Assets Relief Program to recapitalize the insolvent banks.[3]

- The government also took over Fannie and Freddie under a newly enacted *Housing and Economic Recovery Act of 2008* that forced Fannie and Freddie to use their cash as well as a new Treasury loan of $187 billion foisted on them to purchase the private banks' toxic assets at par.[4] This was a transfer of Fannie and Freddie equity to the insolvent private banks laden with toxic (worthless) mortgage assets.

- The US government, thus, effectively made the two well-capitalized stable financial institutions (Fannie and Freddie) bad banks and painted the truly bad, risky and under-capitalized private banks as good banks.

- Private banks' selling of toxic assets to Fannie and Freddie were later considered by the US Department of Justice as mortgage fraud for which the private banks paid $100's of billions in fines to the US government. No banker has been, however, jailed. The US government has been refusing to release many crucial internal financial and policy analyses, which ought to be made public in a democracy, which the courts are seeking to resolve Fannie-Freddie sharehoders' lawsuits, and which the policymakers used to justify their rules to subject Fannie and Freddie to conservatorship in 2008 and then to sweep all Fannie and Freddie profits to Treasury since 2012. (Acharya 2015b).

- Presidential candidate, Mrs. Hillary Clinton, admitted in a public speech on March 22, 2016 that the anger driving Mr. Donald Trump's rallies is justified because people lost $13 trillion of their hard-earned wealth and 9 million of good paying jobs:

> You know, a lot of folks ask me, "Why are so many people who go to some of these rallies so angry?" Well, a lot of people are frustrated. A lot of people are worried. A lot of people feel that their best days and therefore our country's best days are behind us. And I want you just for a minute put yourselves in their minds. Think back. We had the worst financial crisis since the Great Depression. Nine million Americans lost their jobs. Five million homes were lost. $13 trillion – trillion dollars – in family wealth was wiped out. A lot of Americans haven't recovered from that. A lot of Americans haven't had a raise in 15 years. A lot of Americans worry that life is not going to be better for their kids.

- Mrs. Hillary Clinton has eschewed how such gargantuan systemic robbery could be perpetrated with impunity (no major banker has been jailed). Acharya (2013)

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[3]Wikipedia, "Troubled Asset Relief Program," https://en.wikipedia.org/wiki/Troubled_Asset_Relief_Program

[4] Wikipedia, "Housing and Economic Recovery Act," dated July 30, 2008, https://en.wikipedia.org/wiki/Housing_and_Economic_Recovery_Act_of_2008

shows - in a paper invited and published by a journal with 18 Nobel Laureates as authors - that specific laws - voted by the US Congress and signed by Presidents have been designed dogmatically/philosophically to facilitate systemic robbery with impunity so that the appointed robber barons never go to jail despite massive finable fraud. Acharya (February 10, 2016) and references cited therein present factually:

a. how this established Anglo-American philosophy or dogma of governance - not some esoteric invisible god, as falsely claimed by elite academy and publishers - has systemically robbed wealth creators and ruined the American economy (Acharya, November 16, 2015; and Acharya, November 27, 2015),

b. how the Anglo-American dogma is inefficient, unstable, unconstitutional and unanimously disagreeable, and

c. how the only alternative system of governance (antithetic to the Anglo-American system) - which is efficient, stable, constitutional and unanimously agreeable and which obtains in general dynamic equilibrium in peerless, nonpareil and unbiased research (Acharya 1991-2016) - can salvage the dire predicament facing the US economy.

- Practically, the anger admitted by Mrs. Clinton, is due to the gargantuan loss of hard-earned wealth and elimination of well-paying jobs. The loss is significantly more than the relatively paltry gain from systemic robbery that has flowed primarily to associated political and banking leaders and elite academic gurus and think tanks. This makes systemic robbery inefficient. Systemic robbery is also fundamentally unfair (unconstitutional). It begets instability - gravitating towards equilibrium through a painful recurrence of the Great Depression. This anger is leading Mr. Donald Trump's current anti-establishment campaign. President Obama's 2008 campaign too sounded like anti-establishment. From day one, however, Obama Administration was completely swayed by the same establishment expertise that had run the two previous administrations (Acharya 2015a) and that was the cause of the 2008 financial catastrophe according to the US Congressional Financial Crisis Inquiry Commission (2011).

- If the current anger actually leads to a supplanting of the established systemic robbery with a unanimously agreeable, efficient, stable and constitutional system, the angry people rising to power will claw-back the systemic loot; this is the basis of my claim that the established Anglo-American dogma of governance should not be agreeable even to the gainers of systemic robbery.

- My communication with President Obama and Obama Administration's Volker Rule route to checkmate systemic robbery illustrate (later) how President Obama could barely see a few trees in the dense forest, without being able to fathom the gargantuan robbery of wealth creators due to the established moral-hazard driven modern Jungle Raj in the Anglo-American system of governance.

- Even the U.K. Prime Minister Gordon Brown had admitted in a column in Washington Post on October 17, 2008 that the 2008 financial crisis was due to irresponsible and unaccounted lending of bank loans to private hedge funds. Stopping the flow of artificially cheap public funds to private banks, as opposed to asking banks to not use the funds (ordained by government to be kept under custody of private banks) for proprietary trading - ***through enactment of the unanimously agreeable, efficient, stable and constitutional safe central banking policy*** - should have been the primary goal of President Obama if he meant real change he wanted people to believe in. As I have written to President Obama, he missed a golden opportunity to become the greatest U.S. president due to his inability or unwillingness to enact a safe central banking policy. President Obama has, ironically, left the door open, however, for Mr. Donald Trump to be the greatest U.S. president - indeed the greatest global leader; if Mr. Trump is elected and is able and willing to establish ***a system (rules) of governance that does not ever rob individual or common wealth, even surreptitiously,*** by adding these bold-italicized words to the preamble of the constitution.

- The above publicly known facts prove veracity of the basic finding of the paper, presented preemptively before the 2008 financial crisis unfolded, that public lending to private hedge funds managed by private banks is financially suicidal for taxpayers.

This paper is inextricably linked to Mr. Barack Obama's presidential election victory in 2008. Acharya (2008-2015) narrates how god, rationally defined, helped Mr. Obama's election victory. When Mr. Obama chimed "change we believe in," independents and some Republicans, who lost their hard-earned wealth in the market crash of 2008, presumed that Mr. Obama would reform the system of banking and finance to prevent recurrence of such crises. Mr. Obama, however, forgot his promise to people or he did not really mean the kind of change people had presumed he would make to undo the established system of robbery. This led to a dramatic electoral loss of the Democratic Party in one of its Senatorial bastions in Massachusetts in early 2010. I reminded President Obama about his promise in a memo dated January 17, 2010 (Acharya 2010), entitled, "Reforming the Financial System to protect Taxpayers and Productive Households" with copies sent to House Speaker Nancy Pelosi, Senators Harry Reid, Richard J. Durbin and John McCain, Chairman, House Oversight and Government Affairs Committee and Chairman, Financial Crisis Enquiry Commission:

> Under the current financial system, in every five to seven years, (a) the capital market custodians (top bankers) scare the households (through short-selling strategies) to sell the risky assets and then to transfer the atrophied household savings to "riskless" bank deposits or money market funds, (b) the economy shrinks, and (c) the Federal Reserve responds by lowering the interest rate on the decimated household savings.

In this system, households are flogged by both the capital market honchos and the Federal Reserve. The result is enervated savings, destruction of earned capital, severe underemployment and rising unemployment, which pave the way for yet another Great Depression.

The households comprise innovators, scientists and producers of globally competitive goods and services. They produce food, technology and engineering goods. They serve and secure the nation. They protect what America stands for: individual liberty. Yet, their retirement savings are wangled away by indolent, unproductive bank traders. Wangling such savings (repertoires of hard work), even surreptitiously, amounts to subjugation of the true innovators and producers – who keep the nation strong and secure - by those who do not produce anything but weaken the nation willy-nilly.

Ban short-selling to forever close the path to another Great Depression: Currently, bank traders – who do not produce globally competitive good and services – have two potently destructive instruments at their disposal: (a) short-selling and (b) massive taxpayer-insured bank funds. They use these instruments to make capital markets highly volatile in order to nibble away the hard-earned savings of the innovators and producers of globally competitive goods and services.

The bank traders are induced by trading-based bonus schemes to wangle and ultimately destroy the wealth created by the productive households. They do not seem to worry a bit about ruining the very financial institutions which provide them the berth for such trading or the very taxpayers who have unknowingly and naively underwritten such financially suicidal instruments for the traders. It is as if to add salt to the injury of the taxpayers and productive households, the Federal Reserve and the US Treasury provide the ultimate security to the bank traders by transferring taxpayer funds to the ruined financial institutions.

Short selling is the most potent instrument available to bank traders. Individual households can also sell securities short, but they invariably lose when massive taxpayer-insured bank funds are available to bank traders. When top institutional traders lose (as they did during 2007-08), their patrons (the banks) lobby for bailout funds created-borrowed by the government. So, the current financial system does not serve the taxpayers or the productive households who indeed prop the government and the nation.

The current system is designed to cause Great Depressions by gradually weakening the economy and the nation.

Banning short-selling will help serve the taxpayers, producers, government and country. A nation should not predicate its policies on thoughts or advices of self-serving bank traders that short-selling is necessary to hedge risk. Sure it hedges the risk of the nonproductive bank traders and rewards them handsomely, while ruining the hard-earned savings of the real producers who prop the nation and the economy.

Ban bonus schemes tied to trading profits in directly insured and tacitly protected (too-big-to-fail) financial institutions: These policies will also obviate the vindictive knee-jerk actions like taxing bank executive bonuses or levying bank liabilities. Seeking retribution from bankers, who act optimally from the point of view of their businesses, is not sanguine for a nation. If anyone is to blame for the disaster, it should be the Congress and successive Administrations for not adopting policies which are optimal for taxpayers. Aren't these policies necessary for a nation to compete and stay innovative, creative and productive? Why are we then scared to adopt policies that are necessary and good for the country?

Top bankers have succeeded in keeping the current financial system intact to continue the unfettered wangling of savings of the producers of globally competitive goods and services. They have succeeded in scaring the lawmakers to not change the system.

The households are, however, not scared of reforming the system. They are angry with the Congress and rightly so. They are longing for a reformed system that rewards innovation and that bans indolent schemes (like short-selling) and back-door protection of bank traders designed to surreptitiously wangle the savings of the true innovators and producers. They are longing for a reformed financial system that will make the nation stronger and resilient, consistent with their nonpareil achievements like septa bites of broadband transmission per second and the cheap super computers on household desktops. Such longing is consistent with the dream of the founding fathers and the constitution.

After circulation of the above memo, President Obama solicited the support of ex-Federal Reserve Chairman Paul Volker to announce angrily in the press conference on January 21, 2010 that unless the Dodd-Frank Act of 2010 (which was already finalized with consent from President Obama) included a ban on proprietary trading by banks, he would not sign the Act. The authors of Dodd-Frank Act were dismayed about President Obama's last-minute change of position, but had to include a ban on proprietary trading by banks under Volker Rule. Mr. Volker justified his rule in a column in the New York Times on January 30, 2010. I questioned President Obama through another memo about the true author of the so-called Volker Rule (Acharya, January 29, 2010).

It was only after I reminded President Obama about his forgetting the changes he wanted people to believe in that cost the Democratic Party its Massachusetts Senate seat in January 2010 did he incorporate in the already finalized Dodd-Frank Act the Volker Rule (which should have been Acharya Rule) on restricting the flow of public funds for trading within banks. In any case, the Volker Rule is infeasible and not implementable and has, therefore, remained almost defunct; this rule does not restrict lending of public funds to private hedge funds. Konczal (December 10, 2013, Washington Post) presents pros-and-cons of the Volker Rule.

With hind sight, I now think President Obama has done a great service to not induct my name to the Volker Rule for the following reasons:

- "Banning proprietary trading" proposed by Mr. Paul Volker is not even close to my unanimously agreeable, efficient, stable and constitutional rules on no public lending to private hedge funds through my safe central banking policy.

- Private hedge funds trading with cheap public funds - highlighted in the first draft of this paper and my memo of January 17, 2010 - must have led Mr. Paul Volker and Mr. Barack Obama to design a band-aid (a ban on paper of proprietary trading by banks) to redress the deep malaise of moral-hazard driven systemic robbery of wealth creators wrought by federal deposit insurance and guarantee of too-big-to-fail banks run by too-big-to-be-jailed bankers aided by the Federal Reserve Act of 2013.

- The proprietary trading ban included in the Dodd-Frank Act of 2010 does not preclude public lending to private hedge funds designed by law for privatizing profits and socializing losses, which is the basic thrust of this paper akin to my safe central banking policy.

- Mr. Obama and Mr. Volker eschewed an efficient and constitutional resolution of the moral-hazard problem presented in my research since 1991, while obfuscating the public that an infeasible and unworkable Volker Rule would magically resolve the moral-hazard driven systemic robbery of wealth creators of the economy.

- Maybe Mr. Paul Volker and Obama Administration advisers (who indeed were the same Clinton Administration advisers whose failure caused the 2008 financial catastrophe according to the Financial Crisis Inquiry Commission) detested the prospect of crediting an unprivileged esoteric individual hailing from a remote village in India with the crown of discovering a unique, unanimously agreeable, stable, efficient and constitutional safe central banking policy that would resolve the established systemic robbery and make the USA great again. Prejudice for temporal pyrrhic victory has an unbearable price: uncontrollable anger against the establishment (Acharya 2008).

- Personally, I am really privileged due to birth in a family with lineage starting with *Saint Batchasa* and for having a great grandfather scripting economic policies for prosperity and civilized coexistence in the 17th century when the current field of economics was not even born in the West. My research on unanimously agreeable rules of governance that ensure stability, efficiency and fundamental fairness (constitutionality) has absolutely no root in contemporary Western economics and is antithetic to the established Anglo-American economic dogma of systemic robbery of wealth creators.

Pundits of systemic robbery have floated many proposals, after the 2008 crisis, ostensibly to 'overhaul' or 'reform' the system of financing homes of enterprising wealth creators - like (a) by creating a new Financial Mortgage Insurance Corporation to supplant Fannie Mae and Freddie Mac, possibly after merging these mortgage giants, or (b) by raising the mortgage lending fees sufficiently to make it profitable for private banks to take away mortgage lending business from Fannie and Freddie while undercapitalizing and eventually killing the latter after sweeping all of their profits since the 2012 decree of the Treasury Department.[5] In reality, such punditry amounts to yet more large-scale systemic robbing of enterprising wealth creators:

- These housing finance reform proposals - floated by pundits of systemic robbery - are designed to effectively transfer a gargantuan amount of public finance, via emaciated (de-capitalized), subdued and powerless Fannie and Freddie acting as conduits, to private banks and their private hedge funds for systemically robbing the public whenever catastrophes recur (like in 2008).

- The pundits of systemic robbery want (as per their proposals) to do so by erasing the current equityholders of Fannie and Freddie to forever eliminate every trace (such as naked Big Short positions) of the 2008 robbery by private banks and their hedge funds of Fannie and Freddie equities including $187 billion of taxpayer funds transferred to the latter from the Treasury (that Fannie and Freddie have repaid) after imposing the 2012 Treasury Department decree to sweep all profits of Fannie and Freddie.

- The Treasury Department internal memos justify the 2012 Fannie-Freddie profit sweep as serving the best interests of 'market participants.' The so-called 'market

[5] See Acharya (2015b). The latest such punditry on systemic robbery has been presented by Wall Street Journal with a title "Fannie Mae and Freddie Mac: If You Can't Kill Them, Merge Them?" based on a recent paper by Parrott, Zandi, Zigas, Lewis and Sperling (2016). The paper is an important shift for some of the five authors, who include Jim Parrott, a former Obama White House housing adviser; Moody's Analytics chief economist Mark Zandi; Barry Zigas, director of housing policy at the Consumer Federation of America; and Lewis Ranieri of Ranieri Strategies, who co-invented the mortgage-backed security. The fifth author is Gene Sperling, former director of the National Economic Council for presidents Barack Obama and Bill Clinton and a close adviser to Hillary Clinton, though the paper says "the ideas expressed are purely his own."

> participants' actually are a few too-big-to-fail banks run by too-big-to-be-jailed robber barons and a mega conglomerate of these banks that Berkshire Hathaway has become.

Surreptitious lending of public funds through financially emaciated and powerless Fannie and Freddie to private banks and then to private hedge funds is inefficient, unstable, unconstitutional and unanimously disagreeable within the model of general dynamic equilibrium presented in this paper. The pundits of systemic robbery have not presented any equilibrium model, let alone a general dynamic equilibrium model of the economy to substantiate their policies.

The rest of the paper is organized as follows: Section 2 presents the general equilibrium paradigm and results and Section 3 concludes.

2. General Dynamic Equilibrium Model and Results

Consider a very general economic environment as modeled in Acharya (1991-2016 and 2007b): leveraged firms with potentially more informed equity holders making asset risk choices and financing-dividend decisions, fair market pricing of financial assets, a not-for-profit government minimizing the cost of governance and seeking to enact efficient policies without taking sides (e.g., not imposing policies and rules to facilitate systemic robbery of wealth creators by private banks and bailing out the latter by printing-borrowing on the back of wealth creators). The goal of the theoretical model is to determine government, corporate and market rules in general equilibrium.

Theorem - 1 (Safe Central Banking Policy): In the model described above, a safe central banking policy - which (a) eliminates federal guarantee of bank deposits, (b) offers every business enterprise and household an option to keep in the central bank any part of its deposits it wants to be held absolutely safely, (c) completely deregulates all private banks without any privilege to rob public or private wealth via moral hazard through too-big-to-fail or too-big-to-be-jailed privilege and market making and clearing power to observe information from order flows - is efficient, stable, fundamentally fair and unanimously agreeable.

Proof of Theorem - 1: See Acharya (1991-2016).

Corollary to Theorem - 1: Safe central banking is the only way to make private banks responsible to hold sufficient capital to attract uninsured private deposits like the trading houses currently do. The private banks will then have complete freedom to lend their uninsured deposits to private hedge funds.

Discussion on Safe Central Banking:

Safe central banking gives an option to every firm or household to keep a part of their savings that they want to be held absolutely safely in a central bank account. This policy obviates banking panics and eliminates inefficient federal guarantee of bank deposits and associated moral-hazard driven systemic robbery:

- Everyone (rich and poor) prefers to have a part of their savings absolutely safely and invest the rest in risky assets. The exact ratio of safe to risky investments is a choice that depends on an individual's risk preference. But the idea of allocation of savings between absolutely safe assets and risky assets is unanimously agreeable.

- The issue is who can keep the absolutely safe portion of individuals' or enterprises' savings? Currently, private banks can keep a part of their savings at the Central Bank (Federal Reserve) in capital reserve accounts. But non-banks (individuals and non-banking enterprises) are not permitted to do so.

- Lack of safe central banking facility to non-banks and households precipitated the Great Recession of 2008 which was worse than the Great Depression according to Federal Reserve.

- In 1991 I saw the lacuna in the established system of banking and finance: lack of absolute safety of non-bank enterprises' and households' savings. I developed a comprehensive mathematical model of the economy and mimeographed it at the Fed in 1991. This model showed that safe central banking policy attains in equilibrium.

- I translated my math-econ model into plain English and sent a memo along with a published paper to all members of U.S. Senate on March 31, 2003 with a proposal for my equilibrium safe central banking policy to preempt a looming crisis that I saw coming. The US Congress held testimonies of top Fed officials and urged for a conference of experts to which I was invited in November 2003. I did not go to the Fed conference but requested the conference organizers to circulate my safe central banking paper.

- The 2008 financial catastrophe was primarily because of lack of safe central banking facility for non-banks and households: The Fed had to guarantee 3.5 trillion dollars of previously uninsured money market funds and 7.8 trillion dollars of previously uninsured bank debt to prevent a run on these funds and to avert the domino of crashing market in 2008.

- The Fed did in 2008 what I had proposed since 1991.

- Now, large investors and firms do not trust banks for absolute safety of their savings. They have been buying Treasury securities. The economy has almost gravitated towards my equilibrium safe central banking without any formal (law-based) government act.

- There is still no formal government guarantee of bank debt and deposits above 250000 dollars. If what is happening after the 2008 crisis (the equilibrium/stable solution that I had proposed since 1991) is formally adopted as safe central banking law, mega banks will no longer be able to blackmail the Congress for the custody of absolutely safe deposits or use the deposits on their custody to bet against everyone else with a view to privatizing profits and socializing losses.

- Once safe central banking policy is adopted as law, private banks will be forced compete for deposits from non-banks and households and the latter will trust only those banks that have sufficient capital (money of bankers) to hold their deposits without federal insurance by paying higher interest as a result. This will make the banks highly capitalized to compete for uninsured deposits. This will also let the banks that cannot muster sufficient capital perish.

- The safe central banking policy is unanimously agreeable. By this I mean no one can publicly argue against it. The TBTF-TBTJ banks - currently enjoying enormous benefits by blackmailing non-banks, households and Congress - may privately grumble about safe central banking, but they will have to realize publicly that the established current system of moral-hazard induced systemic robbery has decimated enterprising individuals comprising the economy.

- The economy is now at the cusp of a socialist takeover - with Mrs. Hillary Clinton adopting a declared socialist Mr. Bernie Sanders' proposals - which would take away not only everything the TBTF-TBTJ bankers (robber barons) do not want to lose, but also of the assets of enterprising individuals to feed the inefficient and indolent through subsidies and doles - making the economy perpetually non-competitive. This prospect should make the TBTF-TBTJ bankers and everyone (rich and poor) agree to my safe central banking policy proposal.

The Federal Reserve has now admitted that moral hazard is a serious problem affecting the economy (Acharya 2014). It should, therefore, formally embrace the Safe Central Banking policy presented here so that the Congress can amend the Federal Reserve Act of 1913 accordingly

The trading activity of an investment bank is as highly leveraged as most hedge funds. Hedge funds usually borrow taxpayer funds to trade in financial securities, commodities and other assets. Hedge fund trading may be construed as a market mechanism to beget fair prices of assets efficiently. But when a stock index like NASDAQ doubles in a year to 5000 and then falls 75% in another year, one cannot support a hypothesis that the market is able to determine the fair price as, for example, the discounted expected value of future dividends.

Rationally, the market appears to be an unfair game in which private hedge funds play with individuals and public pension plans and mutual fund managers.

Commercial banking activity is also highly leveraged. But it provides an immense service to society by taking short-term deposits and debts to lend on long-term basis (a) to homeowners for living and working to create wealth and (b) to corporations that create jobs. The theory of financial intermediation justifies correctly the role and existence of commercial banks. The commercial banking activity of investment banks is likewise a noble service to society.

This paper is not about the commercial banking activity. It focuses on the hedge fund activity of investment banks and universal banks and other individuals and institutions. After the repeal of the Glass-Stegall Act in 1999, commercial banks have formed firewalled subsidiaries to trade like hedge funds. Such firewalled subsidiaries are created legally on paper as bankruptcy remote entities, which are like limited liability companies, but are reported as off balance sheet items to avoid scrutiny of the Security and Exchange Corporation.

If a hedge fund trades with its own or privately borrowed funds, it should be its business like any other business activity. This paper is not about private funding or borrowing of hedge funds. It is about the government allowing hedge funds to borrow publicly insured deposits and taxpayer funds, either directly from the central bank or indirectly from federally insured deposits of commercial banks. This paper argues that lending taxpayer funds to private hedge funds is tantamount to financial suicide by taxpayers.

Theorem - 2 (Public Lending to Private Hedge Funds): The dynamic general equilibrium presented in Theorem - 1 precludes public lending to private hedge funds via private banking system. Furthermore, public lending to private hedge funds is inefficient, unstable, unconstitutional and unanimously disagreeable.

Proof of Theorem - 2: Safe central banking policy obtains in the dynamic general equilibrium model. This policy precludes (i) federal insurance of deposits under the custody of private banks, (ii) public guarantee through too-big-to-fail or too-big-to-jail policy for banks and (iii) central bank lending to private banks. This means public lending of private hedge funds via private banks or any other means is precluded in general dynamic equilibrium. Any policy not supported by general dynamic equilibrium is inefficient, unstable, and unconstitutional (fundamentally unfair). Safe central banking policy is unanimously agreeable. Public lending to private hedge funds being antithetic to safe central banking policy is, thus, unanimously disagreeable.

Corollary to Theorem - 2: Surreptitious lending of public funds through financially emaciated and powerless home financing institutions (Fannie Mae and Freddie Mac) to private banks and then to private hedge funds is inefficient, unstable, unconstitutional and unanimously disagreeable within the model of general dynamic equilibrium presented in this paper. The pundits of systemic robbery have not presented any equilibrium model, let alone a general dynamic equilibrium model of the economy to substantiate their proposals.

Discussion of the Current Policy of Public Lending to Private Hedge Funds

Just visualize that a bunch of hedge funds borrow taxpayer funds to trade securities held by taxpayers. The gain to hedge funds from such trading is a loss to taxpayers. After trading for such gains, some hedge funds may no longer generate further gains. A few hedge funds may thus collapse. A hedge fund's collapse shows that the fund could no longer wangle wealth of the vast majority of other taxpayers-investors. The vast majority of taxpayers-investors will not, optimally, bail out a collapsing hedge fund or lend more taxpayer funds to the remaining hedge funds.

Well-connected (privileged) hedge funds tend to obtain huge amounts of credits at the lowest possible interest rate from the federally insured deposits held in commercial banks or reserve funds held by the central bank. Such credits are essentially taxpayer funds. The vast majority of investors-taxpayers do not have any power to set the cost of these funds. A common presumption is that the central bank will act in the best interest of the vast majority of investors-taxpayers in setting the optimal rate of interest on taxpayer funds.

This paper is not about any mistakes or criticisms of the interest rate policy of the Federal Reserve, which is analyzed in a different paper (Acharya 2015b). It is about the government or central bank policy of public lending at lowest possible interest rates to private hedge funds - in which bankers, politicians, academic gurus and government regulators have vested interests. Such fundamentally unfair (unconstitutional) privilege foisted on public as public policy has not only cost the public in trillions of dollars of hard-earned wealth lost and in millions of good-paying jobs wiped out. This public policy has also angered the public against the establishment, like never before. This will ultimately make everyone including the privileged private hedge fund beneficiaries lose. This public policy is, thus, unanimously disagreeable.

Hedge funds deploy the taxpayer funds borrowed at the lowest possible cost to trade in the direction of sentiments to exaggerate either the rise or the fall in the price of certain assets. The direction of trading is accentuated by media driven panic and euphoria among the vast majority of taxpayer-investors.

Availability of cheap credit to hedge funds has been primarily responsible for price bubbles like in the Japanese and NASDAQ securities. Bubbles and bursts permit better informed and better connected hedge funds to garner taxpayer funds at the lowest possible interest rate to squeeze the wealth of retail traders, smaller hedge funds and the passively invested mutual funds and pension plants. The retail traders and smaller hedge funds have a decisive disadvantage as they cannot borrow taxpayer funds cheaply and have to pay higher rates of interest on their margin borrowings made from broker-dealers. Such lopsided cost of trading eventually forces many smaller hedge funds and retail traders to lose their capitals.

Most small and medium retail traders in the U.S. probably lost their capitals in the wake of bursting of the NASDAQ stock price bubble. The upper middleclass perhaps lost their savings in the following years. Now even larger hedge funds are losing their capitals or have stopped borrowing to trade.

At this juncture, it is natural for the remaining large hedge funds to trade on long side in the market for commodities through media propaganda and on short side financial securities held by the majority of passive investors. As a result, prices of commodities, especially of food, are rising through the roof while financial securities are falling off the cliff. This is causing panic among the vast majority of people and their governments worldwide. Riots for food are now being feared.

One can thus envision miseries for the vast majority of humanity around the world wrought by the “need” of a few privileged private hedge funds to earn higher returns on trades than the cheapest rate of interest on their enormous borrowing of public funds - insured deposits and Federal Reserve funds.

Borrowing insured deposits is possible for hedge fund owners who are connected to commercial banks, directly and indirectly. Most hedge funds are run by the executives of the commercial banks and have no problem in getting massive credits from taxpayer funds. When the Federal Reserve lowers the interest rate due to economic recession, the hedge funds have the opportunity to borrow taxpayer funds cheaply.

The repeal of Glass-Stegall Act in 1999 opened the door widely for many hedge funds to operate as firewalled subsidiaries of large universal banks which combine commercial banking, security trading and investment banking. The hedge fund managers – top executives of financial firms – must have had enormous sway over the government to repeal the act, which was originally enacted to avoid a recurrence of the Great Depression by dissociating commercial banking from security trading and investment banking. The Glass-Stegall Act stemmed from a correct belief that the performance of commercial banking, security trading and investment banking under the same management led to the Great Depression.

The proponents for repealing the Glass-Stegall Act asserted that the Great Depression would not recur when the advanced financial and information technologies are applied in universal banks. There was no data to support such assertion, when the act was repealed or even now. The efficiency in execution of financial transactions, possible due to advanced information technology, would rather precipitate a recurrence of the Great Depression, which may now spread globally.

The main point of this paper is that taxpayers will not optimally allow their funds–held either by the Federal Reserve or by federally insured commercial banks–to be borrowed by hedge funds. The vast majority of investors-taxpayers would rather not lend their funds to the hedge funds to prevent the latter from creating enormous leverage to depress the asset holdings of the majority or to raise the price of commodities like food and oil needed for existence.

Shouldn't the representatives of the vast majority of taxpayers-investors in a democracy act in the best interest of the latter? The most respected lawmakers of the most important and responsible nation like USA should lead in repealing the practice of lending taxpayer funds to hedge funds through the unique unanimously agreeable, efficient, stable and constitutional safe central banking policy. We hope that this paper and the following numerical example will unambiguously convince the lawmakers to formulate a policy to never lend taxpayers' funds to private hedge funds through enactment of the safe central banking policy.

A Numerical Example

In this example, hedge funds borrow taxpayer funds and sell securities held by the vast majority of investors-taxpayers short. The price of those securities drops as a result. The hedge funds make profits by covering their positions as panicking investors-taxpayers sell. The panic is created by excessive short positions taken by the hedge funds ahead of a slightly pessimistic outlook. The example illustrates inefficient dead-weight loss to society as the vast majority of enterprising wealth creators lose massively with barely 14% of such loss flowing to hedge funds as profit.

- Suppose the vast majority of investors-taxpayers buy $1000 worth of securities in mutual funds using their savings.

- The hedge funds sell 20% of these securities short for $200 with leverage using funds borrowed from taxpayers over a period of, say, 4 months. The amount of borrowing needed for short-selling $200 worth of securities is assumed to be $200.

- Suppose that the price of those securities drops 50% to $500 due short-sellers' manipulation strategies. The vast majority of investors-taxpayers panic and sell at a loss of $500.

- The hedge funds gain $200 x .5 = $100, pay an annualized at, say, 3% or 1% for 4 months equal to $2 on $200 borrowed from taxpayers and pay 30% tax on their net gain of gain of $100-$2 = $98. Hedge funds use other ruses to pay much less tax than 30%. Their net gain after tax and interest is $98 x .7 = $68.6.

- The government gains .3x98 = $29.4 in tax from hedge funds' profits.

- The interest cost to hedge funds is $2. The government/public/central bank gains this interest. The total gain to public/government/central bank is $2 + $29.4 = $31.4 in interest and tax.

- The vast majority of investors-taxpayers lose $500. Only a small part of it gained by the government/public/central bank equal to $31.4 and by hedge funds equal to $68.6 or a total gain of 31.4+68.6 = $100, which 20% of the loss of $500 to investors-taxpayers.

- The massive systemic deadweight loss in comparison to gain is inefficiency. The loss leads to anger and instability of established system of robbery. The gargantuan wealth loss leads to less consumption and increased unemployment or underemployment leading to deflation and economic depression, which makes a bloated government predicated on everlasting growth unsustainable.

Many political leaders including Democratic presidential candidate Bernie Sanders as well as policymakers in USA and Europe are proposing to tax hedge funds at higher rate of interest. The government collecting a larger portion of private hedge fund profits as taxes not solve the basic systemic malaise: moral-hazard driven systemic robbery of wealth creators with impunity guaranteed by established rules of law that allow public lending of private hedge funds, privileged short-selling, market making and clearing by too-big-to-fail banks run by too-big-to-be jailed bankers allied with lawmakers vested in the private hedge funds. The extra tax (even the entire hedge fund profit) is a miniscule part of the gargantuan wealth and employment wiped out by systemic robbery. Besides, those who lost trillions of dollars due to systemic robbery would receive nothing from the government's extra tax on private hedge fund profits.

The economy benefits little as a result of the game played by private hedge funds through systemic rules of robbery. Their game has made wealth creators (investors-taxpayers) panic-prone. When the vast majority of wealth creators continually loses its savings in pension plans and mutual funds and pile on debt for survival, the economy falls into a financial depression. During the periods of the game, the total income of the economy can still grow, especially if sufficient money is printed and borrowed. Such economic growth based on temporal income stability hides the excoriating wealth transfer from the vast majority of enterprising wealth creators to a fringe of private hedge fund owners. Lending public funds to hedge funds is thus financially suicidal for the vast majority of enterprising wealth creators (investors-taxpayers).

3, Conclusion

In a democratically free society, individuals should have the freedom to pursue whatever trades they wish to undertake. But should the government, that represents the vast majority of people, allow a small fringe of hedge funds to frame rules and procedures to borrow taxpayer funds to depress financial prosperity of the vast majority of enterprising wealth creators? The answer is clearly no.

The argument that systemic risk will spread throughout the economy if a failing hedge fund is not bailed out is specious. A highly leveraged hedge fund fails when it can no longer squeeze wealth from taxpayers. Not bailing out leveraged hedge funds will thus have no further adverse impact on taxpayers. Not bailing out weak hedge funds and not lending to the rest would rather have a decisively positive impact on the wealth of the vast majority of taxpayers and prevent a recurrence of the Great Depression.

Furthermore, hedge funds do not produce globally competitive goods and services that enhance national exports and currency. They make the vast majority of taxpayers-investors lose. It is, thus, not optimal for the vast majority or a democratic government either (a) to lend taxpayer funds to hedge funds or (b) to bail out the faltering ones.

Taxes on hedge fund trading profits are used up by a bureaucracy that fails to see the best interest of taxpayers or by lawmakers to fund pet projects that do not enhance national competitiveness defined by higher net exports and stronger currency. The gains to private hedge funds and government decision makers come with huge losses to the vast majority of a nation, who are ultimately pushed towards financial depression. The government decision makers should optimally trade off their short-term gains against the long-term adverse impact on them due to financial depression leading to riots by the majority.

The gains to the fringe privileged private hedge fund owners are credits laden as debt on the majority of enterprising wealth creators who produce globally competitive goods and services. The majority of effective producers of globally competitive goods and services basically lose their savings, remain indebted, and face the brunt of rising prices. This unstable inequity in prosperity is due to the lopsided rules and procedures (like lending taxpayer funds and privileged short-selling, market making and clearing) crafted by hedge fund managers and enacted by lawmakers.

Lending taxpayer funds to hedge funds is perhaps the primary reason for the imbalance in massive credits aggrandized by a few households that is held as debt on the vast majority, globally. Even after $10 trillion of new government debt and $4.5 trillion of new money created by the Federal Reserve, US has 94 million people seeking employment, the rich gotten richer with the top 1% commanding more wealth than the rest and 62 individuals having more wealth than the bottom half. Such imbalance has led to financial and social instability everywhere. Potential riots and mass default on the credits due to such imbalance cannot be ruled out. Such events occurred during the Great Depression. They are <u>not</u> optimal even from the point of view of the few hedge funds that pile up enormous credits, indolently, by foisting lopsided laws on the majority. Lending taxpayer funds to private hedge funds or taxpayer bailout of failing hedge funds (which include large banks) should, therefore, be optimally discontinued.

Surreptitious lending of public funds through financially emaciated and powerless home financing institutions (Fannie Mae and Freddie Mac) to private banks and then to private hedge funds is inefficient, unstable, unconstitutional and unanimously disagreeable within the model of general dynamic equilibrium presented in this paper. The pundits of systemic robbery have not presented any equilibrium model, let alone a general dynamic equilibrium model of the economy to substantiate their proposals.

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