The Current World Economic Crisis

- What caused it?
- How bad is it?
- What is being done to remedy this international crisis?
- Will this work?
- New approaches?

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Brief History
of
Largest transfer in US History of wealth from the private sector to Wall Street and major causes for current economic crisis

(Slide 1)

- Financial panic of 1907 led to the Outlawing of Bucket Shops by various states
- 1913 Federal Reserve System (FRS) – a system of 12 central banks with great power to implement monetary policy
- 1933 Glass-Stegall Act – Created FDIC, FRS control of interest rates and reforms to stop opportunistic speculation
- 1980 Depository Institutions Reform Act repealed most of Glass-Stegall (GS)
- 1999 Leach Bliliey Act repealed sections of GS that prohibited a bank holding company from owning other financial companies
- 2000 Commodities Futures Modernization Act – made "bucket shops "(betting on outcomes) legal again (after nearly 100 years) and forbade individual states from banning them
- 2003 Iraq invasion
- 1990s – present
- - Incredible expansion worldwide of the derivative (a financial [albeit bet with your local bookmaker] instrument based on something else) market.
- - Acquiring, reconstituting, and selling to banks, pension funds, and complex portfolios with bundled subprime mortgages developed by mathematicians and physicists. Can't model human behavior.
- - To make these innovative investment gadgets attractive, the major financial institutions offered credit default swaps that were bets these portfolios would not go belly up. Like an insurance offer – but legally could not be called such (no capital backing). A market of $50 to $60 trillion (about four times the nation's debt)

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Brief History
(Slide 2)

- Credit default swaps were also acquired by folks (mainly hedge fund managers) who bet against the subprime market.
- The crash of the subprime market left banks and pension funds holding assets way below the value they paid for them.
- The cashing in of these credit default swaps (albeit bets on the market outcome) left the major financial institutions broke. They had not been required to set aside capital to cover these insurance policies that could not be called an insurance policy.
- The financial gadgets that these companies invented (using their high-powered Nobel Prize mathematical wizards) came back to bite them and the entire country. Apparently $100MM CEOs were content to let $45K analysts hawk these gadgets regardless of the impact on their companies, the US economy, and the entire world.
- CBS’s “60 Minutes” - in their excellent analysis - said if these subprime portfolios are the TNT for the current crisis, the credit default swaps (derivatives – albeit “bets”) are rocket fuel. Both feed stocks provided courtesy of the largest and most prestigious financial intermediary institutions on Wall Street.
- The derivative market is estimated to be multiples of the “Gross World Product” (GWP).The side-bet credit default market was unsupervised, unregulated, had no market-clearing mechanism, and there was no requirement for these large financial intermediaries to set aside capital to back these gadgets up in the highly likely event that this gimmicky subprime mortgage market that they had created and structured would collapse and they had to pay on these “policies.” It did. Now taxpayers are being asked to bail them out? Your local bookmaker goes broke on risky bets and s\he comes hat in hand for a bailout?

Brief History

<u>(Slide 3)</u>

- September 2008 – Crunch Time
- September 7, 2008 - Fannie Mae and Freddie Mac placed under the conservatorship (nationalized) of Federal Housing Finance Agency.
- September 9, 2008 - Lehman Brothers announces it is filing for bankruptcy. Merrill Lynch agrees to be sold to Bank of America for approximately $50 billion. American International Group (AIG) seeks billions from the Federal Reserve Board to stay in business. Fed announces liquidity support to financial markets.
- September 15, 2008 – Dow falls 504 points. Analysts interpret this fall as a result of the Lehman bankruptcy.
- September 17, 2008 - Credit markets panic. Illiquid. Dow falls 449.
- September 18, 2008 - 85 billion loan to AIG authorized by Fed.
- September 18, 2008 – Treasury and Fed. Begin talks on a plan to bail out the failing institutions. Fed. Open Market Committee authorizes $180 billion expansion in overnight swap lines to provide liquidity by other central banks. Treasury announces that it had started a temporary Supplementary Financing Program at the Fed's request.
- September 21, 2008 – Goldman Sachs and Morgan Stanley transform into bank holding companies, placing them under multi regulatory layers and oversight.
- September 23, 2008 – Treasury Secretary Paulson seeks authority for rescue plan. $700 billion is probably equal to 5% +/- of total US mortgage market, wherein, 94% of all Americans pay their mortgages bills on time.

Brief History
(Slide 4)

- EESA, or Emergency Economic Stabilization Act of 2008 (October 3, 2008)
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- The disbursement as planned: $250 MM provided to the Treasury immediately. Requires that the president certify if an addition $100MM is required. The remaining $300MM will be subject to Congressional approval.
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- Trouble Asset Relief Program (TARP). A troubled asset is defined under Section 3(9) of the EESA as:
- - residential or commercial mortgages; and
- - any securities, obligations or other instruments that are based on or related to such mortgages;
- - to be eligible these difficulties must have been originated on or before March 14, 2008.
- Treasury Secretary is authorized S 101(c) to take actions deemed necessary to facilitate TARP. This would give the Secretary the flexibility to establish vehicles to purchase, hold, and sell troubled assets so as to <u>minimize the cost of the TARP to taxpayers</u>.
- Program priority consideration
- - keeping families in their homes
- - Using funds efficiently in purchasing troubled assets; and
- ensuring that all financial institutions are eligible to participate in TARP.

Summary
for
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- Is this a depression or recession?
- So far it is being called a recession.
- The National Bureau of Economic Research published a list of key economic indicators at:
- http://www.nber.org/releases/
- Are boom and bust cycles naturally occurring? Economists are divided on this subject. Some believe depressions and recessions are made in Washington. The Iraq war and the failure to properly monitor financial markets seem to indicate this is a good explanation for the 2008 recession.
- When will we recover? Impossible to answer at this point. It will depend on how effective the current and proposed fiscal (taxation and direct spending) and ongoing monetary policies are. This structural collapse in the financial markets is uncharted territory. The world's financial intermediary markets are much more interrelated and complex than in 1929.
- Will we ever recover the jobs lost? The AFL-CIO estimates that we have lost 1.8 million jobs to China. The loss of jobs due to the current downturn is estimated to be of the order of 1 million and climbing. We will never recapture "Rust-Belt" type jobs.
- Does free-trade hurt the US? Theoretically "No!" Trade and exchange should benefit all involved. We do, however, have a social compact between the government and people. The Darwinism of the pure classical economic model is at odds with this social compact (i.e. Full Employment Act of 1946 and Full Employment and Growth Act of 1978). NAFTA, in retrospect, seemed a rush to judgment. Too much too quick without planning ahead regarding the considerable dislocations caused by outsourcing jobs and importation of goods and services below the existing wage and prices regimes in the USA. If we are going to bail out these self-wounding financial intermediaries, why not bail out those folks whose skills have become obsolete because of government free trade treaties?
- What do we do now? The folks that caused these problems must be held accountable. The financial markets must be restructured to stop these shenanigans in the future.
- Do we bail out the auto industry? Yes and No. This is a heavy duty subject for a different day.
- Finally: Markets do work. Market rules must be enforced. This debacle was a meltdown of the regulatory process and most probably the end-result of massive lobbying. Allan Greenspan and company get an F- .