



Dealing with the Too-Big-To-Fail

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Can we hope that, in dealing with the crisis in financial markets, US government has dodged a bullet without inadvertently lighting the fuse to fire a canon ball?

Bear Stearns was judged to be too-big-to-fail because the hard-to-predict network effects of such a failure would have been potentially devastating to the US and possibly the global economy. Therefore, the government arranged a takeover of Bear Stearns by J.P. Morgan Chase and subsidized it with taxpayer money and guarantees.

Having swallowed Bear Stearns, J.P. Morgan has grown. If either of them was too-big-to-fail then, the consequences of letting the combined entity fail would be even less acceptable.

The wizards who run and oversee the financial system permitted creation and growth of, and risk taking by private financial institutions which they knew could fail, but could not be allowed to. Then, at the brink of failure, they combined them into larger institutions subject to the same risk and logic, only at a bigger scale. This is postponing the day of reckoning with compound interest.

After a year of crisis, the world financial system is rapidly consolidating into a handful of US, European and Asian giants such as

Bank of America and J.P. Morgan Chase. In what sense, and for how long will these firms and the economy remain private and capitalistic if they can walk away with their profits, and dump their bad bets on taxpayers?

The financial private sector can be protected from progressive nationalization by placing limits on the size of firms. Too-big-to-fail, instead of absolute size, can serve as a natural bound on how far private financial institutions are allowed by regulators to grow through organic growth, mergers or acquisitions.

The traditional rationale for intervening in the size of firms has been antitrust—to limit power and promote competition in product markets to promote economic efficiency. Government bailouts of giant financial institutions in order to safeguard the domestic and the global economy suggest another new criterion for reviewing proposed mergers and acquisitions: Will a proposed merger or acquisition create an entity which the government (US Federal Reserve System, US Treasury, European Union, or national governments in Europe as the case may be) will feel compelled to save from failure for the fear of its domino effects? If the answer to this question is yes, the proposal should be disallowed to reduce the chances that the government may have to intervene at some

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Since firms could also grow organically, the legislature could require an annual certification from the Fed and Treasury that no firm in the financial sector (defined as banking, investment banking, insurance, mutual, hedge and pension funds, and brokerage) is too big to fail. If a firm is found to have crossed that threshold, it would be required to divest itself in the manner of antitrust enforcement.

Will this leave the European and Asian giants free to crush the American pygmies in the global market place? EU, Japan and China will have to decide for themselves if adopting a similar policy to save the private financial institutions, and reaping the benefits of their efficiency, is in their best interest.

Placing the responsibility of such reviews on the Fed and the Treasury will create an incentive compatible system for these regulators; they would not be able to rush to Congress and the public exchequer when a financial firm is about to go belly up. US Congress will soon consider legislation to commit public funds to save the financial sector. This is also the only time the legislation to limit the size of financial firms can possibly be passed as a part of a rescue package. Once the public money has been committed, pressures from the industry lobby will make it all but impossible to achieve this end.

The short-term solutions to the current financial crisis carry the risk of setting us up for even more severe problems later. The time for establishing a mechanism to limit on the size of financial firms to protect the financial system and the public exchequer is now.



Source : http://www.pritchettcartoons.com/bear_c.htm

Future of dollar as reserve currency

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After the collapse of the Bretton Woods system in 1971, the dollar has remained the premier currency in the world today. This can be attributed to a strong economy, stable growth and inflation rates for most of the twentieth century and increased investor confidence. The world depended on the dollar for international transactions as many products and commodities such as oil were priced in dollars. Central banks around the world invested a large share of their currency reserves in dollars. As of 2007, the world reserve holdings constituted 64% US dollars, 26.5% euros, 4.1% British pounds, 3.3% Japanese yen and 2.1% of other currencies (International Monetary Fund, International Financial Statistics, COFER data).

For the United States it has been a sweet deal as the issuer of the dollar. It has substantial advantages over other countries with equally strong currencies. Stable exchange rates which enable purchase of commodities at lower costs and a low-cost source of credit are some benefits it enjoys. Further, the United States can buy more than it needs to sell because of which it can sustain trade deficits without any drastic economic impact. The re-conciliation of this deficit can be postponed as long as countries seek dollars as reserve. Therefore, the United States is bound to do all that it can to retain the dollar regime.

Alternatives to the dollar

Although the euro has all the attributes essential for international acceptance such as large economic base, political stability, and low inflation rates, it still has a long way to go to replace the dollar as reserve currency. Activity for the euro has been concentrated in economies geographically close to Europe. Therefore, the dollar enjoys a better global presence than the euro. The fiscal and government policies are aimed at promoting the economic growth of the euro zone. An increase in demand for the euro would push its value up and may hamper the economic

growth of the Euro zone. Therefore, the European Central Bank does not promote the euro as reserve currency. Also, the European capital market is still fragmented and lacks liquidity. Security holders tend to hold debt until maturity because of which the secondary market is not as developed as that of the US.

The pound may be the third largest currency and the fourth largest in foreign currency trading but it is unlikely to replace the dollar. Only about 4.1% of the world's foreign reserve holdings are in pounds vis-à-vis 64% in dollars. The secondary market is well-developed in the United Kingdom however the amount of pound-denominated British government debt is at 0.8 trillion which is significantly smaller than that of the United States and other countries.

The yen was considered a strong contender to the dollar during the 1970's when it was a fast-growing economy aiming for superpower status. However, towards late 1980's, the Japanese economy began to decline and grew at a dismal rate of between 1 and 2 percent. The yen has not succeeded as an international reserve currency despite a continuous current account surplus mainly because of high volatility, exorbitant transaction costs and low yield of less than 1 percent on short-term securities.

China's leadership has been overtly worried over the country's dangerous dependence on the dollar. Beijing holds \$2 trillion in dollar assets, accumulated through years of exports to America and massive purchases of Treasuries by the Chinese government. If America continues to spend, then the dollar might weaken and cause huge losses to China. Therefore, the Chinese government has been pushing for a replacement to the dollar as reserve currency. The Yuan may not replace the dollar as reserve currency in near future because of its under developed capital markets, conservative fiscal policies, and its inability to convert currency for capital account transactions. Currently, the target dollar-Yuan exchange rate policy is being followed by China; it needs to move towards a market-determined exchange rate for the Yuan to become a reserve currency.

A Special drawing right (SDR) is a synthetic unit of account of the International Monetary Fund (IMF) defined in terms of four currencies: the US dollar, the euro, the Japanese yen, and the Brit-

ish pound. The main problems associated with the SDR are:-

- Apart from national monetary authorities, private parties outside the United States cannot use the SDR which would hamper international transactions.
- Ambiguity over decision of issuance. To date, only 2 successful issuances totaling SDR 22 billion have taken place.
- The IMF is merely an institution with limited authority and may not be able to monitor imbalances in the system.

Though the United States is still reviving from an economic turmoil, many experts predict that the recovery will be a W-shaped one. The current signs of revival may only be a precursor to another downturn. However, if the recession were to prevail for a longer duration, its impact on the dollar would reduce the return on investment to investors. Further, if things worsen, the US economy may come to a near halt and most exporters will be forced to diversify and increase their trade with the European Union and Asian countries. A prolonged period of depression such as the Great Depression of 1967 which displaced the pound is likely to cause a replacement of the dollar as reserve currency. However, experts predict that a Great Depression is highly unlikely at this point.

Another unlikely event that can threaten the dollar from its current dominant position is the United Kingdom adopting Euro as its national currency. If such a scenario were to occur, the dominance of the Euro in the world market will significantly increase.

With commodities such as oil and petroleum priced in dollars, other countries have to hold dollars as part of their currency reserves and invest them in the US economy. If the OPEC were to adopt euro pricing and payments, then it is very likely that the dollar will decline in prominence. However, the United States and Saudi Arabia currently share an agreement to price oil only in dollars.

Any sudden changes will only spell doom for the international monetary system. One can expect to see a gradual movement by countries towards adopting other currencies however; it would take both a major shock to the dollar and a viable alternative to replace the dollar as reserve currency.