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PEPPERDINE POLICY REVIEW

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School of Public Policy

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Pepperdine Policy Review is a student-run journal that showcases the best scholarly work of School of Public Policy students at Pepperdine University. It features articles, commentaries, and book reviews that address a variety of important issues.

The mission of *Pepperdine Policy Review* is to publish the best scholarly research, innovative policy solutions, and insightful commentary that School of public Policy students have to offer. This journal seeks to inform policy makers, academic researchers, and the general public of ideas that will help transform public policy debate in the U.S. and abroad. All articles are thoroughly reviewed by student editors and must meet rigorous academic standards.

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Message from the Editor

Volume III of the *Pepperdine Policy Review* highlights the work of three students at Pepperdine University School of Public Policy. Lindsay Young wrote an article about the recent removal of President Zelaya in Honduras, which was also presented at the Pacific Coast Council on Latin American Studies Annual Conference. Kevin Chlebik's article uses game theory to explain the actions of terrorist cells. Lastly, Matthew Saha wrote an article detailing the continuing importance of Russia to U.S. national security. In addition, the *Pepperdine Policy Review* highlights the work of Kevin Simons, a recent graduate of the School of Public Policy, who wrote an insightful piece detailing both sides of the debate concerning the bailout plan.

This year has been a challenging and rewarding endeavor. The *Pepperdine Policy Review* increased its editorial staff in order to handle the record number of submissions that the journal received. This year the *Pepperdine Policy Review* decided to hold a symposium on the current financial crisis. The *Pepperdine Policy Review* sponsored five lectures over the course of the fall semester. Edited transcriptions of three of these lectures are included within this volume of the *Pepperdine Policy Review* for your enjoyment. I would like to thank Dr. Luisa Blanco, Dr. Randall Holcombe, Dr. Jerry Ellig, Dr. Michael Shires, and Dr. Richard Rahn for their thought provoking lectures.

I would like to give a special thanks to Volume III's Symposium Editor, Lindsay Young, who put in countless hours helping to arrange the symposium and edit the transcriptions that appear in this journal. I would also like to thank Josephine Huang and Monica Klem for going above and beyond their duties as editors. In addition, I would like to thank Matt Piccolo and Nicolas Valbuena for their continued dedication to the *Pepperdine Policy Review*, without which publication would not be possible. Lastly, I would like to thank the Class of 2010 for its generous gift to the *Pepperdine Policy Review* and wish them all the best of luck in the future. Please enjoy Volume III of the *Pepperdine Policy Review*.

Nicole S. Hutchinson
Editor-in-Chief

The Honduran Question: The U.S. Answer to Latin America

Lindsay Young[*]

ABSTRACT

Honduras grabbed international headlines when the Honduran Military removed José Manuel Zelaya Rosales from power on June 28, 2009. This paper uses the instability in Honduras as a case study of how the United States should respond to threats to democracy, and approach questions of democratic legitimacy in Latin America. It will first evaluate democratic contentions to put the Honduran crisis into a broader historical context. Next, it will examine the legality of the actions that triggered the democratic crisis because, though legality is not sufficient for legitimacy, it should be an important consideration in determining foreign policy responses. It will discuss the choices that the United States had between the removal of President Zelaya and the election of his successor, and analyze the path that the United States ultimately chose by supporting the reinstatement of President Zelaya, until it was clear that the reinstatement would not occur, at which point it decided to support the November election.

I. INTRODUCTION

Latin America presents a distinct challenge to U.S. foreign policy. The region is highly democratic, but many of the countries have not consolidated their democracies. In the fall of 2009, the turmoil in Honduras was President Obama's first test on how to approach the development of democracy in Latin America and illustrates the concerns regarding the internal struggles of democracy and the limited options that the U.S. has in another country's internal affairs. This paper uses the instability in Honduras as a case study of how the United States should respond to threats to democracy in Latin America and approach the question of democratic legitimacy in Latin America.

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The Honduran military removed President Zelaya from power on June 28, 2009 because of President Zelaya's attempts to pursue a national referendum that would allow presidential reelection. The Honduran Constitution allows for a presidential veto or decree to alter the Honduran Constitution except in cases that relate to the "conduct of the executive branch." A national vote initiated by the president may sound democratic, but the single term provision in the constitution remedied the political structure that had led to years of military dictatorship.

The legislative and the judicial branches of Honduras see President Zelaya's dismissal as an act to safeguard democracy because Article 239 of the Honduran Constitution states that if someone tries to extend term limits, that person is to be immediately removed and disqualified from holding executive office for ten years.[1] President Zelaya tried to work around this restriction by framing his referendum in terms of a broad constitutional reform, but his policies limited democracy by expanding the power of the executive, and ultimately followed the trajectory of Hugo Chávez.[2]

After President Zelaya's seizure and deportation, Honduras scheduled an emergency election for November 29, 2009, and the opposition candidate, Porfirio Lobo, won the election. Prior to the election, the U.S. did not support President Zelaya's removal, but the U.S. is now supporting the 2009 election in an effort to promote national reconciliation and democracy.[3] President Zelaya is still living in exile as a civilian in the Dominican Republic.[4] The U.S. is suffering moderate political backlash because not all countries are recognizing the election as legitimate.[5] For example, countries such as Brazil are considering this move tantamount to supporting a coup.[6] In addition, Freedom House, a non-governmental organization that publishes an annual ranking of countries based on their relative levels of democratic freedom, has relegated Honduras's status and no longer classifies Honduras as an electoral democracy.[7]

The U.S. response to the removal of President Zelaya sets a precedent for democracy and stability in the region. With this in mind, the U.S. had to evaluate its options and ascertain which choice will best promote democracy and stability, and minimize the political consequences to the U.S. In the case of Honduras, the U.S. could have supported, ignored, or denounced the removal of President Zelaya, since the use of force would have been inappropriate. The U.S. made the right choice by moderately supporting President Zelaya's reinstatement, and then accepting the results of the next election as legitimate.[8] Ultimately, the U.S. should choose to recognize free and fair elections in the case of Honduras or any Latin American country that might be in a similar situation in the future because the U.S. must demonstrate strong support for democracy to assist in Latin America's struggle to overcome history.

II. HISTORICAL BACKGROUND

The first step to evaluateing the U.S.'s policy response in Honduras is to put the crisis into a broader historical context. In the case of Honduras, it declared independence from Spain on September 15, 1821.[9] The government began as a series of caudillos, political factions, and the military evolved from arming these political factions.[10] Tiburcio Carías Andino, who ruled from 1933 to 1948, created the first professionalized army, but it was not until 1954, that Juan Manuel Galvez strengthened the military relationship between the U.S. and Honduras.[11] In 1954, the Honduran Congress prevented the democratically elected president from assuming power and Vice-President Julio Lozano took control.[12]

When the civilian government tried to limit the power of the military that had been entrenched in Honduran institutions by earlier military control, there was a military coup.[13] From 1963–1971, General Oswaldo López Arellano ruled Honduras, however, his government's credibility diminished when it lost a border dispute with El Salvador.[14] Consequently, a weak civilian government briefly took control before López seized power again.[15]

In 1975 the military seized power from Lopez and gave control to the more militaristic control by Colonel Juan Melgar.[16] Colonel Policarpo Paz García then deposed Melagar in 1978. Paz Garcia promised to return the country to civilian rule, though he remained as president of the interim government created following the election of a new assembly government.[17] The military retained considerable control over civilian government until 1982, when democracy was restored under Roberto Suazo Córdova.[18] Under the "protected democracy" of the 1980s, the military retained considerable power and benefited from U.S. military aid in response to the Contras of El Salvador.[19] The U.S. established bases to train and deploy Contras against the Sandinista government.[20]

Following the Cold War, the U.S. became critical of the Honduran military and cut military aid and Honduras now ranks 154th in percent of GDP used for military forces.[21] In addition, the International Court of Justice ended the border dispute between Honduras and El Salvador.[22] The Honduran people, sick of corruption and the economic burden of the military, created a movement to demilitarize the government and society through major military cutbacks.[23] Civilian leaders have greater control of the government, but it is nevertheless still important to consider how frequently military control has usurped civilian control in recent history. Understanding the repeated intervention of the military and the U.S. support for Honduras' military dictatorships of the past brings to light why the U.S. response to military involvement in President Zelaya's removal is important.

III. LEGAL BACKGROUND

Interpreting the legality of any democratic crisis can provide insight in to what kind of predicament the country is in. If those in power have clearly acted illegally, it would be hard to imagine a scenario where these actors acted in the interest of democracy. On the other hand, there may be legal ways to subjugate democracy and such actions should not be encouraged. Legality is not sufficient for legitimacy, but it should be an important consideration in determining which actions the U.S. should support, ignore, or sanction.

The Honduran Constitution, which has been continuously revised, is the source of confusion in defining the legality of the Honduran action to remove President Zelaya. The Honduran Constitution's impeachment clause was removed by decree.[24] In addition, while the Honduran Constitution allows for charges to be filed against high officials, it lacks a provision explaining the procedure of removal.[25] Even when there are relevant provisions, there are disagreements about their interpretation.[26] The main points of contention are whether the Honduran government could still pursue impeachment after the clause had been taken out by decree, whether the Supreme Court has the authority to try the President's removal, whether the Supreme Court could use the military to remove President Zelaya, whether the military acted in accordance with the warrant issued by the Supreme Court under the Honduran Constitution, and whether such violations would make the entire action unconstitutional.[27]

Because the impeachment clause, Article 205, Section 15, was repealed in 2003 by Decree 157/2003, the procedure of impeachment by the legislature was also repealed.[28] President Zelaya's removal was based on the Supreme Court's ability to try high officials in Article 313, Section 2, which was established in the same year in Decree 175/2003.[29] Because both provisions were decreed in the same year, one can conclude the intent of the decrees was to replace the legislative impeachment clause with judicial action. Therefore, the Supreme Court's trial of President Zelaya seems to comply with constitutional requirements. In rulings made on May 27, 2009 and May 29, 2009, the Supreme Court declared that the president could not change the constitutional provision against reelection by a referendum, a poll, or any other method that violates the clauses prohibiting reelection in Article 218, Section 9.[30] Therefore, President Zelaya's trial produced a clear prohibition against the President's actions to alter the Honduran Constitution to make him eligible for reelection.

However, the trial presents complications because there is no provision in the constitution explaining how the trial procedure works and specifically, there are no provisions that outline the role of the military or police forces in enforcing the court's ruling. It was not the decision to remove President

Zelaya that caused the most uproar but rather, the means of removal that garnered the greatest objections. The involvement of armed forces in President Zelaya's removal caused the most controversy, second only to the outcry against President Roberto Micheletti's decree that suspended human rights.[31] The Supreme Court holds the authority to apply and enforce laws under Article 304 of the Honduran Constitution and furthermore, the Supreme Court has the authority to request the public forces to enforce rulings as listed in Article 306.[32] For this reason, the Supreme Court appears to have acted constitutionally when it issued the warrant compelling the armed forces to remove President Zelaya.

After President Zelaya's removal, the Honduran Congress followed proper procedure in presidential succession because the Vice President had already resigned.[33] Therefore, the removal of President Zelaya from office and the appointment of his replacement, President Micheletti, seem to be within constitutional bounds. The first clear constitutional violation occurred when the military deported President Zelaya from Honduras. This violated the ban on extraditing Hondurans to foreign states, which is in Article 102 of the Honduran Constitution.[34] While that action may be illegal, the powers of constitutional interpretation lie with the Supreme Court and perhaps, the Legislature.[35] Neither branch would declare that the action of the military tainted the removal process, and the Supreme Court tried and acquitted six generals.[36]

There are critics that contend that the legislature does not have the right to interpret the Honduran Constitution and that the forged resignation letter produced in the legislature is proof of greater wrongdoing by Congress. However, the Supreme Court has the ability to rule on constitutional issues and enforce its decisions. Understanding the legal analysis of the situation is important because it helps uncover the dynamics of the situation. In this case, the legality of the President's removal is questionable, but not flagrantly illegal. Therefore, the U.S. could support the presidential trial, but only tenuously.

IV. U.S. POLICY OPTIONS

Immediately following the removal of President Zelaya, the U.S. needed to decide if it would support, denounce, or ignore the removal of President Zelaya. Any course of action must encourage stability and promote democracy in Latin America with the least political cost to the United States. Stability and democracy are factors that contribute to peace and consistency in government and therefore, can encourage future prosperity. To achieve these goals, the U.S. could have used force to denounce the military's actions, diplomatically denounced the military's actions, moderately supported the removal, ignored the situation until the next election, or supported the reinstatement of Zelaya. There will never be a perfect solution, but projecting the costs and rewards of possible actions can help produce the best available policy in any scenario.

One of the boldest moves would have been to use military actions covertly or openly. This was not a viable option because the history of U.S. intervention in Latin America has left much to be desired. The covert actions during the Cold War caused chaos, bloodshed, torture, and damaged the credibility of the United States in Latin America.[37] Moreover, it would be illogical to forcibly reinstate a less than democratic leader with anti-U.S. tendencies. Military intervention would be exceedingly unpopular in U.S. domestic politics and would promote instability in the region with great political costs to the U.S. Therefore, this choice was not considered.

The use of policy levers, such as pressure from the international community, is more efficient and bears less political and financial costs. With a relatively small investment, trade and aid incentives can also influence the behavior of sovereign nations. If the U.S. wants to influence the outcome in Honduras, a measured approach of these moderate policy tools would be most appropriate. The main issue is whether the U.S. should apply such pressures, and if so, toward what purpose they should be applied.

It may have been justifiable to use policy tools to back the Honduran government's exile of President Zelaya because he was engaging in activity, the Honduran Supreme Court deemed unconstitutional, to further his ambitions of a prolonged tenure in office. The government attempted to follow the proper procedures in addressing President Zelaya's abuses, but President Zelaya's ousting posed the main problem. Layers of decrees changed the Honduran Constitution and muddled the removal process. Decrees removed the institutional framework for punishing the misbehavior of officials and replaced it with vague oversight from the legislature and the Supreme Court. It can be argued that the removal was constitutional considering Article 239 says that if an executive official proposes extension of the presidential term, that act disqualifies the person from presidential service for ten years.[38]

Taking into account the historical context, the support of what many consider a coup would be a difficult political position to defend because "many in Latin America saw Mr. Zelaya's arrest in his pajamas as an unacceptable throwback to the region's dark past."[39] The U.S. has decades of experience backing military dictators and propping up oppressive leaders with military aid, but siding with the leaders that ousted a democratically elected president is typically an antidemocratic act. In the future, the U.S. may lose credibility when it professes to support democracies because supporting the removal of a president could encourage other governments to remove their presidents instead of working within the normal democratic processes. In addition, support of President Zelaya's removal would have signaled a U.S. tolerance for coups that could embolden those planning future coups and the U.S. did not want to encourage instability that might spill over into neighboring countries. The U.S. also benefits from having a consistent pro-democratic policy because a consistent policy helps to achieve long-term stability. Unfortunately, there was no clear consensus about which policy choice was the most pro-democratic and the U.S. could have incurred great political costs. In addition, supporting President Zelaya's removal could have had a destabilizing effect without clear gains for democracy.

Another possible option would have been for the U.S. to ignore President Zelaya's removal and wait for the event to run its course. The next presidential election was scheduled for November 29, 2009. If no action takes place, the most likely result would be that citizens would elect a new president and democracy would resume in the country. This seems to be what happened. Not reinstating President Zelaya had distinct advantages for Honduras and the U.S. If President Zelaya remained out of office, he did not have the opportunity to engage in acts reminiscent of Hugo Chávez that may have undermined democracy. Reinstating President Zelaya might have encouraged him and given him the opportunity to increase his power and entrench his position. This would have had negative consequences for democracy in Honduras. In addition, his anti-American perspective could have caused the U.S. more difficulty in foreign relations. Therefore, not taking a position concerning President Zelaya's removal might have had fewer political costs for the United States than taking a stand against his reinstatement.

Remaining neutral on the issue benefited the current Honduran government and the U.S. could have used this as a bargaining chip to encourage constitutional reform. Although, a U.S. push for constitutional reform may have been problematic and perceived as meddling. Nevertheless, the constitutional ambiguity leads to problems. This ambiguity has been exacerbated by the fact that the use of decrees has resulted in 130 changes to the Honduran Constitution since 1982.[40] In addition, much of the Honduran Constitution contains what would be statutory law in the U.S. because it outlines numerous rights, including labor and children's rights.[41] The large number of decrees, altering the Honduran Constitution, caused the current chaos surrounding President Zelaya's removal because one of the decrees altered the impeachment process, which removed procedural certainty.

Restoring impeachment proceedings and reducing the number of decrees that change the Honduran Constitution could have a long-term benefit by addressing the root cause of the problem. While some flexibility is necessary, Honduras may benefit from the stability of a constitution that is harder to change. The unicameral legislature requires a higher vote threshold to prevent repeated constitutional change because getting one legislative body to agree is often easier than convincing two legislative bodies that constitutional change is necessary. A three-fourths vote to pass a referendum to change the constitution would be harder to achieve than the two-thirds vote that is currently required under Article 5 of the Honduran Constitution.[42].

The U.S. cannot directly control this domestic issue, but it can use indirect means to suggest changes that may help Honduras, or other countries in similar circumstances, consolidate its democracy. Incentives such as not putting pressure on talks to reinstate President Zelaya could persuade the legislators to consider reform. However, such a large change may not be possible while the country is under stress and the fix would have to come from a negotiated political process. In a political arena with many actors, it would be harder for the U.S. to suggest reforms that the legislature could implement in a timely manner. In addition, this policy has the least certain effects because the adoption of reforms will ultimately be out of the U.S.'s hands, and therefore, the prospect of democracy under this plan would have been questionable. There also could have been some negative effects to the region's stability because other potential coup leaders may have become emboldened and the U.S. may have lost credibility for contradicting President Obama's support for democracy, since because both sides in Honduras see their cause as democratic.

The initial U.S. policy was to promote the reinstatement of President Zelaya. One of the first moves by the U.S. State Department was to cutoff assistance to the Honduran government and define the removal of President Zelaya as a coup.[43] The U.S. State Department looked to President Arias of Costa Rica to mediate the dispute within Honduras. [44] The goal was to restore President Zelaya until the end of his term, and then he would not be eligible for reelection under the Honduran Constitution.[45] President Arias warned that the international community would not recognize the November 2009 election if President Zelaya was not restored before the election. President Arias explains that reinstating President Zelaya, even with limited powers, will provide "assurance of the continuity of democracy in Latin America [and that t]he cost of failure of leaving a coup d'état unpunished is setting up a bad precedent for the region."[46] When taking Honduras' militaristic past into account, one can see how restoring the democratically elected president could foster faith in democracy. Yet, there is a small chance that if President Zelaya was reinstated he could have commandeered the government, and then democracy and stability would have been in a much worse situation. The Arias Plan tried to prevent this worse case scenario by restoring President Zelaya with limited powers.

If the U.S. had supported the Arias Plan, it would have shown that the U.S. had a sincere commitment to the restoration of President Zelaya, and that the U.S. was not pretending to admonish President Micheletti, while benefitting from ignoring the situation. The most problematic part of the Arias Plan is that it recommended not accepting the results of the November 2009 election without reinstating President Zelaya. This would have put considerable pressure on the Honduran government to reinstate President Zelaya. The Arias Plan had a potential risk because if negotiations did not lead to the reinstatement of President Zelaya, the consequences of not recognizing the election could have led to a longer period of instability. Over the next presidential term, the democratic process could have lost legitimacy, even though a fair and free election took place, and therefore this provision of the plan could have damaged democracy and stability in the region.

The leaders of Latin America may be better judges of what promotes stability for their countries. The current Costa Rican President promoted the return of President Zelaya, and Brazil supported President Zelaya by taking him in to its embassy.[47] Furthermore, Latin America saw the reinstatement of President Zelaya as fulfilling its own interests of stability and democracy. Overall, recommending the reinstatement of President Zelaya would have had a relatively small political cost to the U.S. because of the support for this policy from Latin American countries. The countries in the region promoted reinstatement as the most stable choice because it might have prevented future coups. There would also have been some democratic gains by minimizing the role of the military in civilian government operations, even if it is at the bequest of the Supreme Court.

V. CONCLUSION

After exploring the various policy options, it is clear that if the U.S. had supported the removal of the Honduran President, it would have been politically costly, may have had negative effects on democracy in Latin America, and may have reduced stability in the region by encouraging future coups. Remaining neutral to the situation would have cost the U.S. political credibility, and have the same ill effects on stability and democracy as supporting the removal of the president. Supporting the reinstatement of President Zelaya could have moderate gains for democracy, increased regional stability by discouraging coups, and had the least political costs.

Yet, the Arias Plan did the entail risk that may have resulted in the worst possible scenario, the unlawful seizure of the government by President Zelaya, especially if concrete limits were not placed on President Zelaya.

Out of these possible options, the U.S. chose not to recognize the removal of the President Zelaya, in order to deter future coup leaders. However, after the election, the U.S. recognized the new democratically elected president. The U.S. made the right choice supporting the Arias Plan with the proviso that if the elections were free and fair the U.S. would recognize their results. This policy has avoided the long-term risks of the Arias Plan and it has the greatest potential to produce the most gains for regional democracy and stability with tolerable political costs to the U.S. In addition, the recognition of free and fair elections makes sense and sends a consistent pro-democratic message.

While the U.S. may have taken the most attractive option, there are still serious implications. Opposition candidate, Porfirio Lobo, won the election on November 27, 2009 and the U.S. supported the results in an effort to promote national reconciliation. [48] But, not all states are recognizing the election as legitimate, and some countries, such as Brazil, are considering this move tantamount to supporting the coup. [49] In addition, Freedom House has relegated Honduras's status and no longer classifies Honduras as an electoral democracy. [50] As a result the U.S. has suffered moderate political backlash. Although these political costs have been mitigated since other Latin American countries, such as Colombia, Peru and Costa Rica, have decided to accept the election results.[51]

The institutions in Honduras have survived and it may be possible to repair the damage to democracy caused by the removal of Zelaya. The Lobo administration has a significant challenge ahead. Honduras must act with clearly defined and democratic actions to regain international legitimacy. The best way to accomplish this is for the executive, legislature, and the people to reexamine their constitution. Much could be gained from clarifying the duties of the different branches of government, the enforcement powers, and most importantly, the constitutional procedures.

The goal of the U.S. foreign policy towards Honduras, and other Latin American countries, should be to foster democracy and stability while avoiding political costs that would erode the U.S.'s soft power in the region. The U.S. made the right choice in Honduras by trying to reconcile factions, while ultimately showing support for the result of the next election. Military actions would be counterproductive in almost any Latin American country because of the region's history with military oppression. The United States must demonstrate strong support to democracy to assist in Latin America's struggle to overcome history. Ultimately, the instability in Honduras sets a precedent that shows the most beneficial U.S. response to questions of democratic legitimacy in Latin American countries is the consistent recognition of free and fair elections.

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Terrorism and Game Theory: From the Terrorists' Point of View

Kevin Chlebik*

ABSTRACT

This paper investigates the interplay between two distinct terrorist cells of the same terrorist organization using game-theoretic models. It will discuss the economic consequences of terrorism and provide a literature review. Much of the available literature focuses on national policies and the effects such policies have on terrorists' behavior. The approach taken here differs in that the primary focus is on terrorists' behavior. By studying decisions terrorists make and understanding why they make them, better counterterrorism policies can be developed.

I. INTRODUCTION

The September 11, 2001 terrorist attack on the World Trade Center and Pentagon (9/11) marked a watershed moment in world history. This unprecedented and unprovoked attack shook the American public and affected international markets. Despite the absence of 9/11-style attacks in recent years, terrorists still exist and want nothing less than to inflict mass casualties on Americans. In the words of Al Qaeda spokesman Suleiman Abu Gheith:

> We have not reached parity with them. We have the right to kill 4 million Americans—2 million of them children—and to exile twice as many and wound and cripple hundreds of thousands. Furthermore, it is our right to fight them with chemical and biological weapons, so as to afflict them with the fatal maladies that have afflicted the Muslims because of the [Americans'] chemical and biological weapons.[1]

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To accomplish this feat, terrorists continually improve their techniques, competing with one another to see who can execute the next 9/11.[2]

Economic tools can be applied to understand the root causes of terrorism so that future tragedies are averted. One of the economic tools used to analyze terrorist activity is game theory. Game-theoretic models are ideal for capturing the essence of interaction between terrorists and counterterrorism agencies. Such models elucidate terrorists' motivations by considering the decisions they encounter. Numerous papers focus on the decisions of nation-states and the reactions of terrorists; however, few, if any, papers focus on the decisions of terrorists and the corresponding reactions of nation-states. The purpose of this paper is to develop game-theoretic models to illustrate possible scenarios terrorist cells encounter. Terrorist cells are active players in these models, and nation-states are passive players responding with either changes in military allocation from opposing states or terrorist reinforcement from supporting states. Understanding the interactions described within these models is essential for developing better counterterrorism policies.

"Terrorism" is a difficult word to define, in part because deeming an act "terrorism" depends subjectively on whether a person sides with the attackers or their victims.[3] One definition of "terrorism is the premeditated use, or threat of use, of extranormal violence to obtain a political objective through intimidation or fear directed at a large audience."[4] A key part of this definition is the political objective, without which similar attacks would be considered merely criminal.[5] Another critical part of this definition is extranormal violence.[6] Terrorists continually try "to outdo one another [with increasingly severe atrocities] in their competition for publicity, funding, recruits, and contacts."[7] For example, a street mugging perpetrated by an individual upset about government policies leading to the outsourcing of his job does not constitute terrorism.

Much of the literature using economic tools to analyze terrorist behavior focuses on the interplay between nations. This paper develops game-theoretic models focusing on the interactions between two separate terrorist cells who are members of the same terrorist organization. Before developing these models, this paper presents an overview of the consequences of terrorist attacks and a review of the literature that discusses how game theory can be used to study terrorism.

II. Economic Consequences of Terrorism

In 2002, the Joint Economic Committee of the U.S. Congress described the costs of terrorism as the loss of human and nonhuman capital, uncertainty in consumer and investor behavior, retrenchment in specific industries or localities, increased costs of security ("terrorist tax"), and anti-terrorist expenditures crowding out more productive activity.[8]

Terrorist attacks take lives and destroy infrastructure. Besides the actual loss of life, the economy suffers from a loss in productivity associated with that life. The loss of infrastructure includes not only the property destroyed, but also cleanup and repair costs.[9] In addition, after a terrorist attack markets experience increased volatility and increased risk premiums due to public fear.[10] Demand decreases for risky assets and increases for safe assets as investors safeguard themselves from this increased volatility.[11] Generally when consumption and investment decline, it adversely affects the stock market.[12] Furthermore, some industries, such as airlines, tourism, and casinos, carry a disproportionate amount of the negative burdens associated with a terrorist attack.[13] Localities heavily associated with these industries, such as Detroit and Las Vegas, are affected as well.[14]

After a terrorist attack, security tightens as businesses safeguard themselves against another attack. The indirect costs for this increase in security are distributed throughout society in the form of travel delays, higher insurance, increased shipping costs, and slower mail deliveries.[15] The inefficiencies associated with this "terrorist tax" create a negative supply shock to all production.[16] Furthermore, there are declines in real rental on capital, productivity, and potential growth rates.[17]

Alberto Abadie and Javier Gardeazabal describe decreased Foreign Direct Investment (FDI) as another cost of terrorism.[18] Countries experiencing high levels of terrorism also experience lower returns on investment, resulting in a decrease in the stock of foreign investments.[19] Abadie and Gardeazabal write that although terrorism contributes to only a small portion of a country's economic risk, the effect on FDI is magnified.[20] For example, the 9/11 attack caused a 0.06% loss in total productive assets for the US economy, but from 2000 to 2003 FDI inflows decreased from 15.8% to 1.5% of the gross fixed capital formation in the U.S.[21]

III. GAME THEORY AS A MODEL FOR UNDERSTANDING TERRORIST BEHAVIOR

Because of the interactions between terrorists and counterterrorism agencies, game theory is an ideal tool for understanding terrorist behavior. For example, the high number of airplane hijackings in the 1970s caused airports to increase their use of metal detectors, therefore increasing the relative cost of hijackings for terrorists.[22] As a result, terrorists switched from hijackings to kidnappings.[23] The high number of kidnappings caused governments to increase security measures for foreign diplomats, so terrorists replaced kidnappings with suicide bombings.[24]

Game theory can also be used to dictate policy for future events. Harvey Lapan and Todd Sandler use a simple model to describe when and if a government should concede to terrorist demands.[25] The common government policy, and one of the four pillars of U.S. terrorism policy, is "no concessions to terrorists." However, Lapan and Sandler note this policy is optimal only if governments adhere to it and terrorists have incomplete information regarding government credibility.[26]

Todd Sandler and Daniel Arce use game theory to describe what they call a "deterrence race" between two countries.[27] If the home country increases domestic deterrence efforts, the terrorists' costs associated with attacking the home country increase.[28] This poses a negative externality on the foreign country because the relative cost for terrorists to attack the foreign country decreases.[29] As a result, the foreign country must also increase deterrence efforts or face an increased likelihood of being attacked.[30] When the foreign country increases deterrence efforts, the home country must reciprocate because they now face an increased likelihood of being attacked since the foreign country is now more secure.[31] The reiterative nature of this scenario causes countries to overspend on deterrence efforts.[32] Sandler and Arce go on to describe how information sharing between the home and foreign countries can exacerbate the dilemma if deterrence efforts are not coordinated.[33]

Sandler and Arce also illustrate the advantage of cooperation through a game-theoretic model that uses two countries and a terrorist group to show a prisoner's dilemma.[34] In this model both countries, without cooperation, choose to deter terrorists, although the optimal choice is for both countries to cooperate and preempt.[35] Sandler and Arce investigate other scenarios where the desired outcome is contingent on both countries acting together.[36] For example, when the goal is for the allied countries to freeze terrorist assets, the desired outcome is achieved only when both countries choose to freeze assets.[37] If only one country freezes assets, the terrorists will divert their assets to the other country.[38] This scenario is a "weakest link" game.[39] Another scenario considered involves intelligence gathering and sharing.[40] If both countries infiltrate the same terrorist organization, not only are their efforts redundant, but they increase the risk of being discovered.[41]

IV. Models

Much of the game theory literature focuses on games where terrorists are passive players, meaning that terrorist actions are determined by the active decisions of other players. The aim of this paper is to develop models where terrorists are active players and nations, whether supporting or opposing terrorists, are passive players. Developing such models will provide insight into terrorist behavior and lead to useful counterterrorism policy recommendations.

These models assume a decentralized terrorist organization where cells act independently. The two active players in these models (*A* and *B*) are distinct factions of the same terrorist group. Al Qaeda is a perfect example because Al Qaeda "has been moving towards decentralization ever since the invasion of Afghanistan, with isolated cells and loosely affiliated groups that have only a tenuous connection to the greater [Al Qaeda] hierarchy tapping into Bin Laden's 'franchise,' appropriating its ideological 'brand name' for their actions."[42] According to some experts, "Al Qaeda has autonomous underground cells in some [one hundred] countries," and has become "increasingly reliant on sympathetic affiliates" of other terrorist organizations.[43] These models also include two types of passive players, supporting and opposing nations. Supporting nations provide resources to terrorist cells based on each cell's relative merit. The opposing nations, whom the terrorists attack, determine military allocations based on terrorist activity.

FIGURE 1: SIMPLE GAME WITH TWO TERRORIST CELLS

		B Attack	Do Not Attack
A	Attack	5,5	4,1
	Do Not Attack	1,4	0,0

The model shown in Figure 1 illustrates a game with two options for the terrorist cells, "attack" or "do not attack". In this game, an attack is assumed to succeed. The terrorists' net payout for an attack is +4, which includes +4 pride points, +1 resource point from supporting nations, and a cost of -1 for resources spent. The effect of a terrorist attack for the other cell is +1, which includes +2 pride points because they are members of the same team, and -1 resource point because supporting nations regard the attacking cell with higher merit and reallocate their support, taking away funds from the passive cell. The dominant strategy in this game is for both cells to attack. When attacking, a terrorist cell experiences a net utility increase of +4 because 5 > 1 and 4 > 0 (see Figure 1).

To develop a model accounting for the possibility of failed attacks, Figure 2 shows the short-term change in military allocation for the opposing nation based on the actions of the two terrorist cells. m_A represents the percentage of the military used to suppress cell A, and m_B represents the percentage of the military used to suppress cell B. This model assumes the opposing nation dedicates its available military force solely to suppress the two terrorist cells so that $m_A + m_B = 1$. Adhering to the game theory convention where players try to maximize their payoffs, the values in Figure 2 are all between -1 and 0 inclusive, so that a terrorist cell receiving 100% of the opposing nation's military attention has a payoff of -1 and a terrorist cell receiving 0% of the opposing nation's military attention has a payoff of 0.

When both cells attack, the opposing nation does not change its military allocations. Also, when both cells do nothing military allocations do not change. When one cell attacks and the other does nothing, the attacking cell (Δm_A or Δm_B) attracts increased military attention lowering that cell's payoff. The non-attacking cell experiences an equal decrease in military attention, which increases its payoff (see Figure 2). Because this model represents the short-term, the opposing nation cannot change its overall military strength with reinforcements or withdrawals.

FIGURE 2: OPPOSING NATION'S SHORT-TERM MILITARY ALLOCATION FOR TWO TERRORIST CELLS

		B: Attack	B: Do Not Attack
A	Attack	$-m_A, -m_B$	$-m_A - \Delta m_A, -m_B + \Delta m_A$
A	Do Not Attack	$-m_A + \Delta m_B, -m_B - \Delta m_B$	$-m_A, -m_B$

The dominant strategy for both cells in this game is "do not attack". To see this, consider when both cells attack. Either cell can improve its payoff by not attacking ($-m_A + \Delta m_B > -m_A$ or $-m_B + \Delta m_A > -m_B$) and when a cell decides not to attack, the attacking cell experiences a decrease in payoff ($-m_A - \Delta m_A < -m_A$ or $-m_B - \Delta m_B < -m_B$). If this cell also decides not to attack, payoffs change back to "attack, attack" payoffs ($-m_A$ or $-m_B$). Because a cell improves its payoff by not attacking, or at least does no worse, regardless of how the other cell plays, "do not attack" is the dominant strategy for both cells leading to a Nash equilibrium of "do not attack, do not attack".

In the long-term the opposing nation can change the total military force, used to suppress the terrorist cells, with reinforcements or withdrawals. Considering the size of the opposing nation's military strength and allocation among terrorist cells is important because there is a difference in a cell receiving 100% of the attention from a small platoon as opposed to 50% of the attention from an entire battalion. Figure 3 illustrates a long-term model similar to Figure 2, where M represents the opposing nation's military strength as a fraction of their total military strength ($0 \leq M \leq 1$). In this model, any change in the opposing nation's military strength affects both cells because of their proximity to one another. Any terrorist attack causes an increase in M, represented by ΔM. When both cells refrain from attacking M decreases, which is represented by $-\Delta M$. Similar to the model in Figure 2, the optimal strategy for both cells in Figure 3 is "do not attack."

Changes in total military strength described in Figure 3 are consistent with the cyclical nature of terrorism and counterterrorism, as described by Joao Faria.[44] The cyclical nature of terrorist attacks is a result of cause and effect. When enforcement is low M is small, therefore terrorists have lower costs associated with terrorist activities, and terrorist attacks increase. In response, governments increase their level of enforcement and M increases, which increases the costs to terrorists and effectively decreases the level of terrorist activities. After the frequency of terrorist attacks declines, governments have less incentive to invest in enforcement, so M decreases and the cycle repeats itself. These terror cycles are similar to predator-prey models described in ecology and biology.

FIGURE 3: OPPOSING NATION'S LONG-TERM MILITARY ALLOCATION FOR TWO TERRORIST CELLS

		B Attack	*B* Do Not Attack
A	Attack	$-(M + \Delta M) * m_A$, $-(M + \Delta M) * m_B$	$-(M + \Delta M)(m_A + \Delta m_A)$, $-(M + \Delta M)(m_B - \Delta m_A)$
A	Do Not Attack	$-(M + \Delta M)(m_A - \Delta m_B)$, $-(M + \Delta M)(m_B + \Delta m_B)$	$-(M - \Delta M) * m_A$, $-(M - \Delta M) * m_B$

Combining the long-term model for military strength and allocation with the initial model, where attacks always succeed, creates a model that considers the possibility of failed attacks. As an intermediate model that does not consider the opposing nation's military strength, Figure 4 shows the payoffs associated with unsuccessful attacks. This model will be generalized and considered in an expected value formula for the final model.

FIGURE 4: PAYOFFS WITH UNSUCCESSFUL ATTACK POSSIBILITY

		B		
		Successful Attack	Do Not Attack	Unsuccessful Attack
	Successful Attack	5,5	4,1	3,-5
A	Do Not Attack	1,4	0,0	-1,-6
	Unsuccessful Attack	-5,3	-6,-1	-7,-7

Successful attacks retain the same payoffs as in Figure 1. Unsuccessful attacks result in -6 for the attacking cell: -4 shame points, -1 resource point because the cell loses merit in the eyes of the supporting nation, and -1 point for resources spent. An unsuccessful attack also gives the other cell -1 point: -2 shame points and +1 resource point since the supporting nation views this cell relatively more favorable than the unsuccessful cell.

The likelihood of a terrorist attack being successful depends on the military strength of the opposing nation. Figure 5 generalizes the previous model, with $M * m_T$ representing the opposing nation's military strength and allocation dedicated to preventing terrorist cell T (either A or B). This multiplier does two things. First, if $m_A > m_B$ then for a fixed M the multiplier indicates more military attention to cell A than cell B. Second, for fixed m_A and m_B, a larger M indicates more military attention to both terrorist cells. The terrorists' probability of success p equals the attack's success rate without opposition multiplied by $(1 - M * m_T)$. Using this probability, the expected value of an attacking cell is: $V = p(\textit{pride} + \textit{resources}) + (1 - p)(\textit{shame} - \textit{resources})$. The expected value for the other cell is: $v = p(\textit{pride free ride} - \textit{resources}) + (1 - \mathrm{p})(\textit{shame externality} + \textit{resources})$. In this model C represents the resource cost for attacking.

FIGURE 5: GENERALIZED GAME BETWEEN TWO TERRORIST CELLS

		B	
		Attack	Do Not Attack
A	Attack	$V - C + v$, $V - C + v$	$V - C$, v
	Do Not Attack	v, $V - C$	0,0

In this game the Nash equilibrium depends on the values for V and C. If $V > C$, the dominant strategy for each cell is to attack, leading to the Nash equilibrium "attack, attack". To see this, one must start by looking at the "do not attack, do not attack" scenario. Because $V > C$ and $V - C > 0$, it is therefore advantageous for a cell to attack. Furthermore, because $V - C + v > v$, it is advantageous for the other cell to attack as well. Hence when $V > C$, both cells can be expected to attack. Conversely, when $V < C$ the dominant strategy for each cell is to not attack. To see this, one must start by looking at the "attack, attack" scenario. Because $V < C$ and $V - C < 0$, it is therefore advantageous for a cell to not attack because $v > V - C + v$. For the other cell, $0 > V - C$, therefore making it advantageous for them not to attack either. An interesting scenario occurs when $V = C$ in that all four possibilities are Nash equilibria because each cell's payoff depends solely on the other cell's action, not its own (see Figure 6).

FIGURE 6: GENERALIZED GAME BETWEEN TWO TERRORIST CELLS WHEN $V = C$

		B	
		Attack	Do Not Attack
A	Attack	v, v	0, v
	Do Not Attack	v, 0	0,0

V. REMARKS

At first glance, the implications of these models seem intuitive. The opposing nation can decrease the probability of a successful terrorist attack (p) by increasing its military strength. In addition, the equation $V = p(pride + resources) + (1 - p)(shame - resources)$ implies the opposing nation can decrease cells' utility for attacks by decreasing resources given by supporting nations, decreasing cells' pride felt for successful attacks, or increasing cells' shame from unsuccessful attacks (see Figure 5). In short, to decrease the frequency of terrorist attacks these models suggest increasing military strength to intercept resources from supporting nations and lower terrorist cells' attack success probabilities, as well as increasing "soft power" tactics to alter the pride and shame felt by terrorist cells and deter supporting nations from providing cells with resources.

The question is which of these counterterrorism strategies, increasing military strength or increasing "soft power" tactics, is more effective. The answer depends on the elasticity of *p, pride, shame,* and *resources*. For a simplistic example, in the equation: $V = p(pride + resources) + (1 - p)(shame - resources)$, would a \$1 trillion investment be better spent increasing p, or collectively decreasing *pride* and *resources* while increasing *shame*? If the investment would increase p by 20% or decrease *pride* and *resources* by 25% while also increasing *shame* by 25%, the investment would be better spent on "soft power" tactics because such investment would lower V more than investing in military strength. Similarly, if the investment would increase p by 30% or decrease *pride* and *resources* by 25% while increasing *shame* by 25%, the investment would be better spent on military strength.

Determining the elasticity of such factors is beyond the scope of this paper and could be the subject of future research. Future research might also investigate the effects of increased military strength on terrorists' attack opportunities–whether the probability of a successful terrorist attack increases or decreases when available targets increase, and whether or not this effect changes from the short-run to the long-run. The purpose of this paper is to offer reasons why the study of terrorism is important, provide a review of previous studies, and develop game-theoretic models from the terrorists' point of view. These models are far from complete, but they do provide insights into the interplay between terrorists and nation-states. The importance of terrorism studies is evident, and with further research, better policies can be implemented to mitigate the effects of terrorism.

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The Rise of Russia and the National Security Implications for the United States

Matthew Saha[*]

ABSTRACT

How the United States approaches its relationship with Russia must be an important consideration when devising the U.S.'s national security strategy. The security implications for the U.S. are profound because Russia's role in the ever-growing global environment reaches many different countries and regions of the world. This paper aims to review the U.S.'s relationship with Russia, past and present, while recognizing how Russia's leadership, military, economic, and energy policies will play key roles in that association. Additionally, this paper will focus on the options, challenges, and threats that are present in the U.S.'s relationship with Russia, as well as provide an analysis of Russia and how the U.S. must approach this long-time adversary.

I. The Iron Curtain

At the beginning of the Cold War, which lasted from 1945 to 1991, Winston Churchill explained how the "Iron Curtain" hungered for power through an expansion of its control in the region. On March 5, 1946 in a speech titled *The Sinews of Peace*, which he delivered at Westminster College in Fulton, Missouri, Churchill said:

> From Stettin in the Baltic to Trieste in the Adriatic an iron curtain has descended across the Continent. Behind that line lie all the capitals of the ancient states of Central and Eastern Europe. Warsaw, Berlin, Prague, Vienna, Budapest, Belgrade, Bucharest and Sofia, all these famous cities and the populations around them lie in what I must call the Soviet sphere, and all are subject in one form or another, not only to Soviet influence but to a very high and, in some cases, increasing measure of control from—from Moscow . . . . I do not believe that Soviet Russia desires war. What they desire is the fruits of war and the indefinite expansion of their power and doctrines.[1]

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After World War II, the U.S. finally found itself standing the tallest among other global powers. The Soviet Union found itself as the second world power and it looked to limit the U.S.'s ability to achieve additional progress and separate itself further from the Soviets. For instance, Stalin "sought to deter the U.S. from utilizing its military strength. He did this by capitalizing on the Soviet lead in conventional arms and exploiting the perception that Western Europe was vulnerable to an attack by the Red Army.[2]

Stalin's policies helped turn the Soviet Union into an industrial and military superpower, but ultimately wreaked havoc domestically with a high level of human suffering.[3] When Nikita Khrushchev took over after Stalin's death, Khrushchev guided the Soviet Union in a different direction by "persuading the other members of the socialist camp to adopt a 'new course' that relaxed the harsher features of the Stalinist system [and] sought to improve relations in other areas of conflict as well."[4] While Khrushchev led the Soviet Union, he struck fear in the U.S. with the Cuban Missile Crisis, and he approved the construction of the Berlin Wall. Additionally, Khrushchev's leadership played a key role in opening up the Third World to Russia. Khrushchev saw the third world "as an arena in which the Soviets could compete with the West with high likelihood of success, but with less risk than would result from a direct challenge in the 'main arena' of the bipolar struggle."[5] This entry into other states in the region allowed for increased trade and influence. Eventually, Khrushchev "voluntarily" retired from office and Leonid Brezhnev assumed control before Mikhail Gorbachev became the last General Secretary of the Communist Party.[6] "During the Brezhnev years, people had been constantly bombarded with the claim that 'life is improving,' even while they were surrounded with abundant evidence that the country was falling apart."[7] The Soviet Union was set to implode, due in part to the nuclear arms race with the U.S., NATO's policy of containment, and the USSR's own economic failings that were crippling it internally and making life miserable for its citizens.

The Berlin Wall had become a symbol of the USSR's oppression and its socialist regime that fought hard to not only keep intruders out, but keep its own citizens within the walls of the Soviet Union. The Berlin Wall came to represent the relationship between the U.S. and the USSR: dividing two cultures, and two philosophies, while buttressed by guard towers with soldiers who would fire upon anyone who dared come too close. The U.S.'s foreign policy of containment and deterrence would soon change.

II. 11/9

In his book *The World is Flat*, Thomas Friedman argued that while 9/11 was the day the U.S. woke up and realized how interconnected and small the world had become, this shift began more than a decade earlier with the fall of the Berlin Wall on November 9, 1989. Friedman argues that the fall of the Berlin Wall "tipped the balance of power across the world toward those advocating democratic, consensual, free-market-oriented governance, and away from those advocating authoritarian rule with centrally planned economies."[8]

Mikhail Gorbachev became the leader that transitioned Russia from the grips of the Cold War to a new type of governance and "significantly altered the foreign policy of the USSR, in part as a response to . . . .changes in the international environment."[9] Gorbachev's role after the Cold War was just as important because the U.S. and Russia relationship "came in from the cold [and t]he two rivals became partners."[10]

After the fall of the Berlin Wall, Russia was not expected to play as significant of a role on the global stage as they previously had because the world was no longer bipolar and the U.S. stood alone as the world's only superpower. The U.S. did not expect future challenges or threats from the Russians, at least, not for some time. When the Soviet Union fell, the U.S. and its leaders were short-sighted to think that Russian leaders would not try to challenge the U.S. once more.

After Gorbachev's failings domestically, Boris Yeltsin became the first president of the Russian Federation. Author Lilia Shevtsova noted that,

> In foreign policy, Yeltsin continued Gorbachev's withdrawal from confrontation with the West, but where Gorbachev had broken the mold of international relations, compelling the West also to seek new policies and think in new terms, Yeltsin not only failed to find a new global role for Russia, but also failed to understand new international realities.[11]

Boris Yeltsin's self-appointed replacement, Vladimir Putin, significantly changed how the U.S. dealt with Russia. While there was neither a Cuban missile crisis, nor a nuclear arms race, the security implications changed as Russia's new leader became less friendly to the West than his predecessors. Putin changed the face of the presidency both domestically and internationally. The former Russian intelligence agent travelled internationally more than two dozen times in his first year as president, and a large portion of the countries he visited were former Soviet states.[12]

Part of Putin's strategy was to counter what Russians considered U.S. hegemony by forging new relationships through his travels and creating strategic partnerships. Putin was the first Russian leader to visit North Korea in nearly fifty years, and he also visited Fidel Castro in late 2000.[13] Putin's meetings with leaders of countries who are sworn enemies of the

U.S. should have been an indication that Russia was untrustworthy. However, after the terrorist attacks on the U.S. on September 11, 2001, Putin was the first to contact President George W. Bush to offer support.[14] By supporting the U.S., "Russia hoped to gain some of the benefits that are shared between allies. But there was a deeper motivation. Russia had for years viewed itself as engaged in its own war against Islamic extremism and thus found in the Bush administration a natural and powerful ally against a common enemy.[15]

It was acceptable for the U.S. to engage Russia when the benefits were obvious for the U.S. Russia cooperated with the U.S. after 9/11 by sharing intelligence information, and allowing the U.S. to enter Russian fly zones.[16] This cooperation was short-lived in part due to the Russian's opposition to the Iraq War.[17]

The fraying of the relationship between the U.S. and Russia continued as Russia developed relationships with countries such as Iran, and nuclear proliferation became a prominent issue. The U.S. Russian relationship became increasingly strained with Russia's agreement to build nuclear plants in Iran starting in 2010, and Iran arguing it needed "[twenty] uranium enrichment plants to produce enough fuel for its nuclear power plants."[18] It is clear that Russia benefits, as long as it receives backing on the international stage to create a balancing effect. "[Russia] is not interested in a nuclear-armed Iran on its southern doorstep. Nor does Russia want to see nuclear proliferation in the Middle East . . .[However,] an agreement [to produce nuclear reactors] would be a boon to Russia's image as a peace broker in international politics . . .Russia also has strong economic interests in Iran."[19]

It is clear that Russia acts in its own self-interest, and the U.S. should use Russia's history and actions as a road map to predict Russia's future endeavors and potential indiscretions. If the opportunity to work with Russia presents itself, the U.S. should consider the partnership for any benefits that can be provided or goals that can be accomplished. However, just as in politics, foreign policy can make for strange bedfellows. While Russia has not always found itself in the good graces of the U.S., the two countries were able to work together when fighting Hitler's Nazi Germany and Islamic terrorists. The important lesson that must be learned is that Russia has no desire to reside on the sidelines, and because of this, Russia should remain a large part of the U.S.'s equation when developing a national security strategy.

III. TODAY'S RUSSIA

Because Vladimir Putin handpicked his successor, Dmitry Medvedev, it is difficult to assess whether Medvedev is acting independently as

President.[20] As Prime Minister of Russia, a title Putin also held while serving as President, Putin remains visible in government affairs both domestically and internationally. While the transformation in Russia is obvious, questions still remain on what to make of its current leaders and in what direction they are guiding their country. While it appears that Medvedev and Putin are insistent that Russia returns to some semblance of relevance, it remains unclear how they expect to accomplish this goal, or more specifically, how much relevance they seek. Furthermore, while Russia may not be the next direct successor to the U.S. as the world's superpower, it is important to remember that Russia remains a member of the nuclear community and can create its own deterrence on the U.S. or other countries, as necessary.[21] In addition, "Russia has one of the largest energy reserves and is one of the largest energy producers."[22]

While the U.S. remains the hegemonic leader in the world today, it is clear that Russia seeks to balance out the U.S. through the United Nations and partnerships with countries that fail to see the U.S. as an ally. Krastev elaborated on the progression in Russia by saying, Russia also:

> "decided not to cooperate with the West in taming Iran's nuclear ambitions or in settling the final status of Kosovo [and t]he country's military budget has increased six fold since 2000.[23]

Additionally, Putin's trip to Venezuela in April 2010, which could result in Hugo Chavez possessing nuclear capabilities, is troubling.[24] Whether Russia is flexing its military might, or expanding its influence, the U.S. cannot ignore these developments and must carefully consider its approach. Because of the countries that Russia has continued to align with, it would be best for the U.S. to consider its national security strategy towards Russia through the eye of realist theory.

IV. REALIST THEORY AND RUSSIA

According to Kenneth Waltz's *Realist Thought and Neorealist Theory*, realist theory tells us that man desires power, and he will fight for it among others who seek the same power.[25]The vision of an anarchic world where states constantly compete with one another must be accepted by those who devise a national strategy for the U.S. Any analysis must consider Russia's history to accurately understand its tendencies. While Russia might not challenge the U.S. in the way it did during the Cold War, it now uses alternative avenues, such as balancing to expand its influence, either directly, or in conjunction with other countries.

The competition for scarce goods is reflected in the limited natural resources available in the world, and the degree to which states are able to maintain their advantage of access to these resources. The resources are being sought by countries with growing economies and populations, such as China, but also by the U.S., which consumes more oil than any other country in the world.[26] If history teaches the U.S. anything, policymakers will correctly assess that Russia will succeed in its quest to achieve more power and influence in its own region and around the world. Having once been a superpower, it should be understood that Russia is unlikely to accept anything less than a return to its past glory.

V. Russia and China

While Russia's relations with countries such as Iran, North Korea and Cuba draw the ire of the U.S., China is perhaps the most intriguing and important ally for Russia. Russia has aligned itself with China in an effort to position itself more favorably than if it took an isolationist approach to foreign policy. Russia and China have a very storied past, which is reflected in several treaties and alliances during and since the Cold War. The Sino-Soviet alliance, which was formed during the early years of the Cold War, but the alliance eventually turned to conflict due to treaties that China claimed were forced onto them by the Soviets,[27] And "By [1969], each party clearly regarded each other—and no longer the U.S.—as its primary security threat."[28]

Today, Russia and China have once again become evolved partners, and their relationship must be seriously considered when devising a national security plan. On July 15, 2001, the presidents of Russia and China signed a Treaty for Good Neighborliness, Friendship, and Cooperation in Moscow, which covered five areas of cooperation including: "Joint actions to offset a perceived U.S. hegemonism; demarcation of the two countries' long-disputed 4,300 km border; arms sales and technology transfers; energy and raw materials supply; and the rise of militant Islam in Central Asia."[29] While many analysts said there was no reason to panic that these two countries were working together, there was "growing concern that the new treaty between Moscow and Beijing [could] increase coordination between the two countries against the U.S."[30]

In 2010, Russia is still using China to balance against the U.S. and while neither could beat the U.S. militarily, there are efforts to siphon away the U.S.'s economic power. As reported in numerous news outlets, China and Russia have both voiced their intentions of moving away from the U.S. dollar and creating a new global currency.[31]

In addition to its alliance with China, Russia has teamed with Gulf Arabs, Japan, and France to end dollar dealings for oil due to the precipitous drop in the U.S. currency. These countries want to move instead to a basket of currencies.[32] This move presents a dangerous threat to the U.S. With the dwindling value of the U.S. dollar, the move could seriously impact the U.S. economy even further if oil is no longer able to be purchased by the U.S. in its own currency. If these states move away from accepting the dollar for oil and instead use a combination of currencies in a "basket," the power could shift swiftly from West to East. Russia's motive for its relationship with China is not only to act as a balance against the U.S., but also to enable China's growth by providing natural resources, such as oil.[33]

Furthermore, China's role as the number one foreign holder of U.S. debt provides Russia with more leverage. The power and large swath of the globe that the two countries control can continue to grow, particularly if the U.S. economy continues to falter, or the government continues to debase its own currency by printing more money.

The U.S. is likely to feel additional pain from the economic downturn. It is unlikely that politicians and bureaucrats will stop the printing presses that are increasing the amount of debt owed by the U.S. because domestically that would mean political suicide for the politicians, and further blame would be placed on the bureaucrats. It is more likely that the U.S. will keep interest rates low and print additional dollars, and when the international community sees this continuing they will cry foul. If countries such as Russia and China team up together and lead a charge to change the currency that is used for foreign oil, which the U.S. is dependent on, it will significantly hurt the U.S. Unfortunately, the U.S. has itself backed into a corner politically, and is likely to have to deal with international decisions before making internal adjustments.

Russia's relationship with China convolutes the U.S.'s diplomatic measures. Instead of dealing with only Russia, the U.S. must also consider China in every equation. In addition to China and Russia's economic relationship, China's growth and Russia's energy policy could greatly affect the U.S., particularly if the U.S. is forced to deal with an energy crisis like it did in 1973 and 1979. Granted, with the history that China and Russia have, it is not implausible to think their relationship could disintegrate to the advantage of the U.S.

VI. Energy as a National Security Issue

The U.S. is the number one consumer of oil in the world, followed by China, which consumes less than half as much oil as the U.S.[34] Since 1973, there have been three instances where the U.S. has dealt with an energy crunch that has hurt the U.S. economy. The first energy crunch occurred in

1973, when members of the Organization of Petroleum Exporting Countries (OPEC) enacted an oil embargo on the U.S. because of the U.S.'s involvement with Israel during the Yom Kippur War.[35] This embargo was followed six years later with a decrease in oil production due to the Iranian Revolution, which brought Ayatollah Khomeini to power.[36]

President Jimmy Carter addressed the U.S.'s national interests in the Persian Gulf, in what later became known as the Carter Doctrine, and stated that "an attempt by any outside force to gain control of the Persian Gulf region will be regarded as an assault on the vital interests of the U.S. of America, and such an assault will be repelled by any means necessary, including military force."[37] With the Soviet Union's invasion of Afghanistan in 1979 and the subsequent rise in gasoline prices, the U.S. saw oil as a critical national security issue[38]

The third energy crisis the U.S. faced was during the summer of 2008 when oil hit $147.30 per barrel.[39] Already facing a slowing economy, U.S. consumers changed both their consuming and driving habits, just as they did during the 1970s.[40] This prolonged the pain faced by an economy that had yet to see the collapse in the credit and financial markets. According to some scholars, such as Michael Klare, the Carter Doctrine is primarily responsible for the U.S.'s venture into the Middle East and involvement in three major wars, including the current military involvement in Iraq and Afghanistan.[41]These scholars fail to address how the U.S. would function as a society if countries such as Russia had moved into the Middle East and taken over oil reserves. Furthermore, while the rationale for foreign entanglements is debatable, the fact is that the U.S. needs oil and energy to function as a country. While efforts have been made to wean the U.S. off of a foreign energy supply through increased domestic production and alternatives that can be made in the U.S., foreign oil cannot be easily replaced.

The U.S's addiction to oil is important to Russia because it is the eleventh largest exporter of oil to the U.S.[42] Additionally, allies of the U.S., such as Western Europe and other countries in the European Union, rely on natural gas that is delivered through Russian owned pipelines. If Russia chooses to cut off natural gas supplies, it will greatly affect Europe, so it is a critical to ensure that Russia does not withhold natural resources from European countries that rely on them.

Because of the scarcity and abundance of oil in certain parts of the world, it is easy to see how oil can be a security risk for the U.S. With its dependence on foreign countries for its energy supply, the U.S. should continue to keep the Carter Doctrine as part of its national security strategy. The U.S. would cease to operate effectively without oil being imported from the Middle East and other countries, such as Venezuela, that Russia may be able to influence into cutting off supplies to the U.S. While avoiding resource wars is ideal, realist theory continues to be the best way for a country to protect itself against adverse actions by other countries. Considering the steps that Russia has already taken against the U.S. dollar, a decision not to use the U.S. dollar when buying and selling oil could be crippling. Both of these decisions by Russia should be considered attempts to sidestep the military power of the U.S., and to cripple its capabilities as a world power.

VII. WHAT RUSSIA WANTS

The U.S. is not without blame for the deterioration of the U.S.–Russia relationship. NATO was created to balance and isolate the Soviet Union after World War II, and to put U.S. military bases in countries surrounding Russia and Russia's allies. From Russia's perspective, the U.S. appears expansionary when it builds a coalition with countries in Eastern Europe that used to be inside Russia's borders. From a Hobbesian point of view, Russia considers the U.S. a threat to its own autonomy, and Russia will do whatever it can to fight against any further losses.

Even though President Medvedev is currently in power, some suggest that Prime Minister Putin is either waiting in the wings and expects to return to power, or he is really running the show behind the scenes.[43] However, when Medvedev gave his second state of the nation address, he surprised most critics by calling for broad policy changes, saying Russia needed to rid itself of government corruption, reform the election system, allow for innovation in the financial sector, and actively look for investment of capital from outside of Russia.[44]

Before this speech, Medvedev had faced the confrontation with George, a back-slipping Russian economy, and an incident where the Russian natural gas pipeline company, Gazprom, cutoff several European countries from their natural gas supplies. These actions left most thinking that Putin is still controlling Russia.[45] If Medvedev can follow through with some of his proposals, Russia may assist the U.S. in future endeavors.

VIII. CONCLUSION

Krastev called Russia a "rising global power, but also a declining state."[46] He elaborated by saying:

> In [ten] years' time, Russia will not be a failed state. But neither will it be a mature democracy. Russian foreign policy will remain independent—one that promotes Russia's great-power status in a multipolar world. It will be selectively confrontational. Russia will

> remain more integrated in the world than it has ever been in its history, and it will remain as suspicious as ever.[47]

If Krastev is right about what the U.S. can expect from Russia, then little good can be expected from a relationship as Russia will only continue to align with countries that find themselves pitted against the U.S. Likewise, the U.S. should be expected to align with NATO and other Eastern European countries, against Russia. Currently, the U.S. is unlikely to do much to deter Russia due to its weakened economic state and Russia's tactical alliance with China. As the U.S.'s biggest trading partner, and the largest holder of U.S. debt, China could prove to be more dangerous than Russia. With regard to Russia, the U.S. must continue to be diplomatic and encourage the changes that President Medvedev called for during his address to the General Assembly. If the domestic changes fail to take place, the U.S. should consider that the failure is due to Putin's ability to influence Medvedev, or as further proof that Medvedev is not running the country. Putin's actions will speak louder than Medvedev's words if domestic reform fails and Russia's partnerships deepen with countries such as Iran, Venezuela, and China.

This paper has touched on the leadership, military, economic, and energy-related issues concerning U.S.-Russian relations since World War II. Russia is a very complex country which the U.S. should engage, while keeping realist theory in mind because Russia has proven itself to be unpredictable, particularly since the fall of Soviet Russia. Krastev, who has lower expectations for today's version of the once-superpower said,

> Russia is not simply a revisionist power-it is something potentially more dangerous: a spoiler at large. The Kremlin's recent actions easily fit this threatening image. In reality, though, Russia is not a spoiler so much as it likes to be viewed as one. Where the West seeks to find aggressiveness and imperial tendencies, it will find uncertainty and vulnerability.[48]

Krastev could be correct in his assessment, but Russia was overwhelmed with uncertainty and vulnerability in 1991 and today, it is back at the forefront of the international conversation. While Russia is not currently vying for supremacy, expecting Russia to remain weak should not be a long-term assumption. In fact, Medvedev and Putin are sure to challenge any such notion, and the U.S. must be ready to respond.

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The Policy Debate Over the Bailout Plan

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ABSTRACT

This paper analyzes the policy debate over the Federal Government's bailout of the financial industry in 2008.

I. INTRODUCTION

The Emergency Economic Stabilization Act of 2008 (EESA), generally known as the "bailout plan," allocates $700 billion of public money to keep financial institutions solvent. The Act, passed by Congress on October 3, 2008, has given birth to many programs designed to stabilize the economy. The Troubled Assets Relief Program (TARP) was the first of the new programs to disburse government funds and remains the biggest and most controversial program to date. The Treasury Department's authority to administer funds through TARP was extended through October 2010.[1] As of January 6, 2010, some $374 billion in public funds have been spent through TARP, of which $165 billion have been repaid.[2] Although many details of the plan have changed since October 2008, the thrust remains the same: the federal government is disbursing Treasury funds to secure financial markets, enable lending, and keep some of the nation's largest banks in business.[3] Many supporters of the plan argue that some banks have such influence on national and global economics that they cannot be allowed to fail.[4] Conversely, critics charge that policy based on this "too big to fail" premise is unfair, inefficient, and risky.[5] The purpose of this paper is to analyze the debate between opponents and proponents of federal government's intervention in financial markets.

The crux of the debate is whether government intervention encourages irresponsible risk-taking and invites other industries to seek federal handouts. This is known as moral hazard. Both proponents and opponents of intervention alike have claimed the highest possible stakes. Proponents have argued that without government intervention in our financial markets a chain reaction of institutional failures would have followed, bringing about a worldwide depression.[6] Opponents counter that government bailouts help

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only to establish a precedent that reduces public welfare and damages public trust.[7]

II. Roots of the Crisis

The current financial crisis stems from the debt market, which has grown rapidly in the past decade to include exotic, poorly understood investment instruments. Sub-prime mortgages, home loans that banks made to borrowers with bad credit, support a crumbling tower of debt. Years of low interest rates made borrowing nearly free for banks, but low rates also brought low returns on safe investments like government treasury bills.[8] Banks therefore sought greater returns by issuing home loans at high rates to high-risk borrowers. Mortgage lenders, newly freed from the responsibility of collecting mortgage payments, then sold pools of loans to investors who used the mortgage payment streams to securitize new instruments, which were in turn sold to other investors. The result is a derivative, "a risk transfer agreement, the value of which is derived from the value of an underlying asset."[9] This specific type of derivative is known generically as a collateralized debt obligation (CDO).[10]

Derivatives are not subject to the same regulation as common stocks. They are not, for example, traded on a market exchange as normal stocks and bonds are, but are bought and sold privately "over the counter," beyond the glare of public and regulatory scrutiny.[11] Consequently, it is difficult to estimate derivatives' true value. Nevertheless, the global derivatives market was estimated at $596 trillion as of the end of 2007.[12] By comparison, global GDP for 2008 was $61 trillion.[13] The result is a complex and lightly regulated market with outstanding obligations approximately ten times the value of all goods and services produced worldwide. Because of the large derivatives market, suspect mortgages have become the engine of a lucrative and explosive sector of high finance. This is the genesis of the current crisis.[14]

Compounding the payoff for investment banks and hedge funds are credit default swaps (CDSs), a risk transfer contract meant to secure debt instruments like CDOs.[15] CDSs are essentially a type of private insurance. The idea is fairly simple: Party A takes out insurance against the potential default of a credit issue, like a bond, mortgage, or CDO, and in exchange for providing that insurance, Party B receives a revenue stream in the form of premium payments from Party A. In the event of a credit default, Party B is liable to pay Party A some multiple of the premium.[16] The market for CDSs grew from roughly $1 trillion in 2001 to $62 trillion in 2007.[17] Unlike conventional insurance, however, CDSs are unregulated.[18] A more damaging consequence is that many CDSs are "guaranteed" by parties lacking the capital to do so; in financial parlance they are "undercapitalized."[19] Indeed, the market for all financial derivatives has put vastly more money at risk than there is underlying value to secure it. Therefore, commentators often refer to the "notional value" of derivatives.

Investors, mainly investment banks and hedge funds, profited from this system well into 2006, as the U.S. housing market continued to soar[20]. As long as borrowers were able to sell their homes at a profit or refinance their loans there was little risk of default. Eventually, however, the housing market cooled and heavily leveraged hedge funds, often running investment to capital ratios of 100 to 1, incurred heavy losses.[21] This problem was exacerbated by the fact that some insurers of CDSs were charging only 1% premiums.[22] The brokerage firm Bear Stearns (Bear) announced the collapse of two of its hedge funds in July of 2007.[23] Bear's fortunes deteriorated over the coming months until the investment bank JPMorgan Chase bought the distressed firm with a Federal Reserve Bank loan in March 2008.[24] Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation), two quasi-governmental mortgage-lending agencies, also suffered heavy losses in the sub-prime market.[25] Faced with the prospect of seeing the two agencies default on their obligations, and thus calling the credit-worthiness of the federal government into question, the Federal Reserve (Fed) and the Office of Federal Housing Enterprise Oversight placed Freddie and Fannie into conservatorship on September 7, 2008.[26]

Merrill Lynch also suffered heavy losses and was sold, with assistance from the Fed, to Bank of America on September 14, 2008.[27] Lehman Brothers was unable to secure government intervention and filed for bankruptcy on the September 15, 2008.[28] The Lehman filing is the largest bankruptcy in U.S. history at over $600 billion in liabilities,[29] and stock market indexes suffered heavy losses as a result of the news of Lehman's bankruptcy.[30] Consequently, the Fed's failure to intervene has been widely criticized[31]. In the immediate wake of Lehman's filing for bankruptcy, the Fed announced it would provide $85 billion in loans to the insurance giant American International Group (AIG). Bear Stearns, Merrill Lynch, and AIG had been deemed too big to fail, and a broader bailout plan was in the offing. Speculation, leverage, and lax regulation had endowed sub-prime mortgages with the power to topple a network of financial giants.

III. LITERATURE REVIEW: CURRENT SITUATION

The seismic events of the past couple of years have renewed the debate on the moral hazards of government intervention in a market economy. The main architect of the bailout is Henry J. Paulson, former Secretary of the

Treasury of the United States.[32] Another key policymaker is Federal Reserve Chairman Ben Bernanke, whose agency opened its discount window to commercial banks for the first time when it lent Morgan Stanley $28.8 billion in March 2008 to buy Bear Stearns.[33] In addition to making new sources of "emergency money" available to Wall Street, Mr. Bernanke also moved to alleviate the crisis by lowering interest rates to encourage lending.[34]

Originally, the Treasury's stated policy was to use some of the money, as much as $250 billion, to buy the worst mortgage-backed assets that banks held.[35] However, the Treasury reversed course and decided instead to purchase preferred stock from ailing banks as a way to provide capital, encourage lending, and ease the credit crunch. This also gave the government a firmer idea of its potential return on investment. The government acted quickly, purchasing some $115 billion worth of preferred stock from eight of the largest banks within three weeks of EESA's passing.[36] That figure has risen to $205 billion in the past year, exclusive of AIG, which the U.S. government now effectively owns.[37] These "equity injections" come at a cost of graduated interest rates to the banks, and more than half of the $205 billion has been repaid.[38] With the extension of TARP's authority until October 2010, the Treasury will likely spend additional funds as needed throughout 2010, although it is unlikely that Treasury will spend the full $700 billion.[39] Additional plans for loan workouts and buying preferred stock on matching terms with private investment have since begun, although on a smaller scale and with less fanfare.[40]

IV. Pros of the Plan

Proponents claim government intervention was necessary because of the extreme circumstances. Some arguments in favor of the bailout plan are that the entire economy is at stake, and that government action will fix institutional flaws.

A. Pragmatism: The Entire Economy Is At Stake

Secretary Paulson's first and most important point when he testified before the Senate Banking Committee on September 23, 2008 was that the bailout was needed because the entire economy is at stake. He told the Committee that, "We must [enact this plan] in order to avoid a continuing series of financial institution failures and frozen credit markets that threaten American families' financial well-being, the viability of businesses both small and large, and the very health of our economy."[41] The Secretary was careful to frame the economic stability argument in terms of Main Street's benefit.[42] With credit markets frozen, business grinds to a halt. General Electric (GE), an icon of American capitalism, struggled to make payroll at the height of the September 2008 panic.[43] Had another bank gone bankrupt, GE might well have gone under with it; the wider impact that GE's failure could have had on other businesses great and small is incalculable. Without credit, manufacturers can no longer borrow to finance production, retailers cannot borrow to purchase goods for sale, consumers lose purchasing power, employers default on payroll, and student loans dry up. This argument tries to divert the attention from Wall Street greed to the potentially severe impact that a financial markets crisis could inflict on those who would otherwise expect to be unaffected by the world of high finance.

Charles Wyplosz, Professor of International Economics at the Graduate Institute of International and Development Studies, Geneva, drives this argument home by writing: "all financial institutions will have no choice but to formally acknowledge their losses. Either they recapitalise quickly, which dilutes existing shares, or they will file for bankruptcy, which is even worse for the shareholders."[44] Again the proponents make the claim that this bailout is not just for the benefit of the banks and corporations who brought this problem to bear on the rest of the world, but is in fact the best option for shareholders. Wyplosz, like Paulson, attempts to connect the poorly understood world of CDOs and CDSs to the average consumer. Without the bailout, retirement savings could be wiped out.[45] The Dow Jones one-day plunge on September 29, 2008, for example, resulted in $1.2 trillion in losses.[46] The interests of the broader economy are at stake, not just the bonuses of Wall Street's executives. It is a populist argument that was embraced by U.S. Senator John McCain and then-U.S. Senator Barack Obama, both of whom voted for the plan.[47]

B. Government Action Will Fix Institutional Flaws

Secretary Paulson addressed the notion that government action will help to fix institutional flaws directly in his November 12, 2008 statement on the crisis and the evolving plan.[48] He stated that "it is already clear that we must address a number of significant issues, such as improving risk management practices, compensation practices, oversight of mortgage origination and the securitization process, credit rating agencies, OTC derivative market infrastructure and regulatory policies, practices and regimes in our respective countries."[49] Indeed, in Europe regulatory reform is seen as an essential component of righting their markets.[50] Executive compensation tied to profit encourages excessive risk-taking; lax regulations that allow 100 to 1 leveraging invite disaster. Hedge funds are not subject to the same capital reserve requirements that apply to banks, thus their exposure, or potential to gain or lose money, is greatly magnified.[51] This leveraging power is exacerbated when credit rating agencies like Moody's and Standard and Poors assign "safe" ratings to bad debt, as many allege has happened in recent years.[52] The current plan does not, however, impose new mortgage lending rules on America's banks, nor have new rules been promulgated to enforce capital ratios on hedge funds.

V. SHORTCOMINGS OF THE PLAN

Some arguments against the current bailout plan are that it creates moral hazard and that the plan is badly flawed.

A. Moral Hazard

Many opponents of the EESA argue against any government intervention.[53] In their view, companies that have made risky investments should be allowed to fail. Such critics abhor moral hazard. A responsible government cannot, they argue, come to the aid of the irresponsible because it provides a safety net for excessive risk-taking. Others are opposed to the structural details of the plan.[54] The core of this argument is simple: bailing out a misbehaving institution is just plain wrong. It sends the wrong message to society, it encourages reckless behavior, and it invites the Samaritan's dilemma. Critics point to 1984, when the Federal Deposit Insurance Corporation (FDIC) injected $4.5 billion into an ailing Continental Illinois to save it from bankruptcy, as the start of modern federal meddling.[55] Five years later the federal government stepped in again to save the Savings and Loan industry and to protect U.S. banks against defaults from foreign governments.[56] Each of these interventions cost upwards of $90 billion in 1989 dollars.[57]

Among the most vocal in opposing such governmental intervention is Jeffrey Miron, senior lecturer in economics at Harvard. He writes: "Government purchase of bank stock, therefore, is a transfer from taxpayers to people who took huge risks and lost. . . . [This] will generate even greater problems down the line. It is time for the government to do the one thing it does well: nothing at all."[58] Underlying this criticism is a faith in financial markets to devise solutions to prevent further crashes. Providing excessive risk-takers with a safety net, opponents of the bailout argue, only encourages riskier behavior, and future abuses are sure to result.[59] As David I. Levin, professor of economics at U.C. Berkeley commented to Bloomberg News, "The structure is designed for the Treasury to be the first line of defense. . . . A whole lot of people made money supposedly by putting their capital at risk, and those are supposed to be the first line of defense, that's how capitalism works."[60]

B. The Plan Is Badly Flawed

The objections that the plan is badly flawed are structural more than philosophical. Indeed, some initially opposed the plan because of its secrecy, and some opposed it later for a perceived lack of direction.[61] Nobel laureate and Columbia University professor of economics Joseph Stiglitz has opposed the plan for its failure to address underlying causes. During the hectic aftermath to Lehman's collapse, he commented: "There is a kind of suggestion in the Paulson proposal that if only we provide enough money to financial markets, this problem will disappear. . . . But that does nothing to address the fundamental problem of bleeding foreclosures and the holes in the balance sheets of banks."[62] [Once again I am baffled. He is being quoted, and he is not quoting anyone else.] These opponents of the plan acknowledge the pragmatism of coming to the aid of our banks, but they object to the lack of practicality with which policymakers are executing their plan. Opponents also argue that even if the government buys an equity stake in companies instead of just absorbing "toxic debt," the public will suffer.[63] Banking decisions will be politically influenced and inefficient, and the federal government's vast holdings will distort financial markets. Still others contend that the current plan will waste money in a trickle-down attack on the sub-prime problem.[64] It would be better, some say, to buy the toxic loans and work out mortgages to reduce defaults, thus securing the banks' health from the bottom up. While this approach has merit, even its proponents acknowledge the enormous difficulty of administering such a plan.[65]

Underlying many such practical concerns is the question: does the government have any way of knowing what it is actually buying? Many economists, journalists, and politicians worry that it does not. The financial instruments at the root of the current crisis are not well understood even by the men and women who traded them for a living; how, then, will government agents be able to properly value them?[66] The opponents of Paulson's plan argue that this is a bad deal for the taxpayer whether the government buys "toxic debt" or even if it gets equity for its money. Are they right?

VI. DEBATE ANALYSIS

Proponents of the current plan worry about the leverage that our banking institutions have on the economy at large. Charles Wyplosz writes, "The Lehman Brothers story has shown two things—banks cannot be simply allowed to go bankrupt and a piecemeal approach will not bring banking systems back into minimal functioning condition. The lesson is that there [has] to be a bailout."[67] Again, the approach is pragmatic; the potential for severe economic consequences is so great that something must be done. As Ben Bernanke said recently, "You want to put the fire out first and then worry about the fire code."[68] According to the proponents of the bailout plan, the country no longer has the luxury of worrying about moral hazard. Critics of the plan, conversely, populate two camps. One camp opposes the plan based on the philosophical grounds that government intervention causes moral hazard and prevents free market solutions.[69] The other camp acknowledges a need for government intervention, but objects to the particulars of the bailout.[70]

Public opinion on the bailout plan appears divided. Various polls show either strong support or strong aversion to EESA, and the results seem largely determined by how the question is framed. Respondents enthusiastically support the plan when they are asked if they favor government intervention to ensure stable markets and a healthy economy.[71] The results are much different, however, when the question is, should "the government . . . use taxpayers' dollars to rescue ailing private financial firms whose collapse could have adverse effects on the economy and market . . . ?"[72] [The difference is "ensuring a healthy economy" versus "rescuing private firms." Everyone is in favor of a healthy economy, while many oppose rescuing private firms. Unfortunately, the "private firms" in question are inextricably linked to a "healthy economy." On that even the critics and proponents of the current plan would agree.

As for the pundits, it is open season on Wall Street greed. Wall Street is an easy target, though it has gone unmentioned in much of the popular press that the principals involved in losing such great fortunes on Wall Street are in fact just a handful of individuals. Merrill Lynch's losses in the sub-prime market stemmed from the investment strategies of only three or four men and their actions cost their firm over $10 billion and its autonomy.[73] Pundits and the public alike have largely overlooked the fact that thousands of Wall Street employees who stand to lose their life's savings are responsible, hardworking men and women who bear no responsibility for the current crisis. Likewise there are thousands of shareholders who stand to lose substantial investments.

Much of the debate follows traditional liberal/conservative party lines. Free market advocates oppose any and all government intervention; for them the market is everything. Joseph Stiglitz, who opposes the bailout plan on structural grounds, calls such advocates "free market fundamentalists."[74] It will be better for everyone in the long run, they argue, to let the market determine where the bottom is no matter how much suffering it inflicts on the global economy. The market knows best. Conversely, modern liberals believe that government can be the solution, or at least part of it.[75] To further confuse the concerned citizen, Nobel laureates and prominent academics populate both sides of the debate.

A recent report on previous government interventions reveals a mixed record.[76] Government action saved Continental Illinois' depositors, but shareholder equity was almost completely wiped out.[77] The Brady Plan allowed U.S. banks to restructure foreign debt, but it merely increased the burden on foreign borrowers.[78] Of the Savings and Loan bailout, the report notes: "To the extent that federal intervention led to general confidence in financial markets, consumers benefited. . . . [but] direct and indirect costs to the private and public sectors was $152.9 billion ($191.4 billion in 2008 dollars)."[79] The Continental Illinois troubles in 1984 eventually led to the FDIC Improvement Act (FDICIA) of 1991.[80] This act was designed to curb excessive risk-taking and thus avoid a similar banking failure in the future.[81] Evidently, this has not been sufficient.

At the outset of the crisis it appeared that the Treasury would have to distinguish between the firms that were merely illiquid, fiscally sound but short of cash owing to the credit freeze, from those that were fundamentally corrupt, short of cash owing to their own bad business practices and unpayable debt. Yet Paulson and his team feared that in the time it would take to conduct a thorough auditing of all the firms involved, the economy could collapse. Instead they made billions of dollars available to all the biggest players in an effort to stabilize markets and assuage the fears of institutional investors, consumers, and the world at large.

VII. CONCLUSION

The debate involves many diverse parties. It is a cliché to say that it affects everyone from Wall Street to Main Street, but it is true. It is also true that those on Main Street may feel aggrieved to face potential tax increases or loss of services in order to pay for the bailout, yet those same people may well have faced even higher taxes and greater loss of services if government had not acted to secure markets.

It would be wise to take some lessons from the demise of Long-Term Capital Management (LTCM), a hedge fund whose collapse in 1998 threatened the solvency of major investment banks.[82] Populated by superstar traders and Nobel laureates, LTCM invested heavily in highly leveraged derivatives during a period of low interest rates. Credit was cheap, leverage was high, and regulation was nearly non-existent.

> Their total profits in 1996 were an astounding $2.1 billion. To put this number into perspective, [LTCM] . . . .earned more that year than McDonald's did selling hamburgers all over the world, more than Merrill Lynch, Disney, Xerox, American Express, Sears, Nike, Lucent, or Gillette—among the best-run companies and best-known brands in American business.[83]

Less than two years later, LTCM lost $4.6 billion in four months.[84] Only an eleventh hour bailout by other private financial institutions, organized by the New York branch of the Fed, averted a chain reaction of even heavier losses.[85] Yet banks with skin in the game learned nothing. Just ten years later the recipe for disaster was the same, but this time the bailout costs started at over $370 billion, not the $3.65 billion required to stabilize LTCM's positions.[86] The market principals, left to regulate themselves, merely repeated their mistakes of the recent past, only on a much grander and more damaging scale. Laissez-faire has not served the economy well. As Roger Lowenstein notes, "The Fed's two-headed policy—head in the sand before a crisis, intervention after the fact—is more misguided when viewed as one single policy. *The government's emphasis should always be on prevention, not on active intervention.*"[87]

It might be better for the country in the long run to let bad businesses fail, but no economist can predict the depth or duration that such "short-term" suffering would entail. Indeed, many economists who advocate such an approach are shockingly oblivious to the domino effect. Merrill Lynch found a last minute buyer out of desperation as the financial markets quaked, but one day later Lehman Brothers was not so lucky and the subsequent fallout was severe.[88] Investor confidence was crippled, capital evaporated from money market funds, and investment-banking giants Morgan Stanley and Goldman Sachs teetered on the brink of insolvency as trading partners abandoned them and traders shorted their stocks during the summer of 2008.[89] A severe credit freeze holds the potential to be too damaging to too many economies to risk a social science experiment to find out how much pain and unemployment a do-nothing approach to policy would entail. Bernanke, an understated man and a scholar of the Great Depression, warned against such an approach when he told a meeting of congressmen in September 2008, "[If] we [do not] act in a big way, you can expect another Great Depression, and this time it is going to be far, far worse."[90]

The moral hazard argument might carry more force if financial institutions showed any capacity to safeguard the system in the wake of disaster. Sadly, they have not done so. The biggest banks paid an average of over $250 million in 1998 for the privilege of keeping LTCM afloat and the market functioning.[91] They had every reason to impose rules that would obviate the need to bail out anyone ever again, but they declined to act. They gambled, they lost, they suffered—yet they did not learn. Ten years on from the collapse of LTCM, Wall Street's most powerful bankers repeated the same mistakes of the firm they had bailed out with their own money. The idea that the market is a perfect self-correcting mechanism is a fantasy.

The federal government has a long history of interceding in market panics, going all the way back to 1792, when Alexander Hamilton authorized the Treasury to purchase government bonds to quell our nation's first financial crisis.[92] In the past thirty years alone it has intervened in Continental Illinois, the Savings and Loan crisis, and LTCM. Whether government's intervention in those cases inspired greater risk-taking is now irrelevant. The current crisis is far greater than those of the past, and government has the popular support to impose regulations that will safeguard the public from Wall Street's brinksmanship. Unless Wall Street is forced to adhere to rigorous standards of responsible and transparent investing, there will surely be a repeat of this crisis before long. History, surely, has taught us that much.

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The Bush-Obama Stimulus Programs and the Future of American Capitalism

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ABSTRACT

This paper discusses the implications of the measures that the U.S. Federal Government has taken in response to the recent financial crisis. It focuses on the Federal Reserve, the Troubled Asset Relief Program, the Obama stimulus package, and the bailouts of various industries by the Federal Government. This paper argues that these policies undermine the fundamental incentives of the market economy, but what we can learn from these policies to avoid similar negative consequences in the future.

I. INTRODUCTION

What is the impact of the Bush and Obama stimulus programs on the future of American capitalism? To adequately address this question, one must consider the nature of American capitalism, how it has produced the great prosperity that we have, what underlies the foundation of American capitalism, and how some of the policies of the past two years threaten those foundations.

Think about the remarkable economic progress that we have achieved—our standard of living, driving around in our automobiles, flying in planes, using cell phones, the iPod, and the Internet. The worldwide web only started in the early 1990s. This remarkable economic progress started with the industrial revolution in 1760, with developments beginning in Britain, and spreading to the rest of the world.[1] One can see the sluggish advancement of standards of living for previous generations by examining their lifestyle, food, methods of production, and consumer goods. Economic progress was so slow that people would not have noticed it in their lifetimes. Life in 1750 was not that different from life in 1650. Likewise, life in 1650

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was not that different from life in 1550 and life in 1550 was not that different from life in 550.

There were about a thousand years of remarkable advances in civilization. Ancient Rome and China had incredible advances in their civilization. However, by about 550 A.D. that economic progress essentially slowed to a crawl and virtually stopped. Essentially, someone who slept in 550 and woke up in 1550 would not see that much difference in how people lived, how they consumed goods, and how they produced those goods.

After the industrial revolution, remarkable economic progress began and is still going on today. Profits and losses in a market economy created the foundation of this economic progress. Profits give people an incentive to look for ways to be productive and to help other people, so entrepreneurs and innovators look for innovations that they can introduce into the economy. Profits play several closely related roles in an economy. Think about our economic well-being, if somebody takes resources and combines those resources into output, and the value of the output is greater than the value of the resources used to produce the input. Increased value benefits all by increasing value in the economy.

We should reward people who take less valuable inputs and turn them into output that is more valuable. In fact, the market economy does that. That is the role of profit. If somebody takes resources that have a certain value and they combine them into output that is worth less than the value of resources that they started with, they are reducing value in the economy. We should penalize people who do that. Losses penalize people who allocate resources inefficiently. Conversely, profits reward people who allocate resources efficiently. Those profits and losses provide incentives in an economy for entrepreneurial individuals who are looking for innovations if they can come up with innovations to increase value in an economy. That profit acts as a lure to give innovators an incentive to be innovative and entrepreneurial.

At the same time, that profit gives people an incentive to take risks, the possibility of losses also gives them an incentive to be prudent in the risks that they take, so that they do not take excessive risks. Profits and losses are a necessary foundation for the operation of the market economy for this remarkable economic progress that we have had over the past 250 years. That is not that long in the history of mankind. This is something relatively recent and is on-going that people tend to take for granted. If we look at the policies that resulted in the economic downturn of the past year and a half, a number of cases depict economic policies that undermine the fundamental role of profits and losses in the economy.

People talk about the health care reform bill, which is in the forefront of public discussion. People are concerned about the huge budget deficits that the Obama Administration is forecasting. This is not a partisan critique because many of these policies began under the Bush Administration. The Bush-Obama policies are a bipartisan effort to undermine the fundamental incentives of our market economy. There are four areas related to the policy. First, there is the role of the Federal Reserve. Second, there is the Troubled Asset Relief Program (TARP). Third, is the Obama stimulus package, and the fourth concern is the bailouts.

II. THE ROLE OF THE FEDERAL RESERVE

The Federal Reserve was set up to be a bank for member banks. Members of the Federal Reserve System borrow from the Federal Reserve through the discount window. The Federal Reserve was established for the sole purpose of making loans to member banks. Over the years, the Federal Reserve's role has evolved. Now, one of the most important functions of the Federal Reserve is to control the size of the money supply through open market operation. Open market operation is the buying and selling of Federal Government securities.

Over the past year and a half, under Chairman Bernanke, Federal Reserve policy has changed substantially. This was a bipartisan effort. These things began during the Bush Administration when Ben Bernanke was appointed chairman of the Federal Reserve by President Bush. Of course, one of the major events that we saw in September 2008 was the Federal Reserve bailing out AIG. It is without precedent that the Federal Reserve would spend $85 billion to bail out American International Group (AIG) as it was on the verge of collapse. Later, the treasury used TARP money to take over AIG with the Federal Reserve, but the Federal Reserve has never bailed out private companies like this.[2] It is unparalleled that a company taking losses and about to go bankrupt was rescued by the Federal Reserve.

The Federal Reserve has started making loans to financial institutions that are not member banks or members of the Federal Reserve System. In fact, they are not even banks. The Federal Reserve began making loans to investment banks and other financial institutions. This is new and unprecedented in Federal Reserve history.

A third action taken by the Federal Reserve was to purchase securities that are not issued by the Federal Government. It now owns and has on its balance sheets securities that it bought from financial firms that are not banks. The Federal Reserve is not sharing information about the securities that it is holding. In 2009, Bloomberg News sued the Federal Reserve under the Freedom of Information Act claiming that they have a right to get the information about what assets the Federal Reserve has purchased and what assets it is holding. As of now, the Federal Reserve has not divulged this information and it is under dispute as to whether that ought to be public information.

Again, it is unprecedented for the Federal Reserve to be buying financial assets from banks that are not members of the Federal Reserve System, and financial institutions that are not even banks. Before the financial crisis, it could be fairly said that the Federal Reserve, while it controlled the money supply and had much to do with regulating banking, was neutral in the way that it operated in the economy and that most firms were treated the same way under objective rules. Now, the Federal Reserve has decided it is going to step in, rescue some firms, and buy financial assets from other firms.

Essentially, the Federal Reserve is engaging in an industrial policy similar to what the Japanese government has been doing for the past half-century. During the 1980s, Japanese industrial policy was heralded as a great way for government to manage economic growth in a high growth economy. Many believed that the reason for Japan's high growth rate was that the Japanese government was getting actively involved in picking preeminent firms in the economy, then helping and supporting those firms. Many in the United States believed that the U.S. should emulate Japanese industrial policy to raise the U.S. growth rate.[3] However, since the early 1990s, the Japanese economy has stagnated, and few still mention the virtues of Japanese industrial policy.

Yet, what the Federal Reserve is doing now is moving exactly in that direction. The Federal Reserve is managing industrial policy in the United States. This is troubling because in helping some firms and choosing not to help other firms, the government is picking winners and losers in the economy, which is undermining the fundamental role of profits and losses in an economy.[4] Former Treasury Secretary Paulson worked for Goldman-Sachs, so it is probably no coincidence that Goldman-Sachs is one of the former investment banks still thriving.[5] Other investment banks like Bear Stearns and Merrill Lynch were acquired, and still others like Lehman Brothers failed.[6] This is because the Federal Reserve, with assistance from the Treasury, was supporting some firms, but not supporting other firms, which sets a very dangerous precedent.

III. THE TROUBLED ASSET RELIEF PROGRAM

The second item of importance is TARP. In late September 2008, Secretary Paulson concluded that the financial system was in a significant amount of trouble. Inter-bank lending had nearly frozen up and financial markets were following suit. The problem, according to Secretary Paulson, was that banks were holding on to certain toxic assets such as mortgage-backed securities that were difficult to value. One might make a loan to a firm that ended up going under next week because of problems with its assets.[7]

Secretary Paulson's solution was the establishment of TARP, which was intended to use $700 billion to buy up those troubled assets. The government would then be holding the toxic assets under TARP, and the banks would get money from the Treasury. The goal was to give other financial institutions an assurance of their financial soundness to help reinvigorate the financial system and get inter-bank lending flowing again. Secretary Paulson claimed that this was an emergency.[8] After about a week of debate, TARP passed through Congress in early October 2008.[9] In retrospect, it seems that it was not necessary because the TARP money was not used for that purpose.

Secretary Paulson requested $700 billion to buy those toxic assets, but that is not what happened to the money. The Treasury had trouble finding ways to buy those toxic assets, and later decided on another plan: buying equity interest in banks. Secretary Paulson's idea was to purchase preferred stocks so that the Federal Government would be a significant stockholder in U.S. banks. Instead of using the money to buy toxic assets like Secretary Paulson had proposed and Congress had approved, the money for TARP was used to partially nationalize the United States banking system.[10]

Secretary Paulson called a summit of the CEOs of the nine largest banks in the United States to inform them that the government was going to buy equity interest in their banks, and become a partial owner of those banks. Many CEOs objected, but Secretary Paulson forced them to take the federal money and have the Federal Government partially nationalize their banks by claiming he did not want some banks opting out of the program while others were in, which would identify certain banks as weak banks. As a result, every bank had to participate in the program, completing a forced nationalization of the American banking system.[11]

After that, the strings attached to this money became apparent. Congress began looking at the executive compensation of these banks and decided that some of the executives were earning too much money considering that the government had just poured $700 billion into their banks.[12] It did not matter that some of the banks originally objected to receiving the money. After seeing the degree of oversight and control that Congress wanted to exercise over them, the banks wanted to get out of the program.[13]

By this time, President Obama had been elected and Timothy Geithner had replaced Paulson as the new Secretary of the Treasury, reinforcing the bipartisan nature of the plan.[14] When the banks asked to buy back the stock held by the government, Geithner decided not to sell the stock back to them just yet. He instituted stress tests that banks had to pass and introduced certain other measures, which essentially prevented the banks from buying back the preferred stock. In other words, he enforced federal ownership of the banks.[15]

One has to wonder what would have happened if Secretary Paulson had initially gone to Congress and proposed a partial nationalization of the banking system rather TARP. Nevertheless, that is what the money was used for, once again initiating a system where the profit and loss aspect that underlies a market economy was undermined. The problem with a system like this is obvious. When the government allows firms to keep the profits, but bails them out in the event that they post a loss, it upsets the profit and loss balance. Firms should be entrepreneurial. They should take prudent risks because that is where economic progress comes from. However, on the other side, firms should be cognizant of the fact that the cost of bad decisions falls on them. Thus, bailouts remove the loss side of that equation, which ultimately will encourage excessive risky behavior on the part of executives.

IV. The Stimulus Package

Exacerbating the situation is the Obama stimulus package, which was about $800 billion. President Obama sought to pass the stimulus package immediately after he took office in order to prop up the failing economy and keep it from sliding further.[16] However, very little of the stimulus bill was actually oriented toward economic stimulus because much of it was spent toward fulfilling President Obama's campaign promises. A sizable amount of that stimulus money was not spent right away, and in fact, there is still more that has yet to be spent out of that $800 billion.

The irony of this is that the consensus among economists is that the economy is recovering, and yet that stimulus money is still coming into the economy.[17] President Obama's argument was that without the stimulus bill, unemployment would rise above 9%.[18] Currently, the unemployment rate is about 9.7%, so by President Obama's own metric—which may be unfair to the president, since perhaps he underestimated the severity of the recession—the economy is in worse shape now than he forecasted it would have been without the stimulus bill.[19]

The underlying logic behind this kind of stimulus spending is basic Keynesian economic policy. During his administration, one of the things that President Bush did twice to stimulate the economy was lowering income taxes. Not only did he lower the rates to give larger refunds on tax day and ensure that citizens would not be paying as much next year, but he sent out checks in the mail to people to stimulate the economy.[20]

According to the ideas of John Maynard Keynes, budget deficits tend to stimulate the economy. Keynes maintains that cutting taxes and increasing government spending provides a fiscal stimulus to the economy. Thus, increased government spending can prop up overall spending.[21] Keynes also proposed doing this without raising taxes because if taxes increase, that takes money out of the hands of the spenders in the economy. Therefore, by running a budget deficit, the economy is stimulated.

When President Bush was elected, the federal budget was in surplus, and for eight years during the Bush Administration, Bush cut taxes and increased government spending, thus increasing budget deficits. If budget deficits really stimulated the economy, by the end of the Bush Administration the United States would have been in nirvana rather than in the worst recession since the Great Depression.[22]

The problem is that the analysis looks at the amount of money being put into the economy, but does not look at where that money is coming from. If the government is spending more money, that money has to come from somewhere. Under this system, consumers are squeezed and investors are crowded out through government borrowing. Thus, Keynesian economics shows the increase in government spending, but not the crowding out that occurs in the private sector. This is another policy that undermines the workings of the market economy.

V. THE BAILOUTS

Another important issue is the bailouts, which are reflected in the bailouts of the banks and the financial firms. The bailouts go further than that, of course, as the government has already bailed out General Motors (GM) and Chrysler. Again, the bipartisan nature of the policy should be emphasized. The bailouts for the auto firms started in the Bush Administration, and were initiated by President Bush himself. If you go back to last fall, the auto companies were saying, "We are running out of money. We are going to have to declare bankruptcy if we do not get an infusion of cash from the Federal Government." They were begging for a bailout from the Federal Government. One place where automobile industry thought they could get some money was from the TARP program. Secretary Paulson said, "No, TARP money is earmarked for buying toxic assets from financial institutions. That money is not intended to bailout the auto industry." The issue went to Congress and Congress debated it. Ultimately, they voted to deny a bailout for the auto industry. Last December, Secretary Paulson changed his mind on the TARP issue. He gave tens of billions of dollars to the auto industry to bail them out from the TARP program. TARP money was used to bail out General Motors and Chrysler, to keep them afloat and avoid bankruptcy. It was only a few months later that the Obama Administration gave them more money. In hindsight, this was not a good idea. In June, GM and Chrysler declared bankruptcy anyway. If automakers had gone into bankruptcy in December 2008, it would have been a private affair. Instead of bankruptcy, the auto industry was propped up twice, once in the Bush Administration and once in the Obama Administration, but they eventually declared bankruptcy in June. By that time, the Federal Government had a lot of money invested in those companies. As a result, the government took a significant minority ownership interest in Chrysler, and a 61% ownership interest in GM. This is a nationalized auto company. The Canadian government and the United Auto Workers also own a share of GM, but the stockholders were wiped out. In addition, the bondholders ended up with 10% of the company converted into stock.

The issue of whether it is a good idea to nationalize our auto manufactures can be debated, but it seems that the United States would have been better off keeping GM in the private sector. The country would have been better off letting them declare bankruptcy in December with no federal money, rather than turning them into a nationalized auto company as we did when they declared bankruptcy in June. Once again, that fundamental profit and loss foundation of the market economy is being undermined. Maybe GM and Chrysler could have emerged from bankruptcy. Perhaps they could have reorganized and come out of bankruptcy like Delta Airlines. Delta Airlines reorganized during bankruptcy, and now Delta Airlines is the largest air carrier in the United States. It is possible for a company to emerge from bankruptcy if they have a viable business model.

If GM and Chrysler were not able to reorganize successfully, then valuable assets could have been purchased by other firms because if a firm has assets with any value, those assets do not just disappear when the firm declares bankruptcy. If GM had factories and assembly lines and were making valuable cars, somebody else would have wanted to purchase them, and although GM might have been liquidated for less than GM would like, the assets would still be there if they were worth anything.

Another side effect of federal intervention is that the bondholders ended up getting a bad deal. The bondholders were holding secured debt. The whole idea of secured debt is that in the case of bankruptcy, you get first claim to the assets of the bankrupt firm. That did not happen because President Obama wanted to push through another package and many of the bondholders were willing to go along with it. The major bondholders in GM at the time were JP Morgan Chase, Citigroup, Morgan Stanley, and

Goldman Sachs.[23] They were okay with the Obama plan because they had taken federal money already, and therefore could not really complain when the value of their bonds eroded.

The problem is that this undermines the value of secured debt in general because firms want to issue bonds. Usually when a firm issues bonds, they are telling bondholders that, "In the event of a problem with this firm, if we declare bankruptcy, you have first claim on our assets." This is no longer the case anymore because the Federal Government took a huge share and left the secured bondholders with very little. Again, there was not too much complaining about it because the people who owned many of the bonds were people who were already beholden to the Federal Government because of the TARP program. This is another example of the negative effects of the TARP program.

When President Obama announced his plan, he complained about some of the bondholders who did not like the settlement, and who thought that they deserved more because they were secured debt-holders. On April 30, 2009, President Obama was trying to push through his plan for bankruptcy for GM and said, "While many stakeholders made sacrifices and worked constructively, I have to tell you, some did not. In particular, a group of investment firms and hedge funds decided to hold out for the prospect of an unjustified taxpayer-funded bailout. They were hoping that everybody else would make sacrifices, and they would have to make none."[24] Again, most did not complain because they were already beholden to the Federal Government because of TARP. One person who did speak out was a hedge fund manager named Cliff Asness. On May 5th, he responded to President Obama and said, "Let's be clear, it is the job and obligation of all investment managers, including hedge fund managers, to get their clients the most return they can. They are allowed to be charitable with their own money, and many are spectacularly so, but if they give away their clients' money to share in the 'sacrifice,' they are stealing."[25]

While President Obama is claiming that the hedge funds are asking for a bailout, in fact, it was only because hedge funds have not taken government funds that they could stand up to this bullying. The TARP recipients had no choice, but to go along. The President's plan takes money from bondholders and gives it to a labor union that delivers money and votes for him.

VI. CONCLUSION

By bailing out bankrupt firms, we are undermining that profit and loss mechanism that stands at the foundation of our capitalist economy. That profit and loss mechanism has resulted in the remarkable economic progress that we have seen take place over the last 250 years. The American economic system may be fragile. It has only been in place for a little more than a couple of centuries. It seems like a long time, but in the course of human events, it is not long. Now, we are cutting the legs out from under the incentives that are at the foundation of American capitalism.

Look at what has happened since the beginning of the financial crisis. Again, the bipartisan nature of this should be emphasized. The TARP program was initiated in the Bush Administration. Ben Bernanke, the Chairman of the Federal Reserve was appointed by President Bush. Many of the policies discussed were initiated under the Bush Administration. Therefore, this is not a critique only on the current Administration or on President Obama. This is something that goes back to the Bush Administration and has been a bipartisan effort.

In response to the financial crisis, we are nationalizing our banking and financial industry, we are nationalizing the automobile industry, and the Federal Government owns 80% of AIG and 61% of GM. Currently, an important policy issue is the healthcare debate. We are thinking about having the Federal Government play a much larger role in the healthcare system that it already dominates. In energy policy, we are talking about the Federal Government playing a much larger role in our energy markets. We are really looking at a fundamental transformation here in the nature of American capitalism.

Many who have been around long enough, have had a pessimistic feeling about our economic future before. The 1970s was a decade of double-digit inflation and rising unemployment. There was an energy crisis with lines at the gas pump caused by Federal Government price controls on gasoline. The Iranians were occupying the U.S. embassy. The 1970s was also the decade that brought in disco music and polyester leisure suits. There is not much good to be said about the 1970s. Despite that, Americans managed to turn things around in the 1980s and the 1990s. By 1989, with the collapse of the Berlin Wall, and in 1991 with the demise of the Soviet Union, it would appear that the virtues of the market economy over government planning would have looked so large that there would be no turning back. Over the twentieth century, in the struggle between socialism and capitalism, the strength of the capitalist economy won. With the collapse of those centrally planned economies, everybody said, "We now see, capitalism is the right way to go. Market allocation of resources is better than government planning." It is interesting that so much of the current debate turns on how much more involved we want the government to be in our economy.

To conclude, there is a message of hope and change. Hopefully, the gloomy outlook of the Obama policy does not come to fruition. The hope is that with a little distance, we will be able to look back and see that we had a little too much intervention and that the market economy really works quite well. Hopefully, there may be some lessons that we can learn from this that will strengthen the market economy.

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The Future of Regulation

Dr. Jerry Ellig*

ABSTRACT

This paper discusses the prevalence of regulation in the U.S. It provides the necessary background information on the process for creating regulations, how scholars can measure the increase in regulation, and the different types of regulations. This paper then goes on to discuss the five major recent trends in regulation and the implications of these trends for the future.

I. INTRODUCTION

Do you feel regulated? On a business trip, your day might start by being woken up, not by the alarm clock, but by a phone. For that call to go through on a cell phone, the phone company had to buy a license from the Federal Communications Commission (FCC) to use part of the radio spectrum. There are various rules and regulations governing how that spectrum came into being and how it is used. Moreover, the tag on your mattress assures that the mattress complies with Title 16 of the Code of Federal Regulations, section 1633, which deals with flame retardant, fire proof mattresses.[1] Then you get up and go into the bathroom, you take out your FDA approved toothbrush, put FDA approved toothpaste on it, and brush your teeth.[2] You might then reach for a can of shaving cream containing only two and a half ounces because, if you flew on a plane, regulations from the Department of Homeland Security prevent anyone from carrying a full size can of shaving cream on an airplane.[3]

Not all of this is necessarily a reason to complain. Your cell phone company was required to obtain a license to use the spectrum, which it bought it at an auction run by the FCC. Auctioning has proven to be a much better method of allocating spectrum than some of the other methods previously used by the FCC.[4] Few people would object to the idea of sleeping on a mattress that is flame retardant. While that regulation may not be objectionable, some might consider themselves competent enough to find safe toothbrushes and toothpaste and most people would like to know what

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information the Department of Homeland Security relied on to construct its regulations regarding carry-on luggage.

Simply put, federal regulation touches everyone's daily lives in many ways that most people never bother to think about. Because regulation is extremely pervasive, it makes sense to learn more about how federal regulation works, what it does, and to think carefully about the process of adaptation and review of regulations.

II. How Regulations Are Created

Many times in casual conversation the term 'regulation' is used to refer to any restriction imposed by the government that defines certain actions as legal or illegal, but the definition is actually more specific. Regulation occurs when a legislature delegates some of its lawmaking power to a regulatory agency, which then issues detailed rules, the purpose of which is to carry out the intention of the legislature. Regulations are issued by a regulatory agency, with the intention of filling in the gaps in legislation. In the case of federal regulation, it fills in the gaps left by the U.S. Congress.

Two kinds of regulatory agencies exist at the federal level in the United States. Many regulatory agencies are actually part of the executive branch and their top officials are hired and can be fired by the President. These include agencies, such as the Environmental Protection Agency, the various agencies that regulate transportation within the Department of Transportation, and any position within a Cabinet department. All these regulatory agencies are directly responsible to the President.

There are also independent regulatory agencies, that is, agencies that are independent of the President, but not independent of Congress. These agencies usually have the word "commission" in their title. The President usually appoints the commissioners, who run these agencies for a fixed term, with the consent of the Senate. The President cannot fire them, and as a result, these agencies tend to function relatively independently of the executive branch. They do not necessarily act independently of Congress, since Congress ultimately approves the budget and writes the laws that the agencies are supposed to implement. Examples of this type of agency are the FCC, Consumer Product Safety Commission, Security and Exchange Commission, and Commodity Futures Trading Commission. The Federal Reserve is also considered an independent regulatory agency.

The most significant difference between the independent agencies and the executive agencies is that executive agencies are supposed to operate within rules laid out in executive orders. Democratic and Republican administrations issue executive orders and these orders explain how agencies ought to analyze regulations. The White House has the ability to tell these agencies, "No, you can't issue that regulation, because you haven't done your homework." The independent agencies, on the other hand, have not traditionally been subject to that kind of oversight by the White House.

Regulations are made through an organized process. There must be authorization in legislation for a regulatory agency to enact a piece of regulation, and it must be empowered to issue a particular regulation by Congress. The agency must issue any proposed regulation for public comment, and it will take comments on the proposed regulation for an average of sixty to ninety days. It will then rewrite the proposed regulation, and issue its final regulation. The regulation may go through several rounds of proposals and revisions. The Office of Management and Budget (OMB) reviews regulation produced by executive agencies, both before it is released for comment and before it is officially published. Finally, before any agency publishes a regulation, Congress is able to review that regulation. Although Congress could nullify any regulation at any time, it also has an expedited process for reviewing regulations under the Congressional Review Act. This Act allows Congress the power to quickly veto a proposed regulation or to veto a final regulation after it is published by the passage of a joint resolution by a simple majority.[5] The Congressional Review Act has only been invoked once in history.

Finally, regulations can be appealed to the courts. When one is affected by a regulation, one can seek reprieve from the courts if a regulatory agency exceeded its authority, the regulation is arbitrary, or the process of creating the regulations is flawed. Regulations must be in accordance with certain rules. There is an organized process for issuing regulations, and there are opportunities at various points for members of the public, to have some effect on what regulatory agencies do.

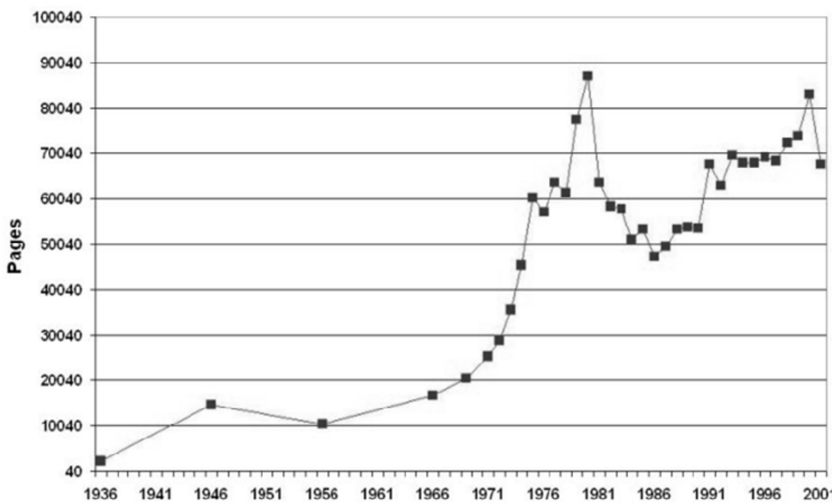
As individual citizens or as members of other organizations, the public can comment on proposed regulations to the OMB when it is reviewing a regulation. The public can make its views known to Congress, which ultimately writes the laws, and, if someone is directly affected by the regulation, he or she may have standing to challenge that regulation in court. If someone else challenges a regulation in court, a citizen can file an amicus brief, or friend of the court brief, offering some information or commentary on the regulation.

III. HOW MUCH REGULATION IS THERE ON THE FEDERAL LEVEL?

There are many ways of measuring regulation, and all of them are inaccurate. Do not take the evidence too seriously, or literally. Measures of regulation reveal the big picture, and whether regulation has been increasing or decreasing. Other than that, these measurement methods are all inexact.

Traditionally scholars have tried to measure the amount of regulation by the number of pages in the Federal Register (Figure 1), because the Federal Register is where agencies have to publish most proposed regulations and where they have to publish final regulations. This method does not necessarily measure the volume of effective regulation because deregulatory action, as well as regulatory action, must go into the Federal Register. However, it does give a decent idea of the total amount of regulatory activity that agencies engage in.

FIGURE 1: PAGES IN THE FEDERAL REGISTER: 1936–2001



Source: UCSD Vote View[6]

Regulatory activity increased during the World War II, and increased again in 1972. In President Nixon's second term, it ramped up tremendously, hitting a peak in the final year of the Carter presidency, and falling somewhat under President Ronald Reagan. Regulation resumed growth under President George H.W. Bush, continued growing under President Clinton, and then leveled off under President George W. Bush.[7]

There are other ways to looks at regulatory trends. One technique is to look at regulatory agency expenditures in the Federal Budget. These do not measure the total cost of regulation; they only measure what the Federal Government is spending to administer regulations. In both of these measures, there is actually a similar pattern, showing where regulation has waxed and waned, sometimes rapidly, sometimes slowly. Once again, by this measure there is a bit of a dip during the Reagan years, and then a huge spike under President George W. Bush, which most largely reflects the increase in regulations regarding national security.[8]

Similarly, by counting the number of people in the Federal Government, who are involved in regulation, follows a pattern somewhat similar to the pattern of expenditures. There is a big jump right after 2001.[9] That reflects the federalization of the air traffic screening force. Private contractors, who worked for the airlines, formerly conducted airport security, but the Federal Government took over screening and this added approximately sixty-thousand federal employees.[10]

These measures generally track each other, albeit imperfectly. During the Nixon and Carter years, the amount of regulatory activity increased faster than the amount of spending. This is also demonstrated by graphing the number of personnel. In terms of Federal Register pages, federal regulators became more productive during the Nixon and Carter years because they were able to produce more pages per person. Regulation has gradually been growing, but there have been some fluctuations in the trend. This fluctuation is evident when examining the number of Federal Register pages versus the number of regulatory staff.

Another way of measuring the amount of regulation is by looking at the total cost against the total benefit of regulation. There are several ways of measuring this and all of them are inaccurate. One of the best ones comes from the Office of Information and Regulatory Affairs within the OMB. Every year they are required by law to produce an annual estimate of the costs and benefits of federal regulations. The estimate they released in 2009 said that the benefits of regulation are somewhere between $126 billion and $663 billion, and the costs are between $51 and $60 billion. However, this is not the total benefit and cost of all federal regulations. Rather, this is the total benefit and cost of federal regulations proposed within the past ten years. The total will arguably be a lot higher on both the cost side and the benefit side.

The other odd thing about the OMB estimate is the method behind the estimation. The estimate uses the cost and benefit projections that were calculated by federal agencies when they proposed these regulations. In reality, this is a measure of the costs and benefits that agencies anticipated when they proposed the regulations. This is not a measure of the actual costs or the actual benefits that occurred after the regulations were implemented. However, the officials that author the report acknowledge these shortcomings.

Another attempt to measure the cost of regulation is undertaken by the Small Business Administration's Office of Advocacy. The Office of Advocacy promotes regulation polices that benefit small businesses. They commission an academic to report on the total cost of federal regulation and examine how it affects small businesses verses large businesses. Professor Mark Crain led the most recent report which estimates that the total cost of regulation is around a $1 trillion or $10,000 per household.[11] The study has been criticized on a number of grounds, but the picture, from either the OMB figures or Mark Crane's study, indicates the substantive effect of regulation, regardless of the problems in the studies.

IV. TYPES OF REGULATION

There are different types of regulations. Economic regulation involves government control of prices, entry, setting quality standards for products and services, and establishing other contract terms, but that is not the most common type of regulation. Health and safety regulation is the largest single portion of regulation in terms of federal activity. Workplace health and safety regulations or other kinds of health and safety regulations, such as all of the Homeland Security regulations are intended to make people healthier or safer. An FDA approved toothbrush is an example of a health and safety regulation.

There are also environmental regulations. Some are intended to improve health and safety, such as getting particulates out of the air because .particulates can cause significant health problems. But, other environmental regulations are not as linked to human health and safety and come from to a broader desire to protect the environment. For example, there are regulations that intend to protect endangered species. The link between endangered species and human health and welfare is tenuous. The values driving those regulations were not whether the regulations protecting endangered species make humans healthier, but rather, to protect endangered species, since eliminating other species is wrong.

There are civil rights regulations that prevent people from discriminating based on race, religion, and other factors. There is not a huge amount of federal money spent on these regulations. Much of the enforcement of these results from lawsuits in the private sector, but that is an important part of regulation. The three previously mentioned categories, health and safety, environmental, and civil rights, are often grouped together and referred to as social regulation.

In contrast to social regulations, there are transfer regulations. These are regulations issued by agencies that spend money or collect taxes. The regulations these agencies issue lay out how they are going to collect taxes or how they are going to spend money. This is a little different from some of these other types of regulation. Much of the way the money is spent is driven by formulas written into the legislation and then the agency is responsible for issuing regulations that implement and update that formula when they distribute the money. Federal disaster aid is administered in this way and the Federal Emergency Management Administration has to issue a set of regulations and ground rules outlining how people can apply for that disaster aid. These types of regulations elaborate on how the Federal Government spends money.

V. IMPORTANT TRENDS IN REGULATION

Five important trends in regulation are essential to understand. The first major trend is a reduction in certain types of economic regulation. Many graphs of federal spending on industry-specific economic regulation come from a publication called the Regulator's Budget. This is jointly assembled every year and updated by the Mercatus Center and the Weidenbaum Center at Saint Louis University.[12] Money spent on industry-specific economic regulation increased throughout the sixties, but in the seventies it started falling. It bounced up a little bit, and then bounced down, but a big drop-off persisted throughout the 1970s and into the 1980s.

These trends largely reflect the decisions to deregulate prices and entry in transportation industries like railroads, trucking, airlines, communications, telecommunications, and certain energy industries. For example, the Federal Government no longer controls the price of natural gas. The price is set through competition in the market. Much of the scholarly research in the 1960s and the 1970s on a cluster of infrastructure industries demonstrated that the principal effect of government regulation in these competitive industries was to enforce cartels, enforce monopolies, and overcharge consumers. This is why the two principal political figures who pushed the deregulation of those industries in the 1970s, particularly the transportation industry, were President Jimmy Carter and Senator Ted Kennedy. Senator Ted Kennedy was the principal sponsor of the airline deregulation bill.

The figures on regulatory personnel show a similar effect because there was a big reduction of regulatory personnel who were involved in industry-specific regulation. Almost all of the academic research, whether it is by economists who are on the left, the right, or in the middle, agreed on the impact of this regulation. In studies by the Brookings Institution in Washington D.C., economists suggested that deregulation benefits consumers with large price decreases and other significant benefits, such as improvements in the quality and timeliness of service. When economists have quantified the effects in 1995 dollars, it totaled around $60 billion per year. At current prices, these figures rise to approximately $75 to $80 billion in annual benefits that consumers get from lower prices and better service as a result of the deregulation that has occurred in these industries. This is driving the reduction in spending and personnel on economic regulation.

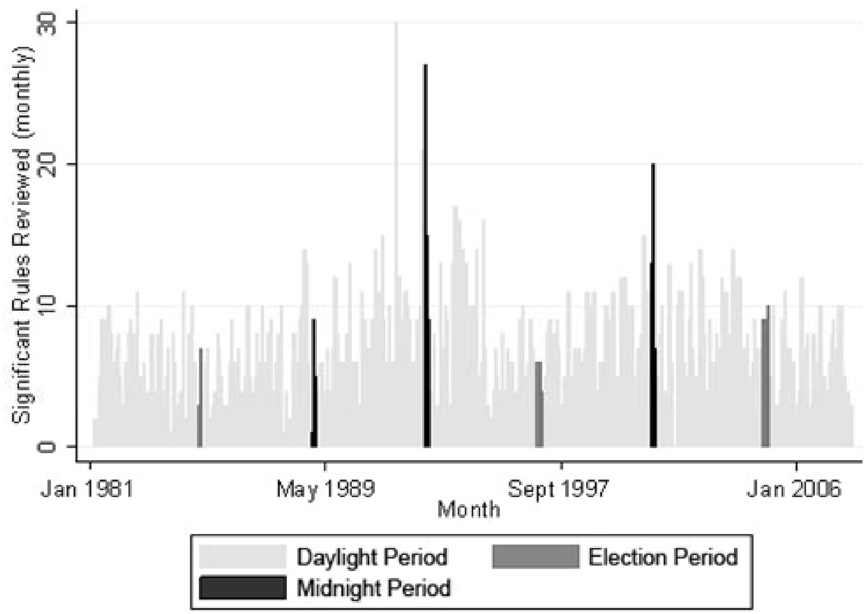
The OMB's guidance documents for regulatory agencies also encapsulate the conventional wisdom of economists with regard to government regulation of prices. In terms of service in competitive industries, the OMB guidance to agencies says, "in light of both economic theory and actual experience a particularly demanding burden of proof is required to demonstrate the need for any of the following types of regulations."[13] Essentially, regulations of prices, quantities, quotas and aspects of industries could be competitive. The highest levels of officials in the Federal Government who review federal regulation accept that economic regulation that puts government in the business of enforcing cartels and monopolies does not benefit consumers. Such types of regulation should raise suspicions, unless there is some other public interest or reason besides the effects on prices and consumer welfare. Ultimately, one major trend is the sizeable reduction in economic regulation.

The second trend is a very large increase in social regulation, particularly in the areas of health and safety regulation and environmental regulation. Federal spending on social regulation has continued to gradually increase since President Nixon's term, with only a slight decline under President Reagan. Similarly, the number of people involved in social regulation has generally increased over time with the only anomaly happening during the Reagan years. The findings in these reports do not reflect the furious battles in Washington D.C. over environmental regulation, which along with health and safety regulation, have continued to gradually increase.

The third trend is an increase in national security regulation. This type of regulation has seen the biggest jump of any kind of regulation. Yet again, most of that surge relates to the federalization of the screening workforce in airports. After 9/11, national security related regulations increased, whereby either new regulations came into existence, or existing regulations became more stringent. The same type of pattern can be observed when examining Homeland Security regulatory personnel. President Obama's 2009 budget provides projections through 2010 and for an increase in funding of the Department of Homeland Security, though the rate of increase is slightly lower than during the President George W. Bush's Administration.[14] It seems the increase in national security regulation was not an anomaly that occurred only under President George W. Bush, but rather that, Homeland Security spending is permanent.

The fourth trend is the appearance of midnight regulation. This has been researched by a number of colleagues at the Mercatus Center, including one who even spent some time in the Federal Government trying to curb this trend. There are various ways of measuring this, but the general phenomenon is the tendency for regulatory activity on the federal level to become concentrated in the final quarter of a President's final year in office, hence the term midnight regulation. Much of this regulation occurs after the election and before inauguration day, as seen in Figure 2.[15]

FIGURE 2: NUMBER OF SIGNIFICANT RULES REVIEWED AND MONTH RECEIVED



Source: Patrick A. McLaughlin, "Empirical Tests for Midnight Regulations and Their Effect on OIRA Review Time."[16]

This trend is consistent among both Democratic and Republican Presidents, so it is not a partisan trend. It tends to be the most common either at the end of a president's eight year term, because then the President is really a lame duck and will not be serving again, or when control of the

Presidency switches from one party to another. The term midnight regulation was likely coined during the Carter Administration and has only really been examined since that time, but each President partakes in this activity to some degree or another at the end of his second term.[17]

Midnight regulation is not inherently good or bad. The real issue is whether each President is issuing good, well thought-out regulations toward the end of his term. Some argue that trying to do a whole lot in that short period of time may be a bad thing for two reasons. First, since most of that activity occurs between Election Day and inauguration day, the outgoing president is not accountable to anybody for his actions.[18] From a democratic perspective, we must evaluate the merits of surges of activity in an administration when it is very clear the President is leaving office and can do whatever he wants without fear of penalty from the electorate. The other reason to think carefully about whether midnight regulation is advantageous is the need for time to review regulations at the Office of Management and Budget. The OMB is responsible for analyzing regulation carefully to make sure that agencies understand the costs as well as the benefits. If agencies are trying to do too much at one time, they may not be thinking carefully about what they are doing. Similarly, the reviewers in the administration become swamped with a lot of work at the same time and may not be able to think as carefully about it as they normally would.[19]

Substantial regulations that have a large effect on the economy are referred to in federal regulatory parlance as "economically significant regulations." This term refers to regulations that have an economic impact of more than $100 million, measured in terms of costs, benefits, or federal spending.[20] The midnight regulation phenomenon holds true for economically significant regulations as well. Figures about economically significant regulations are only available since 1981 because it was Reagan's executive order that created the classification called economically significant regulations. President George H.W. Bush, President Clinton, and President George W. Bush all saw a large spike in economically significant regulations at the end of their Presidential terms.[21]

This is problematic because a quick examination of the resources available to the office charged with reviewing these regulations for the President, the Office of Information and Regulatory Affairs, shows that its budget has pretty much declined steadily from its original level of around $10 million in 1981. This figure grew a little bit under Reagan because Reagan was a strong proponent of this kind of review, and increased a little under George W. Bush. But, generally, the Office of Information and Regulatory Affairs has seen declining resources to review regulations even though the number of people in that office has been fairly constant in any given year.[22]

With these big spikes in regulation concentrated in one quarter, it is logical to assume that the people who are supposed to review these regulations for the President are not able to spend as much time on each economically significant regulation during the midnight period, as they spend at any other time.

As seen in Figure 2, under President George W. Bush, the amount of midnight regulation seems to be lower than under President Clinton or President George H.W. Bush. One reason for this is that the White House Chief of Staff, Joshua Bolten, issued a memo toward the end of the Administration telling federal agencies that the White House would be clamping down on midnight regulations. All proposals of new regulations would have to be submitted by June in order to be able to be processed by the end of the presidential term. Consequently, what happened under President George W. Bush is that midnight regulation was smoothed out a little bit, as some of that regulatory activity was pushed back into the summer and spring of the election year, rather than having it all concentrated at the end of the election year. Susan Dudley, a former colleague at the Mercatus Center, who headed the Office of Information and Regulatory Affairs for the last two years of the Bush Administration, deserves much of the credit for the research on midnight regulation. She has written on midnight regulation and entered the Bush Administration committed to trying to reduce the effects of midnight regulation.

The fifth trend is the probable increase in regulation of financial companies as a result of the recent financial crisis. The important thing to keep in mind is that there will be two kinds of regulation of financial companies. Some regulations will relate to things that people think might have caused the financial crisis. For example, there are contracts called credit default swaps, which are essentially a way of buying insurance when you own a portfolio of mortgages and allows you to hedge against some of the risk that those mortgages will default. Some people think that these played a role in the financial crisis and there have been moves to require that all credit default swaps have to be traded on exchanges where they are more public and more highly regulated.[23]

Another example is the proposal floating around to give the Federal Deposit Insurance Corporation (FDIC) the authority to shut down financial firms that are close to being insolvent even if they are not banks. The FDIC would be allowed to wind them down the same way that the FDIC shuts down banks that are insolvent or close to being insolvent. Some people think if the FDIC had possessed that authority, the FDIC might have caught some of these financial firms before they lost so much money, and therefore negating the need for a bail out.[24]

On the other hand, we are also going to see increased financial regulation that has nothing to do with the causes of the financial crisis. For example, there is a proposal to create a Financial Consumer Product Safety Commission that will evaluate all financial products and tell consumers which financial products are safer for consumers to buy.[25] Aside from the merits of this proposal, it is important to keep in mind that this is a proposal that has been around for several decades. People in Washington D.C. have wanted to do this before, and the financial crisis is simply an excuse for doing something that they wanted to do anyway.

Similarly, those who use credit cards may have read the inserts that come in credit card bills and tell you how the terms of credit card agreements are going to change. In some ways, changes may make things better for consumers; in other ways, it may make things worse. These changes are the result of new federal regulations.[26] The idea behind federal regulations on certain types of credit card companies has been floating around for quite some time, and the financial crisis was just an excuse to enact them.

VI. CONCLUSION

There are two conclusions we can draw from these trends. First, regulation is a growth industry. For those who are either students in public policy programs or interested in public policy that means that there is an ever-increasing demand for people who understand how to assess and analyze the effects of regulation. The second is that there are ways that the public can get information in front of regulatory agencies that may affect the decisions of regulatory agencies. Therefore, all hope is not lost because there are opportunities for all of us to be involved in the regulatory process in one way or another, and hopefully create better regulatory decisions.

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Latin America and the Financial Crisis of 2008: Lessons and Challenges

Dr. Luisa Blanco*

ABSTRACT

In October of 2008 there were two main views of what the financial crisis would do to emerging countries in Latin America. The optimistic view predicted that they would do well overall and that the crisis would not have a significant impact on them because their economies were decoupled from the rest of the world. The pessimistic view saw these economies as vulnerable to the financial crisis, which meant they would become unstable and perform poorly. Over a year later, the outcome is something in between. This article will explain the current state of the financial crisis in Latin America and the policy responses of various Latin American countries. Brazil, Mexico, and Chile, will be highlighted because they present very interesting cases. These examples are important when discussing lessons and challenges in Latin America. The idea is to focus on what these Latin American countries have done that has allowed them to perform relatively well during the crisis, and discuss what challenges policy makers in the region are facing today and will face in the future.

I. THE IMPACT OF THE FINANCIAL CRISIS ON LATIN AMERICA

Four pieces of macroeconomic data illustrate the impact of the financial crisis in Latin America: levels of gross domestic product (GDP), foreign trade, foreign direct investment (FDI), and remittances. World Bank projections from September 2009 estimate a 2% GDP decrease on average for the region for the year of 2009.[1] Mexico, however, is a different case; its GDP is expected to decrease by about 7% in 2009.[2] The Latin American experience during the crisis is quite heterogeneous, because some countries did not experience contractions (Bolivia, Panama, Peru, and Uruguay), some experienced miniature contractions (Brazil, Colombia, and the Dominican

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Republic), and others saw large contractions (Mexico). It is very important economically for Latin America that the financial crisis did not originate there, as it did in previous financial crises. Compared to other regions, Latin America was certainly not the hardest hit. Projections estimate that Western Europe's GDP will contract by 4.1%, Eastern Europe's by 5.4%, and Japan's by 5.7%.[3] The projection for the U.S. is similar to the Latin American region, around 3%.[4]

There are three main factors, using current data from the Organisation for Co-operation and Development (OECD)[5], which affect the well being of Latin America. One is that there was a significant reduction in world trade in the first quarter of 2009, but in the second quarter world trade started to stabilize.[6] There was a significant decrease in exports from non-OECD countries in the first quarter of 2009. One should focus on non-OECD exports, since most Latin American countries are not members of the OECD. The second quarter however, saw an increase of 1%, indicating some stabilization[7]. Some project that the level of exports in Latin American countries reached bottom, so future growth may be approaching. The level of non-OECD imports from the fourth quarter of 2007 to the fourth quarter of 2009 indicates some stabilization, or even future growth. In 2008, exports in non-OECD countries decreased by about 2% in the third quarter and 4% in the fourth quarter.[8] It is not all bad news. Exports actually increased from the first quarter to the second in 2009.

Data from the United States is important for Latin America because Latin American countries export much of their products to the United States. In 2009, there was a significant reduction in imports from the rest of the world into the United States, and especially from Latin America. Monthly averages of United States imports from the world offer a grim picture. From 2008 to 2009, they fell by 28%.[9] Imports also fell in 2001 due to that recession, but only by about 6%. The monthly average of the available observations for Latin American countries shows a very similar picture. There was a drop during the recession of 2001 and a drop in the recession of 2008, and the magnitude is greater now than it was then.[10] Brazilian imports to the United States have increased significantly over time, but dropped precipitously during the current recession. On the upside, they started stabilizing in July of 2009. Chile shows a similar picture, as does Mexico. In fact, such drastic drops and the following stabilizations can also be seen for most of the other countries in the region.[11]

Data from the Economic Commission of Latin American countries show trade falling 31% from the first half of 2008 to the first half of 2009.[12] Commodity prices decreased by 29% in the same time period, which affects Latin America's export market.[13] That drop in exports is comparable to the drop back in the 1930s.[14] Projections of volume of trade reduction indicate a decrease of 13% in 2009, which is comparable to the time period from 1937 to 1939.[15]

Another aspect related to the implications of the financial crisis in Latin America is FDI. FDI plays a key role in Latin America because it provides capital and technology to countries that otherwise would not have it. Projections for FDI are not good. FDI is expected to decrease significantly in 2009, but start to recover slowly in 2010. However, it is expected that FDI will recover to 2008 levels in 2011.

A recent United Nations Conference on Trade and Development's World Investment Report asked international corporations what their investment plans for 2009 were, and 58% answered that they are expecting to decrease their investment in all of their countries. [16] Therefore, the projections are not good. For Latin America a lot of FDI took place before the financial crisis. Now, however, the effects are starting to show. There was a drastic drop of 42% from the first quarter of 2008 to the first quarter of 2009.[17] Although the drop was drastic, the experience of Latin American countries with FDI during the crisis has been quite heterogeneous. For some countries there was an increase in FDI, but for other countries there was a decrease.

Remittances, money that immigrants send from abroad to their home regions, are another important indicator. Remittances have grown significantly for many years in the region, and Mexico is one of the countries that receives the most remittances. In 2009, however, there is expected to be a decline in remittances of about 11%.[18] This fall in remittances will bring them back to the level of remittances in 2006. This drop in remittances is expected because there is more unemployment in the United States, where Latin American immigrants have been hit harder and they are less able to send money back home. The average amount of money sent back was $241, but is now about $230.[19]

There is something called the reverse remittances phenomena that has not been around until now. Immigrants in the United States that used to support their families back home are now unemployed. Now, they need their relatives back home to help them. There is some data showing in some cities in Mexico that the net transfer is negative; more money going out than coming in, which is a new phenomenon in Latin America.[20]

II. LATIN AMERICAN RESPONSES TO THE FINANCIAL CRISIS

Latin American countries responded differently to the crisis than other developed countries did. The first difference is that the crisis did not originate in Latin America. They are being affected by something external, not internal, so they are taking a different approach. Something important to note is that Latin American countries went through important reforms during the 1990s, which improved their ability to face a crisis. They are in much better shape than they were before the reforms.

Just like the United States, many Latin American countries used fiscal stimulus through greater government spending to address the crisis. Because of the reforms they implemented in the 1990s, which forced governments to be more fiscally responsible, many Latin American countries had more room to maneuver and to implement these fiscal policies. In previous crises, some Latin American countries did not have the luxury to do that. They actually had to decrease government spending during a recession.

Another important policy measure was the use of an expansionary monetary policy. In January of 2009, Mexico decreased its benchmark interest rate by half a point to 7.75 points.[21] That was actually its first cut in the interest rate since 2006. That is a substantial shift in policy, caused by the financial crisis. Many other countries in the region had to use an expansionary monetary policy as well.

Finally, Latin American governments have provided assistance to financial institutions, but their approach has been different than the approach taken by the United States because the banking sectors in Latin American countries did not have the toxic assets that banks in the United States did. There was, however, some decrease in credit, to which Latin American governments have responded. The development bank of Brazil started purchasing shares from banks, and the development bank of Mexico, Nacional Financiera, started giving credits to small and intermediate enterprises.[22]

There are some interesting cases worth noting when discussing lessons and challenges for the region. Brazil, for instance, is a leader in the region. It has been affected by the crisis, but is expecting to recover faster than any other country in the region. One of the reasons Brazil has been very successful is that it has a very diversified export sector in terms of products and regions. Another good thing about Brazil is that it has been able to achieve macroeconomic stability. Brazil faced some trouble during the 1980s and 1990s, but was able to implement some reforms that allow it to control inflation and be fiscally responsible. In 2000, Brazil passed the Fiscal Responsibility Law, which forces the government to set a fiscal target for government expenditures, revenue, and debts, and then stick to it.[23]

Mexico is a different story. There is a saying that when the U.S. sneezes, Mexico catches a cold. The current situation is a bit worse than a cold because the Mexican economy is very dependent on exports to the United States. Other factors affect Mexico's economy as well. There are still major problems with the drug cartels, and in May, the H1N1 flu had a negative effect.[24] The recession in the United States, however, is definitely the major reason why Mexico caught not just a cold, but bronchitis.

Mexico is an interesting case because after it faced the Peso Crisis in 1994, Mexico implemented reforms that encourage more fiscal responsibility, including having a reliable and capable central bank.[25] Even though Mexico is in trouble, it has been able to use fiscal stimulus. It is surviving the crisis in much better shape than it would have without the reforms. In one sense, Mexico learned its lesson in the 1990s. Mexico has a relatively healthy banking system that was not exposed to toxic assets. Also, it has large reserves of foreign currency, which put it in a much better position than before.

Chile has also been implementing significant reforms. It has actually done an excellent job in macro-management. This is because Chile created stabilization funds.[26] During the 2000s there was a significant increase in the price of copper and Chile received a huge windfall. Instead of wasting that money, it put it away and saved it. When it needed to implement fiscal stimulus, it had the stabilization funds to draw from. Chile took the windfall profits from the state-owned copper company CODELCO, and put it away and saved it abroad in bonds. Chile is now considering buying foreign stock with its funds. Chile's finance minister offered the following financial philosophy: Chile will spend what is permanent and save what is transitory. In other words, Chile will spend what it needs to spend, but whatever is extra, Chile will save because Chile is going to need it later. This policy seems to be working very well for Chile.

III. LESSONS AND CHALLENGES FOR LATIN AMERICA

A commonality of these countries is that they have implemented effective policies in a timely manner. This is a plus when looking at the financial crisis. There are lessons from the Latin American experience that can be applied to the future. The first one is that Latin American countries realize that it pays to be fiscally cautious. Latin American countries went through significant reforms in the 1990s that allowed governments to spend money more wisely, and provided them with reserves that gave them some security during the financial crisis. For the region in general, government debt as a percentage of GDP has decreased significantly.[27] They are in a better position, because now that they need to increase government spending, they have room to borrow.

Another important fact for Latin American countries is that central banks and improvements to financial institutions played a key role in allowing these countries to be resilient in the financial crisis. In general, central bank performance across Latin America has been solid; many of the countries have gone from having inflation rates in the triple digits to inflation rates in the single digits. Lower inflation gives them more room to work with monetary policy. They can use expansionary monetary policy without causing significant inflationary pressures. Also, the improvement of financial institutions has been important. There has been a significant increase of credit, as well as financial regulation and supervision. This has allowed the financial system to remain relatively healthy during the financial crisis.

The next lesson is very important. Latin American countries after their reforms of the 1990s were able to build up the credibility of their institutions. Countries did not panic when the financial crisis hit. Even when the economic situation was poor, Latin American countries could pursue stabilization policies. The governments have more control, and the central banks can monitor inflation carefully.

The last lesson is that countries should not be afraid to ask for international help. During the financial crisis, many Latin American central banks worked with the Federal Reserve to insure that they would have enough foreign currency reserves.[28] Cooperation is very important. Until recently, Latin American countries were very reluctant to get help from the International Monetary Fund (IMF). In the 1990s, the IMF gave them loans, but attached stringent conditions. The IMF eventually changed that approach. It created a flexible credit line in the midst of the financial crisis. There is no stigma or conditions attached to it. Therefore countries can tap into it and without worrying about damage to their reputations. Mexico took advantage of this credit line in May of 2009, which helped it stabilize its economy.[29] Therefore, more Latin American countries should look into tapping that resource. The World Bank and the Inter-American Bank are also increasing funds available to deal with the financial crisis.[30]

There are several challenges that Latin American countries are likely to face in the future. The first challenge for policy makers in the region is that Latin America's fate depends on the recovery of developed countries. Latin American countries can use fiscal stimulus, but that can only go so far. Their economies depend significantly on their export sector, primarily the export of commodities. Global demand needs to pick up so that commodity prices rise, which will support the export sector in Latin America. Each country can implement its own policies, but in reality global demand is going to play a key role in allowing them to recover. If global demand does not recover quickly, then governments will face some restrictions with their expansionary fiscal policies because they will have fewer revenues to tap into it. They will eventually run out of the extra room that they have now.

Next, policy makers in the region may find it difficult to be fiscally responsible in the midst of a financial crisis if unemployment continues to increase. Latin American policy makers should ensure fiscal sustainability and solvency. If policies in Latin American countries start being perceived as unsustainable, then there is going to be capital flight and less investment. This would be a shame because there have been significant improvements in macroeconomic stability during the 1990s and 2000s.

Another reason that it might be more difficult for Latin American countries to be fiscally responsible is that many Latin American countries have very small tax bases. In order to ensure that they remain fiscally responsible and fiscally solvent, they should implement tax reforms that improve their tax systems. It has been suggested by some that they create an independent agency to monitor government spending and the fiscal stimulus to make sure that solvency is maintained.[31] Other Latin American countries should consider something similar to the Brazilian Fiscal Responsibility Act, as well as stabilization funds similar to Chile's.

Finally, it is important for policy makers to keep in mind that they are dealing with Latin America. While small in comparison to previous crises, the current crisis is still a crisis. Latin America has a long history of instability, poverty, and inequality. According to the World Bank, poverty is around 33%.[32] The financial crisis may increase poverty by 15%. That could create some instability. There is some political instability rising up, so Latin American countries must make certain to maintain a stable environment by continuing the process of democratization and strengthening institutions that promote democracy. They need to be especially careful that social spending is targeted at the population at risk of falling into poverty. Latin American countries need to make sure that social spending is targeted in the right way.

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