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Editor

Donald R. Byrne, Ph.D.
dbyrne5628@aol.com

Associate Editor

Edward T. Derbin, MA, MBA
edtitan@aol.com

The Financial Fiasco of Two-Thousand Eight (FFTTE)

--- Financial rescue or Gang Rape of the Taxpayer?

WHAT WENT WRONG WITH THE U. S. FINANCIAL SYSTEM A SHORT HISTORY OF THE U.S. FINANCIAL SYSTEM FROM 1930

It has been more than three-quarters of a century since the start of the Great Depression. That horrific period began with a collapse of the financial system. Before it was over, 40% of all commercial banks (nearly 10,000 of them) had been permanently closed, many a result of Roosevelt's "banking holiday". A so-called New Deal began and sweeping changes were made to the financial system.

The Glass-Steagall Act (enacted in 1933 --- 1999)

<http://www.federalreserve.gov/boarddocs/testimony/1998/19980617.htm>

forced the divestiture by commercial banks of most of their other non-depository activities such as insurance, investment banking (broker, dealer,

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and underwriter), etc. Since checkable deposits were rapidly becoming the more popular form of medium of exchange money (referred to as M-1 money nowadays), deposit insurance was enacted with the establishment of agencies such as the FDIC (About the FDIC - <http://www.fdic.gov/anniversary/about.html>).

Beginning with the McFadden Act 1927, through current
<http://www.fdic.gov/about/learn/learning/when/1920s.html>

Even prior to the Great Depression, Congress had passed the McFadden Act to prevent the concentration of financial power. Interstate branching by commercial banks was no longer allowed by the passage of this Act. Interest rates, primarily those paid and charged by commercial banks, came under the jurisdiction of the FED in the now long departed Regulation Q as well as federal usury ceilings on loans. The Federal Reserve System (FED), the central bank of the United States, was reorganized. Essentially, the power of the 12 District Banks was made subservient to the Board of Governors, whose power was significantly increased.

The list of changes made by the Roosevelt lead New Dealers goes on and on. Some of this legislation proved helpful and continues on today. Much of the change that occurred in the 1930s has gradually been eliminated or significantly overhauled by legislative, regulatory, and judicial activities.

The separation of commercial banking activities from other activities such as investment banking is now gone and thru the establishment of holding companies, many financial services are housed under the roof of giant holding companies such as Citigroup.

In theory, fire walls of separation between the subsidiaries of the holding company were to be established and maintained, but in practice, those walls have often proven to be more like combustible papier-mâché.

Interest rate ceilings on deposits are a thing of the past. Usury ceilings on consumer loans at the federal level have been eliminated.

The formerly-called thrift institutions (credit unions, savings banks, and savings and loan associations) have been given the power to create checkable deposits, that part of M-1 or medium of exchange money that

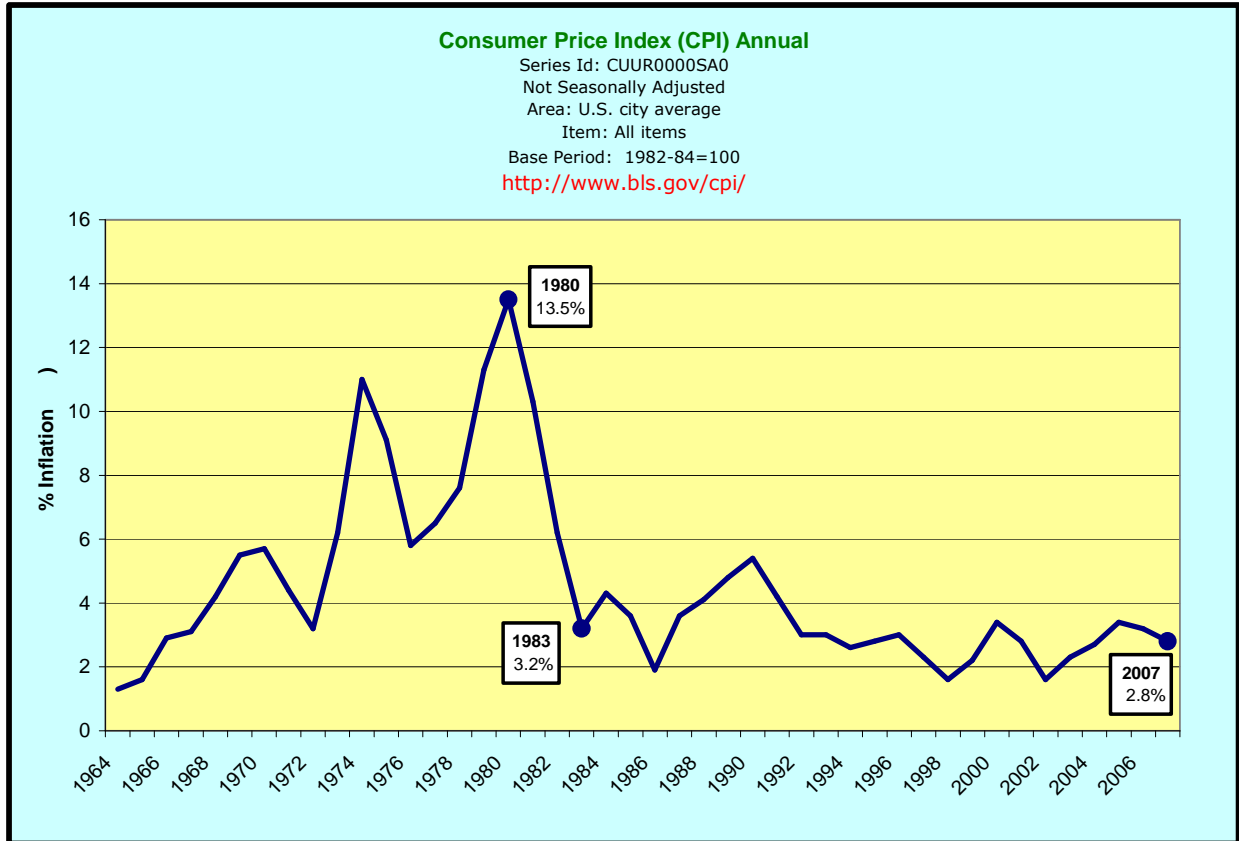
facilitates around 90% of the legitimate transactions of the American economy (the other illegitimate part of the economy is referred to as the underground economy where activities are illegal and indictable).

Deposit insurance has been gradually raised from \$2,500 in January 1934 to the newly established ceiling of \$250,000.

Congress was not directly responsible for all of the changes. The inflation of the 1970s, especially the roaring inflation of the late 1970s, caused enormous and rapid changes in the landscape of the financial markets. The explosion of change in the markets led to many new financial products and processes such as: securitization, asset-liability management, the growth and increased use of the external currency markets (e.g. Eurodollars), stripping of coupon bonds, adjustable rate mortgages, heightened cash management practices such as swept balances, an increasing variety of derivatives, etc. etc. These changes grew to enormous importance as inflation peaked at the end of 1979 beginning of 1980 at an annualized rate approaching 20%.

The era of managing interest rate risk; the sinister and for many, the hard-to-understand risk that faces both the investors and those seeking to acquire the credit, was placed on a par with the management of the many other types of financial risks such as credit or default risk. Along with the inverse relationship of interest rates to security prices and the born-again version of the Fisher effect, Rational expectations, concepts such as duration became the hot topics as rampaging inflation drove market interest rates upward to near record levels and caused the collapse of the prices of virtually all financial securities (Fisher Effect - <http://byrned.faculty.udmercy.edu/2003%20Volume,%20Issue%203/Fisher%20Effect.htm>) .

To quell the chaos, Paul Volcker was called to lead the FED out of its errant ways and to restore the fight against inflation to the *numero-uno* priority of monetary policy. By the spring of 1980, the FED's new policy of monetary restraint forced the nation into one of its sharpest declines in history. While not lasting as long as the Great Depression of the 1930s, it was very intense and lasted two and one-half years. The inflation rate was driven down to 4-5%, but the unemployment rate peaked above 10%. The rest of inflation was to be eliminated more gradually, with a "soft landing" a few years later.

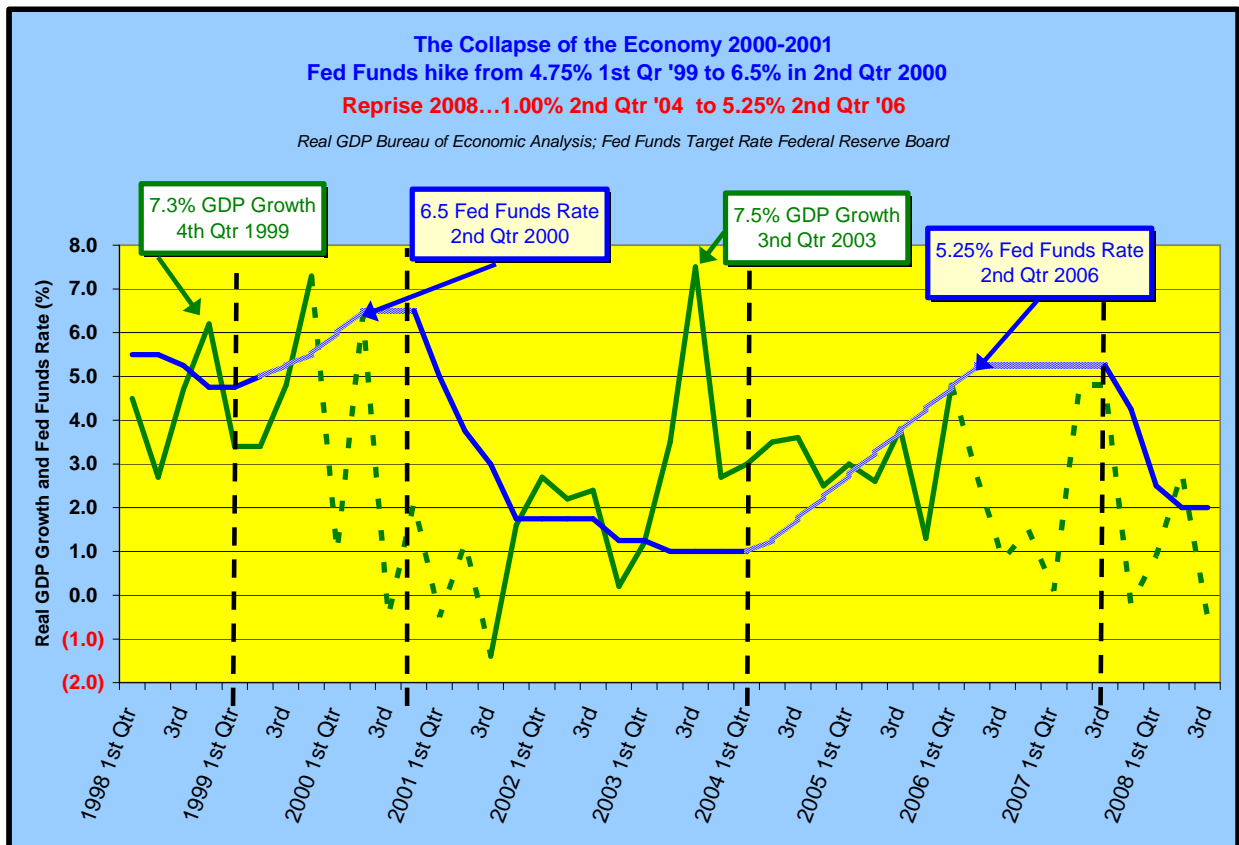


Social engineering of the financial system has increased to more precarious heights from its relatively humble New Deal beginnings. Legislation such as the Community Reinvestment Act have forced financial institutions such as commercial banks and other depositories, mortgage bankers, and other financial intermediaries to make what would normally be classified as bad or junk loans, especially in the area of residential mortgage lending. Vested interests, in this case community activists such as those from groups like Acorn, effectively use the CRA to force financial mortgage lenders to make significant numbers of what traditionally were called bad loans.

THE CONVERSION OF THE U. S. FINANCIAL SYSTEM INTO A POWDER KEG WAITING FOR SPARKS TO SET IT OFF

This brief review of the U.S. financial system contains the elements of the construction of a powder keg waiting to be ignited. The two major sparks that have ignited this powder keg will be spelled out initially, followed by the various factors that gave rise to the increasingly explosive financial powder keg, that was finally ignited.

The two major sparks, so to speak that caused the ignition are the cartelization of the U.S. petroleum industry that occurred mostly between the mid-1990s and was pretty much completed by 2002. The second factor was the ill advised policy of monetary restraint of the FED which began in mid-2004. This was the second time in a period of around six years that the FED aided and abetted a collapse in the U.S. economy, the first being in the first three quarters of 2000.



From the Newsletter
 January 5, 2006

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(The Killing Fields: Weak links in an otherwise strong economy)

<http://byrned.faculty.udmercy.edu/2006%20Volume,%20Issue%201/2006%20Volume%20Issue%201-b.htm>

ENERGY COSTS

As we spelled out in a previous issue of this newsletter and referenced in the prelude, the recartelization of the American oil industry and environmental resistance have kept the energy industry being able to develop and expand to meet the needs of consumers. American businesses and households have been trapped in a virtual killing field of high-energy costs; with little hope of any relief in the near term. While critics lump the U.S. and China together as the primary polluters of the global environment, France has been noted as the poster child for all that is right in terms of energy conservation. The truth is that France has chosen to rely on nuclear energy for much of its electrical production.

<http://byrned.faculty.udmercy.edu/2004%20Volume,%20Issue%203/Newsletter%20Volume%202004%20Issue%203.htm>

RISING MORTGAGE INTEREST RATES

In addition to the rising energy costs and insecurity in the labor markets, households are now facing an additional burden of rising interest rates, affecting their mortgages. As short-term rates are driven up by the Federal Reserve actions in the Federal Funds rates, it influences other short-term interest rates to rise as well.

In the area of variable rate mortgages (ARMs), the Fed's actions are gradually triggering the adjustment clauses in these mortgages. This increases the monthly payments, reducing further the disposable income available to purchase other goods and services and also reduces the cushion protecting homeowners from defaulting on mortgages.

In this very newsletter, again back in January 2006, we warned of the dire results of two "Killing Fields" that were devouring the public's discretionary income. Those two factors that were to ignite the explosion of the financial system were the historically high energy prices reflected in the price of crude oil peaking around \$145 per barrel and rising mortgage payments resulting from the FED's ill advised policy of monetary restraint in 2004. The financial fiasco came to be, with the collapse of the housing market and the revelation of unacceptably bad behavior of the financial services industry led by the greed kings, the investment banking industry.

The (Re) cartelization of the U.S. Oil Industry

As the 1970s and 1980s clearly showed us, when the world economy grows; in unison, the demand for energy, especially oil, surges. Recall that in 1973, OPEC took control of the production and pricing of its crude oil production from the so-called Seven Sisters, ordering them to cut production and raise prices by 300% from \$3.50 per barrel to \$14.00 per barrel. Again in 1978 OPEC reduced production and doubled prices from \$19 to \$38 per barrel. In real dollars, that price was not surpassed until 2008.

In the first illustration

How does world expansion affect demand for normal goods such as energy (income elasticity)?

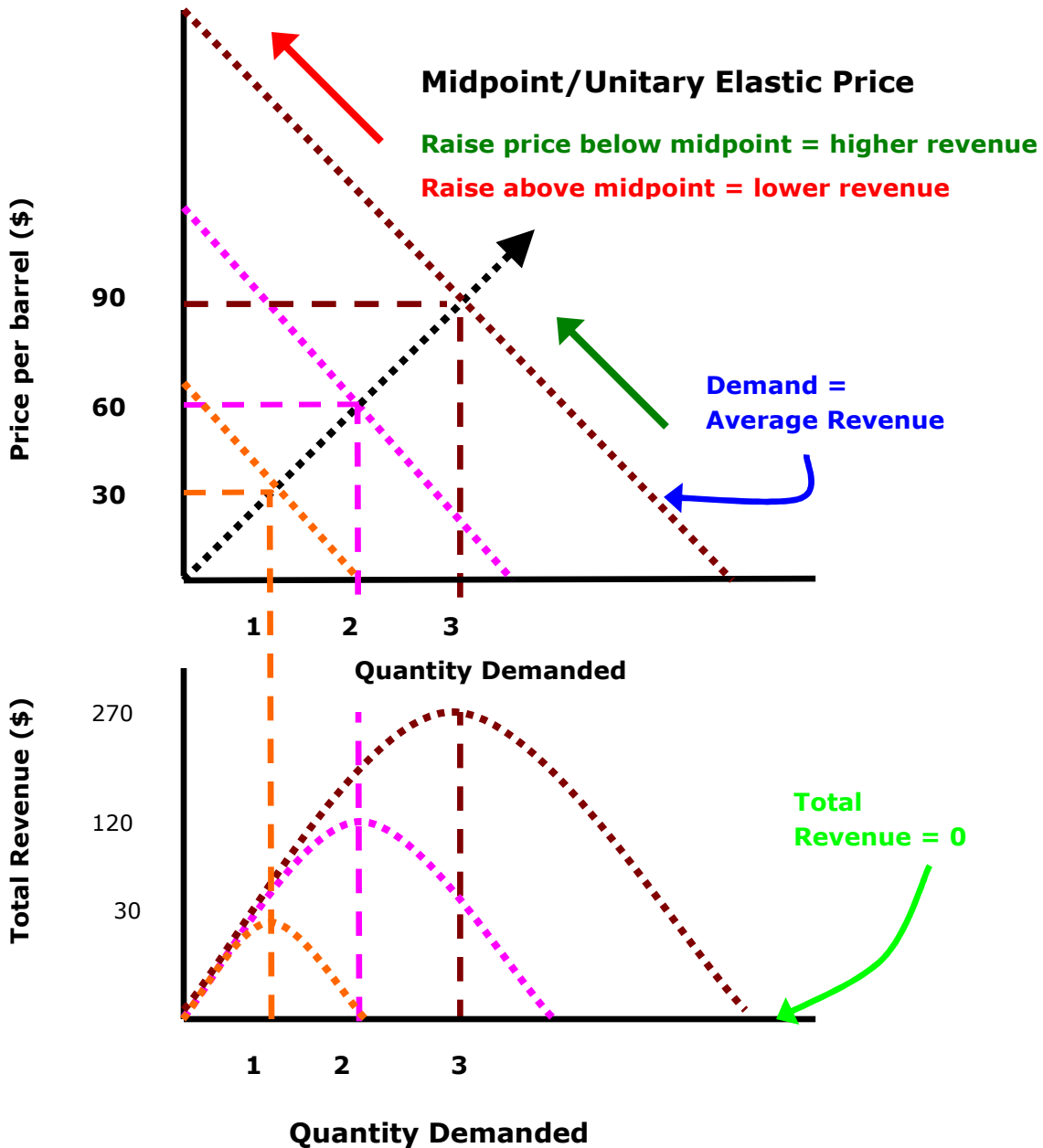
How does price elasticity of demand decrease as demand increases? The first graph helps show how this in turn can translate into increased market/monopoly power of firms.

In the second illustration

How does the contraction of the world economy affect the demand for normal goods (income elasticity)?

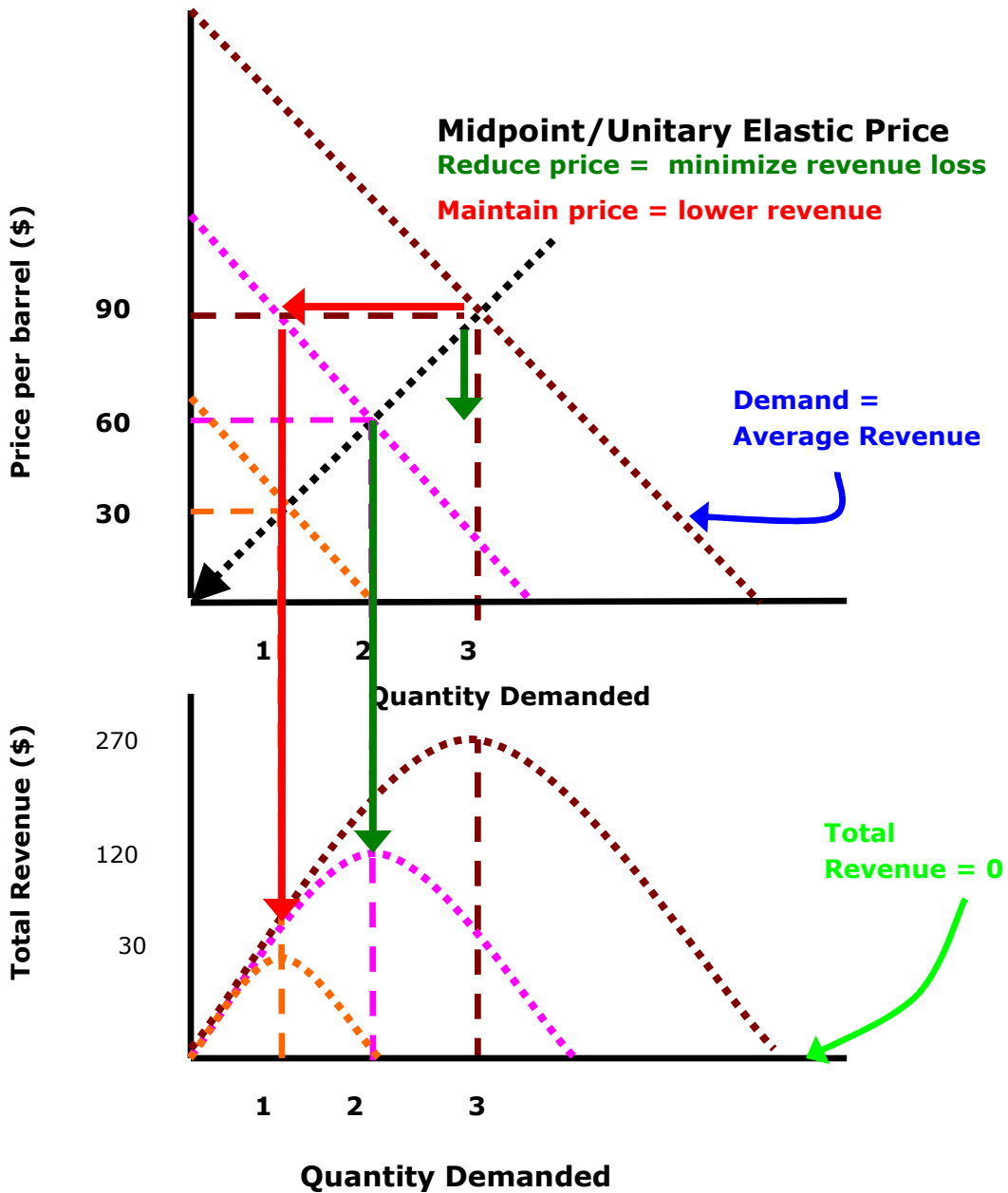
Scenario ONE: Increasing World Demand shifting Demand Curve outward, allowing revenue enhancing price increases

Average Revenue (top) and Total Revenue (bottom)



Scenario TWO: Shrinking World Demand; shifting Demand Curve inward (the only way to minimize revenue loss is to reduce price)

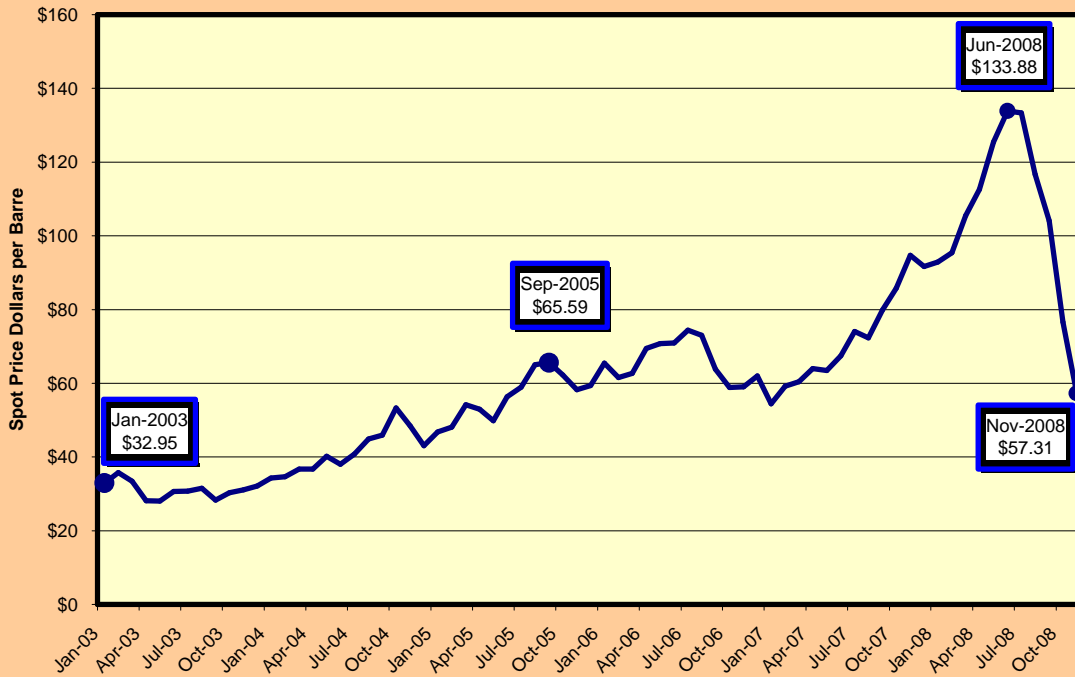
Average Revenue (top) and Total Revenue (bottom)

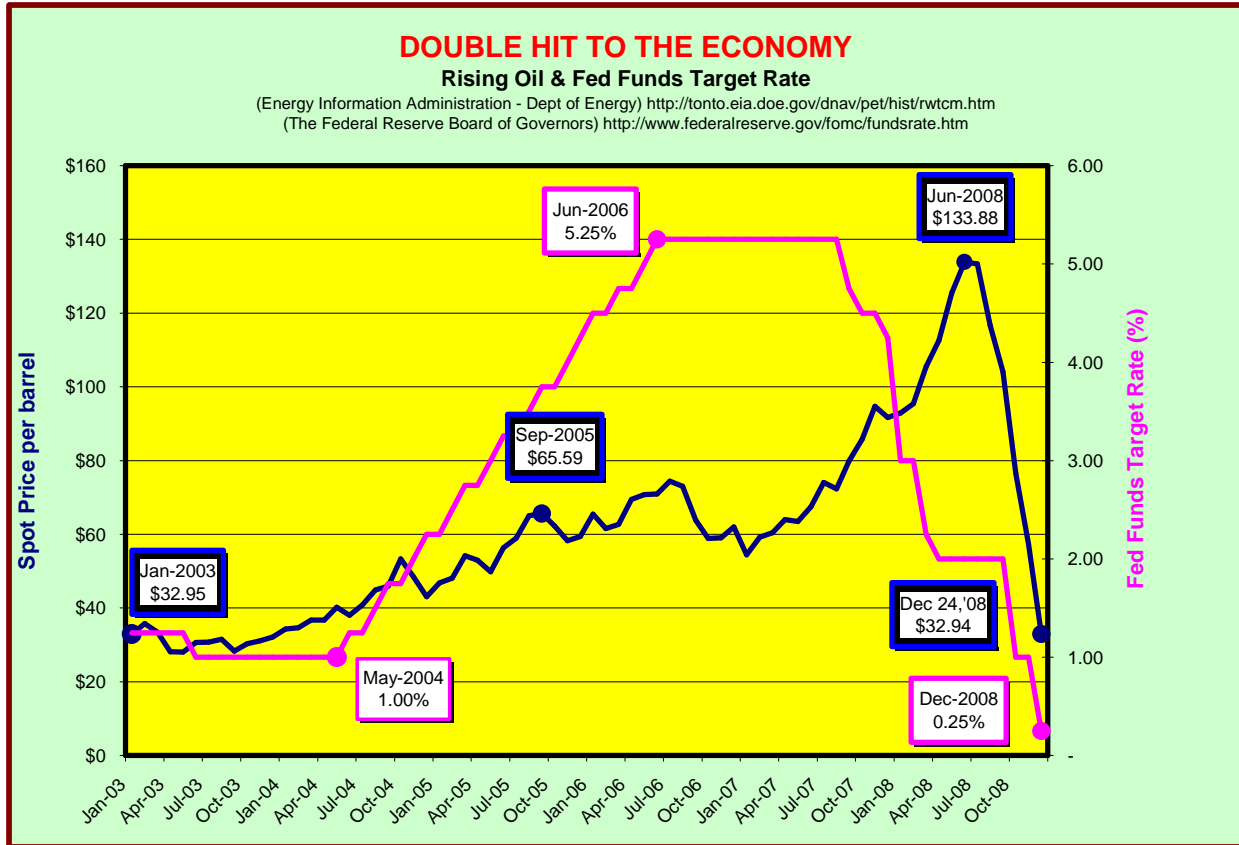


Typically, these oil shocks would last less than two years as the threat of escalating inflation would cause the FED to launch a policy of monetary restraint that would slow the economy and reduce the market power of OPEC as a result. The cartelization of the U.S. oil industry in the 1990s changed that pattern. With 12 of the oil companies (mostly the large ones like Exxon and Mobil) combining into 4 giants, they would “bow to the market forces” and raise their prices to OPEC levels. Alas: so much for the beauty of competitive free market capitalism. Karl Marx cheered heartily from his grave. Rates of return on equity for the giants like ExxonMobil rose to the 35% range – hardly a result of managerial genius. Along with the environmentalist’s pressure to reduce reliance of other competing fossil fuels such as coal, the oil companies had a field day in expropriating the consumer surplus and destroying their discretionary disposable income.

This cartelization of the U.S. oil industry was responsible for extending the period of the 2003 oil shock to nearly 5 years. What do you suppose this would do to the millions who would be facing interest rate resets and rising monthly mortgage payments as the Fed launched a policy of monetary restraint in mid-2004?

Monthly Crude Oil Spot Price
(Energy Information Administration - Dept of Energy)
<http://tonto.eia.doe.gov/dnav/pet/hist/rwtcm.htm>
Monthly Cushing, Oklahoma WTI (West Texas Intermediate) Spot Price FOB





CONSOLIDATION IN THE OIL INDUSTRY

ALLOWING THE MERGERS IN THE DOMESTIC OIL INDUSTRY

U.S. Government Accountability Office

Report: GAO-04-951T

Mergers and Other Factors that Affect U.S. Refining Industry

Released: July 15, 2004

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Click here to download full report (a must read)

<http://www.gao.gov/new.items/d04982t.pdf>

**Statement of Federal Trade Commission Chairman Timothy J. Muris
on the (above) GAO Study on 1990s Oil Mergers and Concentration**

The FTC Defense (2004)

<http://www.ftc.gov/opa/2004/05/gaostatement.shtm>

**The FED and its Ill-Advised Policy of Monetary Constraint
Beginning in mid-2004**

The corporate mindset of the FED changed significantly in 1980 as they were severely criticized for allowing inflation to accelerate to the brink of runaway inflation in the late 1970s. The FED would no longer be reactive, not proactive but would become preemptive in coping with potential inflation. It showed this in 1998 when it began a policy of monetary restraint, fearing what they believed was an overheated economy growing at what their Chairman considered an unsustainable rate. Phrases like irrational exuberance and the wealth effect were uttered by the Federal Reserve Chairman and were repeated on hundreds of newscasts.

March 2008 – Newsletter

<http://byrned.faculty.udmercy.edu/2008%20Volume,%20Issue%201/2008%20Volume%20Issue%201.htm>

Enter the FED in 2004

Now, cloaked in paranoia concerning inflation and still on a guilt trip emanating from the late 1970s when they failed to stem accelerating

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inflation, they shifted to a pre-emptive strategy instead of a reactive or proactive one. The FOMC (Federal Open Market Committee), the real focus of the FED's authority and power, divined that with any significant growth, inflation could not be far behind.

Despite deflationary effects of significant growth rates in productivity, paranoia drove the FOMC to slow the economy. Asset prices became a topic of interest for FED officials, among them Alan Greenspan. Housing prices were especially of concern to the former chairman.

"Our forecasts and hence policy are becoming increasingly driven by asset price changes. The steep rise in the ratio of household net worth to disposable income in the mid-1990s, after a half-century of stability, is a case in point. Although the ratio fell with the collapse of equity prices in 2000, it has rebounded noticeably over the past couple of years, reflecting the rise in the prices of equities and houses."

Remarks by Chairman Alan Greenspan
Reflections on central banking

At a symposium sponsored by the Federal Reserve Bank of Kansas
City, Jackson Hole, Wyoming

August 26, 2005

<http://www.federalreserve.gov/Boarddocs/Speeches/2005/20050826/default.htm>

The rapidly rising tax revenues resulting from several years of tax rate increases recommended by the Treasury Secretary Robert Rubin were turning the Federal Government Budget deficit into a surplus and applying a heavy duty braking to the U.S. economy. A growing trade deficit was also applying additional braking to the economy. Shortly after the FED joined the orgy of policy restraints, the economy collapsed in the third quarter of 2000. It fell from a real growth rate of 7.3% in the Fourth Quarter of 1999 to a negative real growth rate of 0.5% in the Third Quarter of 2000 – not 2001.

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Apparently the FED learned nothing from that experience since they repeated their mistake again in mid-2004 with the same results on economic growth. This time, their pressuring of short-term interest rates triggered the resetting of interest rates on ARMS and the resulting glut of foreclosures ensued. Now the borrowers, already stripped of discretionary income by record high energy prices, could not cope. This included prime, and above prime borrowers, not just sub-prime borrowers.

The first collapse in 2000 was a result of bad economic policy by the FED (monetary policy) and by Congress (fiscal policy). The FED once again began a policy of monetary restraint in 2004, in order to preempt what it saw as a potential problem of inflation. The culprit was a supply side shock coming from OPEC's restriction of supply in the face of a rising world demand for oil and its refined products. This time around, the upward movement of prices was supported by the newly cartelized U.S. oil industry that would "go-along" with the "market-forces".

The data shows clearly that this time, most of the other non-oil related markets were much more competitive, especially at the retail level and firms had a difficult time in passing on the energy related costs. The CPI data shows that prices at the retail level did not reflect the rise in those at the producers' level as shown in the PPI data. In some industries such as light vehicles, already anemic profits suffered intensely as a result. Nonetheless, the FED decided to pursue a restrictive monetary policy. Fortunately, by 2003, fiscal policy had turned expansive, but the trade balance was still in large deficit and depressing. The FED influenced the Fed Funds rate upward from 1% to 5.25% or a 425% increase. Other short-term interest rates followed, such as the one year Libor. This began to trigger the resetting of ARMs mortgages and the foreclosures that soon followed.

This was bad policy by the FED based upon increasingly irrelevant theories of how the economy works. Now, after all the damage, the FED has reversed itself and influenced the Fed Funds rate back down to below 1.00% in December of 2008.

Let's ask the questions:

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If the FED (Federal Open Market Committee - FOMC) had not pursued that restrictive policy of monetary restraint five years ago which was based on pre-empting inflation, would ARMs interest rates have been reset upward and mortgage payments increased and the flood of foreclosures occurred?

We think not.

Bad theory leads to bad policies and disastrous consequences. It caused the collapse of the U. S. economy in 2000 (not 2001) and caused the FFTTE now occurring.

Had the FTC (Federal Trade Commission) opposed the recartelization of the American oil industry in the 1990s, could rising mortgage payments in the last five years have been made more easily?

Again, these were bad policies by government agencies mandated to help not harm the economy.

The sparks of bad policy by the FED and the FTC ignited the powder keg and gave us the Financial Fiasco of 2008 (FFTTE).

Like most problems in life, some of the roots of the current financial chaos began years ago and are often lost among those of more recent origin. After having briefly reviewed the more recent history of the U.S. financial system, this issue of the newsletter will now list the more important factors that turned the financial system into a powder keg waiting to be ignited by one or more sparks. The sparks consist of a much shorter list that will be examined shortly.

Despite all the newscasts and the ranting and raving of the so-called experts, both legitimate and the think-they-ares and wannabes, confusion still reigns. Even with the passage of legislation estimated to cost three quarters of a trillion dollars, critics are already calling for its repeal since it does little to identify and address the underlying problems that caused the financial fiasco of 2008 (**Financial Fiasco of Two-Thousand Eight---FFTTE**). Now we find the auto industry holding its hand out for rescue from it and the UAW's misbehavior over the decades. The so-called financial

legislation is loaded with what are often referred to as “earmarks” virtually unrelated to the ongoing financial chaos.

We ask for your patience as this issue of the newsletter attempts to systematically clarify why it all happened.

The Roots of the Financial Fiasco of 2008 (FFTTE)

How the powder keg that finally exploded was constructed.

1) The use and abuse of LEVERAGE

In the financial services industry, firms use a high degree of what is called, financial or debt leverage (high ratio of debt or liabilities to assets which is the same as a low capital to asset ratio) to offset low operating leverage (or ratio of profits to assets). To earn a reasonable return on owners’ equity (or the ratio of profits to owners’ equity), the low capital ratios are necessary. But this results in a vulnerability to bankruptcy and hence requires the avoidance of any serious degree of risk taking. This basic condition has obviously been ignored at best and not understood by highly rewarded executives, at worst. The same can be said for the regulators and for Congress that habitually passes laws treating these business firms as though they were not-for-profit charities.

2) The GREED FACTOR

Research shows the long-term real rates of return on the average of stock (equity capital investment) is about nine or ten percent over long periods of time. Yet firms are expected to provide rates of return of 20 or 25 percent, if not higher. This can only be achieved with market power (lack of significant competition in the firm’s product markets) or chasing yield which means bearing high degrees of risk. The 30 to nearly 35 percent return on equity of some major oil companies in the last few years, is not due to the genius of their corporate leaders, but rather it is due to the re-cartelization of the American oil industry that occurred in the 1990s as the anti-trust

authorities (Anti-Trust Division of the Justice Department and the Federal Trade Commission) stayed on the sidelines for the most part, mumbling about the Chicago School of economic thinking, for their failure to act.

The major oil companies in the U.S. were just “bowing to the market forces” as they raised oil prices to \$147 per barrel in July 2008. These are the “market forces” that they had successfully emasculated by eliminating much of the competition by mergers and acquisitions in the 1990s. Such mergers and acquisitions helped reward investment bankers at firms such as Lehman Brothers, Merrill-Lynch and Goldman Sachs, with over \$100 billion in bonuses during the three years just before they pleaded for a bail out, to which the FED and Treasury Department with Congressional approval, promptly undertook. The bonuses were not taken back nor were households with foreclosed homes ever aided. Much of these huge bonuses of the investment banking firms were contingent upon high levels of profits, not attainable without incurring risk, whether perceived or not (e.g. mortgage backed securities).

In the case of the federal agencies such as Fannie Mae, insuring formerly uninsurable mortgages were pressured by Congressmen from both Houses of Congress, and community groups like ACORN, using legislation such as Community Reinvestment Act to threaten mortgage lenders to make bad loans or else law suits would soon follow. It is not risk if it never will materialize. Of course it was risk and it did materialize.

3) The **DEMISE** of the **COMMERCIAL LOAN DOCTRINE** of bank management

Commercial banks, as do other depositories (such as credit unions and savings banks) not only have low capital ratios as examined above, but also have liabilities that are very short term in maturity. The checkable deposits that they create in the process of credit creation are payable on demand. The time deposits, while not checkable and not payable on demand have on average, very short term maturities. The time deposits include passbook savings deposits as well as certificates of deposits. Some depositories, primarily large commercial banks, incur other liabilities, usually called borrowed or purchased funds. These other liabilities are usually short term in maturity and carry higher yields, and if they become a significant source of funds, are frowned upon by regulators. In their heyday, significant reliance on these funds to maintain required reserves at mandated levels, caused those banks to be called, go-go banks.

Because of the average shortness of maturity of their liabilities, and their low capital ratios, adherence to the commercial loan doctrine called for bank lending to be short term and self-liquidating. Short term lending was standard practice to match the short term maturity of their liabilities and self liquidating to compensate for the low capital ratios, and as a consequence, their inability to bear serious degrees of risk from whatever source. Working capital loans and not competing with the bond and stock markets to supply long term funds, was the intent of the commercial loan doctrine.

As the money markets developed, bank management philosophy changed to what many analysts called the *Shiftability Doctrine*. Dedicate a portion of the assets to money market securities, which are short term in maturity and low in both credit and interest rate risk, and the rest of the portfolio can be shifted to longer maturities, on the average. Of course, as time has shown, when liquidity is needed and short term securities such as Treasury bills are sold, quite often every institution is doing the same and the prices of those securities fall sharply. Such liquidity is akin to road service in inclement weather. The earliest the service will be there to help you is the following day, since everyone else is calling for the same service. Money markets have at times behaved like the real estate market in the last two or three years. With all the foreclosures, the supply greatly increases and gluts the market causing housing prices to decline by 15% and even more in some markets.

As the financial markets further developed, other sources of funds materialized: federal funds, Eurodollars, repurchase agreements, brokered CDs, etc. Now the argument was that liquidity could be purchased by issuing new types of liabilities, allowing an even greater latitude of maturities on the asset side, and banks especially, shifted to the now popular asset-liability management philosophy (ALM). This lengthening of the asset maturities led such institutions into the lair of the insidious interest rate risk, reflected in the inverse relationship of financial securities prices to interest rates, as we shall see shortly. The parallel development of marking to the market and in certain accounting applications, the lower of cost or market, exacerbated the threat of insolvency. This occurred when interest rates rose either as a result of inflation (the Fisher effect to be examined shortly), or from the FED's restrictive monetary policy which we have seen, helped collapse the economy in the very late 1990s and again in May 2004 through August 2007.

4) Another risk to threaten solvency: The **INCREASE IN INTEREST RATE RISK**

Owning equity or long-term debt securities for investment purposes and for trading purposes is inherently risky in terms of interest rate risk (inverse relationship of security prices to interest rates) even if those securities credit or default risk, or its equivalent beta for stock, is very low. The longer the term to maturity and the lower the coupon rate or its equivalent, the greater the percentage decline in the market price of the security for a one-percent rise in interest rates.

Two components of *Interest Rate Risk*

The two components of **interest rate risk** are the ***price risk*** and the ***reinvestment risk***.

The ***price risk*** is greater the longer the time to maturity and the lower the coupon rate.

The ***reinvestment risk*** is greater the higher the coupon rate.

This is what helps drive the inverse relationship. The combination of the coupon rate and the time to maturity determine the duration of the financial asset. Of course, the determination of these values is more precise for debt securities such as bonds where there is a contractual relationship and much less precise for equities such as common stock, where there is no contractual guarantee of the cash flow.

Interest rate risk should not be confused with credit or default risk. The only link between the two is a result of the risk premium reflecting the probability of default. The higher that probability, the higher is the coupon rate and hence, the smaller the interest rate risk. Other than that, the two types of risks, interest rate risk and credit or default are not related.

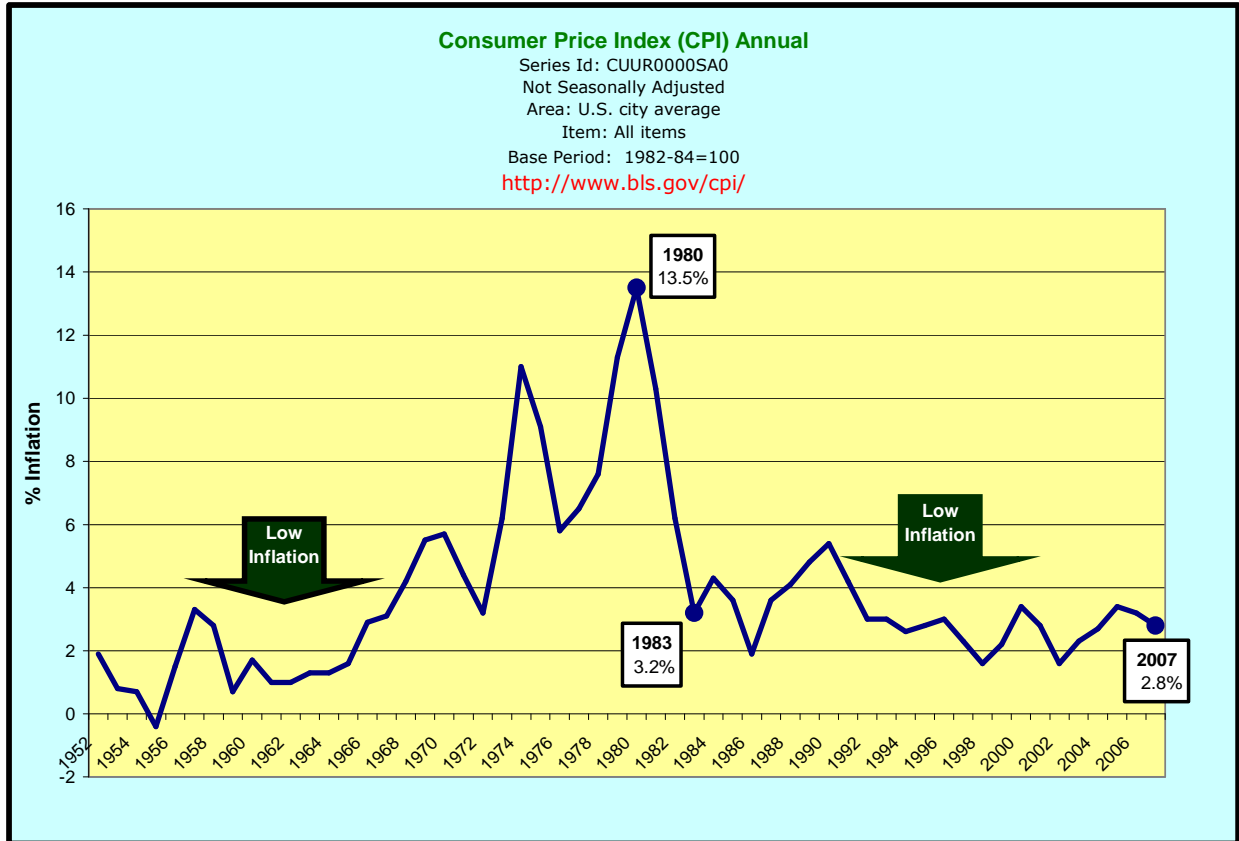
Long-term U.S. Government bonds have little credit or default but have a significant degree of interest rate risk.

You can eliminate the reinvestment risk part of interest rate risk by investing in zero coupon or pure discount debt securities such as bonds since there is nothing to reinvest, but as the coupon interest rates decreases, the price risk increases.

Variable or adjustable rate loans reduce interest rate risk but often increase the credit risk, since some of the interest rate risk is shifted and shared by the borrower (potential for higher monthly payments) instead of being borne entirely by the lender (real interest rate falling as inflation increases). But for sharing in the bearing of interest rate risk, the borrower must be given a reward in the form of a lower interest rate for an initial period of time (usually 2, 3, or 5 years) before the rate can be adjusted upward (or downward) usually once or twice per year, and the payment increased (or decreased). More to follow later...

5) TRANSFORMATION of the **FINANCIAL LANDSCAPE** resulting from the roaring inflation of the 1970s.

The decade of the 1970s caused a tremendous change in the financial landscape, both in terms of the markets and the way both borrowers and lenders reacted to inflation. After the Korean War inflation, the American economy experienced a twelve year period of near price level stability (1952-1964). Virtually all the economic sectors were lulled into sleep concerning the issue of inflation. So what, you say. When inflation is occurring, the nominal or the market rates of interest you observe diverge from their real or price level adjusted interest rate counterparts. The real interest rate becomes less than its nominal interest rate counterpart, by the actual rate of inflation. By 1979 nominal mortgage rates were near 20% and the inflation rate averaged for that entire year, about 15%. This meant that real mortgage interest rates were about 5%. In those days, most were fixed rates and were often for periods running 30 years in maturity.



As the public began to understand and adjust to such high inflation rates, any delusion that the nominal or market rates were the same as their real interest rates counterparts, had dissipated. The behavior pattern of most of the public was approaching that of Rational Expectations. Writing around 1900, an American economist, Irving Fisher, argued that the nominal or market interest would be higher than its real interest rate counterpart by the actual rate of inflation, so the real interest rate was not influenced by inflation, only the nominal or market rates of interest were so influenced. The participants in markets would adjust the nominal interest rate upward by the expected rate of inflation when inflation was occurring and expected to continue.

They would adjust the nominal interest rate downward when deflation was occurring, and expected to continue. The market expectations of inflation would be correct and equal the actual rate of inflation. This is the Fisher

Effect. The same reasoning is found in the Rational Expectations theory as referred to a bit earlier.

As inflation continued into the late 1970s, market rates of interest increasingly reflected these high and rising inflation rates. That is why mortgage rates rose toward 20% nominal levels and Treasury Bill rates rose well above 14% nominally. In reality, their real interest rate counterparts were much lower, by the actual rate of inflation. Given the inverse relation of security prices to (nominal or market) interest rates, the security prices in all financial markets, including the bond and stock markets fell dramatically. The Bears were in charge and inflation had vanquished the Bulls.

6) TOO BIG TO FAIL and TOO SMALL TO CARE doctrines

With the collapse of most of the savings and loan industry and some other depositories in the late 1970s and early 1980s, the collapse of the (wholly owned by the U.S. Government) Federal Savings and Loan Insurance Corporation (FSLIC) was not far behind. There were three such federally owned insurance corporations, the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), the National Credit Union Administration's (NCUA) insurance subsidiary. Only the FSLIC failed, although the FDIC showed signs of going the same path and was saved by the collapse of market rates of interest and the economic recovery that began in mid-1982.

A problem that continues on today is that insufficient premiums were collected to fund widespread failures of the depositories. Even worse, the FSLIC adopted the TOO BIG TOO FAIL Doctrine. At the time, the insured portion of deposits was only up to \$40,000 (<http://www.fdic.gov/about/strategic/report/2000AnnualReport/pg97.html>). FSLIC exceeded that limit and of course ran out of funds and began to borrow from the U. S. Treasury. FSLIC went belly up, so to speak. The resulting bail out of FSLIC and its debt in the amount of \$124 billion is still carried by the Treasury today as part of the National Debt.

(http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf)

The Cost of the Savings and Loan Crisis: Truth and Consequences
(2000)

The savings and loan crisis of the 1980s and early 1990s produced the greatest collapse of U.S. financial institutions since the Great Depression. Over the 1986–1995 period, 1,043 thrifts with total assets of over \$500 billion failed. The large number of failures overwhelmed the resources of the FSLIC, so U.S. taxpayers were required to back up the commitment extended to insured depositors of the failed institutions.

As of December 31, 1999, the thrift crisis had cost taxpayers approximately \$124 billion and the thrift industry another \$29 billion, for an estimated total loss of approximately \$153 billion. The losses were higher than those predicted in the late 1980s, when the RTC was established, but below those forecasted during the early to mid-1990s, at the height of the crisis.

In this most recent Financial Fiasco of 2008 or FFTTE (or as cynics say, Phhhttt in the vernacular), the U.S. Treasury has been mandated by Congress to bail out far less worthy belly uppers such as the investment banker gang, ignoring the huge bonuses paid to the very people that were promoting the sales of the junk securities that are so much a part of the Financial Fiasco of 2008 (FFTTE).

TOO BIG TOO FAIL or TOO MUCH PAC MONEY TO BE LOST

So much for pushing the argument that “the National Debt is too large”, when the same politicians bellowing out this argument are signers of the so called Bailout Bill which will raise that debt significantly and lead to the argument that taxpayers must come up with more bail out money in the form of higher taxes.

“Do not do what we do, do what we say”.

“Talk the talk but do not walk the walk”.

The interpretation of the “lower the National Debt argument” must be, increase the tax burden of the taxpayers.

What about the several million households that lost their homes in foreclosure?

TOO SMALL TOO CARE

As the soon to be beheaded, Marie Antoinette advised her advisors, "If they have no bread, give them cakes" or as found in Scripture, do as Dives did to Lazarus and give them crumbs.

All of those fat bonuses paid to the investment bankers, earned mostly from their sales efforts that helped cause the FFTTE (phhhtt), would go a long way toward healing the households who lost their homes.

7) CONFUSING HEDGING with SPECULATION or perhaps cloaking speculation with a veil of hedging

"If it looks like a duck, walks like a duck and, and quacks like a duck, it is probably a duck", goes the popular saying. One of the first and most infamous of the so-called hedge funds, LTCM (Long-Term Capital Management http://en.wikipedia.org/wiki/Long-Term_Capital_Management), managed and counseled by so-called experts including some Nobel prize winners, was allowed to become so large and so risk laden, that the FED, our beloved central bank, bailed them out under the now seemingly etched in granite, TOO BIG TOO FAIL Doctrine.

What was learned from that episode? Apparently nothing... Perhaps something was learned by the street-wise big hitters. If you are going to fail, be big and fail big, otherwise the Doctrine of TOO SMALL TO CARE will be invoked instead of the TOO BIG TO FAIL Doctrine.

Hedging is an act of reducing risk and paying a cost to achieve a greater degree of financial certainty. Speculation is an act of taking on risk (financial uncertainty), usually for a fee or reward. They are not the same. Securitization, the using futures contracts, and other such efforts can be used to hedge, but they can also be used to speculate. It is not the job of the FED, or the Treasury Department, or Congress to bail out speculators. Much of the price excesses in the real estate and oil markets were a result of speculative activities that did not prevent price excesses but that aided in

those excessive price swings. The literature concerning destabilizing speculation is neither new nor scarce.

Destabilizing Speculation – nothing new under the sun...

<http://www.federalreserve.gov/pubs/feds/1997/199722/199722pap.pdf>

The 1934 U.S. Congress established Federal margin authority with three apparent objectives: to reduce the use of “excessive” credit in securities transactions; to protect investors from over-leveraging; and to reduce the volatility of stock prices. The Congress evidently believed that a federal margin policy could be used to control the amount of credit allocated to “unproductive” investment in the stock market and thereby reduce the effects of destabilizing speculation on stock prices. The view prevailing in Congress held that there existed a fixed pool of credit available to support investment activities, and any credit that was used to purchase stocks was credit that was unavailable to finance productive investments in new plant and equipment. Moreover, it was widely believed that stock-related credit supported the activities of speculators whose trading activities allegedly created unnecessary volatility in the stock market.

8) EFFICIENT MARKET HYPOTHESIS and those who claim they can consistently beat the market

There is a heavily researched, widely accepted, and highly credible theory that no one (nor no group) can consistently beat the market. It is called the Efficient Market Hypothesis or EMH. A similarly researched and widely held theory of much value is the Capital Asset Pricing Model or CAPM. These theories support the growing use of indexing and undermine the belief that expert analysts and active fund managers can consistently beat the market.

Yet these analysts continue to urge buying and selling and churn fund assets as though they can consistently beat the market. “*A Random Walk Down Wall Street*” by Burton Malkiel and similar literature should be a required reading for all investors and Congressional members of both the House and Senate. Lots of upward and downward swings in the market bring lots of commissions and fees to the brokers and dealers and their firms. Investors are charged for both buying and selling securities. Why hasn’t much of this

trading been computerized to avoid the need for trades to be “touched” by employees of the investment banking firms and fees and commission charged for each “touch”? Have we not gone through a computer and information technology revolution? Their billing of customers certainly reflects this revolution. Why are the services of analysts housed in the same firms as the brokers and dealers who benefit from and charge commissions and fees on every purchase and sale of securities?

Could it be to generate “buy” and soon after “sell” recommendations, leading to significant commissions and fees?

What about all the various types of buy recommendations before the FFTTE?

When the market fully recovers – and then some, as it will, what about all of the sell recommendations that drove the market downward by nearly one-third?

What about all the fees the investment bankers received on mergers and acquisitions that more than anything else, reduce competition in markets such as crude oil, thereby preventing the free market capitalist system from achieving those great goals of equity and efficiency, the economic welfare conditions given the public when competition is vigorous? Huge bonuses to the investment banking industry rest heavily on reducing competition through mergers and acquisitions and the ignorance of investors who believe analysts who can readily beat the market in a consistent manner. If this is not so, why the recent record crude oil prices and prices at the pump and why the current collapse of the markets and why the need to bail out those same investment banking firms?

The major factors that cause interest rates to differ

Preferential tax treatments (**tax structure**), yield to risk (**risk structure – the higher the risk, the higher the yield**), and yield to maturity (**term structure – depending upon market conditions, longer term rates can differ from short term...why? Yield curve**)

Excerpts from "Financial Economics"

Donald R. Byrne

Uncertainty of Cash Flow

The ongoing budgetary difficulties of various states such as Michigan and of financial firms (Goldman Sachs, American Insurance Group, etc) and manufacturing concerns such as General Motors, point out clearly that the ability to meet contractual payments such as debt service is not a certainty. In many cases, the probability of paying interest and principal or of distributing an expected dividend is less than 100%. The lower the probability of receiving an expected cash flow, the greater will be the perceived risk by an investor. An individual investor or a financial intermediary that is anticipating the purchase of a financial claim, will assess the risk of not receiving the cash flow as contractually agreed to by the debtor, and will demand a risk premium commensurate with the degree of uncertainty of the expected cash flow. If the market consensus agrees, the interest rate on borrowed funds will reflect such a risk premium to reward the lender for the uncertainty of the cash flow.

When a bank makes a loan it assesses the uncertainty of the borrower paying interest and principal in a timely fashion. This is called credit risk. Similarly, analysts estimate the uncertainty of the timely payment of coupon interest and maturity values on notes and bonds. In this case the term default risk or credit risk is often used. In assessing the uncertainty of the expected cash flow in terms of the stock market, the uncertainty of the cash flow from a stock in relation to the market as a whole is often referred to as the beta of a stock. These examples all refer to the risk resulting from the uncertainty of the cash flow from an investment be it a loan, bond, stock, etc.

An analysis of what is involved is helpful in order to clarify this concept. A surplus budget unit or a financial intermediary that agrees to lend or sell funds to a deficit budget unit or another financial intermediary expects a cash flow in return. In the case of debt arrangement, cash flow is clearly defined in terms of interest payments and the amortization of principal. In

an equity arrangement, for example the purchase of stock, that cash flow is less clearly defined, but nonetheless is expected despite its vagary. In some cases of an equity arrangement, the expected cash flow is expected dividends and the market price that can be converted into a cash flow by selling the security in the market.

Regardless of the legal nature of the claim, a cash flow of some expected yield or rate of return plus return of original investment is expected. Whether the claim matures and is paid off or whether the original investment is re-obtained only by sale of the security, it makes only a minor difference analytically. Whether the cash flow comes from conversion of a capital gain by liquidation into money or simply a result of a contractual periodic payment without the necessity of liquidating the principal claim, the difference is not major, it is a question of timing. The risk premium will adjust the differences in the probability of the cash flows being received. The critical point to see is that these arrangements, no matter how they differ legally, all involve reciprocal cash flows. The lender (investor), whether it is a individual investor or a financial intermediary, offers a lump sum cash flow over time. The greater the certainty of the return cash flow, the lower the risk. The lower the anticipated risk of that cash flow, the lower the risk premium required to the lender or investor. The more uncertain that cash flow to the lender or investor, the greater the risk premium. This uncertainty is usually termed credit or default risk but on equity investments that is an inappropriate term since there is no such thing as default on an equity claim. The firm cannot default to its owner. Nonetheless, the uncertainty on an equity claim is truly there, and on the average, the uncertainty or risk of the cash flow expected from an equity claim is on the average greater than on the average of debt claims.

The cash flow to the owner of stock is riskier than debt in general, because equity claims generally hold out the prospect of a cash flow that is less clearly defined and occurs only if sufficient profits are earned by the firm that issued the stock. In some cases, that cash flow can only materialize through the selling of the stock claim by the investor. Some firms pay low or no dividends but reinvest their cash flows. The rise in the market price of the stock is a potential cash flow that can be realized only by the sale of the stock claim.

The Capital Asset Pricing Model (CAPM)

The CAPM is an attempt to estimate the value of a stock.

It has several building blocks with built in assumptions. While it can be used for all assets, its most common use is in the valuation of common stock. The initial building block is the need to diversify one's portfolio. A stock by itself bears a lot of risk. However, putting that stock in a portfolio reduces what is called unsystematic risk or risk specific to that stock outside of a portfolio. By adding additional stock to a portfolio, the unsystematic risk of each stock is lessened and the unsystematic risk or diversifiable risk approached zero. The argument continues that in efficient markets, the bearer of unsystematic risk will NOT be rewarded since most investors are efficiently diversified and do not bear unsystematic risk. The stock market approaches efficiency, especially over the longer run. Real estate markets, where location, location is the buzzword, are less efficient. Some of the unsystematic risk would then be rewarded to the investor.

First, a share of stock outside of a portfolio is much riskier than when it is part of a diversified portfolio of stocks, because it bears two types of risk.

- **Unsystematic risk** is specific to the stock and can be eliminated by efficient diversification. In efficient markets, the bearing of unsystematic risk is not rewarded; no risk premium is received.
- **Systematic risk** cannot be eliminated by diversification. The investor, however, can choose the level of systematic risk desired and does receive a risk premium for bearing the risk. The higher the level of systematic risk borne by the investor, the higher the reward. The level of systematic risk is called the *beta* of the stock. It is a measure of the relative covariance of the stock to the portfolio.

Note...approximately 2/3 of risk is unsystematic

9) CONFLICTS OF INTEREST

Conflicts of interest abound in the financial services industry. Investment bankers are allowed to trade on their account while at the same time act as brokers and dealers for their customers in the same securities. Rating agencies have been cited in investigations by the SEC for altering their review methods in order to generate more revenue for their firms. Conflicts of interest are not new but in recent years have made the headlines. The accounting profession has had its Enron type scandals. They must bill the clients they audit. The problem was exacerbated by combining auditing with management consulting. This increased the pressure on the auditors as more fees were at stake with management consulting bundled with auditing. It is akin to self regulation, which often means no regulation.

10) Accounting practices such as marking to market and lower of cost or market can accelerate swings in the financial markets, especially downturns which are aggravated by such practices. So-called conservatism makes it even worse as a practice of lower of cost or market is applied to the asset side of the balance sheet but rarely to the liability side, exaggerating a downturn and reducing the owners' equity as a result.

Accounting is not a precise science; rather it is an art of estimating. When is revenue realized? What method of depreciation is appropriate? What inventory valuation method best estimates the real cost of goods sold? The problem becomes even more daunting when the value of the dollar is changing due to inflation or deflation. The very measuring stick they use is changing. Minimizing taxes in earlier years to take advantage of the time value of money is ever present especially when tax rates are high. Show Wall Street analysts the best numbers to encourage buy recommendations, transfer pricings to reduce overall tax liabilities are similar problems facing accountants.

11) DERIVATIVES: the savior of hedgers or the cause of financial dysentery?

Derivatives have been around a long time. They enable farmers and cereal manufactures to make certain the uncertain. Farming is risky enough without having to face the potential of severe price fluctuation at harvest time. Cereal grain futures enable the farmer to focus on farming and the cereal manufacturer to focus on cereal making. A similar argument can be

made for business engaging international trade. The foreign exchange futures market can reduce the risk. In the financial world, fluctuations in asset values are especially correlated with changes in interest rates as explained above. Lending funds to finance mortgages for long periods of time, is very risky (interest rate risk). This is true even when the borrower is a prime borrower. Mortgage initiators can securitize mortgages and reduce and eliminate the interest rate risk for themselves. **Adjustable rate mortgages or ARMs** can also reduce this risk for the lender whether or not the mortgages are securitized and whether or not the borrower was classified as sub-prime or prime. Much of the securitization of mortgages involves mortgage pools. Many of these pools are insured by federal agencies (such as Fannie Mae and Freddie Mac) on a "with" or "without" recourse basis. The former insures the originator against interest rate risk and the latter against both interest rate and credit or default risk. Some of these pools are financed by certificates of participation but some are financed by such securities as bonds. They have become known as **collateralized debt obligations or CDOs**, etc.

Now we are venturing into the derivatives on derivatives. Futures options have been around for a while. They combine two types of derivatives, the futures contracts and the options contract. What is important to know is that for gamblers, indistinguishable from speculators, the derivatives on derivatives increase the leverage and benefit those who want to speculate, more than those who want to hedge. Unfortunately, there is no guarantee that speculation is a stabilizing factor. It can be a de-stabilizing factor. Some, not most, of the run up in oil prices was caused by speculation. While not strictly a derivative, short selling of stocks has exacerbated downward swings in the stock market by speculators, where for a period of time, they are akin to self-fulfilling prophecies. A problem with derivatives is that they can mask the degree of risk of the underlying asset. When rating agencies are under pressure to generate fees, this masking can take on an art form. What is a sub-prime mortgage? It depends upon the definer. Not all agree. Does it depend upon the borrower or the characteristics of the loan agreement, or both? As a rating agency, which definition is most influential in your rating methodology when it comes to a CDO or collateralized debt obligation?

Some information on CDOs – Collateralized Debt Obligations

November 2007

Wall Street's money machine breaks down

The subprime mortgage crisis keeps getting worse-and claiming more victims

http://money.cnn.com/magazines/fortune/fortune_archive/2007/11/26/101232838/index.htm

“Merrill's structured-finance team gets to work creating a variety of bonds that will be backed by the interest and principal payments the CDO collects on the asset-backed securities it owns.”

12) The New Paradigm and the sparks that ignited the powder keg

This Newsletter was started nearly six years ago in order to apply what the editors and others have argued is a New Paradigm of behavior model that is increasingly useful in examining the behavior of the macro economy (<http://byrned.faculty.udmercy.edu/2003%20Volume,%20Issue%201/Newsletter%20Introduction.htm>). As competition has increased in much of the economy (some notable exceptions such as crude oil and its refining), the biases toward recessions and inflationary episodes it had resulting from lack of competition, have lessened. This means that monetary and fiscal policies based upon the old model of demand side macroeconomics is at best of little value and at worst it can result in harmful macroeconomic policy effects. This happened in 1998-99 when the FED adopted a policy of monetary constraint and aggravated an economy that was already stressed by rising federal government surpluses due to several years of tax rate increases often referred to as Rubinomics (<http://en.wikipedia.org/wiki/Rubinomics>), after one of the Secretaries of the Treasury who convinced Congress of the wisdom of such a policy. The rising trade deficit also increased the stress on the overall economy.

The U.S. economy collapsed in the third quarter of 2000, NOT 2001.

The following is from the 2003 Newsletter (note: data from NIPA has been adjusted since publication)

[http://byrned.faculty.udmercy.edu/2003%20Volume,%20Issue%204/Newsletter%20Volume%202003%20Issue%204%20\(4th%20Newsletter\)%2011-22-03.htm](http://byrned.faculty.udmercy.edu/2003%20Volume,%20Issue%204/Newsletter%20Volume%202003%20Issue%204%20(4th%20Newsletter)%2011-22-03.htm)

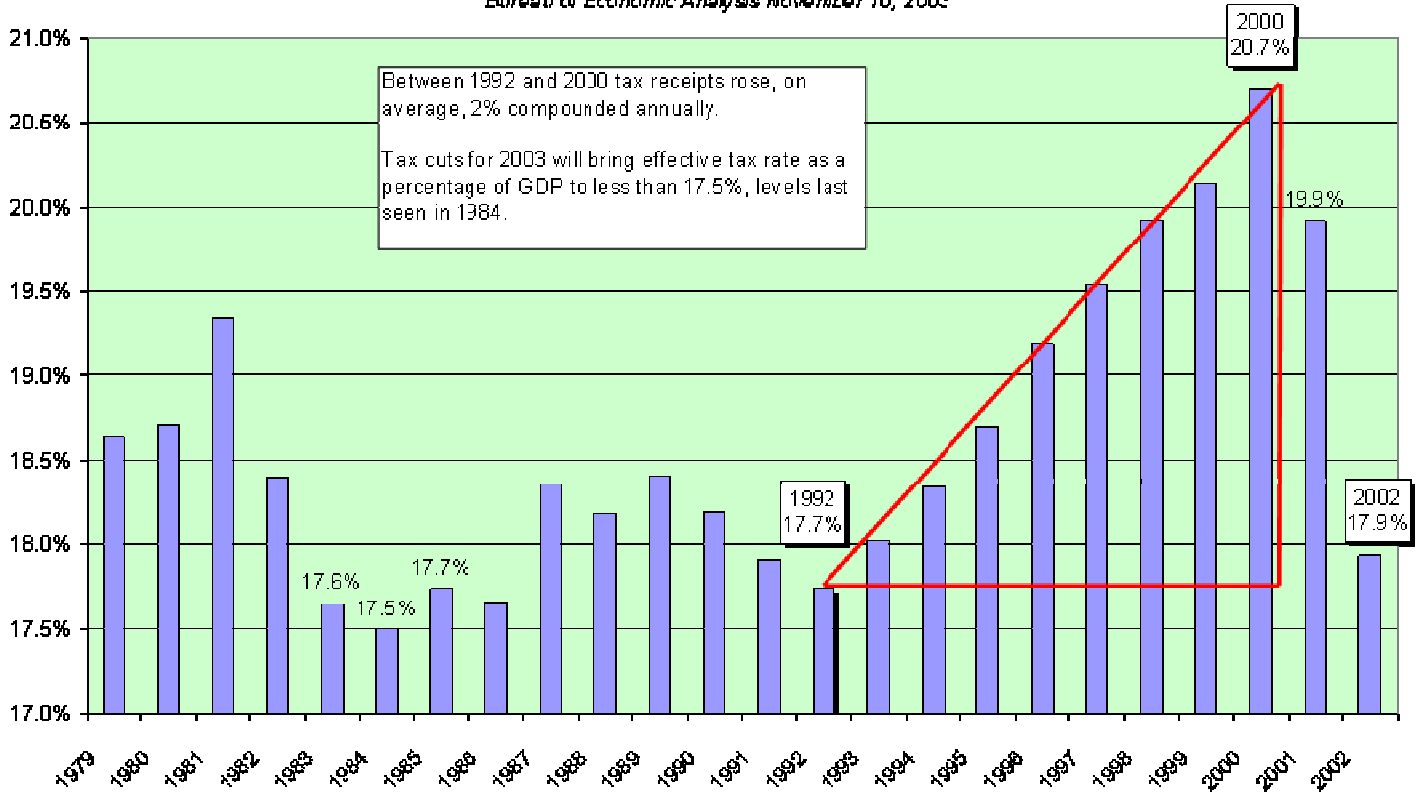
FISCAL AND MONETARY POLICY – TWIN POLICY DISASTERS

In the first issue of this newsletter we argued that there were two major occurrences leading to recession:

(1) Significant rise in federal receipts as a percent of National Income...

Tax Receipts as a Percentage of (Nominal) GDP

Data extracted from Department of Commerce:
Bureau of Economic Analysis November 10, 2005

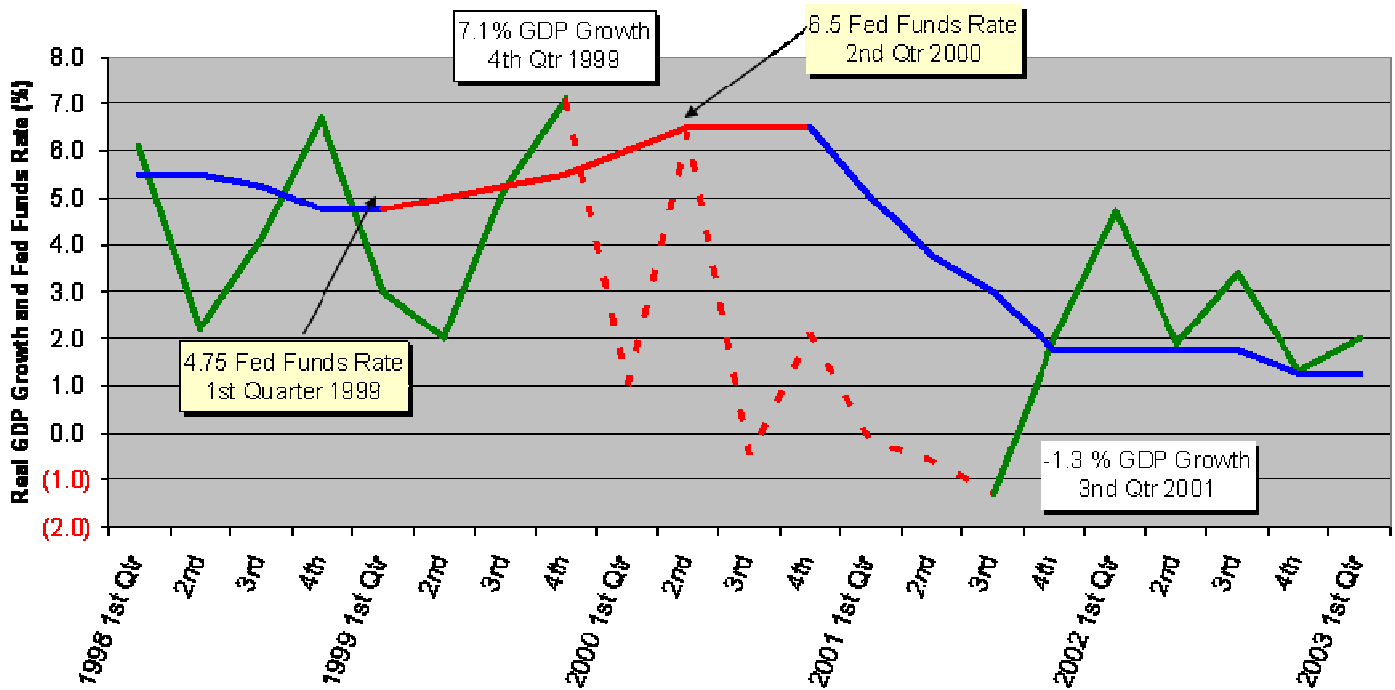


(2) ...and the FED's change to a monetary policy of restraint, leading to rising short-term interest rates.

The Collapse of the Economy 2000-2001

Interest Rate Hikes (Fed Funds) from 4.75% in 1st Quarter 1999 to 6.5% in 2nd Quarter 2000

*GDP Data from Bureau of Economic Analysis:
Fed Funds Data from Federal Reserve Board*



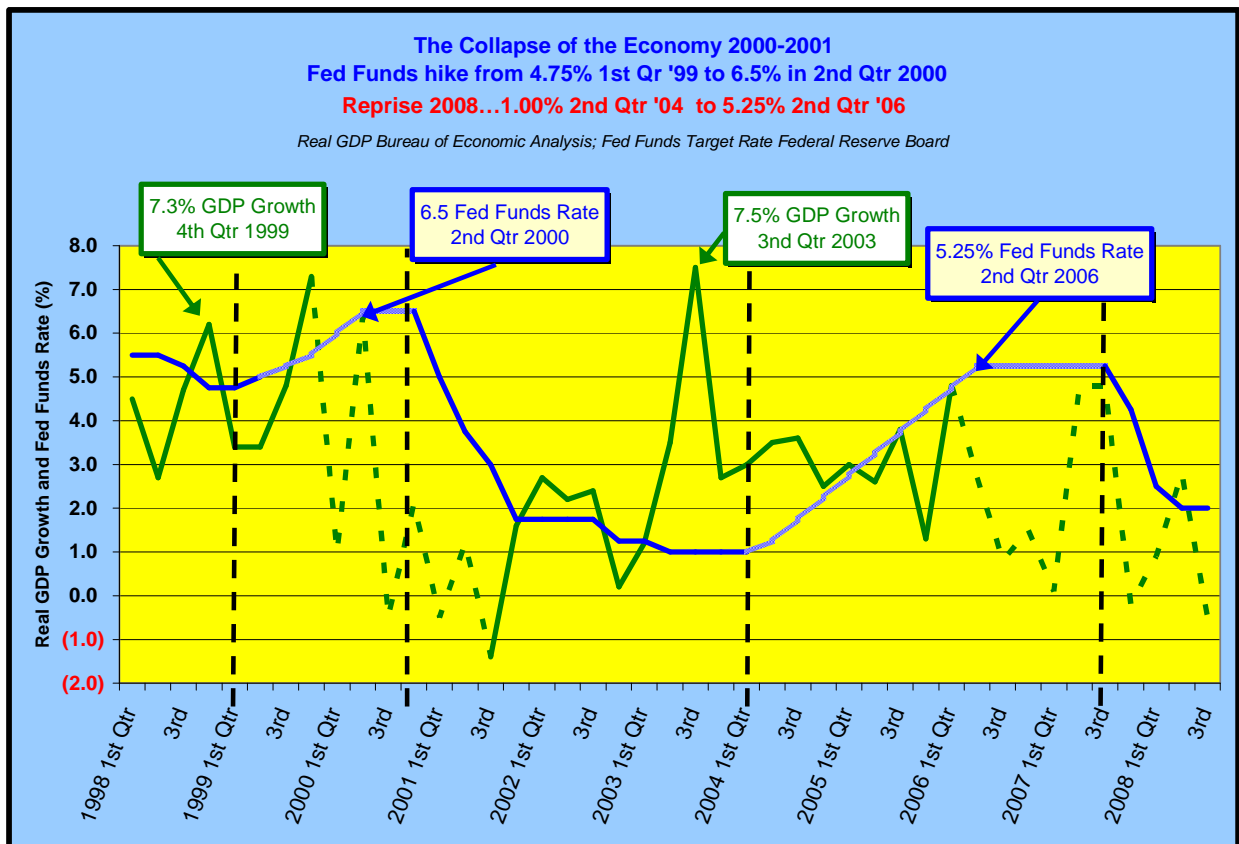
The Third Component

The third underlying and ongoing factor contributing to the collapse of the economy was the persistent trade deficit problem. Of course this issue plagues us still, dampening an otherwise remarkable recovery (remember from your economics classes, imports depress). There are indications that this problem shall be addressed in the future.

The "twin policies" brought the nation's economy to its knees: witness a positive growth of 7.1 percent to a three-quarter long recession, where the GDP collapse bottomed out at a negative 1.6 percent (real

GDP).

As pointed out above, the U.S. economy collapsed as a result of bad economic policy by the FED (monetary policy) and by Congress (fiscal policy). The FED once again began a policy of monetary restraint in 2004, in order to preempt what it saw as a potential problem of inflation. The culprit was a supply side shock coming from OPEC's restriction of supply in the face of a rising world demand for oil and its refined products. This time around, the upward movement of prices was supported by the newly re-cartelized U.S. oil industry that would "go along" with the "market forces".



The Federal Reserve pays 90% of its profits as taxes to the U.S. Treasury

New Economic Paradigm Associates
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On the Web at <http://byrned.faculty.udmercy.edu/>

In 2007, there were \$365 billion paid in corporate taxes to the Federal Government. The Federal Reserve paid \$35 billion of that total, or nearly 9.5% of the total of all corporate taxes collected.

Some Alternative Solutions to Ill-Conceived Bailouts

1) Give the Fed the power to suspend marking to the market and the lower of cost or market rule. Give the FED the power to protect from bankruptcy (chapter 11) when liquidity crises occur.

If the argument is that the Treasury and the FED will make lots of profits, from, the acquisition of troubled assets, then wasn't the mark down misleading and unjustified?

2) Bring back a version of the Glass-Steagall Act: the goal – to separate investment banking from other financial services like the depositories, and insurance companies.

3) Eliminate investment bankers trading on their own account.

4) Legislation to restrict rating agencies from altering methodologies for rating the securities.

5) A new rule for FED instituting monetary policy to avoid their mistakes in 1998 and again in 2004. Preemption assumes the FED through the FOMC understands the way the economy and the financial markets work.

They obviously do not.

Some objective rule should replace much of the FED's independence.

6) Modernize the trading of stocks, bonds and other securities so that investment bankers do not touch and therefore charge fees and commissions on every trade.

Such modernization should incorporate the advances generated by the revolution in information technology.

7) Implement greater restrictions and clearer guidance to the anti-trust authorities on merger and acquisitions when markets would become less competitive including Four Firm Concentration Ratio and Herfindahl Index measures.

8) Clarify rules on speculation in areas such as futures contracts and short selling.

9) Shift the management of depositories such as commercial banks back toward the commercial loan doctrine.

10) Eliminate the forecasting of profits by firms and their need for "guidance" to investors.

FINAL COMMENTS...

If the argument is that the Treasury will make lots of profits, then wasn't the mark down misleading?

Why not a move to chapter 11, until market prices reflect reality and not a credit crunch?

For those who will not see such a return when the liquidity crunch is over, too hell with them – let them go under.

POSTSCRIPT...

Japan went this bail out route and look where it took them.