Free research paper on troubled asset relief program (tarp)

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Executive Overview

Total Asset Relief Program (TARP) is a program by the United States government geared towards purchasing of assets and equity from various financial institutions with the aim of strengthening its financial sector. This program was signed into law by the United States president George W. Bush in 2008. During that year, the government came up with this program to address the subprime mortgage crisis in the state. Initially, TARP authorized an expenditure of $ 600 billion. However, the mount was reduced to $475 courtesy of Dodd-Frank Wall Street Reform and Consumer Protection Act. The stimulus program of Total Asset Relief Program (TARP) was enacted under president Obama. This turned away another incidence of the Great Depression of the 1930s. However, there are various economists who claim that the government should have let the free market element to continue without government internvention thus it would have been necessary measure to wipe out business failures. These views can be analyzed using the Adam Smith’s classical view and John M. Keynes’s neoclassic revolution.

Introduction

The purpose of TARP is to allow the U. S department of treasury to purchase or insure up to $700 billion of the “ troubled assets”. These “ troubled assets” include the residential or commercial mortgages, obligations, securities among other instruments that are related to mortgages. These cases are insured where their purchase promotes the financial market stability. On the same, troubled assets includes other financial instrument where the secretary under the consultation of the chairman of the board of governors of the Federal Reserve System normally determines the amount of assets to be purchased and that are necessary in promotion of the market financial stability. This gives the Treasure the mandate to purchase illiquid as well as assets that are difficult to value. However, this only refers to assets that were originated or issued before March 14, 2008. In short, TARP is intended at improving the liquidity of the assets that can be collateralized debt obligations as they were sold in 2007 which marked the booming market. Nevertheless, TARP does not allow banks to recoup losses on assets. The officials involved predict that when the trading of the assets resumes, the prices becomes more stable hence increase the value of such assets. This results in gains to both banks as well as the treasury. It can therefore be deduced that future gains is the main concept in TARP. This is simply because when these assets are sold in the future, the involving parties are able to make profit. However, the future prices are only based on the hypothesis that these assets will be resold in the market. Their prices only take a small percentage of the mortgages while the fall in their prices represents much higher prices.

In order to sell assets to TARP, the financial institutions involved are required to issue assets warrants. This is a type of warrant that gives the holder the powered to purchase shares in the intended company by issuing a security for a certain price. In this case, TARP works towards ensuring that financial institutions are in a position to benefit from the government’s assistance through recovering their strength. However, the government also benefit in the process because treasury is the main player in the program. In fact, the treasury aims at protecting the taxpayers by through the new ownership and reselling of the assets. Smith argues that by the use of neoclassical approach in promoting the economy, individuals pursue their own interest. However, he frequently promotes societal welfare rather than when one intends to do so. Therefore, it can be argued that by president Obama adopting the TARP, he has been able to promote the general welfare of the society without even being aware of it. Smith refers to it as trade for public good. It is a kind of affectation that can be employed by individuals to promote their merchandise.

Analysis of TARP Using the Classic or Neoclassic Economic Thoughts

Smith often uses the “ invisible hand”. This refers to a situation where an individual intends to pursue his own interest but ends up promoting the welfare of the society. In the case of Obama adopting TARP, several benefits can be linked with his interest of promoting domestic trade. In addition, self interested competition in a free market benefits the society as a whole. This is simply because free market resulting in prices remaining low. It also builds an avenue where there is an incentive for a wide variety of goods and services. This explains the disadvantages of TARP in United States, essentially, TARP has resulted into narrowed market, and reduced competition hence decreased quality of products available for local consumers. Cost of commodities also goes high simply because there is no competition in the market. In this case, the consumers are not in a position to enjoy variety of goods and services due the limit put by TARP against foreign industries (SIGTARP, 2009). Although United States is big enough to support its consumers, foreign industries create some form of stability in the market in terms of increased variety and low cost of essential commodities for the benefit of consumers (Blyth 2002 pp. 20). However, considering the effect caused to the domestic industries which was the main reference for president Obama, it can be argued that when even industry in the world is allowed into the market, competition rises where some domestic industries are not in a position to compete with the same (Hayes, 2008 p. 78). This is due to lack of support and reduced customer base.

According to Adam Smith’s classical view, every individual; always endeavors as much as possible to employ the available capital in the support of domestic industry in order to increase the production of that industry which is seen to have much value. The promotion may go beyond the individual interest (Hayes, 2008 p. 89). Therefore, by president Obama preferring the support of domestic to that of foreign industry, he knows beyond doubt that local producers will grow. In this case, Obama was working towards ensuring the protection of the Americans. This program lays strategies to ensure that there is enough support for industries in the domestic market where the market has been expanded due to limitation of foreign industries from investing in the same markets (Davidson, 2009 p. 170). Indeed, United States seeks gain and dominates their markets. In this scenario, the treasury ensures that money flows in the economy and that domestic investors can easily assess loans from banks at reduced interest rates.

TARP also plays a great role in encouraging banks to increase or resume their lending after the crises. The lending normally takes place between banks to banks as well as to individuals and businesses. In the case, TARP is planning aims at stabilizing the bank’s capital ratios; thus it follows that the concerned banks must be allowed to increase their lending. This avoids the case where the bank hoards cash which may have a negative bearing the case of the unforeseen losses resulting from the troubled assets. It is vital to note that by increasing lending, the credit is loosened (SIGTARP, 2009). This implies that the order will be restored in the financial markets where the investor confidence is increased simply because they can get funds from various financial institutions and invest in different markets. On the same, when lending confidence is in place, the interbank rate also reduces. This means that the rate at which banks lend to each other especially on short term basis decrease something that facilitates lending. Notably, the treasury has a set limit of spending at the beginning of about $250 billion. These funds are used to purchase assets. It can then resell them or hold them and engage in collect ion of coupons. The money from these coupons goes bank into the pool which makes it possible to purchase more assets (Blyth 2002 p. 20). This may increase the initial amount to $ 350 billion. This follows the legal process starting with the president’s certification to the Congress where the money is later released to the treasury.

Since 2008, the TARP money was first used to make houses more affordable. This was the first plan since mortgages are treated as troubled assets. This is done through refinancing for the mortgages mainly those held by Fannie Mae. However, mortgages held privately are eligible for other government incentives which include modification of loans for at least five years. It is therefore evident that by the fact that mortgages are under the troubled assets, the strategy benefit both the financial institutions as well as the individuals involved. Majority of people especially the middle income earners are not in a position to pay mortgages simply because their prices goes high depending on the condition of the economy. Therefore, the government can play a great role in determining the rates of mortgages (SIGTARP, 2009). Indeed, the United States’ government under TARP program has gone to higher level where it can even refinance the mortgagees to the financial institutions. This is a relief to majority of individuals who are at times caught between a rock and a hard place when it comes to paying their mortgages to such institutions.

Smith’s classical view takes into consideration activities that an individual may do sometimes with the aim of earning more money and in the process benefit other parties involved. This is applicable in the TARP program in that by purchasing troubled assets and reselling them at a profit, the profit goes bank to treasury (Davidson, 2009 p. 167). In the process, banks lending rate is reduced. This creates an avenue where consumers lending can be increased due to favorable condition created by the treasury. As stated earlier, when treasury is allowed about $250 billion, it buys assets where is ca later make the decision of reselling them immediately or holding them where it buys coupons something that increases the amount. This way, a profit is gain that is taken back to the poll of money provided by the government (Blyth 2002 p. 20). This money can therefore be used to purchase more assets. The public are the main beneficiaries in this case. Just like the way Smith talks of invisible hand, TARP can be very reliable since some benefits of this program cannot be traced directly. This is because it involves a cycle where the money flows in the economy creating favorable condition for both foreign and domestic investors (Wilson, 2011 p. 36). In fact, when the lending interest rate reduces, more investors are brought in the picture creating employment opportunities for the unemployed.

Both Smith's classical view and Keynes neoclassical approach can effectively be used to analyze TARP. This is because the two views concentrate on the benefits accrued and that at times may not be directly linked with the action taken. Despite the fact that some economists insisted that the government should not have intervened and that free market elements should have been allowed to weed out the business failures, there are evidential benefits accrued from the enactment of TARP (Davidson, 2009 p. 165). This is because it has favored business growth. This is clearly indicated from the fact that it increases the rate of investment. This directly means that employment opportunities have been expanded. Business and individuals have been able to borrow loans from banks because the treasury has participated in creating a favorable condition that makes it possible for the banks to lend at a lowered interest rate. It is therefore evident that Keynes's neoclassical view is more applicable in modern day context as it focuses on improving the economy through government intervention.

Conclusion

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