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Language of Deceit on the Tongues of the Mighty

The most flattering thing that can be said of our brand new Prime Minister Stephen Harper is that he has a way with words, neo-conning them into quite the polar opposite of their accepted meaning. Even a right-inclining columnist like John Ibbitson of *The Globe and Mail* (11/10, "Clean-air pledge is just political smog") draws an unflattering conclusion: "Two months ago, Intergovernmental Affairs Minister Michael Chong said Canadians would be 'pleasantly surprised' by his government's autumn proposals to improve air quality. He may have been right about the adjective; but there's nothing to justify the adverb. Stephen Harper's announcement that his government will introduce a *Clean Air Act* next week was simply a political mirage.

"When the Conservatives declared earlier this year that Canada would fail to meet its Kyoto targets, they were simply speaking the truth. The Liberal government signed the protocol committing Canada to reducing carbon-dioxide emissions, then failed to live up to that undertaking.

"But the Tories had another calculation in mind: most Canadians were confused about global warming, which may or may not be linked to increased carbon-dioxide emissions, and which may or may not be reversible.

"But urban Canadians are very aware that smog is getting worse. The government's strategy was simple: shift the concern from greenhouse gases to smog. Produce a program that toughens automobile emissions and reduces the pollution from coal-fired generating stations. Ignore environmental zealots such as those at the David Suzuki

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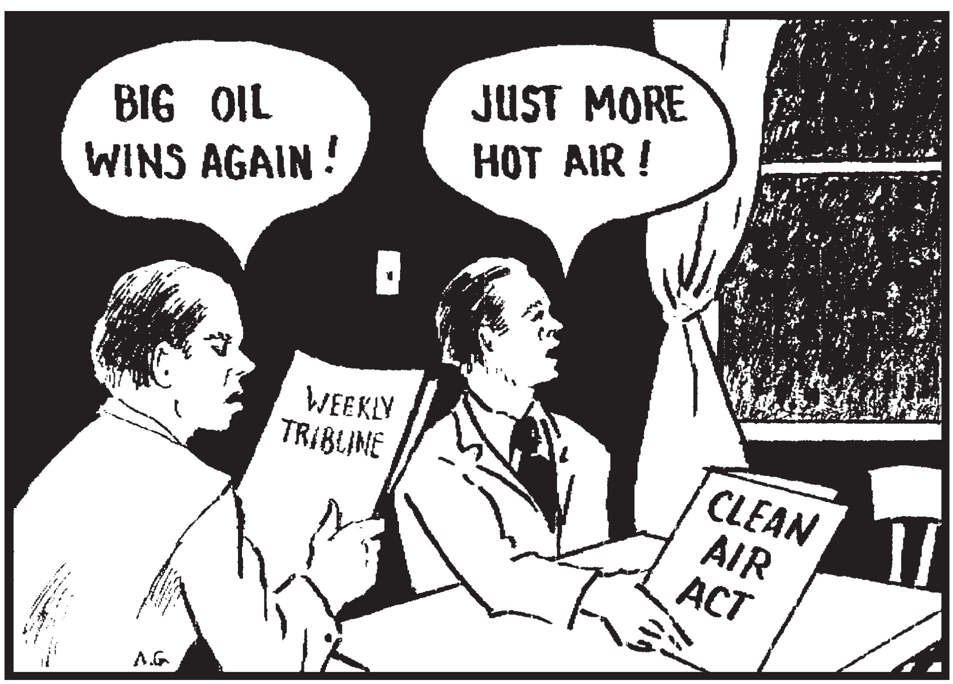

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Once More on 100% Money

Man is an incorrigible simplifier. Focusing on the greatest immediate threat, he tends to pay scant heed to what may be lurking just around the corner, confident that luck and a spot of faith will take care of such "secondary" problems. He tends to be one-dimensional in his ambitions, Surely the Tower of Babel was brought in so early in the Bible as a warning against our ambitions of overweening growth.

My remarks are intended as a gentle warning against rushing into proposals for "100% money," which would put an end to fractional reserve banking, one of the greatest economic inventions. I refer you to the good if incomplete book of Stephen Zarlenga which explained the advantages of token over commodity money. But like all miracles fractional reserve banking stands in need of careful control. We must admire the wisdom in this respect of the Roman Church that committed those who administered a still greater miracle to chastity, to avoiding temptation to have it used for dynastic ends. Above all the holy fathers were not allowed to corner the wine or the wafer markets.

I highly recommend a similar caution in dealing with fractional reserve banking. None of us like the banking profession, but that does not mean that we can, could or should abolish it. For as the title – 100% money – makes clear, it reduces the banks to the role of mere intermediaries, borrowing with the left hand what they lend with the right. If you consider the costly electronic record-keeping, the cost of sifting out good borrowers from bad ones, the reluctance of people to carry much cash around with them, it is clear, that the banks, deprived of a reasonable amount of near-money creation, would have to raise interest rates to unacceptable heights to cover the costs and earn a reasonable profit at legitimate banking. It should deliver a message to you that the banks, when put on the defensive, have themselves claimed just that they were simple intermediaries. It merely adds to the confusion that serves their endless expansion plans that you should be agreeing with them even about the possibility of their being intermediaries. You are helping them apply their war paint.

Moreover it would surrender the most fruitful stretch of socially helpful banking in our history. The fractional reserve system had been kept operating in the national interest from 1938 until the mid-1970s, when the percentage of the national debt held by the central bank in Canada approached 25%. And since the Bank of Canada was nationalized in 1938 by a Liberal government, the interest paid on that debt comes back to the federal government as dividends. Moreover, the statutory reserves amounting anywhere from 8% to 12% of deposits made in chequing and other short-term accounts earned no interest. Because of that it enabled the central bank to increase its loans to the federal government on a virtual interest-free basis within the restrictions in force. The reserves for deposits made into longer-term accounts are considerably less. In Canada all the details of the ability of both the federal government and the provinces to obtain both unfunded lines of credit – up to $^1/_3$ of the annual budget in the case of the federal government and $^1/_4$ in the case of the provinces is still provided for in the *Bank of Canada Act*, but has not been made use of for many decades. There is also a subsection 18(c) of that act that allows the Bank to buy and sell securities of both the federal government and of any province or of any corporation – which would include the municipalities – if guaranteed by either the federal or provincial government.

Bank of Canada Act — Canada's Most Disregarded Legislation

Why is all this still in the *Bank of Canada Act?* Thereby hangs a revealing tale. In 1982, Prime Minister Brian Mulroney, particularly attentive in anticipating Washington's wishes, was preparing the ground for putting "zero inflation" and the "independence of the central bank from the government" into the Canadian constitution. However, his own caucus, the House of Commons Committee on Finance, turned down his proposal. After that he didn't dare mess with the *Bank of Canada Act* again. That is why the Canadian government and the central bank pursue a policy that completely disregards the *Bank of Canada Act*. In it is subsection 14(2) that establishes the ability of the Minister of Finance in the event of a disagreement about basic policy arising with the Governor of the BoC, to deliver in writing a statement of what the federal government desires, and within thirty days the Governor of the Bank "shall comply."

And detailed provisions how much lending the central bank may make to the federal and provincial governments or to any municipality under a guarantee from either the federal or a provincial government. The provisions for statutory reserves before their repeal was in another bill, the *Bank Act*.

Those reserves were phased out between 1991-1993 without debate in Parliament or it being reported in the media.

100% money would make all that cut of our history irrelevant. For decades I and many of the founders of COMER, some no longer alive, worked to enlighten the Canadian public about those three decades of our history when the fractional reserve banking and a nationalized central bank created a fair and highly positive balance between the use of the central banks to finance infrastructure projects of government; while the banks, restricted to banking, served the financing needs of private individuals and corporations. We believe the only way out of the present crisis is to resume the policy of fractional reserves precisely from the point in its highly successful expansion that had been attained in 1975; and move it further in a gradual way, increasing the portion of money created by the central bank for government infrastructural projects and expanding the concept of government investment to include investment in human capital. This would be done in easy steps, stopping at regular intervals to enable the country to assess the progress made by the use of fractional banking for the distinct purposes both of the chartered banks and the central bank itself. For the recognition of government capital investment – finally made in the case of physical capital by the US in 1996, and in Canada grudgingly in 2000, can be seen as fractional reserve banking of a higher sort. Capital projects, for which the materials and labour are available within the country, can be financed by the creation of more Bank of Canada credit if need be, counting on the enhanced production and revenue that will ensure from such investments some years or even decades later in the case of human investment. That has all the features of financing a future increased flow of revenue by making full use of the necessary labour force and materials available to service and retire the financing over a stretch of the future.

But here we must be on our guard against the very human temptation to simplify the world around us. Bankers do not come in a single model. With the great traditions of its historical school of economics that included sociological economists of the status of Max Weber and Friedrich List, German scholars were inclined to regard economic doctrines as expressions of distinct cultures and national needs rather than as manifestations of rigid universally valid laws. That tradition explains why in Germany today there is a considerable amount of work done in identifying and analyzing the variety of national banking cultures, in contradistinction to the one world-wide system imposed by the Washington consensus and the international organizations under its domination.[1]

Samples of Diverse Banking Cultures

Hawala banking that has its origins in India and other South Asian countries emphasizes the lack of a paper trail left by banking operations. This may correspond to many needs and situations, from simple money exchanges to criminal need for secrecy; its influence can extend to tax evasion and the financing of contemporary terrorist activity. It includes deals in US dollars originating outside the US and in no way subject to its legislation. Tax shelters abroad are certainly a major instance of it. But significantly enough, "to remain competitive" – it was not so long ago that special islets of impunity were provided in centers such as New York in which financial operations in dollars were carried out that were in no way exposed to US currency laws.

Then there is the Mexican banking culture, that depends disproportionately in the allotment of credit and renewal of maturing debt on "family and personal connections" – the Mexican *"cuate"* relationships that promise protection and inspire confidence where governments and the legal system have failed to do so from the time of the Conquest.

There are the colonial-minded banking cultures that are ever ready to base their currencies on foreign reserves, particular that of the United States. This has always been promoted by Washington, since the adoption of the US dollar as currency is tantamount to an interest-free loan to the United States. In recent times there has been a perduring attempt to introduce a common currency for the three currencies of the North American countries, which in practice would be governed to suit US interests. The countries cited to support the allures of such arrangement include Panama which never had its own currency. But then its secession from Colombia took place in the course of Washington's bargaining with Colombia for a long lease on the site for the building of the Panama Canal. Bogotá was willing to do the deal but the price it asked was considered too high so the secession was arranged through a French adventurer who organized a revolution for the separation of Panama. The sole victim was a Chinese restaurateur. And from the beginning the currency of the Republic was always the US dollar.

And the tireless propagandists for a single North American currency don't even blush to bring up the cases of miserable third world countries like Bolivia and Ecuador as shining examples of the successful use of the US dollar. What it amounts to in fact is the free gift of money base to the United States. It is in fact free loans from mouse-poor lands to the richest country in the world that will never have to be repaid, and meanwhile, deprived of that money that could be part of their own sovereign power, they must purchase their money base with free exports to the amount of the dollar reserves that their central banks hold.

The Argentine is a special case. Until World War I it was by far the most advanced of Latin American countries, and indeed earned the moniker of Britain's Sixth Dominion. Britain's loss of its investment potential and the means of paying for imports on the scale that it had up to WWI left the Argentine orphaned. For a while it sought a replacement for the vanished British connection in the United States. But a very different banking culture prevailed there than the tradition of British banking *vis à vis* its dominions, real or adopted. That is why it was trapped into agreeing to an arrangement under which it could not issue a peso of its own currency without having the equivalent amount of dollars in its vaults or computers. This meant the surrender of a key aspect of sovereignty. The fact that the once prestigious Argentine had adopted a US monetary reserve currency influenced lesser Latin American lands to do likewise. Bolivia and Ecuador did not come out of the experience unsinged. With its control of the IMF and the world banks, the US imposed hard conditions to collect the interest on its debts – driven every higher "to lick inflation." Loans by the central bank to the governments were forbidden since priority was given to the payment of the alpine interest rates imposed by the US Fed on most of the world.

And that brings us to the most aggressive banking culture ever – that developed by the US over the past century. Confined severely to banking by the *Bank Act* of 1933 brought in under Roosevelt, banks were essentially in the doghouse for their major role in bringing on the major Depression with their gambles. At the time of his inauguration in 1933 thousands of US banks had shut their doors, banks were forbidden to acquire interests in the other financial pillars – the stock market, insurance and mortgage companies. For the Great Depression had occurred because the banks had acquired access to these "other financial pillars," and used their liquidity pools as base money for applying the bank multiplier. Ceilings were imposed on interest rates that banks could pay for their own borrowing or charge on their loans. Not only were these restrictions removed one by one beginning with 1951, but high interest rates were declared the sole means of attaining "zero inflation."

Inflation of course was badly defined to identify any rise of the price index with too

A Simplified Model to Illustrate the Workings of our Pluralistic Price System?

The Globe and Mail (09/10) carried under a flippant title "Mmmm, ingredients" an editorial laden with wisdom about the structure of our thinking that could do much to remake our country into a happier, more prosperous place. It should be made required reading for candidates to the posts of Governor of the Bank of Canada, and Prime Minister.

Let me quote from it before we apply it to high monetary policy:

"Science has a habit of making connections that test the world's capacity in compartmentalizing its knowledge. Smoking is terrible for people, without question, killing them prematurely through heart disease and cancer, but according to research at Duke University Medical Center, nicotine counters such brain disorders as schizophrenia and Parkinson's disease. Coffee drives high blood pressure, but its anti-oxidants help guard against some chronic diseases. Heavy consumption of alcohol can damage the liver, but moderate consumption of red wine, with the cholesterol-lowering resveratrol bequeathed it by the grape skins, may improve one's health – as might moderate consumption of other alcohol, according to some studies.

"The smoking of marijuana, for all the damage it can do to the lungs, has been known to ease the pain of glaucoma even if scientifically quantifying that relief remains elusive. Now comes word from the Scripps Research Institute of California that THC, the active ingredient in marijuana, may halt the progression of Alzheimer's disease by, to quote the Reuters item, 'preserving levels of an important neurotransmitter [called acetylcholine] that allows the brain to function.' The Harper government, which has just taken an axe to the funding of research into the medical use of marijuana as part of $1 billion in cuts, may find more than a few people pressing the latest edition of Molecular Pharmaceuticals into its hands."

We will not accompany the editorialist as he goes on with a wicked glint in his eye to deal with the mixed records of chocolate, sugar, and whatever. It ends up as a delightful essay on the need for approaching any item from the national debt to the alleged powers of sugar as an aphrodisiac with a heavy dose of skepticism It emphasizes the perils to the mind – in this age of hyper-advertisement and vested interest.

The editorial goes on to explore cases where a single cause may have a variety of effects. We would point out, contrariwise, two or more causes may have at least one identical or seemingly similar effect. This line of reasoning may lead us to important conclusions that could save the world zillions of dollars in wealth, and at the same time introduce a greater degree of social justice. Complicated? Not in the least – expressed in the simplest linear algebra that we learned in our first year of high school, it runs so: if a linear equation has n independent variables, it will require n independent equations to solve Thus if we have the linear equation $x + y = 5$, we can solve the equation only if we have a second equation, say $x - y = 3$. To solve it we simply write one equation beneath the other and add them up term by term in which case we arrive at $2x = 8$ and therefore $x = 4$ and $= 1$. Completely solved.

Now let us choose far more complicated variables, Say an excess of demand over supply in a national economy that has the effect of driving up prices because buyers will bid against one another, and sellers will take advantage of the disparity between supply and demand to raise their prices. Call that x.

But another totally different factor – unrelated to x – will also have the effect of creating a higher price level. Say an economy has advanced, as did Canada between 1939 and 1960 from a rural country to a high industrialization. A lot of the services that farmers required they did themselves. In the city it is done for them by trades people and contributes to a higher price level.

As does also the technological revolutions that required better educated consumers, let alone producers. That created the need for more and better schools and universities. These were paid for by taxation which resulted in a deeper layer of taxation in price. Far denser population led to larger cities, with higher transportation costs. This higher taxation, due to a greater investment by government in physical and human resources would constitute the "y" in our simplified linear equations.

Now we see clearly that we get nowhere trying to achieve a flat or a flatter price index by raising interest rates. That would decrease rather than increase the supply of marketed products, and it would also decrease the taxes raised by the government and increase the government debt. The higher interest rates would raise the cost of public services.

In short, illustrated with simplified mathematics, the policy of our central banks over at least the past fifteen years of using interest rates as the one blunt tool to fight what they call inflation cannot work. Properly defined "inflation" would be represented by x. y is a quite distinct factor in the higher prices – the increased investment in government services defrayed by taxation. This in our simplified linear example is represent by y, and I have called "the social lien" since it is the taxation that must be paid in a variety of ways by the population. Without another equation it is possible to determine how much excess demand – real "inflation" might exist, let alone design effective policy for keeping higher prices as stable as possible.

Always however, we must be mindful that two very distinct factors are responsible for the higher prices x (a possible excess of demand over available supply) and y, the Social Lien that represent the taxes of whatever sort is needed to provide the investment and public services needed to run a modern economy.

W.K.

much demand for the available supply of goods and services. But that was another serious over-simplification to which people and politicians are prone. Prices can go up not because there is a lack of product to satisfy demand, but for quite other reasons. For example, our Canadian economy, like many parts of the world including large areas of the US, since world War II has developed from semi-rural states and countries to highly urbanized ones. The new technologies that have been introduced require not only much more highly educated producers, but even far more educated consumers. Large cities require subways. And the Deregulated and Globalized world has needlessly congested highways and airports throughout the world. To deal with such problems calls for vastly increased government services that are paid for by taxation. Taxation has thus come to constitute an ever-deepening layer in the price index of a mixed economy. High interest pushed as high as needed to flatten prices had the effect of enthroning usury. In Canada today the only ceiling on interest rates that it is legal to charge today is 60% under criminal law. That has not helped the relations between the Muslim and Western worlds. For the Koran considers any rate of interest to lenders who do not share in the risk of the borrowing enterprise to be a mortal sin.

This new dominion of finance capital moreover has a dangerous forward lean. Not only the rate of earnings of a public corporations but the rate of growth of those earnings are projected into the remotest future and then incorporated in multiple ways into today's share prices. And of course into the options granted the top CEOs, which would become worthless unless their anticipations are realized by hook or crook. That is what powers the Globalization and Deregulation passion to stoke compulsory feverish growth. To that cause the international Bretton Woods organizations have been enlisted as arm-breaking collection enforcers. Many of the positive functions of banks accordingly have been scrapped as "inefficiencies." Tracking down the bad risks among borrowers is an arduous task. So for "greater efficiency" so banks have taken have taken to syndicating their mortgages and other loans, taking their profit by selling tranches of risk. Investors who buy a high tranche – richest in risk – suffer the loss of the first occurring bad debts, but are compensated for that with a greater share of the eventual profits of the entire batch of mortgages or other loans if in fact such turn out to exist. But obviously this does not contribute to a careful investigation of the borrowers' trustworthiness. Instead the banks take what is known as "banker's exit" or in less elegant language, "selling to a bigger fool." That is a new type of imperialist banking that the world never seen before has seen even its nightmares.

A Promising Benign Banking Culure with a Third World Future

However, there are benign banking cultures as well.

Allow me to quote from *The Wall Street Journal* (15/05, "Entrepreneur Gets Big Banks to Back very small Loans" by Eric Bellman):

"Shivnoor, India – Vokra Akula runs a company that doles out loans of $100 or less to desperately poor villagers so that they can buy a water-buffalo or a bicycle. But he's hardly a good-doer.

"Mr. Akula, the 37-year old founder of SKS Microfinance Pvt Ltd., is at the forefront of the latest trend in 'microlending' or making tiny loans to help entrepreneurs lift themselves from the lowest rungs of poverty. Long the province of charitable institutions, microlending is starting to attract the attention of big business. Intrigued by India's red-hot economy and potential market of more than a billion consumers, financial giants such as Citicorp Inc., ABN Amro Holding NC, and HSBC Holdings PLC have already provided millions of dollars for SKS to lend out. SKS, in turn, says it has notched up healthy profits for the last three years.

"This can work driven only by greed,' says Mr. Akula, a one-time McKinsey & Co. consultant who was born in India and grew up in Schenectady, NY.

"It's a radical ideal that has focussed more on social goals such as the empowerment of rural women than on profits. The approach, pioneered in the 1970s by firms like Grameen Bank in Bangladesh, has since spread all over the world. As many as 10,000 microlending institutions now serve 100 million small borrowers. India, where more than 300 million people live on less than $1 a day, is an especially important laboratory for microlending.

"Default rates on microlending tend to be very low – under 3% – in many cases. By comparison, US credit-card issuers typically charge around 5% of outstanding balances. Even so, micro-lending often gobbles up most of the profit. That's because it can take hundreds and even thousands of loan officers to manage millions of small loans to often illiterate farmers in remote villages. Transaction costs and paper work can be overwhelming. Most microlenders live by hand to mouth, relying on wealthy patrons or development agencies to keep the money flowing.

"People like Mr. Akula see opportunity in making all this more efficient. The son of a physician who moved the family to New York state in the 1970s, after finishing graduate school at Yale university in 1995, Mr. Akula worked with charity and government-backed microfinance organizations in India.

"The programs were run by well-intentioned people, he recalls, but poorly managed. Mr. Akula decided to build his own microfinance company from scratch. His goal: to model a business on McDonald's Corp. or Starbucks Corp., using technology to wring enough efficiency out of each tiny transaction to lower costs.

"After presentations to representatives of the Ford Foundation and the Rockefeller Foundation in New York, he was told he lacked experience in a tough working environment like India. So Mr. Akula raised $52,000 from friends and family members.

"SKS launched operations with Mr. Akula and a single employee in Hyderabad in 1998. The first thing they did was to put a stopwatch on each step of the loan process. Loan officers had to search for borrowers in the fields. Villagers would make payments in unruly piles of sweaty, wadded-up rupees they kept wedged behind blouses and belts. Someone had to count the money and then dole out fistfuls of change."

"Mr. Akula made some simple rules. Borrowers have to meet at a certain time. Instead of allowing borrowers to decide how much to repay each week, they are told to repay the same amount each time in exact change. He set payments to multiples of five rupees to avoid coins. The bottom line: fast turnaround means a SKS officer can visit an average of 50 borrowers a meeting in each meeting instead of 20.

"He convinced friends from McKinsey and KPMG LLP to volunteer their time to create simple loan-management software. It is mostly used by managers without computer experience.

"The software also helped SKS diversify its risk. A few years ago, SKS saw it was becoming dangerously exposed to buffaloes. SKS could have faced huge defaults if there was an epidemic that killed off buffalo or a sharp decline in the price of buffalo milk. So it found other areas like tractor repairs, brick

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making, tire retreading and tea shops.

"Mr. Akula also launched the other part of his plan: attracting capital from big foreign institutions. Once he had more than 100,000 borrowers with a default rate of less than 2%, is wasn't a hard sell. Foreign banks in India face severe limits on the opening of local branches, and yet are under government pressure to make 32% of their loans to what the government labels 'priority sectors,' including agriculture and rural industry. Mr. Akula's proposition to banks: pay SKS to find microborrowers and manage loans for you and you'll get backdoor access to the Indian consumer market.

"Two years ago Citigroup became the first international bank to start lending to SKS.

"'We are taking microfinance beyond philanthropy,' says Robert Annibale, the London-based global director of microfinance at Citigroup. Mr. Annibale says the bank has helped bring more than $100 million to microlenders last year through loans, private placements and bond salesmen – more than three times its business with microlenders a year earlier.

"More efficient systems have enabled SKS to drop its annual interest rates to around 24% from 36% in 1998. That's lower than most people for credit-card debt in the cities. More important the rat is less than half charged by many loan sharks, who have been blamed for many suicides by farmers facing ruin when their crops failed."

100% Money Would Kill Microbanking

This improved version of microbanking is a new promising variant of the microbanking culture. The article I read to you show that reduced to its proper essence bankers can perform a most important social function of introducing tight efficiency in the screening and credit administration to make banking accessible to the most impoverished sections of the Third World. But there is no lack of such underprivileged layers of the population even in the First World. Bring in 100% banking and you would knock out the Akula organization, since it would double or triple the interest they would have to charge.

Moreover, such modest microbanks, efficiently organized and directed to those hitherto without any credit affordable credit to those who have depended upon loan sharks. In the First World today loan sharking finance is being taken over by our major banks. And yet these microbanks are a powerful weapon against our monster big banks in their desperate craze for expansion at all costs.

In a recent issue of *ER* we carried an article based on material from *The Wall Street Journal* reporting that in New York and other centers across the land our large banks are opening up branch banks even at a greater clip than they shut down such branches a few years ago when they were headed for the really big games like Enron, and hedge funds. They are now back with their noses bloodied. Three of our five Canadian banks were sued by class actions in connection with designing and financing some of the most dubious schemes in and around Enron, and some of them have settled out of court the suits of Enron shareholders for billions of dollars. They stand in urgent need of replenishing their legal tender base on which to erect further castles in Spain of derivatives and dubious deals in M&A. And where do you get more legal tender? Why, in retail banking in which the bulk of your customers are merchants and workers who bring in store receipts and wages. Rather than stocks and options, and questionable valuations.

That is where the big banks are vulnerable.

And this is how a well-intentioned government would go about making use of the situation, even before it restricts the banks to simple banking and gets them out of stock brokerage, mortgages. Opportunities for that will come when the stock markets finally collapse, and mortgages go sour with rising interest rates, a drop in house values, and the fancy mortgage variants that have taken over in Canada following the US. But the process can be hastened by the government offering new bank charters that will restrict the newcomers who will acquire them to simple banking. Offering fewer and more modest fees for basic services, this new competition of newcomer banks for saving account clients will hit the banks where it hurts most – their growing need to replenish their legal tender base. When the squeeze of such competition starts to pinch, and the need to bail the banks out becomes acute then, opposition groups with an adequate grasp of banking and its troubled background can raise the issues that need so badly to be raised. That would give us back our history when we need it so desperately. Don't plough that history under further with 100% money.

William Krehm

1. *Banking Cultures of the World* edited by Leo Schuster. Frankfurt: Fritz Knapp, 1998.

An open letter to Rosario Marchese, MPP, NDP Education Critic

October 20, 2006

That was a good debate, October 15, at Queen's University between you and Chris Bentley, Minister of Training, Colleges and Universities, on the subject of funding for post-secondary education. It covered several areas of concern, but the common thread running through it all – brought out by both you and the Minister – was that there were "lots of priorities" and "not enough money" to deal with them.

I found it frustrating to hear that there was not enough money when our governments at all levels spend billions and billions of dollars each year in unnecessary interest on public debt, and said so when there was time after the debate for audience participation. I mentioned that in 2005 the interest on public debt amounted to $63 billion, much of it unnecessary. I referred to the recent action of the federal government to use its $13 billion surplus to pay down its interest bearing debt when it could just as easily have reduced it by transferring $13 billion of debt to the Bank of Canada where it could be carried by the government at almost no cost, and the $13 billion surplus would still be available for education and other essential services.

To counteract those who would say that such use of the Bank of Canada would cause inflation, I reminded those present that the government used the Bank for 35 years (1939 to 1974) to carry a significant portion of its debt without causing inflation. By 1974 the accumulated federal debt since confederation had reached $18 billion. By 1997, after the government reduced its use of the Bank to carry public debt, the debt had jumped over 3000% to $588 billion.

Then I asked you and the Minister if you would press the federal government to use the Bank of Canada as it did for 35 years and invest the savings in education and other essential services. Minister Bentley replied that he did not know much about the Bank, but assumed that if it was not being used as it used to be there must be very good reasons. You responded that the reasons were mostly political – that the Liberal and Conservative parties were indebted to the banks and would not want to take action which would reduce the banks' profitability, but you did not explain why the NDP was not pressing the federal government to use the Bank of Canada as it previously did.

Jack Layton, in his new book "Speaking Out Louder," talks about the "question that is frustrating," "the perception that people have that…they see (the NDP) as wanting to just tax and spend. They say they can't trust (the NDP) to keep spending under control." I have said many times that the NDP has to debunk not only the myth that the NDP can't handle money, but also the myth that the Liberals and Conservatives can. It was under the watches of Liberal and Conservative governments that the debt sky-rocketed, not NDP.

We also have to debunk the myth that Paul Martin was a great finance minister. He does not deserve the plaudits he received for eliminating the deficit. He pushed the line that we Canadians had been living too high off the hog, and now we had to tighten our belts and reduce our expectations. He disrupted the lives of thousands of civil servants whom he fired, slashed programs and downloaded others to the provinces without the funds to support them, in effect transferring his debt problems to the provinces and territories. He did all this even though he knew he had an alternative. He knew that well over 90% of the debt was due to compounding interest – not programs or services – and that he could have reduced the deficit (which consisted almost entirely of debt servicing costs) by transferring debt to the Bank of Canada where it could sit almost interest free. (To avoid inflation he would have had to restore the statutory reserves which Brian Mulroney had removed.)

Where the Money Has Gone

When Canadians hear about NDP programs (economic as well as social) many instinctively grab their wallet – even though they may agree that the programs would be beneficial. Their first reaction is to ask, how much is this going to cost me? What they don't know because the NDP is not telling them (and the Liberal and Conservative parties don't want them to know) is that they are paying billions and billions of dollars every year for largely unnecessary interest. Unless and until the NDP explains clearly and simply that:

1. The Liberals and Conservatives are the incompetent money managers, not the NDP,

2. The NDP would not have to increase taxes to pay for its programs because it would use the Bank of Canada to carry a significant portion of the public debt and apply the savings to programs, many Canadians will be reluctant to give them their vote. It is not enough just to *say* that the NDP could do all that it says it would without raising taxes, it must show *how* it would do this. It is discouraging to canvass for NDP candidates with the tax and spend label hanging on us because so much of what we say is dismissed as not being affordable. "How're you gonna pay for it?" "Where's the money comin from?" We must dispel those myths.

In the NDP platform of the election prior to the last one there was a statement on the Bank of Canada: "…the NDP would use the Bank of Canada to carry some of the public debt…." This came about after several years of writing and urging the NDP to include such a statement in the platform – but it was never mentioned. Much to the chagrin of those who have been trying for years to get the NDP to speak up about the Bank of Canada, the statement was not included in the last platform, having been replaced by a proposal to create a brand new bureaucracy to handle all of the federal government's financing needs – based on the idea that centralized procurement of credit would get the cheapest rate, even though it could never be as cheap as the near zero rate which could be obtained through the Bank of Canada. Those who have been urging the NDP to promote better use of the Bank wonder where the NDP is getting its advice.

Some may say that this is a federal matter and it is up to the federal government and/or federal parties to take the lead – not provincial. I strongly disagree. Because provincial parties and governments (as well as municipal, I might add) are affected they should be acting in their own interests and speaking up. The *Bank of Canada Act*, section 18(c) states: "The Bank may buy and sell securities issued or guaranteed by Canada or any province." It is clear that the intention of the government was that Canada and the provinces could borrow from the Bank.

In my opinion the NDP should be pressing the federal government to use the Bank of Canada as it previously did, and provincial parties should press their respective governments to put pressure on the federal government also. In that way we will be able to say that we do have a plan for paying for the programs we support – and get rid of the tax and spend label.

I urge you to discuss this with your friends and colleagues.

Paying Down the Debt

Several questions were raised as a result of the letter:

1. *If the Bank of Canada would create $13B and pay it to the private banks to pay off the debt to them, would that not inject a net-new $13B into the economy, causing inflation because you would now have $13B more dollars chasing the same amount of goods and services?* Yes, it would.

2. *Would a counter-measure not also have to be taken to ensure that when the private bank receives the $13B, that they remove it from the economy and don't turn around and lend it out again, causing this doubling of the $13B chasing goods and services?* Yes, it would.

3. *Private banks must be forced to withdraw $13B from the economy to ensure that the number of dollars in the economy have not been doubled. Is this correct? If so, how can the Government of Canada control the private banks to make sure they withdraw the $13B?*

The government, through the Bank of Canada, would require the chartered banks to put in reserve an amount of their capital which would result in reducing the banks' ability to create money, specifically, the ability to create $13 billion. At the moment the government cannot do this; they gave up that power in 1991 – just another example of how our elected reps have been giving away the store. That is why the statutory reserves must be re-instated. It may not be necessary for the banks to put $13 billion of their capital in reserve; the amount would depend on the ratio stipulated by the reserve. For example, if the banks were allowed to create $10 for every dollar on deposit, then it would only take $1.3 billion of deposit money to create $13 billion of credit money. At the moment, without any reserve limits, the banks are creating immense amounts of credit money with very little capital on deposit. At one point, Bill Krehm estimated the ratio to be around 400 to 1.

Good luck with convincing John Williamson of the Canadian Taxpayers As-

Soaring CEO Rewards Arousing Grumblings Even in Rightist Ranks

Astronomic high CEO reward in the corporate world is becoming the target for criticism in odd places. In the summation of *The Wall Street Journal* (12/10) the rewards, if anything seem to be moving higher as though stimulated by the extent of the displeasure, rather than restrained. In an article entitled "Behind Soaring Executive Pay, Decades of Failed Restraints" by Joann S. Lublin and Scott Thurm informs us: "In 1993, activist investor Ralph Whitworth shuttered Shareholders Association, a group that was trying to tackle the contentious issue of executive pay. It look as if his work was done.

"Federal securities regulators had just forced companies to reveal details about pay and perks for top officials, in some cases for the first time. The changes 'would make boards think twice' before approving compensation plans that couldn't be justified, Mr. Whiteworth recalls thinking.

"Around the same time, Congress attacked executive pay for the second time in a decade by removing tax breaks on compensation above a million dollars.

"Since then the average pay for chief executives of large companies has quadrupled, according to Kevin Murphy, a professor at the University of Southern California's Marshall School of Business. The average last year was $10.5 million, a figure that includes salary, bonus, and the value of stock and stock option grants.

"There are mention of reasons why Mr. Whitworth was mistaken in his prediction, including the bull market of the 1990s, cozy corporate boards and CEOs striving to keep pace athletes and entertainers. What's often overlooked is the role of all the efforts – by Mr. Whitworth and many others to limit CEO compensation.

"As it turns out, disclosure requirements can push pay higher by revealing to CEOs what their peers receive. Limiting one type of compensation often encourages new types of pay, such as stock options which were pushed as a solution only to become tainted with scandal. Now that shareholders are quick to push out poorly performing chiefs, CEOs are seeking more financial guarantees. And if companies turn to outsiders, they often have to ay extra. In recent years, CEOs have raced ahead of other Americans, including their own lieutenants, Mr. Murphy calculates the average pay was 369 times as much as that earned by a worker last year compared with 131 times in 1993. Meanwhile the average paycheck in the US has barely kept up with the rate of inflation.

"Charles Munger, vice chairman of Warren Buffett's Berkshire Hathaway Inc., and a longtime partner of the famed investor, says he hears complaints even from Republicans who grumble on the country club porch over the pay question. They're mad at 'corporate America.'"

Undoubtedly the trend of CEO rewards has been influenced by several factors. It reflects the fact that the stock market has outranked the general corporate economy, and rewards and achievements are judged by what the company shares have done both in the matter of salaries and company options granted. And then the entire economy, all corporations but particularly the financial sector has cultivated what might be called a forward lean – at time so extreme that the heroes end up in the defendants' dock of celebrated court cases. It borrows the slight of hand of Wall Street, projecting the past rate of growth, real or souped-up, into the remotest future and then modestly discounted for present value into current prices. Much of this is paid in share options so that if reality does not match the projection, there is at least a high temptation to help it appear to match by procedures that often end up contributing to the prosperity of distinguished lawyers. But the general atmosphere and spirit is that of the stock market where hundreds of millions of dollars becomes less offputting than used to be the case when corporate America was far more distant and to an extent a different culture from that of Wall Street. Undoubtedly the crumbling of the leftist movement as an effective factor in American political life has also made its contributions to the prurient opulence of current executive pay.

W.K.

sociation "that he is greatly mistaken when he says that the B of C cannot 'print' more money because this would cause runaway inflation." More importantly is to convince politicians. You won't convince Conservative or Liberal politicians because they are too heavily indebted to the banks. You don't need to convince Green Party or CAP members; CAP is the leader in the field, and the Greens already have a good statement on the Bank of Canada. The person who could do the most good – but so far won't – is Jack Layton. Through whatever means you can muster, convince the NDP members in BC that if they want to shed their image of the "tax and spend" party (which they do), then they are going to have to show the "ordinary" Canadian that their proposed programs are not going to lead to higher taxes. If they balk at this, then vote for CAP!

Richard Priestman

Mr. Harper Puts his Foot in his Mouth

Economic theories can be an effective means for misleading our policy-makers as to where Globalization and Deregulation are taking us. There is not a day that the media does not carry some shocking evidence of this. It is, however, hidden by the bizarre accountancy of our government that continues in place even after a measure of accrual accountancy was adopted by Ottawa in semi-stealth in the year 2000. That happened because of the refusal of the then Auditor – General, Denis Desautels, to give unconditional approval of the government's current balance sheet until it had been done. The Auditor-General had been emboldened to take this stance by the partial adoption by the Clinton government in the US as of January 1996 of accrual accountancy, to do away with the fictitious deficit. That faulty figure had allowed the Federal Reserve to push up interest rates into the skies.

However, the banks, recently bailed out from their speculative losses, by having the debt of all developed (OECD) countries declared risk-free and thus available for the banks to accumulate without any cash down-payment. But when interest rates go up, the market value of pre-existent bonds with lower coupons plummets. And this threatened to bring the banks, so recently bailed out from their speculations, crashing again. Hence the Clinton administration brought in accrual accountancy for its physical investments, that up to then had been written off entirely in the year in which they were made and carried on the government books at a nominal $1.

Redoing the government books to accrual accountancy and carrying the process back to 1958, Washington retrieved some $1.3 trillion, revealing a surplus where a deep deficit had previously been reported. This vastly improved the rating of government credit and transformed the previous deficits into surpluses. This gave Clinton his second term, and laid the ground for Wall Street's high tech boom that climaxed in the year 2000 bust.

Cooking the Books Leads to Disastrous Budgetting

Canada, followed suit only in 2000. But the significance of the measure was distorted in several ways. After heated arguments between the then Finance Minister Paul Martin and Mr. Desautels, the Auditor-General, a demeaning compromise was reached. The A-G issued a statement to the effect that since no new money had been brought into the treasury by the bookkeeping change, there would be no justification for embarking on new programs, just because what had appeared as a sizeable deficit had now turned up to have been a surplus. For "cooking the books" in this way – the expression had been employed during the several-week-long argument between Martin and Desautels – a private citizens might have been sent to prison for fraud and corrupting his auditor. But since this was done by a Minister of the Crown, he merely took a bow for having converted a large deficit into a surplus. That was a surplus that appeared long before the oil boom really had got underway.

That misleading deficit had been traced by COMER – and by two Royal Commissions and a whole line of Auditors-General – to the systematic hiding of physical investments – bridges, highways, buildings, harbours, schools, universities as though they were current expenditure for items that were wholly used up during the year in which they were made. Beginning with the following year they appeared in the "assets" column of the government's books at a token $1 as a sign that they had not been forgotten – rather like the inscription on a gravestone. The debt incurred for building or buying the assets, however, was fully reported and amortized on the government books. The net effect was to make a mockery of double-entry bookkeeping that the Crusaders had brought from the Muslim lands almost a millennium ago. It provided a perfect argument for not introducing social programs essential for the running of a high-tech modern society that Canada had become.

Writing them off in the year in which they were made ("cash accountancy") loaded the price structure with a needless layer of taxation, that had nothing to do with an excess of demand over available supply. Orthodox economists, however, label any rise in the price level as inflation, and jack up the Bank of Canada benchmark interest rate for the greater profits of banks and loan sharks, who for the past 30 years have taken power over the producing economy of this land.

However, ours is a world undergoing tremendous changes. Since the end of WWII Canada has developed from the semi-rural land to the high-tech, highly urbanized country that it is today. Uncounted public services undreamt of sixty years ago have become indispensable. Even to equip themselves as consumers in this world, let alone as producers, Canadians today need a post-secondary education. Only the government can provide and/or finance that. It cannot be left to the market, for advertisement and propaganda for the interests of the financial sector would take over. That has happened in the economics departments of our universities. That alone could explain how our government could mistake this deepening layer of taxation in price for more of the "inflation" that properly should refer only to the price effects of greater market demand than can be satisfied by available supplies. But having suppressed in their thinking the very possibility that two independent causes can contribute to similar effects – in the present subject of our concerns that two distinct causes may contribute to higher prices – governments and official economists have responded to the very different causes of the price rise with "one blunt tool" – higher interest rates. And that both pushes up the costs of the essential public services, and of any increase in supply to satisfy any real excess demand. This official brand of economics have thus not only crippled our thought processes, but contributed to increasing the power of speculative finance. Having sloughed off the restrictions imposed on banks during the depression, they have taken over the entire financial sector – stock exchanges, insurance and mortgages, from which they were banned by the US *Bank Act* of 1933 that became the model for much of the Western world. And by writing off government investment completely in the year when made, just like soap in government washrooms, it is carried on the government books from year 2 on at a token value of $1. That has made possible their privatization for well-connected entrepreneurs at give-away prices. That done, it is listed on the market at its real value, and rent or tolls are charged the public for what had been already fully paid for by taxation.

Government Investment in Human Capital Left Out in the Cold

Moreover, it has remained incomplete in at least one crucial respect – in not reorganizing the government's vast investment in human capital – education, health, and social services. In the 1960s Theodore Schultz had been awarded the so-called Nobel Prize for Economics for having deduced something tremendously important from the unexpectedly rapid recovery of both Germany and Japan from the physical destruction in the war. He and other young economists that Washington had sent to the two countries to predict how long it would take before these two countries reappeared as formidable competitors again on world export markets. And by the 1960s Schultz had identified the reason for their mistaken prediction: they had concentrated on the physical destruction, overlooking that the human capital – the educated and disciplined work forces – had come out of the war basically intact. Hence his conclusion: the most productive investment that a nation can make is in human capital – education, technical skills, health, and social services. COMER is practically alone today in perpetuating the contributions not only of Schultz, but of many great but deliberately forgotten economists, as well as our history. A nation that buries its history, is condemned to relive its worst chapters in ever more nightmarish forms.

I will quote a slim sampling of current news items in our press, which, even when honest is deaf and blind to the deeper roots of our growing disasters in the maintenance of our infrastructures. This state of affairs can be tracked in the shift of power that paradoxically took place in the ever more expensive bailout of our banks from their speculative losses resulting from their previous deregulation. What it added up to was an inevitable accession to power of the social group that has profited by a massive redistribution of the national revenue.

The Globe and Mail (9/10, "Cities struggling to keep up infrastructure" by Steven Chase, Ottawa) reports: "The Montreal area overpass that collapsed less than two weeks ago was built in 1970 during Canada's Golden Age of infrastructure spending, when roads, sewers, and bridges still enjoyed pride of place in government budgets. New investment on infrastructure spending, grew at a rapid 4.8 percent clip annually between 1955 and 1977.

"Between 1978 and 2000 new government infrastructure spending grew only at 0.1 percent a year.

"Today, long-ignored demands to refurbish decades of bricks and mortar have piled up. Estimates of the infrastructure replacement backing range from $60 billion for cities to $125 billion to fix everything that is not being fixed.

"Over the past two years, the federal government has begun to respond to cities' pleas for help, pledging $16.5 billion for infrastructure is among several bridges 'literally ready to fall down' and 'just one of many examples we have of deferred maintenance.'

"In Calgary, for instance, the city is not only now overhauling a downtown bridge first built in 1912. Mayor Braconnier says the 94-yeqar-old structure is one of several bridges 'literally ready to fall down' and 'just one of many examples we have of deferred maintenance.'"

A Mirror Aspect of Accrual Accountancy

But the current news emphasizes another aspect of accrual accountancy that has been completely ignored in our government's dabbling with it. You might call it the "mirror aspect" of accrual accountancy: If accrual accountancy requires that a capital asset of government as well as of private firms be depreciated over its useful life, the failure to make such an investment that is really necessary must be treated as a *capital deficit*, and must be subtracted from the government balance sheet. We can arrive at that conclusion by even a casual reading of the media.

That was brought startlingly to the public's attention by the collapse of a bridge and the loss human life of an overpass in the

MAIL BOX

A Letter to CCPA

After more than 10 years as a member of CCPA, I am regretfully requesting that you stop my membership and subscription.

Your economists have undermined potential allies by opposing monetary reform. I would not have minded seeing little about the issue in the Monitor but I was recently informed by MP Judith W. of the NDP that you opposed the NDP developing policies for monetary reform (the BoC resolutions were dropped in the last election platform) and it is apparent from the actions of the CoC that you ill advise them as well.

I used to advise friends and fellow union members to support CCPA but cannot in all conscience do so any more. The reality is that without monetary reform the system will recurringly break down and the many good issues that you advocate for will be undone as soon as a right wing government is formed. Sadly, under a left-wing government any gains also will be undone. When a recession or depression occurs, your advisers won't know better just as Floyd Laughren didn't know better under Rae's leadership.

Next year marks the 75th anniversary of the *Bank of Canada Act*. It should be reviewed by a Royal Commission made up of ordinary citizens and an equal number of MPs from each party. The Bank of Canada was nationalized in 1938 so its 75th anniversary is fast approaching. Maybe by then the deep intergrationsits will have accomplished their goals and the BoC will no longer exist outside of the Federal Reserve Banking system.

The progressives in this country are splintered enough without CCPA adding to the problem. I will be pleased to resubscribe should I receive some assurance that monetary reform will be treated in a friendly manner by your economists and in your publication.

Two sentences this year, one in the Korten article and the other in the Kennedy article do not cut it for me when there are active efforts to undermine the policies of the NDP and probably the CoC.

Yours truly,

Herb Wiseman

Montreal area. To quote *The Globe and Mail* (09/10, "Cities struggling to keep up infrastructure" by Steven Chase): "Ottawa – The Montreal area overpass that collapsed less than two weeks ago was built in 1970s during Canada's Golden Age of infrastructure spending, when roads, sewers, and bridges still enjoyed pride of place in government budgets. New Investment on infrastructure grew at a rapid 4.8% clip annually between 1955 and 1977. What is unfortunate is we built and built without thinking we're going to have to maintain it, said Saced Mirza, a civil engineering expert at McGill University.

"But the postwar building boom tapered off in the late 1970s, matching a slowdown in economic growth that squeezed government budgets. And the former spending feast was followed by decades of famine that starved the funding available to replace aging infrastructure. Between 1978 and 2000, new government infrastructure spending grew at only 0.1 per cent a year."

However, here we must focus on the roots of the problem that, not surprisingly, escapes the reporter because these key aspects of the government balance sheet have been distorted or suppressed. The 1970s were the years when the deregulation of the banks to allow them to take over the other financial pillars was proceeding apace. By the latter 1980s our banks had been vastly deregulated and were up to their eyeballs in stock brokerage and merchant banking, and mortgages at home and far a field. By the late 1980s, Canada's banks as a group had lost practically their entire capital. To cover these losses, the Bank for International Settlements (BIS) brought in its *Risk-Based Capital Guidelines*. The securities of the governments of developed countries were declared "risk-free" thus requiring no additional capital for banks to acquire. The result was that Canada's banks increased their holdings of government debt from roughly $20 billion to $80 billion and were able to clip the coupons on that debt. To make that possible, federal debt was shifted massively from the Bank of Canada. For the government that was an enormously expensive change. When the Bank of Canada holds federal debt, the interest paid on it finds its way back to the government as dividends. It was partly for that arrangement that the Bank of Canada had been nationalized in 1938, three years after it opened its doors. When private banks hold government debt the interest paid on it stays with them. This was one of the two crucial ways of saving the banks from their crushing capital losses in the 1980s. There was another major measures that served the same purpose.

In 1991, the *Bank Act* was amended phasing out the statutory reserves over a two year period. These had required the banks to redeposit a modest percentage of the deposits it received from the public with the Bank of Canada on an non-interest bearing basis. This provided the central bank with an alternative to raising the benchmark interest rate for bank overnight loans to fight perceived "inflation," If the economy were deemed overheated, the BoC

Outrage Over Ottawa's Cuts

September 30, 2006

"Outrage over Ottawa's cuts" would not be limited to the opposition (as Jennifer Ditchburn, Canadian Press, said) if people understood that it was totally unnecessary and a waste of taxpayers' dollars to use the $13 billion surplus to pay down the federal debt. If the government were truly interested in "ensuring really meaningful tax relief for senior citizens and working families," it would not have done that.

You may ask, isn't it a good idea for the government to pay down the debt to reduce interest costs? Not if it has its own bank (which it does) from which it can borrow at near zero cost. All it needs do to reduce its interest costs is to transfer its debt, in gradual amounts, from the commercial sector (where it pays commercial rates of interest) to its own bank, the Bank of Canada (where its cost to borrow is almost zero). Had it transferred $13 billion of debt to the Bank of Canada instead of using tax payers dollars to pay it down, it would still have the $13 billion surplus for "ensuring really meaningful tax relief for senior citizens and working families." The fact that it chose to cut services instead of using its own bank to reduce the cost of its interest bearing debt shows that it is not so interested in the welfare of senior citizens and working families, as it is in the welfare of its corporate and wealthy friends.

Some people say that using the Bank of Canada in this way is too complicated for the "ordinary" person to understand. Really? It is no more complicated than an "ordinary" person choosing the bank with the lowest interest rate to get a loan.

The government will say that borrowing from the Bank of Canada will cause inflation, ignoring the fact that it borrowed from the Bank for 35 years (1939 to 1974) without causing inflation. For example, in 1950 the inflation rate was 2.8%, and while it rose and fell over the years it was never very high being only 2.9% in 1971 (just before the sudden increase in oil prices). One of the tools the Bank used to contain inflation was the statutory reserve which controlled the amount of credit the chartered banks could create. This was removed by the Mulroney government in the early 1990s and would have to be restored.

Paul Martin, as Finance Minister, received undeserved praise for reducing the deficit because he unnecessarily slashed programs and transfers to provinces, causing great disruption in the lives of thousands of civil servants and their families and in the lives of thousands of ordinary Canadians dependent on those programs. He had a choice. He could have used the Bank of Canada to carry some of the debt, which would have reduced debt servicing costs and the deficit. He chose not to.

The NDP lost a great opportunity to champion the ordinary person by pushing Paul Martin (and now Stephen Harper) to use the Bank of Canada instead of slashing programs, but it, too, chose not to, and even today is not pushing the government to do so. It is still seen as the "tax and spend" party instead of showing how investments in health care, education and infrastructure could be made without increasing taxes. The Green Party has a good policy statement on use of the Bank, while monetary reform and use of the Bank to finance public debt is one of the main goals of the Canadian Action Party.

How did we get to this sorry state of owing half a trillion dollars? From Confederation (1867) to 1974, accumulated net debt amounted to $18 billion, but by 1997 it had increased over 3000% to $588 billion. According to the Auditor general (1993) – and contrary to the impression left by Paul Martin – over 90% of the debt was *not* due to social programs but to interest charges. These charges accumulated *after* the government reduced its use of the Bank of Canada for financing its debt, relying almost entirely on private sector financing.

Richard Priestman
President, Kingston Chapter, COMER

had needed only to increase the statutory reserves and the banks' leverage in making loans on a given cash base decreased. To revive a depressed economy the statutory reserve could be lowered, and the leverage of the banks' loaning capacity on a given cash base increased and loans became more readily available to businesses and the public. High interest rates hit everything in the economy, and mostly the unemployed who could hardly be contributing to perceived "inflation." The reserves also provided more elbow room for federal loans from its central banks within the restrictions in force.

Our Banks are Bailed Out from Gambling Losses but Deregulated to Gamble Bigger if not Better

But the most amazing part of this chapter of our history is that the banks, who were bailed out so lavishly by the government, were immediately deregulated to enable them to gamble their heads off as never before. They were given precedence over our neediest citizens at the head of the official charity lines. To explain this odd phenomenon I would refer the reader to the writing of Duncan North, a US economic historian who concluded that when there is a massive change in the distribution of the national income, the old power group breaks up and new alliances who have achieved supreme economic domination take over politically as well. This fits many well-known political changes like a glove. Such changes of the ruling group occurred in Canada, the US and Mexico – where speculative finance took over and the banks were allowed acquire almost the entire stock brokerage business in Canada, a commanding position in Mergers and Acquisitions, credit cards, derivative boutiques and much else. They bloodied their noses in countries throughout the world where more often than not they were Innocents Abroad. The settlement of the CIBC out of court of Enron's suit against it for having played the lead role in the so-called "partnership" scam. For his part in the scam the Enron official who headed that operation received a reduced sentence of six years in the penitentiary for having turned state witness. This and the class action brought by Enron shareholders against the CIBC and two other of Canada's five large banks indicate that the banks will soon be back at the government's door for their next bailout.

To recoup its heavy costs in its bailout of our banks and funding their even more daring gambles, the federal government cut its grants to the provinces.

And the provinces passed on the compliment to the municipalities. These were left holding the bag. It should be noted that by the mid-seventies the proportion of the federal debt to the GNP that had reached 160% in 1946, had dropped to the mid-twenty percent. There is no way of understanding the drop in infrastructure production and maintenance programs without relating the timing of these developments to the deregulation of our banks and the introduction of Deregulation and Globalization that multiplied the pounding our ports highways, bridges and airports were taking due to the needless traffic that ensued.

A further point: the federal government may download maintenance and necessary investment to the provinces that do the same to the municipalities, but they cannot shake off the resulting problem. Everything in the land is part of the federal tax base whether it enters the federal budget or not. If not enough schools are built, even though it may have become largely a municipal responsibility, more penitentiaries have to be built, which come dearer than schools. The fatal gang shootings in Toronto must eventually concern the federal government

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Language *continued from page 1*

Foundation, but aim for at least a partial endorsement from the moderates in the environmental movement.

"Nice plan. Isn't working."

The PM's Sham Diversion

"To reduce urban smog, the Tories needed to achieve several goals all at once: to work with the Americans to establish continental targets for reducing harmful emissions from coal-fired generating plants. And they needed to toughen emission standards at home. But there was neither time nor sufficient political capital to achieve the first goal, while the second would decrease business competitiveness and require Draconian increases in the price of cars and fuel.

"And the electorate, when it isn't demanding cleaner air, is buying stupidly huge trucks while protesting against rising gas prices. The Liberals, to their sorrow, know all about this.

"Stephen Harper wants to be known as the prime minister who tackled smog. But nothing he has offered thus far suggests that, when it comes to fighting bad air, he is anything other than just another disappointment.

"However, his greatest misstep that concerns the environment, has to do with greenhouse-gas targets under the Kyoto Protocol."

In the same issue of the *G&M* ("PM plans 'intensity alternative' to Kyoto'" by Bill Curry and Mark Hume), we read: "Mr. Harper said his government will introduce next week its *Clean Air Act*, legislation that will trigger at least a year of talks with industry and the provinces to set mandatory reduction targets for pollution and greenhouse gases. But in responding to questions in Vancouver, Mr. Harper uttered a phrase that had the opposition fuming. 'We will produce intensity-based targets over the short range and long term and they will cover a range of emissions, not just carbon dioxide, but nitrous oxide, sulphur oxide, sulphur dioxide, and it will be a comprehensive plan.' It marked the first time the Harper government has said its plan to address global warming would be 'intensity-based.' This means industries would have to reduce emissions per unit of production, such as per barrel of oil. Lowering emissions per unit, however, does not mean that Canada's total output of greenhouse gases will decline. If, for example, there is an expansion in the oil sands, total levels of emissions would increase even if per unit emissions decrease.

"Such an approach runs contrary to Canada's commitments under Kyoto, which calls for the country's total output of greenhouse gases to decline. Last month's report from federal Environmental Commissioner Johanne Gelinas warned that, left unchecked, greenhouse gas emissions from Alberta's oil sands could double between 2004 and 2015. But Mr. Harper said yesterday technology improvements will ultimately reduce total reductions over the long term. He cited a recent federal report that says emerging technologies – such as injecting carbon emissions back into the ground – could reduce emissions by 60% in 2050."

In short, the PM is evading the issue with a plethora of "mays" and "mights" decades ahead. From this there is a lesson to be learned. Once a political leader has done a masterful job in evading one important issue, he forfeits his conscientious use of language in dealing with other key issues that may arise. He acquires, as it were, a forked tongue that wraps itself around the very words of the issue and twists language to cover up rather than to clarify. Mr. Harper's "intensity-based" emission programs warns us of what lies ahead with Mr. Harper in office. *W.K.*

and affect the flow of investment and the federal tax base.

That tax-base and the government credit are the only things behind our currency. And the condescending demagogy of our new PM as that of the previous Liberal one about paying down the federal debt ignores the fact that removing our paper money from circulation will merely raise the value of our currency abroad, push up interest rates and discourage exports and investment. The real debt that our government should be concerned about is the deficiencies in our physical and human infrastructures. What we are faced with then, is a planned crisis in government investment and maintenance that has its roots in a crisis of basic morality, social accountancy, if you will. Canada, if it persists in the Harper course, will become a completely failed democracy. A country deprived of its history, is doomed to repeat past mistakes on an ever greater scale.

In Calgary, for instance, the city is only now overhauling a downtown bridge first built in 1912. Mayor David Braconnier says the 94-year-old structure is among several bridges "literally ready to fall down."

"'In Calgary's case, 66 cents out of very tax dollar goes to the federal government, 29 per cent to the province and only 5% to the local level,' he said. 'That is a fiscal imbalance of epic proportions.'"

And then comes a passage that shows the disorientation that ensues when attention is focussed on priorities amongst public services, all of which are absolutely essential. Doing that distracts attention from the real question – "Where did the tax monies go?"

"Economists say changing political priorities are to blame. In the past 40 years, infrastructure spending was increasingly elbowed aside in federal, provincial and municipal budgets by ballooning demands for health, education, and social spending."

It is tantamount to rephrasing the question: Is it preferable to have people die of breast and colon cancer or having a century-old badly maintained bridge collapse under the increased traffic brought on by Deregulation and Globalization and NAFTA? The correct answer has not been given because it has been suppressed for that very purpose. The money that should have gone to both retaining the overpass bridges and the health system, had simply been allotted to the banks not only to reconstitute their lost capital, but to keep them in good supply for ever larger gambling incompatible with banking.

W.K.

Political Doctrine vs. Science in Economics

A professor of political philosophy[1] recently assigned graduate students to make a seminar presentation about the bearing of philosophy on a specialist discipline of their choice. After a particularly lucid and complete exposition on the "dismal science" the professor exclaimed dismissively that "economics is just the logical implications of a selected set of postulates and therefore can be no nearer to truth and beneficial application than the accuracy of the postulates. This makes it identical in form to philosophical systems generally, of which there have been many in the tradition of European thought."[2]

The suggestion that economic theory is a philosophical system, constructed by logic on a foundation of selected premises, casts doubt on its claim to be scientific. A recent paper by Michael Hudson[3] points out that contemporary mainstream economists "identify scientific theory with timeless generalities. The basic attitude is that logical consistency is the most important feature of economics, even when the underlying assumptions have little relation to empirical reality." The subject of his paper, Simon Patten,[4] examined systems of economic thought, particularly those of David Ricardo, Karl Marx and Henry George, with the intent "to show through his study that the premises on which each of these systems was based were only of transient validity." A few years later this transient feature of systems of economic thought was explicitly adopted and expanded by Edwin R.A. Seligman, a Harvard professor. In a brief chapter of his *Principles of Economics* (7th ed., 1916) Seligman showed how the economic thinking of major epochs in European history, beginning with the Greeks, reflects the physical and social circumstances of the times. Features of economic thought that were later considered to be essential and even obvious did not show up until changed circumstances made previous theories obsolete, redundant and inadequate to explain new conditions of life.

Patten's particular interest in this theme appears to have been its probable application to the new approach to economic reasoning that was becoming fashionable in the late 19th century (emergent neo-classicism). His contribution engages the attention of Michael Hudson through its implications for the history and functioning of monetary and financial institutions. That is the orientation that gives a unique flavour and emphasis to Hudson's perspective on the history of thought. His focus in the Patten paper is on important transformations in economic doctrine since Adam Smith. The core issue is unearned incomes, which turn-of-the-century commentators like Patten noted to be increasingly concentrated in the financial sector. An important emphasis in Hudson's applied work is that the FIRE (finance, insurance, real estate) sectors now overshadow the real economy, incorporating many tollgate features. The themes of transition and method in economics are enlightening background for that judgment and are illustrated with the concept of rent that is developed by Hudson in this Patten paper.

The thread begins with David Ricardo and continues through John Stuart Mill to Karl Marx and Henry George, then concentrates at the end on the marginalist revolution with John Bates Clark in particular and his intellectual opponents among the American Institutionalists (Patten especially). The seed for analysis of unearned incomes was planted by Ricardo. He was active in Britain when the industrial revolution was heating up. At that time and place it seemed natural (cf. Seligman) to assume that labourers were paid just enough to keep them alive and sufficiently healthy to work and reproduce. In that era, the most serious (or obvious) class conflict was between landlords and captains of industry. Ricardo reasoned that the value of goods should be the cost of what went into producing them. That was mainly labour (including the labour embodied in the capital used up in production) and therefore should equal the sum of subsistence wages paid. If the price of goods were higher than this "value," which was normally the case, Ricardo identified the excess as (mostly) a return to property – meaning land. He called this margin *economic rent*, and described it as accruing to owners of the most fertile soils. The rental element in price was a consequence of population growth and the need to use less fertile soils to produce crops. The price of grain had to cover costs on the least productive soils, so the common price created a premium for owners of the best fields. As population expanded, therefore, so did the average cost of keeping it fed. This meant that the costs of labour for the new industrial enterprises had to go up, making their products more difficult to sell in international markets. Furthermore, increasing prices for inputs to manufacturing, whether due to real scarcity of natural resources or artificially contrived monopolies (tollgates), would further erode profits, bringing investment and economic growth to a halt. The response by Ricardo to this dismal forecast was to urge free trade so that Britain could buy cheaper food abroad, while opening foreign markets to its manufactures. Its agricultural tariffs, the Corn Laws, were duly repealed in 1846.

While international free trade seems "fair" on the surface, it was actually a self-interested policy for Britain, as explained in Ricardo's analysis based on the assumptions described above, of decreasing returns to agriculture, increasing returns to industry, which were threatened by static productivity of labor combined with higher costs for its subsistence and increasing cost of inputs due to depleting natural resources and monopoly power over their prices.

It was also consistent with the laissez faire tradition following Adam Smith, which urged governments to stand aside on the premise that market forces by themselves would produce the most efficient outcomes.

This "classical" analysis became uncomfortable, first because of further thought about the implications of its assumptions and then, by some thinkers, replacement of those assumptions by more accurate revisions. Discomfort began within the classical school itself. As economists from David Ricardo through John Stuart Mill analyzed British land ownership and protective agricultural tariffs they concluded that groundrent and rising land prices were payments to landlords that were an "unearned increment" – unearned because they occurred without property owners having to expend any effort of their own. Prices rose due to economy-wide forces. This became an argument for nationalizing the land, or at least its rental income. Rentier income was a class phenomenon in Britain and other European countries. Most rent was taken by the landed aristocracy, the heirs to the original military appropriators and their legacy of feudal economic structures. This made the fight against rentier income largely a class issue. Hudson illuminates this point with a (1908) quotation from Patten:

The older thought assumed that for each kind of income there was a social class which was interested in its defense. The social condition of England at the time economic theory was formulated favoured this concept. The aristocracy held the land, the so-called middle or industrial class owned the capital, while the great mass of unskilled and politically unprotected labourers did the work. The essence of the Ricardian economics was an opposition to the aristocratic landlords, and it succeeded so well that an imputation of being unearned was put upon their income.

The Spread of the Rent Concept

Reformers subsequent to Mill took the idea of rent much further. Karl Marx identified another source of unearned income stemming from a power (tollgate) position. Acknowledging and endorsing the labour theory of value, he contrasted the subsistence wage paid to workers to the prices of the products sold by their employers. The difference or profit margin became an index of the degree to which wage-labour was exploited simply by being hired. (In Ricardo's analysis, workers generally were paid a subsistence wage, and some few lucky landowners captured the rent in the price of their crops. In Marx' analysis, the workers still received only a subsistence wage, and the profits were garnered by well-positioned or cagey industrialists – again a relative few, depending on the degree of tollgate power they had in setting the prices of their products.)

By the 1870s the combination of depicting groundrent and profits as being exploitative (especially monopoly profits, which technically were a form of economic rent) turned classical economics into an ideological threat to landlords and capitalists alike. Much to the embarrassment of economists, classical economics was being used to attack rather than promote society's vested interests. "If this new group of thinkers called themselves sociologists or historians they might be disregarded," Patten observed. But the social reformers "openly claim to be economists, and the worst of the matter is, they have…the mass of the older economists on their side. Nothing pleases a socialist or a single taxer better than to quote authorities and to use the well-known economic theories to prove his case."

This prompted a new school of economists to take a second look at the logic of classical value theory. They "soon realized that their favourite authors were not so perfect as they supposed, and that economic doctrine must be recast" to exclude logic that implied an exploitative character of industrial profit and the "unearned increment" that landowners obtained in the form of rent and rising property prices. A marginal-utility school arose to focus on the psychology of consumers, while attributing all income to the supposedly productive contribution made by its recipients rather than deeming any form of income to be unearned or exploitative. This new generation of economists stopped talking about property and its income, shifting the focus to consumer utility and depicting "time" rather than labour as the exploited factor in production. A related shift was to focus only on marginal changes, taking the existing distribution of property and organization of markets for granted rather than as subject to change. Public policy was left out of the analysis, exiled to the realm of political philosophy. Government was viewed as a deadweight burden draining the economy with taxes, as if these simply disappeared. Mainstream economists turned their eyes within, to become marginal utility theorists and even to mathematize marginal utility to an unparalleled degree.

The approach just described became "neoclassical" economics and originated with the "marginal revolution" led by the Englishman Jevons and the Austrian Menger. Different approaches to the "dismal science" implications of the classical analysis were taken by the German Historical School of economists, and following them, by a school called American Institutionalism. The historical approach emphasized dynamism in economic activity, implying development over time, as contrasted to the static assumptions that underlay Ricardian free-trade theory and laissez faire generally. These economists laid out the conditions for promoting industrial and agricultural technology rather than relying on virgin soil fertility and labour productivity as inevitable elements of increasing cost. This technological approach drew on the chemical view of soil fertility…to increase agricultural productivity, while introducing power driven capital to increase industrial productivity. The result was an analysis of potential costs under conditions of increasing returns in place of the more static Ricardian analysis based on diminishing returns at any given point in time. And in contrast to the laissez-faire doctrine, these economists argued that conditions outside of Britain were so different that government should take the lead in industrializing their nation. (Britain had a head start at industrializing, and its doctrine was a means to preserve and exploit it. This is explained fully in a 1992 book by Hudson on the history of theories about international trade.)

Simon Patten and other young Americans studied in Germany and were strongly influenced by the historical approach. Patten sought an even more far-reaching refutation of British economic thought by widening the range of economic analysis to provide a framework in which Britain and its economic categories appeared merely as a transition phase in a broader evolutionary logic of development. His framework depicted America not simply as an exception to the British rule but as part of the new dynamic of future evolution. Britain and the rest of Europe were invited to catch up to America by moving beyond their "pain-deficit" organization of class conflict into a "pleasure-surplus" economy under more democratic and forward-looking economic regimes. Rejecting the "one size fits all" outlook that assumed universal validity for British free-market economics, Patten saw that economies could organize their legal and tax systems, educational and social policy in a wide variety of ways. The upshot was a broader and more complex view than that which characterized anti-government free-market economics, especially the marginal-utility school that was replacing classical political economy.

But the "Free Market" is a Myth

Protectionist ideas in America had long controverted some fundamental assumptions of Ricardian economics, starting with that of the soil having "original and indestructible powers." Whereas Ricardo assumed fertility differences to be immutable facts of nature, the protectionists saw how the South's plantation crop exports depleted the soil, while the catch-up costs of introducing industrial technology rose as Britain extended its leadership as workshop of the world thanks to increasing returns in manufacturing. Rather than specializing and becoming monocultures, countries needed balanced industrial and agricultural growth. The Institutionalists used this observation to argue that it was British free-trade theory that was unscientific. It lacked empirical verification with regard to presumably fixed soil and labour productivity, and assumed as universal the sharp class divisions and subsistence wage levels that characterized 19th-century Britain. Furthermore, the foundation of the free trade doctrine was itself flimsy. British political economy urged governments to stand aside, on the premise that market forces by themselves would produce the most efficient outcomes. But what are markets, the institutionalists asked, if not carefully constructed arrangements that differ from one nation to the next and one time period to the next, shaped by tax laws, government subsidies, educational systems and the cost of public infrastructure. There is no such thing as a "free market."

Hudson notes that the logical consistency emphasis in mainstream economics depicts theories that endorse protectionist policies, government regulation or planning as "uneconomic" and even unscientific, simply by narrowing the scope of economics to universals. These timeless and "one-size-fits all" assumptions are hardly a guide for policy of specific countries at given points in time. Attempts to deal with countries abstractly are bound to strip away everything political, and hence are implicitly laissez faire. Recognition of the role played by institutional characteristics can hardly be dismissed as anti-intellectual merely on the grounds that it does not oversimplify by stripping away historical considerations and other elements of empirical reality.

Keith Wilde

1. Dr. N. Schwartz-Morgan, Royal Military College of Canada.

2. This judgement illuminates the lecture notes of Jose Ortega y Gasset (*The Origin of Philosophy)* that philosophical systems are subject to corrections over time, as the truthfulness of their premises is thrown into doubt by the march of human experience, including deliberate efforts of scientific investigation. Elements of persisting value are nonetheless incorporated in the new system that is emerging from the ashes of the old.

3. Dr. Michael Hudson, Distinguished Research Professor of Economics, Universities of Missouri at Kansas City and of Latvia in Riga, and policy adviser to the Government of Latvia.

4. Simon Patten, *Rent Theory and the Rise of American Institutionalism* (not yet published). Except for obvious editorial commentary, this article is excerpted from the paper with Dr. Hudson's permission.

A Restatement of the COMER Program

In the 18 years of its formal existence COMER has defended relevance of considerable original work of some of its own leaders, but also of the epoch-making writings of great economists on whose shoulders we stand. It has been an uphill battle. For what we have ranged against us is the systematic suppression in both the universities and the media of ideas that had long been recognized as the basis of our society's most fruitful epoch to make possible tightening domination of an ever narrower group of privileged finance. In our reporting we are adopting a new guideline: when the facts warrant it, we are going to emphasize specifically the teaching of which great forgotten economist would have prevented a given crisis from arising. And how our government's renewed recognition of their suppressed legacy could be of key help for society's survival today.

The great forgotten economist to whose resurrection we dedicate the following article on Europe's deepening population crisis is Theodore Schultz, whose work based on faulty forecasts of hundreds of economists sent by Washington to Japan and Germany at the end of WWII to predict how long it would take before those two formidable economic powers could resume their formidable power as exporters on the world market. In analyzing the badly mistaken forecasts – in which he had a part – Schultz reached the conclusion that the studies went awry because they concentrated on the physical destruction in these two countries, and missed the significance of the fact that their highly educated, skilled, and disciplined populations had come through this virtually intact. His conclusion that is being forced upon the world today: investment in human capital is the most productive investment a nation can make.

A Forced Recognition that Human Capital is the Most Productive Investment a Nation can Make

The Wall Street Journal (20/10, "Population Control: In Estonia, Paying Women to Have Babies Is Paying Off" by Marcus Walker): "Tallinn, Estonia – Pia Kurro sat cross-legged on her bed in a drab, Soviet-era maternity ward that smelled of detergent and old linoleum and breast-fed her two-day-old daughter, Syria, who owed her existence to state subsidies.

"In return for having the child, Ms. Kurro will receive the equivalent of $1,560 a month from her government for over a year, a lot of money in a country where the average monthly salary is $650.

"'I would not have had a baby without the support,' said the 39-year old business consultant."

"Mrs. Kurro embodies an increasingly urgent question: Can government policies aimed at raising a nation's birthrate actually work? The answer is vital to the future of the global economy. Like most developed countries around the world, Estonia has a critical shortfall of children that, if not reversed, will lead to a sharply aging and shrinking population. That will undermine economic growth and public finances as a dwindling work force struggles to support a growing pool of retirees who are living longer."

Inescapable Implications of the Schultzian Reality that the World is being Forced to Recognize

"A handful of developed countries, including the Nordic nations and France, have stable populations thanks to a long tradition of financial support for families. But for other countries in Europe and Asia that have already seen steep falls in birthrates, demographers have doubted that there was much that could be done, Governments agreed, making little attempt to boost their birthrates. Estonia stands out because it has made a dramatic shift, from laisser-faire to aggressive activism, in an attempt to alter its future.

"Estonia's wake-up call came in 2001, when the United Nations' annual world-population report showed that Estonia was one of the fastest-shrinking nations on earth, at risk of losing nearly half its 1.4 million people by mid-century. Estonia's fertility rate had collapsed to 1.3 in the late 1990s, down from 2.2 under communism only a decade earlier."

"In an attempt to stop that downward spiral, Estonia took a bold step: in 2004 it began paying women to have babies. Working women who take time off after giving birth get their entire monthly income for up to 15 months, up to a ceiling of $1,560. Non-wage-earners get $200 a month. The welfare perk – known as the 'mother's salary' – was a sharp about-face for the radically free-market government.

"'Step by step, the declining birthrate became a danger to the survival of the nation, so we had to do something,' says Paul-Erik Rummo, minister for population affairs and a member of the Reform Party in Estonia's ruling coalition.

"Since the adoption of the new benefits, Estonia's fertility rate has improved to 1.5. That's still below the 2.1 children needed to stop the population from shrinking (one child to replace each parent, plus some room to allow for child mortality). But the apparent early success has inspired the government to look at other ways of getting people to have more children – everything from subsidies to nannies to linking pension payments to the number of children one has.

"Many countries once loath to meddle in fertility matters, are concluding that they must take similar steps. 'The competing risk of doing nothing is too great – their future young labour supplies are going to be decimated,' says Peter McDonald, professor of demography at the Australian National University in Canberra.

"The fertility rate in the 30 countries of the Organization for Economic Cooperation and Development, the club of the leading world democracies, was only 1.6 in 2005, down from 2.4 in 1970. Mexico at 2.4 is the highest, with South Korea the lowest at 1.1. Demographers say the decline is due to fundamental changes in society. These include: greater economic opportunities for women; advances in birth control that have made reproduction a matter of choice, and the spread about individual happiness hard to reconcile with caring for a large family.

"Some European countries are experimenting with monthly cash compensation to women who leave work to have babies, including Lithuania, Austria and Slovenia. Starting next year, Germany and Bulgaria plan to pay new mothers benefits linked to their previous earnings. Russian President Vladimir Putin, who bemoaned his country's lack of children in his last state-of-the-nation speech in May, has also promised more aid to parents."

Now let us stop here to examine the tremendous implications of this response to the most basic economic facts no matter what theoretical hobby-horse the learned economics professors may be riding: (1) a disproportion between labour force and the retirees to be supported: a disproportion in potential consumers and the whiplash need to go on expanding by the free-market high-finance driven model. With a shrinking birth rate, high rents, property values, will cave in with disastrous results. The inevitable conclusion was implicit in Schultz's great conclusion in the 1960s: Human capital is the most productive investment a nation can make.

The word "can" must be replaced to "must" in the light of the new evidence. "But won't it unbalance the budgets?" Not if the expenditure on inducing women to have more babies is treated as it should be – as a capital investment, and the failure to make the minimal necessary for such purposes must be seen as a budgetary deficit. Indeed, the latter will grow beyond repair if you allow the situation to deteriorate to where the retired people outnumber the active population. That then is an extension of the Schultz law into accountancy. Since the European Union central bank imposes a 3% budgetary limit on its national members, it becomes a positive necessity to start treating the financial assistance to encourage more women to have progeny not as current spending but as investment. This time it must be picked up in the accountancy of the nation so that it will not be suppressed in the interest of the financial sector. (2) There must be adequate health care and education of the young generation to protect not only the investment already made, but to help develop the full potential of the scarce population. That implies a shift to a higher technology to the extent that it is possible throughout the economy. Such health and educational spending and social services must likewise be treated as investment and depreciated over their useful lives.

Central Banks must Finance Government Investment in Human Capital

Where is the money to come from? Not from private banks because the entire program is not market driven and has to do with the most elementary solvency of the national economy a generation down the road. Only the central bank – with the tax base of the nation behind it – can handle such long-term human investment.

Thus the excellent *WSJ* report must serve as a threshold for a series of further studies involving accrual accountancy in the treatment of the investment in inducing a higher birth-rate, to achieve a sound and prosperous future generation. That moves on from the resurrection of Schultz's great work to monetary reform in all its aspects. Accrual accountancy in human as well as physical government investments must not only be brought in, but explained in their fullest implications in the universities, parliaments, and the media. To initiate the process we cite a good source on Schultz's work in a footnote.[1] It is significant that we are reduced to referring the reader to a book published 35 years ago. The subject matter has never been so critical as it has become today.

William Krehm

1. Theodore W. Schultz "Investment in Human Capital," in Kiker, B.F. (ed.) University of South Carolina Press, 1971.

When Wall Street Hungers, Wall Street is Fed a Convergence of Follies

The Globe and Mail (16/10, "Ottawa eyes privatization of CMHC" by Heather Scoffield) reports:

"The federal government is quietly testing the waters about privatizing the national housing agency Canadian Mortgage and Housing Corp. – a move that could bring billions of dollars into Ottawa's coffers, but would also upset social-housing advocates and possibly cause an upheaval in the bond market.

"Observers believe that there is no chance it would take place before the next federal election."

It is a trait of our increasingly failed democracy to keep the important decisions under wraps, or until after the government has been safely re-elected. The masters of the financial world are served in the shadows.

"CMHC, a Crown corporation charged with making housing more affordable and accessible, is making about $1 billion a year in profit and is sitting on a $5 billion reserve of retained profits.

"Those reserves are expected to rise to $9.5 billion within four years, according to the agency's corporate plan.

"The riches have raised a big red flag and CMHC is facing pressures from all sides.

"Private companies – mainly US multinationals – are ready to rush into the lucrative mortgage insurance market that CMHC dominates.

"Social housing advocates and opposition parties want the excess reserves to be transferred over to fund more affordable housing.

"And the federal government has signalled that it wants out of the housing business altogether, arguing it's a provincial responsibility.

"The solution to these pressures, sources say, could be privatization, selling the commercial parts of the agency to the private sector and keeping the social housing parts of the corporation within government.

"'Trial balloons are being floated around and can be traced back to Finance Minister Jim Flaherty's office,' one Bay St. source said."

This is the routine when some important government asset is being relinquished. It happened with the ending of statutory reserves and it will continue being the routine until the electorate makes it clear that without timely information our parliamentary process is a charade.

"The Crown Corporation was created in the 1940s so that the state's access to cheap capital could be leveraged to make mortgages and home ownership affordable for most credit-worthy residents." The reference to "cheap capital leveraged" for the purpose clearly refers to the use of the Bank of Canada nationalized in 1938. The nationalized central bank came to be used to finance inexpensive housing in the immediate postwar decades in a way that transformed the life style and prosperity of the land.

The Folly of Privatizing Revenue-creating Institutions to Coddle Bankers

"CMHC now has four divisions: affordable housing; aboriginal housing; mortgage insurance and securitization.

"The first two divisions depend on government funding of about $2 billion a year. The mortgage insurance and securitization units are run like commercial operations, and that's where CMHC makes all the money. (The government does not let the agency cross-subsidize from one unit to another so that the mortgage insurance and securitization divisions are truly commercial.) About 96% of the agency's profit comes from mortgage insurance. CMHC controls about 70% of the country's mortgage insurance with the other 30% held by Genworth Financing, a US-based multinational formerly known as GE Mortgage Insurance Canada.

"The duopoly in the lucrative mortgage insurance market will officially come to an end this week. A change in rules earlier this year means that new entrants will be able to enter Canada's mortgage insurance market if they get approval from federal authorities, and now at least three US-based companies are lining up to do so."

Under NAFTA US companies obtaining entry into the lucrative field of mortgage insurance will be able to sue the Canadian government forever retracting its license. Rather than applying the profits from CMHC's lucrative mortgage insurance operations leveraged through the Bank of Canada to fund its affordable and aboriginal housing, it is a betrayal of our national interest to alienate these operations to foreign lenders. Then we will be told that we cannot afford to find the funds without upsetting our budget to provide housing for our own citizens.

"While CMHC's securitization division doesn't make the agency much money, it is a key player in Canada's bond market. CMHC issues government-backed bonds based on pools of insured mortgages, and has become one of the largest bond issuers in the Canadian market. In 2004, it issued almost $30 billion in mortgage-backed securities.

"With liquidity in sovereign bonds decreasing as governments pay down debt, investors increasingly rely on CMHC's securities for government-backed bonds. From the standpoint of the national interest there is thus a convergence of folly in paying down the federal debt and allowing private or foreign insurance companies to take over the CMHC insurance functions.

"But the existence of CMHC is an anachronism in today's competitive environment, argues Derek Holt, chief economist of the Royal Bank of Canada."

Before the government proceeds with the privatization of the great depression-born reforms relating to housing, there should be a thoroughgoing examination by a Royal Commission of the use made by banks of the bail-out funds they received in the early 1990s. And of the bounty extended to the banks by the Bank for International Settlements – sponsored Risk-Based Capital Requirements that allowed our banks to load up with an additional $60 billion of government bonds without putting up any money of their own; and the phasing out of the statutory reserves that had provided an alternative to high interest rates against perceived inflation. This, of course, would include the involvement of three of our five largest banks, including Mr. Holt's Royal Bank in carrying out the trade scam which sent one of the Enron executives to prison for six years, and led to the settlement out of court of the CIBC of the suit of the Enron shareholders against it to the tune of $2.4 billion US.

"CMHC's president, Karen Kinsley, argues in defence of her agency. About one third of CMHC's insurance customers are people or organizations that the private sector won't touch, she said." *W.K.*

The Cover-ups of Economic Theory

The following article, which first appeared in Economic Reform *of December, 2000, will be included in the second volume of* Meltdown *to be published early in 2007.*

We will get nowhere in understanding and managing our ever more complex economy unless we come to terms with the flaws in our theory. From its origins it was partly an attempt at a science, partly an essay in advocacy. Periodically it was taken over by dynamic new interests engaged in conquering space for their new agenda. To accomplish that, they had to examine the claims of the establishment that blocked their way. That was certainly the case with writers on economics in the 18th and 19th centuries.

A limited democracy where the disenfranchised were still illiterate allowed economists ample room for their philosophizing. It could be compared to the free gossip parents indulge in when their young ones have been put to bed, though here the situation was that society's lesser members had still not awakened.

That is how the labour theory of value could acquire so great a following. But by the early 19th century mechanics' institutes had arisen and literacy was making forward strides amongst workers at the very time that the horrors of industrialism were an open book. Economics accordingly developed its own trenches and barricades, and came to cover up as much as disclose. The labour theory of value achieved it most cutting edge in the hands of a stock broker, David Ricardo, who was most concerned with repealing the Corn Laws – a goal that was finally achieved in 1846. They had benefited the landlords and kept food prices and wages very high.

Ricardo, however, was not particularly concerned with the injustices of the free market. Marx and other socialist writers seized upon his "labour theory of value" as a windfall, but deduced from it the "contradictions" of capitalism itself. Ricardo himself had had no quarrel with the view of his friend T. Malthus that wages of workers were pretty well determined by their incontinence. Raise their wages, and the resulting in the size of families would soon drag them down again to barest survival level. However, the fact that even a stock broker could espouse the labour theory of value and polish it to a high gloss helped the socialists in their conviction that their version of economic theory was science in its purest, final form.

Faced with the mounting militancy of an increasingly literate working class, the propertied classes went into a beleaguered mode. This had two aspects. They rallied to academics who replaced the prickly reality of class warfare with an embracing category of traders. That was a tall enough order and could not fly without a large input of some of the high intellectual technology of that day – differential calculus. Since admission to universities was a lot less widespread than today, establishment economists in fact shinnied up the literacy pole to keep ahead of the workers' new reading skills.

Shinnying Up the Literary Pole

The notion of a single self-balancing market brought in by marginalist theory saw all classes from princes to miners as simply traders striving to maximize their satisfactions by weighing the wages and other prices offered them against the delights of leisure in their parlours. In this view involuntary unemployment simply did not exist: what was mistaken for it was a simple trading decision. If workers were prepared to work for the wages offered, there would be no unemployment. Overproduction of unsaleable goods? Nonsense. All the producers had to do was lower their prices and that market, too, would always clear. So what was the problem?

There were in fact two problems. The first was bringing the infinitesemical calculus to the rescue. One of its two quite independent authors was Isaac Newton who deduced it from the binomial theorem that he had discovered in his youth, and we all learned in high school. If you increase variables by infinitesimal (or by *marginal*) amounts, you can as a first approximation ignore higher powers of the increments which are themselves of infinitesimal size. Newton used the technique to analyze the data obtained the empirical observations of Kepler that the planets moved in closed orbits.

But to avail themselves of the prestigious calculus that economists mistook for scientific credentials rather than just one of the many mathematical tools, they had to assume an economy that also moved in closed orbits, i.e., was self-balancing. In essence they cooked the books to be able to adopt a method they had set their hearts on. The assumptions that this called for were hardly short of the heroic. All actors in the economy were taken to be of such negligible size that anything they did or failed to do individually could have no effect on price or the economy. Then, too, these negligible actors had no other information than the price of the last transaction. They went on producing until they broke even on the last unit produced. That, however, is easier said than done. How would they know that they had arrived at the last unit on which they just broke even? Even today with computers all over the lot, most producers, small, medium or large, know what they have earned or lost only when their accountant tells them months after their year has closed.

Obviously all this belonged to a dream planet that had nothing in common with the world of 1871. Applied to the world of Bill Gates, it is arrant nonsense. Nevertheless it is the foundations of just about everything taught about economics in our universities today.

The transformation of all active citizens into traders moved the centre of gravity of the economy from the workshop to the counting house, from industrial to financial capital. It introduced a degree of abstraction that was to be pushed up endlessly in our day. It set the scene not only for the development of derivatives of ever higher order, but for the concept of a world money market where capital is free to roam without hindrance and regardless to the consequences for material production. It doomed industries that produced useful goods and services to become the dice of the grand game rather than the deciding players.

The other great problem in this transformation was the need to assume an ever-clearing market, essential to the self-balancing concept, on an ever grander scale. Yet with the passing of each year that market was producing ever deeper crises with disconcerting regularity. Even in the mid-19th century, the deepening crises were being traced to the inescapable need of capital to expand, but at the same time to keep down the purchasing power of society.

The climax, triggered by the Wall St. crash of 1929, produced breadlines snaking around city blocks. Borrowers didn't dare borrow and lenders didn't dare lend. The government eventually realized that it had to step in and do what was unspeakable in terms of the self-balancing, self-clearing market – provide enough relief and investment to start the economy functioning again at a cringing level. The clash was between an economy that must ever expand under the lash of greed, but also beggar the mass of producers. That leads directly to the ultimate immorality of non-disclosure.

The Crimes of Non-disclosure

Non-disclosure has dominated the US political scene during much of the presidency of Bill Clinton. And certainly overshadowed just about every other issue in the Bush-Gore presidential race. In the one instance it had to do with the outgoing president's backstair romances, and with Bush's cover-up of a drunken driving fine 24 years earlier. But surely the silence about the entire corpus of free market theory resting on the purest fictional assumptions should take priority in our concerns for buried crucial facts. Surely suppressing all awareness of that in our universities and government is more flawed morally than whatever the President may have done with the young lady of his passing fancy, or George W. Bush's silence about his drunk driving conviction.

RENEW TODAY!
(SEE PAGE 2)

Should a building contractor pour the concrete for the footings for a structure an inch less thick than specifications, he would be risking serious legal trouble. But what has been suppressed in the case of the free-market dogma is that well-endorsed simplifications like "leave it all to the market," and "balance the budget every year," and "pay off the debt" send our policymakers shopping for major disaster. And when eventually it strikes, society is left helpless not only without an economic theory that can stand up under the most elementary examination.

William Krehm

More Knuckle-dusters in the Offing on Wall Street?

As lower interest rates recede into the hazy background, the relationship between lenders and borrowers is becoming visibly less gentlemanly. *The Wall Street Journal* (12/10, "Debt-Buyers vs. The Indebted" by Henry Sender) reports: "A potential battle is brewing between two groups of Wall Street's most powerful players – private-equity firms and hedge funds.

"Both raise their money from well-to-do and from large institutions, and promise their investors outsize returns for hefty management fees. But they tend to have different angles on the gobs of debt that trades in financial markets.

"Private-equity funds tend to borrow money to fund takeovers of companies they hope to turn more profitable and sell for a gain. A new generation of hedge funds have started to buy debt and trade it. Right now that makes the two groups happy partners in a buyout boom. But this harmonious relationship could dissolve into a showdown if the economy turns sour.

"As increasingly important holders of, hedge funds are playing a more pivotal role in the reorganization of companies that have gone bankrupt, which could put them on the other side of the table from the private-equity firms behind indebted companies.

"'It's not like in the old days when banks held most of the debt,' says John Danhaki, founding partner of Leonard Green & Partners, a private-equity firm with $3.7 billion under management. 'You don't know who the lenders are and whether you can get waivers if you need them. Hedge funds can blow up your company.'

"Concerned about the possibility of showdowns, some private equity firms are preparing for the day when their portfolio companies might stumble into the hands of aggressive creditors. Their tactics vary. In some cases they're reaching out to lenders. In others, they're doing everything they can to avoid them.

"At this point no major blowups have happened to test both sides, because interest rates are low and the economy relatively strong. But signs of tension are building, in some cases exacerbated by the different time horizons of the two groups – private equity tend to be long-term players, while hedge funds tend to shoot for quicker gains."

Hedge Funds — Finance Capital at its Most Aggressive

"Some private-equity firms have taken the unusual step of telling bankers who make loans and sell them to hedge funds that they want to choose who holds the loans on a name-by-name basis. Some – including Appollo Management LP – have tried to exclude specific hedge funds known to be tough negotiators from deals. In some cases thy have also used side letters in their loan agreements to bar those firms from the right to vote if they acquire the debt in the secondary market.

"Bond investors have played an important part in the reorganization of bankrupt firms for decades. The emergence of hedge funds in the game began a few decades ago. At the time, it was practically unheard for a hedge fund to replace a bank in such potentially contentious proceedings. Private equity firms considered banks predictable and friendly in a restructuring while hedge funds could be more antagonistic.

"While hedge funds are becoming increasingly important partners of debt, private-equity firms are becoming increasingly important borrowers. Of the total $366 billion raised in the loan market for non-investment-grade companies this year, $165 billion went to the portfolio companies of private equity firms, says Standard & Poor's.

"Right now, there aren't many blowups. In the past 12 months fewer than 2% of companies with below-investment-grade debt have defaulted, an unusually low number. With the notable exception of the troubled automobile sector, corporate balance sheets are unusually strong. That gives private equity firms an advantage in debt negotiations for now. [But] Mr. Danhaki says trouble could be brewing. 'Many companies recently purchased by buyout firms are burdened with significantly higher levels of debt than they ever were in the past,' he says.

"The debt itself is widely diffused among lenders, meaning the dynamics of bankruptcies are bound to be different, if they do start to rise. But if the economy falters, or if interest rates move higher, the benign environment could change quickly. And the showdown could begin."

Through the economy there is a grim sense of tougher developments in the offing. What is sorely lacking is serious curiosity why that need be. *W.K.*

Underlying the Irrelevance of Monetary Theory

The following article, which first appeared in Economic Reform *of December, 2000, will be included in the second volume of* Meltdown *to be published early in 2007.*

Marginal theory was crafted towards the end of the 19th century to present a world rent with social discontent in the best possible light. All participants in the economy were viewed just as traders. Each studied the price of the last sale of whatever he had to offer and decided whether it would increase his satisfactions making the sale. With everybody thus redefined as traders, the market became coterminous with the economy. No need worrying about the horrors of the work place, so dramatically portrayed by Emile Zola. Automatically the market would take care of all that sordid stuff, and it could be left to Cambridge dons to work out the details. Economics was reduced to one great euphemism that could keep social discourse polite if irrelevant.

Certain difficulties arose in linking this doctrine to the real world. To apply differential calculus, which was the purpose of the operation, producers were assumed of such negligible power and size that nothing anyone of them did or left undone could possibly affect the market. They had no information other than the price of the last sale. And they went on producing until they just broke even on the last unit sold. But how did they determine that? Leon Walras who gave marginal utility its most rigorous mathematical form, got around this little problem with panache.

He had his traders "cry" their wares and conclude provisional transactions at provisional prices. For these provisional prices they receive provisional certificates ("bons"). But once the last sale has been made and the true "break-even" price established, all previous sales were adjusted to this final price (*Éléments d'économie politique pure*, Lausanne, 1900, p. 215).

But why bother with such nonsense? For good enough reason. It is built into the genes of our "leave it all to the market" thinking and inevitably, unless exposed and uprooted from the model, will show up in the most advanced, supposedly high-tech patterns of our business world.

Take for example the article in *The Wall Street Journal* (8/11) "How Shifting Prices in PC Business Undid Top Dealer InaCom" by Gary McWilliams: "The final chaotic hours of InaCom capped one of the wildest rides in PC history. During an industry growth spurt in the 1990s, the Omaha company gobbled up rivals, becoming a Goliath with $6.9 billion in revenue. It applied PCs and revenue services to a third of America's biggest companies.

"But as PCs changed from an adolescent business to a mature one, InaCom was left by the wayside. Several large PC makers, trying to match Dell Computer Corp.'s astonishing direct sales success, began to deal directly with customers themselves. [They] created a Byzantine two-tiered pricing scheme that crippled longtime partners such as InaCom.

"InaCom found itself in a tangled financial mess. Its auditors never signed off on its 1999 numbers or on a restatement of its 1998 results.

"A bankruptcy judge in Delaware is liquidating what remains of the business."

A Universe of Soft Dollars

A list of those stung by the misadventure reads like a blue-ribbon roster of the industry. "Warburg Pincus Capital LLC had a 24% stake in InaCom, once worth $230 million and now worthless. Hewlett-Packard Co. says it is out $28M. Compaq Computer Corp. has traded lawsuits with InaCom – the PC maker seeking $102M of allegedly misdirected customer payments, and InaCom claiming Compaq withheld $43M in service payments.

"[The company that became] InaCom started in the early 1980s putting computer terminals in the offices of irrigation dealers. From there it branched into providing computers to farmers and other small businesses. Wm. L. Fairfield, who founded the business, recognized PC manufacturers' obsession with ever increasing sales. The more PCs they make and sell, the more cheaply they can buy parts such as chips and disk drives. And by lowering their costs they can reduce the price of their computers, hoping to sell still more of them. To keep this treadmill rolling, PC dealers gave dealers bonuses known as 'soft dollars' for achieving sales targets and market share increases.

"The soft dollars were almost pure profit to the dealers, fattening their earnings. But the system became a trap as dealers came to rely on soft dollars. Pressed to keep their own prices down, dealers sometimes sold PCs at cost or barely above, depending on the manufacturers' bonus payments for their profits."

"It was in fact a parallel currency. And significantly even the name suggests a source of corruption parallel to what 'soft dollar' contributions have produced in the political arena.

"Mr. Fairfield sums it up: 'The soft dollars were a narcotic that caused you to do unnatural acts.'" And what interests us more is that they bring to life the nonsense of the provisional prices "cried" and the "certificates" provided to be withdrawn when a final price went into effect.

The "computer soft dollars" were not really there to rely on. Dell didn't sell through dealers but directly to the businesses that wanted the computers. Burdened with neither inventories nor dealer markups, Dell could underprice others by as much as 15%. To face the price threat, Compaq, Hewlett-Packard and IBM started to curtail their system of soft-dollar bonuses to dealers. In its place, a new crazy-quilt pricing system emerged.

"Under this system, when danger arose that Dell could sign a large company's business, Compaq and the other would make a 'special bid' setting a price for that particular company below even the wholesale cost. The dealer had to deliver the goods. Then to recoup the difference in official and effective wholesale prices, the dealer had to apply to the manufacturer for a rebate.

"That demanded good bookkeeping. Sometimes manufacturers made more than one special bid. Some of these might be in writing, some less formal.

"Although dealers had to file the rebate requests promptly, PC manufacturers had 90 to 120 days to process the claims and pay them. Moreover, manufacturers routinely rejected claims, citing missing or inaccurate serial numbers. Then it might take three or four months before the claim was accepted or again rejected. InaCom had a hard time staying on top of all the paperwork. Its initial claims were rejected 60% of the time. Meanwhile, the old soft-dollar system continued to fade. InaCom collected only $90M of such bonuses in 1999 down from $200M in 1998."

The moral? Not that truth is stranger than fiction, but that much economic truth has *become* fiction.

William Krehm