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FORWARD WITHOUT FEAR

Ian Gordon Economic Forecaster & Interpreter of the KONDRATIEFF CYCLE

Those who cannot remember the past are condemned to repeat it. Santayana

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WINTER WARNING

Closing the Barn Door after the Horse Has Fled

In my Winter Warning newsletter of October 6th. I stated that '*we ought to be hearing EU pleas for a return to a global financial system wherein currencies are backed by a reliable standard of value, such as, the discipline of the gold standard*'. Indeed, emerging from a recent European summit in Brussels, we heard an appeal from Gordon Brown, U.K. Prime Minister, for a major summit of world leaders to be convened before the end of 2008, wherein they could rewrite the rules for international capitalism that have been followed since 1944. Mr. Brown said that he was seeking '*very large and radical changes … a new Bretton Woods*'. Also, Jean-Claude Trichet, the European Central Bank President, who also attended the summit, said that it was *'absolutely clear that financial markets need discipline – macroeconomic discipline, monetary discipline and market discipline'*. Moreover, Angela Merkel, the German Chancellor, said it was time to '*rethink the world's financial system and prevent any repetition'* of the current credit crisis, as the German Government approved a $650 billion (U.S.) rescue package for the German banking community.

Hoist with Their Own Petard

In the meantime and in an effort to stabilize Britain's banking system, the U.K. Government has itself bought into the culture of greed, by announcing a $75.9 billion (U.S.) direct purchase of preferred and ordinary shares of three big British banks. The U.K. Government could own as much as 60% of the Royal Bank of Scotland, which also owns NatWest and ABN Amro; plus more than 40% of Lloyds TSB, which is in the process of acquiring the Halifax – Bank of Scotland (HBOS). Moreover, when Northern Rock and Bradford and Bingley are added to the list, Britain has basically, nationalized its banking sector. Imagine a bank board of directors and senior management positions occupied by government bureaucrats and mandarins! The bank manager will have money to lend, but only in accordance with government policy. This British initiative differs from the American bank bailout program, in that its structure is neither temporary, nor, mandatory in nature. Indeed, with a 12% dividend attached to the preferred shares, which comprise the bulk of the capital injection, Barclays PLC would do well to avoid the bailout package and seek out financing from private sources. All of this illustrates the fact that the rules by which the British economy operates have changed dramatically, leaving the country now part capitalist and part socialist.

The Wolves of Avarice

Over recent weeks, U.S. Federal Reserve Board Chairman, Ben Bernanke, has been frantically, trying to put out various financial fires on an ad hoc basis. From engineering a coordinated, global administered interest rate cut of 50 basis points and supplying ever burgeoning liquidity injections to the banking system, to announcing a new government facility to purchase commercial short-term paper, the Chairman has been reacting to the credit crisis in a manner bordering on panic. Finally last week, the U.S. Treasury, the Federal Reserve Board and the Federal Deposit and Insurance Corporation (FDIC) jointly announced a new Federal Government rescue package for the U.S. banking sector, whose structure (as cited above) is both temporary and mandatory in nature. Essentially, as part of the Government's $700 billion (U.S.) Troubled Asset Relief Program (TARP), the U.S. Treasury will directly purchase up to $250 billion (U.S.) of senior preferred shares, carrying a dividend of 5%, of designated financial institutions for a period of three years; after which time the dividend jumps to 9% for a further two years. These senior preferred shares will rank ahead of any preferred shares already outstanding and are callable by the issuers at par at any time.

Accordingly, nine major American financial institutions, purportedly to include the Bank of America, Goldman Sachs and Morgan Stanley, have been invited to participate in the bailout and have agreed to the terms. At the outset, I perceive two significant challenges to this initiative. Firstly, despite increasing the banking sector's capacity to extend loans, as stated in my previous newsletter, '*it is difficult to force bankers to lend money, when they are not in the mood to do so*'. Secondly, it seems curious that the Bank of America (which has been designated to receive $25 billion (U.S.) from the TARP), for example, would be eligible for this rescue program, when its Countrywide Financial Corporation subsidiary and its senior executives are, not only, under investigation for mortgage fraud by the Federal Bureau of Investigation (itself hampered by a dearth of agents and a shortage of resources) but also, in receipt of several state government and municipal government lawsuits within the past year, charging the company with misrepresentation and fraud. As an unintended consequence of the bailout initiative, is the U.S. Federal Government now in the position of providing assistance to financial entities which may be found guilty of mortgage fraud? The above, notwithstanding, since U.S. sub-prime mortgage debt totals in excess of $1 trillion (U.S.), Treasury Secretary Paulson and Federal Reserve Board Chairman Bernanke, may be forced to revisit Congress for more money after the November election. On that front, if Senator Obama is elected President, together with a Democratic majority in the Senate and twenty seats gained by the Democrats in the House of Representatives, then decidedly, there will be change in America … economic change for the worse!

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Meanwhile, recent U.S. economic reports for retail sales, industrial production and housing starts, all point to a protracted slowdown in the American economy, which is beginning to impact other countries. Notably, due to sharply reduced product demand from the United States, hundreds of small and medium-sized toy manufacturing businesses have recently been closed across China, leaving thousands of unpaid workers without jobs.

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