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THERE'S NEW SPARKLE IN THAILAND'S ONCE-MALIGNED GEM INDUSTRY.

A 24-CARAT WINDFALL

HOW TO GET PROFIT DURING RECESSION

Governments reward those who spend and penalise those who save.

MANY READERS send me questions on many diverse subjects. The most recent questions concern recessions, depressions, and what are they and why they happen?

The anatomy of a recession is actually an economic phenomenon. Land doesn't just disappear; buildings don't collapse and most factories don't vanish. In fact, in a recession or a depression, the world changes very little. All that really changes is the way people relate to the economic changes, which vary enormously.

Real wealth doesn't disappear; the economic phenomena does cause the wealth to change pockets. Property may lose its previous, however generally-inflated, value, but it will still exist at the end of a recession. Just because governments and companies default on their bonds does not mean they are bankrupt.

At the end of every recession some things will be more valuable and others less. The individual who owns the most valuable objects at the end of the recession is almost certain to be one who understands what is happening, why it is happening and the phases of the business cycle. This column is designed to help you be one of those people.

Karl Marx pointed to his version of the cycles in the financial world which cause inflation, followed by high interest rates which, in turn, cause uncontrolled economic contraction or recession, at which time the money supply is greatly increased. This then causes inflation and the cycle repeats itself. Marx stated these "boom and bust" business cycles proved that capitalism does not work because of these internal contradictions.

However, as in just about everything else, Marx was nonsensical. These business cycles would not exist if the world had pure capitalism. It is only because the capitalistic system of *laissez faire* has been diluted by politicians "fine-tuning" the economy.

We are told we have capitalism in nations, such as the US and Australia (and many others) wherein the government accounts for spending well in excess of 30 per cent of the GNP (Gross National Product). If the alleged capitalistic nations had a pure capitalistic system, gold would be the only money.

There could be no inflation because the supply would be constant to everything else. There would be no booms or busts and the only recessions that would occur, would be caused by disorders, such as drought, flood, typhoons, and the like and these would be localised, short-lived and occurring at rare intervals.

The basic root cause of all recessions or depressions is debt. Professor Jay Forrester has written that periods occur, after a previous recession is finished, when people start to regain confidence. Industry re-builds the capital goods sector, employment picks up, and consumer spending increases. A new reinforced view of confidence emerges and the stock market rises. It no longer appears risky to take on debt; the capital goods sector overbuilds, then a mania for investment through debt occurs.

People invest rapidly for fear of being left out. Financial markets go higher and higher, and success feeds on success. This carries on and advances to a craze for debt.

Like a boiler without a relief valve, the economy becomes over-heated and explodes.

At this point, governments usually come to the rescue. They are usually the least-qualified of all to solve the problems as they originally set the debt-spree example. Invariably, government action worsens the situation. Some of their "solutions" include wage and price controls, trade restrictions, credit controls, import and export restrictions, increased taxation, government propping-up of mismanaged banks and the like.

The government solution usually is to pump money into the economy, provide "make-work" fiscal handouts, feeding welfare queues, and other attempts — none of which approaches the core reasons for the recession, and thus can't assist. Perhaps a major cause of the recession is government action: taxes, waste and interference with and competition against the private business sector. Government action to solve the problem is akin to throwing petrol on a fire to extinguish the blaze.

Lack of savings: A major generator of recessions is the lack of personal savings. Saving is setting aside current production for future consumption. Considering the industrialised countries, it can be noted that certain of these enter recessions first and their recessions bite the deepest. Examples of the most recession-prone countries are the US, Canada, Australia, the UK and others who tax the interest on savings accounts. If a person is in the 30 per cent or 40 per cent (or whatever) tax bracket in these countries, the interest paid on savings is taxed at this high rate.

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These countries, such as the US, allow interest paid out to be tax deductible. Thus a person is penalised perhaps 30 per cent tax for saving, but rewarded with perhaps a 30 per cent deduction for spending. It is obvious that a person in these circumstances loses all incentive to save and prefers to buy a boat, a vacation condominium and gadgets because part of the cost is tax deductible. Since spending is rewarded and savings is penalised, personal savings seldom average over three per cent.

Countries, such as Japan, Austria, and Germany, do not tax interest on savings and do not allow a tax deduction on interest paid out on luxuries or anything else. These countries never feel recessions as early, nor to the same degree, as countries that penalise savings and reward spending. When there is a high personal savings pool of money, a downturn in the economy can be stabilised with the pool of capital created by savings. Without this pool of savings, indebted people must get relief from more debt, which is like sending more snakes to a snake-bitten person as a cure.

Imported recessions: A recession or depression in one country can cause an economic contraction in other countries. The world's economies are today too intertwined for any country to avoid economic crisis in other countries.

Even in the 1920s and '30s, when the world was not joined closely by the information era and the jet engine, a crisis in one country caused panic in other nations. The "Great Depression" actually started with panic in Austria, which caused a depression in Germany which, in turn, brought down London and the collapse quickly spread to New York. In a few weeks, the entire world was engulfed in misery. This could be repeated today. A civil war in the Soviet

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Union and the Warsaw pact countries causing financial panic could spread quickly to mid-Europe and thence worldwide.

Another cause of recessions is monetisation of debt. This is merely a spin-off of the factor that debt causes recession in its aftermath. Every debt must eventually be settled. It cannot just be forgotten. There are really only three ways debt can be settled.

- Default of the debtor
- Paid by the debtor
- Monetising. Governments, that create money, can settle debts by monetising them. This is achieved, in the US for example, by the US Treasury selling Treasury bills, notes and bonds, which are all merely "I owe you" pieces of paper.

Naturally, these have no intrinsic value, being merely a written record of a loan to the government. When it is desired to reduce government debt, the banks that bought these — either originally or through the secondary market — are allowed to turn them in to the Federal Reserve System (FED). The FED then credits the bank with that amount of money which the bank can use as reserves for money the banks create when they lend.

This creating of money from thin air, with a bookkeeping entry to erase debt, is called "monetising debt". Naturally, this adds to the money supply of the nation. In due time, the increase of money supply causes inflation. When inflation gets out of hand, the FED then tightens. Eventually, the tightening causes paralysis of industry, stops consumer spending, causes bankruptcies and unemployment and a recession then follows.

The yield curve has been one of the most reliable indicators of the health of economies. This curve in reality is a gauge of the spread between short-term interest rates and long-term interest rates. In times of good economic climate, the spread is quite large. The usual way of measuring this is to draw a line which becomes a curve between the yield of a short-term instrument, such as a three months US T-Bill, and the yield of a 30-year US Treasury-Bond.

It is natural that long-term interest rates should be substantially higher because there is more risk in a 30-year span than a three-month term. There is greater risk of default and greater risk of inflation. If you lend money for only a short period, such as three months, you are not especially fearful that the purchasing power will drop much or that the exchange rate value will change much.

However, you would be much more concerned about your money if you risked it for 30 years. It could be damaged and be almost worthless if eroded by inflation. Whenever short-term rates are nearly as high or even higher than long-term rates, this is a clear sign that the economy is in recession. However, when short-term rates fall adequately so that a large inflation premium exists in long-term rates, you can be sure that within a few months the recession will be over.

A recession is a period of lowered living standards and a depression is a prolonged period of lowered living standards. The technical definition of a recession used by the US Government is two-quarters in succession, with a negative GNP. Thus a recession must be six months old at least before it can be called a recession. This measurement is not very accurate because the US Government has not changed its standards for measuring GNP since 1982.

In the nine years since, the value of the dollar and about everything else has changed. There is a strong probability that the current recession is much older and much more severe than commonly-presumed, if a reliable and up-to-date measurement of GNP were used instead of obsolete nine-year-old standards, which are capable of distortion.

A depression is much more severe. When a recession exists, the central bank can lower interest rates and increase the money supply and in due time the economy will be re-started. In a depression, the central bank can ease and cut rates but nothing will start the economy. The economy is out of control. A classic example of this liquidity trap occurred during the "Great Depression": interest rates were dropped to 1.5 per cent for 14 years and T-Bills paid no interest at all. Even this could not budge the economy.

How to improve your finances during a recession?

- Your main objective during a recession is to preserve what you already have as opposed to taking risks trying to make more.
- Most people lack patience to wait for bargains. They "follow the herd" and invest too early and before the recession is truly finished. During a recession, many analysts and economists work for various governments whose politicians want to tranquilise the public, or for financial houses who want to drum up business.

These analysts are paid not tell the truth but to put out optimistic statements. This causes investors to side-step caution and even borrow to invest, which is a dangerous mistake. It is necessary to wait until the recession is truly over, when things you want to buy are really low-priced. This period cannot be rushed.

"It's possible that the recession is much older and much more severe than commonly presumed because of the obsolete way used to measure GNP."

- Discipline yourself to wait because you really only want to buy things when they are on the bargain counter. Most people do not realise how cheap things can get. In many industrialised countries, property can fall another 50 per cent. Boats can fall 75 per cent, collectables, such as art, can fall exceedingly low when there are few or no buyers. The Hong Kong stock market fell 95 per cent in the early 1970s.
- A recession can have straight deflation, inflation or stagflation. In stagflation, such as exists now, some items, such as property, gold, copper and the like, are in deflation while others, such as many types of services, transportation and sometimes oil and wages, are rising in price. Just because some things are cheap does not mean everything is cheap, nor does it mean they can't still get cheaper.
- Discount inflation and risk into every investment. If you think risk is about two per cent and inflation in your vicinity is eight per cent, your investment must return a yield of 10 per cent before you break even. Never invest unless you can get returns of at least three per cent after brokerage and other handling costs, plus a percentage for the risk factor. Also ensure inflation costs, and the like are subtracted from your returns. Above all, retain the purchasing power of your investment money.
- Don't speculate unless you can afford the possible loss.
- Above all, diversify. Some of your investments will probably go sour. If you spread them around, the odds are with you that all can't go bad at once.
- Avoid scams. Don't buy a newly-proposed investment over the phone. Take time to study and get advice. Be sure of the potential for both loss and gain. It is better to lose a possible profit than lose money you already have. ■

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