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A Production of Hamlet without a Prince of Denmark

The *Wall Street Journal* carries an article (29/12) headed "Economists Ask If Bonds Have Lost Predictive Power" by Mark Whitehouse. More relevant would have been "Economists Blame Bonds for Their Own Failure to Distinguish between Number-crunching and Serious Analysis."

Analysis would attempt to include all important factors involved, where number crunching picks out a couple of statistics and ignores all other factors that contribute to their movement. But let's begin with the orthodox economists' own description of their plight.

"Now that the bond market is behaving as though the economy is in trouble, investors who would like to believe otherwise need ask themselves: is past prologue?

"When yields on longer-term US Treasurys fell below those on short-term securities Tuesday, they trace a pattern that often has been seen shortly before the economy trended lower or even tanked.

""But amid overall interest rates and one of the most stable stretches of economic growth in US history, many economists are saying the bond market must be wrong this time.

"'I think the bond market is on drugs,' says Ethan Harris, chief US economist of Lehman Brothers in New York. 'It's hard to take the yield curve seriously as a recession indicator. Even Federal Reserve Chairman Alan Greenspan has argued that the yield curve may have lost its oracle status" Indeed, the same might be said of Greenspan himself.

"Economist optimists also note that the 'yield curve inversion – so called because it reverses the normal upward slope of bond yields, from short to longer term – isn't yet severe. Indeed, in late New York trading yesterday the difference in yield between two and 10-year Treasury notes – a popular measure of the curve – had eked back into traditional territory. The two-year note's price was down 2/32 to yield 4.375%, while

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Hamlet *continued from page 1*

the ten-year was off 2/32 to yield 4.376%. The yield curve was pointing ever so slightly upward again.

"Most market professionals, however, expect the inversion to return and deepen. And history has been brutal to forecasters who have doubted the yield curve's predictive powers. Over the past 50 years the yield curve has given only two false signals, and the most recent head fake may have been caused by some very big extenuating circumstances: in 1998, investors, spooked by a financial crisis in Russia and the demise of investment firm Long-Term Capital Management, fled to the safe harbor of Treasury bonds. That pushed up the prices of those securities, and therefore drove down their yields, so low that long-term yields fell below shorter-term rates. But the economy survived, and even the swooning stock market righted itself."

"When the curve headed toward inversion in early 2000, with the yield on 30-year bonds falling below the yield on 10-year Treasurys, most of the major Wall St. banks saw little reason for concern. Their rationale: The government, which was running a budget surplus at the time, was selling fewer long-term bonds, creating a shortage of those securities that pushed their prices up and their yields down.

"For a bit of *déja vu*, consider a February 2000 report from Deutsche Bank: 'When this spread went negative in the past, it either foreshadowed a recession or a sharp slowdown in growth in the immediate quarters ahead. Fortunately for Main Street, we do not think the 10s/30s inversion is sending that message."

The Perversion that Created the Inversion

But that is like staging a production of Hamlet, without a Prince of Denmark in the cast. We have often recounted what it was that created that fiscal "surplus" of Washington in the latter 1990s, but I am afraid we must do so once more, given the *WSJ's* innocent belief that it was just the few statistics of their choice that created that inversion rather than the basic restructuring of the American economy.

The campaign to enthrone speculative finance over the economies of the world consisted essentially in deregulating world banking from the provisions introduced by the US *Bank Act* of 1935. Essentially, this had confined banks to banking. It barred them from acquiring interests in the other "financial pillars" – the stock market, mortgages and insurance. These pillars retain pools of liquid finance for the needs of their own businesses. However, allow the banks to get their mitts on these reserves, and they use them as money base for applying the banking multiplier that is the very essence of banking – loaning out many times the credit as the cash reserves they keep on hand. That was a major factor in bringing on the Depression of the 1930s and through it World War II. But the counter-revolution against the Rooseveltian banking code did not stop there.

The Rooseveltian *Bank Act* had essentially put the banks in the doghouse, making them stick to banking. By 1951 the banks had put in place a carefully thought out plan organized largely by the US Federal Reserve from its international bunker, the Bank for International Settlements in Switzerland (the BIS). The latter was a purely technical body that would not even allow elected members of government to attend its sessions. The essence of its program was the independence from government of central banks even though – as in Britain or Canada – their sole shareholder was the government, and the need for a flat price level that had to be imposed by high enough interest rates.

The US *Bank Act* which had become the model in the non-Communist world had provided two major policy tools for central banks to fight any inflationary increase of prices. They could raise the benchmark interest rate set by the central banks, but they had the alternative of raising the statutory reserves – a modest proportion of the deposits taken in from the public by the banks that had to be redeposited with the central bank. The purpose of that was precisely to cool the economy when it was overstimulated beyond the power of available supply to meet the demand. Or if the economy were depressed, they could stimulate it by lowering these required reserves. Interest rates hit anything that moves in the economy, especially the unemployed who could hardly be responsible for contributing to "inflation." Moreover, interest was the prime revenue of money-lenders; and making its increase the sole "blunt tool" for licking inflation was clearly surrendering economic power to a group of operators that has been known to become parasitic even without official encouragement. Moreover, part of the program of leaving everything to the "free market" was doing away with the usury laws and the maximum interest rates that banks could pay or charge. Cur-

rently in Canada, be it said to our shame, the maximum rate of legal interest that can be charged is 60% per annum. And that is under criminal not civil law!

The financing of WWII and the postwar reconstruction had shown how effective the financing of government capital investment could be through the central banks. Where they were owned by the government, as in Canada and the UK, the interest paid on the government debt held by the central bank returned to it substantially as dividends. But even where the central bank was privately owned as in the United States, almost the same proportion of the earnings of the central bank found its way back to the government for several good reasons. The government through the central bank was "the lender of the last resort" – to avoid a run when the banks found themselves unable to honour depositors' claims. That role – in essence bailing out our banks when the need arises – does not come cheap. The deregulation of our banks, begun seriously in the 1960s to once again allow them to take over brokerages, mortgage and insurance companies, and the wiping out of the statutory reserves, had increased the bank multiplier for the system as a whole from a mere 10 to 1 where it stood in 1946 to just under 400 to 1 in 2000. (The "bank multiplyer" is the proportion of bank credit to the cash in their possession.)

The Booboo of the Central Banks that Changed the System

Despite their devotion to number-crunching, government and bank economists never refer to such figures. Nor do they mention an incredible booboo that the central bankers, assembled by the Bank for International Settlements, were guilty of in the 1990s that almost blew away the world monetary system. In the 1980s Canadian banks, like their American cousins, had lost much of their capital in financing schemes that read like Alice in Wonderland. To mention only one: when Robert Campeau, a well-connected Ottawa house builder, suddenly felt an itch to collect US department stores chains, he had no difficulty in getting Canadian banks to finance his scheme. Shortly before he went broke he issued a press release announcing that he would be continuing the interest payments on his convertible bonds, which of course, was misleading.

Nevertheless, when the deregulated banks of the world had lost a major portion of their capital in speculations incompatible with banking, to bail them out from their losses, BIS brought in its Risk-Based Capital Requirements for banks. This declared the debt of developed countries "risk-free" requiring no additional capital for banks to acquire. That was the very essence of the world-wide bank bailout. All they had to do was to clip the coupons of such bonds to replace the capital they had gambled away. Canadian banks thus quadrupled their holding of government debt to $80 billion. And the government shifted most of the debt it had held at the Bank of Canada, on which the interest it paid came back to it as dividends. The interest of that debt, when financed by the commercial banks, stayed with them. That is what the bank bailout was about.

However, BIS at the same time redoubled its efforts to raise interest rates to lick what it took to be "inflation" stone dead. COMER tried warning our government through various channels, public and private, that with the hoards of government debt that the banks had accumulated, the higher interest rates brought in to lick inflation would be catastrophic for them and for the economy as a whole. For when you can buy new bonds with a bigger coupon at par, preexistent bonds with smaller coupons drop in value like stones. To no effect. What clearly mattered, and what continues to matter, is not the economic logic behind whatever policy, but whether it is useful to the financial clique that has taken over power.

The showdown that has contributed grandly to the conundrum of the inverted interest rates today all arose from the financial disaster that resulted from these two perfectly incompatible policies imposed by BIS and the US Fed in the early 1990s. What COMER – amongst a few other brave souls – clearly warned about in the early 1990s came to pass first in Mexico in December

CAP–COMER's Travelling Show

November and Decembers have been busy and fruitful months. In anticipation of the fall of the Martin government CAP, the only party, big or small, that has dared speak the unspeakable truth: why the Bank of Canada which was purchased from 12,000 private shareholders at a good profit with scarce Depression dollars should for the past 15 years have pretended to be independent of the government by virtue of the myth that it would be inflationary if the government borrowed from its own bank to finance its infrastructure investments. When it had done that, for some 35 years after its nationalization in 1938, it worked brilliantly with the interest on the bonds held by the BoC returning to the government as dividends.

COMER, a non-political think-tank, founded by distinguished academic economists and activists almost 35 years ago, has joined the tiny Canadian Action Party in the current election campaign because it is the only political party that dares reveal the real scam that has so demoralized the Canadian political scene. Alongside it, the Quebec sponsorship rip-off is an innocent prank.

No democracy can survive the suppression of the crucial information concerning a major redistribution of the national income.

William Krehm, the publisher of *Economic Reform*, the monthly organ of COMER during the near 18 years of its existence joined Connie Fogal, the leader of CAP as co-speaker at over a dozen meetings in Ontario, Saskatchewan, and British Columbia dealing with the issues raised by CAP and evaded by other parties to one degree or another. The attendance varied all the way from some 80 in larger centers like Vancouver and Saskatoon to as few as ten. In larger centers – especially in Saskatchewan where much of Canada's most fruitful history has been enacted, some of those who attended knew quite as much about the issues raised as the official speakers. But at every meeting there were members of the audience who had not heard of these formative chapters of Canada's past before.

Apart from earlier meetings addressed by the Fogal-Krehm team in Toronto, Kingston and Ottawa, and Saskatoon, the list was Vancouver (Nov. 25), Surrey, BC (Nov. 26), Victoria, BC (Nov. 27), Gabriola Island, BC (Nov 28), Port Alberni, BC, Duncan BC (first meeting, Dec. 1; second meeting at North Cowichan Municipal Council Chambers, Dec. 2), Salt Spring Island, BC (Dec. 3), Gibsons, BC.

If you would like to have the show visit your home town, before the coming election, or in good advance time for the likely next one, contact Connie Fogal, CAP Leader at conniefogal@telus.net. There is a good chance that it can be arranged.❧

1994. There, too, the purely monetary play had been compounded by the wave of Globalization and Deregulation – also known as the "Washington Consensus," though there was more Washington in it than consensus. NAFTA was sold to both Canada and Mexico through misleading propaganda by the US with unfounded reports to the Mexicans of the enthusiasm for it in Canada, and to Canadians of its supposed popularity in Mexico. Canada did, however, resist a persistent hosing of misleading propaganda of US academics and Canadian mercenaries for a "common currency with the US." Unfortunately, Mexico, whose politics are still more corrupt than ours, was sold that bill of goods. Accordingly, it allowed itself to be persuaded to issue special bonds convertible in US currency ("tesobonos"). Foreign bank advisers convinced the government that so long as the Mexican government financed its needs in a free market where capital could move across frontiers without hindrance, there was no risk in such an arrangement. As a result the peso fell out of bed and through the floor in December 1994, as much of the Mexican debt had been transferred from the Mexican central bank to the banking system and converted into dollars fled across the open border even before the extent of the trouble became public.

When Authorities Concentrate on Hiding What They are Up To Rather than Checking Whether It Makes Sense

Mexico was the first victim of the ham-handed initiative of BIS and Washington to combine the bank bailout by shifting massive amounts of allegedly risk-free government debt from central banks to the commercial banks without any down payment. At the same time, the BIS manager, Alexandre Lamfalussy, launched a special campaign urging that interest be screwed up until the "inflation" rate was zero. Nothing but a flat zero would do, he claimed, to avoid the sort of hyperinflation that overtook Germany in 1923. It is true that Germany had lost a world war, and the French and Belgian armies had occupied its industrial heartland, the Ruhr, to collect the war reparations in hard currency that Germany didn't have, and a general strike paralyzed the land, and virtual civil war took over. But all that was irrelevant to Mr. Lamfalussy. And academics throughout the world failed to contradict such nonsense. The empire of speculative capital could never have been established without the complicity of the world's universities.

It was President Clinton, alerted by his Secretary of the Treasury, Robert Rubin, a canny alumnus of Wall Street, who saved the day. Without the backing of Congress, he put together the largest standby fund to that date, $51 billion dollars, with the help of the IMF and Canada, to prevent the Mexican monetary collapse from spreading to the rest of the world.

Rubin went further. Realizing the impossibility of combining the world bank bailout by loading the banks with central debt with high interest rates that destroy the value of existing bonds, he turned to the most deeply buried secret of statecraft in our age: the government deficit of most countries of the world was a fraud. Whereas the private sector when it acquires a machine, a building, or any physical capital good writes off the depreciated value over its useful life, governments, with the temporary exception of Sweden, treated the physical capital assets exactly as they do a purchase of floor wax. It was an ingrained habit with a whole chain of advantages for the speculative financial sector. Carried on the government books at one dollar, the capital asset could be privatized for a ridiculous fraction of its real value, and then organized as a public company and listed on the stock market at great profit. Thereupon the public, that had already paid for the asset once in taxes began paying for it a second time in user fees. The politicians who had engineered the deals applied the skimpy proceeds to reducing the debt, and took a bow for their performance.

President Clinton made this, his greatest contribution, in stealth. One of his basic principles was never to surrender the political center, and the political center simply refused to admit that governments were capable of making investments. Even when they bailed out banks on the average of once a decade or so, the banks were seen as the very soul of efficiency, while governments that rescued them were capable only of wasting money. So while, carrying back the adjustments for several years, the Department of Commerce's Labour statistics retrieved some $1.3 trillion dollars of ignored government assets, these appeared as "savings" not as investments of the government. This, however, they most definitely were not, since savings in modern economic literature implies cash rather than capital invested in bricks and mortar, and steel. However, a wink and shrug to the bond rating agencies sufficed to convey the real nature of the new item and brought down interest rates for government debt. The age of "licking inflation" with shriekingly high interest rates, the Age of Lamfalussy, Paul Volcker, and John Crow, was over. That assured Clinton a second term, and Wall Street the high tech boom that finally led to the Big Bust of 2000.

In Canada, however, the treatment of government investment as current spending went on unquestioned another several years, despite the recommendation of two Royal Commissions and an uncounted succession of auditors-general. Accrual accountancy (also known as "capital budgetting") contrasts with the "cash accountancy" used by the government.

The Contribution of Accrual Accountancy in Bringing on the Interest Rate Inversion

Now, let us see what a different light this sheds on the allegedly prophetic powers of the inversion of interest rates. The low current debt yields are mainly the result of the partial introduction of accrual accountancy by the Clinton government as of January 1996. That brought down both the government net debt that had to be financed and the rates at which it was financed. Moreover, it made available fewer government bonds and a greater demand for them, especially as the forward lean of the stock market increasingly came to defy gravity. Stocks came to be driven up to levels that extrapolated the rates of growth achieved – in fact or fiction – into the remotest future and then their present value produced by such futurism was incorporated into their present price. But when we say "rate of growth" do not for a moment that this necessarily meant growth of actual earnings. The outstanding achievers of the hightech boom were priced not by their earnings but by the growth of their market share. Some of these in fact had never earned a bean, but were attributed market value higher than General Motors in its glory days – on the assumption in this age of free markets, that when they would achieve 100% market share – they would start catching up on the earning thing. "Rate of growth" became, then the coin of the land. And there is no need to pollute it with actual production of useful products.

You can gamble in bonds, shorting them or buying them long, without even troubling yourself to acquire a single bond. Financial houses will arrange for you to deal in the derivatives of bonds, or allow you to achieve the same earnings by dealing in units of abstract risk, a degree of risk calculated from

a conceptual pool of bonds. But there is a catch in this as in all things too good to be true. When a gambler shorts pork bellies or wheat, or listed stocks, he borrows the real commodity and sells it, but will eventually have to buy it to cover his short. When he shorts only the *concept* of a stock, or pork bellies there is no such covering sale in the offing. And the trader who doesn't grasp the distinction is likely to be stung. And more and more of our financial markets are based on fiction and what is coming to be known on the "street" as "bankers' exit" – i.e., the downloading on the innocent of banks' syndicated loans of increasingly questionable quality.

Under these circumstances, it stands to reason that there should be an explosive demand for reliable old-fashioned debt of first world governments at the very time that the introduction of accrual accountancy has reduced both the need for its being issued, and its rate of return.

There are further aspects of this increasingly pervasive pattern: the revolutionary effect of the partial introduction of accrual accountancy. By lowering the needless artificial level of interest rates that was imposed by sheer power grab by the banking interest, it has created an ever deeper crisis not only in the pension obligations of our large producing corporations that has threatened the very solvency of the entire US automobile industry. An early aspect of the forward lean of the stock market economy mentioned above, was the tendency to settle with trade unions by increasing the firms' future pension obligations to their employees rather than by raising their current wages. This was made partly more plausible by the high interest rates imposed under the Lamfalussy-Volcker "zero inflation" regime. But with the incompatibility of this with the banks' bailout from their gambling losses, and the lowering of certain interest rates, the funding of pension funds has becomes ever more dubious, to the point of driving the producing company that is obliged to fund them into insolvency.

And this is taking place at the very time when advances in medical science are making possible longer life spans. What should logically be the occasion for rejoicing with fife and drum has thus taken on aspects of disaster in the world of pensions and government finances.

It is going to take serious analysis rather than number-crunching to get the world out of its present mess.

William Krehm

Whither World Banking?

The following is a quotation from *Frontline* of Madras, India (25/2/05) which tells us much about world banking. That is particularly so, since India is coming into prominence as a one of the few potential challengers of the position of the US as lone superpower. In both instances that is largely because of the quantity and quality of her human stock.

Unfortunately, when the clipping reached me, I was away on a speaking tour, and this caused my correspondence to lapse into even greater disorder than usual. I have thus lost the name of my correspondent who was good enough to send me the clipping from the Madras publication carrying the valuable item published below. *W.K.*

What is Happening to Indian Banking?

"The sector is undergoing fundamental changes that have diluted its traditional role of protecting small deposits against capital and income risks and facilitating the conversion of savings into investment."

C.P. Chandrasekhak

"Currently, banks seem to be the prime targets of the government's reforming zeal. Having encouraged foreign acquisition, consolidation and universalization in the banking system, the Finance Ministry's current thrust seems to be to find a host of new areas of activity for these institutions. According to unconfirmed reports, the Reserve Bank of India (RBI) has approved a proposal of from the government to amend the *Bank Regulation Act* to permit banks to trade in commodities and commodity derivatives. This offer to banks of one more avenue of speculative investment merely furthers the fundamental changes under way in India's banking sector.

"[Such] institutional changes include: a rapid increase in the number of new private sector banks; a process of consolidation of banks that thus far affected the private banking sector but is now being promoted in the public sector as well; privatization of equity in public sector banks; merger of banks and other financial institutions, particularly development banking institutions; and the development of universal banks that are in the nature of financial supermarkets, offering customers a range of products from across the financial sector such as debt products, investment opportunities in equity, debt and commodity markets and insurance products of different kinds."

"Implicit in these institutional changes are changes in the operations of the increasingly 'universalized' banks. The most crucial change has been an increasing reluctance of banks to play their traditional role as agents who carry risks in return for a margin defined broadly by the spread between deposit and lending rates. Traditionally, banks accepted small deposits that highly liquid investments protected against capital and income risk. This made banks crucial intermediaries for facilitating the conversion of savings into investment.

"Given this crucial role of intermediation conventionally reserved for the banking system, the regulatory framework that had the central bank as its apex, sought to protect the banking system from possible fragility and failure. That protective framework across the globe involved regulating interest rates, providing for deposit insurance and limiting the areas of activity and the investments undertaken by the banking system. The understanding was that banks should not divert household savings placed in their care to risky investments promising high returns. In developing countries, the interventionist framework also had developmental objectives and involved measures to direct credits to what were 'priority' sectors in the government's view.

"In recent years, liberalization and 'denationalization' have changed all that and forced a change in banking practices in two ways. First, private players are unsatisfied with returns that are available within a regulated framework, so that the government and the central bank have had to dilute or dismantle regulatory measures as is happening in the case of priority lending as well as restrictions on banking activities in India. Second, even public sector banks find that as private domestic and foreign banks, particularly the latter, lure away the most lucrative banking clients because of the special services and terms they are able to offer, they have to seek new sources of finance, new activities and new avenues for investments, so that they can shore up their interest incomes as well as revenues from various fee-based activities.

"In sum the processes of liberalization fundamentally alter the terrain of operation of the banks. Their immediate impact is visible in a shift in the focus of bank activities away

from facilitating commodity production and investment to lubricating trade and promoting personal consumption. Interest rates in these areas are much higher than that which could be charged in investment in commodity production. According to a study (*Consumer Outlook 2004*) conducted by market research from KSA Technopak, Indian consumers are increasingly financing purchases of their dream products with credit that is now on offer, even without collateral. Personal credit off-take has increased from about Rs 59,000 crores in 2000 to Rs, 160,000 crores in 2003, giving an unprecedented boom to high-ticket purchases such as housing and automobiles,' the study reportedly found." (1 crore equals 10 million rupees.)

"But there are changes also in the areas of operation of the banks, with banking entries not only creating or linking up with insurance companies, but also entering into other 'sensitive' markets such as the stock and real estate. It should be expected that this growing exposure to non-collateralized personal debt and entry into sensitive sectors would increase bank vulnerability to default or failure. The effects on bank fragility became clear after the stock scam of the late 1990s. RBI's Monetary and Credit Policy Statement for the year 2001-2002 had noted. 'The recent experience in equity markets, and its aftermath, have thrown up new challenges for the regulatory system as well as for the conduct of monetary policy. It has become evident that certain banks in the cooperative sector did not adhere to their prudential norms nor to the well-defined regulatory guidelines for asset-liability management nor to the well-defined regulatory guidelines for asset-liabilities nor even to the requirement of meeting their inter-bank payment obligations. Even though such behaviour was confined to a few relatively small banks, by national standards, in two or three locations, it caused losses to some correspondent banks in addition to severe problems for depositors.

"Interestingly, this increase in financial fragility has been accompanied by the emergence of new instruments in the banking sector. Derivatives of different kinds are now being traded in the Indian financial system including, crucially, credit derivatives. Most derivatives, financial instruments whose value is based on or derived from the value of something else, are linked to interest rates or currencies. Credit derivatives are based on the value of loans, bonds or other lending instruments.

"A working group of the RBI had recommended in 2003 that scheduled commercial banks may initially be permitted to use credit derivatives only for managing their credit risks. But banks were not permitted to take long or short credit positions with a trading intent. Credit derivatives were seen as helping banks manage the risk arising from adverse movements in the quality of their loans, advances, and investments by transferring that risk to a protection seller. Using credit derivatives, banks can (1) transfer credit risk, and hence, free up capital, which can be used in other opportunities; (2) diversify credit risk; (3) maintain client relationships and (4) construct and manage a credit risk portfolio as per their risk preference.

"Banks in India have quickly responded to this opportunity. For example, soon after the introduction of interest rate futures in India, Citigroup concluded three securitization deals worth Rs 570 crores ($126.6 billion), where yields on government securities or the call money rate, were used as the benchmark for pricing floating rate payments for investors. The underlying receivables arise from a large number of fixed rate loan contracts made for financing commercial vehicles and construction equipment. The risk here is being shared with mutual funds, who are reportedly the major investors."

Banks Plunge into Credit Derivatives

"Even the conservative State Bank of India (SBI) has taken a plunge into the credit derivatives market to cope with the risk arising from its growing loan portfolio. The banks has reported growth of almost Rs 36,000 crores or 25 percent in its loan portfolio on a year-on-year basis until September 2004, starting from a total loan assets position of Rs. 135,000 crores in the corresponding period of the previous year. Of this credit growth, more than 40 per cent had been contributed by retail assets. Credit derivatives offered an opportunity to hedge against the risks being accumulated in this manner.

"It should be clear that credit derivatives are an industry response to the increasing fragility that comes with the changed nature of banking practices. Derivatives of this kind permit the socialization of the risks associated with the liberalization-induced transformation of banking. These trends are in keeping with changes in the international banking industry as well. As *The Economist,* London, put it: 'The world's leading banks decided some years ago that lending is a mugs' game. They began to get rid of their loans, repackaging them and selling them off as securities, or getting others to re-insure their risk.'

"From the point of view of the banks this effort has been extremely fruitful. Thus, when there was a major melt down in corporate America, as a result of financial fraud and accounting malpractice, leading to the closure of giants like Enron and WorldCom, leading banks that had lent large sums to them appeared unaffected. According to one estimate, loans totalling $34 billion were wiped out through these bankruptcies. But far less amounts showed up as losses in the banks' amounts and, in the second quarter of 2003, Citigroup reported a 12 per cent increase in profits and J.P. Morgan Chase a 78 per cent increase.

"It should be clear that these losses have to show up somewhere in the accounts of the financial system, but as the Bank for International Settlements (BIS) argued, it's not easy to trace them. 'The markets lack transparency about the ultimate distribution of credit risks,' it declared. One reason is that the losses were being borne by insurance companies, which would be treating them like any other casualty loss so that they are not identifiable. The BIS sees this conundrum as being the result of substantial growth of the practice of credit-risk transfer – the shifting of risk from banks on to the buyers of securities and loans, and on to the sellers of credit insurance.

"In sum, the traditional image of the great banks with armoured vaults has little to do with the banks of today. The latter appear to make loans and then pass them on as quickly as possible, pocketing the margin. That allows them to take bigger risks in trading securities, derivatives, and foreign exchange. But these risks do not go away. By the end of 2002, though non-bank entities accounted for just 10 per cent of the syndicated loan market in the US, they held 22.6 per cent of the bad or doubtful loans. The same is now happening in India, increasing the fragility of a host of non-bank financial institutions, such as pension funds, mutual funds and life-insurance companies. Unfortunately, rather than recognise this danger, the Finance Ministry is keen on ensuring changes of the kind described above through a state-dictated process of financial engineering. The full implications of the resulting changes would be revealed only in the days to come. But the experience elsewhere provides cause for concerns."

This – in a brilliantly concise way – says precisely what COMER been saying for some time.❧

The Faith-Based Bubble of Bushonomics

It is no longer news that income distribution in the United States is more skewed in favor of the most wealthy families than it has been for more than a hundred years. On October 5, 2005, the *NYT*'s editorial board published a 13-page explanation under the heading "Tilting the Tax System in Favor of the Rich." It recounts the successes of the wealthy (including directors and managers of large corporations) at influencing legislators to "rewrite the tax code, shifting more of the burden onto others" by:

• Shrinking the *estate tax*, even to the point of hoping to repeal it in this session of Congress;

• Rolling back taxes paid by investors and corporations (especially on *capital gains*);

• Using *payroll taxes* (especially Social Security payments) to mask the costs of tax cuts for the rich.

The consequence is that not only do the poor and working middle classes pay a much higher rate of taxes on their incomes than do the wealthy, but also that total tax revenues are vastly insufficient, far into the future, to meet the usual government payment commitments for things like Medicaid and Social Security and to administer the public domain that has traditionally belonged to all citizens in common. It is consistent with the deliberate and overt objective of right wing strategists to shrink government "down to a size where we can drown it in a bathtub."

Although this campaign of the right is a perpetual one, it really began to bite with the "Reagan Revolution" and became a steamroller under Bush II. The tired rationale of "supply-side" economics is that taking away taxes on capital gains would increase investment in productivity-enhancing capital, thereby generating increased growth for more jobs income and replacement government revenue. But as the editorial says, the tax cuts have never been proved to even pay for themselves.

A recent book comments that never before has a wealthy nation "attempted to lower its taxes on saving so dramatically and so quickly." In a disquieting footnote, the author adds that "the country coming closest is probably Canada. It is in the midst of a five-year tax-cutting plan, which, among other things, lowers the tax rate on corporate profits by a quarter and exempts a substantial share of capital gains from tax." The book, *Neoconomy: George Bush's Revolutionary Gamble with America's Future* (New York: Public Affairs division of Perseus Books Group, 2004), is an important reinforcement to the *Times*' editorial review because of the identity of the author and his links to the doctrinal foundations of the taxation revolution:

Daniel Altman is a young journalist (*The Economist*, later *The New York Times*) who took a Ph.D. in economics from Harvard University. He assures us that the economic policy pursued so relentlessly by the Bush Administration is no half-baked whim of a business elite who simply promise trickle-down as a sop while they grab more goodies for themselves. It is rather the carefully considered strategy of an elite group of academic economists who set their sights on the one blunt instrument of tax cuts, and have pursued it relentlessly, with the obvious cooperation of the President and an obliging Congress.

Altman's focus is the influence of Martin Feldstein on economic policies since the days of the Reagan revolution. Much of his influence has been exerted directly on the G.W. Bush administration by way of his best students, several of whom have held prominent positions (e.g., R. Glenn Hubbard as Chairman of the Council of Economic Advisors). Two of them, in addition to Feldstein himself, were known to be among the potential appointees to succeed Alan Greenspan. Feldstein is further described by Altman as his much esteemed "long time adviser" while a graduate student at Harvard – but with whom he has taken pointed issue on the nature and probable impacts of the *neoconomy*. Feldstein was frustrated in efforts to implement his ideas fully under the Reagan and Bush I regimes. Altman tells us that when G.W. Bush announced his intention to seek the Republican nomination for President in 2000, Feldstein took the step of travelling to Texas to propose the doctrine to him as a campaign theme and serious legislative agenda.

The enthusiasm of Republican Party stalwarts and insiders (Bush appointees) for Feldstein's approach is ascribed by Altman to the psychology of rich CEOs who are typically optimistic risk-takers whose plans almost never come in on budget or on time. They are bold over-reachers who are prepared to take a big risk in the hope of making a lasting legacy. Altman is skeptical of the risk they are taking, and he knows that the Feldsteinian economists are aware of it too, but that they are sufficiently secure in their doctrine that they are willing to follow through relentlessly. (One factor in their confidence may be that the main *neoconomists* are themselves millionaires. Social Security privatization would mean no personal qualms, and it is a key element of their agenda long championed by Feldstein.)

The doctrine, however, is based in untested, non-testable economic theory. If the *neoconomist* professors are right, Altman acknowledges that their path could indeed lead to a period of untold prosperity. But, "it could also lead to nothing less than the collapse of the capitalist system – a real revolution in which the nation's tax-paying laborers rise up against a class of wealthy free-riders."

The core of the *neoconomists*' idea is that aggregate savings are typically insufficient to fund a major increase in technologically advanced capital and the trained labor to use it productively. The key to a quantum leap in such investment is to encourage it from the people who are best able to do it – the already rich. The working classes tend to not save much out of their incomes, and are unlikely able or interested in making direct investments. Ergo, massive reform of tax regulations to favor those with the highest incomes, and especially incomes based on revenues from property and other wealth. Other of their simplifying tax reforms would reduce distortions in employer-employee structure and permit "consumer sovereignty" to manifest more clearly. The whole is premised on belief in the neo-classical economic fixation that the economy is a natural system tending toward a general equilibrium.

Untested, Untestable Theory

The doctrine that Altman describes as untested, non-testable theory is premised in assumptions rather than empiricism. Faith in general equilibrium developed out of the marginalist revolution of economics as "neoclassical economics," partly as a reaction against the short-term counter-cyclical emphasis of Keynesian analysis. Keynes analyzed an imperfect world; the neoclassicals prefer one that is logically perfect. Their reaction began in the late fifties and early sixties with the mathematization of

their theory. The new models were "sets of equations that purported to describe how the economy behaved over time…. [T]hey linked together stocks and flows of labor and capital with functions [borrowed from physics and engineering.] Given a starting point, the models could predict how living standards would change as the economy moved, inexorably, to a stable equilibrium. When the economy reached that equilibrium, [despite some remaining short-term fluctuations]…the average rate at which the economy grew, over long periods of time, would stay the same. The models showed how taxes, saving, depreciation and population growth could determine that rate by changing the economy's supplies of labor, capital and technology. In academia, the focus shifted to the long run…. This philosophy became the basis of true supply-side economics" (pp. 23-4).

Altman emphasizes that the *neoconomists* have consciously avoided important and time-tested ways of complementing their objective of growth in total output and consumption with counter-cyclical fiscal and tax policies. Such programs in the past included short-term expansion in government spending on physical capital or targeted reduction in taxes to stimulate particular sectors such as research, education and training. These encourage innovation in capital deepening and the training/education programs required to bring the labor force up to the level where it can make most productive use of the improved capital. The *neoconomist* program is based in faith that the rich would ultimately choose to invest where it would do the most good to grow the economy and make everyone well off (via abundant jobs and high wages for the working classes). It is most alarming, therefore, to read this book in the context of mounting evidence that the wealthy *do not* invest in growing the real economy – a subject which Altman does not even touch.

Altman recounts the relentless and successful campaign, under Bush II, to change tax rules, all in same direction, for same purpose. The immediate consequences were not encouraging, as economic problems grew worse from 2000 to 2004, by the conventional indicators. The effects of spending cuts to unemployment insurance, medical care and other direct benefits to poor people were masked by *greatly increased expenditures for warfare*. Other high-profile economists called the *neoconomist* scenario wishful thinking on an unprecedented scale. To counter the implied threat to their agenda, the *neoconomists* and legislative allies push for very long-term changes to tax rules, to assure that they have time to work. (The *Times* editorial tells us that "Congress came back from its summer recess this year planning...permanent repeal of the estate tax.")

Might a Popular Revolt Blow Away Bush's Neoliberal Paradise?

Although the neocons may think their reforms are secure, Altman suggests that the potentially explosive circumstances they have created may blow away the familiar US political processes in a populist revolt. This prospect is magnified many-fold when one turns from the faith-based model of the *neoconomists* to the empiricism of a specialist in financial history.

Michael Hudson[1] has shown that most of the savings are feeding a financial bubble rather than being invested in actual physically productive capital and the means to use it more effectively. Instead of investing in real output, the savings of the wealthy go into boosting the prices of financial assets and the owners take their benefits in the form of non-taxed capital gains rather than on earnings from profitable industry. In the absence of real returns, the cost of servicing the new loans that are made out of the savings of the rich, to purchase new financial assets, must be paid out of real incomes that may in fact be declining. As house prices inflate, for example, the burden of mortgage interest cuts into household income, making it impossible for consumers to maintain customary levels of spending. Consumer spending is universally acknowledged to be the primary driver (two-thirds) of economic activity. The net impact of this growing debt service is therefore deflationary. A succinct and systematic presentation[2] of Hudson's argument describes the FIRE sector (Finance, Insurance and Real Estate) as separate from, and a parasite on, the real economy. As a specialist in international financial relations and the history of financial institutions, Hudson's research includes pre-history in collaboration with archaeologists of the ancient near-east. Their work shows the origins of money and finance in credit-based relations between oriental monarchs and farmers in the emergence of the agricultural revolution. Among their principal findings is that when debt-service becomes too big a burden to be born, the debts collapse and a new start is made. Meltdown. This pattern has been repeated throughout history.

The *financialization* threat to the *neoconomist* agenda (cf. August *ER* review of *Democratic Capitalism* and "The Good Capitalism and the Bad" September *ER*) is further reinforced in *Unseen Power: How Mutual Funds Threaten the Political and Economic Wealth of Nations* (Toronto: Stoddart Publishing Co., 2001). This book, the fruit of PhD research by Adam Harmes (York U.) "shows how the explosion in mass investment through mutual funds and pension funds represents... a sea change in the power of the financial markets...explaining how fund managers and not CEOs have come to wield the greatest clout in the global economy. It has led to a massive shift in the balance of power between Wall Street and Main Street – in favor of the former. (The phenomenon is not new; it was one of the main themes developed by Thorstein Veblen.)

The threat of debt deflation has very recently become topical in connection with the bubble in house prices, consumer debt and the sudden upsurge in petroleum-based fuel prices. Articles in newspapers on both sides of the border have detailed the reductions in consumer spending that households are imposing on themselves in order to maintain mortgage payments and buy gasoline. Many people took out larger mortgages in order to pay off credit card debt under the influence of low mortgage rates and inflating house prices. Some now spend 50 to 75 percent of their monthly salaries on home payments. "Americans have put themselves in a precarious spot. They have overspent and taken out adjustable-rate and interest-only mortgages, gambling that housing values will rise while interest rates and the job market hold steady. Homeownership is sinking the family." The imminent repeal of bankruptcy laws in the US promises even more deflationary pressure. And the latest news about government response to Hurricane Katrina is that it is being used to extend the *neoconomist* agenda as described by Altman. That is, to shrink government assistance, repeal minimum wage rules, make the poor responsible for their misery and transfer capital rebuilding contracts to friends of the Administration in Washington (*NYT*, October 11, 2005).

Economists who have worried that high energy bills alone might cause a crisis of "consumer confidence" that could push the economy into a full-blown recession haven't been seeing the half of it, therefore.

Keith Wilde

1. Distinguished Research Professor of Economics, University of Missouri at Kansas City.
2. "Saving, Asset-Price Inflation, and Debt-Induced Deflation" to be published in early 2006 in a volume edited by Prof. L. Randall Wray of UMKC, Edward Elgar publishers.

Whitehouse's Sitting Ducks

Simon Whitehouse is to be congratulated on the sitting academic ducks he has assembled in getting responses to the economic program of the Canadian Action Party. It is on rare occasions that academics, keenly aware of what has become necessary to earn and maintain tenure in the economics departments of our universities, will put their wisdom on the line.

"Stanley Winer – Canada Research Professor in Public Policy, School of Public Policy and Administration, and Department of Economics. If you tell the chartered banks to hand over a portion of their deposits and pay no interest on them, this is potentially a source of funds for the government. However, I doubt if this is a good idea. The banks already pay income tax. Why single out the wealth of their shareholders in this way? There are better ways to change tax structure."

What Professor Winer is saying, though he may not be aware of it, is that history itself is a bad idea. Undoubtedly that is why so little economic history – even that as recent as the 1970s, not to say of the Great Depression – is taught in our universities. Yet the importance of our central bank having interest-free redeposits of a modest portion of the deposits taken in by the banks from the public exceeds by far its "taxing" functions. (It used to be 8 to 12% for chequing accounts and much less for accounts requiring notice before deposits being withdrawn.) Quite apart from its purpose in assuring that the banks can meet the claims of their depositors (backed, be it never forgotten, by the role of the government via its central bank as "lender of the last resort") it has yet other functions that hark back to the Middle Ages. Then the monarch's power depended on his having a monopoly in the coining of precious metals. Where that monopoly was absent or weak with local feudal lords sharing that coining power with the monarch, central power was feeble as in France and Germany. Where it was clearly established, the central power thrived as in England under the Anglo-Saxons. There it was even taken over intact by the Norman conquerors. That is why that power today – where it still exists – is known as s*eigniorage*. He who possessed that monopoly power was indeed a monarch. Where he shared it with petty lords throughout the land, he was at best a sad pretence of one.

Far more than a "tax," it places in the hands of the government the economic power to enforce whatever distribution of power Parliament may decide. During the depth of the Depression of the 1930s, which was brought on by the speculative excesses of the banks, thousands of American banks closed their doors. Under Roosevelt in 1935, the *Bank Act* was passed and became the model throughout the non-Communist world. It was based on a few simple principles.

Is History not a Good Idea?

You will find what Professor Winer considers "not a good idea" explained in any university text book on economics used in Canadian universities prior to 1991, and in none published since then. 1991 was the fateful year when our banks, having lost – as a group – nearly or more than all their capital – were bailed out by the government doing away with the statutory reserves. The most commercially successful of all best-sellers among economic texts – *Economics* by Paul A. Samuelson (Canadian edition prepared by Anthony Scott, McGraw-Hill, 1967) explains some of the purposes of the statutory reserves that banks had to put up with the central bank on an interest-free basis in Chapter 16, beginning on page 319. Nobody in 1967 would pass an economics test who argued that the statutory reserves was just a form of "taxation." Anybody who didn't adopt that dogma today would find it hard getting a PhD at most universities.

The two main policy tools for directing the economy through the money supply were: (1) the central bank set the benchmark interest rate known as the "bank rate" in Canada and the "fund rate" in the US. This is the rate that one commercial bank charges another for a strictly overnight loan to meet its obligations vis-a-vis the central bank. This influences the whole gamut of interest rates right through mortgages, credit cards or whatever. (2) The statutory reserves. When the economy was overheated with too much demand and not enough supply, the statutory demands would be raised, say from their average of across the board of five percent to six. If the economy were depressed, the reserves would be lowered. That left the commercial banks more leverage in applying the "banking multiplier," lending out – as a system – many times the cash in their vaults or on deposit with the Bank of Canada.

However, when interest rates were raised it hit everything that moved or stood still in the economy. The use of the statutory reserves, on the other hand, could be better targeted at those contributing to an overheated or recessed economy.

When our banks had lost much or all of their capital in the 1980s in speculative plays, the loss was made good in two principal ways. In 1988, the Bank for International Settlements (BIS), a purely technical bunker of central bankers, declared the debt of developed countries risk-free and thus requiring no down payment for banks to acquire. All they had to do was clip coupons and they were in funds again. If we adopted Prof. Winer's terminology about the interest-free reserves that banks used to put up with the central bank, we would have to term it a "tax on the government" levied on behalf of the banks. That enabled Canada's banks to quadruple their holdings of Canadian government bonds from 20 billion dollars to eighty billion without putting up a dime.

That also left higher interest rates the only means of combatting higher price indexes, which were taken to be synonymous with "inflation." Inflation, properly understood, refers to higher prices resulting from too much demand and not enough supply to meet it. But prices can go up for very different reasons – "structural" ones. During the first three decades of the postwar, Canada was transformed from the semi-rural country that it was before World War II to a highly industrialized one. New technologies that required much higher standards of education, rapid urbanization that called for all sorts of costly infrastructure like subways, far more public investment was needed. Not even an economist moving from a small town to New York City expects his living costs to stay the same. How then could it possibly do so when society itself makes such a transition? For to provide these public services, requires a higher layer of taxation in the price level. Try suppressing that to make the price index flat, and you merely add to that layer of taxation in price, by depressing the private sector. Use higher interest rates as the one means as "the one blunt tool" for achieving this, and you surrender power to the bankers, for interest is their basic revenue, and mobile interest rates their gaming dice. For the banks' were not only bailed out of their gaming losses in the 1980s, but deregulated further to be able

to gamble better on a bigger and more embracing scale. And what paid for the banks' losses in this expanding casino became was the welfare of every family in the land. That is precisely what happened in 1991 when the alternative to raising the benchmark interest rate – raising the statutory reserves – was abolished.

In addition to ignoring history, the official economists impede the task of future historians by suppressing the records of their own disasters. For example in their surrender of our economy to speculative finance they committed booboos of incredible incompetence, but covered them up so completely that society seems condemned to repeat them again and again. Over the past forty years, the Bank for International Settlements served as a sort of war room for the campaign to bring back the banks to the command of the economy, a state of affairs that produced the 1929 crash and the subsequent decade of depression that led to the Second World War. Thus at the same time as under the aegis of the BIS, the debt of central governments of the developed nations was declared risk-free requiring no additional capital to acquire, the BIS directed a world campaign for the central banks to achieve a flat price level ("zero inflation") with the one remaining "blunt tool," thus pushing up interest rates to accomplish that goal. What they overlooked was these two goals were incompatible. For when interest rates go higher to wipe out every vestige of "inflation," the market value of the banks' preexistent bond-hoards must take a dive as new bond issues with higher coupons are issued at par. The crash first occurred in Mexico in December 1994. where American advisers had imposed the North American Free Trade Treaty that ruled out any hindrance to the free movement of currencies across frontiers, and brought in government bonds convertible into US currency ("tesobonos"). The result brought down the Mexican banking system, and only the largest standby fund hastily organized on US initiative with the participation of the International Monetary Fund and Canada prevented if from bringing on the crash of the world financial system.

The consequences of the banking lobby taking over economic policy were far-reaching though apparently beyond the ken of Professor Winer. President Clinton's Secretary of the Treasury, Robert Rubin, an astute alumnus of Wall St., concluded that the days of sky-high interest rates were over. Instead Secretary Rubin introduced by stealth capital budgeting (also known as "accrual accountancy") that had existed from time immemorial in the private sector. Though much had been made of the "deficit," it was in fact largely the result of execrable bookkeeping.

Government Accountancy would have Put a Private CEO in Jail

That in the private sector would put both the corporations executives and their accountants in jail. Up to then when governments in Canada, the US, the UK and most parts of the world made a capital investment that would last for many years – a building, a bridge, a highway, it would be treated as a current expenditure and written off as though it were completely used up in the year of its completion.

This non-accountancy showed a vast deficit that was not necessarily there. Even the attempt to balance such a budget led to more taxation than was strictly necessary – like paying off the mortgage on your

Questions to the Electoral Candidates

Promises, promises, but where will the money come from?

A cynical person might suspect that the billions of dollars for services and tax cuts promised by our politicians during this election campaign will not be forthcoming. After the election the party in power might simply ignore their promises or suddenly "discover" some unforeseen event which "prevents" them from keeping their promise – not their fault, of course.

The main reason given for not keeping a promise is that there is not enough money, but if not, where did it go? During the great depression we had the same problem; money was very scarce. To overcome this problem, Prime Minister Mackenzie King knew that it would be necessary for the government to take control over the issue of currency and credit. This was accomplished in 1938 when King nationalized the Bank of Canada, and control of the issue of currency and credit was assumed by the Government of Canada. The government borrowed from the Bank for WW II and the post war development, thereby helping "to avert the depression that had been widely expected" after the war. Instead of a depression, the Bank's monetary policy "ushered in the most vibrant period in Canadian economic history" lasting until the early 1970s. Great social programs like Medicare and pensions were started, and money was available for housing, education and infrastructure.

However, step by step, banking regulations were removed after 1950 (not just in Canada, but throughout the western world) and the government once again parted "with control of its currency and credit."

From 1975 on, the government's long-term debt was borrowed almost entirely from the private sector. When interest rates went sky high in 1981, so did Canada's debt. From confederation to 1974, our federal net debt amounted to $18 billion, and that included the debt of two world wars. By 1997 the federal net debt had climbed to a peak of $588 billion, an increase of over 3000% in 23 years. Net debt for the provinces and municipalities amounted to more than $400 billion, for a total public net debt of over $900 billion. Interest at one point amounted to $77 billion a year. It is now down to about $65 billion a year (which is 650 times bigger than the $100 million sponsorship scandal that everyone is bothered about, and it goes on year after year after year). Ninety-three per cent of the debt came from compounding interest – not from government program spending.

Resources for programs and transfer payments to provinces have been diverted to the debt and to the interest on the debt. There is not enough money for health, education, municipal infrastructure, the environment or anything else. To get out of the financial hole we are in and have the resources for the things we need, we must once again take back control of our currency and credit. To do this, the government needs to return to using the Bank of Canada for its long-term debt. Some say this would cause inflation, but this did not happen during the 30 years (1940 to 1970) when the government used the Bank of Canada in this way.

Question for the candidates:

Will you support using the Bank of Canada to carry some of the government's long-term debt and will you lobby your own caucus to do the same?

Richard Priestman

home in a single year.

Then since the capital asset appeared on the government books thereafter at a token dollar, it could be privatized at a small fraction of its real value, *and still show a sturdy profit to the government*. This could be applied to "reduce the debt." That allowed the government to take a deep bow for its "fiscal prudence." The privatized asset, moreover, would be organized as a public company promoted with a good profit to the promoters as the taxpayers who had already paid for it once in taxes now had to pay for it in users' fees a second time.

In the Roosevelt *Bank Act* of 1935 firewalls had been established between the banks and the other financial pillars – insurance, real estate mortgages and stock markets. There was a reason for that. Each of these other pillars maintains a pool of liquid capital for the needs of its own business. Allow the banks to lay hands on these cash pools and banks will apply to them in sequence the "banking multiplier." What results is a skyscraper of speculation with the total bank cash serving in turn as the denominator of its credit or "near-money" production. Economists call interest-bearing debt "near money" because every time the benchmark central bank rate goes up the market value of the pre-existing debt drops, since the interest it pays is less than that of new debt. It thus lacks one of the attributes of true money – a relative independence vis-a-vis movements of interest rates.

Let us move on to the contribution of Dane Rowlands, associate professor and associate Director of the Norman Paterson School of International Affairs. Professor Rowlands had this to say of Mr. Whitehouse's effort: "What the person is suggesting is the creation of new money to fund government programs. In general all economists (with a few fringe exceptions) view this sort of suggestion as simplistic at best and disastrous at worst." Really reducing the issues to the counting of academic noses is hardly in place when so many heads have rolled throughout academe, and celebrities of yesteryears are not even mentioned in economic courses today.

"The idea that money is wealth harkens back to the old Social Credit Party and is generally regarded as symptomatic of wishful, but weak thinking." That is exactly the opposite of what John Maynard Keynes acknowledged learning from the writings of the founder of Social Credit, Major Douglas. But the advantage of wiping out history is that you can reconstruct it to your fancy. Professor Rowlands goes on to say: "It is true that such a policy could have some beneficial effects if the economy were operating in a depression or with significant under-utilized resources, as it was in the 1930s, That is not the case now, and the idea of expanding the money supply, which is what this person is suggesting, would do very little except create inflation." But the 6.1% unemployment of which the US is so proud does not include the ever growing population in its penitentiaries, its armies in Iraq, its war industries, the homeless, the millions engaged in marginal employments such as annoying their fellow citizens during dinner hour with telemarketing, or the imminent bankruptcy of its three Big Three auto firms, with the mass disappearance of pensions that had served rather than higher wages to pay labour in many key industries. Nor the detail that the gap between the wealthy financial touts who deal not even in stocks and bonds, but in the abstract concept of "risk." with their winnings, however, going to swell the proud GDP, as have the disasters of neglect such as New Orleans. As for the "beneficial effects of Social Credit if the economy were operating...with significant under-utilized resources," as it was in the 1930s." It is amazing that the professor has failed to notice that even the hurricane of New Orleans has had some "Keynesian effect" in reviving our sagging overblown stock markets. And if levees needed to protect undersea sections of major cities are not provided that should be noted as a capital deficit rather than as prudent fiscal policy before the disaster. The professor himself comes to serve as a prime exhibit of the guarantee of disaster that economic theory as taught in our universities has become.

Helping Our Government Catch Up with Double-entry Bookkeeping

"Such a policy that this person is suggestion would do very little except create inflation." The very word "inflation" which for decades – despite the preamble of the charter of the Bank of Canada – has become the sole concern of our central bank is misleading, since it assumes the possibility let alone the need for a flat price index in a society undergoing population, technological revolutions, urbanization, increased life spans on most continents. Moreover the absence of accrual accountancy in all government investments until 2000 in Canada, and still in human investments, leaves us flying blind on what the real state of the government budget might be. "The mechanics the per-

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son suggests are also not really correct. The budget would not be balanced, as the fiscal balance is tax revenue less government expenditures." This is not so, there is another important factor – double entry bookkeeping that the Crusaders brought back from the Arab lands in the 13th century or so. Today that requires accrual accountancy that COMER had been advocating for decades. As did two Royal Commissions and a long list of Auditors-General. However, until the 1960s, human investment had not been included in the capital concept. For introducing the view that human capital is the most productive investment a nation can make, Theodore Schultz was awarded the Nobel Prize for Economics in the 1960s, but who but CAP-COMER mentions this today? And even on the Accrual accounting of physical investments of government which the government finally adopted in 1999, when the then Auditor-General, Denis Desautels refused unconditional approval of two successive balance sheets of the government until it were done. Such has been the dumbing-down of Parliament, economists, and the electorate in the interests of our ever more freely gambling banks. Without the freedom of information, democracy is a sham.

"If individuals lend the government money by, say buying Canada Savings Bonds, they have less money to spend themselves and the stimulative effect would disappear unless they themselves borrowed. If they did it would lead to an increase in aggregate demand, but it is not clear that the demand would be translated into significantly higher output. There is a higher probability that it would lead to price increases, since it is not clear how much more output can be squeezed out of the Canadian economy at the moment."

Our history – of a period when the banks were kept strictly to banking – of the postwar 25 years should be the primer for evaluating such uncertainties. At the end of the war, the national debt amounted to some 150% of the Gross National Product. Over the next three decades, Canada caught up with the neglect of its infrastructures during 10 years of Depression and six of war, introduced new technologies, assimilated a vast and most penniless immigration, transformed itself from a semi-rural to highly industrialized nation, and yet the ratio of its national debt to GNP was reduced from 150% of the GNP to under 72% (of the GDP). And at that the physical and human investment of government was wholly ignored on the federal level, and also in the case of most of the provinces. Obviously the professor would have been better advised to concentrate on the "cooking of the government books" of which Auditor-General Desautels accused Prime Minister Martin in 1999, rather than to advance the highly nonsensical theory that the government cannot use its own bank to do at least its financing of essential capital projects. Instead they hold that Ottawa can only borrow from the chartered banks that it so recently bailed out from their speculative splurges. And to top it all the deep deficit left by the end of reserves and the declaration of the debt of risk of the central governments of developed countries as "risk free" That permitted our banks to stock up with federal debt without putting up a dollar of their own. Naturally that left a deep hole in the federal budget since their borrowing – up to 22% of their budget by the mid-1970s. What had cost them practically nothing when done through their own bank, the Bank of Canada, now cost them an immense amount of money, especially since the same Bank for International Settlements had pushed interest rates into the skies to "lick inflation." And that is why in the same year that the reserves began to be phased out, 1991, the GST tax was introduced.

It is amusing to read the professor's statement: "If the government borrows from the Bank of Canada it essentially amounts to printing money, creating inflation and taxing 'money balances' of assets with a nominal valuation. The only scenario by which such a policy would have real beneficial effects would be if it stimulated the economy to produce more. Under current capacity constraints and according to all the evidence I have seen, this is highly unlikely to occur to any measurable degree under current circumstances. Canada has its lowest unemployment rate in 30 years, and the gap between that level and full employment is almost entirely due to regional and structural rigidities that are slowing down the transfer of labour and other resources from lagging regions and sectors to growing ones." The trouble is that with the first call on the nation's resources reserved for the deregulated financial sector, essential sectors such as education, health, environmental conservation are deprived of resources which are lavished on the banks.

Randall Germain – Associate Professor of Political Science, Carleton University, had this to say: "For my part, I rather doubt the numbers involved here, and not just because would involve rewriting the *Bank Act* and reducing the technical independence of the Bank. There is a debate about whether such independence is good or bad, but the bottom line is that it requires legislative change to implement." Is this to mean that the legislature that we will be electing has not the power to undo what was never debated in Parliament, but slipped through as though by thieves in the night? At the moment the *Bank of Canada Act* asserts loud and unequivocally that the Bank of Canada is not "independent" of the Government. The 12,000 shareholders were bought out by the federal government at a good profit (rare phenomenon during the 1930s). The position of the federal government as sole shareholder is set forth in Subsection 17(2) of the Act.

In Subsection 14(2) it is established that if "there should emerge a difference of opinion between the Minister [of Finance] and the Bank concerning the monetary policy to be followed, the Minister May, after consultation with the Governor and with the Governor Council, give to the Governor a written directive concerning monetary policy, in specific terms and applicable for a specified period, and the Bank shall comply with that directive."

18(c) establishes that the Bank may buy and sell securities issued or guaranteed by Canada or any province. That would cover the provinces, but the interest on such securities would not revert to the provinces as dividends since they are not shareholders, but to the federal government. Since the cost of the bank bailout involving a massive shift of debt from the central bank to the chartered banks, the federal government made good the hole in their finances, but downloading programs with adequate funds to pay for them onto the provinces, that passed on the compliment to the municipalities. There is thus a moral obligation of Ottawa to pass on all or part of the interest reaching it as dividends from provincial borrowing from the Bank of Canada or from municipal bonds accepted as security for loans by the Bank of Canada with the guarantee of the federal or provincial governments. Utilizing the provisions in the Act would thus open new dimensions of understanding amongst the three levels of government.

And why would the three professors not devote a word to the use our banks have made of the capital that they were re-endowed with at the expense of the taxpayer since that great act of charity to our banks carried out between 1988 and 1993? They would find the answer on the front page of

the Report on Business of *The Globe and Mail* of 17/08, which reported the settlement by three of our five really large banks out of court of a suit by Enron, possibly the greatest financial scandal of the age. It is worth noting the $274 million settlement by the CIBC *before the case came to court* for devising the complex derivative plays that kept liabilities off Enron's books, and sent a top executive of Enron and his wife to prison for ten years.

It is intriguing to note that the Canadian taxpayers are in for another costly bit of charity to CIBC, since approximately $100 million of the settlement will be chargeable against its earnings in Canada. RBC has made a smaller settlement out of court with Enron as plaintiff, while TD still is facing a court case with Enron. On top of that is the moral black eye that Canada has received by financing the banks and making it possible for them to advise a miscreant US corporation on better ways of abusing the public.

Obviously the whole mess of the takeover of our economy by our deregulated banks calls for a Royal Commission that will guarantee that all suppressed vital angles will be heard. This should be a key if not *the* key issue of the present election campaign.

William Krehm

The Fallacy of Paretian Welfare Economics

The Positivist Claim of Market Populism

Modern market oriented economics has evolved from the neoclassical marginal revolution of the late 19th century. It advocates a laissez-faire attitude to social and economic phenomena and has become a central pillar of the current market populist political economy, which on political side is dominated by the neoconservative trend currently in vogue. The central tenet is that all socio-economic activity can be interpreted within a reference system of market values.

The system's market values are based on the assumption that a set of ideal conditions exists, or at least that the economic environment constantly converge towards these ideal conditions. The set includes the well-known assumptions of open markets, rational agents, information equally accessible to all, self-correcting erosion of monopolistic tendencies, et cetera. Based on the marginal relations arising under these ideal conditions a crowning achievement of the neoclassical period was the Walrasian theorem of general equilibrium, emerging through the fog of human market activity by means of a price mechanism capable of clearing all markets.

This led to the claim by some of neoclassical economists that the science of economics finally had arrived at a rigid and well-founded structure, comparable to that of the exact sciences. On that basis, strong positivist statements about economic conditions and their future trends could be made. And, consequently, the only rational economic actors are those that limit their concerns to their own economic interests when they choose their preference at the margin in free markets. On the political side, this means that only a political system restricting itself to upholding the freedom of markets can unleash the full economic potential of society.

To the problem of how an economic system connects to goals of human welfare, the field of welfare economics branched off to tackle this question. It quickly became dominated by the principle of Pareto optimality, which was developed as an extension of the Walrasian general equilibrium. Its basic statement is that a Pareto optimum exists when no one can be made better off without making someone else worse off.

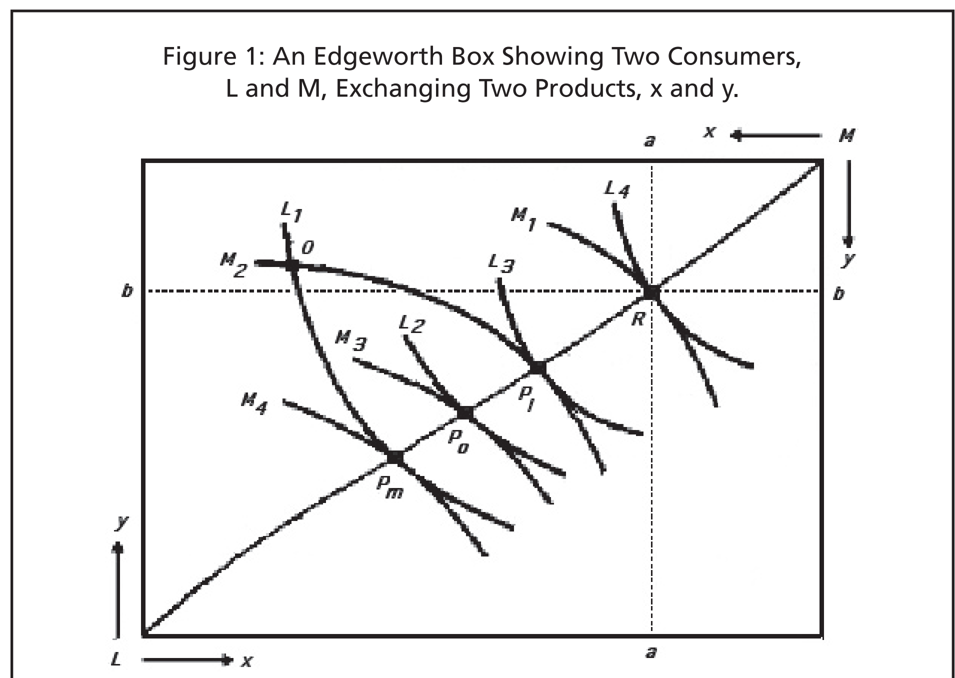
The Paretian principle starts with the assumption that all sets of economic alternatives – for example, for factor endowments, cost profiles, revenue generation, and consumer utility choices – will arrive at equalizing marginal ratios under perfect market conditions. The equalizing ratios are another aspect of the conditions that characterize a Walrasian general equilibrium, and therefore the two theories are closely connected.

For consumers, a key marginal ratio are found at the point where a line representing their budget constraints become tangent to the highest attainable curve showing indifference between competing consumption choices that they can reach. For firms, their primary optimal ratios are at points where lines representing their production possibility frontiers become tangent to curves representing the highest possible equi-revenue position of output choices.

After having determined the optimal marginal ratios for production and consumption, the Paretian argument moves on to show that these optimal ratios give rise to a unique distribution of the produced output when exchange between rational agents take place in perfect markets. Its graphical representation is the contact curve in an Edgeworth box, representing an exchange economy in which there only exist two consumers and two products. (See Figure 1.)

Indifference curves are convex to their origin, so consumer *M's* lowest level of consumption is along *M1* and his or her highest

Figure 1: An Edgeworth Box Showing Two Consumers, L and M, Exchanging Two Products, x and y.



is along *M4;* and vice versa for consumer *L*. Whenever two indifference curves meet along the contact curve, which runs from *L's* corner to *M's* corner, the same line will be tangent to both consumers indifference curves. This means that the ratios of substitution are identical for both consumers at these points, which thus represent Pareto optimal distributions.

There is in principle an infinite number of indifference curves running through the box, here are only shown four for each consumer. Let us assume that the two products, *x* and *y*, at first are distributed between *L* and *M* at point *O* where the indifference curves *L1* and *M2* intersect. This is a Pareto inferior point since the substitution ratios shown by the tangents are not an identical line. Because of that, the situation can be improved by further exchanges until it reaches a point on the contact curve between, and including, *Pm* and *Pl*. At the points, *Pm* and *Pl*, one consumer has been made better off without making the other worse off, while at all the points in between – here showing *Po* as an example – both consumers are better off.

This raises the question why a particular point along the contact curve is reached and not others, when consumers through exchange move to one of the curve's Pareto optimal points. The answer given by Paretian welfare economics is that this is determined by income distributions, which is taken to be given in each specific case.

At extreme points along the contact curve, the inequality of distributions grow, here shown by an example at *R* where L clearly is at a high level of consumption of both products (*L-a* and *L-b*) while *M* conversely are at a low level (*M-a* and *M-b*). This then, according to the Pareto theory, is simply caused by a difference in incomes between the two consumers. That though shouldn't be of any particular concern as long as the point found is on the contact curve, since it then must be the result of well functioning free and perfect markets.

Some of us might hold the normative view that distributions of the economic output represented by such points are unjust and ought to be changed. But the Paretian postulate is that all such notions are misguided since all that we can expect to achieve by any form of interference – for instance by electing governments that will follow policies of social activism – would be to move away form Pareto superior allocations with a resultant reduction of total welfare as a consequence.

Despite the apparently strong logic of the methodology of the Pareto theory and its modern pendant of laissez-faire economics, it is in fact fatally flawed in two major ways. First of all, the assumption of perfect states, needed to arrive at the identical ratios of the different marginal positions, would require that all economic activity take place under the improbable condition that the time-spatial continuum had collapsed.

Secondly, even if we, for the sake of argument, accepts that all socio-economic actions and reactions can occur as near-instantaneous transmissions so that the time-spatial continuum in no major way disrupt the operations of laissez-faire markets, there still remains the problem of how economic agents can establish a value-utility reference grid that guides their preferences to the mutually optimal choices.

The value content of economic phenomena is only detectable if it can be conveyed by concepts expressible as linguistic statements. While the utility of eating an apple picked up in the back garden can be experienced without being expressible, the transaction of buying apples in a market cannot take place unless a linguistic communication can be established.

This means that during all economic transactional activity, the socio-cultural reference frames upon which the language communication depends are an important element in shaping the events. Since not only differences in social and economic background, but also cultural habits and behavioral predilections of the individuals are an indelible part of the human experience, the reference frames employed during economic transactions will have various degrees of discordant elements that distorts the interpretation of the available information.

Two Kinds of Marginality

Marginal analysis is therefore not a reliable tool for evaluating competing economic goals or differences in interpretation of existing conditions. Leaving the general cultural and behavioral aspects aside, persons with very different levels and sources of incomes will view developments from different social perspectives, which in turn will give rise to substantial discordances between the value-utility reference frames they employ when deciding upon actionable economic choices.

The situation is quite different when marginal analysis is used by an operations-planner – for example a factory manager – who wants to know how he can maximize operational goals. In this case he has well defined goals that within the area of his operational control are not in a competing situation. Based on his experience about which of the variables that are important in relation to the selected goal, he can then employ marginal calculations to explore where the marginal ratios of the variables under consideration reach their optimum.

This leaves an unavoidable subjectivity in the analysis, but this not a weakness in this practical application of marginality. To the contrary, if the operation-planner is an experienced person with a good ability to judge which variable is important and which is not, the subjectivity of his judgment is a strength.

The marginality principle, no doubt, at first was developed as exactly such an analytical tool in the hands of operations-planners when the Second Industrial Revolution propelled large-scale industrial production to the forefront of the economic picture. In this new environment the idea of marginal analysis was a natural development. This explains why three economists in three different countries (Jevons, Menger and Walras) without knowledge about each other works within the spate of a few years came forward with new theories in which marginality played a central role.

However, using the marginal principle as the corner stone for a new general theory was taking the boat too far out. The main use of marginality is in closed situations where non-competing goals are well defined and variables relatively fixed. Conversely, in situations mainly driven by competing interests it is of limited use, one reason being that it is not possible to equalize ratios when reference frames for value and utility measurements are in discordance.

This punches a hole in the claim of modern market populism that there exist positivist theories with the ability to adjudicate the welfare content of competing choices. The reality is that an unemployed worker and an investor in financial markets will, based on their own interests, judge for instance expansive government policies very differently. The worker will hail the promise of new jobs; while the investor will be worried about their inflationary potential that can reduce the real value of his money holdings. While analysis based on economic theories alone can rule out extreme positions, it cannot adjudge competing prescriptions that are of an incremental nature. This will always involve politics and normative notions.

Dix Sandbeck

Extra! Extra! Aussies Sell the Yanks Some Stone-age Banking Software

It is some thirty-five years since I began to analyze the puzzle of so-called "inflation" that was identified with any rise of the price level. This was achieved by the false logic of turning around the very valid proposition that when there is too much demand and not enough supply on a reasonably free market, then prices will go up. However, no proposition necessarily remains true if you spin it around, transforming the previous effect to become the cause and vice versa. From the original proposition that an excess of demand over supply, other things being equal, will drive up prices, you cannot conclude that because prices have gone up, the fault lies with too much demand. Prices might go up for different reasons: for example, because society has developed from a semi-rural society into a highly urban one, requiring costly human and physical infrastructures such as more education, more social services, roads, bridges, police and subways. Directly or indirectly, these are paid for by taxation applied not by the market but by governments.

We have then need of a "mixed" price theory to fit our "mixed society." There will be an underlying price structure that will be market-determined, though the market in question will not necessarily be self-balancing, and on top of that there will be a layer of taxation set by legislatures rather than by the market. Of course the two factors do intermingle, with the taxation contributing to costs in the market-stratum. However, it would be an immense advance if economists opened their eyes to the fact that at least two elements exist in price determination – the structural one and the market one. With such recognition would come the realization that in an advanced industrial, urbanized society prices cannot remain flat, nor can one label any deviation from such impossible flatness as "inflation" to be suppressed with higher interest rates. The latter could only add to costs and scarcities, and in the long run push prices up still further.

But here another important factor enters the fray. Interest is the prime revenue of money-lenders. Obviously, it would be in their interest if prices did remain constant while the real value of their loans could only rise not fall, And if that bankrupted borrowers, because taxation and other costs did soar, that would make possible profitable foreclosures by lenders whose loans are in arrears.

We must then reach yet another conclusion – every rival price theory and indeed every economic model is likely to favour a particular social group. The *Bank Act* brought in under Roosevelt in the US in 1935 confined bankers strictly to banking, and provided two main policy tools for influencing the economy, One was the benchmark overnight interest rate that influenced rates of the entire financial market; the other were the statutory reserves – a percentage of the deposits that banks took in from the public that they had to redeposit with the central bank and that earned the banks no interest. The latter made it possible to stimulate or cool an economy by lowering or raising them.

However, raising interest rates hits everybody in the economy except the lenders whom it favours. It particularly punishes the unemployed who could hardly be contributing to "inflation." Adjusting the portion of the deposits that banks had to redeposit with the central bank, merely reduced the amount of lending and financing that could be done to rein in real inflation, without unleashing the deadly tool of higher interest rates to attain an impossible goal – a flat price structure in a constantly evolving economy.

How Banks' Bailout Followed by Deregulation Transferred Power to Them

The fact that the statutory reserves were done away with entirely in Canada in 1991, and reduced to insignificance in the US, was motivated by the need to bail the banks out from their massive speculative losses in the 1980s. Three years earlier the Bank for International Settlements – a purely technical central bankers' organization had declared the debt of the central governments of developed countries "risk-free." As a result of it, banks could acquire as much of such debt as they cared to without putting up money of their own. That policy indicated that those who promoted it were indecently close to the speculating bankers. Such suspicions were confirmed when the banks shortly after being bailed out were allowed the gamble bigger and better, acquiring interests in the other financial pillars – stock markets, insurance and mortgages – and used their pools of liquid capital that they maintained for their own businesses to gamble bigger if not better.

But BIS and the central banks of the world in their rush to rescue the foundering banks overlooked a crucial detail. At the same time as it declared the debt of governments "risk-free" the BIS escalated its campaign to achieve "zero inflation" by raising interest rates higher than ever. But when interest rates go up the value of pre-existing bonds with lower coupons plummets. That threatened the solvency of the banks that had just been bailed out and led to the collapse of the Mexican banking system at the close of 1994 two or three years brought on major financial woes in East Asia and Russia.

It became clear that to continue the banks' free-loading with government bonds, the age of punishingly high interest rates had to be closed. To achieve that, Clinton's Secretary of the Treasury, Robert Rubin chose a cunning course. The huge government deficit had in large part simply reflected the wretched standard of government accountancy. They treated a building that they acquired, a bridge or a highway that might last a half century as a current expense and then carried their remaining value at a token dollar. Yet on the other side of their ledgers they carefully noted the outstanding debt that they had incurred to acquire such capital assets. A budget of that sort could never be balanced and the attempt to do so should never have been made. For such a n attempt loads the price level with undue taxation that drives prices and leads to perceived inflation. However, it was an article of faith of President Clinton that the political center must always be held, and for that he could not even admit that governments could make investments. Hence the additional $1.3 trillion of assets retrieved from the void by proper depreciation was presented not as investment, but as "savings" which it was not in fact since it was not carried as cash. However, all that explained to the bond-rating agencies, with a wink and a chuckle, produced the improved balance sheet and the desired lower interest rates. To

keep the stock market boom going, it was judged necessary to privatize power-plants, highways, or other such capital items. Such privatizations burden the public with user fees for infrastructures that they have already paid for in taxes. That constitutes a serious transfer of wealth from one social group to another. When done in stealth, some harsh names can be applied to it.

All this provides some missing key background to an intriguing front-page story of *The Wall Street Journal* (6/12, "From Australia, Money Chases Roads, Airports Around the Globe" by Patrick Barta and Mary Kissel).

"Last year the City of Chicago was in a bind. It faced a $220 million budget deficit and its credit rating was under review for a possible downgrade. Voters feared a jump in property taxes.

"Then help came from a surprising place: Australia. Macquarie Bank, Australia's biggest homegrown investment bank, organized a deal to take over Chicago's historic Skyway toll road under a 99-year lease for $1.8 billion – hundreds of million dollars more than some Chicago officials thought it would fetch.

"Australia, once a marginal player beyond its own borders, is emerging as a major financial center. Australia can trace its new wealth to a 14-year economic boom underpinned by a 1992 law that required workers to set aside big chunks of their income for retirement. While Australian households, like those in the US, still spend more than they earn, the nation is amassing a huge investment war chest.

"The retirement pool, invested by private sector managers, tallies a staggering $550 billion, with $80 billion added each year. As a result, the assets under management in Australia is the fourth largest in the world – a particularly impressive feat considering that Australia's population of 20 million is only slightly larger than that of Sri Lanka.

"Because Australia's economy isn't big enough to absorb the cash, investors here are specializing in a niche often overlooked by other investors: big-ticket infrastructure projects like roads, tunnels and airports. Governments typically finance such projects either by digging into their coffers or selling debt, such as municipal bonds in the US. Banks often help organize the financing but usually exit after raising the money.

"The Macquarie model is different. The bank buys or leases the assets outright, then pools them into funds and sells stock in the funds. The strategy brings together the capital amassed by Australia's forced savings plan together with the infrastructure needs around the world. It enables governments to avoid borrowing to pay for their projects – an often unpalatable prospect. Macquarie manages the assets with the help of experts, collecting fees along the way."

RENEW TODAY!
(SEE PAGE 2)

Could Forced Pension Savings and the Central Bank be Used to Finance Infrastructure?

This rules out the use of central banks in the home country of the projects, which would save the citizens the interest costs – since borrowing by the government from their own central bank would involve the return of practically the whole interest paid on such bonds to the central government. In the case of provincial or municipal projects, the central bank – depending on the laws of the particular land would probably have to guarantee the loan if it were a municipal or provincial project. However, it would be in the national interest for the different levels of government to share the advantages of domestic near-interest-free financing rather than depending on a foreign bank in an arrangement based on future user fees.

"On a given day, Macquarie Bank has a dozen bankers roaming the US in search of deals. In San Diego, one of its funds is building a 12-mile-long toll road. Macquarie operates the tunnel that connects Detroit to Windsor, Ontario, and just bought, with other investors, Icon Parking Systems, one of the biggest parking-lot operators in New York City.

"Macquarie funds also hold stakes in the airports of Brussels, Copenhagen and Kilimanjaro, Tanzania. Macquarie funds own stakes in a major port in China, a Japanese turnpike and one of England's biggest toll roads.

"Those deals are kicking up new interest in infrastructure around the globe. The US alone needs $1.6 trillion in spending in the next five years to replace and expand its aging roads, rail lines and other infrastructure, according to the American Society of Engineers.

"Taxpayers are sometimes skeptical. Big companies don't always have a lot of experience managing infrastructure assets, and there is a risk they could fail to maintain them – or ensure safety – in the quest for profitability."

On the other hand if privatizing and profitable investment and capital gains are the dominant motive, putting distance and international legal barriers against revoking provisions that would threaten foreign investment may ensure additional security to the foreign investors rather than to the domestic users of the facility.

This is hinted at in the *WSJ* article: "Many economists endorse the trend, in part because they believe it will help speed up the development of infrastructure. There are also other some tactical advantages in having privatized infrastructures managed by foreign corporations that may be shielded against charges of inadequate maintenance and excessive toll increases by the irrevocability clauses in international treaties." Many also believe private sector owners will be less prone to keep tolls artificially low to placate voters – an outcome that would make infrastructure assets more responsive to market forces.

"The Macquarie model may expose investors to risks that aren't yet fully understood. If global interest rates keep rising, for instance, this could make other investments more attractive and hurt returns for holders of Macquarie funds. At least two of Macquarie's infrastructure buys have turned into busts, including an Australian power-generating facility that faced unexpected competition.

"For now, though, Macquarie is seeing strong growth. The investment bank reported earnings of $610 million in its fiscal year ended March 31 – a four-fold increase from five years ago.

"Until the early 1990s Australia didn't have an economy-wide retirement program, just government-paid pensions for poor families, some employer pensions and tax breaks for personal savings. In 1992, the government p required all Australian workers to divert 5% of their wages into individual private accounts invested by private managers. Time the percentage was increased to 9%."

What is sorely lacking is an objective study of the net effect to the public of such privatization schemes – especially if foreign interests protected by globalization treaties are involved as compared with public ownership using the central bank for financing infrastrucure.

William Krehm

Medical Services Inc. — Was It for This that Karl Marx Did All That Writing in Soho?

In *The Wall Street Journal* of 5/12 is an article by Andrew Browne out of Beijing: "Chinese Doctors Tell Patients Pay Upfront, or No Treatment":

"As soon as the money dries up, doctors warn, so will the drugs that could save the life of Cui Guangshun's 7-year-old son. Dejie, in the leukemia unit of Beijing's Children's Hospital. Such are the rules of China's pay-as-you-go health system: cash upfront, or no treatment."

Was for this that Karl Marx wrote and wrote in Soho, and Mao Dze Dung turned China upside down?

"Mr. Cui's wife, Yang Devin, traveled more than 300 miles by bus to Beijing from their small farm on the grasslands of Inner Mongolia to be near her only child. For weeks, she camped out on a blue plastic chair in one of the hospital waiting rooms to save money on lodging like dozens of other parents.

"Back home, her husband pleaded with relatives and village neighbors for more loans to keep the boy's care going. Most nights, the mother queued in a drab hospital lobby, littered with food wrappings and possessions, to use a touchscreen computer to see how much of the family's cash was left.

"In the past few weeks, Mr. Cui and Ms. Yang have been forced to accept a terrible reality: Even though their son's leukemia is considered highly treatable, they may never raise enough money to cure him. The hospital's estimated fees of $18,500 to complete an initial 6.5-month course of treatment are impossibly high set against the family's annual income of less than $350. Like two-thirds of China's population, they don't have health insurance.

"'There's nothing for it,' Mr. Cui sighed, slumped in the doorway of his red brick home on a recent afternoon. He said he had dug up his potato crop and sold it all. He had threshed his corn and sold most of that, too, leaving barely enough to make the steamed bread that keeps his family going through the winter. 'I'll just have to fetch Dejie home to die,' he said.

"Xie Jing, the chief doctor responsible for Dejie's ward, defends her hospital's insistence that patients pay for treatment ahead of time by putting money into a hospital-controlled account. "If the patients have no money to refill the hospital account, we have to stop giving them medical treatment,' she says. 'It is a national problem.'

"Health care is an issue vexing the world's most developed countries, including the US, where people can lose all their savings if they get sick. But in worst-case scenarios people who need urgent care generally receive it. A poor family like Mr. Cui's would be eligible for Medicaid. Japan and most European countries cover everyone through universal health insurance.

"That's not the case in China, where patients are routinely denied care if they can not come up with the money to pay for it in advance, even in emergencies."

Pay or Die

"The World Health Organization ranked China fourth from the bottom of 191 countries in terms of the fairness of its medical coverage in a survey issued in 2000. This March, a report from a Chinese cabinet think tank said that unless China overhauls its medical care, 'it will directly affect economic development, social stability and public support for reform.'

"The crisis in China's health care is already showing signs of holding the country back. Health costs are one of the main reasons Chinese save as much as 40% of their incomes. That is one of the main reasons they are not spending to consume more goods, as US official have been hoping amid concern about the big US trade deficit with China. Fewer than one-third of China's 1.3 billion people have health insurance.

"As recently as the 1970s, China's health-care network covered just about everybody. Collective farms offered basic treatment and immunization. In cities, health care was a perk of jobs in the government and state factories, which often ran their own clinics and hospitals. But as China embraced free markets, the 'People's Communes' were disbanded in the countryside, and thousands of state factories were shut down or privatized. Starting in the 1980s, hospitals were ordered to turn a profit.

"Today, China has plenty of large hospitals packed with state-of-the-art equipment to compete for paying patients. To maximize revenue, hospital doctors routinely over-prescribe drugs and diagnostic procedures, according to studies by the Chinese government and international bodies like the World Bank. Hospitals sell drugs directly to patient and add a profit margin.

"A World Bank study estimates that drugs account for more than 50% of all Chinese health spending. In the US prescription drugs account for less than 15% of total health spending, according to US government figures. The World Bank says 12% to 37% of Chinese national health expenditures are wasted because of unnecessary drug prescriptions.

"'Hospitals have become huge corporate profit centers,' says Chen Bowen, an official with the Society of Community Health Service, a non-profit organization based in Beijing that advises authorities on health reform. Mr. Chen's research shows that n rural areas, 30% of children who die end their lives at home because their families can't afford hospital care.

"Dejie first got sick with a cold in late September. For weeks before that, he had been complaining of fatigue and pain in his abdomen. The first doctor to examine him took blood tests but saw nothing suspicious, and prescribed stomach medicine and a cold remedy. By then Dejie had turned a shade of yellow and was too weak to walk to school. A second doctor ran new blood tests but offered no better explanation.

"Mr. Cui brought the boy to a larger hospital in the city of Chengde, five hours away by bus, where another doctor broke the news that he had leukemia. This doctor recommended that they seek treatment in China's leading children's hospital in Beijing.

"Mr. Cui recalls that when he heard Dejie had cancer, he stood in the road and sobbed. Dejie lifted his hand and dried his father's tears. 'It broke my heart,' he says. Relatives describe Dejie as a studious boy who prefers staying indoors to playing outside among the chickens and pigs that run around the village. Mr. Cui has hopes his son will make it one day in college. He's proud of the way Dejie can memorize his school textbooks and boasts that the boy can even recite some passages backwards.

"Mr. Cui knew better than to expect help from the government. He says the head of his village, a collection of 30 dilapidated

homes reached by a potholed mud road, turned down his request for a loan, declaring Mr. Cui's collateral – his house – to be worthless. The local Communist Party secretary wasn't much help either. 'People die every day in China,' Mr. Cui recalls him saying.

"But at the Beijing Children's Hospital, a doctor put him straight. 'If you have money the child can live,' Mr. Cui recalls her saying. 'If not, he will die.'

"The first round of chemotherapy lasted one month. Doctors warned that if they had to abandon treatment midway through the second round, when the boy's immune system would be shattered, he could easily fall prey to a life-threatening infection. But they went ahead any way, with no guarantee that the family could raise more cash.

"In China these days, the cost of serious illness quickly becomes a community burden. Of the 30 or so families in Guangming village, a settlement without electricity until 1996, half chipped in with loans that they could ill afford, Mr. Cui says.

"The All China Women's Federation drummed up support the area with television appeals, as it often does when somebody falls seriously ill. The stricken boy's classmates added their savings. Once, on one of Mr. Cui's visits to Beijing, the long distance bus driver let him aboard free, and the conductor took up a collection among the passengers.

"The strain of health-care costs is so severe it is plunging growing numbers of people back into the poverty from which they so recently escaped. At age 38, Mr. Cui is ruined, his debts of nearly $4,000 already amounting to more than 10 years of income. His relatives and neighbors who lent him money are worse off, too."❧

Money Supply versus Interest Rate Policy

The surprising strength of the Toronto stock market after its spectacular performance the previous week could have this explanation: much of the extra money pumped into the US system by the fed and documented by McHugh, is not staying in the US or in US currency but moving on to the Canadian market which is a relatively sheltered vestibule to and from the US economy. Canada has heavy resources in base metals, gold, and fuel and is not completely involved in the US's unpopular foreign policy. However, if a desperate superboom of the dominant speculative financial sector, feeding on a deflation of the producing economy is what the White House is betting on, Canada risks being drawn into the next superboom and bust which cannot be far away. This is a time when using the Bank of Canada for what it was intended when it was nationalized in 1938 – the means to a bold independent course in Canada's interests with banks strictly limited to banking. Instead our banks are getting their noses bloodied in settlements out of court as in the suit of Enron against three of them.

If further confirmation of the origins of our spectacular stock market strength are forthcoming, all the more reason for the candidates of the leading political parties to declare their position on Bank of Canada policy, before it is too late. No reason for Canadians to feel secure. Certainly part of our stock markets' brilliant performances is the takeover, or expectation of takeover, of many of our largest producing corporations. This is one hell of a time for our central bank to be playing the role of stooge for a Fed that hasn't an idea of where it is headed. Unless we review the role of our central bank we could end up in the role of the "Argentine of the North." *Ed.*

Our thanks to Keith Wilde who brought the following article by Robert McHugh to our attention.

What's the Fed Up To With the Money Supply?

Over the past two days, December 21st – when our first Hindenburg Omen (of whatever cluster is coming) – and Thursday, December 22nd, the Federal Reserve has conducted one of the largest two-day Repo injections of money into the system since back in September 2001. On Wednesday they added $18.0 billion in reserves and on Thursday they added another $20.0 billion. Is this a coincidence, coming right as we get another Hindenburg Omen? Probably not. Is something high-risk going on behind the scenes here? Let's review some facts at the Fed. On November 10th, 2005, shortly after appointing Bernanke to replace Greenbackspan, the Fed mysteriously announced with little comment and no palatable justification that they will hide M-3 effective March 2006. M-3 has been the main staple of money supply measurement and transparent disclosure since the Fed was founded back in 1913. It is the key monetary aggregate that includes Fed Repo transactions, that mechanism whereby the Fed increases reserves.

The date when M-3 will start being hidden also happens to be the exact month that Iran will declare economic war against the US dollar by trading its oil in Petro-Euros on its new bourse. But there is more. The Federal Reserve currently has three vacancies within the 19 top Regional Bank and Board of Governor spots. Why? Part of ongoing wholesale resignations. The latest is from the Philly Fed. Fed President and Open Market Committee member Anthony Santomero has announced his resignation after only a brief year and a half tenure. Very unusual. Hey, Fed Presidents are treated like gods. They have enormous power, prestige, and presence. Why quit? He is far from alone. Over the past few years no less than six Federal Reserve Regional Bank Presidents have resigned. This is highly unusual. An immediate impact is that we are about to have a largely inexperienced batch of individuals conducting monetary policy in the United States. So of course, the first thing they will do is hide the key money figures. Two positions for the Board of Governors (there are 7) have been open for quite a while. Plus six of the 12 Regional Head spots have turned over during the past few years.

If a substantial amount of oil transactions will suddenly be conducted in Euros instead of Dollars, this should put pressure on the Dollar as folks exchange Dollars for Euros, jeopardizing the Dollar's status as the world's reserve currency, making it more difficult to print all the dollars the Fed wants to without driving the Dollar into the ground. Iraq threatened to do what Iran has threatened to do just before we went in looking for weapons of mass disappearance. If the Dollar tanks, Treasuries might not be far behind. If Treasuries tank, kiss the Housing-driven boom goodbye. Could the Master Planners be hiding M-3 because they anticipate they may have to monetize the Federal debt, buy our own Treasury Bonds during the coming economic attack against the Dollar? That would require a ton of new fresh money creation – too much to disclose. Could it be some folks at the top of the Fed do not have the stomach to

be part of what is about to go down? M-3 has a direct but lagging impact on financial markets. Look at the chart at the top of the prior page. Whenever M-3 rises, the Dow Industrials rise. Whenever M-3 is flat or declines, the Dow Industrials decline. The Dow Industrials are a bellwether for the economy. If we can monitor M-3, we can better monitor the future path of equities and the economy. It is wrong for the Fed to stop its disclosure for this very reason.

Investors need to know in a free market economy, because M-3 infusion is centrally planned intervention into a free market system. Investors need to know when the Master Planners have decided to intervene. Our buy/sell signals were designed to pick up the scent of Master Planner intervention by analyzing supply and demand forces underlying the markets. So with or without a fully disclosed M-3, we will be able to continue to identify coming multi-week trends. So what about M-3 the past week? The latest figures show that on a seasonally adjusted basis, M-3 rose 27.3 billion last week, a 14.0 percent annualized clip, and is up $76 billion over the past month, a 9.8 percent growth rate. But those are the massaged numbers.

For the raw figures, fasten your seat belt. Are you ready? M-3 was increased $58.7 billion last week (that does not include the huge Repo infusions noted above), a 30.0 percent annualized rate of growth. For the past two week, the Fed added $93.5 billion to the money supply, a 24.0 percent annual clip. Over the past 6 weeks it is up $192.9 billion, a 16.7 percent Banana Republic hyperinflationary pace.

This is nuts, folks – unless there is an incredible risk out there we are not being told about. That is a lot of money for the Plunge Protection Team's arsenal to buy markets – stocks, bonds, currencies, whatever. This level of irresponsible money supply growth makes shorting markets hazardous, yet at the same time says markets are at huge risk of declining. Maybe M-3 growth doesn't stop the decline this time. Should be a fascinating storm in 2006. The recent rise in Gold catalogued 74 points over about a month, a 16 percent rally from precisely the day the Fed announced it would hide M-3 from taxpayers and citizens of this great nation. That is no coincidence. Gold sees hyperinflation, monetization of debt, and intervention into free markets. Gold is telling us it expects Ben Bernanke to be an inflationist.

Robert McHugh

A Still Bigger, Neglected Message from our Oil Crisis

In its 20/12 issue *The Wall Street Journal* ("Five Who Laid the Groundwork For Historic Spike in Oil Prices" by Chip Cummins, Bashan Bahree, Shai Osler and John Fialka) makes a stab at getting to the bottom of the oil crisis. Yet a vital part of the story is still left untold.

"The oil shocks of the 1970s and 1980s happened for a simple reason: huge and sudden cuts to supply. After supply was restored, oil prices eased.

"Today's energy crunch – which has seen oil prices double since 2003 – is different. Once again, supply stocks have played a role, including those triggered by hurricanes in the Gulf of Mexico and the US invasion of Iraq. But the real cause is a profound shift in the global energy system that has been 25 years in the making. The world's thirst for oil has grown faster than the industry's ability to slake it. There is no spare oil.

"Many big forces continued to create the crunch: the Organization of Petroleum Exporting Countries' (OPEC) obsession with avoiding market crashes, Big Oil's emphasis on profits over finding oil, China's new oil addiction, America's old one, and the new role of investors in energy markets. Behind it were decisions by individuals around the world, including a Saudi minister, a British oil baron and a Beijing yuppie."

The OPEC Czar

"Ali Naimi spent his early boyhood in Saudi Arabia tending sheep. He grew up to become the most powerful man in the energy industry, thanks to his skill in herding a more difficult bunch, the OPEC.

"Mr. Naimi started out as an errand boy at the kingdom's giant oil company, where he attended a one-room school-house for promising locals. Later, he was sent to Stanford for a master's degree in geology and quickly rose to head the company.

"By the time he became oil minister in 1995, the industry had plenty of extra capacity, created by a frenzy of drilling in the early 1980s. Oil inventories swelled in 1998 when Asia's economy tanked.

"As chief of the world's largest producer, Mr. Naimi was OPEC's de-facto leader, and he had a strategy. The cartel needed to start behaving like a central bank – united, technocratic and driven by data not internal politics. Because OPEC had a swath of idle oil fields, they needn't develop new ones. To prevent gluts, OPEC should limit crude flow into consumers' stockpiles.

"In the late 1990s, Mr. Naimi began targeting the oil inventories in the US Midwest, a key segment of the world's biggest market. If Midwest inventories fell below a certain level, Mr. Naimi believed, prices tended to rise and OPEC needed to open the spigot. If they rose above a certain ceiling, OPEC had to cut. 'You have to watch that like a hawk,' he told journalists in early 2004 when discussing US inventory levels.

"It was audacious: A foreign official trying to micromanage a key business indicator in the world's most powerful country. OPEC went largely unchallenged in Washington. Oil firmed, but stayed relatively cheap. Mr. Naimi wanted to keep prices from getting so high that world growth – and oil demand – would slow, or consumers would turn to alternatives to oil.

"Mr. Naimi's strategy turned out to have a big vulnerability. By the time it became clear demand was soaring instead of faltering, OPEC had whittled away the extra pumping capacity needed to tame prices.

"In February 2004, the cartel's oil ministers met in Algiers. The world economy was doing well. Oil prices had jumped above $30 a barrel, a price that worried many people, being far above the average around $20 throughout the 1990s. Yet supply-and-demand data from a host of sources – including the US Department of Energy – suggested a glut was building. The cartel announced a 9% cut in output, though it never went through with the cut.

"The data were wrong, and a glut never materialized. Demand Soared. A barrel of Texas crude hit $40 a barrel in May 2004, and in October, after Hurricane Ivan, $60 in June 2005, and reached $ 70.85 in August 30 after Hurricane Katrina.

"In hindsight the February 2004 meeting marked the last gasp for the dynamic that had defined the world's oil for nearly two decades: a tendency to gluts. The market's reaction to the meeting showed the new dynamic: ultra-tight supply.

"Soon after the Algiers meeting, Mr. Naimi led Saudi officials on a visit to China. They expected to find China hoarding

crude. Instead, they found one of the greatest leaps ever in energy use."

The Oil Baron

"In September1996, John Browne, a cigar-puffing, opera-buff, gathered the board of British Petroleum at a Berlin hotel, In his second year as BP's CEO, he had a bold request: permission to find a merger partner. For two days he made his pitch. BP, once a state-owned also-ran needed to bulk up via a big deal, then boost profits by slashing costs.

"Lord Browne got his way, and two years later BP merged with Amoco Corp. in a $52 billion deal. Months later he agreed to buy Atlantic Richfield Co. A frenzy of consolidation followed: Exxon merged with Mobil, Chevron with Texaco, and France's Total gobbled up European rivals.

"But the consolidation and cost-cutting led to a sharp decline in exploration for new oil. That left the industry unprepared to quickly develop fresh crude when demand bounced back this decade. In an interview, Lord Browne argues that dollars spend seeking oil is a misleading measure, because technology allows oil companies to get more for the exploration dollars today. We are in the business of efficiency, because we have to maximize the cash flow available for shareholders, he says. US politicians are blaming Big Oil for causing the crunch by focussing too much on short-term profit."

The Prophet

"Matthew Simmons, a petroleum banker, visited Saudi oil fields in 2003. The kingdom has almost a quarter of the world's reserves. Mr. Simmons came away disturbed. What if these fields weren't so healthy as the Saudis claimed?

"Back in Houston, the 62-year-old Utah native followed up on his hunch. Digging into scientific papers, he wrote a book concluding that Saudi fields might soon go into irreversible decline, *Saudi Arabia's Oil: A Reality or a Mirage*. His scholarship has been criticized by Western oil-company executives and petroleum engineers. The Saudis say they can boost production another 50%, and some experts think they can go higher.

"The New York Mercantile Exchange introduced an oil futures contract in 1983. Ever since, investors outside the industry have been able to trade in oil without taking delivery of a single barrel. Even conservative pension funds have targeted energy as an alternative to low-yielding bonds and pricey stocks. Goldman Sachs estimates investors have put close to $70 billion into instruments that track commodity market indexes this year, up from under $10 billion in 2000. Jeffery Currie, head of commodity research at Goldman in London, says non-industry players now make up 15% of the financial markets tied to the world's oil supplies. The added demand from new investors can further boost prices."

With all this evidence of how the world actually works, let us attempt to grasp the plight of the average citizen who has warmed the seats at a university economics course. There he will have learned about the "pure and perfect markets" where all participants – buyers or sellers – are of such inconsequential size that nothing that they do or fail to do can affect prices. But then you learn of Mr. Naimi, Saudi Oil Minister who disposes of some half of the world's reserves in a game of wits with your average US citizen who must fill up his automobile at the gas station. Mr. Naimi not only can decide how much oil hits the market and at what price. Enter Lord Browne, head of British Petroleum, able to reduce the number of the makers and breakers in charge of world oil supplies further. Obviously that makes the very notion of "the pure and perfect market" even more irrelevant.

But it doesn't stop there. Corporations, dependent as they are maintaining the rates of growth they have already attained on stock markets, extrapolate into the remotest the rate of growth of their earnings and net worth and then incorporate it – discounted for its present value – into today's market price. Once the corporations are evaluated on such a basis, that valuation has to be maintained, as must its rate of growth into the farthest future. For any shortcoming will lead to the collapse not only of the market price but of the usefulness of its stock and debt as collateral for further investment financing. There is nothing to correspond to such financing for the buyer of say oil at the pump. He pays with his credit card that depends on his payment record. Not even his job is secure these days as his counter-party at those gas pumps, the large oil corporation if he works for one, may lay him off to help come in with better earnings to support that obligatory increase in their corporate stock market value.

And yet the fiction of a self-balancing market reigns ever supreme in the halls of learning to match the thanks to mega-corporations for their financing on their walls.

Nor is that the end of the tale. So much cash ends up sloshing around as a result of this unbalanced situation, that astute financial experts have designed speculative plays on oil futures that involve the buyers of immense amounts of claims to immense quantities of oil without in fact taking delivery of a single barrel of the stuff. Such plays, known as "derivatives," completely sever price-formation from the actual economy. Indeed, the phenomenon feasts on society's living organism, determines what wars are fought, and hence the extent of the civil liberties and much else that can be tolerated at home. Well over a decade ago when derivatives were used by speculators to outgun a series of central banks and shoot down their currencies like clay pigeons, COMER raised an alarm about regulating derivatives. In vain. Now that key Western central banks on occasion have adopted that position, they have been shorn of much of their power. It is as though many of society's key decisions on the environment, fuel policies, social programs had simply been transferred to Las Vegas. A reexamination is long overdue of what passes for economic theory.

William Krehm

In Memoriam – Kurt Loeb

It was with the deepest sorrow that we learned the passing of Kurt Loeb, on the last day of the outgoing year. Born in Goethe's home town, Frankfurt-am-Main in 1922, he came to Canada as a 15-year-old refugee, but was back in Germany with the Canadian army nine years later.

It was one of the special gifts of Kurt that he brought to the activist movement an unusual sense of decency, wisdom and wit. Never ever, did he park these rare qualities at the door. With his own business career and a family to look after, he pursued university studies right up to a doctorate in English literature. Later his doctoral thesis appeared in book form: *The White Man's Burden,* a study of the ravages of imperialism on the conquerors as well as the conquered.

For years his Letters to the Editor appeared in the local press as a feature. When you telephoned him, he consoled you for his absence by some hilarious quotation from the literary classics or devised for the occasion. Knowing Kurt was one of life's great experiences. *W.K.*