The Global Financial Crisis 101

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How come many major banks and companies around the world, if not already bankrupt, at least seem to be on the brink of bankruptcy, this despite the fact that only a year or two ago they all seemed to be doing so well?

Here are two grossly overlooked reasons: (1) unsound accounting practices and (2) serial halving of the rate of interest.

How could you start gaining a greater understanding about this? Well, since bankruptcy is an accounting term, one way to approach this important topic would be to learn more about accounting principles, sound and unsound. By doing this you might also gain greater understanding of what to do and not to do, regardless of whether you are an individual investor or a powerful official.

Bankruptcy, assets and liabilities

Bankruptcy is the legal process in which a company declares inability to repay its debts. This basically means that the company doesn't have enough assets to cover the liabilities. So let's learn a bit more about assets and liabilities.

Assets and liabilities always balance, hence the term 'balance sheet'. This might seem strange and counter-intuitive to many. But the explanation is that the company equity also is regarded as a liability, i.e. in this case to the share holders. See the following balance sheet (a balance sheet has a T-structure and is referred to as a T-account).

Assets X $	Liabilities X $
Fixed Assets	Short-term Debt
Current Assets	Long-term Debt
	Equity

Hence, if you take assets and subtract the debts you have a measure of how much equity the company possesses. If the assets increase more than the debts, the company is profitable and its equity increases. If the debts increase more than the assets, the company incurs losses and its equity decreases. Also note that the company's equity can increase also when its assets are decreasing, taken that the debts decrease more. Conversely, the equity can also decrease even though the debts decrease, taken that the assets decrease more.

How then do we know when a company is bankrupt or close to bankrupt? One apparently obvious way is when a company doesn't pay its bills. But there could be several ways why this might happen. For example, there might be a dispute related to the products and services involved. Moreover, the company might have very short term liquidity problems, problems that have nothing to do with the ability to pay its debts. So how can make judgments about these things in practice, how can we know what the assets and liabilities actually look like? Are we to trust the company's own account, or should we trust to the company accountant? Clearly, there is not only a need for some generally accepted principles in relation to this, but also that these principles rightfully can be regarded as sound.

Sound Accounting Principles

Accounting is nothing new. Here are some brilliantly simple and sound accounting principles that have been around for at least 500 years:

> The Law of Assets - an asset must be carried in the balance sheet at acquisition value, or at market value, whichever is lower.
>
> The Law of Liabilities - a liability must be carried in the balance sheet at its value at maturity, or at liquidation value, whichever is higher.

By declaring that the company should carry the lower value of [1] the acquisition value or [2] the market value on the asset side of the balance sheet, the principle assures us that nobody can overestimate the value of the assets. By declaring that the company should carry the higher value of [1] the value at maturity or [2] the liquidation value (i.e. the value of the debt if prematurely repaid today) on the liability side of the balance sheet, the principle assures us that nobody can underestimate the value of its liabilities.

Thus, with these principles we are assured that the assets never are overestimated and the liabilities never are underestimated.

Unsound Accounting Principles

The principles just described could rightfully be called sound accounting principles, exactly because assets never are overestimated and liabilities never are underestimated. But what if you had another set of accounting principles, for example some that has an inherent risk of overestimating assets and underestimating liabilities? What would we call them? Unsound? Here's an example:

> The Unsound Law of Assets - an asset must be carried in the balance sheet at acquisition value, or at market value, whichever is higher.
>
> The Unsound Law of Liabilities - a liability must be carried in the balance sheet at its value at maturity, or at liquidation value, whichever is lower.

With such principles, assets are easily overestimated and liabilities underestimated. Such principles might rightfully be called unsound. What would we expect to see when accounting relies on such principles?

Well, what if assets are reported to grow faster than liabilities? That means that the company seems to make profit. If the market value of the assets for some reasons increases a lot while the value at maturity of the liabilities increases less or even fall, the company might appear to be very profitable. And when companies in most parts of the world all rely on such unsound principles, the aggregate effects might be very big. Not only one or a few companies are affected, but more or less all at the same time. Thus, unsound accounting principles might for example make big banks and companies appear very profitable while in facts they aren't. And finally reality bites and they all have problems at the same time. Not one or a few, but more or less all at the same time.

Back to Reality - Accounting and the Crisis

The accounting standards that are most common today are the IFRS (International Financial Reporting Standards), or else something very similar. Most economically important countries use the accounting principles of such standards. One of the most important things in the IFRS is the concept of 'fair value'. Quoting Wikipedia, "Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction (IFRS1 App A)."

Translating this into English, it means that assets should be carried in the balance sheet at market value and that liabilities should be carried in the balance sheet at its value at maturity or at liquidation value. As it happens, now that market values of some assets have dropped dramatically, exemptions have been introduced so that companies don't have to report the market value but rather the acquisition value. Otherwise the profits would look terrible, just as they looked terrific a year or two ago. Furthermore, there seem to be very few major companies that carry liabilities at their liquidation value, instead they carry the value at maturity in the balance sheet.

Above we discussed what might be regarded as sound or unsound accounting principles and now we know what kind we are dealing with in this global financial crisis. Around our globe, companies have for years been following unsound accounting principles, accompanied by randomly and arbitrarily changing accounting practices. Now, how has facts like these combined with other key economic changes?

Boosting Profits with Unsound Accounting Principles

Cutting interest rates have been very popular in the last two decades in all major countries - in Japan, the US, the UK, by ECB, by the Riksbank, etc. This has led to a massive credit expansion with more money to spend privately, in companies and governments, in turn leading to higher sales revenue for companies. As costs generally are lagging behind - these are based on periodiziced historical expenses - higher profits are reported.

But there's another major reason for a rising equity and higher profits - higher market prices for both fixed and current assets. Examples of such assets are fixed properties or stocks and receivables. At the same time, cutting interest rates aren't affecting liabilities as much, especially if much of the credit expansion appears outside of company balance sheets in the form of private loans. The total value at maturity of the liabilities might have increased but not as much as the assets. Thus, the cutting of interest rates is apparently not boosting liabilities in the same way.

Boosting the asset side of the balance sheet but not as much the liability side, higher equity and profits are reported. This could be summarized in the following T-account. In the left part we see how assets grow and become red hot, and in the right part we see that this is not the case for the liabilities to the same extent. Hence, rising equity and good profits are reported (for this second reason as well).

[With UNSOUND Accounting Principles]

(A) Major Assets Increase
(B) No Major Long-term Debt Increase
(A)+(B) = Major Equity Increase & Profit

Assets X $	Liabilities X $
Fixed Assets	Short-term Debt
Current Assets	Long-term Debt
	Equity

Now, cutting interest rates have been very popular and the rates have been halved many times in many economically important countries in the last couple of decades. This has created huge apparent profits all over the world. As companies appeared to be very profitably they accordingly needed to save very little and could further and further step up spending in all areas. And this also happened on the private side, with very little saving occurring in many economically important countries. Thus, increased spending without profits and without corresponding savings spells capital erosion. And yet it all looked so good on paper.

Profits with Sound Accounting Principles

According to sound accounting principles, to avoid the risk of having companies overstating their assets, an asset must be carried in the balance sheet at acquisition value, or at market value, whichever is lower. This implies that while the assets probably would have grown during the last two decades due to higher and higher acquisition values, the growth rates wouldn't have been anywhere close to as high as the growth rates of the market values.

On the liability side, new short-term loans have increased during the last two decades, spurred by things like lower interest rates and growth in receivables. However, the major effects of serial halving of interest rates appear in relation to the long-term debts. Let's see how.

Let's say you buy a bond issued by a bank or major company and let's say the bond was issued in 1995 at an interest rate of 20%. Halving the interest rate to 10% would more or less double the value of your bond. $1,000,000 before would then have been about $2,000,000. That would have been be a good asset for you. Now, let's say interest rates were halved again to 5% - $2,000,000 before would have been worth about $4,000,000. By three further rate cuts like that (down to 0.625% in this case) your asset would be worth something like $32,000,000, 32 times the acquisition value. And there is still no limit as to how many more times interest rates could be halved. If so happens, the value of your assets would explode. It would certainly be great for you, regardless of whether you report this as profit or not, i.e. regardless of what the current mandatory accounting principles are, sound or unsound.

However, an extremely serious problem for bond issuing banks and major companies is that bonds like these are not assets, but liabilities. This means that such a serial halving of interest rate would have made your outstanding bonds to have a liquidation value of $32,000,000, not $1,000,000. If you would like to buy back this bond to decrease your debts, it would in many, many cases be close to impossible.

[With SOUND Accounting Principles]

(A) Assets Increase
(B) No Major Long-term Debt Increase
(C) (A)+(B) = Major Equity decrease & Losses

Assets X $	Liabilities X $
Fixed Assets	Short-term Debt
Current Assets	Long-term Debt
	Equity

This effect on the balance sheet dwarfs any positive effect of lower interest costs on new loans (especially since you have a problem of getting any). The same holds for any positive effects on the assets side. The assets of the average bond issuing bank or major company have not matched these explosions in long-term debts.

Your balance sheet would have become a disaster, and with a continuous halving of the interest rate, your financial situation would deteriorate at an ever increasing pace. In order to survive, you would have to save as much as you can, to cut in all kinds of spending, like for supplies and salaries. However, at the same time it is most likely that the officials of your country would tell or implore you to spend more and they would likely cut interest rates further and further in a misguided belief that they actually are helping you. This is a situation I think face many banks and major companies today.

Consequently, a terrible situation has been created for many banks and major companies around the world. If we apply sound accounting principles we see that the serial halving of interest rates, despite apparent major increase in profits, in fact have caused a massive erosion of the capital of many such banks and major companies. The funds normally available for lending and for paying things like wages and supplies simply aren't available at the moment, and in the worst case scenario, never will be.

Now we hopefully have a better understanding of why many major banks and companies around the world if not already bankrupt at least seem to be on the brink of bankruptcy, this despite the fact that only a year or two ago they all seemed to be doing so well. Now we have at least some ideas about how a bank like Lehman Brothers in 2007 could be awarded the No. 1 investment bank, and the next year go bankrupt, or why a company like GM in a booming car market, being quite positive in the 2006 annual report, could make record losses in 2007 and 2008 and now is almost bankrupt as well. These are not just examples of some companies with poor management, there's much more to it than that. There are so many cases like this that we might call it a system-wide collapse.

The Popular and the Unpopular Remedy

Very few economists today seem to be able to read a balance sheet and even fewer understand the aggregate effects of meddling with accounting principles and interest rates. Unfortunately, this also holds for most people in official positions, those with the power to really influence the course of events. To handle the system-wide crisis of banks and major companies they propose many nearly desperate things, like consolidating balance sheets in various ways - mergers, acquisitions, takeovers and nationalization - and cutting interest rates down towards zero.

What about such popular proposed remedies? Granted, consolidating balance sheets through mergers, acquisitions, takeovers or taking companies or a whole industry into the public ownership of a national government will to some extent relieve the troubled companies since some liabilities could be canceled out. But at the same time so will the corresponding assets. Thus, the net effect isn't neutral at all since the consolidated balance sheet will shrink, or even collapse. Thus, mergers, acquisitions, takeovers and nationalization aren't really remedies for the crisis, despite the renewed popularity of such extreme measure.

Furthermore, only assets that aren't at the same time some else's liability will survive a consolidation of balance sheets. This kind of asset basically means any kind of real assets. But it has to be a real and at the same time a financial asset to survive such consolidation. There is only one real financial asset that survives any consolidation of balance sheets - gold. Other financial assets are canceled out by mergers, acquisitions, takeovers and nationalization of the banks and other companies. Gold is a financial asset that at the same time isn't some one else's liability. Gold is the ultimate extinguisher of debt. Hence, recapitalization of balance sheets with the help of gold would be one remedy for the current crisis, however unpopular it might seem to some people.

What about one of the other popular proposed remedies, cutting interest rates? From the above discussion it is implied that price stability is not nearly as important as interest rate stability. Yet interest rates are actively pushed up and down in official attempts to control the price level. In the last two decades or so we have experienced a clear downward trend in interest rates in most economically important countries. Speculators in bonds have had a good time, betting on further interest cuts - it's been a free ride for them. By meddling with interest rates, massive problems could be and have been created. There is only one remedy for achieving stable interest rates and stopping such bond speculation. But this remedy is just as unpopular. There is only one remedy for achieving stable interest rates and stopping large scale bond speculation - gold. Gold again, the ultimate extinguisher of debt. When there is a relation between gold and debt there is no need speculating about the future value of such debts, like for example bonds. The link to gold has a very stabilizing effect on interest rates, as history clearly shows.

Gold you insist. How very unpopular! How can this barbarous relic be a remedy? Well, that is perhaps too much to explain right here and now.

Do ut des - I give, so that you may give

The full magnitude of the current financial crisis is not yet known, but we better fasten our seatbelts because the drivers have no clue whatsoever that they are driving faster and faster towards disaster. Fortunately, there is still time to stop and minimize the damage.

I now hope you have a better understanding of why many major banks and companies around the world if not already bankrupt at least seem to be on the brink of bankruptcy, this despite the fact that only a year or two ago they all seemed to be doing so well. And you know what might happen when you rely on a combination of unsound accounting practices and serial halving of the rate of interest. And you know why popular proposed remedies aren't helping, *au contraire*. And hopefully you can prepare better for the ride ahead of us. I wish you all the best!

PS. In case you really want to learn more about that, I suggest you start reading the columns and texts provided by in my view the best monetary expert in the entire world, Professor Antal Fekete. You should also read more about the Austrian economists at for example the Mises Institute, since they have also been warning about the coming crisis for years, despite the fact that they have been largely ignored by the mainstream media.