P emergency bail out

Life

“ We in America today are nearer to the final triumph overpovertythan ever before in the history of any land” was Herbert Hoover’s message to voters in the US Presidential race of 1928. However, once elected into office, within months, he came to terms with his own short sightedness as the world plunged into a downward economic spiral, unparallel in history . . . at least until now.

The sub prime mortgage crisis and the ensuing credit crunch is by all means a haunting reminder of Black Tuesday, when on October 29, 1929, the NYSE crashed as a result of panic selling and led to theGreat Depression.

Without dwelling much on history, it can be concluded that the NYSE crash of 1929 and the Housing market crash of 2007 are both characterized by speculation and greed, a fundamentalfailureof pristine capitalism. Secondly, both crashes have followed an era of loose monetary policy and lax credit regulations for which hot shot individuals at the Central Banks and the commercial banks themselves share the blame. To add on to this, we have the menace created by the alluring yet highly risky business of derivatives.

With nothing much to defend, the question arises, are we headed towards adepressionas in 1929 or is the situation still under control? The likely scenario that we face is a gloomy one. The level of debt that individuals hold is high. The housing crash has wiped out a large portion of the banks credit portfolios. Other advances are also suffering as falling income levels, losses on a highly volatile stock market and rising unemployment are triggering people to default.

This is making depositors uneasy as they are shiftingmoneybetween Banks causing liquidity issues for them. Some Banks have closed down, unable to honor commitments. Others are set to follow. Low liquidity and capital losses means that these financial institutions are refraining from new lending despite the availability of cheap credit. Lack of financial facilitation means that businesses are suffering a lack of confidence and the economy is slowing down, marred with deflation, unemployment, high debt levels and low production. The Secretary of the US Treasury, Mr.

Hank Paulson's Emergency Bail out Plan, is set out to counter these problems and save America and the world from recession. The original idea was that the purpose of the plan would be to purchase bad mortgage related assets, reduce uncertainty regarding the worth of the remaining assets, and restore confidence in the credit markets. The treasury was given sweeping powers with 250 billion dollars of immediate funding. If need arose, an additional 100 billion dollars would be available on the discretion of the President and another 350 billion dollars following a congressional resolution.

Over time, the plan has come to embody a whole list of objectives including provisions on how to prevent foreclosures, deposit insurance, restrictions on executive pay and equity interests in financial institutions. The plan has met a mixed reaction. While there is a strong argument that the plan could be inflationary (Hudson, 2008), some argue that it would tend to be the opposite (UBS, 2008). There is also argument that this plan is aiming to fix a bruised and battered system and that we need a new and revitalized system for credit screening. Detractors also point to the fact that the plan keeps on changing.

It seems, from the looks of it, that the treasury is determined to stop the bloodshed with its 700 billion dollars but lacks any coherent strategy to do so. Whatever the case, lets build on basic macroeconomics to see how the plan will affect the American and the world economy and then make an informed conclusion on what the US Treasury should instead aim at. To take a short trip back down history lane, when the 1929 depression struck, John Maynard Keynes argued that Government intervention through a budget deficit would alleviate these conditions.

Initially the private sector is unwilling to invest. However, as government spending increases, it raises the private sector's interest. Gradually, confidence returns. Monetarists held an opposing view. While Keynes argued that higher incomes would lead the poor strata of society to consume more, monetarists held that this additional income would go back to paying off debts and accumulated obligations and not add to the value of the multiplier. (Lipsey & Harbuy, 1992) The US Treasury and the Federal Reserve it seems are following a middle line here.

While the Federal Reserve is cutting interest rates to stimulate business activity, capital infusions by the US Treasury is intended to help banks lend more freely. Thus, we are witnessing a mixture of Keynesian and Monetarist school of thought. Although there is little argument to the fact that this plan is inflationary in nature, the problem that it fails to address is that the US Treasury, despite making equity infusions in banks, buying troubled assets, lowering interest rates and taking steps to reduce uncertainty cannot force banks to lend.

While some point to the inflationary nature of the program and its evolving nature, it seems that the major flaw is that it cannot help but wait when banks start lending freely and unfreeze the credit markets, stimulating business activity. Thus, as far as the effects go, it seems likely that if the banks refrain from lending even at the now cheaper interest rates and merely choose to sit on the cash, it is highly likely that the plan would fail plunging America into a recession. This lack of financial facilitation will also affect the world as the USA is acting as a demand powerhouse for the world.

It is likely that the World may move into recession too as export markets in America contract. On the other hand, if the plan was to succeed in unfreezing the credit markets and stimulating business activity, we will see inflation followed by bouts of constrained monetary betterment. This would help the world economy too as exports will be less affected and American consumption will fuel their growth. However, in either case, these 700 billion dollars will ultimately affect the taxpayer in future years, in the form of an increased tax liability.

However, the most worrying thought is that the recovery could be a jobless one. The bail out plan may put back business and consumer confidence back on track but the increased money supply might not affect unemployment levels in a major way as US firms continue to move production facilities abroad. Therefore, a coherent strategy aimed at increasing industrial production and reducing unemployment inside the US is augmented. For this reason, other counties, possibly China will have to step up and act as a demand generator. (Shafi 2008)

To conclude, if the plan is not able to unfreeze the credit markets, there is little chance that the world might escape a depression. If the plan was to work, two scenarios present themselves. By returning to the old way of consuming more, the US Treasury will allow the legacy of the old system to survive. Instead, if the focus would be towards industrial and export led growth, the system of budget deficits and trade deficits and the large sums of money conjured in maintaining them will die and a new world order built on fiscal facilitation and sound monetary management will evolve.

References: Hudson, Michael (2008). The bailout is a giveaway that will cause hyperinflation and dollar collapse. The Real News. Retrieved on 13-12-2008 Lipsey G. , H. & Harbury, C. (1992) First Principles of Economics. London: Oxford University Press. Shafi, A. (2008). A Walk Down Memory Lane: The Sub Prime Mortage Crisis and the Great Depression revisited. The Financial Flicker Retrieved on 13-12-2008 UBS. (2008) There is no alternative. " Policy measures are anti-deflationary. They are not inflationary. " Retrieved on 13-12-2008