

## CAICOS Brothers RESEARCH

### Obamanomics: Fighting The Iron Law of Diminishing Returns

By Gilbert NMO Morris



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Imagine a torture programme in which you have a large bowl – say the size of a dump truck - of spaghetti; a bowl piled as high as possible. Imagine that you and 5 other people are sat at the massive table that would require. Now, imagine that you are told that you have to slurp one end of a string of spaghetti but one of the other five persons must slurp the other end of the same string for you to be freed. That is, you must have counterparties, or someone on the other end of your string of spaghetti. Now imagine that for every time you fail to slurp a string of spaghetti with someone on the other end, the amount of spaghetti doubles and your punishment doubles. If you understand this, you understand the basic problem with the \$700 billion dollar attempted “bailout” which the US Congress gave to Treasury Secretary, The Hon. Hank Paulson and you have got an idea of what President-Elect Barack Obama has inherited. No one seems to know whom or what is at the other end of their actions.

This is one amongst a number of pressing issues on the immediate horizon for the new president. I will deal with some of the more pressing problems sequentially and in brief. It should be noted, when dealing with these large, multi-dimensional problems that emit diminishing returns, only organic – vertically integrated - solutions are effective. As such, the three areas in want of organic solutions are:

- i. *The Financial Bailout*
- ii. *The Auto Bailout*
- iii. *The Global Financial System*

In the example above, it is fundamentally indeterminate who is on the other end of your string of spaghetti and matters worsen when you don't. In the case of bad mortgages continuing to destroy US banks and financial institutions (a trend I welcome), a central problem is no one knows who is at the other end of the financial instruments that are causing the problems. Take a basic mortgage: it is written by a broker, several banks may take between 20-30% of the loan.

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This means there is only a tenuous relationship between the bank and the actual borrower. That mortgage is then bundled, and packaged, stripped further into different tranches and sold as bonds or used as collateral. Given

what we now know, different institutions may have had the very same mortgages on their balance sheets, meaning there are less total assets available to back outstanding credit exposures. (Imagine, in the most basic case, that you had a car worth \$10,000. But 20 people loaned \$1,000 using that car as collateral. There just ain't enough car for the loans outstanding).

The long and short of this is I disagreed with the bailout; however styled. It is unacceptable to keep profits private whilst socializing losses and risk; to have bankers who made bad bets protected on the profit side, and have

taxpayers cover losses on the other side. In my view, Paulson is trying to fix an insolvency problem, with a liquidity solution. In the case of banks, the problem is simple: the banks are many and the clients are few. Comeuppance is required. The mantra should have been: Let them fail, collapse, and die!

Too late now. The US government has bailed out (loaned taxpayer funds to) the failing institutions by nearly one half trillion dollars to date. However, in a turnstile of horrors, foreclosures continue, which means more houses returned to the market, enforcing downward pressures on home values, inducing more foreclosures. This preceding analysis deals only with mortgages. The insurance products that are based on the mortgages are even more quixotic. If you accept that half trillion dollars have gone to "stabilize" banks, admit that it has done nothing for house values. The fact is the houses are valued less than the mortgages held against them, whilst the held to maturity instruments by which the mortgages are leveraged are valued less than par. Horrors indeed. This means the insurance contracts must be adjusted, or claims must be activated against them. The credit default swaps (CDS) – which are the leverage insurance instruments that leveraged insurance contracts – are callable, but are in excess of the capacity of the finance institutions to honour. Their relationships to counterparties are by orders of magnitude more confused than the example of the spaghetti problem given above.

As if that was not enough, there is another problem, a systemic one. There are \$11 trillion dollars in mortgages in the US. About 15% of them are "toxic"; so commercially revolting as to be utterly worthless. The leverage and syndication arrangements that contributed to our 'spaghetti problem', has created a systemic legal problem as an impediment to a government mandated solution. The two and one half trillion dollars of toxic mortgages (the approx. 15%) are locked in a nexus of securitization between banks, mortgage brokers and bond holders (Hedge Funds and Pension Funds), that prevents banks or brokers from selling to the government on command without invoking the constitutional "takings clause". That is, to get this programme going the government would have to mandate sale to itself or through its auction mechanism. But that mandate may amount to a "takings"

contravention of the Fifth Amendment of the Bill of Rights.

What should the Obama administration do?

What is needed is an organic approach, that has the result, both of providing a solution and instilling confidence; taking radical departures where necessary. There will be only one chance to get the solution right in a way that imbues confidence. Since the government has pranced this pathway, we must follow the course imposing market-making mechanisms where possible. Therefore, I think President-elect Obama should keep Henry Paulson for the first year of his first term as president. This gives him essentially two chances to deal with the problem; as it will remain Paulson's problem and if it is solved, the solution is the new administration's solution. But unsolved, Paulson leaves, and the administration gets a second chance to solve the problem on its own terms. This strategy aims at multiplying the opportunities to cultivate confidence, rather than a political tactic. Second, there should be a forensic audit of every institution that received (or will receive) government assistance, which is made public. Third, the details and conditions of banks must be made public; with routine updates on the status of the banks and the financial industry. Attempts should be made by means of consolidation, ruthlessly, to reduce the number of banks by 1/3; which means at least 2500 – 3000 of the 8000 banks must see the executioner.

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Those steps are preliminary. Next, more direct changes are necessary. Once the numbers of banks are reduced, there is still the question of foreclosures creating pressures for remaining banks.

Three steps to address this: as President, Mr. Obama should order the Treasury Department to set up an auction programme, in which two things should occur, preliminarily:

- a. Trace the links between as many strings of spaghetti as possible. That is reconnecting the loans as much as possible between lender and borrower.

- b. Where strings cannot be found, sell those 'assets' (mortgage backed securities) at a sharp discount to their book values.

These steps taken, the assets should be sold in two classes by auction: discounted assets and junk. This closes the loop in support of financial services companies and banks, so they end up with equity injections, and removal of the worst instruments from their balance sheets.

The third step concerns the stimulus package the Obama transition team is considering. Instead of a 'blind stimulus package', that merely produces hot cheques for Americans totaling around \$70 to \$100 billion. Rather, the effects of the tax cut President-elect Obama promised, and the stimulus should be combined. Again, an organic approach is wanting. The package should be \$500 billion in total. At least \$300 billion should go, specifically, to guarantee mortgages of homeowners directly. That is, it should not go to the homeowner through the lender, but to lending institution through the homeowner. Second, the remaining \$200 billion should go directly to American households; which amounts to between \$3300 and \$4000 per household. (If this could be done before Christmas, it would stabilize the - much shorted - retailers and preserve some jobs).

Additionally, the auction would mean (notwithstanding the constitutional issues), that you would now have an Exchange for exotic financial instruments that are not federally regulated.

Again, I disagree with the bailout (loan & recovery) programme because capitalism requires horrid companies to suffer homicide, suicide or death *causa naturale*. Some say, this would cause unprecedented financial carnage. Barking nonsense! Once these companies collapse, the Warren Buffets, Wilbur Ross, Maitlins, Ichans, Pickens et.al, along with the ultimate vultures Private Equity Funds, would swoop in on a buying frenzy. The collapse would last 12 hours. Some jobs will be lost, but millions would be saved and the taxpayer would not have to suffer in quiet desperation, whilst bailing out Wall St.; as is popularly imagined.

The strategy set out above claws the bad instruments out of the system and will mean further losses for the banks, brokers and

bondholders. But they are – on the other hand – supported by equity injections from government. Happily, the number of banks having been reduced the restored supply-demand equilibrium would lead to a meaningful competitive environment. The aforementioned bifurcated stimulus, would put a floor under house values – in part - by reducing the number of houses returning to the market, whilst the household cheques, puts the consumer in position to make purchasing decisions.

This is much better than what the US Treasury has done so far. First it said the TARP (Troubled Asset Recovery Programme), was meant to buy troubled assets, only to lurch toward the British-styled equity injections. But both are necessary, if government is going to get involved. Further Treasury failed to address homeowner issues directly, the result of which is that banks are squeezed by declining home prices on the one hand, and a consumer “pullback” on the other. The entire approach must be coordinated to create one large, immediate impact, remembering that confidence is the Holy Grail yet to be attained.

Turning to General Motors and the car industry in general. Again, bankruptcy and various forms of death await; deservedly. I am a capitalist. I accept

capitalist principles when markets are up and take the pain when markets are down.

General Motors and Chrysler are indefatigably awful companies that must be allowed to die. Ford was a schizophrenic

company that emerged from therapy only just in time for an economic meltdown.

But I know that an Obama administration will support the car companies, given its immediate impacts, with knock-on effects in steel, rubber and supplier industries.

Let’s examine the options. First, the deal suggested by the Obama Transition Team is to give Detroit taxpayer money, in exchange, for the manufacture of hybrid cars. I think this is an idea, vapidly oversimplified, altogether too disconnected and likely to produce nothing of the successes imagined.

**Additionally, once and for all, America must state its position on their misunderstanding of the role of International Financial Centres (IFC) in the global financial system.**

A better approach is packaged bankruptcy, in which Chrysler is absorbed into General Motors. General Motors is then reduced in size and brands by those brands that sell enough to make a profit. This will require a skilled butcher and not a surgeon. Absorb the legacy retirement commitments of the companies, and have management present a going forward programme, with appropriate targets and penalties for failure of those targets.

This leanness is the best chance of preserving an auto manufacturing industry in the US that may thrive, per chance. The hybrid car condition is sophomoric unless and until a comprehensive energy strategy is worked out, so that cars, houses, businesses – that is to say almost everything that has to be powerized – is run off of a single grid; again creating cost-cutting economies of scale. This is a clarion for a wholesale plan that comes to the market in breathtaking scale and audacity.

There are several additional initiatives and problems an Obama administration should contemplate: First, in order to reduce immediate costs to the government, Social Security should be paid to persons over a certain net worth in US Treasury Bonds. There are 50 million recipients of social security. Of those receiving retirement benefits, nearly 6% of them are “high net worth” individuals. It is possible therefore to save around \$60 billion of the near \$2 trillion dollars paid out annually; or even develop a programme through which they opt out by choice. This would save a considerable amount of money and is essentially a low interest loan to government. End tax breaks for house purchases above \$500,000 and end deductions for employer provided insurance once the new health plan is operative. Against these loophole closings, reduce marginal corporate tax rates to 20% immediately. These measures would likely produce another \$30 billion in savings, whilst activating growth.

I stress these cost cutting measures because I am actually opposed to “stimulus” packages. Money does not originate *in abstracto*.

**You cannot have American domestic solutions to a global crisis. That is the definition full throttle operations against cascading diminishing returns.**

Depending on where the money comes from, it could have geo-political implications (Middle East, China), or domestic investment impacts, (taxes or government paper issuance). I think the government is going to have to play close to the margin here: risk inflation, but target the stimulus to facilitate investment, whilst reducing direct negative pressures on the US consumer. This means not merely enacting policy because of its immediate temporary benefits, but knowing what each policy option commits one to in the future. It is important to note further, this crisis is of global proportions. American domestic solutions to a global crisis are untenable. That would be the definition of policy-making against cascading diminishing returns. I do not advise a global regulator by any means, but a regular sharing of notes, and transparency at a high enough level that we can spot potentially troubling trends earlier.

Dare I say, these processes will do little good, for it is not that we did not see warning signs, but that hubris, salacious greed, covetous dementia and fecund self-indulgence has put us in crisis.

Second, as was said, an all-stops-pulled-out, Manhattan Project strategy must be enacted on Energy; to shove the US economy off of fossils fuels and onto alternative energy platforms. The culture of investment surrounding such a programme is the only actual large-scale growth option available to the US, and the technologies manufactured in this environment would charge US exports and support the dollar at a moderate strength.

**Obama cannot play by the old or even existing rules. "Change You Can Believe In" must force a correction in the marketplace. Obamanomics, given the issues of our time, has to be constituted by a series of principles, policies and practices designed to fight the iron law of diminishing returns.**

There are other issues, particularly in foreign policy that I shall write about another time; specifically as concerns Afghanistan. However, it is important to make four final points: First, capitalism is not dead. The objective of all these initiatives above should be to stabilize first, then stimulate. There should be a commitment

to brutal transparency for all entities in these government programmes.

Second, the Bush and prior administrations have been printing money to meet commitments. Since the conflict in Iraq and the \$700 billion dollar bailout, significant dollars have been added to the aggregate of money supply. This will lead, foreseeably, to crippling inflation. I wrote 9 months ago that this policy hid the anemia of the Euro-economies behind the farce of Euro-Pound appreciation. I believe the dollar will collapse from current highs, and the Dollar, Euro and Pound will remain in the doldrums. The point is, the only means of gaining economic advantage is to cultivate the innovation economy as was mentioned above.

Third, I am deeply concerned that the brief of this upcoming G-20 meeting will be as narrow as it will be ineffectual. I have written for 10 years now, on the weaknesses in the global financial system. A President Obama should cause to be convened a serious meeting with the largest economies in the world, with smaller nations represented by regional institutions, to deal with macroeconomic issues such as the impacts of syndication and leverage on financial contagion, (which leads to further spaghetti problems) money supplies & exchange rates, balance of payments (now a geo-strategic issue for the US), and the global velocity of private capital flows versus foreign direct investment. Additionally, once and for all, America must confess its misunderstanding of the role of International Financial Centres (IFC) in the global financial system. Failure on this front means the policy nuances Mr. Obama prefigures will go for naught in a hale of effort without corresponding returns.

Fourth, thematically, the new president must get a grip on a philosophy that characterizes the policy demands his administration will face for its duration. As with "Supply-side" for Reagan and "Triangulation" for Clinton, Obama must get in tune with zeitgeist of his era of governance. The new president cannot play by the old or even existing rules. "Change You Can Believe In" must force a correction in the marketplace. Obamanomics, given the issues of our time, has to be constituted by a series of principles, policies and practices designed to fight the iron law of diminishing returns.

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