

**The 2008 – 2011 Economic Crisis in Financial Markets
Observations on the Causes and Contagion**

**The Impact of the Financial Crisis on Global Banking
Higher School of Economics**

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Latin: Signa rerum futurarum a dis ostenduntur.

English: The signs of future things are shown by the gods.

We have transformed from being a society in which the government had no obligation to guarantee anything to anyone, other than the right to secure life, liberty and the pursuit of happiness, to one in which the government now guarantees every commercial aspect of its citizens lives (with selective exceptions, as purchasers of Lehman Brothers and Washington Mutual Bank (WaMu) know too well). As President Gerald Ford once famously said “The government big enough to give you everything you want is also big enough to take from you everything you have ... “ (including your dignity).

From Forbes magazine, 17 November 2008:

Quoting from John Tamny

“Bernanke argues that today’s problems result from ‘a loss of confidence by investors and the public in the strength of key financial institutions and

markets.” More realistically, investors regularly penalize the institutions they’ve lost confidence in, all the while rewarding those who earned it. That is why capitalism works so well, for capital always reaches those who will deploy it best. What is wrong right now is that investors don’t trust the federal policies that got us here, and they’re correctly horrified that the architects of today’s crisis will now be given seemingly unlimited money to fix that which they broke. In short, investors have lost confidence in Bernanke, Paulson and a Washington political class whose very confusion has made the formerly venerated US economy a laughingstock.” (John Tamny, editor, www.realclearpolitics.com)

The topic of this conference is “The Future of Turkish Industry Under Globalization.” This article will discuss “The Impact of The Financial Crisis on Globalization - The Implications for Turkey.”

The international economic crisis has been precipitated by the coincidence of two economic events: 1) developments in the international capital markets with respect to the issuance of various forms of derivatives; and 2) a run-up in the cost of oil on international markets. These two events are, of course, interrelated in that, as the dollar weakened in response to increasing risk in the credit markets, the cost of oil inflated.

Fundamentals of the Banking Business

The banking business is clearly distinguished from insurance and investment banking and the regulatory structure most generally has recognized the clear distinctions. Fundamentally, banking involves the taking of deposits on short- or intermediate-term basis subject to a depositor’s demand withdrawal rights. Investment banking involves employment of equity capital or borrowed

funds not subject to demand withdrawal. Insurance involves the purchase of security against the risk of loss from covered events which can include default on financial instruments.

I) The “Business” of Banking

Bank lending is of two forms: lending secured against the value of collateral (asset based lending) and lending “secured” against “historical” personal or corporate cash-flows. In normal times, assets are either at least of stable or increasing value. Similarly, in normal times, cash-flows tend to be stable, moderately increasing or oscillating about moderately increasing trend-lines.

Occasionally, the economic fundamentals break down. In the period from 1978/79 to 1983, following the oil turmoil of the mid-1970s and the Congressional dismal (badly implemented) dismantling of state usury laws, interest rates soared to untenable levels resulting in th destruction of asset-values and cash-flows. Again in the mid 1980s, Congress eviscerated the remains of the successfully stimulative 1981 Economic Recovery Tax Act, again with a badly structured phase-out of the ACR (depreciation) provisions resulting in such substantial deflation in asset value that more than 3,000 banks and savings & loans were closed and more than \$ 500 billion in assets were transferred to the Resolution trust and liquidated. In the current crisis the stage for a catastrophic disaster was set following 9-11(September 11, 2001), the lowering of the Federal Reserve discount rate below two percent for a period of over two years, coupled with the inter-departmental/agency regulatory squabbles over derivatives regulation and Congressional “mandate” for sub-prime and “Alt-A” lending.

The precipitating economic event was the historical run-up in energy costs (oil, in particular) in the late spring and mid-summer of 2008, in large part due to the weakness of the dollar resulting from the Fed’s easy monetary policy. Note

the common factor to all these economic downturns, summed up in the aphorism: “I’m from the government and I’m here to help you.”

Since banks will not lend upon decreasing asset values and/or uncertain or diminishing (or vanishing) cash flows, prudently, banks turn to the only truly secure assets available, i.e., government securities. Indeed, a return of zero to one percent may well be attractive in an economy in which assets values are deflating at two to twenty percent per annum (a de facto real rate of return). Goldman Sachs and Macroeconomic Advisors economists’ have suggested the Federal Reserve’s “federal funds” rate (on inter-bank overnight borrowing) should be - 6% as of 31 January 2009. (See: The Economist, 31 January 2009, p 74, “Monetary Policy - Trapped”)

The real problem for government policy is the reflation of the private sector. In the current, crisis, concomitantly with re-pricing of asset-values, however, the “markets” are reassessing whether there has been a parametric shift in energy costs or whether there will be sufficient availability of energy at affordable (economic) cost that consumers will be comfortable returning to the market. It will be months, maybe even another year or more, before consumers find oil priced at \$35 to \$48 per barrel an indicator of economic stability. Indeed, the current policy of “throwing money” at the problem, in the long run, may be counter-productive to the extent it further weakens the dollar.

II) The Supply & Demand for Funds – Inventory Management in Banking

Banking can also be thought of as a business in which “inventory” management is crucial. Ideally, “just-in-time” rules should apply: the funds necessary to fund a particular loan should be received by the bank at the exact time the funds are to be dispersed to the borrower, and, indeed, the terms of the

loan should be precisely matched, except for the interest rate differential, with the terms of the deposit. In practice, there is a constant inventory of funds (deposits) to be managed by placement in short-term instruments such as treasury securities. The extent of the mis-match results in a global market measured in trillions of dollars.

III) Know Thy Customer Risk Management

The growth of global giants in the banking industry has also resulted in an “impersonalization” such that one of the fundamental rules of sound banking, the “know thy client” rule, no longer is practical. Small, local banks have the ability to observe the lifestyle and conduct of a client on a daily basis. Huge banks lending enormous sums on an institution to institution basis do not have this intimate knowledge of their borrowers and the contractual inclusion of restrictive covenants and/or performance clauses are no better than the auditing procedures by which they are measured.

In speaking of the market for derivatives, there are various “flavors.” There are CDOs, (collateralized debt obligations), CDSs (Credit Default Swaps), option agreements, forward rate agreements, interest-rate swaps, currency derivatives, options and manifold other financial instruments.

The Bank for International Settlements (BIS) estimates that the total “notional” (face value) amount of financial derivatives outstanding is over \$680 trillion as of June 2008. World GDP is estimated to be \$60 trillion, so the amount of derivatives outstanding is more than 10 times world GDP. US GDP is about \$ 14 trillion, while EU GDP is about \$ 14 trillion, so together the US and the EU

account for almost 50% of world GDP (contrast this with the early 1960s when US GDP alone was 60% of world GDP).

The market that has been identified as most “at risk” in the recent economic trauma is that for credit default swaps (CDSs), with the peak amount outstanding in 2007 in the neighborhood of \$62 trillion and, as of October 2008, the amount outstanding is estimated to be \$55 trillion. These are the base amounts of the derivatives presumed to be outstanding, the so-called “notional” amounts. The actual amount of risk is far less in that there is an extensive amount of cross coverage in the insurance contracts issued at CDSs. It should be noted that CDS sellers are banks (44%), hedge funds (32%), and insurance companies (17%).

At the moment, there is no international clearinghouse for these financial instruments and no one really knows the full amount at risk and, more importantly, there are no international standards, or for that matter, national standards as to collateral or reserves that are to be held to provide security for execution of the obligations under the CDS contracts.

It should also be noted that, although, CDSs are the financial instruments primarily at risk in the current crisis due to the high volume of CDS contracts related to the issuance of “sub-prime” mortgages, they are actually less than 10% of the entire market for derivative instruments. The single largest component of the market for derivative instruments is that for interest rate swaps, which are estimated to be over \$390 trillion.

In a primary transaction, such as the issuance of a mortgage on a property, there is always the element of risk. There is the risk that the purchaser may lose his or her job and, ergo, the ability to repay the mortgage, the risk of natural

disaster, the risk of incapacity due to health and other types of risk. In the case of the issuance of sub-prime mortgages, the risk was higher because the financial qualifications of the purchasers were below par. In order to offset the increased risk of default, the ultimate stakeholders in the sub-prime mortgages would purchase derivative instruments to provide insurance against default. But the issuers of these derivative instruments themselves were subject to risk of default and, therefore, in effect, what was created were financial structures with compound probabilities of default. This risk was heightened due to the fact that the derivative issuers had very low or no collateral required to be held against the derivative contracts.

Thus, one of the roots of the current international economic crisis is innovative financial instruments.

In part, this article will discuss the effect of innovations in the financial markets which have occurred over the past 40 years and which have culminated in the creation of instruments which, in part, have precipitated the current economic debacle. This innovation in the financial markets has involved the (non-conspiratorial) collaboration among economists, mathematicians, lawyers and bankers and/or investment bankers . The economists have increasingly refined the micro (and macro) marginal concepts of economic activity. The mathematicians have elegantly described these concepts in terms of systems of equations. The lawyers have captured these concepts in language with sufficient specificity that recordable property interests are identified. The bankers and/or investment bankers sell the resulting property interests incorporated into sophisticated financial instruments to the international financial markets. The problem is that the mathematical sophistication of many of the instruments is so technically complex that determination of the market values of the instruments may cost more than the instruments are worth.

Innovation is often initially destructive. Consider the internal combustion gasoline engine. It was very destructive for the industries that raised horses and other livestock for the use in moving people and pulling wagons. The development of the electric industry was very destructive for the manufacturers of candles and those industries which produced mechanical devices using water power. The potential destruction of the nuclear industry is obvious, but its potential for providing benefit to mankind is equally obvious notwithstanding the dangers. Organized and localized modern farming was destructive for nomadic cultures.

In today's market, people have the ability to be well informed or less well-informed, depending on their diligence or, if they so choose to remain entirely stupid, it is for the most part an individual choice. It is really the remorseless perfidy of governments that is most treacherous and destructive. The current "sub-prime" crisis is a perfect example.

In the past year the world has witnessed is a catastrophic coincidence of governmental incompetence (mostly congressionally mandated) managed by a big bumbling bureaucracy.

One of the most difficult lessons for governments to learn is that there is an economic reality which prevails notwithstanding any and all efforts by governments to manage economies. The Turkish people are more familiar with this concept of economic reality. The reason is that, from time to time, the economic reality of a managed authority, typical in most political systems, the standard of living within the country was at a level below the country's economic potential and the political processes provided enough of a barrier to the outside world that the lower level of economic activity became self-perpetuating. The

government that was “big” enough to provide everything for everyone , in fact could not be counted on to provide anything for anyone.

In the United States, over the last 80 plus years, there has been the emergence of a national culture of increasing dependency on governmental protections. Prior to the explosion of growth of the federal government in the 1930s, the fundamental economic rule for individuals, or contracting parties generally, was, for the most part, **caveat emptor**, that is, “**buyer beware.**” The principal of caveat emptor places responsibility upon the individual for the purchasing decision. If the individual feels that the product is not of the quality desired, then the individual should not buy the product. This idea can and should apply as much to financial products as to consumer durables.

From the 1930s to the present, increasingly, well-intentioned consumer protections have been enacted at the state and federal levels, placing responsibility for the quality of products on the manufacturers of those products and providing increasingly intimidating and punitive legal redress to consumers. From the point of view of populist political policy, the legislatures that created the legal structure of these protections seemed to be acting reasonably logical. But in economies, hundreds of billions if not trillions of transactions are enacted every year and every transaction can be subjected to faulty products and/or buyer’s remorse. The net effect of producing overly protective consumer law is that the marketplace is subject to the potential of millions of legal claims against manufacturers. Moreover, the consumer attitudes have evolved to the point that consumers no longer feel they have any responsibility to evaluate the quality of the prospective purchase, or, at least, to bear the burden of disappointment if the product falls short of their (perhaps overblown) expectations.

in the United States In the last ten months, from August 2008 to May 2009,we have seen the extension of this culture of eroding consumer responsibility extended to all types of financial institutions and all types of financial instruments. In effect, the United States government has become the guarantor of all financial transactions.

Economic Reality # 1

A Simple Example of How Asset Values vary with Rates of Interest:

The example provided below applies to all types of asset values, e.g., prices for homes, buildings, oil & gas and other commodities as well to investments in stocks. The exact extent to which the variation may impact various assets is a function of the risk associated with the assets.

Just prior to September 11, 2001, in the United States interest rates were at about at 7% per annum. At that point in time the Federal Reserve Discount Rate was at about 4.5%. In 9/11 the Federal Reserve slashed the Discount Rate immediately to 2%. It then held the discount rate at 1% for more than a year before beginning to gradually increase the rate.

In this time, the interbank overnight lending rate, that it is, the Federal Funds rate, was also quite low, just above the discount rate. These very low interest rates gave banks and savings and loans and other financial institutions the opportunity to obtain large amounts of money at historically low cost and place those monies into various types of risky investments, including, with governmental encouragement, into so-called and “sub-prime” mortgages. The actual number of dollars that was invested in subprime mortgages was not large relative to the entire pool of mortgage origination. It was in the neighborhood of

20% of all originations. In normal times, the default rate considered “normal” on mortgages is in the neighborhood of 1 ½% to 2%. For the sub-prime loans, the default rate has increased substantially, by some estimates as high as 20%, meaning that one in five of home buyers that purchased homes with subprime mortgages are in danger of foreclosure.

As an example of the economic processes by which assets are impacted by interest rates, consider the following example. It will be assumed that a prospective home purchaser pre-9/11 had available \$900 per month for payment on a mortgage for the purchase of a single-family home, town-house or condominium. If the prime mortgage interest rate available for the purchase of that home were 7%, and the term of the loan was 30 years, the \$900 per month payment could finance the purchase of a home at the amount of \$135,000.

Following the events of 9/11 and the lowering of the Federal Reserve Discount Rate to 1%, it took some time before the financial institutions could put in place lending programs that responded to the opportunity. So we will assume that it took until 2003 for banks to become aggressive and to start offering interest rates below 5%. A purchaser with \$900 per month of income available for a home payment, assuming an initial “teaser” rate of 4.5% and, again, a term of 30 years, would be able to purchase a home in the amount of approximately \$178,000. But the originators of mortgage loans, banks, savings and loans and other financial institutions provided the prospective purchasers with even lower “teaser-rates,” very low rates that would enable the purchaser to purchase a home of even greater value. These teaser rates were set at a very low rate which effectively created negative amortization, that is, the actual principal amount of the loan would increase over the first few years. The typical situation was that the homeowner would be expected to repay the loan at that higher interest rates after a period that varied from three to five years. So, for example, if the interest

rate of a loan originated in 2003 increased in 2007 from 4.5% to an annual rate of 7.5% a monthly payment would increase from \$900 a month to \$1956 per month. Very few homeowners, especially those that were high-risk sub-prime borrowers, could afford to adjust to an increase in monthly payment from \$900 per month to \$1956 per month.

This was even more the case in the fact that from 2003 to 2007 other expenses increased, particularly the cost of energy and specifically the cost of gasoline. A very large proportion of the homes purchased through sub-prime loans were located in distant suburbs, relatively far from the place of business where the homeowner worked. As a result, it was a necessary to drive to work and back home every day, in some cases a drive of anywhere from 15 to lead 35 miles per day each way. As gas prices increased in 2003 from about \$ 2.50 a gallon to close to \$ 4.00four hours a gallon in early 2008, homeowners were faced with gas bills that increased on the average from about \$160 a month to over \$320 a month.

Many of the people purchasing homes in 2003 expected that the prices of those homes would increase sufficiently to “**bail-them-out**”(i.e., relieve them of the dangers of negative equity). Indeed, as is usual in an expansion, home prices increased by anywhere from 6 % to 20% in the first two to three years following 2003. A homeowner experiencing 10% per annum growth in the price of a home after three years, by 2006, would see the \$135,000 home become a \$180,000 home. Other prospective homeowners saw the market trend and jumped on the bandwagon.

The problem began when the Federal Reserve started increasing interest rates, albeit relatively slowly, in late 2002, intent on restraining inflation. By mid-2008 the Federal Reserve discount rate increased to about 4.5% and the

corresponding mortgage rates charged by mortgage originators increased in the range of 7 % to 8%. The increased price of money, that is the interest rate, led to a substantial decline in the price of homes. Initially homes declined in price by eight to 10% but subsequently have declined as much as 30 to 40% in some markets.

This meant that the subprime borrowers were “**upside-down**” in their home purchases, that is, the value of the loan on the property was higher than the value of the property. This was especially true for late comers to the market, that is, those that entered the market in 2006 and 2007.

Economic Reality # 2 Energy Prices

Commodities are subject to the same economic rules which apply to all assets. It is not surprising that following 9/11, as interest rates were lowered and the dollar correspondingly weakened, the price of oil and gas increased along with inflation in other asset markets.

In the oil and gas market, as in all markets, **economic reality rules**. Prices rise quickly on the upswing and are sticky on the downswing in the market. Despite the fact that substantial parts of the oil and gas market are controlled by cartels and shadow cartels, economic reality eventually has its way. In the years following 9/11 to mid-2008, gas prices challenged economic reality, rising to \$147 a barrel.

Notwithstanding the effort of the cartels to cut back production, in the end, the market will find a **sustainable clearing price** for oil and gas that **equates supply and demand**.

Reviewing historical precedents in the energy sector, it would not be surprising to see will go as low as \$30 to \$45 a barrel. Just as oil did not remain at its peak of \$147 a barrel for very long, it is quite likely that oil will not remain at its bottom very long. The bottom may only be a matter of a few days and then the prices will again begin increasing to some equilibrium level which is sustainable for a period of years.

If the price of oil moves into the \$40-\$50 a barrel range as an average for 12 to 24 months as a sustainable equilibrium, it is quite likely that certain resources will be uneconomic. For instance, in many cases offshore production of oil **costs** as much a \$70 a barrel. Oil from shale and oil sands may also prove uneconomic at \$40 - \$50 a barrel. The cost of production is simply too much. In this case, most likely the production facilities will be mothballed, at least in the short term.

For most the month of May 2009, the price of oil has ranged from \$50 to \$60 a barrel, largely based on early indicators of strengthening economic fundamentals and anticipation of surging emission of dollars and consequential dollar-weakness.

Economic Reality # 3 Issues of Banking and the Capital Markets.

With respect to the **financial derivatives** that have been evolving over the past 35 years and, specifically, those instruments which have arisen in the past 10 years, it becomes obvious that financial innovative processes can be very disruptive. The question is how does such innovation come about?

In a general sense, every financial instrument is a derivative. A mortgage contract derives its value from a promise by the borrower to repay the amount borrowed. The mortgage (and correlatively, the amount borrowed) is secured by

a “**deed of trust,**” that is a contract that ties the borrower’s obligation to repay to a pledge of ownership, in the event of the borrower’s default, in the purchased property as a security. The purchased property can be taken from the borrower by a legal proceeding if the borrower fails to pay. Moreover, in some cases the lender can seek additional payment from the borrower if the property does not have sufficient value to cover of the losses incurred in the nonpayment by the borrower.

The derivatives most at issue today are those that derive their value, not by direct ties to the property, that is, the real estate, but rather from direct reference to the financial instrument (mortgage & deed of trust). The now infamous financial institutions Freddie Mac (Federal Home Loan Mortgage Corporation) and Fannie Mae (Federal National Mortgage Association) assembled packages of mortgages and sold them through banks and investment banks and to other financial institutions throughout the world. Although these instruments were packaged in a way to be relatively riskless, creative people in the marketplace understood that not only was there risk associated with these instruments but also that there was money to be made by creating other derivative instruments to provide insurance against that risk.

The development of these rather sophisticated financial instruments resulted from a collegial collaboration among economists, mathematicians and lawyers. The economists created concepts of refining marginal economic interests (“**slicing & dicing,**” so to speak), while the mathematicians developed statistically based mathematical models which enabled the economic descriptions to be described stochastically. The lawyers put all of these concepts into words and found ways to provide archival sources for recording be described financial instruments.

Overall, it seems such financial instruments were clever and well intended, but, certainly, there were fundamental flaws in the formulation of these financial instruments. First and foremost, there was a fundamental mistake in risk assessment. In an elementary course in probability and statistics, one learns that the statistical processes by which probabilistic models can be developed which include incorporation of Bayesian prior probabilistic assessments. But, in the end, probability ends up being either zero or one. If your risk assessment is on the mark and essentially correct, the probability that you are right is one. If your risk assessment is off the mark, the probability of you being right is zero.

Fundamental Economic Concepts & Issues

There are certain issues which arise in every economic crisis. First is the concept of “**disintermediation**.” Disintermediation is the process of individuals and companies withdrawing their funds from banks because of the fear that the bank will collapse and their deposits may not be available to withdraw. For example in the few days leading up to its seizure by the US Federal Deposit Insurance Corporation (FDIC , Washington Mutual, a top ten U. S. bank reportedly faced over \$16 billion of depositors’ funds being withdrawn(disintermediation).

Recently, the United States Congress increased the amount of insured deposits in banks and other institutions to \$250,000 per person, per bank. Other bank regulators around the world have done the same thing, including in Russia, where the amount insured has been increased to \$ 26,000 per person, per bank.

The next concept to be discussed is the “LTV” ratio, that is the **loan-to-value ratio**. This is the percentage amount of a loan that a bank is willing to make against the appraised value of a property. Thus, if the LTV ratio is 70 % and property is worth \$100,000, the bank would be willing to lend \$70,000 secured by the property.

What has happened in recent years during the “sub-prime” crisis is that banks have extended the LTV ratio way above prudent levels, in some cases to 100 % and even to as much as 110%. That is, if a property has an appraised value of \$100,000 and the LTV ratio was 110 %, the bank would be willing to lend \$110,000 against a property that was only worth \$100,000. The only explanation for such lending practices was the anticipation that inflation will increase the value of the property, so that after some period of time the loan to value ratio would return to a more rational level. Historically loan-to-value ratios in excess of 70% can be troublesome. Very rarely in a downturn does property decrease in value by more than 30 %. However, in crises such as the Great Depression or perhaps even in the present crisis, values of properties may well decrease more than 30%.

The next issue to be discussed is the “**mark-to-market**” controversy. Following the turmoil with Enron and WorldCom in the early 2001 to 2003 period and with the hysteria that led to the passing of the Sarbanes-Oxley legislation on corporate governance, a rule was implemented that the banks, investment banks and corporations were required by accounting principles to implement a “mark to market” regime. “Mark to market” was one of the primary causative factors in the current downturn.

“Mark to market” requires that the owner of an asset record that asset on its balance sheet **at its current market value** notwithstanding the fact that the

asset may have been purchased at a much higher value at sometime in the past (or a much lower value). Further this accounting is required notwithstanding the fact that the institution has no inclination or intention to sell the asset anytime in the immediate future. This has introduced extreme economic volatility into corporate affairs since the value of assets vary radically depending upon many economic variables.

This “mark to market” policy was every bit as flawed as the policy that was used by the Federal Reserve prior to the Volcker administration in 1980 when the Federal Reserve was using a policy that followed the various components of money supply (M1, M2, M3), primarily M1, in establishing market interest rates. These monetary components varied radically from week to week, and, as a result, this Federal Reserve policy caused significant uncertainty in the marketplace and interest rates increased from 8 % in the mid-1970s up to 21 % (prime rate) in the early 1980s. Policymakers should stay away from enacting legislation that requires tracking wildly vacillating economic variables.

Economic Reality # 4 The Impact of Military Conflict

After 9 / 11, the United States military action against Afghanistan and a year and half later took military action against Iraq. Both of these events have had a substantial impact on both the U.S. and the international economy.

First the cost to the US taxpayer has been close to \$1 trillion, if not more, and there is no clear end in sight. Much of the expense of the war has been funded out of increasing budget deficits, ergo the national debt, so the direct impact on taxpayers has not been substantial. However indirectly the **uncertainty** created in world markets, particularly in the energy market, has had a very

substantial impact on taxpayers. It seems reasonable that the political risk, translated into economic uncertainty, caused by these military actions, especially in the early years has been as much as **30 to 40%** of the price of oil (political risk premium) . That would mean oil at \$100 a barrel would be \$30-\$40 lower were it not for these conflicts. Thus, the risk-premium in the energy market is estimated to be 30 % to 40 %. If political risk in the international markets were reduced, the price of oil would fall further.

The Russian - Georgian military conflict also had a impact on the international markets, although, overall the impact was much less. In the long term, both the US actions in Afghanistan and Iraq in the Russian action in Georgia may lead to longer term stability.

Economic Reality # 5 - Consumer Confidence

The biggest problem in the international marketplace today is a question of **Confidence** and that's confidence with a capital "C." Citizens of the United States, the European Community, Asia and Russia and elsewhere in the world do not have confidence that governments can take actions which will improve the situation. Consumer confidence in the United States is at a low that hasn't been seen in more than 40 years and in both Russia and China, one has the sense that the citizenry is just waiting for the "other shoe to drop," that is, a sense prevails that each country will be faced with a repeat of the 1998 economic crisis.

The only action that would be most welcome by consumers and businesses would be to create favorable tax policies. Faced with a severe recession in 1981, United States adopted the so-called Economic Recovery Tax Act of 1981 which very strong incentives for businesses to invest. The

incentives were so strong that within two years the mostly Democratic controlled Congress took steps essentially to eviscerate the policy. This can be done by legislating a variety of tax reductions, tax credits and incentives focused on business. Faced with a severe recession in 1981, United States adopted the so-called Economic Recovery Tax Act of 1981 which provided very strong incentives for businesses to invest. The incentives were so strong that within two years the mostly Democratic controlled Congress took steps essentially to eviscerate the policy which had been pushed by the Republican Reagan administration. Too much of “good thing” (pro business policies) is not a Democrat controlled Congress’s favorite policy.

Nevertheless, the tax policy implemented by the 1981 act was so proactive that it might very well serve as a good model for the international community to deal with the present crisis.

G20 - Contemplation of Future Policy Developments in the International Markets

1) is arguable that the current crisis has done major damage to the World Trade Organization (WTO). Although, at the G20 meetings, there was an effort to save face by seeking a pledge from members to avoid tariff wars, one of the fundamental principles of constructing bilateral and multilateral trade agreements is that national industrial and financial subsidization should be eliminated. However, in the last several months, nations around the world have taken financial and industrial subsidization to unprecedented levels.

2) the participating G20 nations may well decide to form a derivatives clearinghouse for derivatives issued anywhere in the world. Derivatives not properly registered with this clearinghouse would not be able to seek enforcement on their contracts from national or international judicial fora.

3) derivative instruments of all types may become subject to reserve requirements and/or collateralization similar to that imposed on banks by national regulatory regimes and/or the Basel II accords, as adopted at the national level.

4) banks may be prohibited from issuing variable rate loans of any type or loans with “teaser” interest rates and be required only to issue fixed rate obligations. In the consumer marketplace, the issue is that banks are better able to judge future financial variations than the consumer and, for that reason, the consumer should not be subjected to the vagaries of the financial marketplace.

5) banks may be limited in the loan to value ratio (LVR) of their loans. The loan to value ratio may be limited to 60%, 70% or perhaps even 80%. This would require borrowers to have a substantial stake in their financial transactions. This may or may not preclude the formation of special high risk lenders, not banks, that could loan monies for purchases up to a higher loan to value ratio (even to 100%). These entities would not be banks, but would be specialized financial companies. These loans could not be resold in secondary markets and could not be insured by derivative instruments.

6) corporations may have restrictions placed on their debt to equity ratios. The debt to equity ratio maybe limited to some level in the neighborhood of 60 – 40 to perhaps 80 – 20. In imposing this type of limitation, governments ought to give

consideration to the elimination of the tax advantages that are now available for interest deductibility on borrowed money.

7) all members of the G20 need to give consideration to reducing the complexity of their tax codes and provide substantial reductions in both personal and corporate taxation.

8) bar (prohibit) loans used for the purchase of corporate stock.

9) require rating agencies (Moody's, Standard & Poors, Fitch, etc) and appraisers to be fully independent and to hold capital reserves in the event of substantial error in appraisals.

10) alter the Basel II risk model portfolio appraisal procedure to provide a base capital requirement plus risk weighted component.

11) drop the market-to-market ("fair-valuation") asset markdown/markup procedures.

12) for loans in default, allow banks to make reasonable judgments as to the eventual "collectability" of said loans.

13) impose caveat emptor (buyer beware) as the legal standard in all contracts (both consumer and commercial contracts, including financial contracts). Once buyers realize that they, and they alone, have the responsibility for the quality assurance of the purchase, much of the commercial litigation will cease. Only true force majeure would provide the basis for setting aside the obligations of a contract.

14) a G20 imposition of “stand-still” agreements (moratoria on foreclosures and other legal actions for collection on loan agreements. This recognizes that the damage done by such legal action often results in the lender receiving 10% to 30% of the amount borrowed, as the borrower is often forced into bankruptcy, and historically, after a period of one to five years, reflation usually restores underlying asset-values to pre-crisis levels. This approach, of course, raises serious constitutional issues.

15) tax law should be amended to encourage corporations to retain earnings in amounts necessary to survive a downturn (U.S law has an “accumulated earnings” provision that applies penal tax levies if firms have “excess” retained earnings (which basically means not enough money is being directed into the Federal revenue stream, thereby depriving Congress of money to “play” with, which Congress is all too want to do).

16) Reconsideration should be given to the universal banking model, ensuring that the capital requirements accross product lines are adequate and that the “firewalls” which are intended to prevent conflicts of interest are real and effective. If effective fire-walls can not be constructed, it may be necessary to revive legislaton of the 1937 Glass – Stiegel Act which required banks, investment banks and insurance companies to be fully independent entities..

These are the issues that are common to international capital markets regulation. It is not to be argued here that implementation of the foregoing policies would be enacted as the proposals certainly would face extra-ordinary opposition from a wide-variety of stake-holders just as was the unsuccessful effort in the United States in the late 1990s to regulate financial derivatives.

Compensation -

One of the more controversial issues in the current crisis is the seemingly extravagant compensation of financial executives in the amounts of tens of millions of dollars.

As the issue is exploited by politicians, individuals in banking, investment banking and the insurance industry are portrayed as greedy capitalists responsible for the collapse of the world economy, notwithstanding the fact that the crisis is far more rooted in the megalomaniac incompetence of the political classes.

For the most part, the compensation was based on performance clauses contained in employment contracts signed well before the crisis was on the horizon. However, at a time when tens of billions of taxpayers dollars were being injected into the financial markets to keep the companies from bankruptcy, it was certainly politically insensitive for the financial industry executives to initiate such payments, not withstanding the fact that the payments were earned and failure to be pay would constitute breach of the employment contracts.

**Dr. Karl Viehe
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Note - Karl William Viehe, B.A., M.A., J.D., M.L.T. - Mr. Viehe has been the U.S. Vice Chairman of the Russian - American Securities Law working group. In this capacity, Mr. Viehe was a principal drafter of the Russian Capital Markets legal structure implemented 28 December 1991 by President Yeltsin. The co-chairman of the working group was Dr. Yegor Gaidar, named shortly thereafter as Acting Prime Minister, on the Russian side, and, on the American side, Mr. Richard Bernard, now Executive Vice President, General Counsel, New York Stock Exchange. Mr. Viehe drafted substantial portions of U.S. AID's Commercial Bank Training Program, also contributing significantly to the commercial bank training program implemented by the World Bank.

Mr. Viehe has been an Adjunct Professor of International Law (and, in 1995, designated as the "Scholar in Residence" at the National Law Center) at the George Washington University, Washington D.C., and Adjunct Professor of International Business at the American University, Washington, D.C. and a member of the faculty at the International Law Institute, Washington D.C. Mr. Viehe has also taught at St Albans School (National Cathedral School for Boys) and Georgetown Visitation School.

Mr. Viehe has twice been Co-chairman, with the General Counsel of the Department of Commerce, of the U.S. Department of Commerce annual conference on "Current Issues in International Trade" and three times co-chairman, with the Internal Revenue Service Assistant Commissioner(International), of the United States Internal Revenue Service's annual conference on "Current Issues in International Taxation." These events have been co-sponsored by The George Washington University.

Mr. Viehe has provided legal consultation, guidance and advice on Eurasian market projects to CONOCO, Chrysler Corporation, Marriott, General Motors and a number of other U.S. companies.

In 1995, as a member of the Pugwash Society, Dr. Viehe shared in the Nobel Peace Prize awarded to that society for its more than half a century working towards world peace.

Mr. Viehe has spoken at international conferences and/or meetings in the United States, Russia, Poland, Belorussia, Armenia and Georgia and authored more than twenty publications.

BUSINESS CONSULTATIONS

1990 to 1996: - Consultation to the World Bank, the United States Information Agency and the Central Bank of Russia on the development of training curricula for the training of commercial bankers throughout Russia. A substantial part of the training program was based on the curriculum I provided.

1991 to 1995:

CONOCO Oil - Consultation on “Polar Lights” oil project in Russia, a \$440 million dollar investment. Included liaison with the Department of the Treasury, Department of Commerce, the United States Federal Reserve, The U.S. Export-Import Bank, the Overseas Private Investment Corporation (OPIC) and various agencies of the World Bank.

1991 to 1994: - Consultation with a U. S. auto dealership group and Chrysler Corporation on various projects in Russia, including a project to establish dealerships in eleven cities, mostly in capitals of republics of the constituent states of the former Soviet Union. This project was terminated shortly after the events of October, 1993 at the Russian White House, due to the perception of excessive political risk.

1996 - 1997: - U.S. General Counsel for PromstroiBank of Russia (Industrial Bank of Russia). Consultation on successful strategy to have PromstroiBank registered as the only Russian bank to be accredited in the United States, both by the State of New York and the United States Federal Reserve Bank. PromstroiBank became insolvent in the 1998 Russian financial collapse and was subsequently liquidated..

1996 - 1999: - Conceived of and initiated application for the first financial instrument guarantee issued by the World Bank’s Multilateral Investment Guarantee Agency; successfully developed strategy and guided the recipient to issue of the guarantee to an investment fund for Ukraine, listed on the Irish stock exchange, in the amount of \$100 million.

1992 to 2002: - Consultation to General Motors in Russia on various projects, most recently personal consultation with the President of General Motors, Russia in the Chevrolet - Niva Project, which commenced production of a sport - utility vehicle in September 2002, with a capitalization of \$330 million.

2005 to Present : - Consultation to Sojitz Company (www.sojitz.com) in Russia on various projects in the oil & gas and automotive industries. Sojitz is a large Japanese trading company with annual revenues in excess of \$ 40 billion. Current projects include liquefaction of natural gas and retooling of Russian automotive industrial enterprises, with project values in excess of \$ 10 billion.

2007 to Present : - Consultation to Gaz Group (www.gazgroup.ru) in Russia on various investment banking and business development projects in the automotive industries involving contracts and proposed partnerships with foreign companies. Gaz Group is a large Russian manufacturer of cars, buses and trucks with annual revenues in excess of \$ 4 billion. Current projects involve acquisitions and interim refinancingю