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Global Financial Crisis - why?

Failure to understand the system is the greatest systemic risk

by Prof. Gunnar Heinsohn

- Crisis – enterprises under debt pressure
- Major damage caused by central banks through zero interest rates

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Foreword

Most readers will be able to truly understand the global economic crisis for the first time after reading this issue of m.o.m.®, which presents them with a completely new economic theory. Together with his colleague Prof. Otto Steiger, who passed away in 2008, Prof. Gunnar Heinsohn has solved the previously unsolved conundrum of economics and created what they call **property economics.**

Entrepreneurs and managers will quickly understand what it's all about, while academic economists who have at best suspected these relationships, have been so far unable to diagnose the crisis or to come up with suitable remedies.

This issue of m.o.m.® is longer than usual and is not light reading. However, readers will be rewarded with new insight and knowledge that is important for economic survival.

I would like to thank my colleague Gunnar Heinsohn for this topical article. I have already summarized his theory for m.o.m.® readers in the August 1998 issue in its former form. Subscribers are welcome to download it from the m.o.m.® platform.

St. Gallen, in April 2009

Yours sincerely

Prof. Dr. F. Malik

F. Malik

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Global financial crisis – why?

by Prof. Gunnar Heinsohn[1]

Experts surprised and frustrated by failure of businesses despite near zero interest rate of central banks

In 1996, **Japan's central bank** cut its interest rate to 0.5 percent, a value close to zero. Seven years later, the Bank of Japan (BoJ) was shocked to realize that increasing its lending by almost 30 percent to commercial banks had increased the amount of money available to businesses by a mere three percent. **But nobody learned from this**.

In 2008, the Federal Reserve System (Fed) reported that, despite an interest rate of 0.75 percent for almost three years, every four dollars lent to commercial banks from 2003 to 2007 had only generated one additional dollar of national income. At the same time, commercial banks, whose employees only accounted for five percent of the overall workforce, instead of accounting for a mere 10 percent of all US debts in the 1980s were suddenly responsible for a breathtaking 50 percent. In the Eurozone, where banks were even more insatiable for the almost free money from Tokyo and New York, one additional euro of national income cost as much as 4.70 euros.

But this by no means marks the full extent of the abyss we are in. Since 2008, governments have been assisting central banks and have issued promises worth trillions of dollars for **recapitalizing banks**.

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[1] **The author**, Gunnar Heinsohn (65, summa cum laude doctorates in sociology [1974] and economics [1982]) is professor emeritus at the University of Bremen.
In 1984, he published *Privateigentum, Patriarchat, Geldwirtschaft* (Property, Patriarchy and the Monetary Economy, Frankfurt am Main: Suhrkamp) that replaced mainstream's barter paradigm of economics by a property paradigm of economic activity.
Eigentum, Zins und Geld (Property, Interest, and Money, Marburg 1996), and *Eigentumsökonomik* (Property Economics, Marburg: Metropolis, 2006) - both co-authored by Otto Steiger (1938-2008) - became major outlines of this new approach. In the German language «Encyclopaedia of Economic Treatises: 650 Pioneering Works from Antiquity to the 20th Century», covering texts from altogether 460 authors from the discipline's history, he is the only German author alive to be represented with four works (cf. *Lexikon ökonomischer Werke: 650 wegweisende Schriften von der Antike bis ins 20. Jahrhundert*, Düsseldorf: Wirtschaft und Finanzen, 2006, pp. 186-190.). The central ideas from *Eigentum, Zins und Geld* are presented in the German Bundesbank's money museum (*Geldmuseum der Deutschen Bundesbank*, Frankfurt am Main) where they are contrasted with the ideas on money by Aristotle, Adam Smith, Bernhard Laum and John Maynard Keynes.
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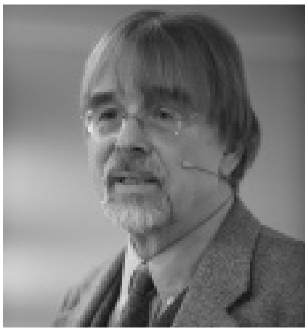

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Even the Financial Times believes that this will bring a cure, only to become bitterly disappointed: «There is not a single country where such measures … have made the banks more willing to lend to businesses and consumers. … It is a policy crisis of the first order.» (March 1, 2009).

This is why, in December 2008, the Fed cut its interest rate to 0.1 percent, hoping that this would not cause any damage and confident that a positive effect would be felt sooner or later. The BoJ has kept interest rates close to zero since 1996. In February 2009, the Bank of England also jumped on the bandwagon. Its new interest rate of 0.5 percent is the lowest since it was established in 1694. When the «real economy» failed to be «flooded» with money, desperation was joined by anger. **Joseph Stiglitz**, who was awarded the Nobel Prize in 2001, is now demanding the application of strict selection criteria: «The banks that get money from the government should be the ones that actually onlend it» (Der Spiegel, March 30, 2009).

Why can't central bankers, Nobel prize winners, and smart journalists succeed in getting what they so badly want? All they want to do is to help, to channel funds to businesses and their workforces. **Don't they know what businesses are?** Why are they unable to predict what will happen to the money that does not reach businesses? **Could it be that they are ignorant of economics?** America's ex-prodigy Larry Summers – Harvard professor at 28, treasury secretary in the Clinton administration, and now top economic adviser for Obama – frankly admits: «Large swaths of economics are going to have to be rethought on the basis of what's happened» (Newsweek, March 2, 2009). In other words: **we are in the middle of an emergency operation on the economic body, but we are still unable to understand its anatomy.** Lionel Barber, editor of the Financial Times (April 22, 2009) agrees: «For too long, too many experts treated the financial sectors and the wider economy as parallel universes. This was fundamentally wrong.»

On April 5, the Frankfurter Allgemeine added the following: «Do we still need this science?» Economists are variously classified as astrologers, physicists, historians, physicians, philosophers, and psychologists. Why not simply begin with the **science of economics**? This is not a theory about humans and the human soul, nor is it about production. Even beavers do this and humans have been doing it

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since the Neanderthal era. **Only rarely, however, has our species worried about collateral, pledges, interest, selling, and foreclosure.** Therefore, these operations cannot be inherently human, though every human has the potential to understand them. Analyzing these transactions as the derivatives of property is a task for scientific economics.

What is money and what are enterprises?

N**eoclassical theory** regards entrepreneurs as **owners** of scarce endowments who want to improve the composition of the latter to be able to increase their output to **meet demand**. There is no place in neoclassical economic theory for entrepreneurs as pledging and debt-driven owners. When talking about **property rights**, the property referred to is **material possession but not intangible property**. There is no term for **immaterial securities**.

As endowments consist of different goods, the theory claims that their optimum combination is only possible if useful components are swapped in from other endowments («asset stocks») and objects that are unprofitable for the owner's endowment swapped out. Neoclassical economic theory considers the market to be this «exchange of real goods». To facilitate the exchange of goods, an especially popular item is elevated to the status of money as a so-called standard good. Thus, instead of exchanging goods in the form of pigs against goods in the form of donkeys, a money good is conveniently exchanged for a donkey good. Accordingly, the optimization of endowments is said to precede real exchange, which in turn precedes its facilitation through money. Money is therefore regarded as a **veil** concealing the actual operation, i.e. the combination of endowments underlying the monetary transaction.

Credit, too, is merely viewed as the **exchange of a good**, though over a certain time period («intertemporal exchange»). The item only returns to the party that swapped it out twelve months later. In the case of a cow, the owner would have to do without its milk for twelve months. Therefore, he is entitled to compensation for this **non-consumption**. This compensation, the rate of interest, again takes the form of a good.

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The economic system consists of four estates without which there would be no economic activity, only production

1st estate **central bank**	2nd estate **commercial bank**	3rd estate **companies**	4th estate **labor**
Ownership side immaterial can be encumbered+sold	Ownership side immaterial can be encumbered + sold	Ownership side immaterial can be encumbered+sold	Ownership side = freedom immaterial **cannot** be encumbered or sold
Burdened for the **creation of money** against **interest** for the simultaneous loss of freedom over property	Encumbered for money credit + burdened for **more interest** in onlending to non-banks	Encumbered for investment money against interest, which forces realization + **market**	Right to rent out labor to gain interest free wage money
Possession side material	**Possession side material**	**Possession side material**	**Possession side material**
Used at the same time	Used at the same time	Innovatively used to generate money + interest debt via production	Innovative work earns money with no pledge of collateral + interest

In reality, businesses form an **estate (3rd pillar)** in the economic system that must defend their **immaterial ownership, i.e. property side** against price decline and foreclosure. They do this by means of **innovations** on the **material possession side** of the estate, where goods are modified and manufacturing processes are revolutionized. To implement these innovations, they must invest money in property, plant, equipment and wages. To borrow this money, they must conclude credit agreements with commercial banks, in which they are forced to pledge the property to be defended, which involves a **risk of loss**, and undertake to pay interest. Thus, the total debts of a company are always higher than the amount of money borrowed. Only if the enterprise is able to generate this «surplus» with modern technology and sell it, in other words if it is able to **create a market**, will its collateral be redeemed and become available for new debts. If this does not happen, the collateral will be realized, and the enterprise will disappear.

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The market as the arbiter of purchase agreements is therefore not a place for the exchange of goods independently created by it. **Rather, purchase agreements are only imposed through credit agreements that can only be concluded between creditor owners and debtor owners.** Therefore, market and interest-driven growth only exists where there is **immaterial property** in addition to the material possession. As property is capable of being encumbered, the material possession side of the estate must be modified constantly for the purpose of generating interest. If there is no property, the range of options will be limited to the modest production systems of social animals such as bees and human tribal communities, feudal regimes and genuine socialism.

Thus, the money invested by an enterprise **is not a standard commodity** that facilitates market exchange. It is not made up of tangible items, but generated from the immaterial, i.e. legal ownership of such. Being a **right** that cannot be seen, heard, tasted, or touched, it needs to be **codified**. This means that a loan never means the lending of goods: when a creditor gives his debtors money, i.e. when he grants them a title redeemable in his property, he does not lose anything material. There is no surrender of goods for which he would be entitled to demand an extra amount of goods as interest. However, he loses **authority** over the property burdened for the creation of money. He is not allowed to encumber it again. During the credit term, he is not permitted to sell or donate it, but he must keep it for possible realization. **This loss of authority over his property, which results from the encumbrance, is what the supplier of money charges interest for.** At the same time, he continues to use the material possession side of his estate without any restrictions. For example, if the estate is a pasture, he only temporarily blocks its non-physical property side for the collateralization, while his physical cows continue to graze and he continues to milk and drink or sell their milk.

Thus, interest is not the price for money as a commodity, such that by reducing interest central bankers can revive the circulation of goods. **The price of money is its exchange rate**. Interest is not the price of credit either; if this were the case, the party that offered the highest interest rate would have to receive it. Rather, credit is usually granted to a debtor who can pledge the best property as

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collateral. The money supplier believes that the **default risk** of this party is particularly low. The debtor's sound property increases the creditor's willingness to take the risk of burdening his property for issuing money and, therefore, allows him to be satisfied with even a lower rate of interest (prime rate).

Why do even healthy companies participate in generating standard crises?

Of the **four types of contract** entered into by enterprises with (i) banks, (ii) suppliers, (iii) hired staff, and (iv) buyers, the last two are the most precarious. The money borrowed to pay hired staff disappears once and for all, unlike the money spent on machines, which can at least be sold as scrap. Moreover, prospective buyers cannot be forced to buy. On the other hand, the Sword of Damocles always hangs over companies in the form of the threat of foreclosure in the event of non-performance of their contracts with banks and suppliers. **The answer to the predicament involving wages that are lost forever and the ongoing pressure to generate additional performance for the interest is given in the form of technical progress, a feature that only exists as a permanent phenomenon in property based systems but is absent in mere possession systems of tribes, feudalism and socialism.**

All owners who do not take on debt for technical progress ultimately impair their prospects of signing purchase agreements. They would be unable to fulfill their debt agreements with the banks and would have to transfer pledged property to the banks. Their debt capacity would be reduced or eliminated. In the case of in-house innovations, a company can take its time in assuming debt for their realization. In contrast, in the case of inventions of competitors, it is **forced to invest** without delay, as the possession side of its estate would promptly be outdated, even if it was modernized just recently. As a result, the company would be unable to fulfill its interest and repayment obligations in relation to the ownership side. When borrowing money for these innovations, the **significance of the interest due is secondary compared to the cost of obliterated company property.** For example, if the business is worth one billion, and

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100 million needs to be invested to defend it, an interest rate of – let's say – 5 instead of 3 percent would not stop the company from taking on debt. The additional interest of 2 million would be burdensome, but insignificant in comparison to the defended billion.

Regardless of the interest rate, all enterprises in a certain industry – let's say companies producing writing instruments – must promptly take on debt for operational refitting as soon as a writing computer is invented somewhere. As all owners continuously strive to keep clear of the threshold signaling too much debt, the **entire industry** is forced to participate in **process and product innovations**. This step is inevitable even if they clearly realize that the number of new buyers will not increase automatically upon completion of the innovation despite the overall increase in production speed and quantity. Individual companies are unable to draw any problem-solving conclusions from the knowledge of **inevitable overproduction**. Enterprises can only choose between doing without technical progress, which is certain to result in immediate impairment of their property, and taking the **chance** of being among those who, following technical progress, will earn sufficient buyer money to pay back their debts and thereby redeem their collateral. **To defend their property, entrepreneurs must knowingly decide between participating in tomorrow's overproduction or losing property right away.**

In connection with these innovation investments based on defending property, entire industries experience **boom phases**. Technology sellers pledge property in order to raise loans for their companies. And so do the buyers of modernization products. Others take on debts for purchasing shares in the two industries, thereby increasing their debt capacity by means of the price increase. The prices of manufacturers of **modernization technology** in particular, from whom all potential users – including future losers – **must** buy, go through a bull phase, as initially everything points to growth and success.

After the innovations have been implemented, let's say two of the ten modernized companies **collapse** in the course of the **dismantling of unavoidable production overcapacities**. The previously inflated prices slump back. As a result, many loans are insufficiently collateralized, which forces affected banks to write down

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their assets and drags some of them into the abyss. **Commercial banks are just as unable to withdraw from the business in advance as the entrepreneurs who seek credit from them.** To defend their property, they must assume the risk associated with its encumbrance. At best, banks may speculate whether it will be their own customers who will be victims of the inescapable overproduction or the debtors of competing banks, whose computers nobody wants to buy although they too are state of the art.

Why does a central bank's zero interest rate fail to help stricken companies after a standard crisis?

Following price deflation during **the standard crisis**, the survivors enter a more relaxed competitive phase until the next innovation boom. They can pay their debts through regular sales, thereby redeeming their collateral for new debts. In this way, the prices that fell when excess capacities were eliminated as well as their equity positions start rising again. Thus, their debt capacity is normalized. Special measures by central banks are not necessary.

But what about the **suffering of the workforce** in the case of the companies who have gone bankrupt? Few can remain indifferent to this. On the other hand, **anybody who tries to solve the problem by cutting the interest rate to zero does not belong in a central bank.** The commercial banks of bankrupt companies are perfectly aware of the only two life-rings that would save these companies, but cannot provide them: firstly, they **cannot** provide the failing company with **new inventions** whose implementation would enable it to regain competitiveness. Secondly, they cannot provide it with **pledgeable property** with which a new loan for implementing its own or third-party inventions would have to be collateralized. Central bankers, too, cannot transfer first-class collateral to potential debtors, and they do not have any secret reserves of inventions that they can pass on to failing corporate debtors via the commercial banks for an economic upturn. In fact, they are doing the right thing when they **allow the painful selection process to run its course.** Providing relief for the needy is the responsibility of the **social welfare system**. This should never be done with money-generating mechanisms. Only the profits of the central bank

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could be used for such aid programs. But their top management does not understand this and is even willing to forego these profits: **after the crash of the Internet boom in 2000, they fell prey to the fallacy that «to achieve satisfactory economic performance» (Alan Greenspan) interest can be waived.**

Central banks, too, serve as commercial banks for the banking system as a whole with a focus on business and systems. The central bank, too, blocks own capital when lending, a temporary loss of authority over its property that must be compensated with interest (discount). «Cheap» paper money can buy property because it is collateralized with central bank property. It makes no difference whether the money comes from a private issuing bank, as used to be the case until the beginning of the 20th century, or from a central bank. **A bank that does not charge interest robs its owners of profit and, therefore, cannot even provide welfare support for those laid off by the losers in the standard crisis.** Ultimately, it even becomes impossible to provide welfare support for those laid off by the losers in the standard crisis.

Nevertheless, the central bankers' dream is to provide help on a much larger scale. This is especially true where not merely the rescue of individual industries, but the **well-being of the entire economy** is at stake. If all industries together need to invest massively because substantial innovations affect all production processes and necessitate comprehensive investments, an **innovation boom** with rising debts and prices takes so long that a **new era without crises** may seem to dawn. Usually, these are revolutionary developments in the fields of transportation and communication, which must be adopted by all businesses to defend their property. Moreover, new materials that can be employed extensively and innovations that serve a wide range of purposes, such as steam, fuels, or electricity, also belong to this category.

The concurrent emergence of several such innovations marks the **beginning of a large and inevitable crisis** in the future in which a portion of the enterprises in – let's say – twenty industries at the same time are doomed to failure because all of them have been refitted so successfully that overproduction and excess stocks are inescapable. The **Internet boom** with its crash in 2000 was a typical example of this situation. To stop the suffering of companies and

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workforces, Greenspan initiated his well-meant but disastrous **low-interest policy**.

To prevent mistrust between banks, central banks should supply financial institutions that have run out of funds – usually an overnight occurrence – with money by instantly accepting their assets as collateral for credit or buying them at short notice, thereby acting as a last-resort lender. For this, they should charge a higher interest rate in order to forestall requests from banks that do not really need money, i.e. banks that have not accumulated any new claims against debtors that they need to convert to money. This concern was what led **Walter Bagehot**, the originator of the central bank theory, to formulate its key rule: **«These loans** [to solvent albeit illiquid banks] **should only be made at a very high rate of interest. This will prevent the majority of applications by persons who do not require them»** (Lombard Street; 1873). Bagehot's second key rule, which is just as vital as a conscientious decision not to reduce interest rates, pertains to first-class collateral. No insolvent bank and no bank with subprime property titles should even be allowed to get close to a central bank counter. The central bank itself would crumble if it had to compensate amounts not refunded by such banks from its own capital.

How do commercial banks generate a hypercrisis with zero-interest money that never reaches businesses?

In the normal course of business a commercial bank has to find an enterprise as its debtor which is compelled by its competitors to modernize its company or which wants to drive them out of market by way of innovation. The firm receives credit if it can secure it by providing property assets as collateral. Enterprises are compelled to borrow in order to stay in competition. They don't borrow a second time for the mere reason that the interest rate suddenly dropped. If by chance their borrowing requirements coincide with low interests, it goes without saying that they take the opportunity. If, however, the starting point is central bank money offered at an ultra-low discount rate to commercial banks, they have to track down alternative investment opportunities. **Every innovation boom is driven by debt, but unfortunately the zero-interest boom is not driven by innovation.**

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Even the 3 out of every 4 dollars or the 3.70 out of every 4.70 euros that remain with banks at an interest rate close to zero and that never get to the actual businesses must be refunded and yield returns. No matter how low the interest rate may be, the resulting monetary expansion is colossal. From 2001 to 2008, the total amount of money in the world exploded **from 36 to more than 70 trillion dollars (IMF)**.

So the commercial banks, or the investment banks and hedge funds they employ, use the unexpected plum credits to buy anything that yields more profit than the low interest rate. If the interest rate is one percent, they will go for any investment class that yields more than two percent, such as raw materials, mines, factories, works of art, coffee, bonds, existing real estate, or other banks. Due to this demand, all these industries experience a **sudden price increase**. But what are these appreciations really? If breakfast eggs would be an asset class, a farmer would thank the Lord for the doubling of the price of his hens. But his wife would understand that only their price has been inflated. After all, she isn't collecting a single egg more than before from the coop.

Thus, banks no longer invest in increasing effectiveness and production via their corporate debtors as previously, but in increasing prices. Therefore, the abrupt «value increase» is nothing but inflation. An item that was priced at one hundred yesterday and that is a favorite object of purchase for the one percent money because it will yield four and a half percent suddenly costs three hundred and now only yields one and a half percent, thereby becoming unattractive even if the discount rate is very low.

Previously, however, inflated asset classes have enabled the collateralization of higher and higher loans for more and more purchases. To increase their wealth by money borrowed almost free of charge, i.e. without any detour through production. Financial sector debt in the US jumped from 16 percent of GDP in 1976 to at least 121 percent in 2008. There are estimates of even 151 percent or $17.2 trillion. When the bubble burst in 2008, the American nation, including private consumers, enterprises, and government institutions, had debts amounting to 360 percent of economic output. For comparison: in 1929, just before the Great Depression, this debt amounted to only 160 percent.

This was caused partly by the 20 million Americans who previously were kept at arm's length by banks because of the lack of property

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that might be pledged, but who were offered an interest rate that was simply irresistible and miraculously low starting from 2001, especially in view of the fact that the banks were still earning money. The banks, of course, were happy to benefit from the zero interest rate offered by central banks, which were not available for enterprises and private individuals.

The banks used to accept residential property that was still to be built and that was «certain» to gain value as collateral from these **subprime borrowers**. The schemes involved housing for 60 million people, with an average of three inhabitants per unit. This figure corresponds to the population of France or Great Britain. Mortgages were bundled and sold around the world. Due to their awareness of **risk**, investors took out **insurance** on virtually anything and everything, which others gambled on until the contracted liabilities totaled 62 trillion dollars. But as early as November 2004, the Fed discount rate briefly increased fourfold from 0.75 to three percent, and then eightfold to six percent by May 2006. Banks were forced to charge interest rates that would have deterred anyone from ever crossing the threshold of a bank. Mortgage debts worth three trillion dollars became irrecoverable and devoured the banks' equity capital.

This does not mean that the debts of house owners did not involve any output. After all, the bricklayers, plumbers and roofers had done their jobs. However, from the outset the debts had not been collateralized in such a way that banks could have settled their receivables. When they eventually foreclosed on their debts, the flood of houses resulted in such a severe price slump that even mortgages that had been duly collateralized were suddenly undercollateralized. As a consequence, banks lost money even in the case of correctly financed living space, unless owners were able to provide additional collateral.

The bubble burst with global market losses of 40 to 50 trillion dollars, when estate prices were so inflated that returns were not even sufficient for a tiny central bank fund rate. Unlike the debts of house owners with commercial banks, the debts of commercial banks with central banks or other commercial banks were initially **collateralized**. But unlike the mortgage money, they do not involve **output**, which can only be generated by the two estate pillars business and labor. **The crash caused by this non-output eventually dragged the zero-interest loans of commercial banks**

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into a state of under-collateralization. The banks borrowed one million to buy a security whose return was higher than the central bank interest rate. When the purchased security dropped to 500,000 in the crash, the loan of one million became toxic in the accounts. The wonderfully low interest rate does not provide any help whatsoever in recovering the missing 500,000. Accordingly, banks have to take recourse to solid securities to cover the debt. Emergency sales even impair the prices of correctly managed companies. **If even such emergency yields are not sufficient to cover zero-interest debts, the funds must be obtained from equity.**

Some banks are sliding into the abyss because their equity is no longer sufficient to compensate the markdown of the securities financed through credit. Other banks that refrained from participating in the zero-interest spree are doomed to failure because the value of the collateral they accepted has dropped so drastically that, in the event of foreclosure against companies that were totally healthy until yesterday, they are unable to recover their outlay. **This means that the crisis has arrived in companies from the «real economy», which are in fact debt-driven pledgers of collateral**.

For healthy companies whose value has dropped in the crash, banks must request additional collateral for existing loans. If the affected companies are forced to take on debt for **property-defending innovation** at this time, we have the situation that infuriates our experts so much because these companies are left without collateral, while banks continue to insist on collateral. As is the case with any innovation, enterprises have the choice of either **taking on debt for innovation or failure on the spot.** However, due to the zero interest rate, which was actually meant to help them, they have lost their debt capacity. All the clamor of central banks and the wrath of Nobel prize laureates, government departments and the media are futile in view of the double down pricing of banks and enterprises.

The well-meant **zero-interest money of central banks** has caused **major damage**, not only because real estate debts have not been collateralized and bank debts have not been associated with output, but also because correctly financed real estate and enterprises have experienced a severe markdown resulting in **incapacity to take on debt**.

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Which is the lesser evil?

In this crisis, **ignorance of the economic system** has lead to **shots in the dark**. In pure trial-and-error acts, immense amounts are dumped on insolvent banks that are unable to grant loans to enterprises because they cannot take on debt due to the loss of collateral. Even the choice of the lesser evil is only possible if the system is understood. **In view of the lack of corporate collateral, what else can be done?**

A. After the fundamentally correct **state insurance of bank deposits**, these banks should have been abandoned to their fate and a **good bank** should have been established alongside them using part of the hundreds of billions of government securities. Equity of 100 billion enables the build-up of claims worth 1 trillion against debtors. Such a new bank should have **recruited the most talented experts from the failed institutions** and started working for companies that need to invest in innovations to defend their property and that are even able to provide collateral. This approach is by no means unheard of. After all, more than 80 new banks have been established in the USA since 2008 whose main advantage is that they can serve their customers without toxic credits and marked down purchases.

B. Purchasing **company bonds** – for which they do not need to pledge property – with government bonds (i.e. exchange of claims). The latter are **easier to liquidate** by companies than their own bonds because their buyers would be subordinate in the event of the bankruptcy of the issuers, unlike creditors whose loans have been collateralized directly.

C. Purchasing of **shares in top companies by a fund of government bonds** that supports their overall prices and the value of their equity positions, thereby maintaining their suitability for use as collateral. It would turn taxpayer debt into shares in the industrial top performers. Why should Western governments not be able to do what the governments of Abu Dhabi, China, Kuwait, and Singapore have already done?

D. Not giving government guarantees to insolvent banks for loans to companies, but to **potent money collectors** with a steady cash inflow, such as life insurers. These, in turn, can lend directly to companies whose bonds they no longer want to buy because they would be subordinate in the event of bankruptcy.

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E. **Investment programs** are especially helpful due to the fact that they supply advance money to businesses and workforces that are unable to borrow money because they have nothing to pledge at the moment.

The absence of such steps has enticed enormous sums – especially from insurers – into government securities whose purchase **does not trigger entrepreneurial activity**, as is also the case with the purchasing of gold. The only effect is that claims against banks are redirected to taxpayers. Taxpayers, however, do not produce anything in their role as citizens, which is why they have nothing to sell for money that could be used to service government debt. Being so busy defending their personal property during the day, taxpayers are not fairytale figures who can also work at night to produce goods that could be sold to service debts.

The **insane idea of reducing the interest rate to zero** has resulted in a mega bubble because the «cheap» debt of commercial banks never involved output. The antidote provided by a similarly large flood of taxpayer debt will be just as lethal, as it is also detached from the output generated by business and labor. After all, governments do not pay using money from taxpayers, whose taxes do not even cover the budget. Rather, they pay with government debts in the form of bonds that they sell or even donate and furnish with an interest and refunding guarantee. But what does this mean? **Regardless of current tax deficits, they are "guaranteeing" a double tax rate for the future, together with the force needed to extort the money from citizens.**

A government that is confronted with a dwindling, aging, and less skilled population, such as the German government, will have more difficulties fulfilling such payment commitments than a government that expects a growing, tolerably qualified population not threatened by extreme ageing, such as the US population.

At the same time, the Fed's zero percent spree is still going on. Shares in commercial banks are starting to rise again because they are buying government securities. Of course, these treasury bonds still yield more than zero percent return, but they are just as **devoid of output** as the 0.75 percent purchases after 2001.

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Correct forecast about the financial system back to 21. November 2002

At one of our conferences, Prof. Malik analysed the situation at the time and its causes and predicted the crisis affecting homes and real property correctly and in good time. The conference was recorded and filmed and is available on DVD (Die Neue Corporate Governance) at our shop: www.mmzsg.com

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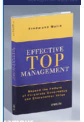
On the same subject you may also read m.o.m.®-Letter 2/04 und 3/04.

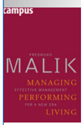
Malik book releases

Malik, F. (2008) **Die Richtige Corporate Governance. Mit wirksamer Unternehmensaufsicht Komplexität meistern** [The Right Corporate Governance. Mastering Complexity by Effective Corporate Supervision]. Frankfurt/New York: Campus Verlag
New publication of 10 November 2008 (in German only). www.malik-mzsg.ch/buch/rcg



Malik, F. (2006) **Effective Topmanagement**. **Beyond the Failure of Corporate Governance and Shareholder Value**. Berlin: Wiley Verlag. www.malik-mzsg.ch/book/etm

Malik, F. (2008) **Unternehmenspolitik und Corporate Governance. Wie Organisationen sich selbst organisieren.** [Company policy and corporate governance. How organizations organize themselves.] Frankfurt/New York: Campus Verlag.
www.malik-mzsg.ch/buch/ucg



Malik, F. (2006) **Managing, Performing, Living. Effective Management for a new Era**, Frankfurt/New York: Campus Verlag. www.malik-mzsg.ch/book/mpl

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