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At the Intersection of Global Economics and Politics

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INTRODUCTION

The United States and the world are at the most painful intersection of economics and politics. The United States is in its first major recession since 1992 and the world is in its first coordinated world recession since World War II.[1] The non-capitalistic governments, that used to gloat over the down cycles of capitalism, have become trade dependent neo-capitalists who now must share those same cycles. The world cannot decouple from the United States because it is the world's largest economy, representing 25% of all world production and demand.[2] Based on an IMF report, the United States ranked number one in representing 25.3% of world production, Japan was second at 8.1%, and Germany and China came in third and fourth respectively, each representing only about 6% of world Gross Domestic Production (hereinafter "GDP").[3] These three countries, even combined, do not add up to the GDP of the United States. Thus, it is evident that the global recovery cannot even start if the

* On October 15, 2008, Hofstra University hosted the third and final televised Presidential Debate between Senators John McCain and Barack Obama. In the week leading up to it, The Journal of International Business and Law organized a symposium on U.S. Foreign Policy and Its Effect on the Domestic Economy featuring Dean Thomas Cooley (NYU Stern School of Business), Amb. Karl F. Inderfurth (George Washington University), W. Michael Reisman (Yale Law School), Lea Brilmayer (Yale Law School) and Dennis Keegan (Chairman and Chief Investment Officer of the Auspex Group). This article stems from Mr. Keegan's comments at the fall symposium. Mr. Keegan served for fifteen years with Salomon Brothers, Inc., in New York and London. During his career with Salomon Brothers, he headed up the U.S. proprietary trading, European fixed income arbitrage, and foreign exchange divisions. He was the chairman of Salomon's risk management committee, co-head of global fixed income, and co-chief executive of European operations. Mr. Keegan earned a bachelor's degree in economics at UCLA, and an MBA from the UCLA Anderson School of Management, where he currently serves on the Board of Visitors.

[1] To be noted, although 2001-2 was a recession, it was the mildest recession recorded despite the stock market crash and the attacks of September 11, 2001.

[2] INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK: FINANCIAL STRESS, DOWNTURNS, AND RECOVERIES (2008), http://www.imf.org/external/pubs/ft/weo/2008/02/pdf/text.pdf [hereinafter WORLD ECONOMIC OUTLOOK].

[3] *Id.*

United States recovery is not underway.

However, in order for the United States economy to recover, politicians must lead governments in taking bold pro growth steps and avoiding the knee jerk protectionist policies which can transform a recession into a depression. Protectionism, currency devaluation and trade barriers are political expedients to be avoided because they do not create effective growth. For example, in the 1930s, the Smoot Hawley Tariffs and other economic policies in many countries damaged trade relations and interfered with the necessary adjustments in wages.[4] The economic consequences of these political decisions turned that recession into the Great Depression.[5] Furthermore, low inflation rates limit the effectiveness of purely monetary policy. As this article will demonstrate, the United States is leading the world with aggressive pro growth counter cyclical fiscal and monetary policies.

In addition to trade, the world is connected by its integrated financial system. The United States government under the Bush Administration and the United States Federal Reserve Bank (hereinafter "the Fed") under Bernanke were quick to realize the implications to the financial system as the subprime mortgage crisis led to the falling housing prices.[6] The mortgage foreclosures caused a collapse of bank balance sheets thereby inciting chaos in the world financial system. With the financial system disrupted, trade and investment could not be financed. Such a severe drop in trade inevitably, of course, stopped economic growth. By destroying bank balance sheets, which prevented banks from lending, the real estate collapse fed a broad scale credit crisis that choked off all sources of consumer demand. The Fed started dropping official interest rates by September of 2007 and the Federal Government moved into counter cyclical fiscal stimulus early in 2008.[7] Many other countries did not appreciate the threat of the collapsing asset prices and the nascent recession. Through the first half of 2008, there were more nations actually tightening policy measures to control inflation than there were countries easing policy to aid growth.[8] Canada and the United Kingdom followed the United States with

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[4] *See* RICHARD K. VEDDER, ET. AL., OUT OF WORK: UNEMPLOYMENT AND GOVERNMENT IN TWENTIETH-CENTURY AMERICA 112-127 (1997).

[5] *Id.* at 209-225. *See also* PETER TEMIN, LESSONS FROM THE GREAT DEPRESSION 41-88 (MIT Press, 1991).

[6] Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Address at the Federal Reserve Bank of Kansas City's Economic Symposium: Housing, Housing Finance, and Monetary Policy (Aug. 31, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20070831a.htm.

[7] Associated Press, *Bush Signs Stimulus Package into Law*, MSNBC.COM, Feb. 13, 2008, http://*www.msnbc.msn.com/id/23143814*.

[8] IMF Survey online, *IMF Urges Action to Strengthen Global Financial System*, IMF SURVEY

the policy of lowering rates in December 2007.[9] The European Central Bank, China, Australia, Japan and most developing economies did not adopt pro growth policies such as dropping interest rates until the middle of 2008.[10] The common wisdom among those countries still tightening policy was that the world had decoupled from United States' business cycles and those countries' monetary and economic authorities were focused on inflation caused by booming commodity prices. The Fed was early in realizing that inflation was not the problem. As recession spread globally, the United States acted to aggressively pursue new and creative policies to dampen the cycle, ease market conditions and support bank lending. The United States beyond its domestic activities took the unusual step to create facilities to allow more dollars to be available globally by making swap facilities available to foreign central banks. This directly provided dollars to the international market, enabling foreign banks to maintain dollar liquidity and not be forced to sell dollar based assets in distress.[11]

The best solution for all nations is not protectionism, but rather an aggressive countercyclical pro-growth policy in each country The United States has led the way aggressively and creatively, but these national policies are limited and work with long, uncertain time lags. The United States is also in a fiscal position with respect to the level of debt to GDP that may give it more room to maneuver than many other developed countries. The United States has net debt to GDP of 48% (at the end of 2007) compared to Germany at 57%, Japan at 94%, and France at 55%.[12] The United Kingdom and Canada are in strong positions to react with pro-growth policies because they have a net debt to GDP ratios of less than 40%.[13] As with the United States, monetary policy will also be extremely constrained in most countries as 25 years of successful

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MAGAZINE, Mar. 12, 2008, http://www.imf.org/external/pubs/ft/survey/so/2008/new031208a.htm. *See also* Patrick Roy, *International Economic Update*, FEDERAL RESERVE BANK OF DALLAS, Mar. 20, 2009, http://www.dallasfed.org/institute/update/2009/int0902.cfm; Butterfield Private Bank, *Money Market And Currency Report*, June 25, 2008, http://www.butterfieldprivatebanklondon.co.uk/wedfax/2008/MMC_080625.pdf.

[9] *See* Press Release, Bank Of England, Bank of England Reduces Bank Rate by .25 Percentage Points to 5.25% (Feb. 7, 2008), *available at* http://www.bankofengland.co.uk/publications/news/2008/004.htm. *See also* Press Release, Bank of Canada, Bank of Canada Lowers Overnight Rate Target By 1/4 Percentage Point To 4 Per Cent (Jan. 22, 2008), *available at* http://www.bankofcanada.ca/en/fixed-dates/2008/rate_220108.html.

[10] Press Release, Bd. of Governors of the Fed. Reserve Sys. (Dec. 11, 2007), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20071211a.htm.

[11] Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 18, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20080918a.htm.

[12] WORLD ECONOMIC OUTLOOK, *supra* note 2.

[13] *Id.*

inflation fighting for the developed world has brought inflation and long term inflation expectations down to low single digits. Despite the 2007-2008 fear of commodity driven inflation, core inflation measures in the United States and most developed nations' economies never moved far into the danger zone (over 2.5%).[14] The current recession and rapid drop in headline inflation will quickly bring the potential for deflation, such as negative inflation rates, into the economic and policy framework. A level of zero inflation makes it difficult for monetary policy alone to drive growth. In deflationary conditions, the government cannot stimulate demand through the traditional method of bringing policy interest rates below the inflation rates to induce borrowing and therefore accelerate consumption. The limitations on monetary policy, the inability to take official rates below zero, make it important that pro-growth fiscal deficits and pro trade national policies are pursued in the United States and across the world. These two limitations, the zero rate policy bound for interest rates and the stretched levels of debt to GDP in many nations, account for why the Fed and other Central Banks have taken new creative policy alternatives trying to provide a greater quantity of money and liquidity to the economy even if they can't take the price of borrowing below zero.

I. TODAY'S RECESSION IN CONTEXT

As demonstrated in the table below, despite the hyperbole in the media, the current recession is severe but is still only a recession. The most remarkable difference between this recession and previous recessions is the change in the unemployment rate. Although the expected peak unemployment rate of 8.8% is below the 9.7% rate the United States experienced in 1982 and 1983,[15] the absolute change in the level of unemployment from recent annual lows of 4.6% to 8.8% is nearly twice the increase experienced in the previous three recessions.[16] In the previous recessions the unemployment rate had increased by only 2-2.5% from its low point.[17] In this recession the unemployment rate has already risen 3% and is expected to peak at more than 4% above its low point for the cycle.[18] As with previous recessions, the

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[14] *Id.*

[15] Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey*, U.S. DEPT. OF LABOR, Apr. 19, 2009, *available at* http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS14000000.

[16] *Id.*

[17] *Id.*

[18] Tessa Moran, *US FED: Fed Worsens Protections For 2009 GPD, Inflation, Unemployment*, FORBES.COM, Feb. 18, 2009, http://www.forbes.com/feeds/afx/2009/02/18/afx6067181.html.

unemployment rate will continue higher even after the economy starts to grow.[19] This is because unemployment does not decrease until the growth rate in the economy exceeds the long term potential growth rate which, for the United States economy, is generally assumed to be around 3% of GDP per year.[20] In other words, the unemployment rate will continue to rise until U.S. GDP growth exceeds 3% on an annual basis. An estimated length of over 18 months also makes this the longest recession since the1970s and accentuates the impact of the high unemployment rate. The stress on unemployment will continue to elicit strong government response as it percolates through the political system.

	January 80 to July 81 and July 81 to Nov 82 Back to back Recessions	**July 90 to March 91**	**March 01 to November 01**	***Estimated December 07 to June 08***
Pre recession low in unemployment rate-year	7.20% - 1980	5.20% - 1989	4.10%-2000	4.60% - 2006
Peak Unemployment rate-year	9.70% - 1982/3	7.50% - 1992	6.00%-2003	*8.80% - 2009*
year over year low in GDP- end of period	-2.70% - Sept 1982	-1.00% - Mar. 1991	0.20%- Dec. 2001	*-2.80% - June 2009**
year over year rebound in GDP- end of period	8.50% - Mar. 1984	4.1% - Dec. 1992	4.10% - June 2004	*?*
Peak Annual federal budget deficit for the Recession	5.60%	5.90%	4.80%	*11.9%**
Peak Net Federal Debt as a percent of GDP	33%	56%	43%	*60%**

* BASED on CBO Baseline Estimate

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19 BD. OF GOVERNORS OF THE FED. RESERVE SYS., MONETARY POLICY REPORT TO CONGRESS 37-41 (2009), http://www.federalreserve.gov/monetarypolicy/files/20090224_mprfullreport.pdf.
20 *Id.*

Yet, as is evidenced by the above chart,[21] this is clearly not a depression because the parameters of economic weakness remain in the range of recessions. In the Great Depression, as opposed to a recession, the GDP was falling in excess of 15% per year and unemployment peaked over 30%.[22] The 2009 net federal budget deficit figure in the chart presumes that the majority of the Treasury's remaining $350 billion Troubled Asset Relief Plan (hereinafter "TARP") continues to be equity investments, therefore increasing the reported deficit, as opposed to debt purchases which would be netted out with no impact on the net total deficit.[23] The table assumes a federal budget deficit of 11.9% which implies a $1.7 trillion shortfall in 2009.[24] That means an increase of over 8% in the expected federal budget deficit compared to 2008.[25] In the 1982-3 recession and 1991-2 the fiscal impetus, the increase in deficit was only 0.8%.[26] The 2001 increase in fiscal stimulus, the year over year increase in deficit, was 3.5%.[27] Since the major stimulus in 2001 was a permanent tax cut, the impetus of expanding budget shortfalls impacted 2001 and kept deficits high over several years.[28] The current increase in federal deficit spending is important. Clearly, if the government increases spending by 4% of GDP and the rest of the economy was flat over the year, GDP would be up 4%. Yet, in reality, there are other drags and many portions of the economy will record negative growth in 2009, resulting in overall GDP growth of less than 4% despite the government's aggressive spending.

Thus, the key to creating employment and reversing the negative momentum in the economy is to increase demand. The government spending employs people and creates demand. While current increases in demand are just offsetting loss of demand in other sectors because the vast majority of the

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21 WORLD ECONOMIC OUTLOOK, *supra* note 2.

22 Christopher Chantrill, *Time Series Chart of US Government Spending*, http://www.usgovernmentspending.com/downchart_gs.php?year=1930_1940&view=1&expand=&units=b&fy=fy09&chart=F0-total&stack=1&size=m&title=&state=US (last visited Apr. 19, 2009). *See also* S. Mintz, *The Great Depression and the New Deal*, DIGITAL HISTORY, http://www.digitalhistory.uh.edu/historyonline/us34.cfm (last visited Apr. 18, 2009).

23 *See* CONGR. BUDGET OFFICE, A PRELIMINARY ANALYSIS OF PRESIDENT'S BUDGET AND AN UPDATE OF CBO'S BUDGET AND ECONOMIC OUTLOOK 1-18 (2009), http://www.cbo.gov/ftpdocs/100xx/doc10014/03-20-PresidentBudget.pdf.

25 *Id.* at 2 tbl.1.1.

25 *Id.* at 11 fig.1.1.

26 *See* OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 2008 (2008), http://www.whitehouse.gov/omb/budget/fy2008/pdf/hist.pdf.

27 *Id.*

28 *Id.* at 21 tbl.1.1.

economy is reducing demand for goods and services.

II. WHAT ARE THE DRAGS ON THE ECONOMY?

The fundamental drags on the United States economy are rooted in the loss of wealth to the American consumer as a result of the drop in the housing market and the stock market. The International Strategy and Investment Group (ISI), which is headed by Ed Hyman, estimates consumer net worth will have dropped by 15% in 2008 compared to low single digit declines recorded in recessions since the 1970s.[29] The drop in wealth reduces consumer willingness to spend money. The Case Schiller 10 City Home Price Index in October 2008 indicated a 19% drop in home prices over the last year.[30] According to the United States Census Bureau, the United States home ownership rate exceeded 67% in 2006, indicating that the drop in home prices impacted a larger percentage of the population more directly than the stock market.[31] This drop takes home prices back to their 2004 levels.[32] Four years of price appreciation was lost. As for the stock market, as represented by the Standard and Poor 500 Stock Index (hereinafter "the S&P Index"), it was 45% below the S&P Index 2007 high price and the all time high as of November 2008.[33] The drop in the S&P Index is similar to the drop in 2001-2 and is larger than the stock market drop in the prior two recessions.[34] Many studies demonstrate that the "wealth effect" impacts consumer demand.[35] The drop in consumption experienced by the economy as a result of the drop in consumers' wealth varies greatly in different studies, but it does seem to relate to how permanent the consumer

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[29] *See* Rex Nutting, *Household net worth plunges 18% in 2008*, MARKETWATCH, Mar. 12, 2009, http://www.marketwatch.com/news/story/household-net-worth-plunges-18/story.aspx?guid=%7b8BBD33C0-EB35-47BB-9CE1-D7AC35EE2734%7d&siteid=yahoomy&print=true&dist=printMidSection; Catherine Clifford, *Household net worth sinks $11.2 trillion*, CNNMONEY.COM, Mar. 12, 2009, http://money.cnn.com/2009/03/12/news/economy/flow_funds/.

[30] STANDARDS & POOR'S, CONSUMER HOME PRICE HISTORY (2008), http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_History_022445.xls.

[31] Press Release, U.S. Census Bureau News, Census Bureau Reports on Residential Vacancies and Homeownership (Feb. 3, 2009), *available at* http://www.census.gov/hhes/www/housing/hvs/qtr408/files/q408press.pdf.

[32] STANDARDS & POOR'S, *supra* note 29.

[33] *See e.g.* StockCharts.com, S&P 500 Index (1960 – Present Weekly), http://stockcharts.com/charts/historical/spx1960.html.

[34] *Id.*

[35] *See* ERIC BELSKY & JOEL PRAKKEN, HARVARD UNIV. JOINT CTR. FOR HOUS. STUDIES, *Housing Wealth Effects: Housing's impact on Wealth Accumulation, Wealth Distribution and Consumer Spending* (2004), http://www.jchs.harvard.edu/publications/finance/w04-13.pdf.

believes the loss in wealth will be. To remedy the situation, there needs to be aggressive action by governments and central banks to have this loss be perceived as temporary.

Central bank monetary policies are only effective if they lower the real cost of money and therefore increase the consumers' and corporations' propensity to spend. When consumers start to spend and buy goods, corporations will then start to rebuild inventories and hire more employees. Currently, the demand for goods has been crushed by the financial crisis as corporations' experienced evaporating demand because buyers were unable to find loans to finance new purchases for consumption or investment. The major bottleneck preventing government policy initiatives from accelerating demand has been the broken banking system. More than a year of falling official interest rates, from a high of 5% to an effective rate of near zero and a significant United States fiscal stimulus of 1.5% of GDP in 2008 has failed to ignite demand because the lower rates have not been passed on to the end consumer.[36] The failure of demand to re-accelerate has forced companies to position themselves for lower demand and lower growth, resulting in an increase in unemployment, which thus extends and deepens the recession. Despite the aggressive action by central banks to lower official rates, the market interest rates have remained high. Those market interest rates keep the real cost of borrowing and cost of money for corporations and consumers very high, particularly compared to the collapsing inflation rates. High market interest rates that are at historically extreme wide spreads over official government rates reflect the unwillingness or inability of banks to supply credit. The result severely dampens the transmission of government stimulus to final demand.

As demonstrated in the chart below,[37] enormous capital was lost by financial institutions due to the collapse of housing prices and the related mortgage losses as well as other overly aggressive bank lending decisions in the early part of this decade. It is important to note that all that lost capital has been replaced by public and private equity investment. Some of the capital has come from traditional market sources, but a lot has come from government institutions. The majority of United States Treasury's first tranch of $350 billion TARP funds, committed as of December 2008, went to replace equity

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[36] Press Release, U.S. Dep't of the Treasury, The Consumer and Business Lending Initiative: A Note on Efforts to Address Securitization Markets and Increase Lending (Mar. 3, 2009), *available at* http://www.treas.gov/press/releases/reports/talf_white_paper.pdf; Rebecca Wilder, *Credit Remains Tight; Corporate Spreads are Elevated,* RGE MONITOR, Mar. 10, 2009, http://www.rgemonitor.com/us-monitor /255921/credit_remains_tight_corporate_spreads_are_elevated.

[37] Bloomberg, WDCI (Dec. 2008).

lost by banks and other financial companies.[38] Other countries are acting to replace bank capital with France and Germany, each committing between 40 and 80 billion Euros and the United Kingdom starting a 50 billion sterling plan to recapitalize banks.[39]

Losses and Write downs	Loss through 12/08 $Bns	Capital Raised though 12/08 $Bns
TOTAL Worldwide Financial Co.s	1005.8	926
US Financial Companies	678	552
Worldwide Banks	745	797
Wachovia	96.5	11
CITI	67	114
Merrill Lynch	56	30
Washington Mutual	46	12

Yet, banks are still attempting to remedy their losses and expected future losses. The Fed Board Senior Loan Officer Opinion Survey through the end of 2008 continued to show banks still tightening credit availability and plan to reduce their balance sheets with respect to their current levels of capital.[40] Historical experience leads the banks to expect that until the recession ends and US GDP growth turns positive, there will be accelerating losses on credit cards and corporate loans as the recession proceeds through a normal cycle.[41] Thus,

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[38] Maya Jackson Randall, *US Treasury: $134.5 Billion Left In TARP; Expects Cos To Repay 25 Billion*, DOW JONES NEWSWIRES, Mar. 28, 2009, *available at* http://news.morningstar.com/newsnet/ViewNews.aspx?article=/DJ/200903282009DOWJONESDJ ONLINE000448_univ.xml; Reggie Middleton, *Amid the Rally, I Look at the Doo Doo 32 and Their Receipt of the TARP*, SAFE HAVEN, Jan. 6, 2009, http://www.safehaven.com/article-12240.htm.

[39] Jennifer Yousfi, *U.K. Unveils Its Own Banking Bailout Package*, Money Morning, Oct. 9, 2008, http://www.moneymorning.com/2008/10/09/british-banking-bailout/; ORRICK, HERRINGTON & SUTCLIFFE LLP, ORRICK CLIENT ALERT: U.K. GOVERNMENT TAKES NEW STEPS TO SUPPORT U.K. FINANCIAL SYSTEM (2009), http://www.orrick.com/fileupload/1603.pdf; Press Release, European Central Bank, Adjustment of Risk Control Measures for Newly Issued Asset-Backed Securities and for Uncovered Bank Bonds (Jan. 20, 2009), *available at* http://www.ecb.int/press/pr/date/2009/html/pr090120.en.html.

[40] *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE JANUARY 2009 SENIOR LOAN OFFICER OPINION SURVEY ON BANK LENDING PRACTICES (2009), *available at* http://www.federalreserve.gov/boarddocs/ SnloanSurvey/200902/fullreport.pdf.

[41] William C. Dudley, President and Chief Executive Officer, Fed. Reserve Bank of N.Y., Remarks at the Council on Foreign Relations Corporate Conference 2009, Financial Market Turmoil: The Federal Reserve and the Challenges Ahead, *available at* http://www.newyorkfed.org/newsevents/speeches/2009/ dud090306.html.

the banks are attempting to build equity capital reserves to prepare for future expected losses. The government policy initiatives are not transmitted to higher demand and consumption because credit is not effectively available to those who would still desire to build businesses or add to consumption. The added liquidity provided by the Fed and the equity provided by the TARP have only shored up the bank balance sheets and prevented a more accelerated collapse in credit. The financial system has used the policy initiatives so far, merely to reduce the speed of credit being withdrawn from the system.

III. CREATIVE POLICY RESPONSE

The Fed has been creative and aggressive in responding to the banking crisis. The strong policy response is not surprising since Bernanke's academic research specialized in the causes and impacts of the Great Depression, including how it could have been avoided.[42] The Fed has increased its non-United States Treasury assets from effectively none at the beginning of 2007 to $1.9 Trillion in the last few months of 2008. The Fed did this in order to provide the desperately needed financial support to banks' balance sheets and the market for securitized home mortgages and thereby stop the spiraling collapse of credit availability and the concomitant drop in asset prices. The Fed has responded to the dysfunction in credit markets by creating numerous programs to offset the current credit collapse that is aggravating the economic situation. Among the many programs the Fed has created, several are of a fixed targeted size and some are unlimited in potential size, meaning the value of assets purchased can be determined by the needs of the financial systems.[43] If the "unlimited" programs the Fed has created stay at their current levels on the balance sheet and the Fed becomes fully committed under its other programs, the Fed balance sheet will expand to at least $3.8 trillion. This implies that only about half of the Feds balance sheet expansion has taken place and future purchases will probably be even more effective, on the margin, in narrowing credit spreads. The Fed appears committed to replacing dysfunctional commercial bank balance sheets with a federal balance sheet.[44]

The Fed has created a proliferation of new programs to support asset prices and to replace or support bank balance sheets and lower market interest rates. In addition to traditional 28 day repurchase agreements, the Fed has

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[42] *See* BEN S. BERNANKE, ESSAYS ON THE GREAT DEPRESSION (2004).

[43] Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Statistical Release (Mar. 26, 2009), *available at* http://www.federalreserve.gov/releases/h41/Current/h41.pdf.

[44] Lawrence H. Meyer and Brian P. Sack, *Monetary Policy Insights; Policy Focus*, MACROECONOMIC ADVISERS, Dec. 16, 2008.

created Term Auction Facility (TAF and Forward TAF) and Term Securities Lending Facility (TSLF and related TOP) to support bank balance sheets and reduce the cost of money for banks.[45] These term lending arrangements as of January 2008 made up $766 billion of the Fed balance sheet and have an announced capacity of $1.25 trillion.[46] As mentioned previously, the Fed has additional operational new programs that will be available on an unlimited, as needed basis.[47] These unlimited programs, including the central bank FX swaps, Asset Backed CP Facility (ALMF), commercial paper funding facility and purchases of agency discount notes, were not in existence a year ago, but in early 2008 represented $920 billion on the Fed balance sheet.[48] All these programs are available on an open-ended basis and are designed to lower market interest rates in addition to funds available to banks at the traditional discount window (known by the acronym PDCF).[49]

Beyond these programs, the Fed has also been involved in rescuing financial companies to prevent disruption of the flow of money in the banking system.[50] In addition to the $4 billion which the Fed has already tied up in credits to AIG and Bear Stearns, if necessary, it has committed to lend an additional $300 billion to these said institutions and to Citicorp.[51] Moreover, the $300 billion guaranty to Citicorp allows Citi to carry those assets at a 20% risk ratio, effectively saving Citi $20 billion in capital requirements.[52] The Fed has also committed an additional $800 billion to be invested in 2009 through its

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45 BD. OF GOVERNORS OF THE FED. RESERVE SYS., MONETARY POLICY REPORT TO THE CONGRESS 47 app. (2009), http://www.federalreserve.gov/monetarypolicy/files/20090224_mprfullreport.pdf [hereinafter MONETARY POLICY REPORT].

46 *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE'S BALANCE SHEET, *in* CREDIT AND LIQUIDITY PROGRAMS AND THE BALANCE SHEET, http://www.federalreserve.gov/monetarypolicy/ bst.htm (last visited Apr. 2, 2009) [hereinafter BALANCE SHEET].

47 Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Speech at the National Press Club Luncheon (Feb. 18, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090218a.htm

48 BALANCE SHEET, *supra* note 44.

49 BD. OF GOVERNORS OF THE FED. RESERVE SYS., LENDING TO PRIMARY DEALERS, *in* CREDIT AND LIQUIDITY PROGRAMS AND THE BALANCE SHEET, http://www.federalreserve.gov/monetarypolicy/bst_supportspecific.htm (last visited Apr. 19, 2009).

50 Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Speech at the Stamp Lecture: The Crisis and the Policy Response (Jan. 13, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm [hereinafter Bernanke, Speech at the Stamp Lecture].

51 BD. OF GOVERNORS OF THE FED. RESERVE SYS., SUPPORT FOR SPECIFIC INSTITUTIONS, *in* CREDIT AND LIQUIDITY PROGRAMS AND THE BALANCE SHEET, *supra* note 47.

52 *Id.*

new Term Asset-Backed Securities Loan Facility (TALF) and in purchases of agency debt and mortgage backed securities.[53] These latter moves are designed to lower the spread of mortgages and other loans over treasuries, in order to lower the cost of money to the end user: corporations and consumers. The Fed balance sheet that has already expanded from $800 billion to $2.1 trillion seems clearly on its way to $3.8 trillion and beyond, as the United States central bank tries to return normal pricing and credit extension to the United States financial markets.[54]

Like the Fed, the United States Treasury is clearly on the way to aggressively intervene in the financial system. By January 2009, $350 billion of its $700 billion TARP facility has been committed to date and the majority of that, about $250 billion, has been spent on equity investments in banks.[55] Bank equity is important because every $8 billion of equity supports $100 billion of fully risk weighted assets or $400 billion of lower risk weighted assets such as mortgages.[56] It is likely that the majority of the remaining $350 billion dispersed by the Treasury will also go to bank equity.[57] Even if the TARP package is not increased beyond the original $700, it is important to understand that only 50% of the planned spending has taken place as of the end of 2008.[58] The Treasury also has a program guaranteeing $3 trillion in money market funds in order to keep the commercial paper market open.[59]

Equally as important, the United States Treasury has stepped in and put Freddie Mac (hereinafter "FRE") and Fannie Mae (hereinafter "FNMA") into government conservatorship.[60] These two institutions are the conduits for more than 60% of all mortgages in the United States. If FNMA and FRE are not able to function, then the United States mortgage market would effectively close. As of January 2008, FNMA and FRE had reported $110 billion in losses

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[53] Bernanke, Speech at the Stamp Lecture, *supra* note 48.

[54] *Id.*

[55] Middleton, *supra* note 36.

[56] William J. McDonough, President, Fed. Reserve Bank of N.Y., Risk-Based Capital Standards: Amendments to Regulations H and Y for Consistency with Other Regulatory Agencies, Circular No. 11144 (Mar. 25, 1999), *available at* http://www.newyorkfed.org/banking/circulars_archive/11144.html.

[57] Press Release, U.S. Dep't of the Treasury et al., Joint Statement by the Treasury, FDIC, OCC, OTS and the Federal Reserve (Feb. 23, 2009), *available at* http://www.treas.gov/press/releases/tg38.htm.

[58] Middleton, *supra* note 36.

[59] Press Release, U.S. Dep't of the Treasury, Treasury Announces Extension of Temporary Guarantee Program for Money Market Funds (Mar. 31, 2009), *available at* http://www.treas.gov/press/releases/tg76.htm.

[60] Statement from Tim Geitner, U.S. Sec'y of the Treasury, on Treasury's Commitment to Fannie Mae and Freddie Mac (Feb. 18, 2009), *available at* http://www.treas.gov/press/releases/tg32.htm.

and are only continuing to operate solely due to the Treasury intervention.[61] The Treasury, by providing a de facto debt guaranty, is enabling the mortgage market to continue to fund new home purchases. The ability to fund new home purchases is a critical step to eliminate the overhang of unsold and foreclosed properties that are depressing home prices.

Additionally, the FDIC (Federal Deposit Insurance Corporation) is also involved by guaranteeing bank debt. The FDIC has approved a program to provide a Federal guarantee for up to $1.4 trillion in bank debt so that market disruptions do not create a liquidity crisis for banks.[62]

The originality, depth and breadth of these bold moves are unprecedented. Multi-faceted new government responses and policy tools not used since the Great Depression are, in fact, beginning to turn the economy around. The Fed asset purchases directly impact the market rate, lowering the interest rate on a wide array of assets. The TARP is working by giving banks enough equity to limit the shrinkage of balance sheets and increasing the confidence that the banking system is safe and will continue to function. The FNMA and FRE intervention are maintaining access to capital in the mortgage markets. The FDIC lowers the cost of money for banks so that the cost of loans can reflect more closely reflect official interest rates. In aggregate, liquidity is entering the system, providing the potential for increases in demand and growth in GDP.

IV. SIGNS OF ECONOMIC THAW

Basic monetary numbers indicate the Fed has provided plenty of fuel for a recovery. The monetary base is up 102% year over year and M2, a broader indicator of readily available cash and bank deposits, is up over 17% on an annual rate.[63] Every time money supply has grown this fast, it has been a coincident indicator of economic recovery.[64] The extremely low return (0%) on holding these cash balances will soon push decision makers toward new

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[61] Kerry E. Grace & Lauren Pollock, *Freddie Mac Posts Wider Q4 Loss on Bad Loans*, DOW JONES NEWSWIRES, Mar. 11, 2009, *available at* http://www.smartmoney.com/breaking-news/on/?story=ON-20090311-000994-1704.

[62] Press Release, Fed. Deposit Ins. Corp., FDIC Announces Plan to Free Up Bank Liquidity: Creates New Program to Guarantee Bank Debt and Fully Insure Non-Interest Bearing Deposit Transaction Accounts (Oct. 14, 2008), *available at* http://www.fdic.gov/news/news/press/2008/pr08100.html.

[63] *See* Daniel L. Thornton, *Is There Less Agreement About Inflation?*, *in* FED. RESERVE BANK OF ST. LOUIS MONETARY TRENDS 1 (2009), http://research.stlouisfed.org/publications/mt/20090101/mtpub.pdf.

[64] *Id.* at 6.

investment and spending.

The spreads between various market rates and government rates, although still very high,in January 2009 were starting to come down.[65] These high spreads were being brought down as fear and uncertainty dissipated and nominal yields on short maturity treasury securities remain near zero. The spread between 3 month treasury bills and 3 month Eurodollar was still wide at 150 basis points at the end of 2008, but that spread had peaked near 600 basis points after the Lehman Brothers collapse.[66] The CDX North American Investment Grade 5 year index at the end of 2008 was trading at a spread of 200 basis points, down from an October high of 280 basis points, but still high compared to historical spreads of 50-75 basis points.[67] The A2 commercial paper rate that had been as high as 6% in October was down to 1.25% by January 2009.[68] These spreads narrowing are an indicator that the government's money is starting to work its way into the economic system and return the price of credit to more normal spreads.

Conventional prime mortgage rates in January 2009 are below 5%, after being well over 6% just two months prior.[69] The decline in house prices combined with the lower mortgage rates and relative stable median household incomes means that the housing affordability index is over 140.[70] This level of affordability has not been seen since the early 1990s and is usually a harbinger of a resurgent housing market.[71] Another reflection of that relationship is that the monthly interest payment for a median priced existing house is now less than 17% of after tax income, the lowest percent of median household income

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[65] Scott Lanman & Vivien Lou Chen, *Bernanke Says Fed Aims to Ease Credit-Market Strains (Update3)*, BLOOMBERG, Mar. 20, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aAWzQMDmmdhk&refer=home.

[66] Kim-Mai Cutler, Money-Market Rates Climb on Lehman Bankruptcy; Bill Yields Fall, BLOOMBERG, Sept. 15, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aUUeQpyhIwmA.

[67] Prieur du Plessis, *Credit Crisis Watch (December 8, 2008)*, THE BIG PICTURE, Dec. 8, 2008, http://www.ritholtz.com/blog/2008/12/credit-crisis-watch-december-8-2008/.

[68] Bernanke, Speech at the Stamp Lecture, *supra* note 48.

[69] Primary Mortgage Market Survey, *Contract Rate On 30-Year, Fixed-Rate Conventional Home Mortgage Commitments*, http://www.federalreserve.gov/releases/h15/data/Monthly/H15_MORTG_NA.txt (last visited Apr. 19, 2009).

[70] NAT'L ASS'N OF REALTORS, HOUSING AFFORDABILITY INDEX (2008), http://www.realtor.org/wps/wcm/connect/77f28a804c7c3587a76aa72e4ec772bd/research__REL0811A.pdf.pdf?MOD=AJPERES&CACHEID=77f28a804c7c3587a76aa72e4ec772bd.

[71] MKM Partners, *Home Sales May Have Already Bottomed*, BARRONS.COM, Apr. 1, 2009, http://online.barrons.com/article/SB123852012752974373.html.

since the 1970s.[72] The University of Michigan's "Good Time to Buy a House" survey is at 72%, which is its strongest level since 2005.[73] These lower absolute interest rates on mortgages are benefiting affordability of housing, but in January 2009 mortgage rates were still more than 100 basis points wider than normal over treasury securities.[74] Given a normal spread over treasuries, mortgage rates would be 100 basis points lower, and monthly cost of buying a home would be 20% lower with interest rates on mortgages at 4% instead of 5%.[75] Stability in the housing markets will ease the pressure on bank balance sheets and reassure consumers who were shocked to see their major financial asset, their home, in decline. A more confident consumer is the key element in turning around the United States' economy.

Corporations are facing a lower cost of money, as referenced above by the A2 commercial paper rates, which in turn reduce the required rate of return on investment encouraging companies to expand.[76] Simultaneously, consumers are seeing lower mortgage rates combined with lower house prices, which increases the number of people who could afford to buy a home or makes trading up to a new home more attractive.[77] These are examples of a better functioning market increasing demand. Increasing demand eventually leads to more production and more employment.

CONCLUSION

America sneezes and the world gets a cold. The whole world is now focused on the cure. Successful growth strategies in the United States are

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[72] Nat'l Ass'n of Home Builders, *Housing Affordability Surges at Year-End 2008*, NAHB/WELLS FARGO HOUSING OPPORTUNITY INDEX (HOI), Feb. 19, 2009, http://www.nahb.org/news_details.aspx?sectionID=135&newsID=8665; *How Much Further Will Housing Fall?*, SEEKING ALPHA, Sept. 2, 2008, http://seekingalpha.com/article/93550-how-much-further-will-housing-fall.

[73] Jeffrey Kleintop, *Healing in Housing*, *in* LPL FINANCIAL RESEARCH, WEEKLY MARKET COMMENTARY (2009), http://www.thesapientsolution.com/research/20090105WMC%20-%20Healing%20in%20Housing%20-%20thesapientsolution.pdf.

[74] Paul Krugman, *Mortgage rates are still too high*, N.Y. TIMES, Dec. 26, 2008, http://krugman.blogs.nytimes.com/2008/12/26/mortgage-rates-are-still-too-high/?apage=3.

[75] Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Statement before the Committee on Financial Services (Feb. 10, 2009), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/bernanke021009.pdf.

[76] Press Release, Fed. Reserve Bd., Commercial Paper Rates and Outstandings (Apr. 16, 2009), *available at* http://www.federalreserve.gov/releases/cp/.

[77] Julie Haviv, *U.S. mortgage applications jump; rates at record low*, BOSTON.COM, Mar. 25, 2009, http://www.boston.com/news/nation/articles/2009/03/25/us_mortgage_applications_jump_rates_at_record_low/.

critical to global growth. The United States is 25 % of the world GDP and its economy is at least three times the size of the number two economy.[78] Although the year 2009 will probably be remembered as the start of the Obama Boom, the structure and actions that reversed the economy had already taken place under the Bush administration and the Bernanke Federal Reserve Bank. Aggressive United States policy implementation is creating the preconditions for growth. Housing has become affordable. Bank balance sheets are being supported by government policy. Aggressive fiscal stimulus, reflected in Obama's first budget, will impact the economy by approximately 4% of GDP in 2009.[79] The Fed has been clear that their goal is to stimulate growth. Money supply, credit spreads and coordinated global policies all indicate that growth should be reignited. The European Central Bank, China, Canada, the United Kingdom and every developed country is pursuing pro growth monetary and fiscal policies. This broad and consistent set of policies will insure positive GDP growth by the end of 2009.

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[78] WORLD ECONOMIC OUTLOOK, *supra* note 2.

[79] CONG. BUDGET OFFICE, *supra* note 22.