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## **When capitalism no longer works - a profit warning**

De Koning, Kees

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# **When Capitalism No Longer Works - A Profit Warning**

**By Drs Kees de Koning**

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## Introduction

Both the United States<sup>12</sup> and the United Kingdom<sup>3</sup> publish data on the Balance Sheet of Households and Non-profit Organisations. The U.S. has been publishing these data since at least 1995 and the U.K. more recently since 2002. Eurostat, the European Union's statistical agency, does not yet collect these data in the same format. In November 2011 Eurostat together with participants of the OECD and the ECB published a report of a Task Force which focussed on the household perspective and distribution aspects of income, consumption and wealth<sup>4</sup>. The report foresees that such households' balance sheet data are unlikely to be available before 2020.

The aim of this paper is to study the available data from the U.S. and the U.K. as well as apply circumstantial evidence of three EU member countries: Germany, Spain and Italy. The paper attempts to analyse if these time series can help in setting policy objectives.

Such a study seems timely as the U.S. Federal Reserve Bank in St.Louis is organising a Symposium on the subject of Household Financial Stability Research. The Symposium is to be held in February 2013.

My approach restricts itself to the collective net worth data for individual households and does not deal with the distributional aspects of income, consumption and wealth. If collectively households are unable to increase their net worth from year to year, it is less fruitful to analyse which group of households suffers most. Ultimately all groups suffer through changes in unemployment levels, through losses in values of homes and company shares and through government taxation and debt accumulation.

The aim of capitalism is to make people richer rather than poorer. It is supposed to be a better system than communism, which, in its purest forms, takes away individual responsibility and replaces it with a central planning discipline.

Within the western capitalist countries the individual households are at the core of the economic and financial system. They are the drivers of the economy by providing their services to produce output, by using their income to consume, pay taxes and to save. Individual households provide all funding to all other households in western societies: to a government, to banks, companies and all other financial intermediaries. All these latter entities manage the funds provided to them on behalf of the individual households. The latter entities manage the risks taken with these funds and the individual households hope and expect a reward for such risks taken with their monies.

Over the years, managers of any of these entities could have and did made mistakes in risk taking activities. The most fundamental mistake is to use funds for activities for which there is no or little demand resulting in no or low incoming cash flows. This mistake is most common in commercial enterprises. A second -equally fundamental- mistake is funding activities for which it is highly unlikely that the fund users can repay the borrowings. This mistake is nearly always made by individual banks and such mistakes can affect many banks. A third and also a major mistake is for a central bank to take over debts -such as government or mortgage bond debt- and not to pay households a risk premium any longer. The ultimate risk holders for such actions are and will remain the individual households collectively. Under all circumstances they remain liable for all government debt. If they do no longer get paid for holding risks, their net worth position will suffer.

The result of all managers' activities is found in the balance sheet of households and non-profit organisations: the net worth of individual households. For households this is the "value at risk" amount.

<sup>1</sup> <http://www.federalreserve.gov/releases/z1/current/accessible/b100.htm>

<sup>2</sup> <http://www.federalreserve.gov/releases/z1/current/annuals/a1995-2004.pdf>

<sup>3</sup> [http://www.ons.gov.uk/ons/dcp171778\\_276513.pdf](http://www.ons.gov.uk/ons/dcp171778_276513.pdf)

<sup>4</sup> [http://epp.eurostat.ec.europa.eu/portal/page/portal/pgp\\_ess/0\\_DOCS/estat/TF1\\_Final\\_report\\_Household\\_Perspective.pdf](http://epp.eurostat.ec.europa.eu/portal/page/portal/pgp_ess/0_DOCS/estat/TF1_Final_report_Household_Perspective.pdf)

The most fascinating facts which can be distilled out of these figures are the changes in net worth positions from one year to the next: such changes represent the real “Country’s Profit or Loss” levels. Simultaneously the return on equity over the net worth amounts can be deducted from these data.

Studying the U.S. data, the average Country Profit for the period 1995-2007 was US\$3.2 trillion per annum. The exceptional years were the years 2000-2002, 2007 and especially 2008 where the Country’s Loss reached the amazing level of US\$12.6 trillion. For the U.K. the average Country Profit level was £450 billion per annum between 2002 and 2007. For 2008 the Country’s Loss was £840 billion. Country profit developments also constitute an excellent guidance on what will happen to economic growth.

This paper aims to explain what can be done to prevent Country Loss making activities and which actions can be taken to shorten the current crisis period. Preventive measures could include the establishment of an Office of a Secretary (or Minister) for Savings, whose role it would be to oversee all managerial activities which give rise to Country Losses. Curative measures could include using existing long-term savings sources for enhancing economic growth.

Over the last five years some surprising facts have occurred. The US stock market index (DJIA) reached a level of 14165 in October 2007. In August 2012 it stood at 13107. Collectively companies have not added any value to the Country’s Profit over a five year period. Secondly government debt levels have shot up, but only some countries have seen a steep increase in long term government bond yields, while others like Germany, the U.K. and the U.S. have seen their long term yields drop below inflation levels. Thirdly property values have not added any value to Country Profits in the U.S., certainly not in Spain and Italy and for the U.K. they have stagnated. Finally in all major western countries - except for Germany - unemployment levels have gone up over the last five years. In Spain and Greece where unemployment is experienced by a large group of the labour force, such situations represent a failure of the capitalist system.

When individual households can no longer earn their way out of a crisis, serious questions have to be asked about the long term viability of the capitalist system. What is needed is an effective risk management system to avoid and correct the pitfalls of making Country Losses.

## **1. How It All Started**

Ever since August 9, 2007 when French bank BNP Paribas told investors that they would not be able to take money out of two of its hedge funds because it could not value the assets in them due to a “complete evaporation of liquidity”, the financial crisis has overwhelmed governments, banks, pension funds and life insurance companies, other companies and last but not least individuals who lost their jobs and a substantial share of their asset values. Collectively households got poorer not just in one country, but in all the five countries studied, the U.S, the U.K. and Germany, Spain and Italy.

In the U.S. during the few years preceding 2008, mortgage originators started to have mortgages approved by banks on basis of doubtful principles. A Deutsche Bank study<sup>5</sup> came to the conclusion that 37% of the mortgages granted were interest only mortgages; 38% of the mortgages also required no down payment so 100% of the value of the home was borrowed; 43% of the borrowers were not required to provide any proof of income and finally 80% of borrowers were attracted by providing them with a low start up interest rate for a period of two years, after which interest rates were hiked steeply.

According to the study, the subprime market segment “only” amounted to U.S\$1.2 trillion out of the total home mortgage market of U.S\$10 trillion.

U.S. investment banks started to package these subprime mortgages into Collateralised Debt Obligations. Based on AAA ratings from the U.S. credit rating agencies, the investment banks sold these CDO’s around the world, but also to U.S. money market funds. When the real risks to these mortgages appeared, as cash

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<sup>5</sup> [http://www.globalsecuritisation.com/08\\_gbp/gbp\\_gssf08\\_022\\_031\\_db\\_us\\_subprm.pdf](http://www.globalsecuritisation.com/08_gbp/gbp_gssf08_022_031_db_us_subprm.pdf)

flows faltered, the U.S investment banks were in no position to maintain a market in these CDO's., something they had promised to do. The CDO's turned from "going concern" to "liquidation" CDO's. The pricing fell of a cliff and many CDO holders could not get out of the risks. Huge losses on savings were made.

The errors in cash flow predictions had a major impact on residential property values in the US. The S&P/Case Shiller home price index dropped from an index value 170 at the end of 2007 till 139<sup>6</sup> a year later. Banks, apart from lending to their own clients, also lend to each other, as well as trade in risk products. The banks, as well as the financial markets, became uncertain which bank had what type of exposure. Interbank lending dried up. It led to bank closures and bank rescues especially in the U.S., the U.K. and some European countries. Credit tightening took place around the world. This led to an overspill into the share markets. The shares dropped on real and perceived company and bank risks. The U.S. and other governments' budgets were also affected. They had to borrow substantial funds to bail out banks and to compensate for lower tax incomes. The U.S. defined benefit pension schemes saw their asset values drop by 30% in 2008 and they alone lost around \$1 trillion in the same year. As companies guarantee the pension benefits in DB schemes this led to another unwanted side effect, in 2009 U.S. companies maintaining DB schemes were forced to set aside U.S.\$90 billion compared to U.S.\$45 billion in 2008, a doubling of contributions in times of recession. The "oil spill" effects of the subprime mortgage debacle had serious effects on the long term savers and on the real economies throughout the world through lower or negative economic growth rates with higher unemployment rates, bank lending restrictions or contractions, a drop in company sales levels and increased government deficit levels. The original loss on cash flows from subprime mortgages was multiplied many times over in the financial markets and the real economies. In the US alone the net worth of all households dropped by US\$12.6 trillion in 2008.<sup>7</sup> Compare this to the original US\$1.2 trillion in subprime mortgages and it becomes obvious how a major cash flow prediction error can be multiplied by a factor of more than 10 in net worth losses.

An excellent introduction to the American Financial Crisis can be found in America's Financial Crisis: The End of An Era by Barry Bosworth and Aaron Flaaen<sup>8</sup>.

## **2. Capitalism and the Developments in the Net Worth Position**

### **2.1 Introduction**

Currently success in the capitalist model is measured through incomes (National Income) and output (Gross Domestic Product), both sides of the same process. Economic growth data -reflecting the changes in GDP- are closely monitored. Economic theories are based on supply and demand, market prices and the profit motive -risk taking versus rewards-. Individuals are supposed to make rational choices.

The links between economic growth, the financial and real estate markets and the individuals are all measured through the changes in the net worth position of all households in a country. The net worth position reflects households' "value at risk" position. It includes share equity holdings, net equity positions in homes, net government bond holdings, net deposits with banks and pension pot holdings. A loss of US\$12.6 trillion in net worth on an output level of about US\$14 trillion in 2008 did not represent a rational choice by individual households in the U.S. They did not aim to lose 19.2% of their total savings level in a single year, let alone 90% of GDP value in a single year. For the U.K. comparable figures<sup>9</sup> show a similar, albeit slightly less disastrous picture. In 2008 total households net worth dropped by UK£841 billion or 12.4% of total savings, which represented a savings loss to GDP value in that year of 41.3%.

Societies based on the western capitalist model have organised themselves in all kind of businesses units as well as having an elected government. These institutions take managerial decisions on behalf of individual

<sup>6</sup> [http://en.wikipedia.org/wiki/Case-Shiller\\_index#Historical\\_values](http://en.wikipedia.org/wiki/Case-Shiller_index#Historical_values)

<sup>7</sup> <http://www.federalreserve.gov/releases/z1/current/z1r-5.pdf>

<sup>8</sup> [http://www.brookings.edu/~media/research/files/papers/2009/4/14%20financial%20crisis%20bosworth/0414\\_financial\\_crisis\\_bosworth.pdf](http://www.brookings.edu/~media/research/files/papers/2009/4/14%20financial%20crisis%20bosworth/0414_financial_crisis_bosworth.pdf)

<sup>9</sup> <http://www.ons.gov.uk/ons/rel/cap-stock-national-balance-sheet/2012-results/stb---national-balance-sheet-2012.html>

households. Only 100% family owned companies combine entrepreneurship with wealth creation. All other companies -including banks and insurance companies-, as well as pension funds and a government rely totally on “other peoples’ money”. All their funding originates from individual households. It is this structure of western societies which lies at the heart of the current economic problems. Individual households have practically no say over what business managers -including government business managers- decide to do with the money they have received from these households. Family owned companies usually practice prudent risk management strategies, as they themselves have to carry the financial implications of their own decisions; for instance in Germany, but also in some Far Eastern countries, the family owned businesses represent an important share of total output. For other sectors of society -again including governments- prudent market behaviour is not an automatism; it is not an inbuilt mechanism. The profit drive of companies but also the actions (or inactions) of governments can be at odds with the aims of the household sector to see their net worth values grow. Market abuse -like in the case of the US subprime mortgage crisis and also in the case of Spain where 800 000 residential properties were built for which there were no buyers and funded by some local banks- was possible as there were no countervailing powers to stem such abuse. The checks and balances needed to run a “profitable” country, a country whereby output growth adds to net worth growth for individual households were and are not in place. The western capitalist model is under serious threat if it cannot correct its weaknesses.

Current discussions about changing the modus operandi of the operations of the western model focus widely on changing the gearing ratios for banks, insurance companies and pension funds. They also focus on past abuses such as Libor fixing and PPI (payment protection insurance). Such focus totally misses the point that both equity and debt represent savings provided by individual households; it is the latter households’ “value at risk”. Changing the ratios between equity and debt for banks, insurance companies and pension funds does neither improve the quality of risk taking nor the potential level of “profits” or “losses” to individual households. In the case of Libor fixing, this was a people related activity, including a lack of oversight by government authorities at the time. If an example has to be set, than the people rather than the capital base of the organisations involved, should be brought to justice.

Risk taking is at the heart of the capitalist model and of course some risks will turn out to be less well judged than others. However when collective risk taking does not lead to increases in net worth for all households together, it means that output production has been hampered by poor risk management decisions. Such poor decisions include taking or taking over risks for which the risk takers -the individual households- are not rewarded. In all these cases the financial assets provided by all individual households have not been used to the benefit of such households. It is interesting to mention that in the U.K. in the period from 2002 till 2007 the net worth increase was between £400 and £500 billion annually. It showed a steady increase. The country operated profitably during these years. Simultaneously the economy continued to grow. In 2008 the total net worth dropped by 12.4%, it gained about £600 billion back in 2009 and another £460 billion back in 2010, but totally stagnated in 2011 at the 2010 level. The expectations for 2012 for the U.K. are not much better as economic growth is expected to be stagnant this year. The 2011 net worth level is only just above the 2007 level, the difference being: £250 billion. This was measured on a nominal basis and not on a real value after adjusting for inflation levels.

The U.S. shows a somewhat similar picture. In 2006 its households net worth increased by US\$4.4 trillion as compared to the previous year. However in 2007 some major changes occurred. Households’ dwelling values dropped by \$1.87 trillion while home mortgages increased by \$674 billion, a combined change of values of \$2.54 trillion. If the value change and the increased level of home mortgages had not occurred in 2007 than the households net worth would have been up by slightly over \$3 trillion.

## 2.1 Risk Adjustments

The key lesson which could and should have been drawn from the Balance Sheet of Households and Non-Profit Organisations is that the adjustment mechanism for asset depreciation works differently for Individual Households than for companies. The two main asset classes held by Individual Households are: individual homes and government bonds. They both represent an asset as well as a liability for individuals. Shares are not included in that companies through their sales levels depreciate their assets and if companies

make a major mistake in their cash flow predictions, they go bankrupt. However collectively individual households do not disappear; they do need food, shelter, gas, water, electricity, transport, education, healthcare and self-defence. Regretfully current adjustment mechanisms in the capitalist system for homes and government bonds seem adamant that, financially speaking, individual households should disappear.

### 2.2.1 U.S. Housing Market Developments.

In the U.S. errors in home mortgage lending decisions can easily be traced through four types of statistics: the foreclosure filings, the level of actual bank repossessions of homes, new housing starts and the price developments in the housing market.

The stress in the housing market in the U.S. can be measured in the annual levels of foreclosure filings, which represent actions taken by lenders when borrowers get into a default situation. In 2005 such foreclosure filings were 801,563. In 2006 this level increased to 1.215,389, in 2007 the level reached 2.2 million and in 2008 it moved to 3.1 million. In 2009 it became 3.46 million. In 2010 the level moved further up to 3.84 million only to reach 3.92 million in 2011. In August 2012 it was still high at 193,508 in a month, or 1 in 681 housing units were affected by foreclosure filings. The highest stress level has been 1 in 298 housing units and the lowest 1 in 317,498 units. The number of housing units repossessed by banks was 269,000 in 2006, 489,000 in 2007, 679,000 in 2008, 945,000 in 2009, 1.125 million in 2010 and 1.147 million in 2011. (Source: Statistic Brain.com)

Keeping up with payments on outstanding mortgages is one element of the housing market, new housing starts and home values are the other two elements.

The level of new housing starts -monthly figures on a seasonally adjusted annual rate- reached its peak in October 2007 at 1.264 million. In January 2008 it dropped to 1.084 million and a year later in January 2009 it had more than halved to 490,000. (Source: Ycharts.com). The S&P Case Shiller home price index dropped from 170 by the end of 2007 till 139 a year later.

When new housing starts drop to half the level of a year earlier, this affects output (GDP), households income for those directly and indirectly involved in the house building business and thereby economic growth levels as well as unemployment levels. This also had a strongly negative effect on tax income for the U.S. government.

The repossessions of homes represent a different category. Once banks take possession of a home they will want to cut their losses on the property. It usually means that the net equity in the property has already been wiped out - a loss to a household's net worth. Secondly the extra supply of "second hand" homes puts home values under further severe strain as evidenced by the drop in the S&P Case Shiller index in 2008. Such repossessions and sales do nothing for economic growth, as the houses have all been built in earlier periods, but they do affect households' net worth values, through the change in speed of home values' depreciation. The mistake in granting mortgages to people who could not afford such mortgages is that 850,000 rather than 269,000 used houses came on the market with a for sale sign in 2008. Such extra supply should never have occurred; it distorts the true market values for homes. The price setting for homes was based on an error of judgment by some banks. It was based on financial markets rather than on real markets considerations.

The negative impact was and is subsequently compounded by the reaction of all banks. Their lending criteria are based on households' income levels and on the value levels of homes. As banks are making losses on home loans, through their own fault as some banks acted irresponsibly in granting mortgages, all banks will tighten their criteria for granting such loans. With rising unemployment levels, lower economic growth rates plus falling house prices and reduced bank capital base levels, banks will become extra cautious in approving home mortgages. The change from lending excessively to lending super cautiously is causing house prices to drop further as potential buyers no longer have access to finance and those that once owned a house which was repossessed, have no longer the credit status nor the means to start up



again. The house values move even further away from a rational level. In the meantime the net worth levels of individual households keep dropping.

What this all means is that homes as a store of value fall foul of financial markets actions; actions which reinforce the downward trend, rather than correcting itself into equilibrium. Such financial market actions force economic growth rates down through a decrease in the levels of new housing starts; such actions also force housing values down through the forced sale impetus of increased levels of repossessions. The subsequent banking losses force banks into restricting their overall lending levels. The extreme case of credit risk misjudgement in the run up to 2008 also led to substantial increases in government deficits through bank bailouts and losses in tax income. Last but not least it pushes up unemployment levels and decreases the financial net worth of individual households, reducing the “equity positions” of these households. Financial markets dictate real asset values, rather than the other way around.

As stated in section 3.3 individual households will do anything within their own income possibilities to keep up the mortgage payments in order not to lose their homes. From 2007 till the first quarter of 2012 U.S. households have paid off \$800 billion in mortgages, rather than increasing the total level of outstanding mortgage loans.

The risk management errors by banks and their subsequent efforts to regain as much money as possible from individual households did cause home values to depreciate much faster than their economic lifespan warrants. The value assessment is only a financial market price, not an economic market price. Such financial market price setting is a self destructive price mechanism for all concerned: the banks; the individual households; companies for consumer demand levels; pension funds and for government tax income levels. What all these actions imply is that the depreciation of households’ homes is accelerated for no other reason than the fact that bankers, collectively, got their cash flow predictions wrong and subsequently try to limit their own losses. Of course, home value depreciations should rarely be accelerated or decelerated under normal economic circumstances. In section 4.2.2 a possible solution is explored in helping individual households to overcome this asset valuation problem.

The U.S. is just a case in point. Banks in other countries act in a similar fashion.

### **2.2.2 Government Bond Markets.**

Governments issue short and longer term bonds as if to indicate that their borrowings will vary over time. The reality is that governments, nearly everywhere in the western world, have seen huge increases in outstanding debt levels, for the U.S. to over 100% of GDP level. Governments, generally speaking, do not behave as ordinary borrowers in spelling out over which period such debt will be repaid. Government bonds are open-ended commitments as neither the U.S. taxpayers, nor any European ones can be asked to repay or reduce the debt levels any time soon. Even a balanced budget situation only means that interest payments are foreseen in the fiscal expenditure levels, not the repayment of principal amounts. The conclusion is that maturity levels are highly uncertain, but will certainly have to stretch out over 50 or more years for most developed countries.

The second element is that Keynesian government expenditure injections -expenditure level above tax income level- increase government expenditure (consumption) only for one year, after which it becomes an ordinary consumer loan type of funding, backed by the future income of all individual households. It shifts the burden of the debt to a future generation; their “depreciation payments” have to come out of future incomes. I believe that Keynes intended his remedy for occasional use rather than the regular use that governments have made of it. Therefore there is a need for fiscal discipline.

The current adjustment mechanism relies totally on government to government action, including IMF participation. It is not surprising that when financial markets -acting on behalf of individual households- foresee a potential write down on their values of government bond holdings -a not totally unexpected situation after the Greek tragedy-, will want to escape from such markets. They act like the bankers in the case of the valuation of U.S., homes. They want their monies out of a 50 or more year obligation in a very short period of time. Regretfully government to government actions reinforce the markets’ views that

getting out rather than staying with the government debt risk has been the right solution. One cannot expect the richer countries to fund the government debt of the poorer ones for fifty or so years. However one could expect the richer countries to help individuals in the poorer countries to start helping themselves again. This will lead to more exports and imports and thereby constitutes a self-help scheme for economic growth in the richer countries as well. Financial markets will do the rest. One could also expect the richer countries within the Eurozone currency zone to counteract capital flight by issuing bonds and deposit such funds with the ECB. This gives the ECB the chance to buy up government bonds of the threatened countries making use of real savings. For this type of risk taking individual households in the richer countries should be rewarded. Such action constitutes a financial market transaction which will induce the financial markets to return to funding all government debt of the Eurozone countries. The only conditionality need be an application of fiscal discipline. Further attention to these points have been given in sections 3.2 and 3.4 and 4.3.3

What is clear is that the downward trend has to be broken, just like in the case of home values. Individual households should be given the chance to earn their way out of the crisis. Combining economic easing as described in 4.2.2 with fiscal discipline will lead to the least disruptive way of “depreciating” the values of government bonds and thereby maintain economic growth and country profit making.

### **3. Factors Determining “Country Profit”**

The annual increase or decrease in the net worth of all individual households can be described as a true reflection of the profit or loss levels for a country in a particular year: the Country’s Profit or Loss level. In appendix 2 the country profit levels for the U.S have been calculated for the years 1996-2011. Similar figures for the U.K. have been included from 2002. Also the return on equity for all individual households has been calculated reflecting the increase in net worth in a current year divided by the average net worth position during the year.

In the cases of the U.S and the U.K., if one compares Individual Households return on equity (IHRoE) with economic growth rates, the IHRoE appears to present itself as a lead indicator for higher or lower economic growth levels.

Four factors will be analysed which can help explain why IHRoE and economic growth rates are so closely linked. They are:

- Risk taking and risk spreading transfers;
- Illiquid assets;
- Current incomes and existing debt obligations
- Risk avoidance by individual households.

#### **3.1 Risk Taking and Risk Spreading Transfers**

Generally individual households, when buying a home, take a direct risk on their future income flows. For all other accumulated savings such risk exposure is totally indirect. Even if the portfolio of financial assets has been chosen by the individual, the moment the savings are handed over, all managerial decisions affecting the value at risk for individual households are taken by companies, banks, pension funds and life insurance companies and a government. Spreading of risks is further enhanced by using mutual fund managers, pension fund managers, insurance companies, venture capital companies, private bankers and all others who provide specialist risk management services. What has been striking over the last some thirty years is how the derivative markets have blossomed, with interest rate, credit, currency and commodity linked derivatives facilitating risk transfers from one group of risk takers to another group. Some multinational companies have set up their own bank in order to arrange cash and risk management for all group companies. Risk transfers have also been stimulated by the invention of securitisation of risks and the use of Collateralised Debt Obligations, which were extensively used in the sub-prime mortgage securitisation process. Quantitative easing constitutes another instrument of risk transfers.

On top of all this, financial markets have developed products such as share lending, contracts for difference and other products which do not require 100% savings for speculating on the outcome of the underlying risks.

The balance sheet of households of the U.S indicates that it is not the financial assets which have grown out of proportion to total assets. In 1995 the financial assets represented 65.5% of total household assets. In 2007 this ratio stood at 64.9%. The U.K. shows a similar picture. In 2002 the financial assets as part of total assets of households stood at 49.4% and in 2011 the ratio was 49.9%.

What has gone wrong in risk taking is that some parties can make profits out of individual household's losses. The salesmen, involved in selling poor quality sub prime mortgage products, generated incomes for them as did the investment banks and the credit rating agencies. When the losses appeared, most of the risks had been sold on to third parties, who themselves, unwisely in hindsight, relied on the favourable credit opinion of the credit rating agencies. The capitalist system has no means, as yet, to hold the product originators to account, in case their risk judgment harms country profit levels in a major way.

It is not only businesses which may harm Country Profit making. Governments and central banks can do so also. What harms Country Profit making is for a government or central bank to provide guarantees or buy up risks at 0% interest costs, without providing the risk underwriters -the individual households, the taxpayers- with a reward for the risks being taken. Such risks are embedded in quantitative easing practises, in private finance initiatives and in unfunded future government liabilities like unfunded civil servants pensions obligations. In privately owned businesses no risk is entered into without a (potential) reward. In order for Country Profit creation to work properly, governments should follow the private sector example and pay for such risks directly to the ultimate risk providers, the individual households. In times of recession it is essential that such payments are made in the current year to add to incomes, rather than postpone payments. Otherwise they undermine a critical aspect of the capitalist system.

Risk judgments should come with responsibilities. What could be done in this respect will be discussed in Section 4.

### **3.2 Illiquid Assets**

If one studies the set up of the elements which make up the net worth of individuals, it is striking that a very large proportion of it is constituted by illiquid assets. Illiquid assets can be defined as asset classes which cannot be turned into cash in a short period of time. In an article called: "The Savings Paradox or Managing Financial, Economic or Fiscal Risks"<sup>10</sup>, I drew attention to the fact that homes, company shares and government bonds are the three main asset classes for which individual liquidity i.e. the ability to buy or sell one's home, a share or a government bond is dissimilar to collective liquidity. For instance in the case of homes, collective liquidity would mean that either all mortgagees would be asked to repay their mortgage loans instantly -an impossible request- or all owners would wish to swap houses into cash all at the same time and simultaneously buy another property, again another impossible scenario. What the real estate market prices really reflect is the marginal demand and supply. This is also the case for company shares and for government bonds. Additional marginal demand for homes can be created by lower interest rates for home loans, but only if higher household incomes are generated to make additional mortgage lending a viable proposition. In other words such demand is easier to accommodate with higher economic growth rates and higher country profit levels. The household net worth computations clearly show that in the U.S. since the start of the recent recession since 2007, collectively households have reduced their exposure to home loans in real as well as in nominal terms. A substantial loss in net worth makes increasing the level of home mortgages a less bankable proposition for many households. On the other hand over aggressive selling techniques for mortgages -based on doubtful lending principles- will lead to an excessive marginal supply as foreclosure levels will increase dramatically as they have done since 2007. This leads to a steep drop in market values and in country profit, an unwanted situation and undesirable economic event as the 2008 country loss figures testify.

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<sup>10</sup> <http://mpira.ub.uni-muenchen.de/40146/>

The 2000-2002 drop in economic growth was caused by company shares sharply dropping in values, effecting country profit levels. In 2008 both home values and share and mutual fund values dropped together.

A few remarks should be made about government bonds. From a savers point of view, the government bond markets of some countries like Germany, the U.K. and the U.S appear to be the most liquid in the world; one can always find a buyer. Collective liquidity focuses on the other side of the obligation: the possibility of an immediate transfer into cash of such assets. Of course taxpayers could not possibly raise the cash to repay all outstanding government debt at once. Collectively this type of asset is illiquid, just as much as real estate and company shares. Why is this distinction important? When markets assess that some doubts creep in about a particular country, their funding of government debt creates an upward pressure on yields. Ireland, Portugal, Greece and more recently Spain and Italy have experienced such pressure. Such pressure stems from collective liquidity concerns. In section 3.4 attention is drawn to the other side of such concerns: the capital flight to “safe” government bond markets.

### 3.3 Current Incomes and Existing Debt Obligations

What both the U.S. and U.K. data show is that when current incomes come under pressure, individual households give priority to safeguarding their principal asset: the home from being repossessed by lenders. This means that in a period of reduced Country Profits or even Country Losses (slow economic growth or recession periods) households reduce other spending in order to reduce debt obligations, especially those linked with the homes. In the U.S. since 2007 -instead of increasing home mortgages by some U.S.\$800 billion to U.S.\$1 trillion per annum as was average before 2007- the outstanding debt has fallen by about U.S.\$800 billion over the period 2007 till the first quarter 2012. Secondly the home values showed consistent growth from 1995 until 2006, initially for the first three years growing by some \$400 billion annually till end 1997. The second period to 2002 the growth accelerated to \$1 trillion and slightly above. From 2003 till 2005 included, it grew by \$1.6 trillion and it reached its growth peak in 2005 with a growth of about \$3 trillion. In 2006 the speed of growth dropped off to \$700 billion. Ever since 2006 the home values have been dropping by in total \$6.3 trillion (or 28% of 2006 values) till the end of 2011.

In the U.K. the value of the housing stock reached its peak in 2007 at £4,077 billion, growing annually since 2002 by about £300 billion. Even at the end of 2011 was the value at £4,064 billion slightly less than 2007 values. These are nominal value data, not taking into account that U.K. inflation levels increased from 2.6% in 2007 till 3.9% in 2011. The annual increase in home loans during the period 2002-2007 was between £90 and £130 billion per year. In 2008 the loan base still grew with £ 50 billion, with zero growth thereafter.

When current incomes do not grow or grow less rapidly and when country profit levels decelerate or turn into actual losses, experience -as evidenced by the data above- show that households aim to restore their own balance sheets by reducing debt levels first and spending less on purchasing current goods and services. Economic growth levels suffer as a consequence.

### 3.4 Risk Avoidance by Individual Households

Individual households have one choice which none of the risk managers can avoid to obey. They can move their savings into what they regard as the safest government bonds in the world. The amazing fact is that it has little to do neither with the absolute level of government debt, nor with the government debt to GDP ratio. One can put it in figures to see how the world has changed since 2007. Trading economics<sup>11</sup> has calculated the average 10 year implied government bond yield for the five countries studied. They are for the U.S. 6.5% for the period 1912-2012, for the U.K. 6.0% for the period 1989-2012, for Germany 5.1% for the period 1989-2012, for Spain 5.7% for the period 1993-2012 and for Italy 5.9% for the period 1993-2012. The actual government debt to GDP levels are respectively: for the U.S. 103%, for the U.K. 85.7%, for Germany 81.2%, for Spain 68.5% and for Italy 120.1%. Now the current 10 year yield as per end of

<sup>11</sup> <http://www.tradingeconomics.com/bonds-list-by-country>

August 2012 was, for the U.S 1.63%, for the U.K.1.49%, for Germany 1.34%, for Spain 6.48% and for Italy 5.82%.

What these figures illustrate is what companies practice and what individuals also do: Move money (savings) to places regarded as the safest places for not losing the principal value of the savings or earnings. This precautionary savings motive is neither guided by yield, nor by outstanding level of government debt compared to GDP, but purely by the wish to protect the principal amount of savings. The fact that such risk protection costs money in real terms, after taking the inflation levels into account, has been no deterrent to invest in government bonds in the U.S., the U.K. and Germany. From a country profit point of view for all five countries, this is the worst possible outcome. There are three reasons for this: (1) Government debt can be described as a huge consumer loan, whereby government expenditure in past years was not funded by tax incomes in the same year. Consumer debt has the lowest multiplier effect of all three asset classes. (2) Funding companies and banks helps create economic growth in the current and future years and so does (3) Investing in homes, which creates jobs and also helps economic growth to flourish, provided that mortgage loans are granted on a prudent basis.

Consumer loans -whether entered into by an individual household or by the collective of households through government spending above income levels-, need to be serviced out future incomes. When a larger and larger proportion of income and savings is used for servicing consumer loans rather than for "investment funding", the whole economy becomes less efficient, hence less country profit. This is why fiscal discipline is a must. What is less important is the actual level of government expenditure as long as it is matched by income transfers in the current year. However one should stress that economic efficiency is just as much a must for government households as it is for the private sector.

The unwanted side effect of individual households as well as companies and banks moving cash to the so-called safe haven economies is that government bond yields in the U.S., the U.K., and Germany are now far below average long term yields of the past and even below inflation levels. This hinders Country Profit making. The rewards no longer compensate for inflation levels. Households get poorer. The increased levels of government debt since 2007 were mostly unavoidable as banks had to be rescued in order to prevent an even more calamitous loss in country profit levels. However, paying interest rates on a long term basis at below inflation levels, harms pension funds and all other savers, who want to build up a nest egg for the life time cycle of work and retirement. When the other asset classes -shares and homes- do not perform well, it is a government's prerogative to ensure that their "consumer loans" provide the bond holders with a reasonable reward over inflation. Past long term rates did not deter economic growth to happen. Paying higher rates, especially to pension funds in a country can be arranged as will be explained in section 4.2.2 on economic easing.

The governments of the U.S. and the U.K. have taken it upon themselves to lower the long term government bond yields through a series of bond purchases by their respective central banks. Such actions are called: quantitative easing. In the U.K. £375 billion out of a total government debt level of around £1 trillion has been bought up by the Bank of England. Regretfully neither the U.K. share market nor the mortgage market or the home values seem to have been positively effected as the net worth data for individual households clearly demonstrates. By the Bank's own admission it has created the inflation level to rise with 1%, which put pressure on households to maintain the same volume of consumption. Economic growth did suffer, especially if one considers that households wanted to restore their own balance sheets by paying of debt rather than increase consumption. Such quantitative easing policies are based on a misunderstanding of what helps to create Country Profit. The misunderstanding is that Central Banks, which practice quantitative easing, acquire risks for which they offer no return. The individual households, which provide the value at risk amounts, remain the ultimate risk holders, but they see no financial return any longer over their risks. Country Profit making is undermined. The ECB is considering a similar scheme of quantitative easing by its insistence to buy up short term Spanish government bonds. Again this is based on taking up risks, which ultimately have to be serviced by the individual households in the Eurozone countries, without paying a risk premium to the risk takers as Central Banks can print money at 0% costs. In section 4.3.3., an alternative solution is provided, whereby the individual households of the seven countries: Austria, Germany, Belgium, the Netherlands, Luxembourg, France and Finland can take the risks on taxpayers in other Eurozone countries. The first group, via their governments, attract real savings

out of the financial markets, deposit these savings with the ECB and enable the ECB to buy up some long term bonds from countries like Spain and Italy. The risk-reward ratio is that the risk underwriters: the individual households in the seven Eurozone countries gain the benefit of Spain's and Italy's higher 10 year bond yields over their own cost of funds: a Country Profit increase, while simultaneously the long term yields in Spain and Italy come down. Once the financial markets know that this intervention will be repeated till the latter two countries pay around 2% over inflation, they themselves rather than the taxpayers will want to take up such risks, making further intervention unnecessary. The individual households in the seven countries should be rewarded for underwriting these risks. They should see a cash pay out of the profits made by the ECB over this funding and lending exercise. Such risk taking-reward exercise increases Country Profit levels in the seven countries. It also eliminates the capital flight to safety which takes away "values at risks" from one country, only to lower Country Profit levels in all countries.

#### **4. Country Profit Levels and Collective Risk Management**

##### **4.1 Introduction**

2008 will stand out in economic history as the year that the U.S. lost about four times its average Country Profit of previous years in a single year. The impact on the balance sheets of individual households was huge. Their reply was -as evidenced by the data provided in the Balance Sheet of Households and Non-Profit Organisations- to protect the home from being confiscated by lenders. This was done by collectively reducing outstanding home mortgages. As home values kept dropping at the same time, the owners' equity as a percentage of household real estate dropped from 56.6% in 2006 till 40.7% currently. The latter is a slight improvement over the level of 38.8% which was reached as recently as the fourth quarter of 2011. Such households' actions have two effects. The first one is that when incomes are spent on reducing debt levels, less remains available for spending on current consumption, so economic growth suffers. The second effect is that the dynamic effect of increasing mortgage loans together with increasing home values has been taken out of the economic equation. Loans and home values have to move in tandem in order to increase Country Profit. A major economic growth element has been sterilised by the, very understandable, households' actions.

The collective preference by households to use incomes to repay mortgage debts in priority over spending on consumer goods has a major effect on demand levels in a society. On top of this, during the period since 2007 the growth element of simultaneous growth in loans and home values was also eliminated. Consequently corporate equities did suffer.

In the U.K. households are also paying off their consumer debt. In July 2012 they paid back the net amount of £147 million. This represented the biggest drop since August 2006. Again households are repairing their balance sheets, in a way which harms demand in the U.K. economy and thereby Country Profit making.

Corporate equity values show a much greater volatility than home prices. For instance the 1999 corporate equity values in the U.S. of U.S.\$9.763 trillion have not been reached up till to-day. The volatility is a consequence of the difficulty in predicting corporate cash flows in uncertain times. Optimism and pessimism change the outlook on a daily basis.

Apart from homes and shares, individual households can also change their asset allocation between the three asset classes. This element is of particular importance in the Eurozone countries, more than for the United States. If doubts arise about the collective liquidity of homes or shares or by financial market pricing rather than economic pricing, individual households will aim to protect the principal sum of their savings, by moving such funds to the perceived "safest countries" and into the safest asset class: government bonds. The U.S., the U.K. and Germany and some other Northern European countries have been on the receiving end of such cash movements. Others like Ireland, Portugal, and Greece and more recently Spain and Italy have seen the negative effects of such movements. These decisions are not only taken by individual households directly, but also by the managers of their funds, like companies, banks and portfolio managers. This drive to "safety" harms Country Profit making as it takes savings out of one community to another and places it into the least productive asset class: government bonds.

The conclusion to be drawn from the above is that prevention is highly preferable over correction, as the correction period has now lasted five years and most economies are still in a worse shape than they were in 2007. However as preventive measures were not taken in the past, corrective measures need to come first at this stage. From a Country Profit perspective the most important element is to speed up economic growth levels, not just in the U.S. but in all European countries as well. This can only be achieved by a demand driven initiative as supply driven measures rely on growing net worth levels. In section 4.2 possible initiatives to increase demand levels will be set out. In section 4.3 possible preventive measures will be explored.

## **4.2 Corrective Measures**

### **4.2.1. Introduction**

The traditional method to stimulate economic growth was the Keynesian method of incurring additional government debt to increase government spending in a current year. There are three reasons why the Keynesian practice has probably outlived its usefulness. The first one is that from a Country Profit perspective, government debt is the least productive of the three asset classes, the more productive ones being homes and corporate equities. Once the borrowed money has been spent by a government, there is usually no direct cash flow to earn back the borrowed money. The multiplier effect has to come from indirect earnings via the increased output by the private sector and increased earnings by the working population. The second one is that starting up and stopping additional government expenditure seems a difficult process for most governments. It is much easier -also for the electorate- to accept the additional spending rather than the pay-back process of additional taxes. Last but not least the current levels of government debt for the U.S., the U.K. and most European countries, coupled with the reduced government tax levels in a recession period make it almost impossible to sensibly spend one's way out of recession by prime pumping. Individual households will reward the prudent countries over the profligate spenders.

The second method, based on Friedman and Schwartz' study of the Great Depression of the 1930's, was the monetarist approach to economic growth. They claimed that the supply of money in the economy determines economic growth and the rate of inflation, which was most likely correct in the circumstances of the Great Depression. Their policy recommendations, still followed to-day by some Central Banks, is to flood the market with liquidity and follow a low interest rate policy.

The principal weaknesses in the monetarist arguments are three fold: Firstly the Country Loss in 2008 was caused by funding a loan portfolio for debtors who were in no income position to repay and service their debts -the subprime mortgage crisis-. The cause of the crisis was a risk misjudgement by banks on a large scale. It caused an income and a value crisis for individual households, whereby the decreasing home values started to have a multiplier effect on incomes. As the evidence provided by the net worth data testifies both in the U.S. and the U.K., the reaction by the collective of households was to start repaying mortgage debt rather than increasing home loans. No supply of liquidity through the banking system can change such reaction. The monetarists never considered that financial market actions could induce an accelerated depreciation of individual households' assets -homes and government bonds- out of step from economic values of these assets.

The second weakness is in the type of business which makes the error of judgment. If companies make an error of judgment in over estimating demand for their products, the ultimate penalty is closure of a company. Often however such closure can be avoided as cash flow errors show up quickly. However if banks make an error, such errors take longer to work their way through the system and the risks are also multiplied by affecting other banks or the whole banking sector. Mortgage lending and providing consumer credits are practised by nearly all banks in the world. Banks base their credit judgments on future incomes and values. If incomes and values fall simultaneously, as they did in 2008, than the collective banking sector needs to retrench, notwithstanding having liquidity provided and low interest rates maintained. Such a crisis is a collective solvency crisis and is based on the income and value losses all households

experience collectively through Country Losses. Financial misjudgement errors have a much greater impact than corporate errors. They have a much higher multiplier effect.

Finally the third weakness lies in the low interest rate policy. What is good for borrowers is not necessarily good for the fund providers: the individual households. In the past sound levels of economic growth have been happening when long term government bond rates were at or over 5% per annum. It is an extremely doubtful argument to state that a long term interest level below the inflation rate is a sound policy for creating Country Profit. Individual households have no choice but to leave their value at risk in an economy. There is no way they can turn assets into cash without harming Country Profit making. Governments have a choice: either to support Country Profit making or slowing down economic growth with negative real long term interest rates.

In the next section Economic Easing is discussed. This method avoids the pitfalls of both the Keynesian and the Monetarist approach.

#### 4.2.2 The Economic Easing Method

Individual households in the U.S., the U.K, the Netherlands and Canada have build up large pension fund reserves in order to pay for future incomes. These reserves have been accumulated via the contributions of individuals and sometimes companies or even governments on their behalf. The second element consists of investment returns. In a way pension funds, in their investment returns, closely resemble the country profit levels in a country. Pension funds usually have no gearing; they consist of pure savings allocated over the asset classes. Their accumulation and distribution pattern of savings is closely monitored by the countries concerned. Much debate is going on about the manner of measuring, predicting and allocating future investment results over the different age groups as longevity plays a major role in the changes. What, so far, has not been discussed is how pension funds can contribute to economic growth. The principal concept is to link savings directly with consumer spending in the current period. The current size of pension funds in the U.S., the U.K., the Netherlands and Canada make such a link possible. In all these countries the accumulated fund levels now exceed or closely resemble the annual GDP level. In my background paper to the Tenth Annual Conference on Pensions, Retirement Security and Strategies for Investment Conference organised by Harvard Law School (March 28-30 2012), I suggested to use “economic easing” as a method to stimulate economic growth.

Economic easing can be defined as the action of turning a small part of savings accumulated for future expenditure -the pension savings- into current consumption.

Take the U.S. case as an example. If 2% of pension savings were distributed in 2013, this would mean that \$280 billion extra consumer demand would be created, provided all beneficiaries spend their pension dividend on consumer goods, something they should be encouraged to do. If, assuming again, that markets know that such action would be repeated in later years until economic growth reaches its optimal growth path, than such certainty will make companies wanting to invest their cash reserves or obtain additional bank or capital markets funding. Jobs will be created. Production levels will be increased. Company profits will increase, hence share prices will improve. Country profit levels will start to improve. Finally the government will benefit from higher tax incomes. The positive multiplier effect will start to work.

Of course the temporary cash injection in to the U.S. economy out of pension reserves can not be done without a compensation for the pension funds. Such compensation will need a change in the tax laws. Until now the U.S. and other governments have always practised that taxes pay for government expenditure. To make economic easing a success requires a change in tax philosophy. Individual households provide all the funding for all business units, including a government, in the U.S. and in other countries. When an economy is stimulated in above described manner all households in a country benefit. It would therefore be appropriate that when the benefits are shared, also the costs of it are shared. This implies that a small portion of future tax receipts is set aside for returning the savings back to the pension funds. The boost for the economy in 2013 would not be provided by the government -a Keynesian cash injection- but directly from individual households’ savings to individual households’ spending -economic easing-. Government debt does not increase, but a small share of future incomes need to be returned into savings, which only a



government can do through its tax collection. The savings into cash and back into savings cycle constitute a taxpayers' obligation as all taxpayers were beneficiaries of the economic boost in the first place.

The practical implications for implementing an economic easing policy are as follows:

- **Step 1:** The Government aims to reach an agreement with all pension funds (DB as well as DC schemes) so that the latter can pay say 2% of their value to all pension savers and retirees. The values could be fixed as of 30<sup>th</sup> December 2012.
- **Step 2:** Once an in principle agreement has been reached, such pay out (a pension dividend) could be made available in four equal quarterly instalments of 0.5% of the value, starting as soon as administrative hurdles have been overcome.
- **Step 3:** The pay out could be for an equal amount per pension saver and retiree. This would benefit the younger and the less well off more than those closer to retirement date and those with the larger pension pots. However the younger participants have the longest period of contributions and investment risks ahead of them.
- **Step 4:** As the aim of this measure is to stimulate economic growth; the government might agree to have the pension dividend paid out tax free.
- **Step 5:** If pension funds are short of cash, they could be allowed to borrow these amounts from the Central Bank in their respective country, until pension contributions and dividend and interest flows have come in.
- **Step 6:** As a logical extension of economic easing, which is done to create more Country Profit for all households, a government could agree that the pension savings used for current consumption will be repaid by the taxpayers.
- **Step 7:** The logical conclusion could be that such repayments take place as and when economic growth rates have reached the desired level, in other words when Country Profit levels have reached their long term average.
- **Step 8:** The rewards for pension funds in participating in such a scheme could be a taxpayer's guarantee, based on an inflation level plus 2% remuneration per annum for the pension funds. The indirect rewards for pension funds are more substantial as the increased level of demand in the company sector will be translated in higher share prices. Banks will experience less loan losses. The government will also benefit indirectly by higher tax incomes. The maturity of the economic easing facility should be determined by the pension funds and the government jointly based on actual country profit developments.
- **Step 9:** As the repayment obligation is not linked with the repayment of past government expenditure, economic easing does not influence government debt levels. It is in effect a scheme to bring forward the use of a small part of the savings and have such savings replaced by all taxpayers as and when Country Profit levels start to rise.
- **Step 10:** Finally the beneficiaries of the pension dividend should be convinced that the amounts are for consumption purposes rather than for adding to the savings level.

The economic easing method can be started up and stopped very easily. It can also be maintained for longer than a year, if needed. Both groups of taxpayers and pension pot savers and retirees are the inhabitants of a particular country, they constitute the individual households and the managers of all the savings made by the households. A potential positive side effect of economic easing is that it will stimulate individual households to participate in funded pension scheme savings as only pension savers and retirees will receive a reward for savings. Such participation will reduce the pressure on future government's budgets to provide for the basic state pension.

Economic easing can be implemented in the countries with a substantial funded pension system. In the cases of Spain and Italy, for instance, these countries have not built up such pension reserves. However, in order to shorten the worldwide economic crisis period, the economies of these countries could also be stimulated.

The European Financial Stability Fund or the European Stability Mechanism are the ideal vehicles for replacing the role of the pension funds for Spain and Italy and potentially for some of the other Eurozone countries as well. Spain, for instance would need around Euro30 billion in the first year of easing. The guaranteeing nations for the EFSF funding would need to accept that the repayment obligations come from Spain's taxpayers and is not a government debt obligation. They would also need to accept that repayment obligations should follow the developments of Country Profit developments for Spain. Therefore the facility's repayment schedule should be agreed between the EFSF and the country once Country Profit levels have improved.

### **4.2.3 The Case of Spain**

Apart from economic growth Spain needs a solution to its overhang of 800 000 unsold homes. By solving this problem the banking problem will be much less acute. A possible solution is described below.

In Spain, the cause of its current crisis has very little to do with the Euro as a currency or with the Spanish government acting imprudently, but all to do with some banks turning savings into 800 000 homes which could not be sold to potential buyers. What other European governments might have done to help manage these collective risks from spreading to the Spanish economy and Spanish government is set up a second home acquisition scheme for their own nationals rather than lend Euro100 billion to the Spanish government, or directly to the Spanish banks. The latter injection equates to Euro125 000 for each unsold home. The unsold home problem could have been solved much more effectively by supporting foreigners in buying homes in Spain from the Spanish banks or population. This could be done with the help of a subsidy. Instead of providing Euro125 000 per home, give foreigners a subsidy of 20% of the amount i.e. Euro25 000 per home. If the lending is also executed by German, British, French, Dutch, Swiss, Austrian and Scandinavian banks than the inward capital movement into Spain will help solve the real estate crisis, part of the banking crisis and a substantial part of the government debt crisis. The homes should be of a minimal value of Euro150 000, which equates to properties of 120 sq meters in the Spanish Mediterranean Coastal provinces. Such potential buyers should themselves put in an amount minimally equal to the governments' injection. The remainder amount should be up to the foreign bank's credit judgment. The buyers should also agree not to sell the properties for a minimum of five years. The Bank of Spain could supervise the scheme. Of course the scheme would be stopped as and when the supply of homes comes nearer to the full utilisation levels.

The consequences: The Spanish property markets will turn around pretty quickly; a place in the sun is still a dream for many Northern Europeans. The Spanish banks will be relieved from their property overhang on which no cash flow is received while their borrowings still carry interest costs. The Spanish people who sell and move to other properties will usually have more cash available as 50% of homes are owned in Spain without a mortgage. European governments usually operate either capital gains taxes or income taxes on second properties, so they will get their money back in due course. Last but not least the capital inflows into Spain and the strengthening of the banking sector plus the additional tourist incomes will help the Spanish economy to turn around as well. This comes all at a fraction of the costs of the Euro100 billion. Spanish government bond yields will come down as well. The example is just one of the ways in which understanding the causes of the risks to savers can help devise sound solutions. The "perceived risk" outlook for Spain will fundamentally change by implementing this scheme.

## **4.3 Preventative Measures**

### **4.3.1 Introduction**

The financial, economic and fiscal crises of 2007-2008 started because some business entities were loading up risks on society, which the obligors could not repay. As such repayments involved the housing sector,

the latter sector lost substantial values. There are two sides to any lending-borrowing relationship. However risk management clearly is the responsibility of the lenders. The lenders failed in their duty of prudence. Not only did they fail, they also failed in their duties by selling such risks around the world. Most of the lenders did not suffer personally as they got their rewards and cashed out early and went off to do other things. If the lenders and the facilitators of the risk transfer had been obliged to guarantee the risks they sold, the volume of risks transferred would not have gotten out of hand to the degree it did.

### 4.3.2 A Minister for Savings?

What it all means is that economic risk management i.e. Country Profit risk management, deserves a CEO, a Minister (or Secretary) for Savings. The Minister should be independent from Government, but of course not independent from parliament. His responsibilities would be to oversee that risk originators, be they banks, companies, but also the government, in its expenditure for infrastructure and capital goods projects and for taking up or taking over financial risks, follow prudent risk management practices. The Minister would not replace existing regulators for banks, companies and pension fund supervision. However his role would be to assess whether certain collective practices, which may not be illegal, would harm Country Profit making. The emphasis is on risk management assessment and economic efficiency. The role of the Savings Minister is different from a Minister for Finance, the latter's role is to establish the government's budget and collect the required tax payments. The role of the Savings Minister is also different from a Governor of a central bank. The latter is in charge of the monetary policy initiatives and is not in charge of all elements which contribute to Country Profit. Prevention of risk taking excesses is a worthwhile cause to have a senior person committed to it. The U.K. government has already set up an Office of Budget Responsibility, covering its own actions. It has an independent status, but has no powers to intervene in economic or financial risk management.

Other elements of risk taking occur in underwriting share issues. Here the question is should the underwriters be committed to guarantee their risk judgment for longer than the day of placement of the shares: for instance over a year or longer period with declining responsibilities; again not a legal judgment but a risk judgment.

Another risk element occurs in Mergers and Acquisitions. Again the same question as above needs answering.

### 4.3.3 Eurozone Government Bond Risk Management

The 17 Eurozone countries share one currency, but each country has a different inflation rate, a different rate of economic growth, a different level of unemployment, a different level of outstanding government debt and a different state of its banking sectors. Taxation levels differ and so do the savings levels for pension provisions. Managing the gap risks between short and long term savings intentions needs positive government actions, not necessarily at European Union level, but collectively at individual country level.

This could be done as follows: Countries such as Austria, Germany, Belgium, the Netherlands, Luxembourg, France and Finland could attract 10 year funds from the financial markets not for government spending but for financial risk management purposes by depositing these funds as reserves at the ECB. As an example, Germany could use these powers until its borrowing yield reaches 3.9%, 2% over its current inflation level. These savings remain German savings at the ECB. For the other six funding countries their inflation rate plus 2% would also be the yard stick. The ECB could with these funds, subsequently buy up long term government debt of the 10 countries, provided that they follow the fiscal pact. In these 10 countries the yield has overshot the level of inflation plus 2%. In the case of Spain, which always had a very prudent central government, its inflation rate is, like Germany's, 1.9%, but its yield is 6.48%. In this example the ECB would buy 10 year Spanish bonds currently at 6.48% and subsequently at lower yields till the Spanish yield also stands at 3.9%.

The ECB's interest income from Spanish bonds exceeds the borrowing costs of the seven countries. Such interest income will be fully distributed over the funders pro rata of their funding contributions. In this way the costs of issuing more government debt than needed for own government expenditure of the seven

countries is more than met by the income from bonds of the 10 countries held by the ECB. Governments of the seven countries could ensure that the Profit made out of the funding and loan transaction by the ECB is returned to individual households. Individual households will see that the cross country risk taking is rewarded with a pay out. At the same time fiscal prudence stays intact. The action is aimed at maintaining financial stability across the Eurozone, rather than increasing government expenditure levels in any participating Eurozone country. The interest costs will be met by the real borrowers, the 10 nations. The fund suppliers –the seven nations- get an extra income, while the taxpayers in the 10 countries benefit from the balancing act of the ECB. The ECB's mandate may need to be adjusted for executing this type of financial transaction. The great advantage is that the ECB does not need to rely on money printing, but can rely on moving real private savings within the Eurozone countries. The other major advantage is that the risk guarantors -the individual households in the seven countries- get paid for such risk taking. The risks involved are minimal as the 10 countries can fund their government bond obligations, not on wrongly “perceived risks” but on actual realised risks. By lowering the overall risk level in the Eurozone countries all countries -including all households- benefit. Of course, the criterion for assisting the 10 countries is that they apply the fiscal pact requirements. Executing such a balancing act has to be done on a daily basis; only the ECB is up to this task. The European Financial Stability Fund cannot operate in the required manner. The financial markets will relish this type of market stabilisation by the ECB and private sector fund flows will soon return directly to the higher paying Eurozone countries, making intervention unnecessary.

#### 4.3.4 Future Risk Management

Governments have high levels of debt. Rather than increasing such levels further, they might start considering when some of this debt can be repaid. Central banks operate monetary policies to maintain price stability, set the interest rates and provide liquidity to economies. They might consider that currently individual households do not want more liquidity as they are paying off both mortgage and consumer debt out of current incomes and savings. They also might consider that multinationals and large companies are holding substantial sums of money in cash, as the economic outlook remains too uncertain. These companies also do not need additional liquidity. Banks in some countries which experience capital flight do need the liquidity, but one may consider that the causes of such capital flight originate in the illiquidity of the asset classes and that possible solutions other than providing liquidity are needed. Central banks may also consider that their customers: individual households and companies are better served by stable interest and exchange rates rather than volatile ones. They, together with a government, may jointly act when financial depreciation of assets -especially homes and government bonds- starts to influence economic growth levels and unemployment levels.

Once economic growth levels have been restored to long term sustainable high levels, once unemployment levels are also at sustainably low levels and once managerial errors by the financial, commercial and government sector have been reduced, the question arises what to do in an “overshoot” situation, whereby financial market exuberance runs away from reality.

To calm markets down under these circumstances, governments can consider to run budget surpluses, which make it possible to pay back some of the outstanding government debt obligations. Such actions reduce the Country Profit level as the credit multiples in a society are reduced. In the case of the U.S., a reduction in government deficit funding can easily be combined with the economic easing method. If financial markets still run away on being over-optimistic the FED could consider buying up some government bonds, not with the purpose to resell them, but with the purpose to eliminate them out of government budget surpluses in future.

Two subjects have not been mentioned yet: international trade and exchange rates. China as a major exporter to the world has seen its exports drop to both the U.S. and to European countries. This shows how much Country Profit making is an interrelated business between countries. China has used its foreign exchange reserves to support the value at risk for especially the U.S. and particularly through buying up a share in U.S. government debt. In this way it has been of help to fund the U.S. government's deficit. This can only be a short term solution. In the longer run each country needs to balance its current accounts, so that capital movements are movements used to strengthen the productive base of countries. When most

countries apply the Country Profit opportunities in their own countries, exchange rates are likely to show more stability as there will be less reason to speculate on the outcome of the economic process.

## 5. Conclusions

If one would choose which data most closely resemble the actions of individual households collectively, the choice would not be the economic growth data but the balance sheet of households and in particular the net worth data. The latter -especially the changes in net worth from one year to the next- provide the perfect reflection of the combination of income flows and value changes in asset values. Individual households do have a balance sheet and a P/L account and they do have financial and non-financial assets. They also do react to losses on savings or threats to asset values. Economic growth data do not have such benefits as they reflect income and output data only.

In the above the implications of achieving a more stable Country Profit pattern have been set out.

In doing so for the United States, it shows that the U.S. was capable generating an average annual incremental value in net worth, which we have called "Country Profit", of U.S.\$3.4 trillion for the period 1995-2005. The average net asset value -the value at risk amount- for the individual households combined was U.S. \$42.357 trillion over the same period. The return over assets employed (return on equity, the value at risk) was on average 7.67% during 1996-2006.

For the U.K. the average annual Country Profit levels were UK£461 billion over the period 2003-2006, while the net assets employed were UK£5.662 trillion. The average return over assets employed was 8.08%.

For the U.S. the tide turned in 2007 due to the drop in the values of homes by US\$1.870 trillion and still an increase in home mortgages of US\$675 billion, reducing Country Profit by US\$2.545 trillion. In 2008 the US suffered its largest Country Loss since at least 1985 at -US\$12.612 trillion. The main elements of the loss were in homes at -US\$3.325 trillion, loss in corporate equities at -US\$3.872 trillion, loss on mutual fund shares at - US\$1.264 trillion, loss on pension fund reserves at -US\$2.982 trillion and loss on equity in non corporate business at -US\$1.611 trillion.

The cause of the 2008 Country Loss can be traced back to the risk originators and distributors of sub-prime (doubtful might have been a better term) home mortgage risks, who sold these risks to institutions around the world. The cause of the current predicament is also linked to the fast track depreciation of household assets out of line with the economically justifiable depreciation levels. The financial sector has been more inventive than the company sector in transferring risks to outsiders. When the financial sector does not follow prudent banking principles especially involving the housing markets, the losses caused by this sector tend to show a greater multiplier than those for the commercial sector. This is because it affects banks in a number of ways, sometimes directly if they were holding the doubtful CDO's, but certainly indirectly by a drop in house prices. It also affects households as their financial buffer is eroded, in two ways, again directly through lower values and secondly by having reduced income growth chances, either through unemployment or due to recession pressures.

The household balance sheet data since 2007 clearly show that households fight to keep their mortgage payments up to date in order not to lose their homes. This reduces available income for consumption purposes, leading to reduced growth in demand. The same data also show that the dynamic balance between house price increases and increased mortgage lending has also been disturbed, taking a major element of economic growth out of the equation. Households both in the U.K. and the U.S. also reduced their consumption credit levels in real terms since 2007.

The U.S and U.K. governments' action to flood the financial markets with money, by buying up government debts paper has had no results on Country Profit in the U.K. and only a limited result in the U.S. What it has done in both countries is push up inflation levels. In hindsight the U.S. would have been

better off if the FED had accepted the mistakes of the risk originators and bought back all sub-prime mortgage paper at a small discount to the original values. It could have left the home occupiers in place and make a financial arrangement with each of them to rent the places from the government. It could then have gradually released some homes of the worst offenders in non payment of rents. It simultaneously could have pursued the risk originators and the credit rating agencies for miss selling of risk practises, which should be made a commercial crime. The Fed has now spent US\$2.3 trillion on bond purchases, with more to come, rather than say US\$1 trillion. Hindsight might be useful for future crises, but not particularly for the current one.

My conclusion is that individual households need to be encouraged to spend more in the current year. The accumulated pension savings are an ideal source of funds for this purpose. The economic easing method could be the way forward, with pension funds being repaid out of future tax payments.

My other main conclusion is that macro-economic risk management needs strengthening. One solution may be to appoint a CEO Risk Manager for a country. Prevention is cheaper than a cure.

Finally the drive by households to seek “safe havens” for their cash by investing in government bonds of some countries has a detrimental effect on country profit making opportunities in other countries. Methods eliminating such effects for the Eurozone countries have been worked out in this paper. Quantitative Easing methods do not take away the risks to tax payers but reduce the rewards to them, a Country Profit reducing method.

Drs Kees de Koning  
Chorleywood, United Kingdom  
8<sup>th</sup> September 2012  
E-mail: [keesdekoning008@hotmail.com](mailto:keesdekoning008@hotmail.com)

## Statistical Appendices

## Appendix 1: Key Economic Data

## 1. United Kingdom

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Year	10 year govt bond yield	Inflation Rate (Aug-July)	Govt Debt To GDP rate	Economic Growth (Aug-July)	Unemployment Rate (Aug-July)	House Price(Real) Index Nationwide (2007=100)	Net Worth Ind. Households (x £billion) Year end
August 07	5.1%	2.6%	43.4%	3.5%	5.5%	100	6,808
August 08	4.75%	2.6%	44.5%	-1.2%	5.4%	85.5	5,967
August 09	3.8%	3.2%	54.4%	-4.4%	6.5%	84	6,568
August 10	3.4%	3.0%	69.6%	2.1%	8.0%	83.8	7,034
August 11	2.75%	3.9%	79.6%	0.7%	8.0%	79.3	7,045
August 12	1.6%	3.5%	85.7%	-0.5%	8.25%	76.4	Not yet known

Source: *Tradingeconomics.com* columns 1 - 5; column 6 *Nationwide Building Society*; column 7 *U.K. Office of National Statistics*

## 2. United States of America

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Year	10 year govt bond yield	Inflation Rate (August-July)	Govt Debt to GDP rate	Economic Growth (Aug-July)	Unemployment Rate (Aug-July)	S&P Case-Shiller Home price index (2000=100)	Net Worth Ind. Households (x \$trillion) Year end
August 07	4.75%	2.5%	66.6%	1.9%	4.5%	197.37	66.166
August 08	4.0%	3.6%	67.2%	-0.4%	5.4%	164.65	53.555
August 09	3.8%	0.8%	69.4%	-3.5%	7.9%	146.11	59.160
August 10	3.0%	1.3%	89.9%	3.0%	9.7%	148.41	60.857
August 11	2.6%	2.2%	98.5%	3.1%	9.3%	142.77	58.088(Sept)
August 12	1.6%	2.7%	103.0%	1.75%	8.5%	134.2(March)	62.866(March)

Source: *Tradingeconomics.com* columns 1 -5: column 6 Standard and Poor; column 7 Federal Reserve B 100 Balance Sheet of Households and Nonprofit Organizations



## 3. Federal Republic of Germany

	(1)	(2)	(3)	(4)	(5)	(6)
Year	10 year govt bond yield	Inflation Rate (August-July)	Govt Debt to GDP Ratio	Economic Growth (Aug-July)	Unemployment Rate (Aug-July)	House Price Index 2002=100
August 07	4.3%	1.7%	67.6%	3.2%	9.7%	104.3
August 08	4.3%	2.9%	64.9%	1.0%	8.2%	107.4
August 09	3.5%	1.2%	66.7%	-5.2%	7.9%	106.9
August 10	2.6%	0.7%	74.4%	3.7%	8.0%	107.5
August 11	2.4%	1.9%	83.0%	3.0%	7.3%	110.2
August 12	1.4%	2.2%	81.2%	0.5%	6.8%	113.5 (July)

Source: *Tradingeconomics.com* columns 1- 5, *pfandbrief.de/cms/* column 6

## 4. Spain

	(1)	(2)	(3)	(4)	(5)	(6)
Year	10 year govt bond yield	Inflation Rate (August-July)	Govt Debt to GDP Ratio	Economic Growth (Aug-July)	Unemployment Rate (Aug-July)	House Price Index 2007=100
August 07	4.4%	2.6%	39.6%	3.5%	8.3%	100
August 08	4.7%	4.1%	36.1%	0.9%	9.2%	93.8
August 09	4.0%	1.2%	40.2%	-3.4%	15.1%	85.2
August 10	4.0%	0.9%	53.9%	-0.1%	19.2%	84.3
August 11	6.3%	3.0%	61.2%	0.7%	20.6%	76.3
August 12	6.5%	2.2%	68.5%	-1.3%	24.6%	68.6 (1Qtr)

Source: Trading Economic columns 1-5; Source: INE, Instituto Nacional de Estadística (Spanish National Statistics Office), column 6

## 5. Italy

	(1)	(2)	(3)	(4)	(5)	(6)
Year	10 year govt bond yield	Inflation Rate (August-July)	Govt Debt to GDP Ratio	Economic Growth (Aug-July)	Unemployment Rate (Aug-July)	House Price Index 2007=100
August 07	4.6%	1.8%	106.6%	2.4%	6.2%	100
August 08	4.8%	2.7%	103.6%	0.5%	6.5%	102.6
August 09	4.1%	1.9%	105.7%	-4.4%	7.9%	102.2
August 10	3.8%	1.1%	116.0%	-1.2%	8.5%	102.3
August 11	5.1%	2.2%	118.6%	1.2%	8.2%	103.0
August 12	5.8%	3.2%	120.1%	-1.0%	10.7% (July)	Not yet known

Sources: Trading Economics Columns 1-5 Source: European Central Bank Column 6

**Appendix 2: United States: Country Profit, Return on Equity, Financial Assets/Total Assets; Liabilities/Total Assets 1996 - 2012**

Year	(1)	(2)	(3)	(4)
	Country Profit/ (Loss) x US\$ trillion	Return on Equity %	Financial Assets/ Total Assets %	Liabilities/ Total Assets %
1996	1.894	6.50	66.3	15.2
1997	3.859	12.05	68.0	14.5
1998	3.950	11.00	68.8	14.0
1999	5.105	12.61	70.0	13.6
2000	0.264	0.61	66.7	14.5
2001	(0.148)	-0.34	64.0	15.6
2002	(1.034)	-2.43	60.7	17.2
2003	5.922	13.14	62.2	17.0
2004	6.941	13.48	62.3	16.7
2005	6.261	10.78	61.2	16.6
2006	4.424	6.97	63.2	16.9
2007	0.518	0.79	64.9	17.7
2008	(12.612)	-21.07	63.3	20.8
2009	2.040	3.74	65.8	20.0
2010	3.565	6.21	67.8	18.8
2011	0.878	1.47	68.3 (Qtr 4)	18.3 (Qtr 4)
2012	2.828 (Qtr 1)		68.8 (Qtr 1)	17.6% (Qtr 1)

Source: Federal Reserve: Balance Sheet of Households and Nonprofit Organizations B.100

### Appendix 3: United Kingdom: Country Profit, Return on Equity, Financial Assets/Total Assets, Liabilities/ Total Assets

Year	(1)	(2)	(3)	(4)
	Country Profit/ (Loss) x UK£ billion	Return on Equity %	Financial Assets/ Total Assets %	Liabilities/ Total Assets %
2002	-	-	49.4	16.9
2003	430.3	9.04	48.9	17.4
2004	431.1	8.31	47.9	18.0
2005	475.8	8.43	50.1	17.6
2006	504.9	8.23	49.7	18.1
2007	420.9	6.38	48.3	18.3
2008	(841.2)	-13.2	48.1	20.6
2009	601.2	9.59	50.0	18.9
2010	466.3	6.86	50.2	18.0
2011	10.3	0.15	49.9	17.9

Source: Office of National Statistics 10.10 Households & Non-Profit Institutions Serving Households

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FFA, 1995-2004, June 7, 2012

#### B.100 Balance Sheet of Households and Nonprofit Organizations (1)

Billions of dollars

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	
<b>1 Assets</b>	<b>33252.4</b>	<b>35508.9</b>	<b>39719.6</b>	<b>44112.0</b>	<b>49773.2</b>	<b>50633.9</b>	<b>51109.7</b>	<b>50858.7</b>	<b>57844.9</b>	<b>65953.7</b>	<b>1</b>
2 Nonfinancial assets	11472.1	11963.8	12692.9	13760.2	14945.6	16867.3	18416.8	19979.2	21853.6	24891.6	2
3 Real estate	8843.8	9234.1	9867.6	10808.2	11821.9	13528.5	14900.6	16280.5	17981.0	20789.3	3
4 Households (2,3)	8055.3	8431.7	8864.8	9694.3	10645.3	12197.6	13571.7	14854.5	16458.5	18959.3	4
5 Nonprofit organizations	788.4	802.4	1002.8	1114.0	1176.6	1330.9	1328.9	1426.0	1522.5	1830.0	5
6 Equipment and software owned by nonprofit organizations (4)	97.4	99.3	104.4	115.0	127.6	142.8	156.8	174.0	190.6	208.1	6
7 Consumer durable goods (4)	2531.0	2630.3	2720.9	2837.0	2996.2	3196.0	3359.4	3524.7	3682.0	3894.1	7
8 Financial assets	21780.3	23545.1	27026.6	30351.8	34827.6	33766.6	32692.9	30879.5	35991.3	41062.1	8
9 Deposits	3399.5	3539.1	3707.3	3934.6	4116.0	4439.9	4960.9	5244.4	5445.4	5828.2	9
10 Foreign deposits	23.4	35.5	37.2	37.7	40.7	48.3	48.7	49.9	52.1	57.5	10
11 Checkable deposits and currency	586.5	544.8	503.8	528.6	508.9	405.1	480.0	464.1	458.2	400.0	11
12 Time and savings deposits	2317.2	2457.9	2594.9	2696.9	2792.3	3049.3	3331.1	3642.6	3965.9	4454.6	12
13 Money market fund shares	472.4	500.9	571.3	671.3	774.2	937.3	1101.1	1087.7	969.2	916.1	13
14 Credit market instruments	2379.7	2545.0	2501.4	2554.6	2670.9	2563.6	2460.1	2596.5	2837.4	3949.7	14
15 Open market paper	71.7	75.8	77.1	80.2	84.9	97.3	88.2	82.2	77.3	83.7	15
16 Treasury securities	828.0	888.9	797.8	733.1	810.2	579.1	434.0	263.7	408.0	492.6	16
17 Savings bonds	185.0	187.0	186.5	186.6	186.4	184.8	190.3	194.9	203.8	204.4	17
18 Other Treasury	643.0	701.9	611.4	546.4	623.7	394.3	243.7	68.8	204.2	288.2	18
19 Agency- and GSE-backed securities	216.4	332.8	389.7	441.7	541.8	594.0	407.3	247.6	384.0	406.0	19
20 Municipal securities	533.4	493.0	497.6	498.7	528.1	531.2	580.7	678.3	703.7	1561.8	20
21 Corporate and foreign bonds	616.7	648.7	640.2	706.5	603.9	656.7	838.6	1205.2	1140.4	1268.3	21
22 Other loans and advances (5)	0.1	0.1	0.2	0.2	0.6	1.9	2.6	2.8	3.1	5.9	22
23 Mortgages	113.3	105.8	98.7	94.3	101.6	103.4	108.7	116.6	120.9	131.3	23
24 Corporate equities (2)	4434.2	4712.2	6144.1	7506.8	9763.0	8140.2	6825.9	5163.3	6784.2	7475.5	24
25 Mutual fund shares (6)	1253.0	1561.9	1949.3	2352.2	2894.6	2708.0	2618.2	2223.3	2915.3	3432.3	25
26 Security credit	127.6	162.9	215.5	276.7	323.9	412.4	454.3	412.7	475.4	578.3	26
27 Life insurance reserves	566.2	610.6	665.0	718.3	783.9	819.1	880.0	920.9	1013.2	1060.4	27
28 Pension fund reserves	5725.1	6386.7	7360.7	8265.4	9264.1	9171.3	8764.3	8189.6	9718.9	10635.5	28
29 Equity in noncorporate business (7)	3566.8	3687.9	4131.9	4382.5	4638.5	5133.3	5331.4	5684.0	6300.2	7548.6	29
30 Miscellaneous assets	328.3	338.9	351.5	360.8	372.6	378.7	397.8	444.9	501.3	553.8	30
<b>31 Liabilities</b>	<b>5043.3</b>	<b>5405.7</b>	<b>5757.2</b>	<b>6199.6</b>	<b>6755.9</b>	<b>7352.9</b>	<b>7976.2</b>	<b>8759.2</b>	<b>9823.1</b>	<b>10991.2</b>	<b>31</b>
32 Credit market instruments	4846.1	5183.8	5489.4	5902.9	6377.6	6963.5	7627.8	8439.1	9462.9	10531.5	32
33 Home mortgages (8)	3318.9	3537.0	3752.9	4054.0	4430.8	4814.0	5320.9	6025.6	6907.9	7852.4	33