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ABSTRACT: On the surface, there could be no two worlds farther apart than Haifa Street in Baghdad and Wall Street in New York. Similarly, no two cultures could be more different from those of the National Security Council's Situation Room and a Wall Street financial firm's corporate suite. However, over the last decade no two centers of power have dominated the news in the United States more than the Pentagon's wars in Iraq and Afghanistan and Wall Street's ongoing financial and economic crisis. Based on research, analysis, and interviews with senior leaders from the financial services industry and the 2010 Quadrennial Defense Review, it is clear that both national security and financial services are inextricably linked with national power and the ability of the United States to project that power around the world.

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PLACES VISITED

Domestic:

Washington, DC Area:
Commodity Futures Trading Commission (CFTC)
Pentagon Federal Credit Union
Financial Industry Regulatory Authority (FINRA)
Morgan Stanley
Federal Reserve Board of Governors
Office of U.S. Senator Kay Hagan
Carlyle Group
Glover Park Group
Bank of America, Mid Atlantic Region
Lockheed Martin
Northrop Grumman
Securities Exchange Commission (SEC)
Federal Deposit Insurance Corporation (FDIC)
Center for Naval Analysis
Freddie Mac
CareFirst Inc.
In-Q-Tel

San Antonio, Texas: United Services Automobile Association (USAA)

New York City:
American Securities Capital Partners
New York Stock Exchange
Federal Reserve Bank of New York
Barclays Capital
New York Mercantile Exchange
Allen and Company
Financial Times
Moody's Investors Service
Goldman Sachs
American Express

International:

Beijing, China:
U.S. Embassy
UBS China
China Investment Corporation
China Banking Regulatory Commission
China International Capital Corporation

Shanghai, China:
U.S. Consulate
U.S. China Business Council
ZBen Associates
CLSA
Chinavest
Wachovia
HSBC

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"I've said this repeatedly, we have to have a thriving financial sector. Because essentially, part of what's made America so successful is our ability to….finance our dream – and make it happen."[1]

President Barack Obama

INTRODUCTION

In 2008, the United States experienced a severe financial crisis that shook the nation's economic core and threatened global stability. Given the wars in Iraq and Afghanistan, the financial crisis could not have come at a more inopportune time. America's dwindling military clout was suddenly exacerbated by its weakened financial influence. As a result of an oversupply of money, over confidence in the growth of real estate prices, poor lending standards, new and poorly understood financial instruments, an over-reliance on credit rating agencies, excessive use of leverage, huge foreign capital flows, and inadequate government regulation, the United States' financial system teetered on the brink of insolvency. The crisis ultimately led the United States into the deepest recession since the Great Depression of the 1930s, and plunged the global economy into a widespread contraction. Unfortunately, the financial crisis not only had an immediate impact on U.S. national power and status but will most likely have a long term negative effect on the ability to maintain present funding levels for the U.S. military.

Today, the financial system has stabilized, and new financial regulatory legislation is pending in Congress to prevent a recurrence of the most recent crisis. Concurrently, as the war in Iraq winds down, the conflict in Afghanistan is picking up. The accumulated costs of nearly a decade of war are not only a burden on the nation's finances, but in a self-reinforcing loop, they make it more difficult to recover from the financial crisis. Simultaneously, the financial crisis and the resultant federal stimulus put heavy pressure on the military to cut near and out-year spending. The Congressional Budget Office forecasts a $1.4 trillion budget deficit in 2010, which represents 9.2% of gross domestic product (GDP) and is the second highest such ratio since World War II.[2] In the future, the debt-to-GDP ratio is forecasted to rise from 53% in 2009 to 60% in 2011, and 67% by 2020.[3] To finance the mounting debt, the U.S. increasingly relies on foreign creditors such as China, who currently holds $877 billion of Treasury securities.[4] As a result of the growing national debt, the U.S. faces the threat of a sovereign debt rating downgrade that would trigger higher interest rates, slower economic growth, and a weakening of the dollar's standing as the global reserve currency.[5] With a reduction in financial strength, the United States' ability to project its power and influence throughout the world diminishes.

In light of the 2008 financial crisis this report examines the health of the United States' financial services industry and its relevance to national security, especially in a military context. It then examines the impacts and adequacy of current regulatory reform initiatives to prevent future financial crises, reduce systemic risk, and reduce the probability and effects of a downgrade to the United States' credit rating. The report then considers the international ramifications of U.S. regulatory reform and a sovereign debt downgrade, especially vis-à-vis China. Finally, the report provides U.S. government policy recommendations to prevent a recurrence of the most recent financial crisis and strengthen the financial system to reaffirm U.S. global financial leadership.

FINANCIAL SERVICES INDUSTRY IN A MILITARY CONTEXT

On the surface there could be no two worlds farther apart than Wall Street in New York and Haifa Street in Baghdad. Similarly, no two cultures could be more different than the Pentagon's E-ring and a Wall Street financial firm's corporate suite. However, no two centers of power have dominated the news more than the wars in Iraq and Afghanistan and Wall Street's ongoing financial and economic crisis. Both of these worlds are inextricably linked with national power and the ability of the U.S. to project that power around the world. The Department of Defense (DoD) released its Quadrennial Defense Review (QDR) Report in February 2010. There are three nexus points between the QDR and the financial services industry. First, both DoD and Wall Street are vulnerable to asymmetric attacks that could disrupt or destroy their ability to function effectively. Specifically, as demonstrated by the 9/11 attacks, both are vulnerable to terrorism and each is increasingly vulnerable to cyber attacks. Second, the QDR heavily emphasizes DoD's need to better integrate with civilian, government, and private sector institutions in order to best use the full panoply of power available to the U.S. Last, acquisition reform is vital to the way DoD wants to do business in the future, and the financial services industry plays a key role in the capital markets for defense firms.

DoD and Wall Street - Threat of Asymmetric Attacks. The QDR begins by saying, "the United States is a nation at war."[6] The QDR could have better elaborated by stating, the United States is a nation at war in the midst of a worldwide economic crisis. Though the 9/11 attacks in New York and the Pentagon were nearly a decade ago, the threat has not changed. In many ways the security environment has become a more complex "and uncertain security landscape in which the pace of change continues to accelerate… [and further] the distribution of global political, economic, and military power is becoming more diffuse."[7] Though DoD has always planned and operated in this volatile environment, following the 9/11 attacks and the subsequent economic crisis, Wall Street now finds itself in this uncertain and dangerous arena.

DoD and Wall Street - Better Integration. President Obama's vision for U.S. foreign policy is that national interests are based upon a strong domestic foundation and emphasizes the integration of all elements of national power.[8] From the general integration of elements of national power to the specific integration of cyberspace capabilities, DoD and Wall Street are each integral to the President's vision. The elements of national power can never be separated from one another. Military and economic power must go hand in hand - vividly described in the QDR as the "connective tissue of the international system."[9] The QDR lays the foundation for implementing this new vision by describing how globalization has intertwined the "strength and influence of the United States…with the fate of the broader international system."[10] In today's world, DoD's missions in Iraq and Afghanistan are as equally important to national interests as Wall Street's ability to provide capital markets.

DoD and Wall Street - Defense Industrial Base. In addition to detailing global threats and proposing new avenues for integration of national powers, the QDR also focuses on reforming business practices. At the top of the list is DoD's weapon systems acquisition process. Per the QDR, DoD's focus is on two areas: resetting and rebalancing the force, and acquisition reform.[30] Both DoD and Wall Street play key roles in how the U.S. acquires military capabilities and each have equity in reforming the acquisition process. Nearly eight straight years of war have taken a toll on military hardware. Everything from helicopters to trucks has been utilized at unanticipated rates. The QDR is clear: the U.S. “must reset equipment lost through combat.”[11] Coupled with the sheer replacement of equipment is the Pentagon’s desire to rebalance DoD’s weapons systems to focus on today’s non-traditional wars instead of the Cold War. Further, DoD would like to reform the acquisition process in order to “buy weapons that are usable, affordable and truly needed; and ensure that taxpayer dollars are spent wisely and responsibly.”[12]

Recommendation: The Pentagon and Wall Street are only 250 miles away from each other but historically they always seem much farther apart: fatigues and power suits are rarely in the same room together. However, today’s volatile, international threats, coupled with the ongoing economic malaise, have brought DoD and Wall Street together and the recent QDR highlighted their nexus points: shared threats from asymmetric attacks; the need to integrate military and economic powers; and joint concerns about the future of the defense industrial base. In addition to the QDR initiatives concerning these three areas, there are two other endeavors the Pentagon and Wall Street should cooperate on: Wall Street-military educational exchanges and establishing a capital markets forum to give Wall Street better insight into defense procurement plans. By working together, DoD and Wall Street can integrate their respective elements of national power in order to counter the increasingly complex array of national security threats facing the United States.

HEALTH, OUTLOOK, AND IMPORTANCE OF THE U.S. FINANCIAL SERVICES INDUSTRY

The financial services industry is the foundation of the United States’ prosperity and global economic power. It comprises a wide range of consumer and commercially oriented companies that offer a variety of products and services, including various consumer lending products, insurance, and securities and investment products. The industry includes banks, credit card companies, insurance companies, consumer finance companies, stock brokerages, private equity firms, venture capital firms, investment funds, and government sponsored enterprises.

Banking:

Impact of the Financial Crisis on Commercial Banking. In response to the 2008-2009 financial crisis, the commercial banking sector received unprecedented financial support through various U.S. government programs (i.e. Troubled Asset Relief Program, Temporary Liquidity Guarantee Program, Term Asset-Backed Securities Loan Facility, and Public-Private Investment Program) while simultaneously undergoing large-scale consolidation. Under close federal oversight, four of the top five commercial banks either merged or acquired other large banks struggling with mounting financial losses. Washington Mutual became the largest bank failure in the U.S. in terms of assets and was acquired by JP Morgan Chase. Crippled with rising losses, Wachovia was purchased by Wells Fargo. At the beginning of 2009, a struggling Merrill Lynch was purchased by Bank of America. With these consolidations, the commercial banking landscape drastically changed as the four largest commercial bank holding companies, Bank of America, JP Morgan Chase, Citigroup, and Wells Fargo increased their market share of the commercial banking industry from 23% in 2008 to 38% in 2010.[14]

In order to restore public confidence in the banking sector's ability to withstand difficult economic conditions, the U.S. government conducted stress tests in April 2009. These tests, known as the Supervisory Capital Assessment Program (SCAP), estimated loan losses for the top 19 banks under a base case and an adverse scenario. Following these tests, 8 of the 19 companies tested were required to raise additional capital to be able to withstand further economic turbulence. With the government's "soundness approval", it became relatively easy for the banks to raise funds from the capital markets. With access to the capital markets, banks were able to increase their Tier 1 capital ratios and pay back the funds received from the TARP. With restored confidence in the major banks and improved Tier 1 capital ratios, the commercial banking industry stabilized.

Health and Outlook for the Commercial Banks. While the overall banking environment has stabilized, the industry continues to cautiously maintain adequate capital levels and avoid excessive risk which leads banks to hold excess reserves and reduce the number of loans they are willing to make. Banks with strong capital levels have already paid back their TARP funds and will likely continue to grow market share, attract higher quality borrowers, and recruit a better workforce. While the overall industry may have stabilized, it still contains a large number of smaller unhealthy banks. At the end of 2009, the Federal Deposit Insurance Corporation (FDIC) had 702 distressed banks on its "problem list", up from 552 in September and 416 at the end of June.[15] With a growing number of troubled banks near insolvency, the industry will continue to consolidate.

The nature of the financial industry favors large banks due to economies of scale. Larger banks, which offer multiple products, are able to leverage their distribution systems to provide the widest variety of financial products to the greatest number of people in the most efficient manner. It is also easier for them to advertise widely and generate name recognition. Access to low-cost financing is also a key advantage; larger banks generally secure financing for their operations at lower costs compared to smaller competitors.

Competition among banks is based on customer service, interest rates on loans and deposits, range or variety of products and services, lending limits, and customer experience. Despite the decline in the number of commercial banks and an increase in the number of ATMs, growth in the number of banking offices highlights the continued need to be accessible to customers. Competitive conditions will further intensify as merger activity produces larger, better capitalized and more geographically diverse companies capable of offering a wider variety of financial products and services at more competitive prices. Competition for retail deposits will also intensify as banks seek to reduce their reliance on wholesale markets for funding. New entrants into retail banking such as Goldman Sachs and Morgan Stanley will also increase competition in the industry. As competition in domestic markets intensifies, larger banks will look to build their business overseas.

Post Financial Crisis Banking Regulation. The U.S. government must explore better ways to regulate the banking and consumer credit industry to prevent a recurrence of the 2008-2009 financial crisis. One of the laws that Congress should review is the 1999 Gramm-Leach-Bliley Act, which allowed investment banks, commercial banks, and insurance companies to merge into "financial supermarkets." Under this law, commercial banks, investment banks, and insurance firms are allowed to merge and ultimately form institutions that are "too big to fail." Additionally, the lack of a central regulator for investment banks and insurance companies requires review. Other regulatory concerns include the number of regulators and their individual responsibilities. Many of the products that started the financial crisis such as sub prime mortgages are under-regulated. Congress must also look to regulate other areas of the financial system that pose risk, including hedge funds, derivatives and the credit default swap market. While the future structure of financial regulatory reform is unknown, it will undoubtedly change the banking industry's business model.

Government Sponsored Entities:

Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac operate under government conservatorship and at the end of 2008 owned or guaranteed 56.8% of the U.S.'s $12 trillion home mortgage market.[16] It is widely accepted that lax lending standards in the U.S. mortgage market during the early 2000s and a widespread belief in increasing home prices ultimately led to delinquencies and foreclosures that shocked the U.S. and the downfall of Fannie Mae and Freddie Mac. Imprudent mortgage lending, aggressive mortgage securitization, lack of transparency and accountability in mortgage finance, government encouraged sub-prime lending, and failure of risk management systems are all causes of the financial crisis that can be partially linked to the Community Reinvestment Act (CRA) and the operations of Fannie Mae and Freddie Mac.[17]

Proponents of the CRA do not believe the act contributed to the financial crisis. Many opponents and proponents, however, agree that the CRA enabled "yield chasers" to seek fast profits in a frenzied environment that led to the unintended consequence of people owning homes without adequate equity or an ability to repay the loan. Many borrowers had poor credit, no income or limited income, and should not have received a home loan. In a CNN commentary, Congressman Ron Paul, a member of the House Committee on Financial Services, cited the CRA as a federal requirement that "forced banks to lend to people who normally would be rejected as bad credit risks."[18] Michael S. Barr, a former Treasury Department official, stated that institutions fully regulated by CRA made "perhaps one in four" sub-prime loans and that "the worst and most widespread abuses occurred in the institutions with the least federal oversight.[19] Bob McTeer, President of the Dallas Federal Reserve Bank from 1991-2004, reinforced the detrimental effects of the CRA by testifying that "there was a lot of pressure from Congress and generally everywhere to make home ownership affordable for poor- and low-income people. Some mortgages were made that would not have ordinarily been made. When a bank made a decision to purchase mortgage-backed securities (MBS), they would somehow determine if some of them were in zip codes covered by the CRA, and therefore they could get CRA credit."[20]

While CRA legislation contributed to the demise of the housing sector, the slowing economy amplified existing weaknesses in the housing market. Economic growth drove GDP expansions of 3.1, 2.9, and 2.2% in 2005, 2006, and 2007.[21] A portion of this growth, however, was built on highly leveraged products such as the housing loans that were securitized and hedged with credit default swaps. These complex financial securities were sold globally and ultimately became very difficult to value in relation to the underlying assets. With increasing home values, readily available home equity credit, and large mortgage market profits there was no perceived need for regulatory action.

With the CRA requirements and an expanding market for mortgage-backed securities, financial institutions also embraced aggressive lending practices. Following 2002, full loan-to-value (LTV) ratios rose significantly and secondary liens became more common and larger. By 2006, more than 25 percent of non-prime originations had LTV ratios of 100 percent or more.[22]

At the same time, the Federal Reserve was managing an increasing appetite for more U.S. dollars which put downward pressure on interest rates.

Approximately 14 million U.S. homeowners currently owe more on their homes than what their homes are worth. In the next two years, projections call for additional home foreclosures. To stabilize the market, the Federal Reserve has been keeping interest rates low and purchasing mortgage-backed securities so homeowners can refinance their existing homes and banks can issue loans for new home purchases. The Federal Reserve's mortgage-backed security purchase program ended on 31 March 2010 with $1.25 trillion in purchases.[23] Absent the Federal Reserve buying mortgage-backed securities, private entities, international countries, and sovereign wealth funds are anticipated to make purchases. While the U.S. housing market appears to have stabilized, a significant number of experts believe mortgage rates will rise starting in June without Federal Reserve intervention.[24] On a positive note, Fannie Mae reports that 2009 average new loan metrics are looking significantly better when compared to 2007: a loan to value 67% vs. 75%; FICO score 761 vs.716; mortgages refinanced 80% vs. 50%; interest-only mortgages 1% vs. 16%; sub-prime mortgages are not statistically significant vs. 17%.[25]

Venture Capital and Private Equity:

Impact of the Financial Crisis. With peak returns of 165% in 1999, private equity and venture capital investments were once considered the road to riches for those wealthy enough to take part in the venture. Despite this huge success, the industry was not immune to the 2008 financial crisis and large losses. Economists and investors differ on the future prospects of private equity and venture capital investing. Some predict an end to the current method of doing business while others argue that with minor regulatory modifications, private investment has the resiliency to weather the current economic storm.

Despite recent disappointing returns, private equity investing continues to rise. Private equity deal volume grew almost eightfold from 2000 to 2007 with total capital invested going from 3% to almost 25% during the time period.[26] A 2009 Preqin research report indicates private equity firms are sitting on a record $1 trillion with which to make new purchases, waiting for the right opportunity to invest.[27] Investor confidence points positively towards a recovery of the market. While these examples do not speak for the market at large, they do demonstrate confidence and a desire to continue these types of ventures.

Venture capitalists did not fare much better than private equity investors. From their peak in 1999, venture capital generated a dismal 8.9% loss in the first quarter of 2010 and have averaged a 0% return since 2004. One of the biggest challenges facing venture capitalists is the lack of exit strategies. During their peak performance in the late 1990s, investors made huge profits when companies went public during an initial public offering (IPO). In 2009, only 13 venture-backed firms went public, down from 94 in 2004 and 271 at the height of the boom in 1999.[28] With fewer companies going public, venture capitalists must find alternative methods to cash in on their initial investments. According to the National Venture Capital Association, the revitalization of the venture-backed IPO market is critical to the U.S. economic recovery and to the ongoing viability of America's competitiveness.[29] In an industry where profit is the measure of success, the lack of a functioning IPO market hinders positive returns.

The Next Innovative Market. The information technology (IT) boom fueled the success of venture capital investments in the 1990s. With IT maturing, investors must now find the next innovative market, and many appear to be leaning toward clean technology. "Clean technology" describes knowledge-based products or services that improve operational performance, productivity, or efficiency while reducing costs, inputs, energy consumption, waste, or pollution. While clean technology has the potential to become the next innovative market, especially as governments mandate its usage, it also makes the market dependent on government support. Private investors may find themselves competing against corporate giants with more capital and stronger connections to lawmakers. The government's role will be crucial to provide sufficient incentives for desirable investments while not mandating inflexible solutions that hamper investment opportunities.

Impact on Innovation. Economists argue the benefits of venture capital on innovation. Apple, Microsoft, Google, and Starbucks are examples of successful venture capital backed companies. Combined, these four companies accounted for 10 million jobs and $2.1 trillion in revenue between 1970 and 2005.[30]

Skeptics of venture capital financing argue that for every successful corporation there are multiple failures. While this is true, the gamble for investors is to pick enough winners to outperform the inevitable losers. Additionally, opponents argue many of these now successful companies could have acquired capital through conventional means and have been equally successful. While this may have been possible, conventional lending institutions may have been reluctant to take the risk of investing in a company without an established performance record.

Future Sources of Capital. Future sources of capital for private equity investments will likely come from outside the U.S. Global capital, specifically from Asia will source much of future funding. As an example, in November 2009, the Blackstone Group signed a $732 million joint venture with Shanghai's municipal government creating the first U.S.-Chinese private equity fund denominated entirely in Chinese currency.[31] There is insufficient data to confirm if other firms will follow this U.S.-China model, given the obstacles to forming joint ventures such as this. In addition to U.S. regulation, there is the uncertainty surrounding the future application of China's regulatory laws. It is also important to note that this deal may be an anomaly given the Chinese government's $3 billion stake in Blackstone.

Likewise, venture capitalists will need to seek alternative sources of capital for future ventures. Prior to World War II venture capital relied on investments from wealthy individuals. In 1979 the Department of Labor clarified the Employee Retirement Income Security Act lifting restrictions on pension funds from making risky investments and enabling pension funds to take a more prominent role in venture capital investments. Today, venture capital investments come from institutional investors such as banks, financial institutions, public pension, endowments, family foundations, corporate pension plans, and insurance companies. Much like private equity, venture capitalists may need to expand their sources of capital to markets outside of the U.S. such as China, India, and Vietnam.

Post Financial Crisis Adaptation: In the past, private investors enjoyed a large degree of regulatory freedom, but future investors will need to adapt to a changing political environment. As the political dynamics change, firms must respond to new regulatory, fundraising, and portfolio management demands. This will require a larger and more costly administrative infrastructure, so investment teams can remain focused on the investments.[32] This will become evident as the industry departs from the IT environment and enters into other potential markets such as clean technology where government oversight will become the norm.

It is unlikely that the private equity or venture capital industry will see triple digit returns in the near future, but over the long term and some innovative ideas anything is possible. The fundamental strategy of a high risk/high payoff venture remains true today and in the future.

IMPACTS AND ADEQUACY OF U.S. FINANCIAL REGULATORY REFORM

A spotlight has been placed on reform of the financial services industry in reaction to the recent financial crisis, even though the financial services industry holds the distinction of being one of the most heavily regulated of all industries. While the sense of immediate crisis has passed, government and industry stakeholders are attempting to develop long-term reform actions. Topics like systemic risk, consumer protection, and regulatory roles will dominate the news for the foreseeable future. This section addresses regulatory reform in several specific areas.

Financial Services Oversight Council

A key proposal is the establishment of a Financial Services Oversight Council. As proposed by the White House, the council would be comprised of existing regulators (i.e. Treasury, SEC, Federal Reserve, FDIC, etc.) and would monitor large firms whose failure pose a risk to the entire financial system.[33]

While few seriously object to the creation of a council, some critics doubt its potential effectiveness. Critics cite differing missions among organizations, bureaucratic turf wars, and a mutual lack of respect for each other as limiting factors.[34] The result is a "feel good" council that addresses public concerns, but has little actual teeth. Douglas Elliot, a former executive at JP Morgan Chase and now at the Brookings Institute, observes, "It's always very difficult to act against a bubble: A committee of bureaucrats doing it? I don't see it happening. Bubbles are politically popular; they are always going to happen."[35] In other words, the ability of such a council stopping the next financial bubble or crisis is slim. This proposal appears headed for approval because it shows action, but in reality, it would likely have little effectiveness.

Impact of Future Regulation on a Potential Downgrade to the US Credit Rating

One obvious question is whether or not a new regulatory regime can prevent the next crisis. One possible crisis would be the result of a downgrade in the U.S. credit rating. Moody's recently warned it would consider downgrading its triple-A rating for U.S. Treasury Bonds if the U.S. continues to record large deficits.[36] A downgraded credit rating would signal the U.S. is no longer one of the safest places to invest, lead to higher interest rates, and could push U.S. debt even higher.[37] Unfortunately, this is a fiscal policy issue. The government must cut spending and/or raise revenues to avoid crisis. Financial regulatory reform efforts would have little impact on fiscal policy beyond shielding the government from funding future "bailout" actions. If fiscal mismanagement is the catalyst for the next crisis, then the on-going reform initiatives will most likely fail to prevent a new crisis.

How will the regulatory debate play out?

While the U.S. economy continues to improve, other domestic and foreign priorities will take center stage. As a result, entrenched interests in the financial services industry will have more time to influence proposed regulation. As attention shifts to other issues, Congress and the President will be less inclined to make dramatic changes. The result will be relatively benign reform - enough to support political interests, but not enough to rein in powerful members of Wall Street. In this case, regulation will not prevent the next crisis, but may mitigate its impact.

The Federal Reserve: Is Political Independence and Regulatory Oversight Essential?

The primary role, functions, and independence of the Federal Reserve System (the Fed) have been the subject of heated debate since its inception. Increased Fed activity or perceived regulatory failure increases the level of debate. Recently, the Fed's independence and regulatory role have been questioned. The Fed was created by an act of Congress, which retains the right to provide guidance and direction to the central bank, and set goals for monetary policy through legislation. The Fed determines the method of implementing monetary policy. This relative independence is sustained in two ways. The Fed does not rely on Congress for its operating funds, and the appointment process and long tenure of Fed Governors limits Presidential and Congressional influence.

Arguments for Fed independence are threefold. First, monetary policy needs to be free from short-term political pressure so that effective decisions with long-term benefits can be implemented. Second, the Fed was created to act as a lender of last resort, able to react quickly to changing economic circumstances. This allows the Fed to implement broad congressional policy on a day to day basis. The third argument is more complex. Those who support Fed independence argue that fiscal and monetary policy should be kept separate. Others argue that fiscal and monetary policy is complementary and should be set by a single authority. Recent economic stimulus actions by the Fed and the Obama Administration suggest that separating monetary and fiscal policy is better for the economy in the long term, particularly in a high deficit environment.

There are arguments against the independence of the Fed as well. One argument is that the Fed simply defers to the views of "Wall Street." Similarly, another implies that putting monetary policy in the care of an unelected body diminishes the democratic nature of the state. Recent activities of the Fed tend to validate this concern. Some critics argue the Fed should operate within a clear set of published guidelines, increasing Congressional oversight; others advocate independent audits of the Fed's monetary policy by the GAO.

The case for the Fed having a substantive role in financial regulation is not as clear as the case for independence. The House of Representatives passed the Wall Street Reform and Consumer Protection Act late in 2009, and the Senate's version passed committee in late March 2010. Both agree that some form of oversight council needs to be created to focus on systemic risk, but there are major differences in the assignment and scope of responsibility for regulatory oversight. The House version creates a Consumer Financial Protection Agency (CFPA) as a separate agency. The Senate bill creates a similar organization, but houses it within the Fed, with funding coming from the Fed. It also reduces the Fed's regulatory responsibilities over bank holding companies, limiting Fed regulatory authority to bank and thrift holding companies with assets over $50 billion. Chairman Bernanke opposes these limits, arguing that the Fed has the expertise suited to supervising large, complex financial organizations. Replicating such a capability would be timely, expensive, and unsettling on the markets. Additionally, the Fed's participation in the oversight of "banks of all sizes" improves its ability to act as a central bank responsible for monetary policy.[38]

The Fed has shown itself to be responsive to systemic shocks in order to insure the country's financial stability. This effectiveness supports continued independence in executing monetary policy and the independent funding stream and management appointment process. Moreover, monetary policy should not be subjected to audit by the GAO. The Fed is well positioned to serve as a systemic watchdog, but to fulfill this role it needs to have a robust mechanism for monitoring the health of the markets. Acting as a financial regulator is one such mechanism. Furthermore, the Fed brings unparalleled expertise in financial matters which would be expensive, time consuming, and destabilizing to replicate. The Fed, on the other hand, must be more transparent where possible and more engaging in regards to regulatory oversight. Given the central role and demonstrated effectiveness of the Fed, diminishing its independence would substantially destabilize the economic structure, alter the nature of the country's monetary establishment, and reduce its ability to avert and react rapidly and effectively to crisis.

The Role of a Business Conduct Regulator

Faulty mortgage underwriting and deceptive practices have devastated consumers. The onslaught of mortgage foreclosures and bankruptcies has reached historical highs, and continues to rise due to underwriting practices that, in many cases, put homeowners in homes they should never have been in. This has caused many borrowers to walk away from homes they could not afford and has spurred proposals for major reforms in consumer protection, lending and underwriting practices. Despite poor underwriting, borrowers were also complicit in agreeing to housing obligations they knew they could not afford.

Consumer Protection Gaps. Major gaps in consumer protection contributed directly to the financial crisis. One reason for these gaps is the diminished resources provided to federal consumer protection agencies, with the Federal Trade Commission (FTC), Food and Drug Administration and the Consumer Product Safety Commission budgets and personnel cut by as much as 50% over the years.[39] This left the agencies with fewer resources, but increased duties for oversight and regulation.[40] State agencies have seen similar cuts due to enactment of federal laws which move disputes to the federal level for resolution. This is often favored by industry because it is easier to shape one federal environment than to shape each of the 50 states.[41]

This trend is a product of the era of deregulation which stripped agencies of oversight powers and facilitated the generation of risky products and hidden financial fees aimed at exploiting consumers.[42] The relatively benign economic environment further encouraged complacency among financial intermediaries and investors regarding systemic risk and economic volatility.[43] Rising home prices, fueled by weak credit underwriting and growing leverage, and supported by a market appetite for securitized loans, resulted in an "unexamined and unrecognized, interconnectedness and fragility."[44] This general breakdown in market discipline with respect to fiduciary responsibility created strong incentives to exploit consumers.

Consumer Protection Reforms. There is much debate and major differences regarding proposals for financial consumer protection reform and effective financial regulation. Some warn of creating an agency so broad that it lacks the authority and resources for effective oversight and enforcement, and sustains the status quo. Others argue that a "super agency" will consolidate too much power and authority, ultimately strangling the financial system. On the fringes, there are concerns that current proposals are not radical enough. The two main options are creating a new government agency or an independent private organization, with most current proposals suggesting an independent government organization.

The June 2009 Administration proposal describes a plan for a new Consumer Financial Protection Agency (CFPA), with "broad jurisdiction to protect consumers in consumer financial products."[45] It proposes consolidating the efforts of the Fed, the FTC, the Federal Deposit Insurance Corporation (FDIC) and federal bank chartering agencies. This new agency, tentatively placed in the Fed, would have full authority over 16 "enumerate" laws designed for the protection of consumers.[46] The SEC, the CFTC and most insurance products would be excluded from the CFPA's oversight.[47]

An alternate approach focuses on protecting consumers by developing financial literacy. One House proposal folds the CFPA into a larger reform bill titled "The Wall Street Reform and Consumer Protection Act of 2009" (CFPAA), which is designed to "promote transparency, simplicity, fairness, accountability and access in the market for consumer financial services." The CFPPA intends to enable the consumer to make responsible choices about financial products and services by developing financial literacy.

The proposed agency would ensure that credit, deposit and payment products and services are offered in a fair, sustainable and transparent manner by establishing jurisdiction over debt collectors and buyers, requiring unified mortgage disclosure, and restricting credit card issuers to issuing "plain vanilla" credit cards.[48] The proposal also requires credit card issuers to disclose payoff terms under different circumstances.[49] "The purpose of the House CFPAA is to protect and inform consumers of financial products, which by their nature can be too complex for non-professionals to understand."[50] The Senate version creates a similar agency for consumer protection, housed in the Federal Reserve, as well as an financial literacy office with a consumer hotline.[51]

Despite substantial differences, the two proposals echo similar themes of financial sector restructuring to prevent future crisis and autonomous provisions to protect consumers. The bottom line now is sorting out the concerns of mirroring existing agencies that have failed thus far, consolidating too much power within any one organization and establishing "the who and the details of the how."[52]

Consumer Protection - National Security Implications. Consumer protection has a direct effect on national security through military personnel readiness. Protecting military members and dependents from practices such as predatory lending, payday loans, excessive interest rates, and the numerous auto loan scams targeting the military needs to be included in the current debate on consumer protection. In 2005 the Department of Defense released a report with findings of predatory lending practices targeting the Armed Forces. Legislation was signed in 2006 providing provisions for protecting service members and their dependents from risky financial products, insurance, and "other bad investments that are generally targeted at service members.[53]

Despite these efforts, these practices continue. In February 2010, the Undersecretary of Defense for Personnel and Readiness sent a memo to the U.S. Treasury Department Assistant Secretary, raising new concerns of continued practices that "threaten military readiness."[54] The memo highlighted cases of service members and their families being targeted by payday lenders to "ease the struggles" of daily expenses. Young families are targets because of their "steady paycheck" combined with a lack of financial literacy to understand the complex financial products and services.[55]

As a result, the U.S. Treasury hosted a roundtable to hear military advocacy groups and DoD personnel's views on core consumer protection required in pending proposals.[56] Advocates called for better protection for mortgages, credit cards, overdrafts and new sectors such as check cashiers, credit bureaus, debt collectors and mortgage brokers. Exacerbation of the problem due to increasing troop deployments signaled a need for immediate action through legislation in 2007.[57] Service members will continue to be targets unless the current consumer protection proposals specifically address these issues and their effect on defense readiness.

Regulating Financial Innovation

The financial crisis was the product of many interrelated factors.[58] Financial innovations were, however, an essential component of the crisis, and linked the other contributing factors in a way that concentrated risk, distorted asset valuations, provided a false sense of safety, and ultimately facilitated the disruption of global financial markets on an historic scale. One aspect of regulatory reform that might help prevent a similar crisis is careful enactment of regulation of financial innovations to increase the transparency of risk accumulation, support fundamentally sound valuation, and discourage incentives that work against the responsible allocation of capital and credit.

Key Financial Innovations. A key innovation that facilitated the transfer of risk and generation of credit was the Collateralized Debt Obligation (CDO). A CDO allows a lender to pool, repackage, and sell debt obligations backed by collateral. This provides benefits by allowing lenders to recapitalize and make new loans. It allows them to vary the risk and maturity attributes of CDOs to satisfy the needs of different investors, increasing liquidity. The securitization of these assets also obscures the value of the collateral securing the original debt obligation, making it difficult, and often economically infeasible to identify and analyze the inherent value and risk of the CDO. This problem is magnified with the CDO squared (CDO2), which is the creation of CDOs from CDOs, and near impossible for the CDO cubed (CDO3), which are CDOs created from CDO2s. Residential Mortgage Backed Securities (RMBS), which played a central role in the recent crisis, are a subset of CDOs, backed by "…residential debt such as mortgages, home-equity loans and sub-prime mortgages."[59]

Credit default swaps (CDS) also played a critical role in precipitating the financial crisis. A CDS is "a credit derivative contract between two counterparties in which the buyer makes periodic payments to the seller and in return receives a sum of money if a certain credit event occurs (such as a default in an underlying financial instrument)."[60] Importantly, the purchaser of a CDS does not have to have a stake or position in the underlying credit facility. As a result, a CDS can be used to hedge credit risk, but can be used just as easily to speculate on credit events.[61] Since the seller has no capital reserve requirements, this has the potential to create great concentrations of risk and ultimately was an important contributor to the financial crisis.

CDOs, RMBSs, and CDSs can become enormously destructive if they are used without accurate assessment for the risks inherent in their design. While no prudent investor or financial manager willingly assumes recognized, uncompensated risk, macro and microeconomic factors can create an environment that causes them to do just that.

Contributing Environmental Factors. Innovative financial products combined with numerous other environmental factors contributed to the cause of the financial crisis. These included global macroeconomic conditions that encouraged investment in innovative products, a series of skewed incentives among rating agencies, mortgage brokers, agents and originators, and a lack of regulation, transparency, and due diligence in the CDS markets.

Specific macroeconomic factors included the extended maintenance of an exceptionally low federal funds rate and the extended imbalance of global capital flows. Resulting low fixed-income returns propelled investors to assume excess risk in pursuit of yield. Much of this took the form of purchasing CDOs, particularly RMBS. This created a ready supply of capital to fund new, cheap mortgages. Investors relied on ratings agencies to conduct a thorough analysis of the risks they assumed. Ratings agencies, however, were not as knowledgeable as investors might have hoped. They assumed relatively benign financial conditions, continued rising house prices, and underlying asset diversification.[62] As a result, ratings agencies rated senior tranches of CDOs and RMBSs as the equivalent of U.S. debt.[63] This made the instruments very attractive investments, since they had a higher yield than U.S. debt at the same perceived level of risk.

Ratings agencies had an inherent conflict of interest that may have inflated the ratings that they assigned. Issuers of structured finance products paid the agencies to provide ratings.[64] To compete for market share, it was helpful to provide a positive rating for the product. Agencies did not simply provide ratings however, they also advised issuers on the characteristics required for an instrument to attain a particular credit rating. This conflict of interest resulted in a gradual erosion of rating standards and material misrepresentation of safety afforded by CDOs and RMBSs in particular. This became apparent when, in June and July of 2007, many sub-prime RMBS products were downgraded four levels, from AAA to A+, an extremely rare event.[65]

These products of financial innovation supported the creation of a new model of mortgage lending based on the ability to repackage and sell mortgages to investors as RMBSs. This model, known as "originate and distribute," incentivized originating mortgages, and repackaging them as RMBS for rating and distribution to buyers.[66] The incentives associated with this model do not encourage accurate assessment of risk at any point in the process.[67] Instead, the incentives drive an underassessment of risk at every step in the process. Mortgage brokers and agents who marketed the mortgages were unregulated, and compensated for volume, not quality of loans.[68] Loan originators also repackaged and sold mortgages, benefiting from volume with little regard for quality as well.[69] Ratings agencies, as noted earlier, had an interest in providing the best ratings possible for the repackaged mortgages.[70] Finally, investors, seeking yield, had little incentive to question the quality of the assets they purchased as long as they continued to outperform alternatives. Even if they did wish to perform detailed due diligence, the complexity of the RMBS would have made it extremely difficult to identify and accurately value the underlying assets.

Finally, the one innovation that might have provided protection did not. Many investors, sought to hedge their investment by participating in CDSs. In some cases, the CDO contained a CDS component that earned the CDO an enhanced credit rating by reducing the amount of loss in case of default. While CDSs function like insurance, they are not regulated to ensure that the party obligated to pay in case of default has the capital to do so.[71] In fact, lack of regulation made it difficult to determine the identity of the counterparty in many cases.[72] Finally, CDS exposure can be enormous since it can be used to speculate by parties who have no stake in the reference entity. This can lead to extensive, unrecognized counterparty risk. The lack of transparency of CDS exposure, combined with a lack of due diligence, contributed to the failure of CDSs to provide the intended protection when counterparties who had sold a high volume of CDSs such as AIG were unable to fulfill their obligations to the purchasers.

The combination of a global capital glut, inadequate rating agency models and processes, rating agency conflicts of interest, a mortgage lending model that rewarded the short term goals of originating mortgages and generating fees with little regard for loan performance or quality, and the false sense of security and high concentrations of risk created by CDSs were critical elements to causing the financial crisis.

Regulatory Potential. Carefully developed regulation has the potential to limit the destructive effects of financial innovation while preserving the benefits they provide to borrowers and investors. Balance is key. Financial innovation can provide extremely efficient allocation of capital and risk to satisfy the needs of borrowers and investors. The key to regulation is to increase the transparency of the risk inherent in the use of innovations and enable investors the ability to conduct of due diligence. Establishing requirements to trade widely used financial innovations on an established exchange will help to establish transparency, revealing risks and enhancing realistic valuation. Additionally, the full disclosure of contingent liabilities for all on and off balance sheet obligations must be mandated, and reporting the potential impact of contingent liabilities simplified. Underwriting standards need to be reviewed, and minimum underwriting standards established.

Rating Agencies - The Gatekeepers

Three main credit rating agencies, Moody's, Standard & Poor, and Fitch, account for about 85% of the market. These firms have become the gatekeepers of the financial industry. No one issues or buys a debt product without a credit rating. Because credit ratings had been reliable and stable for many years they have become a key tool used to assess risk.

Institutional investors and regulators rely on credit ratings as a foundational component of the financial industry. Institutional investors purchase most debt issues, and many have covenants that restrict purchases to investment grade securities. Since there is a sharp distinction between investment grade credit ratings and non-investment grade ratings, a high credit rating is a prerequisite for most bond and security sales.

Regulators also use credit ratings for decision-making. For example, financial institutions are required by regulation to hold a set amount of assets in reserve. Highly rated bonds meet that requirement in many instances, where lower quality bonds do not. Thus, regulators rely on credit rating agencies to control systemic risk.

Essentially the financial system uses credit ratings as a proxy for value. Because of this, credit ratings affect systemic financial risk. In an interconnected global financial system, credit rating changes can be significant market events. A rating downgrade – especially one that goes into junk territory – can trigger large sell-offs as institutional investors and financial institutions are forced to reset investment portfolios. This has the possibility to bankrupt the downgraded firm because its cost of borrowing rapidly increases. Abrupt, unanticipated credit downgrades lead to market losses, uncertainty, and diminished liquidity. Because of their role in the financial crisis, numerous lawsuits were filed against the big three credit rating agencies. Additionally, there are six bills or amendments in the current Congress that address credit rating agencies. All of them call for increased regulation.

It is important to note that a credit rating is an informed opinion. It is supported by research and analysis, goes through a methodical review process by trained professionals, and carries the weight of the rating firm, but it is just an opinion. The rating is a forward-looking attempt to estimate the probability of default and the severity of loss in the event of default. Credit rating agencies encourage investors to use a range of tools to inform investment decisions. A credit rating, they say, should only be one component of any investment decision.

Credit rating agencies have long been concerned about over-reliance on credit ratings within the finance industry. Credit rating agencies are particularly opposed to the use of credit ratings in regulatory decisions because the use of credit ratings implies that the rating is more than just an opinion. Credit rating agencies value their independence, so they view the use of credit ratings for regulatory purposes as a threat to that independence. If credit rating changes have too large of an impact on the market, government action and influence can place their independence at risk. After all, the essential issue for an efficient marketplace is an independent, third-party rating of the actual creditworthiness of the debt issue.

Financial Literacy

Various studies indicate a poor level of financial literacy among the majority of adults, and debt levels among the young have skyrocketed, along with consumer credit and personal bankruptcy.[73] A poorly educated consumer will make poor decisions, subsidizing another crisis.

Past regulation attempted to protect consumers by shielding them from questionable lending practices. The Truth in Lending Act of 1968 increased transparency of loan costs. The Credit Card Act of 2009 requires banks to show the time it will take to pay off a balance by making only the minimum payment. Unfortunately, these regulatory initiatives failed to educate the consumer. Federal Reserve Chairman Ben Bernanke, testifying before the Senate Committee on Banking, Housing, and Urban Affairs in May 2006, stated "Like any other businesses, financial service firms will provide better products at better prices when they are subject to market pressures imposed on them by informed consumers." Education is the most effective way to address this problem.

Data shows that counseling borrowers before the purchase of a home helped reduce delinquency rates by 19% and those receiving one-on-one counseling showed a 34% reduction in delinquency rates.[74] This illustrates the effect of financial literacy efforts. A few states are taking their own initiative by requiring personal finance courses for their students, and more are adding financial education requirements to their curriculum. These tactical, locally applied programs are effective, but lack a strategic framework to create broad success.

The U.S. should enact financial literacy regulation. Federal funds for education must come with a caveat requiring financial literacy in formal education programs. Additionally, the American consumer must be educated at the individual level through federally funded programs. College education grants and loans must require personal finance education. Consumers receiving federally funded home loans must complete required counseling prior to loan approval. As civics is taught in today's schools to grow an educated voter, personal finance needs to be taught to create an educated consumer. Congress needs only to press and support the issue in broad terms for states and educators to solve the problems themselves.

Predatory Lending Regulation: Enough or More?

Current regulatory bodies and laws do not effectively protect the U.S. consumer. Though the Federal Reserve was made aware of unscrupulous lending practices in 2000, Federal Reserve Chairman Alan Greenspan elected not to take action.[75] Congress had already recognized this area of abuse, passing the Home Ownership and Equity Protection Act (HOEPA) in 1994. HOEPA restricted some forms of predatory lending, specifically limiting prepayment penalties, balloon payments, and unnecessary insurance products.[76] As a result of persistent problems, Congress revised and strengthened HOEPA in 2002.

Additional steps have been taken to curb predatory lending. The Talent Amendment and 2007 Authorization Act limited the amount of interest that payday loans could charge the military. In addition, the Office of the Comptroller of the Currency provided predatory lending guidance as a preventive measure and Fannie Mae and Freddie Mac tightened their mortgage buying provisions. In 2008, Fannie Mae outlined a plan to eliminate predatory lending in the mortgage market by "issuing business guidelines to industry participants to avoid purchasing loans with abusive features,…expanding the application of conventional conforming practices to the sub prime market…offering a broad range of alternative responsible products…working with its servicing partners to keep borrowers in their homes."[77] These actions occurred too late to mitigate the damage of the current crisis, but may curtail future problems.

The most effective, anti-predatory legislation has been implemented at the state and local level. Dating back to 1999, numerous states and cities across the U.S. implemented effective laws to protect the consumer by restricting prepayment penalties, limiting rates and fees, and limiting the number of refinances or flipping of mortgages.[78] Looking forward, both Federal and State governments need to continue to develop and implement policies to protect consumers from predatory lending institutions.

THE FINANCIAL IMPORTANCE OF CHINA

One of the most important developments in the global financial system is the growing importance of China as an economic and financial power. China is the largest holder of U.S. debt, the world's largest exporter, the largest holder of foreign exchange reserves, and home to three of the five largest international banks. Closely intertwined with the U.S., China's monetary policy, exchange rates, reserve accumulations, and capital flows exert economic pressures and influence within the U.S.

The Undervalued Renminbi and Export-driven Chinese Economic Growth

China has pegged its currency to the U.S. dollar at what many economists believe is an artificially undervalued rate, in a successful – China overtook Germany last year as the world's number one exporter – attempt to bolster its exports.[79] U.S. political leaders, facing increasing trade deficits and persistent high unemployment, have ratcheted up rhetoric of retaliatory trade measures unless China allows the value of the *renminbi* to rise. As tensions mount on both sides, it is important to examine the underlying economics behind Chinese and U.S. currency and trade issues.

From the start, it is important to remember that the paramount concern of the Chinese Communist Party (CCP) is to maintain its grip on power through an unwritten bargain with the Chinese upper and middle classes: strong economic growth in exchange for ceding individual political voice to the CCP. Keeping up its side of the bargain, the Chinese Government has pursued policies that have led to tremendous growth over the past three decades. But if Chinese economic growth falters, the CCP is very aware that their societal power bargain could easily fall into jeopardy.

Exchange rates, when allowed to float freely, are generally determined by market forces of supply and demand. Flexible exchange rates move to equalize long-term purchasing power parity among countries. The Chinese Government, however, has pegged the value of the *renminbi* to the dollar. To keep the *renminbi's* value artificially low, the Chinese "sterilize" the dollars they accumulate from export sales and have amassed an unprecedented amount of dollar-denominated reserves, much in the form of U.S. Treasury notes. China's total foreign currency reserves exceed $2.4 trillion, with an estimated two-thirds held in dollar-denominated instruments.[80]

Imbalances in Chinese and U.S. Savings and Consumption

At the same time, the Chinese have a tremendously high domestic savings rate and corresponding low consumption rate, driven by the lack of an official Chinese social safety net.[81] Their high savings rate contrasts sharply with the U.S.'s extremely high consumption rate and low savings rate. In short, Americans have been consuming too much and saving too little – borrowing ever-greater sums of foreign-origin capital to finance our standard of living and budget deficits – while the Chinese have done the opposite.[82] These two forces have worked together to create a situation that is increasingly untenable for both countries.

At first blush, the Chinese appear to have carved out a very strong economic position, with 9.9% growth annually since embarking on economic reforms in 1978, but this growth has come at a considerable cost to China's populace.[83] The forced low value of the *renminbi* has significantly reduced the purchasing power of their citizens in the global market, and through restrictions on capital flows that limit options to its populace, the Chinese government essentially forces its citizens to finance local governments and State-Owned or Influenced Enterprises (SO/IEs). Many of these SO/IEs, which account for a significant share of Chinese industrial production, are inefficient and unable to compete without state subsidies, while many of the local governments suffer from corruption and misuse of official assets.[84]

Inefficiencies from State Control of Chinese Financial Flows and the Banking Sector

Control of capital flows and of the banking sector has enabled the Chinese Government to capture the deposits of its citizens and direct them to Government projects. Historically, Chinese banks have been disastrous financial intermediaries, lending on government instruction without consideration of profitability or risk. Banks – at State direction – poured money into wasteful infrastructure and poorly run SO/IEs.[85] High-ranking members of the CCP dominated banks' boards and, foregoing higher returns on alternative uses of capital, steered capital to fund unproductive pet projects. As a result, Chinese banks ten years ago were among the weakest in the world, with limited infrastructure, limited international exposure, and balance sheets laden with a high percentage of bad loans.[86] Many of the SO/IEs have been plagued by corruption and use bank loans for unclear-value-added purposes that a free market would not support.

Since 2000, the Chinese have been moving toward a more open and transparent banking sector. The banking sector is still dominated by China's four largest banks (Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and Agricultural Bank of China), which account for approximately 80% of all Chinese deposits. The asset sheets of these major banks are still relatively weak in terms of quality, profitability, and diversification of services, in comparison to international peers. But, through better business practices, these banks today enjoy growing profits, sounder business practices, and higher returns on investment

(17.1% in 2009, 7% above the global average).[87] One of the main contributors to improved governance has been the introduction of foreign expertise to bank boards. As part of a reform effort, China sold minority stakes in its largest banks to selected foreign strategic investors, with the Government still retaining control. The strategic foreign partners have helped to transform China's banks and make them more competitive.[88]

On the central bank side, the story has been similar. The Chinese central bank, the People's Bank of China (PBOC), was established in 1983 at the beginning of Chinese attempts at bank reform. The PBOC plays some roles similar to those of the U.S. Federal Reserve – e.g., issuing and enforcing orders and regulations, issuing and administering the circulation of currency, regulating inter-bank lending. But the PBOC is not independent; it is an implementer of CCP policies. For example, the Government has continually increased the reserve ratios for Chinese banks, in effect taking potentially useful capital out of the economy in an effort to keep inflation under control. This subjection to government direct and indirect government intervention is one of the greatest challenges to the Chinese financial system.

The relative success of reforms of the Chinese banking sector over the past decade does not mean that the industry is completely stable.[89] Most important, the Chinese banking system still does not function as an efficient financial intermediary.[90] Many analysts expect a new wave of non-performing loans from the $586 billion economic stimulus package that the Chinese Government enacted at the end of 2008 in response to the global financial crisis.[91] Moving forward, the Chinese Government has little maneuvering room as it tries to accomplish the competing objectives of financing employment and social stability while at the same time trying to transform the Chinese economy to make it commercially viable without massive subsidies diverted from its citizens.[92]

Rebalancing Chinese and U.S. Capital Flows

As noted earlier, Chinese Government exchange rate policy and control of capital flows have created a mutual dependency, with the U.S. dependent on Chinese purchases of U.S. debt, and China dependent on exports to the U.S. while saddled with a resultant huge accumulation of U.S.-dollar reserves. With U.S. interest rates at record lows, Chinese dollar reserves are not efficient vehicles of savings or wealth generation. (Conversely, the U.S. benefits significantly from these low-interest loans provided by China; absent this investment, the U.S. Federal Reserve would have to raise U.S. interest rates.) The Chinese Government finds itself boxed in with its accumulated dollar reserves: if it tries to sell or divest the dollars, market forces will drive the value of the dollar down, resulting in large losses in value for China's foreign reserves.

The solution clearly demands a rebalancing of China and U.S. capital flows. China is already doing its part, and domestic consumption is growing. Its Eleventh Five-Year Program (2005) places greater emphasis on developing a consumer-driven economy to sustain economic growth. The Financial Times recently estimated that Chinese domestic consumption is growing "at about 15%."[93] On March 21, 2010, China's Commerce Minister announced that, following a drop in China's current account surplus in 2009 and a 50% drop in China's trade surplus in January-February 2010, China would likely see a trade deficit in March 2010, reversing a six-year trend of trade surpluses.[94]

U.S. Political Concerns about an Undervalued R*enminbi* are Misguided

Nevertheless, persistent U.S.-China bilateral trade deficits – though a meaningless measure in today's globalized production and supply chain – have increasingly become a political flashpoint in the U.S. A bipartisan group of 130 Congressmen has urged Treasury Secretary Geithner to impose countervailing trade duties on China in retaliation for its currency manipulation. Punitive tariffs would be a mistake, constituting a tax on American consumers in a misguided attempt to benefit a small number of American exporters and supposedly create more American jobs. Contrary to what some politicians believe, tariffs on Chinese goods would not create American jobs. U.S. import demand would more likely shift to the products of an alternative low-cost producer, such as Vietnam or Cambodia.[95] Additionally, many American jobs benefit indirectly from inexpensive Chinese imports that are used as components in finished American products. Chinese value-added content in their exports tends to be relatively small, estimated at only one-third to one-half of products' value.[96] The remaining value is added by other countries, reflecting the globalized world economy.

U.S. policymakers also need to remember that the undervalued *renminbi* and (relatively) strong dollar have enabled American consumers to spend relatively less on imported Chinese goods (on the backs of the Chinese Government's de-facto tax imposed on its own citizens), leaving us more disposable income to spend on other products or services, directly raising our overall standard of living. Depreciation of the dollar against the *renminbi* would reduce our terms of trade and actually constitute a loss to American consumers, decreasing our relative purchasing power in world markets.

Protect the Dollar through Fiscal Responsibility

Rather than resort to protectionism against China, the U.S. needs to focus on its domestic problem of reducing federal budget deficits and national debt. As we watch a new financial crisis unfold in Greece, with the potential to spread to other parts of the European Union (EU), the imperative of financial discipline becomes even clearer. While the U.S. is in a much more favorable fiscal position than Greece, Greece's experience shows that it is very difficult to make the changes required to get government debt under control. Greece relies on the backing of the EU. The U.S. relies on the confidence of the entire world and the *seignorage* that goes along with the dollar's position as the world's reserve currency. The dollar enjoys high global confidence because of perceived safety, lack of political risk, higher return vs. risk, liquidity, and efficiency. These inherent sources of value to foreign investors have enabled U.S. financial markets to enjoy a comparative advantage over other world markets. But they have also enabled American consumers and the U.S. Government to spend beyond our means. The rest of the world, led by China, has been financing our consumption.

Concerns about our large deficits could lead to movement in world markets toward a different currency to replace the dollar as the global reserve currency. Fortunately, there is currently no candidate to replace the dollar's role. But world confidence in the dollar could wane if U.S. economic growth is not sufficiently strong to help us withstand other economic shocks in coming years. More immediate, Moody's warned earlier this year of the possibility of a downgrade of the U.S.'s sovereign credit rating due to concerns about our debt burden.[97] A downgrade, as Greece just painfully experienced, would trigger a disastrous chain of events, requiring an increase in U.S. interest rates, tamping down on U.S. economic growth, and complicating U.S. borrowing efforts in global markets.

Even if we avoid a credit downgrade, the U.S. needs to be concerned about the possibility that the Chinese will get nervous about the value and prospects of the dollar and increasingly diversify their investments outside the U.S. In March 2009, Chinese Premier Wen Jiabao declared himself "worried" about China's holdings of dollar reserves.[98] Other officials have followed with similar chidings about our profligate ways. There are already ominous signs that the Chinese government is shifting its dollar holdings from longer to shorter-term and has decreased its purchases of dollar-denominated debt.

Chinese movement away from dollar-denominated debt will put downward pressure on the dollar. To protect the interests of the American public – both current and, especially, future generations – we need to take action to get the U.S. Government's fiscal situation under control by reducing federal budget deficits and our tax system's incentives for consumption over savings. This will be a tricky exercise in balance, since such actions will cause recessionary pressures in the short-term, while we are still recovering from the last financial crisis. We need to start taking action now to get our financial house in order for the nation's long-term benefit.

CONCLUSION

"This is a wartime QDR."[99]

Secretary of Defense Gates

"Never before in modern times has so much of the world been simultaneously hit by a confluence of economic and financial turmoil such as we are now living through."[100]

Secretary of the Treasury Geithner

These two statements by the current Secretaries of Defense and Treasury highlight the magnitude of the dilemma faced by the United States at the nexus of military and economic powers and the ability of the United States to project its influence around the world. The United States, a nation at war in two conflicts grappling with the worst recession since the Great Depression of the 1930s, has been forced to reevaluate the meaning of national power and the sovereign distribution of those powers.

The United States' prosperity, economic strength, and national power must be supported by a strong financial system capable of raising and efficiently deploying large amounts of capital. If the United States allows its financial system and supporting financial services industry to weaken, it significantly undermines its economic strength and ability to project global power militarily, diplomatically, and economically. To enhance domestic prosperity and global economic leadership, the United States must strengthen its financial system and supporting financial services industry. From a military perspective, if the United States fails to make fiscal reforms, the impact to national security is dire: less economic power, decreased defense budgets, and a death spiral of debt and decreasing military power all in the context of a near decade long war. After considerable study and interviews with numerous financial leaders, the Financial Services Industry Study Team makes the following recommendations:

- Implement financial regulatory reform that seeks to correct the conditions that led to the 2008 financial crisis while ensuring the financial service industry remains globally competitive. The Obama Administration and Congress must leverage lessons learned from the financial crisis to reform the U.S. financial landscape by improving regulatory agency oversight, reducing systemic risk imposed by large financial service companies, and increasing the oversight and transparency of existing and new financial products.
- Implement prudent fiscal policy that stimulates economic growth, reduces deficit spending, and moderates U.S. debt levels. To avoid the looming sovereign debt-rating crisis and a potential rebalancing of China's investment portfolio away from U.S.

Treasuries, the Obama Administration and Congress must take aggressive actions to reduce the country's budget deficit and debt.

- Establish DoD-Wall Street fellowships and include defense company cost and capital structure education in senior DoD courses to build a better understanding of the relationship between the Defense Industrial Base and capital markets.

While tough decisions still lay ahead, all is not dire. The financial system has stabilized from the 2008 crisis and the United States still maintains a strong global economic leadership position. If the U.S. government undertakes the needed financial regulatory and fiscal reforms now, the country will emerge economically and militarily more prosperous and secure.

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