

Outlook: The BG (Bernanke-Geithner) Bubble of March-May 2009 and the Aftermath

Part I – Where are we now?

Background

Between 2000 and 2008 US households indulged in taking on massive debt. Oddly, US household income increased 47% between 2000 and 2008, and was actually slightly steeper than during the preceding period up until 2000. There was no *lack of income* reason for households to indulge in the gigantic debt that transpired.

Nevertheless, we know that political measures begun around the year 1992 had as their prime goal the relaxation of a crucial part of financial regulation and hard-won banking praxis in the extreme belief that the markets will always clear and balance, thus also balancing the economy. The resulting excessive liquidity and credit fuelled the Tech bubble and the housing bubble. Now Chairman of the Federal Reserve Bank Ben Bernanke and Treasury Secretary Tim Geithner have succeeded with creating their own stock market bubble, the BG Bubble of March-May 2009.

Without going into too much of the legislative detail of regulation, there were a few portal events which opened the way for the exceptional expansion and débâcle that followed.

1 President Bill Clinton, by dint of the control that Congress had upon these two parastatal lending giants, *forced* Fannie Mae and Freddie Mac to relax normal lending criteria and lend to the poor. Under President Clinton, bank regulators enforced the Community Reinvestment Act, a 20-year-old statute requiring banks to serve their low-income communities. The administration also stiffened the enforcement of the fair housing and fair lending laws. Already in 1992, Congress mandated that Fannie and Freddie increase their purchases of mortgages for low-income and medium-income borrowers.

2 Also during President Clinton's period of office the *Gramm-Leach-Bliley Financial Services Modernization Act of 1999*, was passed by Congress and the Senate, repealing part of the Glass-Steagall Act of 1933 which was made law during the Great Depression. Inter alia, Glass-Steagall had the purpose of keeping commercial banks and investment financial institutions completely separate so that depositors' accounts would not be unduly threatened by the added risk of any untoward financial event.

The Gramm-Leach-Bliley Act was launched with the avowed intention of opening up competition among banks and insurance companies. However it paved the way for investment banks to gain access to savers' money for use in what became disastrous speculative ventures in various securitisation jinks, linked first and foremost to fraudulent housing loans.

3 The other negative macro-economic event a little later at the turn of the millennium was when the Federal Reserve's base interest rate was arbitrarily brought all the way down to 1% in 2001. Furthermore, in an unprecedented policy pattern it was *kept there for several years* by the Federal Open Market committee (FOMC) led by the Chairman of the Federal Reserve Bank at that time, Alan Greenspan.

Such an (uncalled for) low interest rate for such a long time paved the way for the housing bubble, since it made it very easy for fraudulent mortgage salesmen to convince not only the poor that they could own their own property but also convince the unethical and irresponsible *affluent* segment of the market that they could speculate massively in property. Herein lies the root cause of the considerable household debt taken on by US households in the period of 2000 – 2008.

The present outlook on US Housing

The Case-Shiller index for house prices over the whole of the US shows that the housing bubble is not finished bursting. House prices have not dropped to anywhere like a historic norm. Even though the US media daily call the bottom in house prices in typically irresponsible journalist fashion, to expect no more drops in house prices is completely unrealistic. Even though most of the sub-prime defaults are slowly declining, the defaults and delinquencies of the mortgage categories of Alt-A and prime are going to *increase* through 2009, 2010, 2011 and will become as large year on year as sub-prime were in 2008! There are several years of unwinding to go. The last reset from the millennium housing bubble era will occur at the end of 2012!

The present scenario is as follows:

There is a small price and sales activity dislocation in the U.S. housing market. Although a few cities are still building the new start rate is coming down overall. While any new starts will very slightly reduce inventories it is a drop in the ocean compared to the number of homes being added to the inventories there. Most other cities are experiencing yet more defaults, month on month. The majority of sales are of distressed properties. The length of time it takes to sell a house in the US has now reached an average of 10,5 months for the first time since the 1930s, and the great Alt-A and Prime default numbers are only just starting! For a video by John Authers of FT.com see *here*.

<http://www.ft.com/cms/bfba2c48-5588-11dc-b971-0000779fd2ac.html>

Overall, thanks to the Obama measures to force the banks to extend the mortgage periods, reduce capital owed, in order to provide breathing space for afflicted families, *the rate of the rise in defaults has temporarily slowed, but defaults and delinquencies are rising again and inventories will rise again*. The reason for the latter is that total unemployment is rising because the underlying macro-economic and credit problems besetting closing manufacturing plants and small businesses are not being addressed. The boom and bust difficulties besetting the house building industry itself are severe and the lay-offs of building workers is not going to alleviate the unemployment picture. The House building industry and real estate in the US is in very great difficulties, and will be so for *at least* 3 more years.

House prices continued to drop in April. The S&P Case-Shiller index showed that in Q1 2009 there was the greatest drop in US house prices since the Index began 21 years ago. The 10 city composite showed a drop of 18.6% and the 20 city composite showed a drop of 18.7%. The average of the country was 19.1% y.o.y and 32.2% since February 2006. *Thus the problem of declining house prices and the accompanying implosion of wealth is getting progressively worse.*

More on the drop in housing starts can be seen *here*:

<http://www.bloomberg.com/apps/news?pid=20601103&sid=ah.Vr.4XkDm0&refer=news>

Although complicated, an estimation of the future US housing market scenario at the present time is not rocket science. It is also facilitated by US national statistics which cover housing selling prices city by city and region by region since 1945. When severance packages for each cohort of laid-off workers have been exhausted the continuing lay-offs will bite into the mortgage market and *new* prime defaults will arise.

The general underestimation of the depth of the housing crisis in the U.S. is very serious. The U.S. housing market *is not going to bottom out until it reaches under 100 on the Case-Shiller index*. Robert Shiller, Professor of Economics at Yale, and other economists such as Professor Nouriel Roubini at Columbia, have repeatedly warned of the severity of the deflating housing bubble.

Any 'green shoots' will shrivel, wilt and die (or turn into yellow weeds: Roubini) when the effects of unemployment continue, while the US banks continue to contract and founder due to new prime housing defaults. In addition, new sovereign government crises and other global bad news will reverberate around the planet and there is a lot to come: especially from Europe. We haven't seen anything yet.

The European Union

When they were Soviet satellites, Central and Eastern European countries (CEE) did not produce a normal range of goods to satisfy the needs of their populations. They were allocated particular products or raw materials to produce and bartered these with Gosplan, the Central authority in Moscow for other goods produced in Russia or by other satellites. When the Soviet Union collapsed in 1989, CEE countries had a poor position to start with. Their natural markets within the Soviet Union fell away, and Western countries refused to buy their products regarding them as technologically stuck in the 1930's, i.e. grossly inferior.

The struggle was to jump ahead as fast as possible. Many CEE countries have lost citizens to other countries abroad, some of whom send back a part of their pay packet to their families. CEE countries have offered industries cheap labour and many industries in Western Europe have re-located in CEE as a stepping stone to re-locating in China. CEE Governments have had great difficulty managing the transition from communism

to capitalism, while at the same time being under the threat of losing jobs and production to China.

To fill out this picture, mix in naivete on borrowing abroad (deficit spending), and an IMF advised policy of lowering taxes according to the infamous 'Washington consensus' which was hegemonic at the time. Add Western emphasis on raising consumption instead of production, housing bubbles and credit crises. Then add the collapse of their currencies which landed them in a burgeoning foreign debt. Finally stir in mean and thin support from Western Europe, the richest nations in the European Union and some of the richest countries in the world, and the dough of bark bread is ready to rise. The whole Central and Eastern European region is in a very difficult predicament.

See Radovan Jelasic, Governor of the Central Bank of Serbia:

<http://www.ft.com/cms/s/0/b8abe858-1268-11de-b816-0000779fd2ac.html>

Western European countries are now inflexible and reified in their outlook. Plus they are inward-looking and lacking in will to assist and reform the Central and Eastern European financial system. Western European countries have fully locked themselves into a rigid political-economic model and cannot adjust to change.

Martin Wolf of FT.com, describes on 26 May 2009 the EU weakness thus:

Why has the European Union suffered so badly in a crisis that began in the US? The answer is to be found in four weaknesses: first, Germany, the EU's biggest economy, is heavily dependent on foreign spending; second, several western European economies are suffering from post-bubble collapses in demand; third, parts of central and eastern Europe are also being forced to cut spending; and, fourth, European banks proved vulnerable to both the US crisis and to difficulties nearer home. Given these realities, recovery is likely to be slow and painful.

According to the latest consensus forecasts, the EU economy is expected to contract by 3.6 per cent this year and the eurozone's by 3.7 per cent, while the US is forecast to shrink by only 2.9 per cent.

If the EU is forecast to contract by 3.6% and the US by 2.9%, how is the world economy going to suddenly jump into the black in Q4 2009?

A jump from minus 3% to plus 1% would be a GDP growth of 4%. What new industries are going to produce this amazing growth? Huge production of solar, wind, wave, tidal, or thermal alternative energy systems coming on stream? No? What else then? *The truth is that nothing significantly new is projected. R&D is hunkering down. The US-EU-UK bloc has delegated to China to do all the entrepreneurial R&D and industrial risk-taking. It is too messy for our Lordships.*

Due to the shocking lack of support for CEE countries by Western Europe one can seriously wonder whether Western Europe might actually prefer Russia to take CEE away again. More than forty years of cold war appear to have cemented Western European attitudes into a we/they approach that makes it difficult for them to accept any

Central and Eastern European country as equal partners in the EU. The Wall came down 20 years ago but Western Europe has not accommodated the change. The present attitude is a shocking indication how much they are stuck in their model.

Western Europe turned a deaf ear to Central and Eastern Europe at the last European Union (EU) meeting of 19th March 2009, and referred it instead to the IMF for crisis funds! Western Europe is in complete denial about the real need to pull out all the stops to assist its Central and Eastern European neighbours and fellow members of the European Union.

At the subsequent G20 meeting, the IMF was granted \$1 tr by the member countries to assist all developing countries including the CEE countries. The mind boggles. The EU has a population of 750 million, more than twice the size of the US. The US deficit is likely to be \$2tr per year for the next few years, *yet the G20 has allocated the entire rest of the world with 5,5 bn people \$1 trillion in loans in a one-off support from the IMF.*

The United Kingdom

The third international reserve currency of the world's fourth largest economy, the British pound, is now in greater difficulties since S&P downgraded the UK from 'stable' to 'negative' for the first time since after the Second World War. The UK government has completely exhausted its peace-time possibilities of raising taxes through the past tax and spend, boom and bust decade, and by decimating its manufacturing base.

The replacement of manufacturing industry by the City of London as a global financial centre, has been severely damaged by the collapse of several banks and financial institutions. A series of forced bank mergers and monetary interventions from the Bank of England have seen investors move to other financial centres, resulting in a flight of financial expertise from London to abroad, even to Asia. The only effective weapon the UK has left is printing money and supplying cheap liquidity to the banks. See:

<http://www.cnbc.com/id/15840232?video=1128776963&play=1>

There can be only one end to this story: hyperinflation.

Fiscal Spending

The US fiscal (i.e. government) spending since it began dealing with the crisis in 2008 is \$12.8 *trillion* (tr) up until the end of Q1 2009. A Bloomberg article which lists the entire expenditure so far, can be seen *here*:

<http://www.bloomberg.com/apps/news?pid=20601087&sid=armOzfkwtCA4>

Note that of the total of \$12.8 *trillion*, it is *all* on pumping credit into the failed banking system one way or another, except for some of TARP \$787 bn and some of the \$700 bn Obama (Stimulus package II) which also stimulates consumption. From other sources we know that only about \$75 bn is designated for use in stimulating alternative production, mostly alternative energy production. So of all the fiscal spending of \$12.8

tr so far, only \$75 bn or 0.005859 of the total, i.e. just over half of one percent (!) is for the stimulation of new production.

The tragedy taking place is that it would have been far better if all the failing banks had been allowed to fail, and then if just \$1 trillion had been *spent each year over five years* to stimulate the production of alternative energy systems, biotechnology and other new products and services for which there is a great need but for which the need has not been satisfied.

As an example, every year hundreds of interesting medical drugs and technologies do not enter the market because small research firms do not have the millions necessary to fund the costs of Phase III trials and the application process to the Federal Drug Administration for approval. Many medicines and devices that could save Health Care services billions of dollars fall by the wayside.

The marvellous eye-drops which I use and which have cured my cataracts are just one of many examples. The fundamentalist mantra is that if a product is good the market will fund its research. Get a life. Markets are sticky. Pharmaceutical research is very risky, as risky as trying to build railroads across the US Mid-West or the wastes of Central Australia. Markets are seldom perfect and many do not clear easily. A small research institute or university department is never going to have sufficient megafunds to fund the Phase III trials and application processes for the discoveries. The idiocy is in creating effective and painstaking research but then not allowing the products to get to the market.

There are realms of other industries which need support or direct liquidity to expand. While banks have been pre-occupied with their criminal activities, they have completely lost sight of one of their main functions in capitalism: to evaluate and support projects of private enterprise.

President Obama has promised that a million new hybrid cars will be made by 2015. These will not be electric or hydrogen cars but will run partly on batteries driving an electric motor and an internal combustion engine partly for loading the batteries and for kicking in when exceptional torque is required. Better than conventional but hardly green. A nice little research project while the planet gets warmer and the polar ice melts.

Hybrid car engines are old technology. I saw my first hybrid car prototype in 1979. It was produced by the innovative workers of Lucas Aerospace in the United Kingdom on their own initiative in their spare time. They hoped the company would begin to make hybrid cars to save the company from an approaching collapse. The UK government quickly moved to quash the innovators. MI5 was sent in to spy on the brains and brawn in the project. The engineer who was Chairman of the Union running the project was sacked from his job. The message was clear: "No innovation, please, we're British." Just a few years later, the UK totally lost control of its motor car industry. It is now owned and run by foreign interests. Anyone surprised?

President Obama was elected on a programme of 'change' and 'can do'. But how much 'change' and 'can do' is the goal of 1 million cars when the US has 250 million cars and about 15 million are replaced every year? What will all the rest run on? Obama says \$800 million will be spent on researching bio-fuels. How long will that take? The last time ethanol was propagated (2008) it led to a global agricultural crisis.

A more serious effort would be much wider and begin by considering the following in a 'blue-skies' seminar:

What is the delay in replacing energy production with renewable energy systems costing the United States every year, e.g:

- 1 in the import of oil, which negatively loads the USA trade balance?
- 2 in cheaper energy?
- 3 in missed export opportunities of alternative energy systems?
- 4 in missed employment opportunities?

The task gets the most rigid minds to think outside the box.

The Media Myth of the Recovery in the US economy in Q4 2009

On 29 May 2009 Bloomberg's David Reilly refuted the idea that the US economy was due for a recovery soon:

The issue with consumers: Their balance sheets are a bloated mess with household debt still unsustainably high at more than 130 percent of income. Getting the ratio down to a more realistic sub-100 percent level -- never mind the 60 percent to 70 percent range seen in the 1960s and 1970s -- involves serious consumption cutbacks. With consumers accounting for about 70 percent of the U.S. economy, this one-time engine of growth may easily become a dead weight.

The entire article can be seen *here*.

http://www.bloomberg.com/apps/news?pid=20601039&sid=a0XPimJ3ggs&refer=columnist_reilly

I began this article by mentioning the massive debt that US households (quite unnecessarily) took on in the period of 2000-2007. That debt must be slowly worked off, and to achieve this US consumer must learn to live with a much lower level of consumption. The drop in GDP due to the lower level of consumption should be made up by government, in synergy with private industry, stimulating new production which will in turn create jobs and add to GDP growth.

The present US administration has however chosen an impossible path. While the problem itself is massive overleveraging by some households, the government has borrowed from all taxpayers to try and boost consumption back to 2007 levels. How crazy can anyone get?

On 28 May 2009 in his article 'Ten Risks To Global Growth', Professor Nouriel Roubini

wrote in Forbes.com:

Yet true de-leveraging by households, corporate firms and financial institutions has not even started, as private losses and debts are being socialized and put on the balance sheet of governments.

The full article can be seen *here*.

<http://www.forbes.com/2009/05/27/recession-depression-global-economy-growth-opinions-columnists-nouriel-roubini.html>

Finally, although there has been a lot of talk and wishful thinking in the media since January, *there is no evidence to support a recovery in the real economy towards the end of 2009.*

This statement can be checked by asking: what great new dam, roads, train systems, technologies, discoveries, ventures, or products do we know of that are going to come on stream in Q4 2009 and cause a *world* increase in GDP from -4% to +1%? The stark truth is: there aren't any. Therefore there won't be any recovery. If anything there will be a slide, which will be augmented if and when China can no longer fund its expansion. October and November 2009 will instead be particularly risky both for the economy and the stock market.

Furthermore, will the G20 really decide to tackle the growing protectionism and alarming fall in trade, at least 20% down globally and 41% down in China? So far the world appears to be no closer to a new Doha round to eliminate once and for all the restrictive and unfair subsidies and import quotas maintained mainly by the US and the EU, plus the rise in protectionism in the last few months.

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Part II - The Short and Medium-Term Global Outlook

The Banking Sector and the Stock Markets

The interbank lending rates and the TED spreads coming down to a lower level (although still not normal) are happening not a week too soon, for it will still take a long time for banks to re-capitalise. In fact that will only happen properly when the economy itself takes off again, which is dependent on proper demand-side management (industrial asset-creating fiscal spending), which is unfortunately neither happening in the US to any significant extent, nor in the EU. So although the aversion of a systemic banking collapse appears thankfully to be averted for the present, *the recovery of the economy has not been secured.*

On Wednesday, dollar Libor for the benchmark three-month sector set at 0.71625 per cent, extending its run of declines for 36 straight days. A comparison of Libor with the Fed funds rate shows that the gap between these two rates is at its lowest level since February 2008.

Financial Times, 20 May 2009.

On 20^h May Treasury Secretary Timothy Geithner was honest and clear about what was working and what wasn't. He pointed out that while the TED and other spreads were coming down, the stabilisation of the financial sector was only the beginning and there was a lot more to do. The market fell! In my opinion this was his best performance so far at reporting back, and for this (not for his policies) I would give him an A+. The market is already seriously deluded. Although not enough, transparency is a good weapon in trying to bring it down to earth.

Those 'investors', whether institutional or private, who thought we could now go leaping back to the economy of June 2007 must now listen carefully and finally get the message. Nasdaq never got back to 5000 during the last 9 years, and the Dow took 26 years to get back to the prices of the peak of 1929. The message that must be drummed home is this: the old order is not coming back anytime soon, and this crisis is far more than a recession. Already by June 2009 the recession will be longer than any other in history (18 months) and is now moving towards depression length (43 months).

Of course a lot of institutions must have been very happy they could milk the March-May 2009 rally as much as they did and recover at least part of their losses. However, there is little value left. See:

<http://www.chartoftheday.com/20090522.htm?>

It appears that the markets are moving sideways waiting for more definite news.

Eventually since the fundamentals are poor and weakening, at some point there will be the series of slides and unwinding of positions many institutional investors on the sidelines have been waiting for, i.e. to see 'blood on the floor' so that they can get back in at the absolute bottom. If it does not come now it will come later.

Of course for those traders who make money in both bull and bear markets and who are *in situ* at the stock exchange during the day and wish to ride any ephemeral young bulls up, whether intra-day, intra week or intra-month, that is entirely up to them. But knives fall fast, witness October 2008, when a lot of people got badly cut. Realistically, only after a correction which brings the P/E ratios at least down below double figures should investors think about going back in. The market has simply risen too far too fast.

I believe people must stop getting reassured by people like Warren Buffet. Such born optimists have just been too far ahead of the game, thinking this is just a normal but deep recession. As I have written before, it is not as if Buffet would lose everything if he made a wrong move on some stock or other. Having such vast reserves, Buffet does not have to operate under the constraints that others do and he gets the best rates on preference shares just because he is who he is. In my opinion he does not understand the macroeconomic ramifications of a Depression. He was also too young to remember the Great Depression in any great detail.

Bill Bradley, former US senator, recently made this remark about Warren Buffet:

Warren Buffet buys Goldman Sachs, and after he buys, the price drops 45 to 50%, and if he is going to break even on the investment he's got to earn 9% for the next 12 years, I don't think that is a recovery.

Many people like Buffet appear to be too steeped in market behaviour of the past 60 years to realise that everything been transformed through the events of 2007-2008. The market has changed, the financial system has changed for the next 30 years at least, the world has changed, and the global economic outlook has changed. Unless they change, they are part of the past, not the solution. In fact Buffet is doing great damage by his 'reassuring grey eminence' appearances, because it is preventing people from seeing the light, which they need to see in order to begin to act to protect their interests. As Mohamed El-Erian would say, we are now in 'a new normal'. And in the short and medium term it will be a very rocky time.

Exuberance or Liquidity?

Let me be crystal clear on this. There is no evidence from the fundamentals of economies around the globe, except for China, to warrant the March-May rally of 2009. The fundamentals everywhere are weakening. The market was fuelled by the Obama social security cheques and tax rebates just as happened to the market in Q2 in 2008 under the George W Bush administration. The same liquidity drive has been happening in a range of countries across the world, instituted by a string of governments copying each other because they don't really know what to do. Thus the March-May rally of 2009 was not a bear-market rally at all, *but an unsustainable bubble driven not by*

fundamentals but by liquidity.

The famous term 'irrational exuberance' coined by Alan Greenspan in 1996, is applicable at this point to describe the bear market rally of March-May 2009. Robert J Shiller, writing about the use of Greenspan's term, wrote this:

The phrase survives in our language as more than a relic of one minor stock market episode because it has acquired a meaning that refers to the mindset that occurs during speculative bubbles like that of the 1990s.

The huge difference between 1996 and 2009 is that due to the U.S. 2002-2008 housing bubble and the stock market crash of October 2008 we now know for absolute certain that bubbles are not caused by irrational exuberance, but by an excess of liquidity. Herein lies Greenspan's historic mistake. With *his compartmentalised mindset* he failed to realise that by lowering the Fed's interest rate to 1% for 3 years he and the FOMC would create one of the biggest bubbles in economic history. At the time, I found his comment, coming from a person vested with the ultimate influence over monetary policy which can dampen inflation and other bubbles in what was then the most powerful economy in the world, no less than surreal.

Greenspan evidently did not have the foggiest notion of the psychological or physiological dimension of economic largesse. In his more recent apology in a government hearing he blamed himself for not believing in his wildest imagination that executives would make irrational decisions [for the company, its staff, the clients, the country as a whole, its citizens, the economy of the world – my insertion], This statement exposes Greenspan as someone who has erected a dichotomy between what he sees as irrational behaviour on the one hand, and human economic behaviour which he sees as rational, on the other. One wonders if he can remember any utilitarian theory from his first year studies in Economics.

At any rate it is now easier, thanks to his 'apology' in which he attempts to shift the blame for the errors on his watch on to bank CEO's and innovative gurus, to understand how Greenspan, with his outlook, became successfully seduced by the naked absolutism of Ayn Rand. Greenspan could comfortably take it easy with his responsibility as Chairman of the Fed by believing that his role was not to interfere with how banks lent, and besides, it was his belief the markets would always clear and achieve balance and equilibrium in the economy. So far the history.

Fatal Mistakes

The tragedy that is now unfolding is that Alan Greenspan's successor, Ben Bernanke, is going down a parallel road. Having misdiagnosed the causes of the credit crunch as a lack of liquidity, perhaps due to an over-exposure to his studies of the Great Depression, and failing to realise like Ann Schwartz that the credit crunch did not originate as a lack of liquidity but as a crisis of confidence between banks due to the toxic assets created by the malfeasance in the housing bubble, Bernanke has presided over issuing an

unprecedented and astronomical deluge of liquidity over the banks and the population which has now led to another stock market bubble.

Had Bernanke and Geithner instead worked with entrepreneurs and unions and academic and company scientists and engineers to decide on which new products to make and build and deliver, and which needed state guarantees and loans in order to get started, there would have been no second bubble. That chance and those funds have now been wasted, and instead we have another nasty stock market bubble resting on weak fundamentals and have to await the next fallout.

Exactly as in 1929, a bad recession was turned into a depression by the wrong responses. In 1929 the problem was liquidity, in 2007-9 it was instead a crisis of confidence in the banks, which could have been dealt with far more resolutely through the Federal Deposit Insurance Corporation (FDIC) and Chapter 11 bankruptcy proceedings.

The only way to teach shareholders and bondholders to avoid holding shares in dodgy banks is for them to lose their investments. That lesson has not been learnt because of the massive transfer of capital from the taxpayer to the shareholding and investing class to prop up their banks. At the same time it is a disturbing and undeniable fact that the bad, unethical banks have been rewarded for their misdemeanours.

The phrase 'too big too fail' is a convenient fig-leaf for a gigantic transfer of wealth from the taxpayers to the shareholding and bondholding investors of the dodgy banks which should have been allowed to go to the wall. Had the toxic banks and AIG been allowed to fail, there would have been a mighty reverberation around the world, and a lot of re-structuring going on for up to a year. But after that the crisis would have been over. The crisis would have been limited, toxic banks quarantined as they fell ill. As and when a dodgy bank gathered too many stinking mortgages on default, well, then it would fail and be taken over by the FDIC. But the larger economy would not have been affected in nearly the extent that happened.

The depositors' money was always guaranteed, and other better banks would have immediately stepped in to take the place of the dodgy banks. The only banks left would have been solvent and liquid ones and so interbank lending would have resumed and companies would have been able to obtain loans and commercial credit. The lack of trust between banks would not have dragged on - wreaking the havoc it has done and still may do when approaching storms hit.

The stock market would have spiked downwards and found a real bottom in November 2008, and all countries would have now been on the way to rebuilding their economies. Some would not even have been noticeably affected.

Faulty Ideologies

The crisis in the economy itself has furthermore been very badly handled. In both the first four years of the depression in 1929-1933, and this present crisis, far too little was done to stimulate *production* and far too much was done to strangle trade. It was only after President Hoover's disastrous first four years of office (1929-1933) when Franklin Delano Roosevelt came to office that some stimulation of new production was adopted. The world still does not seem to have learnt that lesson.

It appears that the result of a 42-year Cold War is that the American public has been indoctrinated to believe that any government intervention to take over banks, take out the toxic assets, re-structure them and rapidly re-privatise them, is socialism. The mantra is 'Heaven forbid that it should ever happen in the United States of America'! The mention of the FDIC doing more or less that with Indymac does not evoke any understanding but an accusation that, well, Obama is maybe a socialist. When it is pointed out that the Indymac takeover was begun by the FDIC under George W Bush, there is a crushing silence.

The ignorance is amazing. Under capitalism, bankruptcy and re-structuring always involves government agencies and the law because they are there to see that it is done fairly and rationally. It is the most capitalist solution and has damn all to do with socialism.

The other 'red rag to a bull' for Americans is the idea that Central Government could stimulate public works and issue tenders to private enterprise for a massive launch of all the possible alternative energy systems for which technology has been available for decades. Consequently, for fear that the population will taunt the new administration with the 'socialist' tag, the present US fiscal spending on alternative energy systems and cleaner cars is only a tiny fraction of all the bank bailouts and the consumption cheques, instead of the other way around.

Liquidity in Excess

Ben Bernanke is so obsessed with liquidity that he famously said that if necessary he would spread dollar bills all over the country by helicopter. If his words were not so stupendous they might be funny. But in fact his words are waiting to be eaten. The Bernanke and Geithner path of stimulating consumption is completely unsustainable, and will create both further bubble and bust, and then the ultimate crunch: hyperinflation and stagnation. That is the spectre of Germany in the 1920s or Zimbabwe in 2006-9. Only starvation, emigration, war or internal collapse generally change such outcomes.

The paradoxical flight to the safety of the U.S. Dollar we have seen until May 2009 will at some future stage be reversed, especially since the US is likely to be downgraded from its AAA rating at some point during the next few years – some believe when the ratio of US debt to GDP reaches 100%. Such an event will in turn push yields on Treasuries up and weaken the dollar further. For more on this topic see *here* :

<http://www.bloomberg.com/apps/news?pid=20601080&sid=aIu71a7dj5w8&refer=asia>

PIMCO chairman Bill Gross said March 19 the Fed would need to expand its balance sheet to as much as \$6 trillion to spur growth. See more *here*:

<http://www.bloomberg.com/apps/news?pid=20601009&sid=aIAxWDoJUK3g>

However it doesn't take a banker to realise that such an amount is not going to come out of the US Federal Reserve, much less the US Congress, for despite all the money printing going on and the selling of U.S. Treasuries, there comes a natural limit to all excessive quantitative easing: hyperinflation. The more money floating around the less Treasuries are worth. The less they are worth the more the yields have to rise to attract buyers. The higher the yields the heavier the cost of servicing the debt and thus the more unsustainable the printing of Treasury Bills becomes. Not too far in the future the entire annual US deficit will be used up by paying the interest on the debt already taken, and nothing will be left to repay the principal.

See *here* about the bond vigilantes protesting about the US deficit increase:

<http://www.bloomberg.com/apps/news?pid=20601009&sid=akW9GQw.X9KM&refer=bonds>

John Taylor, Professor of Economics at Stanford and a senior fellow at the Hoover Institution, has delivered a scathing warning to the Obama administration that policy must change, now. More can be read *here*:

<http://www.ft.com/cms/s/0/71520770-4a2c-11de-8e7e-00144feabdc0.html>

The Increased Risk of War

At some point the policy will break down and issuing Treasury bonds and Treasury Inflation Protected Securities (TIPS) will no longer work. The US and UK governments will probably start a big war somewhere as they so often do, in order to have the excuse to cancel all debt repayments and steal the resources and perhaps the gold reserves and the oil of a few countries. Such action would be abominable in the extreme, but not that improbable.

The US and the UK go to war every decade anyway, just to test their weapons systems, so ruthless leaderships might find going to war in the hope of bringing back some lolly rather attractive. Just like Tony Blair and George W Bush knew that having a war guaranteed a return to a second period of office. Not that this is anything new. However these war-mongers had learnt from UK Prime Minister Margaret Thatcher who, I was later told by undisclosed sources, had been informed by the British Royal Navy of the impending Argentinian invasion in the Falklands two weeks before it happened but found it convenient to ignore it until faced with an ongoing invasion. A sitting war-time leader is most often returned to power by a loyal electorate. However, history also

teaches us that great powers actually do very foolhardy things at the end of their reigns, hastening their demise all the faster, and a global economic meltdown is a very precarious time to start a war.

Another method would be significantly to raise taxes or halve the take home pay of all the workers in the country, and confiscate private hoards of gold as well. The latter was actually done in the US in the 1930s. However, measures like drastically reducing take home pay and confiscating wealth is not an ideal course of action. Not only is it probably very difficult indeed to achieve politically, it will of course reduce demand and a further downward spiral of grinding poverty and depression will begin. The present US-UK-EU governments, by their ignorance of how to use fiscal spending to stimulate production rather than consumption, are throwing away the means by which this can be achieved.

A New Paradigm for this Era

There is also the ever-present risk that the government will get cold feet at the gigantic mounting debt which the bank rescues and consumption stimulus is accumulating. If the issuing of Treasury Bonds looks impossible to continue, the US may be tempted to cease its stimulus packages and raise interest rates. If this happens, then businesses will once again collapse and unemployment will once again rise. Such a turn would be a repeat of the 1937 attempt by President Franklin Delano Roosevelt to let the economy cope on its own without any more stimulus.

It immediately tanked for a further 4 years until 1941, when war-spending took over as a fiscal spending stimulus, this time on weapons, which unfortunately are not wealth-producing assets that produce goods and services. Weapons, although they may sometimes be necessary for defence, destroy wealth, besides contributing to the world total of misery and desolation. Thus the US only really regained full employment and a full economic recovery in the early 1950s, more than two decades after the first crash of 1929.

Robert Shiller stated the following in an interview by FT.com on 19 May 2009:

We may be in for a difficult period, if the economy is slow to recover, if national debt keeps rising. Uh, if the stimulus package is not enough, we could see a turnaround in the support for economic stimulus, analogous to the support we saw at the peak of the markets in 1937.

The US government became disillusioned with its deficit spending, and started correcting that, raising taxes and cutting expenditure. Moreover they were concerned about low interest rates being possibly inflationary so they started to tighten up on monetary policy. The same could happen again, now, before we get a solid recovery.

A lot of economic phenomena can often be seen clearly after the events involved; looking in the rear-view mirror and calling history is a favourite pastime of economists. This is because economics is not an absolute science with 100% predictive power, for

the simple reason that many factors known and unknown need to be taken into consideration to make an accurate judgement, and this is often not possible at the time because the information does not yet exist, even for the economists and statisticians whose business is analysing and making judgements on the basis of economic data.

Occasionally, however, a new paradigm stares one in the face. All too often, the more obvious and glaring the new paradigm the more it is missed. It becomes part of the furniture, camouflaged into the background. Nevertheless, it is sometimes vitally necessary to discern the condition of a country and its people at a particular point in time, right in the midst of history in the making, and without having the advantage of a rear-view mirror. I believe we are now at such a juncture.

To use another analogy: sometimes, when the car engine seems to be in trouble it is necessary to stop and check whether the oil gauge is really working and take a look at the dip-stick. In other words sometimes you have to question the message you are getting and look at the fundamentals. Despite all the blather about 'can do', 'the entrepreneurial spirit', 'what America is all about' (US), 'our marvellous heritage in economics and engineering and science' (UK), 'our advanced rational and scientific approach to production and our social welfare society' (EU), events over the last three decades are massively refuting all three areas' claims.

Further back in time, yes, all three economic areas were good at what they say. However to look the truth in the eyes, the US has been on a mad trip of low taxes and current account deficits and foreign borrowing since the Reagan era, and while the production of new goods and services for the market have not been coming forward, the only really telling innovations that have taken place in the last decade have been the very disastrous ones in the financial sector which has brought about this present global catastrophe. The US production of goods and services has been in decline for 30 years.

The UK has let its manufacturing base shrink because it could no longer innovate enough and had a laissez-faire attitude to education and vocational training, simply because it no longer bothered to understand it. Furthermore, dealing with smelly, dirty, communist miners who were in belief and class and behaviour far too different from the ruling class was deemed too much of a bother. So it decided to go down the US route and develop a 'world financial centre' in London instead.

Such centres would be staffed by reliable middle and professional class people who had the same accents, wear the same clothes and would obviously be more reliable and not sink the ship. Or so it was thought. As for all the other vocationally trained workers necessary to maintain buildings and transport networks and staff schools and hospitals they could be imported. The result of this policy we now all know. British branches of American banks bought the toxic assets the US banks wanted to get rid of, then all the banks wanted a share of the pie to get bigger bonuses, and so finally the US brought its UK ally down with it.

Then we have the European madness. The European countries with all their self-lauded accolades about superior democratic institutions have built an incredibly messy, undemocratic, highly inefficient, loose political union of sorts. The union has displayed an endemic terrible series of democratic deficits and indecision, and has never solved its problem of two-digit unemployment. For over thirty years it imported millions of workers in the name of globalisation and much else, but *de facto* only integrated half of them. The rest live in fenced-off high rise ghettos highly alienated and disenchanted and ready to start a civil war. When the natives now get laid-off from their jobs, there will be fireworks.

In this article I refer to the UK as separate from the EU. This is for several reasons. Its economic policies and military policies have since 1980 been very closely linked with that of the United States, and on various issues the United Kingdom has sat on the fence of the European Union.

However there are similarities across the entire US-UK-EU bloc, one of the most seminal being that due to the lack of true counter-cyclical fiscal spending measures geared to stimulating production of new viable products and services in the US, UK and the EU, we have only just begun the long drawn out churning process that a long slide into a depression involves.

Since about 1980, all three economic areas managed to muddle along for nearly three decades and borrowed from the rest of the world to finance their deficits until China really appeared on the scene in earnest at the beginning of the millennium. This real competition from China and to some extent India and other emerging countries with real innovation in products that were better and cheaper than in the US-UK-EU, has thrown open the cracks and contradictions for all to see.

The US-UK-EU bloc will pay dearly for this lack of knowledge of political science and economics among its lawmakers and administrators and the general population, for it is leading them down the wrong path when dealing with the economic crisis.

And so it becomes suddenly prominently apparent that the present paradigm change in the world is not about the US being eclipsed by China. *It is about the US-UK-EU being eclipsed by themselves, shooting themselves in the foot through their own decadence, arrogance and rigidity. They are a bloc, a system. They are held together by a common history, a common economic system and they have related cancers in their economic control systems.*

And their brain cancers are this: a stupid fundamentalist ideology which precludes a thorough political-economical analysis (US), total incompetence in the ruling class due to a sick class structure and an ancient democratic model which is no longer fit for purpose (UK), and a complete unwillingness to allow a root and branch renovation of a highly dysfunctional political-economic model that has now petrified into stone (EU).

The common strand is the following: *The US-UK-EU bloc has forgotten how government and business should work together when necessary to create the large scale production of new goods and services that will replace or complement old industrial structures.*

Therefore: is it any wonder that these three areas, the US, UK and EU cannot do it now even when it is a question of economic survival? None of these governments can stake out a real bold course and get on with it. Instead, they are afraid of being called socialists if they use Central government to stimulate production. So they are skulking around in the background like cowards, secretly hoping that China will pull them all out of the depression, so their ignorance and laziness and shoddy thinking will not be revealed to their populations.

For the moment the current spreading of liquidity is going on apace, and the banks are now finally lending to each other again, even if reports indicate that they are still using government funds or raising capital to improve their capital ratios and still not lending sufficiently to individuals and businesses to stave the rise in company bankruptcies. The patient appears to be temporarily better. However the stark reality is that the medicine of massive liquidity being administered to cure the cancer in the economy is so drastic it is very likely going to come back and kill the patient altogether - in the form of hyperinflation. See also:

<http://www.cnn.com/id/15840232?video=1129969025&play=1>

The Future of the Dollar

Normally, when the stock market vapourises wealth into thin air in terrifying downward slides, at least some of the proceeds of the investors' closed positions will re-enter the bond markets. However, when the second great slide happens, the perception of the US as the leader of capitalism and the consumption locomotive that will pull the world out of the downturn will take a knock.

Normally, when bonds become slightly more attractive, yields come down slightly and the dollar implosion is less than otherwise, reassuring China over the 'safety' of its Treasury Bill investments. But we are now very far into the history of the present 18-month recession. There are now increasing worries about a collapsing dollar happening perhaps even in the medium term, or the US dollar gradually declining as the risk of the US losing its AAA rating is slowly priced into the market with every dollar of debt the US sells. See also:

http://www.bloomberg.com/apps/news?pid=20601083&sid=aQZVg_9sZEKM

See:

<http://business.timesonline.co.uk/tol/business/economics/article6317766.ece>

for the continuing deflation in the UK and also for the contraction in EU GDP see:

<http://business.timesonline.co.uk/tol/business/economics/article6297015.ece>

China

China is not yet a fully developed country like the US and to a lesser extent the EU. Nevertheless, it is bravely trying to pull itself up by its boot-strings. In the absence of any similar massive fiscal spending on production in the US-UK-EU, the risk is that the Chinese expansion might fail at some point, due to the continued low exports to the ailing the US-UK-EU bloc, and the country might fall into a recession of its own.

David Kloppers, CEO of BHP Billiton:

<http://www.miningmx.com/news/markets/166391.htm>

Jerry Lou of Morgan Stanley has put out a strong warning about the possible long-term unsustainability of the Chinese drive to create a complete and sufficient home market by building huge infrastructure projects to provide housing, schools, roads, hospitals. The fiscal spending drive directed by the Chinese government is not wholly driven by fundamentals because half of the Chinese export markets have fallen away. The drive is now fuelled by re-directed savings, i.e. liquidity.

In other words half of the Chinese government drive to spend in underdeveloped areas in the interior to create housing and provide white goods for more Chinese (and thereby jobs and pay packets) plus improved Health Care and a burgeoning financial and insurance sector, is coming from dollar assets being converted into hard assets. Thus it is not being funded by good fundamentals in the form of current account and export surpluses but increasingly by past savings and by slowly ditching its US dollar paper assets. This means that there is an outer limit for this method of funding the expansion.

If the US-UK-EU bloc were to change its policies from fiscal spending for consumption to fiscal spending for production, trade would begin to rise and China may be able to continue its expansion project, benefiting the world economy in return. Without a resurgence of trade in the medium to long term, building an internal market to replace the 41% shortfall in its export trade may become much tougher for China.

Nevertheless, this enormous Keynesian demand management stimulus is exactly the right thing to do after a major economic shock i.e. to create new production lines rather than just give away free money through tax rebate and social security checks. The stimulation of large scale production creates both jobs and real wealth in the form of hard assets. However the desperate pace of the project is definitely not of the Chinese choosing. China was forced into it as the only intelligent way out due to the collapse of the US, UK and latterly the EU markets, or see half a billion of its citizens starve.

China will thus get much further down the road in keeping up its GDP than the US, UK

and EU. However in the absence of the latter doing the same as China and using fiscal spending to create new industries and jobs and thereby a demand for Chinese products, the drop in Chinese exports might mean that China will also have to face a gap between the liquidity needed for more production and the real supply of capital in a few quarters' time.

So while Jerry Lou at the moment sees the Chinese demand for commodities e.g. from the BRICCSAA countries (Brazil, Russia, India, China, Canada, South Africa, Australia) as still being there for the moment, he recognises that in the absence of a US-UK-EU recovery anytime soon, China will have a financial problem, he thinks by Q4 2009. See:

<http://www.cnn.com/id/15840232?video=1128710611&play=1>

To put it into plain language: Given its prior industrial structure geared towards export and with half of its population still poor with low incomes and thus low buying power, it is not certain that China can sustain its home grown GDP growth of 7-8% for ever. Since US-UK-EU demand under present policy is not going to return to 2006 levels for many years, China too may have a recession. Lou suggests this would most likely start in Q4 2009 or Q1 2010.

This will undoubtedly have a dampening effect on China's BRICCSAA partners' exports later this year and in the beginning of 2010 and this is something countries like South Africa need to be aware of and begin to implement its own infrastructure projects to take up the slack and in fact to improve growth – in South Africa's case very long overdue anyway.

The US – China Divorce

China is likely to cease investing in US Treasuries in order to finance its project of stimulating the production of goods and services in the underdeveloped regions in the interior. It has also begun to build up its own financial sector with pensions, social security networks, and better vocational education for its workers. Since the Chinese demand for US Treasuries will fall, the US will have to coax its own population to invest in Treasuries to finance its deficit spending. Yields on Treasuries will rise and the stock market will not be able to compete and will decline. The result will be less capital available for enterprise and if the US has not learnt to spend on massively encouraging new industry by then, the US economy will decline.

In sum, the US and China have been in a sick marriage for twenty years whereby China has parked its savings in US Treasuries while it concentrated on building up its industry in record time, and the US foolishly used Chinese savings to fund US deficit spending. China will soon reach a point where it will altogether cease saving in US Treasuries and instead use all its own savings to fund its own internal economical expansion. The US will have to borrow from its own population to fund its budget deficit and the

repayments of its loans to its creditors, among others China.

For the investor, after the next bear slide provides a suitable entry point, I would imagine this means avoiding anything denominated in USD, perhaps sticking with Asian stocks or BRICCSAA commodity stocks until Treasury yields hit 6% or China falls into a recession, or interest rates rise above 2%. Then when everything falls apart there always remains a switch to Gold, Silver and Money Markets. Or retire and become a subsistence farmer.

Outlook: The BG (Bernanke-Geithner) Bubble of March-May 2009 and the Aftermath

Part III – Summary and Conclusion

Discussion

The outlook is not rosy. In part it is because investors in particular stare fixedly at the stock market and tend to judge the economy by the ups and downs of the stock market. Both investors and entire populations around the world are still in denial. They should instead look around and study the world, for then they would discover the fundamentals are weakening everywhere.

This recession is not a classic manufacturing and inventory recession or an inflation recession with high interest rates. It has been caused by a \$20 *trillion* implosion in wealth in the US housing sector. It is gone, dissipated into thin air. Such an implosion has not been seen since the Great Depression and represents not only an enormous global reduction in wealth and but also in demand.

The dangers of stimulating consumption

The US government is stimulating consumption spending to try and make up for this contraction but a) can only raise \$20 tr to spend on behalf of the consumer with great difficulty b) shouldn't try to anyway because it will just create inflation and an inflationary depression. Now the question may be put: why should \$20 tr not be employed to replace the lost wealth?

The lost \$20 tr was vested in real estate. Additional trillions were invested in the stock market. World wide, \$52 tr of wealth were wiped out from the stock markets since July 2007 – disappeared into thin air. The U.S government spending another \$20tr will just create inflation because that would be too much money chasing too few remaining goods and services. Some of it will be used to pay down debt, and some of it will be put into bank accounts, but because most banks are rebuilding their capital ratios, it won't get lent out to some needy entrepreneur. Some of it might get invested in the stock market, blowing up another bubble. Also, that \$20tr has to come from somewhere.

The stimulation of production

The correct way to grow the economy out of a depression is an augmented form of the President Franklin Delano Roosevelt policies of stimulating production and employment and export, first taught by the Stockholm School in Sweden in the early 1930s but suggested much earlier by other economists such as Knut Wicksell and John Maynard Keynes during the 1920s.

In the middle of the worst time of the first four years of the Great Depression, Sweden practised the stimulation of economic growth in order to boost employment - first in 1931 through the depreciation of the krona, thereby boosting exports, and then in 1933 through monetary policy, exchange rate adjustment and fiscal spending by the new Social Democrat Government.

Some believe that it is doubtful that the modest levels of the fiscal spending in the first budget in 1933 contributed more than a small fraction of the increase in economic growth for the next few years, believing that the most powerful form of growth stimulus still came in the form of a cheaper krona, which enabled an increase in export production. Nevertheless, the policy was successful.

A good deal of Sweden's exports in those days were commodities such as iron and steel, timber and finished products of the same and those countries importing these raw materials or products gained an advantage in turn by obtaining materials that were cheaper than from other countries. These advances in practical economics took place in advance of John Maynard Keynes' 'General Theory of Money, Interest and Employment' which he published in 1936.

After a reform in 1938, an export surge was achieved by allowing companies generous depreciation write-downs which allowed for a higher quota of re-investment of profits in machines and fixed capital.

Contrary to popular belief, Keynes' original theory was used as Swedish government policy only from 1947 to 1960 and then abandoned for another policy by two Swedish economists, Rehn and Meidner. Their reason for abandoning the original Keynesian model was that Keynes' original theory was designed for a situation of negative growth and deflation, such as a depression. These two influential economists felt that when a country is no longer in a depression, the policy becomes inflationary.

The Rehn-Meidner model, although still using the idea of government intervention, had as one of the main goals the achievement of full employment and price stability. More can be read about these models *here*.

http://www.ne.su.se/paper/wp00_13.pdf

As noted above, Keynes' original theory was designed as a policy for the Great Depression when large amounts of the factors of production were idle – timber in the forests untouched, ore still in the ground, workers unemployed, capital sitting on the sidelines. *Yet these are the same conditions we have today.*

Government assistance and intervention in production in the economy has however been a part of growth and development since early capitalism. The fiscal (ie. government) spending side of the policy is simply as follows. From the fiscus (borrowing if necessary) the government should spend on providing guarantees for the establishment of the production of new and needed goods and services and by building

infrastructure which will facilitate the production of these same goods and services. The latter are often major works projects for which any individual firm would not be able to raise the capital on its own.

A historical review

In the nineteenth century, a number of railroad building projects failed or ended in bankruptcy and had to be completed with state aid or state guarantees. To avoid these failures and the disruption and implosion of capital investment this involved, it became more rational to obtain guarantees before embarking on large and risky projects. Better oversight also produced better planning and risk assessment.

So also in the United States:

In 1862 Congress passed the Pacific Railway Act, which authorized the construction of a transcontinental railroad. The first such railroad was completed on May 10, 1869. By 1900, four additional transcontinental railroads connected the eastern states with the Pacific Coast.

Four of the five transcontinental railroads were built with assistance from the federal government through land grants. Receiving millions of acres of public lands from Congress, the railroads were assured land on which to lay the tracks and land to sell, the proceeds of which helped companies finance the construction of their railroads.

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By 1900, much of the nation's railroad system was in place. The railroad opened the way for the settlement of the West, provided new economic opportunities, stimulated the development of town and communities, and generally tied the country together. When the railroads were shut down during the great railroad strike of 1894, the true importance of the railroads was fully realized.

Library of Congress

Those today with the fundamentalist religion of 'free market' capitalism without any government intervention would obviously think that the US government has been a terrible socialist government in the last 160 or so years. Yet governments have guaranteed and co-ordinated and facilitated and economically supported capital ventures throughout the history of capitalism, even from the earliest beginnings. Early trading ventures by European traders were so costly and risky that the state invariably owned the companies or regulated them by charter – the Dutch East India Company is one in mind.

The Dutch East India Company was the first multinational corporation in the world and the first company to issue stock. It was also arguably the world's first megacorporation, possessing quasi-governmental powers, including the ability to wage war, negotiate treaties, coin money, and establish colonies.

Later when ships became numerous and long voyages less risky, private shipping developed and expanded. More can be read about early state intervention or control *here*:

http://en.wikipedia.org/wiki/Dutch_East_India_Company

State guarantees, charters or support generally occur when the projects benefit not only the companies that complete them but the wider public through the increase in activity and thereby the growth of the economy. But these projects require a certain industrial savvy among the politicians of that country who see the business and economic growth value of the new products and realise that the country at large can benefit from these projects.

Whenever a country has idle factors of production, innovation is necessary to maintain growth. This scenario is especially valid in a depression. The new product or service that is developed supplies the needs of the people in the form of the new goods and services, all while people will be newly employed to produce the goods and services to be enjoyed by others and themselves in the population who will buy them. The economy will thus gradually, year by year, grow out of the depression. It is a process, not an event. There are no quick fixes for a depression, as the world will now soon learn.

The competencies required of Government and the media

This competence among politicians at the level of government, central, regional or local, is a mixture of business acumen, canny risk assessment and the real 'can do spirit' which benefits a nation. EU countries, the UK and the US have all many times during their economic development been able to mobilise the right people to facilitate innovative projects which together once again restored growth, reduced unemployment and fostered prosperity in their countries.

Sadly, there is very little of the real 'can do' spirit left among the political class in the US-UK-EU bloc today. Few politicians understand business today, nor are they able to see the value in megaprojects which will benefit the economy as a whole and willing to invest political capital for the love of their country. Perhaps this is not so surprising. The spirit of the present time is a selfish, individualistic, mean, 'I'm all right, Jack', 'beggar thy neighbour' attitude which, masquerading as a holy political mantra, holds that any intervention by the government in the business life of the country is socialism, and that companies and government should be held apart by water-tight compartments.

Such a simplistic outlook is unfortunately the hegemonic view of at least the majority of the US population today. It is a highly ignorant and dangerous view of both the necessary functions of government and the necessary interconnections between business and government. Should those who advocate such policies and social structure ever obtain control of government to enforce this dichotomy, the economy would revert to a subsistence level prior to capitalism, and the majority of the population would starve to death.

Why is this issue so important? This fundamentalist and highly obstinate attitude locks

the whole country into a paranoia towards possible solutions involving the correct role of government in preventing a great depression. It refuses to allow the government the right to facilitate the innovation of new production because it does not happen to stimulate just their little pay-packet or their company or their shares. In typical Ayn Rand fashion the protagonists deny 'the common good' and only wish to act in their own interests.

Publilius Syrus, 1st Century BC:

Whom Fortune wishes to destroy she first makes mad.

In the US, the High Priests of this holy political mantra are highly prevalent among the news presenters of the CNBC and other media agencies. They love mentioning Friedrich von Hayek, but their knowledge is superficial. Von Hayek believed that government should intervene in serious crises in the economy. By their smokes and mirrors they are successfully hiding the real contradictions in current US financial policy from their viewers.

The wrong path and its consequences

The clammy High Priests are wrong, but so is the US government in the type of interventions used. The present US government response has spent most of its fiscus on propping up the US investment banks instead of letting them fail and be re-structured and restarted. The Obama administration's present finance policy, which is largely a continuation of the policies of George W Bush, is an astronomical waste of resources which should have been used to stimulate new products, services and lines of production. The two US governments have also twice let a consumption stimulus wash over the population.

Very little has been invested in the creation of production lines of new products and services and the infrastructure to facilitate these. The US looks very much like it might end up saving its banks but destroying its economy. A more likely scenario is however that when the real economy does not recover, it will come back to bite the banks as well. That way both the banks and the economy will go down. The stock market? I'll leave you to guess.

In a speech in Las Vegas on 27th May 2009, President Barack Obama said the following:

95% of all working families saw their take-home pay increase because of the tax-cut that we provided in the recovery act. 54 million seniors received \$250 extra in their social security checks. Laid-off workers have received greater unemployment benefits and paid less for their health care. For the thousands of families whose homes have been made more energy efficient – it's also saved them about \$350 on their energy bills.

Other Americans saved thousands by taking advantage of the tax credits the recovery act has provided

for the purchase of a new home, or a new fuel efficient car or energy efficient cooling and heating systems, windows insulation, and all of this has helped to fuel demand that is helping businesses put more Americans back to work. But this is just the beginning!

Ouch! Sadly, apart from perhaps the energy efficient cooling and heating systems and windows insulation which will save energy and the import of oil, unless there is a change in policy, President Obama risks going down in history not as the Roosevelt equivalent who saved the United States economy and brought it out of the Great Depression, but the Herbert Hoover equivalent who turned the recession into a depression, and got booted out of office after just four years.

Nowhere are we out of the woods yet. Although the London Interbank Offering Rate (LIBOR) is now 0.72% on its overnight rate, and the Chicago Volatility Index (VIX) has diminished to 13%, the US banking sector continues to contract. Japan's GDP is declining by 11% at an annual rate and the EU by 15.2%. Many EU banks are in poor shape, having been using a leverage of 30:1 or even 40:1. Taiwan's economy shrank 10.24% during Q1 2009.

The dithering by the US-UK-EU bloc is both a fact and highly disconcerting. *It has taken a full two years* since the first troubles of Northern Rock in May 2007 to restore world-wide interbank lending.

However, that bank lending and inter-bank lending is being restored is not the end of the recession. It is merely the absolute minimum starting point for laying the foundations for any recovery at all.

UK debt is now 15% of its GDP per annum, and the UK is carrying a total debt of 450% of GDP. Furthermore, \$2 tr worth of UK debt is held in foreign currencies, while the £ is weakening, making it more expensive to pay back. German deflation is 2.7% y.o.y. At the same time as world production is *decreasing*, the gold market *increased* 38% y.o.y, a sure sign of fear and economic uncertainty.

During this last three month (March-May 2009) stock market rally of 25 - 40%, US retail sales, housing starts, industrial production, employment all *declined*. Loan defaults are still around 6%, with no sign of declining. Commercial real estate is the next shoe to drop with defaults now 5.6% and rising.

Where then are the 'green shoots' in the economy?

Stock market analysts and traders have been making the myopic mistake of studying company books and noting improved profitability through inventory reduction. Armed with these they have rushed out and hailed a recovery in industry, sending stocks on a 25 - 40% binge. This short-sighted method does not take into account that with buyer demand still falling, margins fall again and the next time there is no more to cut and the firm goes bankrupt.

Then it is an everyday fact that the world has been bedazzled by the inauguration and the many reassuring appearances of the new Democratic President, and has become fixated with watching for any signs of economic recovery in the US rather than anywhere else – even rather than in their own countries! Worried people hoping that the recession is over have fallen for platitudes such as 'green shoots' which were in fact nothing else but clever market babble for what was in reality *another liquidity bubble, taking place before our eyes*. A stock market bounce of 40% does *not* mean the *economy* has recovered.

Some poor people have been led to believe that a strong stock market rally *causes* a recovery in the economy six months down the line. They have already drawn the conclusion that now we have had the BG rally of March-May 2009, the economy will recover in Q4 2009. Let us take a look at what actually happens when a real recovery takes place. First, company order books begin to fill. Investors find out about this and price in the future increase in stocks accordingly. The market rises. Given the initial six month lag between orders being received and products appearing on the market (in some case much longer, even a couple of years) it might appear on the surface that the stock market pulls up the economy. *But synchronicity is not causality*.

US Government economic policy so far

To the credit of the new administration, the US government has moved surprisingly fast despite the constraints imposed by its ancient creaking and cumbersome constitution. It has passed a number of laws in record time designed to deal with the afflictions in its banking sector, as well as holding innumerable hearings and investigations into the toxic conditions in various parts of the US economy and financial industry.

Without discussing the efficacy of these measures, in five short months legislation passed has included the restoration of the up-tick rule to prevent naked short selling, the relaxation of mark-to-market accounting practices, and measures to assist home owners in mitigating the burden of mortgages they cannot pay in order to prevent foreclosures.

More recently, 'tests' have been completed to ascertain which of the 19 larger banks are in more need of extra liquidity than others to cope with a more adverse economic environment. This long-winded and time-wasting manoeuvre has however finally restored a semblance of order to the credit markets. The whole exercise was a psychological manoeuvre to get the population to accept that about 10 banks needed another \$74 bn in credit injections in order to withstand some rather arbitrarily defined 'worse times', something the population might otherwise have balked at, given the groundswell of opinion against banks and bankers since Congress passed TARP in 2008 and latterly especially after the 'bonuses and compensation' revolts of 2009. Nevertheless, credit lines are being unfrozen to some extent.

A credit card holder 'bill of rights' has also been passed, as well as various packages to assist with the re-structuring or bankruptcy proceedings for the stricken US motor car

industry. A commission of enquiry has also been launched to get at the bottom of the faulty financial practices so that future legislation to correct these non-existent or faulty procedures will be sound. While many of these measures are indeed a welcome step in the right direction, they are not in themselves enough to ensure that the US will climb out of the recession.

Unfortunately, from Central government in the US there have also been the row of bailouts massively to boost the liquidity of the larger banks instead of allowing them to fail and apply for bankruptcy proceedings. One notable exception was Indymac, the real estate bank with a huge amount of Alt-A mortgages for the relatively well off. 83% of these mortgages were obtained by lies by the mortgage applicants as to their real incomes – hence the so-called 'liar loans'.

The FDIC took over the bank, cleaned out the toxic assets, re-structured and re-privatised it in the space of 8 months. Alongside Fannie Mae and Freddie Mac, Indymac was the third largest real estate bank in the US. The FDIC has been doing this, paid by the taxpayer, for 76 years. Just like the courts. Paid by the taxpayer. Just like the police, and fire brigade and schools. Paid by the taxpayer. Terrible socialist country the US, isn't it? So much socialism! However, those who agree are such hypocrites. They don't complain about depositor insurance. But of course they wouldn't complain about that because it is for their own direct selfish benefit....

In any country at any time there is a Zeitgeist. Sometimes it is just a variation on the same theme. In the 1950s it was McCarthyism, i.e. witch-hunting socialists. There were reds everywhere, especially under your bed. If your car didn't start in the morning it was because of a socialist. Somehow that was more un-American than the ones who were under the bed. Now it is gravely declared that it is the new government that is socialist. Whether that also qualifies to be un-American I haven't heard exactly.

Perceptions and focus

Unfortunately, while all this useless name-calling is going on, the rest of the world still have their eyes completely fixed on the US and China, thinking that these two countries will presently haul themselves and all other countries out of the pit. They have obviously never been caught in mud. If two people get stuck in mud, twenty others on dry land can maybe get them out. But if all are stuck, it is 'bye-bye, nice knowing you' when the tide comes in.

They have not understood that whether the world can avoid the approaching depression depends not only on whether the US can quickly restore the solvency of its banks and stop the foreclosures in the housing market from increasing, but on a number of other factors which are equally if not even more important, and which need to be implemented by each and every country:

- 1 Fiscal spending must be directed, not to transfer assets on a massive scale from the

taxpayer to the banking, mercantile and investor class, nor as massive benefit transfer payments to the population to boost consumption, but to start new industries in the way that China is doing and for example in the areas that the US is doing, but far too little of so far: new alternative energy systems of production and distribution, bio-technology and other areas where, despite the downturn, there is keen interest and demand.

2 Measures to improve trade and increase trade is vital if the world is not to go through the same catastrophic systemic collapse of trade and GDP growth as during the 1930s. The present decline in trade is a very serious development and a good indication that, if trade is left unrestored, the recession will be extended into a depression. It is therefore an absolute imperative to agree on a new and binding WTO agreement very soon, since world trade has already declined by 20%, and is still declining.

Summary and Conclusion

With the data we have so far at end of May 2009, we can now say: this is where we are and at the moment this is all that can be said about the outlook for the future. We have:

- 1 A synchronised global recession, except for China.
It is now the worst global recession ever, except for the Great Depression.
- 2 There has emerged some financial credit/market stability due to increased transparency over the liabilities of the 19 largest US banks.
However, that bank lending and interbank lending is being restored is not the end of the recession. It is merely the absolute minimum starting point for laying the foundations of any recovery at all.
- 3 Further retrenchment in employment and further contraction in the financial sector will bring added renewed pressures.
- 4 Most developed economies will experience deflation over the coming months.
- 5 The US and UK housing market falls have *not* bottomed out. Besides, increasing unemployment will pull the markets down further.
- 6 The current market March-May 2009 BG bubble is due to an unprecedented provision of liquidity, especially by the US. P/E ratios are now in double-digit figures.
- 7 A return to production and stock market levels of 2006-7 in the next few years is completely out of the question. *The world has changed.*
- 8 There will be significant growth in fiscal deficits in the next 5-7 years.
- 9 Global production is falling faster than consumption as inventories are being reduced. But the margin left to repeat this trick is disappearing. Expect more bankruptcies.
- 10 Corporate earnings are still weakening world-wide.
- 11 The US-UK-EU bloc has lost the ability to innovate new viable production through government intervention in synergic co-operation with business.
- 12 China will cease investing in US Treasuries in order to use its savings to continue to finance its internal expansion. The divorce could be amicable or nasty and depends entirely on the maturity and diplomacy of both parties. For both parties

- the divorce is a crisis and an opportunity.
- 13 If the US does not switch from consumption stimulus to production stimulus, then the following scenario assumes the worst:

The US will coax its own population to invest in Treasuries to finance its deficit spending. Yields on Treasuries will rise and the stock market will decline.

The result will be less capital available for enterprise through the stock market. Also, household savings will increase but the banks will continue to re-capitalise and therefore will not lend as much as is needed. Companies will continue to fail through lack of credit.

Through an increase in savings, consumption will decline and the US economy will decline.

The US is likely to get a change in government in 2012 which goes back to the low-tax policies and deficit spending of the past. The US economy will then fall off a cliff and both the US and UK governments will probably make an excuse to postpone their debt payments.

- 14 A global economic recovery is entirely dependent on whether US-UK-EU governments switch from stimulating *consumption* to stimulating *production*. As this has hitherto not happened, in anything except a paltry amount, a global economic recovery towards the end of 2009 is highly unlikely.
- 15 The three further major risks to a global economic recovery are Hyperinflation, Protectionism and War.

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