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THE WAY FORWARD: CURING THE FINANCIAL *'DISEASE'* WITHOUT KILLING THE HOST

The keystone of democracy, the political system that the Western World of today embraces and wants other countries to embrace, too, is that the individual should be protected from the State.

In the People's Republic of China (PRC), a Communist country, it is held that the State should be protected from the individual.

The keystone of nearly all of the economies of the world, today, ironically, is that their economies must be protected from certain activities of domestic and foreign banks on which those same economies depended, heavily, in days of yore.

The banks of the world have the ability, today, to cause most economies to sink deeper and deeper into recession – unless prevented from so doing.

The continued contraction of lending by banks, in the Hongkong Special Administrative Region (HKSAR) of the PRC, in the PRC, proper, in the United States of America as well as in eurozone will continue to harm the economies of the world – unless prevented from so doing.

It is not a matter of determinations, based upon sound financial prudence, because most banks have closed their doors to nearly all borrowers, the most qualified and right down the line.

Therefore, the first priority of many (if not most) governments must be to repair the banking systems so that it can be business as usual.

Unless this problem can be successfully tackled, viable businesses will be forced to go to the wall and, as every viable business collapses, due, in the main, to a lack of short-term, bridge financing, so more people will be thrown out of work, pressures on governments will increase as the State finds itself in a position of trying to cope with the situation of locating the financial and logistical wherewithal to feed its growing number of mendicants.

This, undoubtedly, will result in civil unrest.

A hungry man is easily irascible, especially if he is the only substantial bread-winner of his family.

A resumption of banks' normal lending practices must be attained as quickly as possible or the critical situation, facing the world, cannot be ameliorated in the short or intermediate term, resulting in widespread economic and political disorder, the extent of which will cross many countries' borders.

Legislation is urgently required by many governments in order to protect the economies from its banks.

This legislation must be drafted so that it does not interfere with banks' normal practices or lead to excesses by those who would draft the unconventional legislation that, it is hoped, could lead to convention business practices, being resumed, once more.

Effectively, this is what has, already, taken place in the United States where questions are being asked by members of The Congress of high-flying, business executives as to the levels of their salaries and bonuses with the veiled (but very real) threat that, if they do not rein in their past excesses with regard to their perquisites of office, then, emergency funding by the US Government will be curtailed, forthwith.

Regardless of the action that will be taken in 2009 by governments, around the world, it, still, will, most likely, be the most difficult 12 months since The Great Depression of 1929.

The main question is this: How to stop the rot?

As far as President Barack Hussein Obama is concerned, spending upwards of $US2 trillion is the answer.

Not all of the members of The US Congress, however, concur with the new President's determination.

A very pronounced contraction in spending, by consumers and businesses, is underway; and, this is leading to declining industrial output in the Western World.

Industry, by and large, is very reluctant to take risks, today, because:

(a) There is the question as to whether or not the products of industry will be well received by consumers, many of whom are facing very difficult times in respect of their personal finances;

(b) There is almost a guarantee that banks will not stand behind industry with funding if the financial situation continues to deteriorate and short-term bridge financing is required; and,

(c) Research and development of new products cannot proceed as in the past because the priority of most managements, today, is not tomorrow's new and improved products, but, instead, what products, already being manufactured, that is tried and true products, can bring in the most shekels in the shortest possible period of time. This is of paramount importance because there are not that many avenues, available, to fund normal operations.

Inter alia, as a direct result of the aforementioned, the total manufacturing output in the fourth quarter of 2008 fell sharply.

In the first half of 2009, it is expected that total manufacturing output of the Western World will continue to fall, at least equal to the contraction level of the fourth quarter of 2008.

One, already, sees the signs on the industrial horizon.

Detroit has told the world of its problems as consumers in the US continue to delay purchases of new motor cars.

Unemployment in the Western World has reached hitherto completely unexpected high levels within a period of less than 12 months – and unemployment continues to escalate.

How It All Began – In Earnest

The collapse of the Wall Street investment bank, Lehman Brothers Holdings Incorporated, probably touched off a global fall in the prices of equities**.**

TARGET () uses the word, *'probably'*, because, in all likelihood, in this medium's opinion, if it had not been the collapse of this investment bank, it would have been another financial catastrophe, somewhere else.

Lehman Brothers declared that it was insolvent on September 15, 2008.

It was founded in 1847 and it was, formerly, considered among the bluest of the blue-chips of the private banking world in the US.

Few people expected to witness the demise of this investment bank.

The failure of this bank was the first of many to come.

In the month, following the failure of this bank, the depreciation in the prices of listed equities was estimated to have dropped more than any month of the previous 300 years.

The shockwaves from the failure of Lehman Brothers were felt from one corner of the world to another.

In November of 2008, electricity production in the PRC, proper, being distinct and separate from the HKSAR of the PRC, fell by about 8 percent, Year-On-Year.

Previous to November of 2008, electricity production in the PRC had been rising by about 15 percent, Year-On-Year.

In Brazil, it was discovered that, in November of 2008, the sales of motor vehicles contracted by about 25 percent, Year-On-Year.

In Japan, industrial production in November of 2008 dropped by about 8.50 percent, Year-On-Year.

The second-largest economy of the world shrank in the final quarter of 2008 by about 3.30 percent, annualised at about 12.70 percent.

It was the largest decline since 1974.

In Germany, in November of 2008, the value of exports declined by about 10 percent, Year-On-Year.

In the fourth quarter of 2008, the German economy fell by about 2.10 percent, compared with the previous quarter.

Also, in the fourth quarter of 2008, the Quarter-On-Quarter comparisons were:

a. The economy of France contracted by about 1.20 percent;
b. The economy of Italy contracted by about 1.80 percent;
c. The economy of Holland contracted by about 0.90 percent;
d. The economy of Austria contracted by about 0.20 percent; and,
e. The economy of Portugal contracted by about 2.00 percent.

According to the Statistical Office of the European Communities (**Eurostat**), the statistical arm of the European Commission, producing data for the European Union and promoting harmonisation of statistical methods across the member states of the European Union, the economies of eurozone shrank by about 1.50 percent in the final quarter of 2008, annualised at about 1.20 percent for the entire year.

In the 2 months to December 31, 2008, more than one million jobs were lost in the United States, alone.

In the United Kingdom, manufacturing output in November of 2008 retreated to the levels of the 1980s.

And so it went on.

And so it continues.

The collapse of Lehman Brothers was not the root cause of the problems, facing the world in the last quarter of 2008, but, to be trite, it was, undoubtedly, the straw that broke the camel's back.

Imbalances in the world's economies, built up over a period of about one decade, probably could be said to have been the root cause.

But these imbalances went almost unnoticed or, alternatively, were conveniently pooh-poohed or disregarded by people with vested financial interests, people who determined that this was a decade in which to make a financial killing.

Bonuses and salaries on Wall Street were running at record levels: Why rock the boat?

With the spectacular economic growth in Asia, of the PRC, proper, and of India, in particular, more fuel was added to the imbalances in the world's economies.

Asia, with its newly acquired wealth, found itself with huge pools of hard convertible cash, all of which had been earned by exporting goods and services to the Western World.

For the most part, at first, this situation was not seen as a threat to anybody.

Large current account surpluses were building up, especially in the PRC, proper.

The US Congress started to get a little concerned.

The Bush Administration complained that the renminbi was being artificially held at a low level by Beijing. This was claimed to be an unfair advantage to the Beijing – at the expense of US industry.

Beijing thumbed its nose at Washington, stating words to the effect: *'You take care of your economy; and, we shall take care of ours. Thank you, very much.'*

Because of the plethora of savings at home, Asia sought to diversify its sovereign funds, much of which were channelled into assets, held in other countries.

Within a relatively short space of time, the PRC Government was the biggest creditor of the United States.

It had never happened before: A Communist nation of about 1.30 billion people, pulling some of the financial strings of the largest and most-successful, single democracy of the world!

As it transpired, the poorer nations of the world were channelling huge amounts of money into the richest nations of the world.

These amounts of money were staggering.

The US Congress, at this time, was getting concerned.

The Bush Administration was very concerned.

With so much money, flooding into the economies of the Western World, one would have thought that real interest rates would fall.

And, in fact, real interest rates did fall, but not because of the influx of cash from the poorer countries of the world into the richest countries of the world.

What happened was that inflation in the industrialised countries was stable and relatively low, relative, that is, to the preceding 30 years.

So, nominal interest rates fell.

There followed a scenario whereby there was a decided fall in risk-free investment returns while, at the same time, large amounts of capital were looking, desperately, for a home – in the West.

As such, there was created a rather large demand for assets that offered higher returns than could be obtained on the home turf of the sovereign funds.

But there is an adage that many people had tended to overlook at this juncture: The higher the return; the higher the risk.

So, in the US and many parts of eurozone, large amounts of money were lent to people – many of whom, clearly, did not qualify for the loans under normal circumstances – on conditions that, otherwise, would have been considered *'sweetheart terms'*.

This situation resulted in the price of assets rising while, at the same time, interest rates were falling.

The rest is history, as everybody and his cat knows:

a. Banks and finance houses, first from the US and, then, later from around the world, created financial instruments to hold the assets;

b. The financial instruments were sold from Peter to Paul until the holder of last resort did not know upon which assets the instruments were supposed to represent;

c. The appetite for these financial instruments could not satisfy the demand;

d. More financial instruments were created, instruments that were not indigenous to the US or Europe, such as the minibonds of Lehman Brothers; and,

e. The search for bigger and better yields continued.

Replication of risk became the order of the day as banks lent to banks, using the exotic instruments that had been created by the financial system, itself.

Chaos followed in its wake.

The creation and further development of an unsustainable situation had been created.

Today, the world is enjoying the sprouting seeds of these financial instruments, many of which had only been planted just one year ago.

When the penny dropped, it was discovered that many banks did not have sufficient capital to support what was, by this time, inflated balance sheets, holding onto financial instruments, some of which, clearly, were worthless or close to be worthless.

Today, the Americans like to call these instruments, *'toxic assets.'*

The Bush Administration suggested buying up some of the banks' toxic assets and, then, packaging them, once again, into different containers, along with little red ribbons, in the hope that, in time, they would have a value and could be resold back to banks and, in this way, cost the US taxpayer, zilch.

It did not work and, eventually, a halt to the purchases of these toxic assets was ordered by the US Treasury.

Failure!

Fresh capital from the private sector became more and more difficult to obtain and so banks were forced – they claimed – to reduce lending.

This had the immediate effect of a violent disruption of the economies of the West.

When credit was offered to qualified borrowers, the levels of the interest rate were much higher than those in the past, and the terms and conditions were much more onerous than those of the past.

One of the many new conditions, imposed by many banks, included the beneficial owners of the businesses, putting up guarantees to the lending banks, usually in the form of cash.

In other words, loans were afforded, in part if not in whole, based upon the levels of the cash deposits, placed in the banks, by the beneficial owners of the businesses.

So, the qualifications of the prospective corporate borrowers included, inter alia, the personal wealth of the beneficial owners of the businesses, and this condition was considered as important, if not more important, than any other qualification of the prospective corporate borrowers.

Small businesses found it difficult to make ends meet in such a situation.

This situation is continuing, today.

In order to bring things back to an even keel, to coin a sailing adage, there is this paradox:

a. The consumer must return to the High Street;

b. Society must be re-educated as to the tried and true virtues of saving money: Borrowing less money while savings mount;

c. Banks must be encouraged to lend money to qualified borrowers; and, lastly,

d. Interest rates must rise from their present, unprecedented low levels.

What is evident is that banks need more capital in order to perform their part of the bargain.

The current Obama Administration has, recently, twisted the arms of lawmakers to release what amounts to about $US2 trillion in order to restart the US economy.

It would appear that there is little alternative to this policy – sadly.

Unconventional measures are needed in these unconventional times.

Before penicillin was discovered in 1928, arsenic was used to cure certain diseases.

The trick, when administering arsenic to cure a disease, was to use a sufficient amount of the poisonous element in order to kill the disease without killing the host of the disease.

Ay, there’s the rub!

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