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A Harper Posy

At least there is this to be said for our Prime Minister. He does not keep you guessing about where he is headed. In a single day he offered us the following moral thumb prints. In *The Globe and Mail* (29/06), we could read:

On page A4, "Top bureaucrats take aim at Ottawa's diplomats" by Alan Freeman, Ottawa: "Canada's diplomatic service has been served marching orders to better 'align' its work with the Harper government's priorities and make sure it is 'attentive' to the government's needs.

"The directives, included in e-mails from the Foreign Affairs Department's top bureaucrats to all employees at home and abroad, disclose the Harper government's three priorities in foreign affairs: Afghanistan; North America and the hemisphere; and emerging markets, focusing on China and India.

"The directives, obtained by *The Globe and Mail*, come at a time when Mr. Harper continues to complain that Canadian diplomats are ignoring the government's foreign policy directives. According to published reports he lashed out at the foreign service at a June 15 closed meeting with ethnic media representatives in Toronto.

"The bureaucrats make no reference to the role of Foreign Minister Peter Mackay or his office, a telling omission since it is widely perceived in Ottawa that Mr. Harper and Clerk of the Privy Council Kevin Lynch have taken over foreign policy formulation.

"Mr. Mulroney, the government's bureaucratic point man on the Afghan mission, was previously the Prime Minister's foreign affairs adviser.

"Some department officials have grumbled about the government's fixation on the Afghan mission and its decision to scrap long-held priorities like aid to Africa and relations with Europe. This realignment of missions is expected to lead to closings

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Harper *continued from page 1*

and downsizing as the government cuts $40-million from this year's Foreign Affairs budget."

Strange, indeed, in a Globalized and Deregulated world.

And on the same page there is another item: "Tories turn to Deutsche Bank on sale of federal buildings" by Jeff Sallot, Ottawa, from which we quote:

"The federal government is hiring Deutsche Bank to provide independent advice on the financial wisdom of a controversial plan to sell nine big office buildings and lease them back from private owners."

The idea of retaining a German bank to "crunch the numbers" and advise our government whether to sell to private buyers key buildings in main cities and then lease them back is so ridiculous, that you rub your eyes in disbelief. The pretext was that the buildings require considerable expenditure to be brought up to scratch. But that could be financed with the Bank of Canada, which has had only a single shareholder since 1938 when the Liberal government of William Lyon Mackenzie King bought out 12,000 private shareholders. And that being so, virtually all the interest the federal government pays on loans from the Bank of Canada, comes back to it as, a jolly capitalist institution less, of course, some minor handling expenses. Moreover, since 2002, when the federal government after weeks-long rows with its Auditor General of the day, finally agreed to bring in "accrual accountancy" – also known as "capital budgeting" – and stopped treating spending for the acquisition of capital assets as current spending like shoe polish. Financing of maintenance on government buildings should be readily financed through the central bank on a virtually interest-free basis. That would enhance the value of the government's assets – just as the non-maintenance of government buildings would have to be entered as more capital debt.

So why would our Prime Minister feel obliged to ask the opinion of a German bank which is bound to be a needless extravagant way of handling government funds?

The 1938 nationalization of the Bank of Canada by a Liberal government allowed our government to finance a greater proportion of its costs in fighting in World War II than the US or the UK financed through their central banks which at the time were still privately owned. To be exact some 16% of the total costs of that war to Canada. It is incredible that a supposedly sophisticated and highly patriotic PM would not even consult the laws of his own country and the history of his own land before deciding so elementary a matter.

On the front page of the same issue of the *G&M* we read, "PM under fire for backing US version of climate plan" by Brian Lagin, Ottawa, and Karen Howlett, Toronto: "Stephen Harper was accused yesterday of giving George W. Bush cover in a US effort to water down a new international agreement on climate change.

"The PR faced criticism for remaining non-committal whether Canada would support a proposal being forward by Germany for a post-Kyoto agreement when the industrialized G8 nations meet in Germany next week. That lack of commitment was giving Mr. Bush the opportunity to deflect pressure from other countries that want a deal done, critics said.

"'The German presidency is insisting that the final declaration includes mandatory targets to reduce greenhouse gasses, but the Bush administration is opposing this,' Liberal Leaders Stephane Dion told the House of Commons. 'We want to know whether he will put his foot on the gas, or on the brake.'

"For his part, all Mr. Harper said yesterday was that he wants to act as a bridge between the nations that support the German proposal and other countries, like the United States.

"Five other major countries – China, India, Brazil, Mexico and South Africa – will also be part of next week's discussions.

"The Germans want an agreement that would limit the rise in average temperatures this century to 2 degrees Celsius and to cut global emissions by 50% below 1990 levels, as well as raise energy efficiency in power and transport by 20% by 2020.

"The countries are also trying to agree on whether to hold a major meeting in December in Bali to start developing a successor to Kyoto, which runs out in 2012.

"In Toronto yesterday, Environment Minister John Baird told reporters, after a closed-door meeting with his provincial counterparts, that he supports the European-backed proposal to reduce greenhouse-gas emissions by 50% by 2050. Mr. Baird uses a base year of 2006 for the reduction, not a base year of 1990. Canadian emissions are up more than 25% since 1990.

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The Big Lie

Budget-time is the time of the Big Lie which requires even bigger lies as cover-up. To celebrate this strange harvest brought in by Canada's new minority government, *The Globe and Mail* (24/02/06, carried a "Fiscal Health Report: The Past 20 Years on Canada's Ever-changing Bottom Line" by Heather Scoffield). It began by citing the importance of the year 1995 in the lives of two prominent politicians – one on the right and the other on the left. A charming journalistic device, but hardly enough to make up for Ms. Scoffield – who clearly had no choice in the matter – not mentioning the root cause of the slaughter-year for social programs that 1995 became. Filling in that omission will lend relevance and continuity to Scoffield's tale.

"February 27, 1995, was a fateful day for both Alexa McDonough and John Manley. The two politicians sat on opposite sides of the political spectrum, but the federal budget that was delivered that day 10 years ago was a thunderclap for them both. The 1995 budget would go on to define not only the careers of two politicians, but also a decade of fiscal policy, the economy and political culture of the country, and the public persona of Prime Minister Paul Martin himself."

Two Different Tales

But how different is the story recounted by these two politicians from the opposite side of the political spectrum. For one, Ms. McDonough who became the leader of the leftist NDP, the budget of 1995 was a disaster smashing social programs that it had taken generations to put in place. For the rightist, Liberal Manley, disaster was the unknown sudden causes of the deficit that made it necessary to do the remorseless dismantling of what had become a hopeful way of life.

But something is missing in either version of the fiscal catastrophe that made the extraordinary measures necessary and heroic in Mr. Manley's telling, heartless in the version of Ms. McDonough. It was as though some unknown astral body had hit the earth and wiped out forests and even species. Passing from metaphor to literal reality, the hidden catastrophe changed the face of Canadian politics, the pulse and purpose of our democratic process. So great a gap in the telling that starts with the response to the catastrophe rather than with the nature of the trauma is too upsetting to be glossed over. The contrived silence on this crucial happening itself provides a measure of its enormity. That is why we must begin by filling in that disturbing gap.

During the 1980s Canada's banks had been allowed to leave the restraints, in place since the Depression of the 1930s, that Roosevelt had imposed on American banks. Of these 38% had already gone bankrupt and many others were rapidly approaching that fate. The emergency bank legislation enacted in the mid-thirties set up fire walls that separated banks from the other three pillars of the financial system – the stock market, insurance companies, and real estate financing. Each of which had a pool of liquidity essential for its own business that, however, proved irresistibly tempting to deregulated bankers, given the essence of banking – a cheque-clearing system that allowed the creation of a high multiple of the cash that banks actually had in their coffers.

That is what brought on the credit boom on Wall St. and when that bubble burst in October 1929 ten years of deep depression ensued. The depression in turn led to the regimes that brought on World War II. The banking crisis of the late 1980s was very much a replay of what happened in 1929 but on a vastly greater scale. It arose from their shattering losses in gas and oil, real estate and other gambles. This changed the nature of the world financial system – so drastic that it has brought back our banking to the undisciplined regime that led to the Great Depression. That is why two party leaders' accounts like those of the *Globe and Mail* story are but a stump of the full story of how everything learned at stupendous cost in the Great Depression has been forgotten. Worse still, it has been declared unmentionable.

Resulting Changes of Career

Never had the world paid so high a price in needless beggary followed by six years of what then seemed high-tech butchery. But the lessons they brought us of how to run a more humane world was the priceless result of all that sacrifice. Since then all memory of these lessons has been erased and buried, expunged from our textbooks, declared never to have happened.

Let us resume the *Globe and Mail's* account of Paul Martin's final touches in completing this undoing of all these tragically bought lessons: "It allowed Ottawa to eliminate the deficit and turn around Canada's international reputation so quickly that other countries sat up and took notice. It also cut into social programs so deeply that some of them have yet to recover.

"For Ms. McDonough, who was abandoning her 14-year career in Nova Scotia for development work in Africa, the 1995 budget was a personal watershed. She had travelled to Toronto for an evening stint as a television analyst for the Martin budget. That night, as she faced conservative commentator Ted Byfield on television, she concluded on the spot that she should change her course. She decided to scrap Africa and leap into federal politics to fight Paul Martin's budget plans.

"Mr. Manley took the budget personally, too, even though he was on the right side of cabinet along with Mr. Martin. As minister of industry at the time, he saw his departmental budget cut by an enormous 50%, and had to lay off 25% of his work force. Programs he considered integral to Canada's competitiveness were among the casualties."

A Living Document

"For both politicians, the 1995 remains a living document, even 10 years later. For Ms. McDonough, it worsened the disparity between rich and poor, butted the healthcare system and made sure the homeless stayed that way.

"Mr. Manley, however, swallowed his departmental loyalty and bought into the 1995 measures. Ten years later, he, like many Liberals, points proudly to the budget as the dramatic move that corrected Canada's oppressive fiscal drift and led the country into a prolonged period of prosperity. It was the budget, he said, that dragged Canada out of the doldrums and restored confidence for the 21st century. It got us credibility,' Mr. Manley said."

These two leaders were unhappy about what was inducing Mr. Martin to bring in his anti-social budgets, but neither reached down to the root causes of this overturning of the great social heritage that had come down from the sacrifices of the Depression and the War. That is why these are back to haunt us today.

W.K.

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Confirmation from the Horse's Tonsils

The origins of Wall Street's tight rope walk between the subprime mortgage crisis and the takeover boom is pure high tech and low morality. *The New York Times* tells part of the tale (23/03, "The Subprime Loan Machine" by Lynnley Browning): "Edward N. Jones, a former NASA engineer for the Apollo and Skylab missions, looked at low-income home buyers nearly a decade ago and saw an unexplored frontier.

"Through his private software company in Austin, TX, Mr. Jones and his son Michael, designed a program that used the Internet to screen borrowers with weak credit in seconds. The software was among the first of its kind. By early 1999, his company, Arc Systems, had its first big customer, First Franklin Financial, one of the biggest lenders to home buyers with weak, or subprime, credit.

"The old way of processing mortgages involved a loan officer collecting reams of income statements and ordering credit histories, typically over several weeks. But by retrieving credit reports online, then using logarithms to gauge the risks of default, Mr. Jones's software allowed subprime lenders like First Franklin to grow at warp speed.

"By 2005 at the height of the housing boom, First Franklin had increased the number of subprime loan applications it processed sevenfold, to 50,000 every month. Since 1999, Mr. Jones's software has been used to produce $450 billion in subprime loans."

High Tech and Low Credibility

"The rise and fall of the subprime market has been told as a story of a flood of Wall Street money and the desire of Americans desperate to be part of a housing boom. But it was the little-noticed tool of automated underwriting software that made that boom possible."

In a sense the technology that was supposed to have been the magically efficient tool took over and became the master, with Wall Street sinking to the tool role. "I spawned an array of subprime mortgages, like those that required no down payment or interest-only payments. The software effectively helped move what was a niche product into the mainstream.

"Automated underwriting is now used to generate as much as 40% of all subprime loans, according to Pat McCoy, a law professor at the University of Connecticut.

"The software itself, of course, cannot be blamed for lowered lending standards or lax controls. But critics say the push for speed influenced some lenders to take shortcuts. During the housing boom, speed became something of an arms race, as software makers and subprime lenders boasted of how fast they could process a loan. New Century Financial, second to HSBC in subprime lending last year and now on the verge of bankruptcy, promised mortgage brokers on its Web site that with its Fastqual automated underwriting system, 'We'll give you loan answers in just 12 seconds!'"

From Software to Soft Morality

"Dozens of little-known software companies compete with Arc systems. With small staffs, they typically sell their software to home lenders with vast networks of call centers employing hundreds of thousands of loan officers. Some big Wall Street banks and housing lenders bought the software, then developed their own systems. First Franklin, which has been acquired by Merrill Lynch, said that it stopped using Arc last year to create its own proprietary system.

"A 2001 Fannie Mae survey found that automated underwriting reduced the average cost to lenders of closing a loan by $916. The software quickly weeds out the very riskiest of applicants and automatically approves the rest. Early forms of automated underwriting were first developed and used in the 1970s to process car loans and credit card applications. By the mid-1990s, software, for buyers with good credit, had gone mainstream at Fannie Mae and Freddie Mac, the large, government-sponsored mortgage-financed companies and big traditional lenders. But none had been developed for subprime lending, then a niche market.

"Proponents say the software makes things fairer and more objective for risky borrowers. 'It takes subjectivity out of the "good ol' boy and girl" system in which Martha knows Joe, who approves the loan – then you end up with a bad decision,' Mr. Jones said. Because his program, Landtech, could parse credit reports for more than 3000 risk variables. 'We had better analytics than the trading desks on Wall Street.'

"But some wondered whether such analysis gave comfort where not deserved. Since the subprime housing market began falling apart last year, Arc Systems' sales have dropped 30%. Still, Mr. Jones sees a sparkling future for automated underwriting. 'The smart money on Wall Street is now looking for the gems – and they'll use AU to find them.'"

But three months later *The New York Times* (21/06, "Bear Stearns Staves Off Collapse of Two Hedge Funds" by Vikas Bajaj and Julie Cresswell) let us know that the skies were anything but comforting: "The game of brinksmanship began yesterday and continued throughout the day. Bankers traded telephone calls, frenetically negotiating the fate of two hedge funds.

"All wanted to avoid a fire sale in the mortgage-securities market, but at the same time not get stuck with an exploding liability. The day ended with deals that forestalled a meltdown. But had they merely delayed the inevitable?"

What was the possible loss to two Bear Stearns funds if they auctioned off mortgage securities with a face value of up to $2B?

A New Bogus Self-balancing Market?

An intriguing situation is shaping. Might the deepening troubles of the mortgage market be leading to increasing indulgences of governments with the Leveraged Buyout sector? Could it be an up-dated version of the legendary self-balancing market? The reasons lie in two distinct but now deeply intertwined areas. The capital losses and unfinished, empty, foreclosed housing represent a destruction both of real values and of near-money. And much of both the Leveraged Buyout activity and the brainless mortgage activity was very cunning and quite unwise.

We have already noted the key part that high technology has played in the subprime mortgage field. But an excess of money was also crucial in producing an utter lack of caution in LBO territory. In the world-wide casino that the economy has become, this medley of high tech which makes possible the dangerous combination of so much excessive liquidity and low caution.

When we are talking "liquidity," we must note it is not an excess of cash which is money that the government spends into existence rather than borrowing it from banks. Using the central bank, the government gets back almost all the interest it pays either as seigniorage for having made over

to the banks the hereditary monopoly of the ancestral sovereign in coining precious metals – once the form of money creation. Plus compensation to the state for the unwritten guarantees of bailing out banks too large to be allowed to fail, and the guarantee of depositors' deposits should the banks go broke. In Canada and other countries where the government owns the central bank it is even simpler – the interest on government debt held by the Bank of Canada comes back to it substantially as dividends – a good old capitalist institution that Mr. Harper should embrace.

Where our currency is interest-bearing as is our bank credit, its value moves inversely to interest rates. And with the phasing out of the statutory reserves – the percentage of the deposits received by the banks from the public that had to be redeposited with the Bank of Canada – the sole control of the economy resides in the benchmark interest rate set by the central bank. That means that when the central banks raises interest rates to "lick inflation," all federal government debt that the banks were allowed to load up with without putting up a penny of their own money would drop in value – and the banks will be in trouble again.

The Perils of a Zero Denominator

That was one of the reasons that prompted Washington under Roosevelt to bring in legislation that forbade the banks to acquire an interest in the other "financial pillars" – stock market brokerages, insurance and mortgage companies. For once they were allowed to do that, they would be tempted to use those pools of liquidity as base for their near-money creation. But Deregulation and Globalization removed all such restrictions on the banks' gambles, and their losses deepened the peril of their ensuing leverage.

COMER for years used to track that multiple of the banks' near-money creation that they lent into existence and was thus burdened with interest in contrast to the "legal tender" that the government spends into existence and is thus interest-free. We understated the proportion to avoid a zero cropping up in the denominator of the ratio, which would have driven the ratio to a meaningless infinity. We avoided this by treating as reserves the cash in their tills and ATMs to meet their cash needs. But had they paid that out it might have started a run on the banks. In 1946 when banks had no business other than banking because, because of the laws brought in under Roosevelt. the value of that ratio was 9 to 1. By 2000 it had surpassed 400 to 1 and dropped back temporarily because of the crash of the stock markets. Had we continued our ratio series it would have by now probably reached the region of 1000.

Again, lest you may think that we are exaggerating, let us refer to the American major press, this time to *The Wall Street Journal* (18/05/07, "A Street Pioneer Fears a Blowup" by Greg Ip): "Like many pessimistic observers. Richard Bookstaber thinks financial derivatives, Wall Street innovation and hedge funds will lead to a financial meltdown.

"What sets Mr. Bookstaber apart is that he has spent his career designing derivatives, working on Wall Street and running a hedge fund.

"'The financial markets that we have constructed are now so complex, and the speed of transactions so fast that apparently isolated actions and even minor events can have catastrophic consequences,' Mr. Bookstaber writes in a new book that is part memoir and part treatise.

"Mr. Bookstaber has a doctorate in economics and now runs a hedge fund at FrontPoint Partners, which was bought last year by Morgan Stanley.

"But it is his prior positions at Morgan Stanley and Salomon Brothers (since absorbed into Citigroup Inc.) that form the core of his book, *A Demon of Our Own Design: Markets, Hedge Funds and the Perils of Financial Innovation.* In those jobs, he says he played a small part in causing both the 1987 stock market crash and the 1998 collapse of the hedge fund Long-Term Capital Management LP.

"'The odds are pretty high that we'll see other dislocations that match the type of turmoil we saw with these crashes, Mr. Bookstaber, 56 years old, says in an interview. 'Any one derivative, with some exceptions, may be easy to track. But by the time you layer a lot of them one on top of the other, it becomes increasingly complex, so that a small, unexpected event can propagate in surprising and nonlinear ways – and there is no way to anticipate all these possible events.'"

A Financial Hiroshima?

Our readers will be familiar with this view supported by more detail, but the mathematical essence is that COMER has developed for years is alluded to. Essentially they are those of the atomic bomb – exponential growth. When you talk of the "indefinite number of storeys of a derivatives," you are talking of ever higher powers heading to infinity. And each is a platform for jumping into a military adventure – a gamble on "safety" when all other exits have been slammed shut. And it is, of course, the final touch to call such plans "risk management."

Mr. Bookstaber's views have been sought out by the Government Accountability Office which is preparing a report on hedge funds.

"His first experience with the destructive powers of derivatives came in 1987 while helping design and market 'portfolio insurance' for Morgan Stanley. Portfolio insurance was designed in the early 1980s as a way for big institutional investors to use budding options-pricing to protect their portfolios. When stocks went down, portfolio insurance required the investor to sell stock-index futures according to a formula, then to buy futures when stocks rose again.

"The trouble was that when many investors did the same thing, the sale of stock-index futures helped pull down the entire stock market. That fueled the 1987 crash. Mr. Bookstaber who sold portfolio insurance to investors in Japan and managed it for Morgan Stanley clients such as Chrysler, Ford Motor Co. and Gillette writes, 'I had helped precipitate a financial crisis of monumental proportions.'"

Curing Pneumonia with Injections of Syphilis

Today we are left watching the US government's attempt to make up for the destruction of purchasing power in the subprime mortgage field by encouraging the further growth of the leveraged buyout boom. It is like curing a bad case of pneumonia by injections of syphilis. This will require ever growing encouragement and favours of one to match the losses of the other. In the long run it will be no more effective that trying to offset massive losses in overpriced Leveraged Buyouts by massive subsidies to the prostrate subprime mortgage industry. Either way the major root of the trouble was the repeal of the Rooseveltian law that prohibited banks from entering the fields of the other financial pillars. Bookstaber seems to view the problem from the position of a Wall Street salesman, and his observations are an important bit of the story. The full diagnosis requires system analysis that will consider how a mixed economy works and the interrelations between the productive economy and the financial sector.

William Krehm

Reply to Stephen Zarlenga of the American Monetary Institute

Dear Stephen:

The friendly feelings that you express in our e-mail of 30/05 are mutual.

You write: "Your issue – allowing the banks to continue to hold on to special monetary privileges – would never be considered for a focus of a workshop of the American Monetary Institute, You had an opportunity to bring it up during one or two sessions on the American *Monetary Act*, and had time to make your point, but a far as I could tell did not convince anyone. Then if I remember correctly your travel schedule took you away before the conference ended."

Let me take your answers in reverse. My air flight reservation was made after consulting your conference schedule and I booked my departure when nothing was left but time on the beach. Moreover, I had carefully read the first 15 chapters or so of your book for five installments of a very laudatory review that I was writing for *Economic Reform.* In these I encountered a good version of the development of fractional reserves, that is the very essence of banking – lending out more money than is actually in the bank's vaults, but never failing to meet depositors' claims as they come in. I had no notion from those 15 chapters that it was you purpose to prohibit the banks to do banking, for fractional reserves are the very essence of what banking is about. What you propose to limit them to is "intermediation" which is passing on no more than has been deposited with them, but taking the risk of getting it back at a profit.

That raises a couple of problems that you avoid addressing with your reference to "morality." Morality would require you to explain how you are going to replace a historical function without which the development of modern society could not have developed. This involves among much else carefully assessing the creditworthiness of the individual borrower – no small task in the modern world of credit cards, email transfers, etc.

It is astounding that you should ignore this problem at a time when the banks are tottering with their investments in subprime mortgages, where debts are syndicated, and packaged electronically according to their degree of risk ascertained in this way, and to fill the exploding demand of financial markets for such graded debt, which is supposed to produce serious "risk management." What results is supposed to be "more efficient" by relieving the bank of a key banking function. And by wishing to reduce the banks to "intermediaries" – as they have often wrongly claimed to be – you feel more moral? You think that the government is in a position to do such mini-investigation? Then you should not have evaded the question, but have allowed those who came to the conference to ask it. I did in the question period, but received no answer.

While you are pursuing your Utopia of running a modern world without the legitimate services of banks, little or no attention was paid to bringing back – in more stringent form – ways of dealing with the appearance of credit cards and countless other convenient forms of credit. These have all been abused to lure their users into spending beyond their means and becoming victims of usury. Or strengthening walls that should have been reinforced to prevent banks from taking over the other financial pillars and misusing their reserves for speculations.

Nor did your concern for morality prevent you from announcing the probable attendance of William Greider, whose book *Secrets of the Temple* ushered in a new epoch of the monetary reform. Greider is a leading member of *FOMC Alert* that I spoke of in my scant 20 minutes, providing their email address – a voluntary research group specializing on the operations of the monetary system, that provides its publications to researchers free of charge. Greider is a prominent leader of that institution, and though you borrowed the name of that great champion of fractional reserve banking, you considered it immoral to devote your sessions to a discussion of it?

Palley's Plan for Extending Fractional Reserve Banking

While picturing me as abandoned by my collaborators of COMER, the fact is that *FOMC Alert* has taken up the idea of Thomas Palley for the necessary extension of fractional reserve to the "other financial pillars" – the stock market and insurance. The legislation brought in under Roosevelt banned the banks from entering these, but now constitute a many-storeyed playground for their games.

Palley proposes requiring their backing the financial assets with statutory deposits with the central bank as still exists in a crippled form in the US in the case of federal banks. That is something that you might have examined at your sessions.

And what do you think that an army of say a half million civil servants checking the creditworthiness etc. of customers of the government retail banks would be? And its cost to borrowers? And its effect on the price level? And how would you distinguish between real inflation – due to an excess of demand over available supply – and the mere changing structures of the mixed economy with much of the price rise resulting from the increase of necessary public services. That happens to have been a COMER special subject – almost 40 years ago the leading French publication of the time purchased a and published a 60-page article on the theme.

If I may say so, Stephen, your problem is that you see the important field of monetary reform as something that you personally – in the good old American way – must patent. You actually had others at that conference who have generalized the single tax idea of Henry George to the entire economy and advocate that legitimate patents that do exist be bought out by the government to keep them out of prices. But I gathered they were warned that if they raised issues not on the scheduled list, they would not be allowed to sell their books on the site.

You raise the issue of Bill Hixson. Elsewhere in this issue you will find my criticism of Bill's latest book, part of which COMER published a decade ago. In the portion more recently written on page 69 you will find the following passage: "Whether the government should create all the money and private financial institutions create none of it is debatable. But that the government should create only $13 billion per year compared to $170 billion per year created by the private banks is simply crazy." Surely that doesn't sound like a flat-footed endorsement of 100% money.

And in the response to your request for a comment on my comment. You quote Bill in part as follows referring to 100% money: "I also believe that we should approach this ideal in a step by step process over several years so as not to rock the boat too violently at any one time. I believed this way several years before 1997, at the time of the founding of COMER, and I believe the same today."

The trouble is that with the escalation of the leverage of banks we don't have those several years to wait. The canoe has become an ocean liner and it is sinking. It has become a time of ever higher military solutions. To stave off what you consider the only moral solution several years means to give up the battle. Most decidedly Bill Hixson will not be of that position, if it is spelled out to him.

I would not wish to pay anything less than the deepest respect to your or anyone else's moral sensitivities on the matter of 100% money or anything else. For people who feel it is immoral to have banks do banking – that is lend out more money than they have with the central bank or in their vaults, there are churches, mosques and synagogues to satisfy their religious feelings on the subject.

Since you did not consider it bending morality a bit to invite a future presidential candidate hopeful to address the conference, you might have concerned yourself with educating the man to the perils of disposing of the Sarbanes Oxley legislation that still survives in the US, or in Canada the entire *Bank of Canada Act* which is still on the law books but utterly disregarded. That translates into lead-poisoned water mains in our cities, and planet warming. It is ridiculous to omit all discussions of these matters at an economic conference. But how can you discuss them if you exclude mention of the proper use of fractional reserves? Fractional reserves are a complement to non-commodity money, about which you in your early chapters had written so well.

Banks should not be in the credit-card business, or in the stock market, etc., in any shape or form. But move to credit money and you must investigate the risk factor domestically and abroad. Are you going to leave that to governments? If you do, you don't read your newspapers. And if you consider the vast volume of politics that has gone into organizing your economic conference, not excluding the blank Certificates of Merit handed out for the awarded to fill in, and much else, you should have no difficulty in getting the point.

And there is urgency about acting. When economic policy fails in an economy set up to grow exponentially, there is only the military solution left to our governments. They have after all abandoned just about everything that was learned about economics, including fractional reserve money for the public good.

Bill Krehm

Globalization Reassessed

In our universities, media and official international conferences, globalization is presented as the only possible future for the world. There is no room for any serious discussion on the point – especially because wars, little and big, are becoming bigger and more routine as this supposedly irresistible program of internationalization proceeds. In the words of Margaret Thatcher "There IS No Alternative" – TINA.

And yet not only are there alternatives, but increasingly even leading business publications – in their news columns – are reporting the discontents and blind alleys into which this allegedly perfect system has led the world.

The latest of these is in *The Wall Street Journal* ("Globalization's Gains Come with a Price" by Bob Davis and John Lyons reporting out of Puebla, Mexico, and Andrew Batson from Dalian, China. From Puebla, Mexico, comes the following tale: "Like millions of other low-wage workers here, Hermenegildo Flores was supposed to benefit from Mexico's decision to open its economy to foreign trade and investment in the 1990s. For a time, he did. As US companies boosted purchases from Mexican factories, Mr. Flores's salary nearly doubled to $68 as week in 2001.

"The foreign competition from places like India, Pakistan and El Salvador intensified. Mr. Flores, who sewed pockets onto blue jeans, says his foreman would go about shouting 'If you don't work harder, we're going to shut this plant down and move to Central America.'

"Today, Mr. Flores is unemployed, having accepted a $900 buyout in April after the company switched to new machines.

"A decade ago, the globalization of commerce promised to be a boon to low-wage workers in developing nations. As wealthy nations shed millions of jobs making apparel, electronics and other goods, economists predicted that low-skilled workers in Latin America and Asia would benefit because there would be greater demand for their labour – and higher wages.

"In some ways globalization delivered as promised. But there was an unexpected consequence. As trade, foreign investment and technology have spread, the gap between economic haves and have-nots has frequently widened, not only in wealthy countries as the US, but in poorer ones like Mexico. Many economists say that the biggest winners by far are those with the education and skills to take advantage of the new opportunities, leaving many lagging behind. Incomes of low-skill workers may rise, but those of skilled workers rise a lot faster.

"'While globalization was expected to help the less skilled in developing countries, there is overwhelming evidence that these are not better off, at least not better than workers with higher skill or education levels,' write economists Pinelopi Koujianou Goldberg of Yale University and Nina Pavenik of Dartmouth in the spring issue of the *Journal of Economic Literature*.

"Globalization deserves credit for helping lift many millions out of poverty and improving living standards of low-wage families. That's particularly true in China, where the incomes of low-skill workers have consistently risen. But because globalization is also creating more inequality, it is raising questions about how much inequality countries can bear, and whether these gaps could ultimately create a backlash that will undermine trade and investment liberalization around the world."

Whether Development is Fast or Slow, the Gap Widens

"Many developing nations seem to be following in the footsteps of the US, where the income gap has grown sharply since the early 1970s. A 2006 study of Latin America by World Bank economists Guillermo Perry and Marcelo Orreaga found that the income divide deepened after economic liberalization in nine of the 12 countries examined. While that could be partly explained by Latin America's slow rate of growth, income gaps are widening as well in fast-growing Asian countries, including Thailand and India. It has even grown in the past decades in South Korea, long known for an egalitarian commitment to education.

"Then there's China. One of the fastest-growing economies of the world, it has generated significant wage gains for its rank and file. Yet income inequality is also growing because of the huge gains posted by the upper crust from 1994 and 2004. China's income inequality as measured by the Gini Index – zero is perfect equality and 100 is perfect inequality – increased to 47 from 29, according to World Bank researchers Martin Ravallion and Shaohua Chen. From 2000 to

2005 per capital income of the bottom 10% of urban households in China rose 26%, while those at the top saw gains of 133%.

"While Mexico hasn't experienced the spectacular growth of China, wages of low-skilled have improved over the past four years. Since 2000, the percentage of Mexicans living in poverty has fallen below 20 % for the first time in the nation's history.

"The World Bank estimates that the top 10% of Mexicans accounted for 30% of the country's total spending in 2004, while the bottom 10% accounted for less than 2%.

"The consequences of the widening inequality are profound. Those without much education or skills often find themselves stuck in jobs in the underground economy that don't pay health care or pension benefits. That has boosted emigration to better-off domestic regions or to the US and Europe, where anti-immigrant sentiment is surging.

"Growing inequity also feeds the populist argument that globalization is a sucker's game that benefits only the elites.

"That has powered popular presidential candidates in Ecuador, Bolivia, Nicaragua and Venezuela, and came close to carrying Mexico last year. In China, the ruling Communist Party worries that support for liberalization could crumble.

"How does globalization boost inequality? Foreign firms bring new technology to developing nations and forces local firms to add skilled workers who can handle that technology and shed workers who can't. Access to education plays an important role. Developing nations rarely crank out enough college-trained workers, boosting wages for fresh graduates.

"The effects of globalization are vividly on display in Puebla, a lively city of 1.5 million known for its baroque churches and colonial architecture. Located between the port of Vera Cruz and Mexico City, 70 miles to the north-west, Puebla's trade and textiles, like industries throughout Mexico, were protected after World War II by high tariffs and quotas. During the 1970s these barriers helped produce rapid economic growth, but the system collapsed in a debt crisis and deep recession that swept through Latin America in the 1980s. To restart the economy Mexico began dismantling its import barriers in the 1980s and tied itself tightly to the world economy through the North American Trade Agreement (NAFTA) in 1994 and a passel of other accords since then. Mexico's politicians and economists predicted that globalization would produce many new jobs in Mexico, especially for those at the bottom as companies producing low-skilled goods set up shop south of the border. 'Mexican wages will not remain low if we are capable of growing,' said Mexico's President Carlos Salinas in 1991 when he was promoting NAFTA.

"For a time, that turned out so. Towel makers Industrias Cobitel SA picked up two big new US customers and doubled its production workers to 250 by 2000. Exports accounted for 40% of the company's sales in 2000, triple the percentage before NAFTA. Business was so brisk that many employers didn't care whether new hires had much schooling.

"But foreign investment and competition also prompted a big demand for skilled labour. Local companies that had gotten away with outmoded machinery either upgraded or closed."

Volkswagen's Impact

"Volkswagen AG, the city's largest employer, has had a specially large impact on the city's economy. For years it produced "Vochos," as VW Beetles are called in Mexico, on an old-fashioned production line where dents were banged out with mallets. But as Mexico opened its economy, VW ratcheted up the demands on its work force. The company started building the new Beetle in Puebla in 1998 followed with other models aimed at US buyers. New machinery was imported. Welds are now done by laser. Robots paint the exterior of cars for an even finish. In the past decade the company has doubled its engineers to 700. They make from $400 to $600 a week and are college graduates. At the same time VW slashed its work force by about 15% since 2000 to 4,000, eliminating mostly assembly jobs. At the same time VW outsourced production of seats, steering wheels and wire harnesses in a sprawling industrial park outside the gates of the manicured VW campus. Workers in those factories make about one third of the $225 a week that that VW workers can make. Many auto-parts companies won't hire former VW employees because they can't make the financial adjustment.

"Ricardo Mosqueda Martinez lost his job at VW and worked for a time at a parts supplier. 'When I first saw the paycheck, I thought for myself, "Is this a joke?" He didn't last long there, Like many other VW employees, he ended up in Puebla's informal economy working as a gypsy taxi driver and doing other jobs.

"For Poblanos, as Puebla natives are called, with the right education, globalization has also opened opportunities absent in Mexico a decade ago. Victor Pasilla, the 30-year-old son of a hospital security guard, makes $600 a week designing oxygen sensors for a Puebla start-up, Biomedical Integral SA, which hopes to build a surgical bed for export. 'It's been a big leap,' says Pasilla, who has outfitted his parents' home. where he still lives, with its first telephone and computer.

"The surge of well-to-do residents has changed Puebla's look in the once poor south of the city. Housing developments of small, brightly coloured homes, each topped with water-tanks, have opened for young families who have become eligible for mortgage-financing. There are also new shopping malls with international clothing stores.

"Low-paid textile or auto-parts workers don't shop there, though many now frequent the local Wal-Mart which offers food, clothing, and appliances at good prices. Low-wage workers live, as they have for many years, in cramped urban tenements ringed with razor wire to keep out thieves.

"Part of Mexico's problem is that US manufacturers looking for bargain prices have rerouted orders to China where wages are even lower. Puebla's towel maker, Cobitel, had to cut payroll after a big South Carolina textile customer shifted orders to China in 2004. Overall, Mexican textile jobs that pay health benefits fell by one third to 127,000 this year, according to Labour Ministry statistics.

"But China's success doesn't fully explain the puzzle of growing income inequality. If it did, China's low-wage workers would have seen especially fast growth in income. While low wage workers have benefitted, it is elite workers who have benefitted most. In part, that's because the Chinese companies doing work for overseas markets usually look for a set of skills few Chinese have, such as foreign language fluency and mechanical knowledge."

Social Tensions

"Investment by Japanese and Korean companies have transformed the coastal city of Dalian, as crumbling slums are boarded up and factories have given way to new shopping malls and fancy apartment complexes. But surging real estate prices have made Dalian nearly unaffordable for lower-paid locals. As a result social tensions have become an increasing problem for the Communist Party, whose legitimacy rests on its ability to deliver a broad improvement in the

standard of living. Wary of being identified as favouring an urban elite, leaders have this year expanded social programs for the poorest and campaigned against wealthy people who flout tax and family planning laws.

"Expanded education can ease inequality as more workers qualify for skilled jobs. In Mexico the income gap partly reflects improved educational levels. Since 2000, for instance, Puebla State Popular Autonomous University, a large private university, has added undergraduate degrees in such specialties as Bionics, electronics and software and is planning to add degrees in biotechnology, power-grid administration and plastics.

"Anther major factor: So many Poblanos have given up on their home turf and migrated to the US that competition has eased somewhat for lower-skilled jobs. The greater number of Poblanos working abroad has increased the amount of cash sent back home, boosting the income of many residents.

"Mr. Flores, the unemployed tailor has two brothers who have decamped for the US. Because he doesn't want to leave his wife and daughter, Mr. Flores instead is seeking work as a day laborer, building houses for Puebla's surging new middle class."

As excellent as the *WSJ* review of Globalization is, it omits both the warnings of its basic menace and the means of controlling and reversing the process. I will merely mention a couple of such important links and refer our readers to other parts of the current number of *ER* and other publications of COMER for fuller treatment of the matters raised.

The lack of sufficiently educated and technically trained workers is cited for globalization fast turning from a blessing to a disruptive force increasing social inequality. The obvious conclusion from that should therefore be that increasing the technical training and properly educated and technically trained work force is a vital capital investment, that must be recognized as such and, hence, government expenditures on education and health, the environment must be treated as capital investments in the accountancy of the government. That implies that stripping such physical and human investment by the state to balance the national budget doesn't make sense. The failure to prevent the disruptive under-education and under-training of the population is not fiscal prudence, but fiscal irresponsibility.

How will the government find the funds for that? By making use of its central bank to finance such investment in environmental, educational and health programs requiring only resources available within the country. And to keep them available until the domestic economy is able to meet foreign competition, blind, wholesale free-trade schemes must be resisted. For like the free-trade promoted by Britain in the 19th century, they can only serve the interests of the financial sectors of the leading countries who themselves have surrendered serious economic analysis to a still more destructive version of TINA ("There is no alternative"): the goal of infinite ever accelerated growth in a constantly eroded environment. That is unsustainable. And as we have witnessed in the Near East, it can lead only to a desperate resort to military solutions when peaceful ones collapse.

William Krehm

…And the Madness of Crowds

We recently characterized popular understanding of economic affairs as a *delusion*, alluding to the title of an old book.[1] It began by saying that "everything you thought you knew about economics is probably wrong. Worse, it is a deliberate lie. And worst of all, the people who persuaded you to believe in the lie are not even fully conscious of it themselves." We identified this disturbing analysis as our interpretation of writings by Dr. Michael Hudson, a specialist in not only financial markets but also in the history of financial institutions and the economic theories that have been brought to bear on them over the centuries. (Readers can check out Hudson's authority of knowledge for these and other criticisms of policy and ideology via the Internet. Go to www.michael-hudson.com.)

In commenting further about financial delusions Dr. Hudson observes that "the true madness of crowds does not lie in their alleged propensity to get excited with greed, but just the opposite: a passive tendency to accept the status quo as natural and hence inevitable." For even when they have the apparent freedom under democratic political constitutions to press for reforms that would enhance general prosperity and distributive fairness, they sit by and watch their legislators dispense the national wealth to favored constituents. This has been especially blatant over the past couple of decades as North Americans have had regularly reported news of increased concentration of wealth and income distribution, legislated tax breaks mainly to the most wealthy, and monumental frauds permitted by lax regulations and complicit regulators.

The Origins of Poverty in Servitude

Hudson notes that, "on an economy-wide scale, some 90 percent of the population is indebted to the wealthiest 10 percent." His analysis of why this servitude is accepted in apparent passivity focuses on why and how indebtedness originates and grows.[2] The earliest indications of it for Occidental civilization are in the agricultural societies of the ancient near east, where farmers paid shares of their crops to rulers who provided some degree of territorial protection and also made loans of seed from the collective granaries. If crops failed or were seized by invaders, debts could accumulate, resulting in seizure of property or various forms of servitude for the debtor and his children. Furthermore, debts accumulated at compound interest rates. "Formulae for calculating how savings accumulate (i.e., what debtors owed) date to some four thousand years ago when mathematics played a major role in training Sumerian and Babylonian scribes. Ever since then the doublings and re-doublings of public and private debts have outstripped the growth in output of agriculture and industry. This has always meant that large numbers of debtors have had to settle their obligations by selling or forfeiting their property, often leading to property turnovers so widespread as to transform the distribution of land and other wealth."

Someone could therefore be born under an obligation to pay or to serve an overlord from whom he received no equivalent exchange. And even if not oppressed by inherited debt, many were born to serfdom on land that had been forcibly seized by the owner's ancestors. From at least the beginnings of historical records, "free lunch" has been provided by the many to the few. "The tendency of debts to grow more rapidly than the collective ability to pay has been especially insidious, leading to wealth and political power concentrating at the top of the economic pyramid." As should be expected, there has always been at least a degree of resistance to this dynamic. "From ancient Babylonia, Judah, Sparta and Athens, Rome and Byzantium down through

the Enlightenment and into modern times, economic wisdom and traditional morality have sought to save society from the dead hand of the past."

Political Economy Fought Back

The "free lunches" and other remnants of serfdom were recognized as barriers to economic progress by the classical economic thinkers of the 18th and 19th centuries, and their approach was carried forward by institutional reformers in the first half of the twentieth. They examined the property ownership and debt relationships that form the context in which production and distribution take place. "Their perspective was long-term, conceiving economies as evolving systems based on institutions, including laws, tax policies, government spending, the regulation of credit creation and the disposition of bankruptcies." Their purpose was to design national policies that would best promote higher productivity and more general prosperity. What kinds of money-making activities should be encouraged? What kinds of productive facilities should be provided collectively, as public services? How should taxes be levied to be most productive of revenue and least burdensome or inhibiting to desirable enterprise? The general answer to these kinds of questions was that sources of "free lunch" (collectively defined as *rents* in economics terminology) should be primary targets for taxation – not only for reasons of fairness in the distribution of inherited wealth but also to encourage productive investment and enterprise. "This focus on institutions and policy was the thrust of classical 19th-century British political economy as developed from Adam Smith through Ricardo, John Stuart Mill, and even Karl Marx and Henry George. Although it might be called "socialistic" today, their aim was to promote industrial capitalism." They perceived that this goal was frustrated by property rights and financial obligations left over from Europe's feudal past. Hereditary estates and permanent public debts reflected military seizure of territory and sovereign grants of land and revenues.

The classical approach was applied in the United States following the "gilded age" of financial excesses, and in line with progressive economic thinkers such as Thorstein Veblen and Simon Patten. Reforms of financial institutions and more strict regulation were part of the ground work for the prosperity of mid-century. Since the 1960s, however, there has been a regression from those institutional structures, and a parallel deterioration in the individual financial status of most Americans. Hudson attributes it to a successful counter-attack on classical political economy by proponents of *rentier* claims.

The successful counter-attack of the *rentier* class has *financialized* what was once a vigorous industrial economy. A rising share of business income these days is *not* from the classic idea of profits earned by employing labor to produce goods and services to sell at a higher price than it cost to produce them. Instead, it comes from *rents* – that is from payments that do not have a counterpart in costs of production. It applies not only to payments for the use of real estate, as in common parlance, but also to any revenue stream that is secured by law as a property right. Examples include patents, copyrights, production quotas, licenses to use the broadcasting spectrum, to engage in certain kinds of professional practice – in short, any monopoly privilege that is not a direct part of the cost of producing goods and services. The bulk of these property claims is held by only 1 percent of the population.

The approach of political economy has been usurped by financial managers who steer the economy to polarize and concentrate wealth in ways that impoverish most people. One reason for the passivity of the public in accepting this arrangement is that national accounting conventions define every income as a payment for services rendered. That helps mainstream economists to get away with their assertion that "there is no such thing as a free lunch." Gullibility is therefore partly due to deliberately fostered ignorance. Furthermore, even for the curious who are motivated to get a better grasp on reality, "mainstream economics has narrowed so tightly as to leave no room to fit a critique of finance and property into the curriculum. Today's economic models are based on assumptions that prevent them from addressing the most important real-world problems. They take existing political and legal structures as given and examine the economy from the vantage point of politically passive parts – individuals and small firms." This neo-classical approach is called marginalism, and Hudson scorns it as *merely* marginal, for it "asks only how income is earned in a presumably unchanging environment. This assumption of no institutional change is mathematically necessary for probability statistics and trend analysis to be deemed scientific."

The Complicity of Economics

The claim of economists that there is no free lunch and that everyone's income is a fair reflection of his or her contribution to the collective wealth and income is a fraud. "The reality is that the economy is all about how to get a free lunch." It is set up to give special tax breaks to financial and property claims on the one hand, and to then expand credit creation so that people become more and more deeply indebted. In this way the Wall Street crowd gain control of everyone's savings. This enables financial houses to rake off management fees while at the same time using these savings to inflate the prices of the assets they hold. "The reason that saving are reported to be low these days is that people borrow to buy property hoping that it will rise in price more rapidly than the interest rate they must pay. Without realizing it, people engage in *arbitrage,* that is borrowing at one rate to invest at a higher rate. And many imagine themselves to be sophisticated for doing this."

There is thus a degree in which people these days are participating in a kind of financial mania. Hudson's treatment suggests an element of sympathy for their madness, however, for in the bubble environment created by the dominance of financial interests over government policy, most kinds of assets are inflating and it is difficult to know where one can safely park some savings.

Keith Wilde

1. Mackay, Charles (first published in 1841). *Extraordinary Popular Delusions and the Madness of Crowds.* See *ER* of March, 2007.

2. The content of this short article is selected from various papers and books by Dr. Hudson. Quotation marks indicate direct borrowings and very close paraphrasing.

Harper *continued from page 2*

"Ottawa's climate change initiatives were under attack at the Toronto meeting, with both Ontario and Quebec saying they would like to see Ottawa accept tougher measures.

"The Pembina Institute, an environmental think tank, based in Ottawa, also assailed the government's proposed regulations, saying they have little chance of meeting its target of stopping the growth in Canada's greenhouse gas pollution by 2010-12.

"NDP Leader Jack Layton said Mr. Harper's failure to commit to the German proposal is taking some of the pressure of Mr. Bush."

That is a lot of cowardice and double-talk for a single day, and for the head of a minority government. Imagine what he would be like with a majority in Parliament behind him!

W.K.

What's the Difference Between Bankers and Counterfeiters

This has got to be the most unusual book review ever on several counts. Let us begin by noting that a small section of the book "*The Bank of Canada – A Misused Tool* (pages 221 to 230) was written by the reviewer. That and the greater part of another section (Part II, *It's Your Money* – pages 101 to 230) was published a decade ago by him as well (COMER Publication).[1]

Yet these oddities have some unexpected advantages. They bring to life a long-passed period of economic thought when there was remarkable space left for the exchange of ideas between country and country, between professional and "amateur" economists. A key centre where that freedom was exercised was the University of Waterloo. Most of the conferences that led to the formation of the Committee of Monetary and Economic Reform were organized there by John Hotson, a leading staff member, who had a special talent for seeking out individuals who would not accept teaching or learning by rote. He seemed always organizing groups and conferences, or attending conferences. He passed on that prejudice to his local followers. At the annual US Eastern Economic Association we soon had our own sessions.

However, bit by bit, that freedom started wearing out at a clip that reflected the bankruptcy of the official policies that we challenged. It was at such a conference on the United States that he met Bill Hixson, and before long Hixson visited Toronto to look over the people associated with Hotson.

Hixson, who lives in Kentucky, comes from a family of monetary reformers. He had fought with the American Army in Europe, and graduated from Harvard on a veteran's scholarship. But he was excluded from an academic post on graduation because of his leftist past. With dry humour, he would relate how by then he had counted the medals on Stalin's chest and found them far too many, and had severed his connections with that faith. But he hadn't it in him to grovel for forgiveness. So he earned his living during his most active years as a partner of a small company that treated railway ties to keep them from rotting. On his retirement, he did a similar job on the timbers of state. A natural writer, in quick succession he had two books on monetary reform published by commercial publishers, The first, *A Matter of Interest*, published by Praeger, carries an introduction by John Hotson.

Apart from his dry wit, Hixson has a particular talent for handling statistics. It was a most timely weapon when the reform movement was the object of sweeping pressures by the new orthodoxy. The latter could be summed up by its insistence on a flat price level imposed by interest rates high enough "to do the job." But at the same time there was an explosion of losses of the ever more deregulated banks grew as they prowled the world in search of lucrative gambles. Statistics, as handled by Hixson, were hard to argue against, and his writings were thus excellently timed for the day. I remember when, as a result of the lifting of just about all its economic defenses under the North American Free Trade Agreement, the Mexican economy in 1994 collapsed, with the peso dropping some 40% and the banks eventually taken over once again by the government What was even more alarming was that the collapse threatened to spread internationally.

BIS Almost Brings Down the World's Money System

What brought on the emergency was that the Bank of International Settlements, a sort of club of central bankers to whose meetings elected officials of governments were never invited, in urgency to save banks from bankruptcy had issued two directives: government debt of developed countries was declared risk-free and hence needing no down payments for banks to acquire. This allowed our banks to increase their holdings of federal government debt from $20 billion to around $80 billion over a two-years period. This served to make up their losses in gambles that since the 1930 Depression had been forbidden banks. At the same time, in their haste to rescue the banks, BIS directed the phasing out of the statutory reserves (in Canada) and in whatever country borrowed money from the IMF, and reduced them to a travesty of what they had been (in the US, for example). And then the manager of BIS, M. Alexandre Lamfalussy, called on central banks to attain zero inflation, for according to him a mere 1% of 2% price rise would not do. But what BIS overlooked was that the two measures were incompatible. If you raise interest rates drastically, the market value of pre-existent bonds will fall drastically. After getting together the largest standby fund yet to that time – $51 billion dollars with the US contributing $25 billion of that, the IMF $25 billion, and Canada $1 billion – the US government decided that the period of high-interest rates was over. The solution was readily at hand.

Like practically all governments throughout the world governments up to that point – with the exception for a brief period in Denmark and Sweden – had treated government capital investments exactly as they do their purchase of soap or floor-polish. They wrote them off in the year of their acquisition, and then carried the asset on their books at a token one dollar so that the auditors would not think they had forgotten it. On the other hand they carefully noted the debt incurred for the acquisition of the capital asset, and amortized it over many years that approached the useful life of the asset itself.

Obviously this created the appearance of a deficit that was not necessarily there. And the deficit served to drive up interest rates – no small detail when the government had loaded itself up with bank and public debt. Formerly, under the *Banking Act* brought in by Roosevelt in 1933, it had done much of its financing with the central bank and – as sole owner of the central bank in Canada since 1938 – Ottawa got back practically the entire interest it paid as dividends. That misleading figure for the deficit drove up interest rates throughout the land.

Because we both had a good knowledge of Marx and empathized on most basic matters, Hixson and I were particularly close. I, however, have been much absorbed by the structure of problems, and Bill by more immediate relationships.

Now, the US government adoption of accrual accountancy drastically reduced the the spurious deficit. Worked back to 1959 it brought to light well over $1 trillion. But a small problem remained. Governments are not supposed to be able to make investments. The entire planned comeback of the banks to the glories of pre-crash 1929

and beyond depends on maintaining that myth. So the figures of the Department of Commerce showed the new budgetary surplus statistic under the heading "savings" which it, of course, was not, since that term implies short-term debt of the highest quality that can readily be exchanged for legal tender – i.e., federal government debt. When we were directed to the statistic by a correspondent in the US, we at once knew that we would have no problem confirming what we suspected and asked Bill Hixson to check, and got the answer as fast as the post office would allow. No change in the real US financial position had taken place to justify the figure. It was not "savings." Later we got confirmation that it was merely the adoption of double-entry bookkeeping into the US government's accountancy. That was an example of Bill's familiarity with his government's statistics.

Assessing Keynes

When we deal with Keynes's frequent improvisations to reach his deeply humanitarian goal, we should scan his method carefully for what may be useful today. Without employing the language, he viewed the economy as a world of vectors rather than of scalars. Blocked by the American superpower in his efforts to bring in a more just and humane world, in the final year of his life – 1946 – he moved his attack to the bogus accountancy on which the ideology of the American superpower was based – a rigged accountancy that refused to recognize the vast investment of government in infrastructure for what it was but wrote it off in the year in which it was created.

No private firm – or individual – could get away such anti-accountancy.

Instead of judging Keynes entirely on his deficient use of the central bank, it would be more just to go on and give him credit for his seeking out the other greater vulnerabilities of the system in power that had already blocked him in the adequate use of the banking system.

Of course the members of COMER varied in their readiness to adopt this view of policy in terms of interacting vectors or systems theory rather than in scalar terms. But we should note that by the time you introduced accrual accountancy into government accounts and applied it to government investment in human capital as well as physical investments, the budgets of developed countries would have been so close to being balanced as to have destroyed the ideological wall erected between the official use of our central banks and the real needs of their countries.

Of course, among the leaders of COMER some showed greater appreciation and made greater use than others of this vector view of policy in a mixed and striven society. For example, John Hotson presented to the House Committee on Finance my proposal for tax bonds that in essence embodied the balanced exchange available for certain categories of consumer taxes in exchange for lower interest payments with certain added insurance features.

Thinking in Vector Terms

The most effective addition to my view of price levels in a mixed economy as a vector field came from Harvey Wilmeth, a member of the economics faculty of the University of Wisconsin. I had published in France in 1970 a long paper arguing that the price level is supposed to be determined by the balancing of supply and demand and was becoming increasingly influenced by a deepening layer of taxation that reflected the growing industrialization, urbanization, and government-created infrastructure and services. Wilmeth compared it to the advertising strategies of merchants who might offer a free bicycle with every TV bought for $400, and when asked the question, "Was the price of the television set really $400?" and answered, "Most people would say that the price of the TV would be closer to $300 and the balance is the price of the bicycle." And he concluded that to consider the current price as entirely market driven was including price level effects of taxation twice: once as part of the cost of the privately produced output, and then again as the taxation on the finished product. It was easy for me to work out the simple arithmetic supporting that observation.[2]

Instinctively the Saudi and other oil powers of the Middle East have employed not dissimilar "vector policy." Thus during the oil crunches of the 1970s they used the infidel US banks to recycle the hundreds of billions of dollars that the oil companies were extracting from the world economy. The banks simply dumped much of it into Latin America, much as the Soviets did their nuclear waste in the Arctic. A lot of that money didn't get beyond the secret US bank accounts of corrupt Latin American politicians.

Latin America has never since shaken off the shackles of that debt, though the IMF and Washington have devised countless schemes for "restructuring" it. Incurred in US dollars, with the drop in the domestic currencies, its burden has increased by the year. Invariably, the IMF restructuring has helped bail out American creditors rather than the debtor nations. And the IMF has dictated the slashing of social programs to keep the mounting indebtedness serviced.

So Washington is back to sticking together vast coalitions with band aids and rubber bands, soliciting every corrupt dictator, recruiting and training the bin Ladens of to-morrow as it did those of yesterday. Not only has D&G proved less than inevitable, but not even sustainable.

You didn't have to search in mounds of rubble to foretell the First Disaster of Lower Manhattan – the stock market collapse of the latter 1980s that saw banner corporations – like "our" Nortel – practically wiped out. A simple test had been designed decades ago to detect the approach of such "mishaps." But because they were incompatible with the "inevitable" overfeeding plans of those in power, these search tools were left to rust.

The simplest of these is Tinbergen's Law that tells us that the variables in any solution must match the number of available linear equations in any effective policy tool. And all the actual maths you need for that is what you learned in your first-year algebra classes in high school. The habits of mind to adopt such approaches, however, is another less conventional thing. Whether Keynes fully appreciated the potential of the central bank or not, I cannot say. But I do know that when he died he was still looking for combinations that would make use the independent variables that would work around the blockage of his efforts to use the central banks for social goals. A key one of these was as familiar as double-entry bookkeeping which is carefully enforced by law in the private sector.

I proposed the government's use of capital budgeting of the sort that is standard in the private sector a decade or two before COMER was founded.[3] To my delighted surprise I soon learned that at least one Royal Commission had beat me to the draw by a couple of decades or so, not to mention a distinguished line of Auditors General. Unsuccessfully, of course, because those in control of the government needed the semblance of a growing deficit to convert the land into the hunting grounds of the financial sector.

Next step after identifying so many conflicting subsystems was the use of systems theory which studies how different subsystems must each function by their own code

for the system as a whole to operate. Averaging out the efficiencies of the subsystems into an over-all statistic can be misleading. If a subsystem is not essential for the master subsystem to function, then it simply does not qualify as a subsystem. The notion of a self-balancing market made up of units so infinitesimally small that whatever they do or leave undone can in no way affect the price level is obviously the polar opposite of systems theory. Yet there was a time when the Eastern Economics Association devoted part of its sessions to the subject of whether the free market through it magic power would find the needed new oil deposits when prices went high enough – faith in a faithless age. At the time graduate courses were held in prominent universities on systems theory. However, about a decade ago at a conference on systems theory at Ryerson University, I was the sole person who read a paper applying its concepts to economics.

When health, the environment and social justice have been declared "externalities" it is apparent that systems theory is not an option but a necessity to make economy not only people-friendly but workable. All subsystems interact with one another. None can be dismissed as just another's food chain.

And once we see the economy and society as systems composed of many subsystems, we have to view any measure affecting them not as a scalar but as a vector. A scalar is an absolute measure without sense of direction. A vector has a sense of direction and can possibly veer. It crosses boundaries between subsystems and when it does its significance may change. The subsystem that it enters may set new laws that it must respect.

There are other ways developed by mathematicians and scientists that can be immensely useful in foretelling what economic policies can only spell disaster. There is, for example, dimension analysis. This explains why bigger is not necessarily better. Forces depend upon mass which is related to volume. Volume varies as the cube of linear dimension. The power of resistance of muscles and bones, on the other hand, is likely to vary as the cross section with increases with the square of its linear dimen-

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The Links between Bureaucracy and Theocracy

After years of elevation of former head of the Federal Reserve, Alan Greenspan, to the status of medicine man, master of the mysteries of money and the economy, and near-deity, he is now being bumped down to mortal level again.

This message has been delivered to our neck in the woods by *The Globe and Mail* (23/03, "Greenspan blamed for subprime crisis" by Barrie McKenna): "Washington – Members of Congress are pointing angry fingers at Alan Greenspan and other US bank regulators for fostering a mortgage market 'on steroids' and failing to thwart a predictable subprime meltdown."

However, it had not been without some rough preliminaries that Greenspan was ranked a near-divinity for infallibility in the first place. There was for example the instance in the mid-1990s when he delivered himself of his famous "irrational exuberance" remark warning against the Wall Street boom, and had been told by the Wall Street press to stick to commodity prices but butt out of any judgments on the level of stock prices. And he took that advice and never again expressed an opinion on the level of the stock market. In a very real sense he purchased his near-divine status, by taking in his stride a very human-imposed behaviour.

At which point, depending on your favourite theology, you may make the comparison with more primitive religions where the wooden or stone images of gods are actually whipped for not delivering better weather or fate to the tribe that worships them. Once, however, the divinity, be he of wood stone, stone or flesh, complies, he is worshipped for ever. However, with an economy geared to expand ever more rapidly to avoid collapsing, "for ever" lends itself to some surprising translations. Thus it happens that even Alan Greenspan's elevation to the starry dome has come to a precipitous end.

"Christopher Dodd, chairman of the US Senate banking committee, complained yesterday [that] Mr. Greenspan who retired last year as US Federal Reserve Board chief, was an early proponent of the type of exotic mortgages now being blamed for an epidemic of foreclosures across the US.

"Mr. Greenspan urged lenders to move away from traditional fixed-rate mortgages in a June, 2004 speech to help US consumers, Mr. Dodd told a hearing probing the subprime mortgage meltdown. 'The Federal Reserve seemed to encourage the development and use of 'adjustable rate mortgages' that today are defaulting and going into foreclosure with poor credit scores and low incomes.

"'The Fed then did little to rein in banks as lending standards deteriorated in a mortgage market that seemed to be on steroids,' said Mr. Dodd.

"The committee heard testimony from two consumers who said they were lured into mortgages with initial low 'teaser' interest rates that quickly ratcheted up to unaffordable levels. These so-called adjustable-rate mortgages, or ABMs, were commonly sold to subprime borrowers with poor credit score and low incomes.

"'It seems to me that you were all asleep at the switch,' New Jersey Democrat Robert Menendez said pointedly as he quizzed officials from the Fed, the Treasury Department, the Office of Thrift Superintendence and the Office of the Federal Deposit Insurance Corp.

"There are roughly $1.28 trillion (US) subprime loans outstanding, of which 14.4% were in default at the end of 2006. But regulators said the problem would get worse this year and next, when interest rates on 1.8 million subprime loans are due to rise.

"The regulators complained they lacked authority over a proliferating industry or mortgage intermediaries, who seemed to fall between the cracks of federal and state oversight. But at least one witness acknowledged the Fed probably could have acted quicker to tighten lending standards before so many borrowers got in over their ears.

"Mr. Dodd has said that he'll soon introduce legislation to crack down on lenders who prey on the poor and uneducated. But executives of several mortgage companies told the committee that regulation would make credit problems worse by denying loans to worthy home buyers.

"Other witnesses said the real villains in the subprime meltdown aren't regulators, lenders or consumers, but Wall Street, which had an insatiable appetite for mortgage-backed bonds.

"'The real market demand for bond services is on Wall Street,' explained Irv Ackelsberg, a Philadelphia real estate lawyer and consumer advocate. "That's the real market and the real culprit.'"

W.K.

sion. That explains why an insect can drop from the top of a skyscraper and reach the earth unharmed, while a man will be killed by falling a few storeys. That is enough to knock out the inevitability of Deregulation and Globalization. It should invite second thoughts about allowing banks to merge, especially since each party is usually in such cases big enough not to be allowed to fail. Combined with banking deregulation that invites them to engage in mega-gambles secure in the knowledge that the government will bail them out.

The Wealth of Policy Design Revealed by Vector Thinking

Then there is modular congruence arithmetic of the great 19th century mathematician, Friedrich Gauss. Don't be frightened by the words "modular congruence" – like the hero of a French classic who was surprised that he had been talking prose all his life. Our ancestors intuitively applied Gaussian modular congruence when they named the days of the week. Instead of devising a new name for every day since the birth of Christ, they eliminated the multiples of seven and started over again the same name-cycle. Globalization and Deregulation, however, by contrast, add mileage indefinitely through unfamiliar lands. That multiplies the variables of the problems that crop up, while the variables in the solutions remain just market supply and demand. To lessen the burden of some variables of the problem, we may choose variables in our proposed solution that have opposite effects on the extent of our perceived problem, and lessen both of them while maintaining a zero effect on a troublesome key statistic. For example, reduce a consumer tax like the Goods and Service Tax in Canada, and at the same time have the federal government shift an amount of its debt from the banks and the general public where it costs them interest, to the Bank of Canada, the government's wholly owned bank where interest paid for financing the government as dividends. That would reduce the federal deficit, and the upward pressure on the rates of interest throughout the economy.

That matched dosage of two variables with opposite effects on the treasury will clear an ideological fortress that dominates the economy today – the need for a balanced government budget that is still without meaningful accountancy. But the effects of these two reduced vectors with a zero joint effect on government finances does not stop there. Having introduced the notion of vectors rather than just scalars in our analyses, we are able to track the further progress of these balanced vectors throughout the economy, society and the environment. They will bring down interest rates across the board, This would give married women the option that they often do not have today of staying home to look after their families. It would reduce the cost of protecting the environment.

The same technique of identifying other pairs of policy vectors with similar quantitative but oppositely directed effects could be sought out and applied. Then we would no longer have to postpone dealing with the planet warming build-up, which scientists have told is likely to be irreversible if we neglect dealing with it within the next three decades.

With the world pushed increasingly into military solutions by the failure of official economic policy, it is incredible that our governments should not even have conducted research on the possibilities opened up by systems theory for dealing with all our major problems – environmental, economic, health, and diplomatic by releasing the resources that are available if properly organized to prevent society from blowing itself up and/or destroying the earth as a planet inhabitable by humans.

At this point, let us get back to Hixson's treatment of Keynes. He had found himself blocked by the American super-power at the 1944 Bretton Woods Conference, in the matter of putting the responsibility for keeping some stability between currency values and debt between the debtor nations and their creditors. But he did not abandon the struggle. In the last year of his life – 1946, he made the attempt to introduce accrual accountancy into government books.

Among the leaders of COMER plenty of room was left for understanding the old solutions and even new ones. Yet at the same time the freedom of discussion in the world at large and in the universities was rapidly being abrogated, and the new "solutions" being imposed. Above all John Hotson was a magnificent organizer of conferences, where a variety of views on any subject were invited and listened to. That is what had attracted Hixson and myself to him.

I remember one conference that he organized with the notable help of Hazel Henderson from Florida and other American reformers. Workshops were provided on every theme, representatives of large polluting corporations like Inco sat on the platform and were given the opportunity of answering criticism of their firm's environmental record.

The idea of Zarlenga checking the writings of Hotson to see his views on 100% money that I might be hiding is quaint. Many of the basic documents issued by COMER in those early days were signed by myself and Hotson. Some by Hotson alone, or appeared unsigned in *ER*, of which I took over the practical editorship because Hotson was busy with his teaching at Waterloo.

Harvey Wilmeth, of the economics Faculty of the University of Wisconsin, was of the greatest assistance in developing my notion of a mixed significance of any price index movement in a mixed economy. Because changing government infrastructures – both human and physical – had become an essential feature of an economy undergoing constant technological revolutions, urbanization, and population density, the layer of taxation not directly determined by the market sector constantly grows in depth. It must not be confused with "inflation," properly defined as higher prices due to an excess of demand over available supply.

Bill Hixson and I were particularly close, too, because apart from his gift for getting along with people, amongst the founders of COMER I shared with him a knowledge of Marxist economics.[4]

It is ridiculous that Stephen Zarlenga should apparently not been able to organize conferences without all sorts of gimcrackery – blank "Certificates of Achievement" distributed for the awardees to fill in, coloured hats, warnings to people that they would not be allowed to sell their books at the conference if they raised forbidden subjects. Even so, some excellent papers were delivered in no particular sequence or opportunity for discussion. The overriding impression was that Stephen wanted to claim a patent on monetary reform.

William Krehm

1. And because of this most unusual situation let me avail myself of correcting an important typo on page 222: the first two words on page 222 give you a misplaced date: "In 1991 an elaborately…" should read "In 1982…"

2. Krehm, William (1975). *Price in a Mixed Economy – Our Record of Disaster* (p. 149-150). Toronto.

3. Krehm, William (Ed.). (1999). *Meltdown: Money, Debt and the Wealth of Nations.* COMER Publications.

4. Marx was of little help in understanding price in a mixed economy, which of course, would not begin to develop until a good century later. Thus in his *Histoire des Doctrines Économiques* (1925, vol. 2, pp. 57-58, Paris), Marx takes the French translator of Adam Smith, G. Garnier, to task for arguing for the productive nature of state services. "Of course, a Frenchman could not miss coming up with *Ponts et chaussees* (bridges and roads)." And arguing against Ganilh (p. 80) on the same point, he delivers himself of the following: "The tax on his wages that the state and the Church is taken from him for the services imposed on him. What he pays for education is blessedly little. As to his expenditures for services of doctors, priests, lawyers, that is so much wasted money."

More Knuckle-dusters in the Offing on Wall Street?

The long-existing forebodings have come to pass.

As lower interest rates recede into the hazy background, the relationship between lenders and borrowers is taking on a less than gentlemanly edge. *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 trade 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 has 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.

"Increasingly, important holders of hedge funds are playing a more pivotal role in the reorganization of companies gone bankrupt. That 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.

"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 hold 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. In some cases they 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 of 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."

Dynamics of Bankruptcy Changing

"The debt itself is widely diffused among lenders. The dynamics of bankruptcies are bound to be different, if they do start to rise. 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.

There is simply too much money around, and we are choking in it. It's got to be invested, no matter in what. That is the only conclusion that we can draw from *The New York Times* article (1/06, "Big Investors Jumping Back Into Shaky Home Loans" by Vikay Bajaj and Julie Creswell): "The subprime mortgage business is in tatters; loan volume is plummeting, defaults are rising and some of the biggest lenders have cut back or shut down.

"So what is the smart money – private equity, hedge funds and investment banks – doing? It is swooping in and taking over those battered businesses, seeing opportunity among the wreckage.

"'There is a lot of money pent up,' said Steve Probst, national state manager with Fairway Independent Mortgage, a lender based in Sun Prairie, Wis. 'And a lot of people are betting that the market will snap back quickly.'

"It is a risky proposition. In many parts of the country, there is a glut of unsold homes. Defaults and foreclosures are rising, putting further burdens on home prices and mortgage lending. Some housing officials worry that the new infusion of capital may refuel aggressive and risky lending to people with poor credit, known as subprime borrowers, delaying a much-needed winnowing of the business.

"These dark clouds do not faze the new money in subprime. Among those making the biggest bets is Cerberus Capital Management, which first made its name in distressed debt. One of the country's largest private equity firms, Cerberus has a record of making risky contrarian bets, including the recent agreement to take control of the troubled Chrysler Corporation for $7.4 billion.

"Cerberus acquired control of the subprime lender Residential Capital last year when it led an investment consortium that bought a 51% interest in GMAC, the finance arm of General Motors. And in April, Cerberus, which also owns Aegis Mortgage, a subprime lender based in Houston, announced plans to acquire Option One, the troubled mortgage subsidiary of H&R Block. Taken together that would make Cerberus the biggest subprime lender in the country, far ahead of large mortgage giants like country-wide Wells Fargo and others, according to first-quarter lending statistics

from *Inside Financing.*

"This year when rising mortgage defaults and a credit squeeze on Wall Street have forced many subprime mortgage companies into bankruptcy, some analysts predict that the industry may shrink by a third or more. Many industry officials acknowledged that a shakeout was necessary. In the last several months, however, private equity firms and others have acquired, taken stakes in or provided nearly 30% of last year's $600 billion in subprime loans. It is, analysts and industry officials suggest, an unusually quick bet on a distressed business that by most indications is in the early phases of long-term entrenchment."

A Shakeout in Subprime Mortgage Debt Becomes Necessary

"With billions in capital available to them, investors like Cerberus, Ellington Capital and the Citadel Investment Group see an ideal buying opportunity. Yet trying to time the bottom of a sliding market has been tricky. Rising defaults and the costs of buying back poorly performing loans from investors left Residential Capital with more than $1.5 billion in losses in the six months that ended in March. (In March, General Motors, which still owns 49% of G.MAC was forced to put an additional $1 billion into the unit because of mortgage woes.)

"Investors who buy subprime mortgages are demanding higher-quality loans after being burned by high rates of default and fraud in loans written in 2005 and 2006. That is forcing mortgage companies to tighten lending standards by demanding that borrowers make bigger down payments and have better credit histories, changes that have significantly reduced the pool of qualified borrowers."

The article runs on and on in the same direction, but what concerns us is the surfeit of credit. Bank credit when it is of much higher quality than subprime loans is referred to by economists as "near money" for it is created by being lent out by banks as interest-paying loans. Since 1971 when the world went off even the pretence of being on the gold standard, the only "complete" money is what the government spends into existence and thus does not bear interest but has the entire economy of the land through the government behind it. Because it is not *lent* into existence but *spent* into existence, it does not move inversely to the rate of interest – a feature that gives it greater stability. When interest rates go up, the value of preexisting loans bearing interest declines in value, and vice versa. That diminishes its usefulness in price indexes and for other purposes.

The current glut of bank credit and the deepening shadows of subprime debt is closely related the deregulation of banking throughout the world – particularly since the 1970s. We have not seen the end of that phenomenon because deregulation has so harnessed future hypothetic rates of profit growth to keep present stock prices soaring, that the process cannot be allowed to flag. Indeed, the option reward system for high corporation executives has been so lavish in boosting the future and incorporating much of it into today's prospects, that any failure of the corporations to achieve the forecast market prices of corporate shares would bring on a disastrous folding of forward-leaning evaluations. Options of high executives would become worthless, and share prices would drop.

Much of this can be traced to the deregulation of the banking industry that gave the banks access to the other "financial pillars" – stock market brokerage, insurance, and mortgage corporations and to their pools of liquidity that could now serve the banks as the money base for their money creation.

I will quote from a paper that I read before members of the economics faculty of Laurentian University, Sudbury, 35/3/99, when such communication with the economic faculties of our universities was still possible. "The private institutions that have taken over money creation are not just in control of the gambling joints, but they are amongst their own best customers. They have acquired command of the public treasury and then down-sized government services. When the deficit had been pushed high enough, it took over from inflation as the driving obsession of government policy.

"First they loaded it with high-interest debt to bail out the private banks from their losses during the eighties.

"That set the stage for the privatization of government assets *at fire-sale prices* – the leveraged buyouts by private corporations. Indeed, the bizarre accountancy of our government made it impossible to say what a public asset was worth. When a physical capital assets is acquired by Ottawa (unless it is through a separately organized crown corporation) it is written off in a single year and then carried on the balance sheet at a token $1. Because of that the government could sell the Parliament Buildings for one thousand dollars, and book a profit of $999, which would, of course, be used to 'reduce the debt.' Then it could rent the Parliament Buildings back at a rent that would be bound to go up over the years. [In 2000 the Auditor General of the day put his foot down, and since the United States had brought in accrual accountancy (also known as 'capital budgetting') in 1996, our government finally brought in capital budgetting.]"

A Forward Lean of the Economy

"However, government investment in human capital – education health and social services – is still expensed as a current item, as is environmental protection. *Economic Reform* has tracked a statistic compiled from data in the *Bank of Canada Review* – the ratio of the chartered banks' assets to the cash held by them. Basically that represents the banking multiplier *as it could best be improvised after the statutory reserves were phased out in 1991-93.* Under that system, the banks had deposited with the central bank some 8% to 12% of the deposits they took in from the public, and on that they earned no interest – just as they had earned no interest on the gold backing they left with the Finance Ministry to cover the paper money they had issued when there was no central bank prior to 1935. In that year the Bank of Canada was opened as a private institution with 12,000 shareholders. Until two or three decades ago there were strict limitations on what the banks could do with the credit they created. Today, however, they can invest it in just about anything – gamble on the stock market, in derivatives, in foreign junk bonds. The ratio of the credit created by banks to that of the government-created debt – most of what is used as money today – has increased from 11 to 1 in 1946 to 404.7 to 2 in 1998. After that with the stock market collapse, it fell to about 380."

Today with deregulation having proceeded further, it is probably around 1000.

This provided a timely warning where our economy was headed, but the government and the universities paid ever less heed. *It was driven by the excess of capital seeking investment by the bank multiplier being applied in turn to the cash and near-cash reserves of several different non-banking financial pillars in sequence.* The bill for the government ignoring the warning of COMER and others about where Deregulation and Globalization was leading is now just starting to come in. That basically is what the present subprime debt crisis is about.

William Krehm

Our Rock-solid Banking System

Among the certainties of our world when Canada was still a dominion of the British Empire was the conviction that we had two great advantages as a nation: the rock of Gibraltar that dominated our approach to the Mediterranean and thus safeguarded our supply of Indian Maharajahs who so frequently were brought over to open Toronto's Canadian National Exhibition. And then there was the Canadian banking system. Little was known about the mysteries of banking but what helped nurture Canadian self-respect was that though our American cousins might have most of the world's money, our banks, unlike theirs, rarely failed. That was particularly the case in the early 1930s. There had been one Canadian bank of national proportions that went bust in 1922, the Home Bank, and there was mighty little banking that took place at all during the 1930s. But when we had need of some self-assurance – which was most of the time – we could always look at our sparse record of bank bankruptcies.

It wasn't until well into the 1980s that we ran into a cluster of new banks – mostly in our West but one in Toronto that shut their doors for good. One detail that should have disturbed us much more than it was allowed to, was that a day or so before on one of these new banks closed the then Governor of the Bank of Canada went public to declare how sound it was. As a result of that spectacular goof, Ottawa was stuck with compensating the innocents who opened accounts with that bank as a result of that reassurance. However, the real warning that should have been drawn from that bizarre episode in our central banking history was not heeded. Obviously the government that should have been the watchdog of the soundness of our banks had crossed the boundary line and become their shill. A perfect forecast of more of the same to come.

And meanwhile our banks went on merging and taking over the other "financial pillars." There had been some very good reasons for banning these other fields of financial enterprise as playing grounds for banks. For each of these for the purposes of its own business kept its own pool of liquidity – either cash or short-term securities of top-quality that could readily be transformed into cash. Recovered due to the simple diet they had been put on during the Depression, all banks lusted after these reserves. By merging with or absorbing the other pillars that owned them, they could serve as the money base for the banks' own black magic. But the art of banking, however, is no easy one: no matter how little actual cash a bank may retain – whether its own or its depositors' – it must *always* be able to meet the claims of depositors or to whomever they may have assigned their deposit. Financial fortresses and castles have been built on that assumption. If a single bank cannot honour a single such claim, that whole panorama of faith and security comes down crashing. And restoring a banking system that has flunked this test is no easy matter.

Reasons for Restricting Banks to Banking

That is why formidable ramparts were set up to keep banking on the straight and narrow. The rewards of surrendering to the temptation of banks' money-creating powers are so immense, that there are those who believe banking itself to have been designed by the Devil. We are not of that school, but we do hold that all sorts of early warning signals should be heeded and even encouraged rather than suppressed. Nor should our law books have been crammed in recent years with ever greater opportunities for banks to enter non-banking financing enterprises – notably stock brokerages, insurance, and real estate mortgages. Complete freedom of criticism of banking theory and practice should not only be allowed, but encouraged.

This requires a good knowledge of history, of accounting – not only of that used in the private but in the government sector. And precisely because the deregulation and globalization of the economy is taking place, it should be kept in mind that the vastly broadened powers of money creation being granted the banks will be exercised in parts of the world where legislation, traditions, and social landscapes are unfamiliar to our banks. The combination of the bank multiplier with the ongoing deregulation of the real and financial economies is making even the domestic finance-scape terra incognita for banks.

I am engaged in preparing the second volume of *Meltdown* – a selection of outstanding selections from the 18 years of COMER's monthly newsletter *Economic Reform.* Even I am astounded by the criticism that members of COMER were able to express of government and Bank of Canada policy at sessions of the House of Commons Financial Committee to which we were invited. Similar criticism was carried by leading newspapers. That hasn't been the case for years. And the reason for that is not that it has been less needed, but on the contrary because it is more needed and increasingly hard to rebut. Hence it has simply been suppressed.

And the crucial empty time and mind-space has been filled by the repeated drumming-in of the mantra that all goes well, "inflation has been controlled." That view of the world economy drags a leg right from the very concept of "inflation." Budgets that are balanced by ignoring the destruction of the environment cannot be considered "balanced." The cost of repairing the damage to the environment or to society itself must be entered into our accountancy as a capital debit. But that is only one of many flaws. Some – under extreme duress – have been rectified.

When to bail out the American banks from their massive losses in their taking over the Saving and Loans real estate operations in the early 1980s, the central government debt of developed countries was declared "risk-free" requiring no down-payment for banks to acquire. So Canadian banks quadrupled their holdings of such debt to $80 billion, and confined themselves to cashing the interest coupons. However, the same non-elected international body that formulated that relief measure for the banks also raised the benchmark interest rates set by the world's central banks "to lick inflation." But in the urgency of the bailout, they overlooked that when you raise interest rates, preexistent government debt with lower coupons falls in market value. That precipitated the collapse of the Mexican peso and the Mexico economy – our partner in NAFTA, and almost brought on the collapse of the international monetary system.

To deal with that the US government as of January 1, 1996, Department of Commerce figures began for the first time reporting the undepreciated investments of the government in its asset column. Up to then it had carefully reported the debt incurred to finance such capital investments – roads, bridges, buildings, battleships, as debt but had written off the entire assets paid for by hat debt in the year when the financial transaction was concluded. It was the equivalent of calculating your personal worth by reporting the mortgage on your house outstanding but omitting the asset value of the house it helped pay for. It violated the basic principle

of double-entry bookkeeping. In 1996 this was rectified, but under the misleading heading of "savings." That expression had hitherto been reserved by economists for assets in cash or near-cash form and quality. The avoidance of the proper heading was not to disturb the ideological conviction that governments are not able to make productive investments – they can only bail out the banks that, of course, can.

Governments Discover Double-entry Bookkeeping

The sensationally improved balance sheets of the government that resulted – explained to the bond rating agencies that are accustomed to such evasions – sufficed to win for US government a higher credit rating which brought down the interest paid on its debt, and that staved off the inevitable for a while. Takeovers at home and abroad provided the semblance of feverish prosperity. But a growing malaise made itself felt in feverish stock market performance. It found its way even in the news columns of the better financial press, for business men at some level have a need for reliable information rather than their own packaged propaganda. That even can influence the take-over strategies of low-brow media sharks in their bidding for such firms as Dow-Jones. So much for the newspapers – a waning breed. In the field the assets that provide reliable information services command a far higher multiple in proposed offers.

There had been nodding heads and whispering of recent experience about the difficulties of some clients to extract some of their substantial excess equity from winnings in their margin accounts with the Bank of Montreal's brokerage arm. Instead of cash forthcoming from the account to pay the income tax incurred on the very winnings in question, there was reference to committee meetings that would have to authorize it. That is not standard practice in brokerage houses. One client was reported having incurred some $10,000 in penalties from Revenue Canada for late payment of the taxes on the earnings that had been reported in the client's report from the BMO brokerage arm. The client in question after spending hours ante-chambering at BMO Toronto's head office, and on the telephone with Revenue Canada, laid hands on the money elsewhere, paid the penalty and lessened his dependence on BMO since it appeared to be showing some difficulty meeting its contractual obligations. That, of course, hardly enhanced its credibility as a stock brokerage *or as a bank*.

By May 18, the client's suspicions were confirmed and updated by detailed articles both in *The Globe and Mail* and *The Wall Street Journal* (*WSJ*: "Bank of Montreal Lifts Trading-Loss Tally" by Kevin Kingsbury and Monica Gutschi) informs us: "Bank of Montreal increased its estimate of how much it lost betting on natural gas, saying it is investigating possible 'irregularities' in trading and valuation.

"The bank said it now believes it lost 680 million Canadian dollars or about US $615, concluding that its April 27 estimate of C$350 million to C$450 million was based on possibly inaccurate information from its principal broker.

"The greater losses still aren't enough to shake the bank's Tier 1 capitalization ratio, which will fall about 0.2 percentage points as a result. But the disclosure raises questions about what led to the losses, when the bank became aware of the problem, and why it was unable to come up with a timely assessment of its exposure.

"Bank of Montreal said last week that it suspended its relationship with brokerage firm Optionable Inc. Owned in part by Nymex Holdings Inc. – pending an investigation of what led to the losses.

"Bank of Montreal said yesterday that natural-gas trader David Lee and Bob Moore, executive managing director of commodity products, are no longer with the company. A new team of traders has been assigned to the portfolio, and its risks have been reduced by a third, the bank said.

"Earlier this year, the bank sought independent verification of the portfolio's value. It hired an outside firm in mid-February to review the bank's valuation, risk management and controls. The results were delivered in mid-April and led in part to the disclosure of the trading losses, the bank said.

"Bank of Montreal didn't say why it sought the independent verification. The bank's principal broker was Optionable which said last week that it provides brokerage and execution services only for trades it is instructed to make.

"After April 27 new information was obtained, and [Bank of Montreal] determined that a more market-based methodology would be used for this portfolio, ' the bank said. The company is set to release its second quarter results next week, at which time the firm will also provide restated first-quarter results.

"Lawrence R. Gelber, a lawyer representing former Optionable CEO Kevin Cassidy said Optionable and Mr. Cassidy aren't responsible for the bank's losses. Mr. Cassidy resigned over the weekend."

Shaking Loose One's Money from a Globalized Bank

What catches the eye and astounds the mind is that the reliable reports of BMO hanging on to substantial profits of the BMO client mentioned above reported by and at no time contested by the BMO office, but that the bank declared could not be released until the a decision by a special committee, for the meeting of which no date had been reported as set. It was during this period that the unhappy client could not pay the federal taxes on the very profits on which the above-mentioned client had been taxed – on the basis of the Bank report to the client. And on the ensuing delay the client paid a late-penalty to an approximate amount of $10,000.

Obviously this is hardly a standard of accountancy up to banking standards which must have payments due clients available for payment when requested.

The morale of the tale is that stock brokerage, and commodity speculation on the banks' own accounts is not compatible with responsible banking. That is the message handed down over many centuries that must be reincorporated into Canada's banking practices.

But what importance might this have for the public at large? A very significant one. For if the BMO lost all that money in gambling on the future price of oil it was undoubtedly against a bank, or a hedge fund financed over 80% by a bank that took the other side of the bet. It mattered less which side might win, the fact is that a betting game on the matter was enough to drive up oil prices substantially. Most of the intrusion into purely financial commodity betting does not involve an exchange or oil or of whatever other commodity. It is the equivalent of gamblers playing poker with the cards marked 10,000 barrels of oil or whatever. The effect does not directly affect the quantity of oil produced except through the price which has little if anything to do with the real cost of a barrel of oil. But, no matter, which side in the gamble may win or lose, it is the consumer of the product that pays the winning-losses as well as any change in the sales price that may result.

In such an economic game there should be no place for banking, a field of gaming that all too readily keels over into speculation.

William Krehm

Correspondence

Mr. Edward Greenspon
Editor, *The Globe and Mail*
Toronto

Have our newspapers really outlived their purpose? The answer emerges clearly from your recent column (28/05, "Canada Pension Plan" by Anthony Westall, "retired journalist looking forward to his CPP Pension Fund each month"). At their best we have need of our newspapers as much as ever. All that Mr. Westall wrote could doubtless have been found on the Internet, but for most of us it would have been lost in blogs, and expressed in a way undisciplined by decades of editorial discipline – in its better sense. Moreover, the pensioners most concerned do not have the eyesight and habits of Googling on the Internet.

Let me quote: "When the Canada Pension Plan was launched in 1966 and the millions of dollars of pension contributions – actually a tax on wages paid by the employees and employers – began to roll in, most were invested in government bonds. The rate of return was not great but the savings were secure, surely the prime concern for any pension fund. And it was a handy source of money for federal and provincial governments.

"But in 1997, with the tidal wave of baby boomers moving towards retirement and expecting their monthly CPP cheque to be waiting, the fund began looking a little thing. So it was decided to raise the rate of return by investing in the stock market. It would be less secure than bonds, but everyone else was making a fortune in the stock market, weren't they?

"An independent panel of financial experts was appointed and the CPP Investment Board began to trade. Those old enough to remember that markets go down as well as up – and that experts are hardly better than amateurs at forecasting the next downturn, or how deep it will be – were a little uneasy. But markets were all the rage and seemingly infallible, so objections were few.

"Will this be a secure investment for the savings of millions of Canadians? Should a relatively anonymous board be using vast amounts of public money to decide the future of a Canadian corporation?

"'We operate independently of the Canada Pension Plan and at arm's length from the federal and provincial governments,' says the CPP Investment Board on its website. It reports annually to Parliament, but after the fact.

"When Bell Canada was a regulated monopoly providing phone service to much of the country, its stock was thought a safe investment for widows and orphans as the saying went. But that changed abruptly when the industry was deregulated and competitors jumped in to challenge BCE. Bell itself diversified into other fields – including this newspaper – but has not been noticeably successful. No doubt that is why the independent experts think they could manage it better.

"Maybe they could, and maybe they couldn't. BCE is in the high tech communication business. Almost anything can emerge from the research laboratories to bring about radical change in the industry, and probably will. BCE might be a leader and make piles of money for the baby boomers' pension fund,. or it could be a loser. Even if BCE got into difficulties, under new ownership we wouldn't know right away because to "take it private" in the jargon of the business, it would cease to be a publicly traded company subject to all the laws and regulations governing such securities. and become a privately owned business – a private business bought with public funds raised by taxation.

"Add the fact that many analysts predict a downturn before long, and a takeover of BCE looks less than copper-bottomed.

"Now the board plans to go even further opening CPP investment offices in London and Hong Kong so that it can be a bigger player in international finance.

"Setting risk aside, was it ever intended that the CPP Investment Board should be an entrepreneur and a major player in the market? Managers of private pension funds have been players for years and have done very well for their clients. But they are risking private money for private benefit. The CPP is a public trust."

Why Did Interest Rates Drop?

There are only a few very relevant background details to add to Mr. Westall's excellent summary of what happened to the Baby Boomers' pension prospects. But it remains to ask why interest rates dropped so drastically starting in 1996, and remained low up to very recently. That was due to the US virtually smuggling accrual accountancy into its books that depreciates its capital investments over their useful lives as taxpayers must. Like practically all governments, it had been treating them exactly as it does current spending, writing them off in the year when they were made. Since the debt incurred, on the other hand, was carefully amortized, that created the illusion of a government deficit that was not necessarily there.

That fictitious deficit was, however, a useful political tool, since on the pretext of "balancing the budget" that was not correctly kept, social programs were slashed and downloaded to our provinces. And the provinces passed on the compliment to our municipalities. That is why so many municipal services are so pot-holed today.

Why did the federal government slash and download vital programs? That, like so much else, blew in from the US. The Wall Street crash of 1929 had led to 38% of the US banks closing their doors by the time Roosevelt was inaugurated for his first term in 1933. One of the first things he did was declare a bank moratorium, and within months brought in legislation confining the banks strictly to banking and forbidding them to acquire interests in the other "financial pillars" – stock market brokerages, insurance and mortgages. The reason: these "other pillars" keep liquidity pools for their own business. Allow banks to get their hands on these, and they will use them as legal tender base to which to apply the banking multiplier – lending several times the amount of liquid cash in their possession. By the 1970s the banks had recovered and were raring to get back to the fleshpots of the 1929 boom.

In the 1980s they took over the Savings and Loans – essentially mortgage trust companies – and before long were servicing their own subdivisions in the Arizona desert with few prospective buyers in sight. To bail the banks out of their vast losses, the US government took them over and after absorbing their losses resold them. And to help the process that went on internationally, the Bank for International Settlements (BIS), a sort of central bankers club that had come to serve as a sort of war-room directing the comeback of the world's banks to the freedom and deregulation that the banks had enjoyed until October 1929.

Of the two policies structured by BIS towards this end, one declared the debt of governments of advanced countries risk-free, thus requiring no down payment for banks to acquire. In Canada the result was that

by 1993 the Canadian banks had increased their holdings of federal debt from some $20 billion to around $80 billion without putting up any money for their acquisition. They had only to cash in the coupons to reconstitute much of their lost capital in ventures incompatible with banking.

At the same time, however, BIS intensified its campaign for "zero inflation," i.e., flat prices indices. This policy assumes that all price rise is a pathology to be repressed. This overlooked the rapid process of urbanization throughout the world, the new technologies that required a far higher education standard for producers and even for consumers than had been the case, and the measures for the protection of a badly abused environment that called for higher taxes. Our modern mixed economy was unthinkable without a deepening layer of taxation in price. And to deal with the tax and price effects such "externalities" interest rates were pushed up to screeching levels.

In its enthusiasm for "zero inflation" plus Deregulation and Globalization, BIS, that directed the grand ball that danced to the tune of "zero inflation," overlooked a detail. If you raise interest rates high enough the market value of preexisting bonds with lower coupons plummets. And that is precisely what happened, causing a drop of the Mexican peso by some 40% and threatening to bring down the world monetary system. Quickly, without waiting for Congressional approval, the Clinton government put together the largest standby fund to that date $51 billion US, with the IMF and the US contributing $25 billion each and Canada $1 billion. That eased the immediate crisis. It also convinced Washington that the day of high interest rates was over. They are simply incompatible with the free-loading of the banks with government debt that the government might have financed practically without interest through its own central bank. For central government debt is the only legal tender that remains since the doing away with the gold standard in the early 1970s.

Washington got out of the mess in a simple way. Up to then all governments – with the earlier exception for a while of Sweden and Denmark – had treated the investments of government just as they did the purchase of, say, floor wax in their buildings. They wrote them off 100% in the year of their acquisition while they carefully amortized the debt taken on for the capital investment – schools, bridges, roads buildings, battleships, in the year of their acquisition. Now the Department of Commerce raised those asset values to their initial value depreciated over their expected useful life and carried such adjustment back to 1959. All in all they added something well over $1 trillion US to their assets.

But since governments according to the reigning orthodoxy, were not supposed to be able to make investments – only banks seemingly were trustworthy enough to do that. So in the Department of Commerce statistics was called "savings" which usually refers to cash or near-cash assets. But with a nudge and a wink to the bond rating agencies that vastly improved balance sheet did wonders in bringing down interest rates. That gave Clinton his second term and gave us the high tech and the high-tech bust that came in 2000.

"Cooking the Books"

Canada profited by the low interest rates that resulted from the adoption of accrual accountancy by the US government, but itself clung to "cash accountancy" treating our government's capital investments as a current expenditure. Until in 1999 the Auditor General, Denis Desautels, refused to approve unconditionally two successive balance sheets of the government until the change was made. For weeks the then Finance Minister, Paul Martin, argued with his Auditor General, who accused him of wishing to continue "cooking the books." Finally in 2000 a compromise was reached. Accrual accountancy was brought in, but the Auditor General had to agree to a demeaning and misleading statement that since no new money had been brought into the treasury, it did not warrant spending for new programs. And the Finance Minister took a deep bow for the surplus that suddenly appeared as a sign of his "fiscal prudence."

All this is important for our pensioners' grasp of the incredible cost of those sky-high interest rates before 1997. The security of pensioners would have been infinitely better served if the bank had remained restricted to banking as they were to help us out of the Depression, to finance our part in WWII, in the tremendously executed catch-up of Canada's up-dating of its neglected infrastructures after 16 years depression and war, transition from a semi-agrarian to a highly urban society, several technological revolutions, the assimilation of a vast, mostly penniless immigration to standards unknown before the war. The *Bank of Canada Act*, which still provides for both unfunded and funded financing of all three levels of government (against guarantees of a provincial or the federal government in the case of municipality).

If your newspaper continued a discussion starting from Mr. Westall's fine piece, it would make a tremendous contribution not only to imminent pensioners but to the nation. Please note I am not suggesting that you adopt the use of the Bank of Canada for its original purposes, but only that you inform the public of that option and invite a public discussion the tremendous role it played our history. What is involved is not "funny money," but the good old capitalist institution of dividends. For in 1938, a Liberal Government headed by William Lyon Mackenzie King, bought out the original 12,000 shareholders of the Bank of Canada at a good profit. That is why our government should be doing the financing of its essential investment in physical and human capital through its own central bank, rather than getting into trouble financing gambles like Enron and the current hedge funds that are up to their eyebrows in the collateralized debt plays.

William Krehm, Editor,
Economic Reform

PS. I would be thankful for your forwarding a copy of this to Mr. Westall.

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