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CONTENTS

2 Snagging Some Attention in Kingston
4 New Power to Labour Unions in Takeovers?
5 The Secrets of the US Housing Slump and Beyond…
8 The Greening of Geopolitics
11 The Iraqi Adventure Is Not the Only Mess that Blair Shares with Bush
12 Are Banks Becoming More "Efficient" Running Stock Exchanges?
13 On the Immense Relevance to the Economy of Systems Theory
14 On 100% Money
17 What Is Governor on the Public Payroll For?
18 Big-boy Letters
19 Murdoch Rattles Carefully Propped-up Self-esteem of the Media
20 Light Out of Detroit?

Can Canada's Richest Province Not Afford Clean Drinking Water?

Suppose you had a neighbour so miserly that he denied his children warmth, proper food and clothing so that he could put more money in the bank each week. Instead of fixing the plumbing, he gave them water to drink from the old lead plumbing pipes, or from the muddy wells in his backyard that had been polluted by a pig farm next door. All this, said he, was for their good since he was banking the money to allow them to retire 60 or so years ahead. You would of course conclude that he was batty, since he was putting them at risk of not even growing up.

It seems however that our government is guilty of policy of this sort.

This the story that *The Globe and Mail* (3/06, "Lack of funding putting Ontario's water at risk" by Karen Howlett) tells: "Ontario risks compromising the safety of its tap water because many small towns and cities lack the resources to meet proposed stringent new standards for operating new drinking water systems, says the head of the new task force that two years ago called for a sweeping overhaul of the province's water systems.

"Seven years after the Walkerton tainted water tragedy claimed seven lives and left thousands ill, many Ontario residents have something new to worry about – lead in their tap water.

"Last week, the province's Environment Ministry ordered 30 cities and towns to test older homes – typically those built before 1955 – for possible lead contamination in their drinking water. (The order went out after high levels of lead were found in four London homes.)

"The lead levels were detected even after flushing, which typically replaces water that has come in contact with lead pipes. Lead poses a health risk for pregnant women and young children. The order says excessive corrosion of pipes may be causing lead to leach into the water of other municipalities, including Toronto.

"New Democrat MPP Peter Tabuns crit-

Continued on page 16

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Snagging Some Attention in Kingston

The campaign of Kingston COMER affiliates to secure funding for municipal infrastructure and other public investments through Bank of Canada caught the attention this past season of Andrew Ball, a business and economics journalist with Queen's University Student Radio, CFRC at 101.9 FM. His comments on the proposal were heard by some COMER members and Richard Priestman invited Mr. Ball to attend a meeting of the group. The invitation was accepted and Mr. Ball brought his micro-recorder to 99 York Street on November 19. (His condensation of the discussion was broadcast on Wednesday, the 22nd.)

The necessity of making a coherent exposition of their position for the interview was an occasion for the COMER members in attendance to collectively review and restate the nature and extent of their shared precepts and policy prescriptions. (Written contributions to the preparation of this report were made by George Biro, Don Findlay, Richard Priestman and Peter Zuuring.) Discussion focused on the issue that had aroused Mr. Ball's interest. That is, the COMER proposal for financing public investment in obviously needed areas such as municipal infrastructure, health promotion and medical care, education, development of alternative energy sources and reduction of CO_2 emissions--would be inflationary. Andrew's participation included responding to questions about the content of training programs for business students and of economics policy courses that he personally follows as an elective. An economics text currently favored in university programs was on the table, and reference was made to it in parts of the discussion.

What is inflation anyway?

It was easily agreed that inflation has become an imprecise concept, especially since business news from radio and TV regularly presents it as simply an increase in some price index or other. Furthermore, the explanation offered frequently alludes to some factor such as crop failures in Florida or oil pipeline explosions in a war zone. These factors constitute a *real* increase in cost of production. Higher prices are not necessarily *inflated* prices, in other words, for they can reflect higher costs. The traditional, indeed the essential, meaning of inflated prices is that they are blown up by the non-real villain of monetary instruments that can't hold their value. This failure is normally attributed to excessive growth in the quantity of money. To quote the economics text: "When a government creates large quantities of the nation's money, the value of the money falls." More generally, any excessive increase in M(oney supply) can cause an increase in P(rice level) unless the Q(uantity – including quality) of goods produced grows also. This happened famously to Spain with the gold it brought back from the New World. And even more famously to Germany in the 1920s.

The Advantage of Owning a Bank

Attention then turned to the role that legislated powers of the Bank of Canada should be playing in the financing of municipal and other public-interest investments. Mr. Ball had expressed concern that this would inevitably entail an increase in money supply. It was noted that this need not be inflationary. Many volumes of argument and historical experience can be cited to demonstrate that an increase in money supply may facilitate a commensurate or even greater increase in real production. Putting it the other way round, an inadequate supply of money and/or credit can be a serious constraint to production and exchange. A critical consideration is the time horizon that is built into a deliberate increase in money supply. Investments in education, transportation networks, water and sanitation conveyances, scientific research and technology development, health maintenance, resources sustainability, etc. make a society more productive and prosperous, but it may take some time to reap the full reward. The kind of increase in M that is required for these purposes is more accurately conceived of as *credit*. The German hyperinflation was the consequence of printing ever greater quantities of *currency* in an effort to command a quantity of goods that was not increasing. The government in that case was competing as a *consumer*. The COMER proposal, by contrast, is for government to expand the supply of credit to *invest* for longer term, more permanent prosperity.

When government invests for purposes such as those mentioned above, it must

do so on credit, for current tax revenues are sufficient for little more than regular operational requirements. The costs of borrowing (interest payments) become an operating expense and are added to the government's annual operating budget. That is how Canada was developed, from the days of John A. Macdonald and the financing of the Pacific Railway, for example. And from the late 1930s until the 1970s, the Bank of Canada was used to finance wars and megaprojects without inflation or runaway debt. An important reason for that benign effect is that the Bank is wholly owned by the Government of Canada. That means that annual interest payments on government borrowings for investment in development projects, which are revenue to the Bank, are mostly returned as profits to the sole shareholder. In other words, investments in important public infrastructure can be, and have been, virtually interest free. Hence, the question that affiliates of COMER are putting to their political representatives around the country is "why aren't we using the same means now, when our needs are obviously pressing?" ("If we own the bank, why aren't we using it?")

The answer that "it would be inflationary" is highly suspect. If true, why was it not the case prior to the 1970s? What has changed? To predict inflation implies that the proposed investments would not be productive (of an increase to Q in the equation MV=PQ). And it suggests that the real issue is how aggregate national resources should be *allocated.* That is, for what purposes (and in what relative quantities) should our men and materials be used, in the concrete, material sense. Even more critical are the issues of who should get to make those decisions and reap the benefits.

Not Only Allocation, But Also Distribution

Although well-designed and executed investments in public utilities make individuals and enterprises more productive in the future, men, machines and materials might already being used to full capacity. In that circumstance (as did occur in wartime), then a rational allocation calls for a rank ordering of projects and selection of the most important ones first. Unless extreme exigency (such as war) justifies the imposition of rationing by government, there is competition for resources among proponents of the various projects and prices rise for men and materials. Projects with the promise of most immediate and highest returns are those most likely to win. In the short term, therefore, some activities are postponed in anticipation of lower relative prices after the current burst of investment projects starts bearing fruit. These conditions might look like inflation, but they are also the circumstances of real growth in the nation's productive capacity. They therefore offer the opportunity for a general increase in welfare.

Closer examination of the inflation bogey suggests that its meaning is more political than economic. It disguises a distribution of income that favors the few against the many. For even under conditions of full employment, a truly sovereign government could out-bid private investors if public investments were of highest priority. The convenient objection is that this balloons government debt at a burdensome cost to taxpayers, and there is no room for more. As Andrew Ball noted, the debt is conventionally attributed to "the high spending days of Trudeau, Mulroney, and a couple of wild minority governments." COMER's counter observation is that the debt burden need never have become so large and that it can yet be significantly reduced through effective use of the Bank of Canada. A closer look at how the debt became so large and who gets the benefit of interest paid by taxpayers exposes the distributive issue. These are questions that require a search into the past.

History, for empiricism over assumptions.

Details familiar to readers of *ER* were recited for Mr. Ball: Partly as a response to pressure by the banks in the face of major losses on their investment ventures in the seventies and eighties, the federal government gradually transferred most of its borrowing to the private market. When BoC sells government bonds (i.e., borrows), it depresses their price, raising interest rates. Government guaranteed returns were a plum that capital pools could not resist, even though it meant competition for private investment projects. The consequence was a sharp spike in interest rates, a "favor the saver" policy that produced a budget deficit as government interest costs shot up, forcing even more borrowing and a consequent ballooning of government debt. That was the "spending program" that got the government into trouble. It transferred billions of taxpayer dollars to private investors via record-high interest rates. That is how the big debt was created and how paying the interest on it continues to dwarf all other federal budget items today. In this situation, tax revenues reward private investors. That might be acceptable if there were some distributive equity in ownership of the debt. And there would be if more of it were owned by Bank of Canada.

Income distribution is not the only political issue that is aggravated by the inflation bogey. There is a fairly widespread opinion that governments ought not build and operate enterprises, period. (Especially, some might add, when it entails giving away going concerns to friends of the government!) Proponents of this view argue that bureaucratic organizations are operated ineffectively or perversely by governments. The counter view is that some social functions are ineluctably public in nature and they are under-funded at this time. The "inflationary" argument against Bank of Canada participation in these is a pretense that "economic science" favors dismantlement of government functions.

In connection with the possibility that government-funded projects might overheat the economy, it was pointed out that legislated powers of the Bank of Canada give it the option of restraining credit expansion by private banks. It can impose or change reserve requirements. Banks were once limited to lending no more than ten times the amount of deposits they held. Removal of this limitation was one of the changes that has occurred since the early '70s. Discussion of this topic led to two interesting observations:

- The economics textbook says that the reserve requirement was suspended in order to "give banks a level playing field." They complained that they were not being treated fairly by having to maintain reserves with Bank of Canada when other credit-granting institutions were not so constrained.
- Mr. Ball manifested some surprise at this, because he was under the impression that the reserve requirement is still in place.

The foregoing is particularly significant because the textbook on the table was one that Mr. Ball recognized as the one he had studied from in Economics 101. Since Andrew also told us that he has taken subsequent courses in economics and finance, it strongly suggests that intermediate and senior level courses fall back on traditional concepts of money mechanics. As he also told us, the courses he has taken focus on abstract principles and pay little attention to history. (This is rumored to be the general situation in university programs and warrants examination by COMER members.)

Keith Wilde

New Power to Labour Unions in Takeovers?

With the takeover mania, our economy has developed a completely new topography, and those who insist on steering by the old charts are hopelessly defeated even before the battles begin. However, new strategies are cropping up. And since sacrifices are demanded of labour forces and pensioners of the firms taken over, some of those who up to now have been cast exclusively as victims can become stakeholders who hold the power to determine whether a given takeover will fly or crash. Our source, the front page of *The Wall Street Journal* (9/05, "New Clout – A Labor Union's Power: Blocking Takeover Bids" by Bernard Wysocki, Jr., Kris Maher, and Paul Glader) is above suspicion of pro-labour bias: "Pittsburgh – As Brazilian steel giant CSN maneuvered last year to merge with Wheeling-Pittsburgh Corp., the two companies paid little attention to the United Steelworkers Union.

"That was a mistake.

"The USW wanted what it considered a more union-friendly bidder than CSN and found one in Chicago upstart Esmark Inc. Executives of Esmark promised that if they got hold of Wheeling-Pitt, there would be no union layoffs there. The union threw its weight behind Esmark, which then mounted a fierce proxy fight to oust the Wheelint-Pitt board. In November it won handily.

"We turned the entire board over in one day – little old steelworkers and little old Esmark,' says Ron Bloom, the steel union's point man in the battle."

"At a time when organized labor at times seems a feeble anachronism, the USW is exercising plenty of power, by playing for keeps with the capitalists. Its strategy, rather than simply to pound the table for higher pay or threaten strikes, is to block takeovers, take sides in bidding wars, and fight for board seats.

"The union also muscles its way to the negotiating table in bankruptcies, billing itself as a 'creditor' whose claims are workers' lost wages and benefits. In its most sophisticated tactic, it cuts deals with private equity players and other financiers. 'If you're not in the game, you're going to get screwed,' says Lee Gerard, president of the 850,000-member union, representing workers in chemicals, paper, aluminum and several other industries in addition to steel. Many labor chiefs remain hostile to Wall Street types sailing in to buy struggling companies. 'We see them as a group of wealthy people that control a group of other wealthy people's money,' says Buzz Hargrove, president of the Canadian Auto Workers union.... But the USW's tactics may become more common as unions recognize they must deal with the Wall Street crowd, which as a result of investments now control thousands of union jobs.

"From his office in USW's Pittsburgh office tower, Mr. Blum straddles the world of New York private money, corporate executive suites and Midwest union halls. In the Wheeling-Pitt case he dealt with entrepreneurs who run Esmark as well as with Franklin Mutual Advisers LLC, a big mutual-fund firm that owns 70% of Esmark's shares. In return for Esmark's no layoffs promises, the union promised not to oppose its wish to import steel slabs to Wheeling-Pitt mills if Esmark manages to acquire the company, as it hopes to this summer. The union customarily opposes such imports.

"For the USW, a watershed event came in 2001. Mr. Ross was poking around during it second trip to bankruptcy court, with its mills closed. Mr. Ross remembers telling the union that there was value in LTV, but that it would need wholesale restructuring, including a labor overhaul. 'It was a pretty radical change in the way steel is made.' He found the union ready to embrace a leaner operating structure, altered work rules and new rules on incentive bonuses if it got what it wanted from a new owners of LTV.

"Mr. Ross agreed that if he acquired LTV and it became profitable as part of his international Steel Group, a portion of the profit would go into a trust for retired steelworkers' benefits. The USW has worked with a number of companies to set up such trusts, designed to restore part of the retiree benefits that bankruptcies sometimes wipe out."

Management to be Reduced by Twice the Relative Labour Reduction

"The USW says it agreed with Mr. Ross that if he reopened the mills, they could operate with 30% fewer union jobs; it says management ranks were reduced at least twice as much. Mr. Ross then obtained control of LTV and reopened the operations, and the workers ratified a new labor agreement.

"And in 2001, Bethlehem steel filed for bankruptcy reorganization – again drawing Mr. Ross's attention. Mr. Bloom began negotiations with him a second time. 'So we say to Wilbur, "Okay, we'll support you. We'll shield you from all other bidders, so you can get it real cheap." In return, he asked that 'real money' be put into the retiree benefit trust. He says he told Mr. Ross: 'You get to put LTV and Bethlehem together – you've now just created by stroke of a pen the largest steel company in America.

"Mr. Ross acquired several more steel companies, eventually selling them for $4.5 billion (and a personal profit of $300 million) to Mittal Steel Co., the giant London company founded by Indian-born billionaire Lakshmi Mittal. Meanwhile the American steel company caught another break, as the global commodities markets have improved their fortunes. The USW has sometimes given up its right to approve the sale of a steel company in exchange for benefits for its membership. The union struck such a deal with aluminum company Ormet Corp. last year after a rocky negotiation with a private-equity firm that controls Ormet. The deal brought the union supplemental unemployment benefits and left the private-equity group. Matlin Patterson Global Advisors LLC, free to sell Ormet when it chooses to.

"'Private equity guys buy companies and sell them five to seven years later and they need exit strategies,' says Mr. Bloom. 'We get that.'

"Of the USW's dozens of negotiations in recent years, few show its power better than the struggle over Wheeling Pittsburgh. That company was considered a weak player and candidate for a merger. In 2005, its board retained an investment bank and weighed possible partners, Esmark among them. It selected Brazil's CSN – Companhia Siderurgica Nacional SA – striking a deal which left Wheeling-Pitt management in place.

"The union didn't agree. Mr. Bloom says there was nothing inherently wrong with CSN, but the union concluded that that too much of its benefits would flow to CSN, and not enough to American workers.

"Mr. Bloom was rebuffed when he took his objections to Wheeling-Pitt. In the middle of last year the USW played its trump card. It invoked a successorship clause it had earlier negotiated with Wheeling Pitt that covered the entire company and that

would be triggered in the event of a change of ownership. It announced that it would oppose the merger plan with CSN."

Unions Key Players in Merger Negotiations

"He informed Wheeling-Pitt that it was throwing its support behind Esmark, a company Wheeling-Pitt had rebuffed. A merger between Wheeling-Pitt and Esmark would create a company that combined steelmaking with distribution. 'We liked the vision and Esmark had a reputation for good labor relations.' The USW and Esmark bargain over the terms of the union's support for an Esmark run at Wheeling-Pitt. Esmark agreed not to lay off union members but pressed in return for the right to import steel slabs from the Ukraine. Eventually a deal was struck. In July Esmark decided to wage a proxy battle to oust the existing Wheeling Pitt board, arguing that had rejected it. They won the battle by 69% with the argument that the continued existence of the old board would guarantee strife with the union."

With the entire scenario of American and international corporations their mergers and what goes to create tomorrow's leaders undergoing change, organized labour, especially in its weakened condition cannot possibly accept the dwindling position assigned to it by the new makers and shakers. The fact that labour's pensions, the rewards of a lifetime are often up for stake must be a source of power in the new reshuffling of the productive resources of the countries and the world. A new bag of strategies must be developed and applied that will make labour's pension vulnerability a source of stakesmanship not just of passive vulnerability. Political support and national interest must be evoked.

The role of trade unions may have changed, but can be replaced by a recognition that pension and other privileges earned in the past are not for simple passive surrender. Allies can be sought in aspirants for mergers with firms. This can serve as a means of making an issue of ways of compensating labour of the merged firm for agreeing to altering the hard-earned heritage of the labour force. Where everything opens up for discussion as corporations are restructured, labour can help determine the new economic institutions that are taking form. Surely this warrants a new discipline to formulate labour policy in this age of mergers.

W.K.

The Secrets of the US Housing Slump and Beyond…

If ever there were a predictable event it was the housing slump that has suddenly descended on areas of the US. All that was needed to foresee what was coming was to connect the points so generously provided in the press. But the carefully tracked dogmas of official economists prevented them from doing so. *The Wall Street Journal* (23/08, "Housing Slump Proves Painful for Some Owners and Builders" by James A. Hagerty and Michael Corkery) could not be clearer on the matter. "The pain that home owners and home builders are now feeling follows a raging national house party. As Americans soured on the stock market after the tech bubble burst in 2000, they poured money into real estate, spurred on by the lowest interest rates in four decades, looser lending standards and surging demand in California, Florida and the Northeast. Over the five years ending December 31, average US home prices jumped 58%, according to a federal housing index.

"Then mortgage rates began rising, and last year, a surge of building finally overtook demand. Though economists had been predicting a slowdown for years, many homeowners and builders were surprised by how fast the market changed. 'It's like somebody flipped a switch,' says Lynn Gardiner, a real-estate auctioneer in northern Virginia."

That gives us a few of the dots to join if we are to get to the root of what is happening around us.

"Inflation," the suppression of which was redefined as the *single* purpose of our central bank in the 1970s and the 1980s is taken to mean *any* rise in the price level. To suppress that, central banks are now allotted a single "blunt tool" – raising their benchmark interest rate.

The only distinction recognized in recent years is between core "inflation" and "non-core inflation." "Core inflation" is deduced from a price index with the items of food and fuel not included because of their volatility. However, even if you remove the explicit items of food and fuel from your index, every remaining item still includes them in its costs. That's no theory, but the simple fact that we all must eat, keep warm, and work in a setting well above freezing point.

But that still doesn't bring the official "inflation" concept within hailing distance from reality. Since WWII Canada has changed from a semi-rural land to an industrialized, highly urbanized one. This requires vast, costly infrastructures – subways for our largest cities; new technologies calling for educated consumers let alone producers. That implies an immensely higher level of education. That costs money. Economists in the 1960s reached the conclusion that investment in human capital is the most productive of all investments – based on the rapidity with which both Germany and Japan were able to rebuild their economies after the physical destruction of the war. That was because their highly educated and disciplined populations had been preserved substantially intact. A great economist, near-forgotten today, Theodore Schultz of Chicago University, was awarded a so-called Nobel Prize for Economics for arriving at that view after studying the rapid recovery of Germany and Japan after the war. There are in fact a constantly increasing host of non-marketed factors without which our society could not survive, that are created or financed by government and paid for by taxation.

The Fiction of Official "Inflation"

This results in an ever deeper layer of taxation in price. Ignoring these needs and dubbing them "externalities" as official economists do today avoids looking crucial facts in the eye. Since many of these needs are vital to society's survival, their neglect should not be hailed as a means of balancing our budgets, but a debit item in our society's accountancy. Its need of them makes the world we live in a "mixed economy" rather than a "market economy." But this bad bookkeeping continues and has even been strengthened. For it supports the ever more deeply entrenched power position of the financial sector.

You need only consider the present state of the world. Wars of one sort or another have been raging on almost all continents for a decade or two. Yet today we are still farther from a durable peace than when the Bretton Wood Conference was called in 1944. At that time, though the world economy was far less complex than it is today, nobody spoke of "one blunt tool" to "lick inflation." Instead of a single blunt tool

to keep prices down there was a cluster of policy devices for the purpose. To mention just a few of these: price controls, foreign exchange controls, wage controls, special licenses required for the purchase of scarce materials, tariffs on foreign trade.

But above all the *Banking Act* brought in under President Roosevelt in the US in 1933 had taken special care *not* to proclaim a single factor the "one blunt tool" for running the economy.

The reason for that was an important principle based on what was taught us in our first year algebra classes in high school. If you have a situation with two identifiable independent problems, you need two policy tools so that you can assign one to each independent problem. One won't do. There were no one-legged races for centipedes in the world of your grandparents. That was formulated in scientific terms by Jan Tinbergen, a Dutch economist who had trained as a physicist and it became known as "Tinbergen's Counting Rule."

That sort of reasoning found its way into Roosevelt's banking provisions. They provided not one but at least two major means of keeping the economy in reasonable balance, with a plethora of subheadings.

There was a benchmark interest set for overnight loans between banks that influenced most of the interest rates in the economy. But the weakness in relying too much on that was that it hit everything that moved or stood still in the economy. Above all the unemployed who could not be contributing to inflation. So another major device for regulating the economy was devised – these were the "statutory reserves" – a proportion of the deposits that the banks received from the public – particularly in chequing and other short-term accounts. These reserves had to be redeposited on an interest-free basis with the central banks. In chequing accounts, that proportion varied from about 8% to 12% and earned no interest. If the economy was "overheated" and prices were rising, to increase the amount of lending banks could do as a multiple of the cash they carried was decreased by increasing the proportion of these reserves, and thus lowering the leverage of the banks' lending. If the economy were depressed the reserves would be decreased.

There were several good reasons for no interest being paid on the statutory reserves: they replaced the gold and silver reserves when gold and/or silver had been legal tender, and since precious metals earned no interest, they provided the government with an interest-free use of borrowings from the central bank within the limits in force. Then, of course, the central bank and the government behind it were the lenders of the last resort in the event of a run on the banks – and that could be a very costly service.

But of more immediate relevance was the detail that interest paid on such reserves would weaken their effect in controlling the leverage of lending allowed the banks, and require higher benchmark rates. For if the reserves earned interest from the central bank, the difference between what the banks could earn lending out credit based on higher reserves and what they could have earned on the market, would decrease. And the effectiveness of the whole reserve function would be impaired. There was a firm logic that united banking legislation brought in to get out of the Depression. To an extent it became the model for the non-Communist world of the day.

The 1980s were a disastrous decade because of the increasing deregulation of banking. It was an ongoing two-step drunken dance – the banks were bailed out from their speculative losses, and immediately deregulated further so they could gamble bigger if not better. The Roosevelt *Banking Act*, which had severely restricted the banks acquiring interest in any of the other "financial pillars," i.e., stock brokerages, insurance and mortgage corporations. The reason was clear – each of these other financial corporations maintained its own pool of liquidity for the needs of its own industry. If the banks were allowed to control these, they would use them for banking purposes, that is lend out many times the base money thus acquired to flood the economy with bank credit. And that or course, would create a speculative inflation with the inevitable speculative bust – that brought on the great Depression of the 1930s. And that happened again in the 1980s especially in the United States where the banks acquired control of the Savings and Loans that had been original limited to lending out money as real estate mortgages to the shareholders of the S&Ls. In the process many banks and former S&Ls lost their capital. It fell to the government to take over the mountains of bad debt and re-sell the banking corporations made whole in this way at the expense of the tax-payers.

This coincided with the breakdown of the Mexican banking system, the Eastern Asian bank crisis and the Russian default on its debt.

The Bank for International Settlements

To bail out the world's banks from their immense losses, the Bank for International Settlements, a sort of central bankers' club, issued its *Risk-Based Capital Guidelines* in 1988. These declared the debt of developed countries risk-free, and hence requiring no down-payment for banks to acquire. All they had to do was clip the coupons of government bonds to make up for the capital they had lost in past and in future gambles. As a result Canada's banks quadrupled their holdings of Government bonds by adding another $60 billion dollars, and the Government to make that possible had the central bank reduce its holdings of government debt. When the central bank holds government debt the interest paid on them finds its way substantially back to the central government, since it has been the sole shareholder of the Bank of Canada since 1938. When the private banks hold the same bonds, even though they have put down none of their own money to acquire them, that interest stays with them. That was the purpose of the bailout.

Three years later in 1991, the *Bank Act* in Canada came up for its decennial reexamination, and the statutory reserves that banks had to redeposit for a modest part of the deposits received from the public were phased out over a two-year period. That increased the leverage with which the banks could use the legal tender held by them into an ever higher structure of loans and investments.

Ongoing deregulation allowed them to take over every major brokerage house, every major mortgage and trust company, so that the bank multiplier which in 1946 had amounted to 11:1, by the end of the millennium had reached 400 to one. Then with the crash of the high-tech stocks on the market it retreated through bankruptcies to around 360. And new technologies of speculation ("risk management") have crammed the US law courts with high-finance swindles, the bank "multiplier" has probably approached 1000 to, involving as it does high-power derivatives that even the experts don't understand, hedge funds that take over and force the liquidation of producing companies for quick killings.

And out there was a further unforeseen factor that added to the explosive growth and fury of financial speculation. We have noted that the BIS at the very time, possibly aghast by the storm flood of credit it had unleashed, decided that it had to put its "one blunt tool" – interest rates – into high gear to contain

the financial inflation. But overwhelmed by what it had let loose, it overlooked what would happen to the bank's hoards of 100% leveraged bond hoards if interest rates were pushed into the skies. So, to deal with that BIS came out for absolute zero inflation as the acceptable figure for what it ook to be "inflation."

The result was the collapse of the Mexican banking system. At this time the US Secretary of the Treasury Robert Rubin, a keen alumnus of Wall Street hurried in with a solution. Throughout the world governments had been treating their investments as current expenses. They wrote them off in the year when they were completed, and thereafter carried them on the books at a token one dollar. Naturally that distorted the fiscal state of governments especially when it was combined with campaign to keep prices flat with high interest rates. Now Rubin, decided that the time had come to recognize this ignored public investment and save the world financial system from total collapse.

But the one firm principle of his President, Bill Clinton, was never to lose the "political center" that forked out the means of funding political campaigns. So bringing a previously $1.3 trillion of neglected physical investments onto the government's balance sheets, starting with January 1996, was misnamed "savings." However, that term implies cash or near-cash form, and what was involved here was buildings, highways, bridges, equipment; i.e., in bricks and mortar and steel. However, a wink and a nudge to the bond appraisers brought down interest rates. That not only gave Clinton his second term, but produced the high-tech boom that swelled until the 2000 bust. But at the root of it was the end of the statutory reserves, and the impossibility of bailing out the banks with totally leveraged government debt and high interest rates at the same time that had brought the world to the brink of disaster.

The Relevance of Our Analysis to the US Housing Slump

The end result was both the deregulation of the banks to take over the other financial pillars' pools of liquidity and incorporating that flood of credit into the world's capital and price structures. Such an economy has imbedded into today's stock and option prices the growth rates – real or fictitious – projected into the indefinite future. No space is left for burp or hiccough.

At this point we can resume our reading of *The Wall Street Journal's* piece on the US housing slump. "As Americans soured on the stock market after the tech bubble burst in 2000, they poured money into real estate, spurred on by the lower lending standards and looser lending standard." And meanwhile to move houses, lenders with an ever bigger flood of money to invest, began divising "interest only mortgages." All of which adds to the explosive power of the final denouement.

That excess of money birthed by the ability of banks to acquire government bonds on the cuff, and the central banks' brakes reduced to just higher interest rates produced similar results throughout much of the economy. Thus the *WSJ* (21/08, "Oil's Price Drop Reignites Debate On Turning Point," by Ann Davos and Bhushan Bahree) writes: "A nearly 8% decline in crude prices in the past two weeks, and the market's flirtation Friday with prices below $70 a barrel, is reigniting a debate: Is there an oil price bubble and could it burst? What has been a bigger factor buoying oil prices in the first place: record investor inflows into commodities or supply-and-demand fundamentals. The answer will go a way toward setting the tone for broader financial markets and the economy. High oil prices have affected everything, from consumer spending, to the stock and bond markets, to interest rate increases by the Federal Reserve to curb inflation.

"Institutional money managers have $100 billion to $120 billion in commodities, at least double the amount three years ago and up from $6 billion in 1999, says Barclay's PLC.

"'If oil continues to slide even as international tensions flare, it is going to be much more difficult to argue that crude oil remains a bull market and that all dips are opportunities,' says Tim Evans, a futures analyst with Citigroup Inc. 'Too much money has been chasing too few commodities futures,' is how Philip Verleger, an independent economist, argues. He says that so long as economic growth continues, oil could climb as high as $100 a $100 a barrel in the fourth quarter of 2007. If the economy slows and the demand for petroleum eases, investors will scramble to the exits. There is no floor. The price could fall to single digits. It won't stay there for very long, but it could fall."

With the military hot spots erupting throughout the world, the handiest false solution is jumping into further military adventures. For war is the greatest of all consumers, though not the least expensive one.

William Krehm

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The Greening of Geopolitics

This is a virtual volcano of an article that comes complete with a dangerous smoking hole at its centre.

The writer seems obsessed with the adjective "green." Though it is going to take more than a brush and a pot of paint to get from here to his goal: "America will need to get its groove back. After the trauma and the divisiveness of the Bush years, we will find a way to reknit America at home, reconnect America abroad, and restore America to its natural place in the global order – as the beacon of progress, hope and inspiration. I have an idea, it's called 'green. I want to rename it geostratic, geoeconomic, capitalistic and patriotic. I want to do that because I think that living, working, designing, manufacturing, and projecting America in a green way can be the basis of a new, unifying movement for the 21st century. I think that living, working, designing, manufacturing a more muscular Republican and Democratic green ideology not to trump the traditional Democratic and Republican agendas but rather to bridge them in addressing the three major issues facing every American today: jobs, temperature, and terrorism.

"After World War II, President Eisenhower responded to the threat of Communism and the 'red menace' with massive spending on an interstate highway system to tie America together, in large part so that we could better move weapons in the event of war with the Soviets. That highway, though, helped to enshrine America's culture (atrophying our railways), and to lock in suburban sprawl to low-density housing, which all combined to get America addicted to cheap fuels, particularly oil. Many in the world followed our model.

"Today, we are paying the accumulated economic, geopolitical and climate prices for that kind of America. But if we want to continue our way, the next president will have to rally us with a green patriotism. Hence my motto: Green is the new red, white, and blue.

"If it were only a matter of colors! The dirty little secret it that we're fooling ourselves. We have not even begun to be serious about the costs, the effort and the scale of change that will be required to shift our country, and eventually the world, to a largely emissions-free energy infrastructure over the next few years.

"Islam has always been practiced in different forms. Some are more embracing of modernity, reinterpretation of the Koran, and tolerance of other faiths, like Sufi Islam or the populist Islam of Egypt, Ottoman Turkey and Indonesia. Some strands, like Salafi Islam – followed by the Wahhabis of Saudi Arabia and by Al Quaeda – believe Islam should be returned to an austere form practiced in the time of the Prophet Muhammad, a form hostile to modernity, science, 'infidels' and women's rights. By enriching the Saudi and Iranian treasuries via our gasoline purchases, we are financing the export of the Saudi puritanical brand of Sunni Islam and the Iranian fundamentalist brand in Shiite Islam. That creates recruits for the Taliban.

"The Saudi Islamic export drive first went into high gear after extreme fundamentalists challenged the Muslim credential of the Saudi ruling family by taking over the Grand Mosque of Mecca in 1979 – a year that coincided with the Iranian revolution and a great rise in oil prices. The al-Saudis responded to this challenge to their religious bona fides by becoming outwardly more religious. Awash in cash due to the spike in oil prices, the Saudi government and charities also spent hundreds of millions of dollars ensuring that Wahhibi imams, teachers, and textbooks preach Saudi-style Islam. Eventually, notes Lawrence Wright in 'Lightening Tower,' his history of Al Quaeda, 'Saudi Arabia, which constitutes only 1% of the world Muslim population, would support 90% of the expenses of the entire Islam faith.'"

A Dangerous Simplification — Friedman's First Law of Petropolitics

"No wonder more Americans have concluded that conserving oil to put less money in the hands of hostile forces is now a geostrategic imperative. James Woolsey, the former CIA director minces no words: 'We are funding the rope for hanging ourselves.'

"The way the Saudi ruling family has bought off its religious establishment, to stay in power, is not healthy. Cutting the price of oil in half would change that. In the 1990s, dwindling oil income sparked a Saudi debate about less Koran and more science in Saudi schools, even experimentation with local elections. But the recent oil windfall has stifled all talk of reform.

"The price of oil and the price of freedom always move in opposite directions in states highly dependent on oil exports, what I call the First Law of Petropolitics."

Obviously this is a shattering simplification of a tremendously complex question that merely subsumes Washington's bullying strategies throughout the world under the heading of "freedom" and "science." But I ask my readers to bear with the author until he delivers himself of his really significant proposals for cleaning up the environment.

"We thought the fall of the Berlin Wall was going to unleash an unstoppable tide of free markets and free people, and for about a decade it did just that. But those years coincided with oil in the $10 to $30 range. As the price of oil surged to $30-to-$70 range in the early 2000s, it triggered a countertide of authoritarianism in Russia, Iran, Nigeria, Venezuela, Saudi Arabia, Syria, Sudan, Egypt, Chad, Angola, Azerbaijan and Turkmenistan. If we continue to finance them with our oil purchases, they will continue to shape the world in their image, around Putin-like values.

"People change when they have to, – not when we tell them to – and falling oil prices make them have to. That is why we are pressing for a Plan B for Iraq – a way of pressing for pressing for reform in the Middle East without going to war again – there is no better way than bringing down the price of oil. When it comes to fostering democracy among petro-authoritarians, it doesn't matter whether you're a radical lib. If you're not also a Geo-Green, you won't succeed.

"The notion that conserving energy is a geostrategic imperative has also moved into the Pentagon, for slightly different reasons. Generals are realizing that the more energy they save in the heat of battle, the more power they can project. But the Iraq war has given birth to a new movement in the US military, the 'Green Hawks.' According to Dan Nolan, who oversees energy projects for the US Army's Rapid Equipping Force, it started last year when a Marine major general in Anbar province said he wanted better insulated, more energy-efficient tents in the desert. When we began to analyze his

request, it was really about the fact that his soldiers were being attacked on the roads bringing fuel.

"To that end Nolan's team is now experimenting with everything from new kinds of tents that need 40% less air-conditioning to new kinds of fuel that produce water as a by-product. When the army desegregated, the country really desegregated; when the Army goes green, the country will really go green.

"The second big reason green has gone Main Street is because global warming has. A decade ago it was mostly experts who worried that climate change was real, largely brought about by humans, and likely to lead to species loss and environmental crises. Now Main Street is starting to worry because people are seeing things they've never seen before in their own front yards, and reading things they've never before read in their papers – like the recent draft report of the United Nations 2,000 – expert paper, which concluded 'changes in climate are now affecting physical and biological systems on every continent.

"Yet no one exactly knows what will happen. But ever fewer people want to do nothing. Most people have no clue how huge an industrial project is required to blunt climate change. Here are two people who do: Robert Socolow, an engineering professor, and Stephen Pacala, an ecology professor, who together head the Carbon Mitigation Initiative at Princeton, a consortium designing solutions for the climate issue. They note that the scientific consensus is that the risk of things going haywire – weather patterns getting violently unstable, glaciers melting, prolonged droughts, – grows rapidly as CO_2 levels 'approach doubling.'"

Three Decades Left to Save the Planet

"According to Pacala, 'If we do basically nothing, and global CO_2 emissions continue to grow at the pace of the last 30 years for the next 30 years, we will pass the doubling level – an atmospheric concentration of carbon dioxide of 560 parts per million – around mid-century. To avoid that and still leave room for developed countries to grow using less carbon, and for countries like India and China to grow, emitting double or triple their current carbon levels, until they climb out of poverty and are able to become more energy efficient – will require a huge global industrial energy project.

"To convey the scale involved, Socolow and Pacala have created a pie chart with 15 different wedges. Some wedges represent carbon-free or carbon-diminishing power-generating technologies; other wedges represent efficiency programs that could conserve amounts of energy and prevent CO_2 emissions. They argue that the world needs deploy any 7 of these 15 wedges, or sufficient amounts of all 15, to have enough conservation, and enough carbon-free energy, to increase the world economy and still avoid the doubling of CO_2 in the atmosphere. Each wedge, when phased in over 50 years, would avoid the release of 25 billion tons of carbon, for a total of 175 billion tons of carbon avoided between now and 2056.

"Here are seven wedges we could choose from: replace 1,400 large coal-fired plants with gas-fired plants; increase the fuel economy of two billion cars from 30 to 60 miles per gallon; add twice today's nuclear output to displace coal; drive two billion cars on ethanol, using one-sixth of the world's cropland; increase solar power 700-fold to displace coal; cut electricity use in homes, offices, and stores by 25%; install carbon capture and sequestration capacity at 800 large coal-fired plants. And the other eight are not easier. They include halting the cutting and burning of forests, since deforestation causes about 20% of the world's annual CO_2 emissions.

"'There has never been a deliberate industrial project as big as this,' Pacala said. Through a combination of clean power technology and conservation, 'we have to get rid of 175 billion tons of carbon over the next 50 years – and still keep growing. It is possible to accomplish that if we start today. But every year that we delay, the job becomes more difficult – and if we delay a decade or two, avoiding the doubling may well become impossible.'

"McKinsey Global Institute forecasts that developing countries will generate nearly 80% of the growth in world energy between now and 2020, with China representing 32% and the Middle East 10%, So if Red China doesn't become Green China, there is no chance we will keep the climate monsters behind the doors. On some days, says the US Environmental Protection Agency, almost 25% of the polluting matter in the air above Los Angeles comes from China's coal-fired power plants and factories, as well as fumes from China's cars and dust kicked up by droughts and deforestation around Asia.

"The good new is that China knows it has to grow green – or it won't grow at all. On Sept. 8, 2006, a Chinese newspaper reported that China's Environment Protection Agency and its Bureau of Statistics had re-examined China's 2004 GDP number. They concluded that the health problems, environmental degradation and lost workdays from pollution had actually cost China $64 billion or 3.05% of its total 2004 output. Some experts believe the real number is closer to 10%.

"There are the nitrogen oxides, sulfur oxides, and mercury that produce acid rain, smog and haze – much of which comes from burning coal. The Communist Party's legitimacy and stability of the entire country depend heavily on Beijing's ability to provide rising living standards for more and more Chinese.

"So if you're a Chinese mayor and have to choose between growing jobs and cutting pollution, you will invariably choose jobs; coughing workers are much less politically dangerous than unemployed workers. That's a key reason why China's 10th 5-year plan, which began in 2000, called for a 10% reduction in sulfur dioxide in China's air – and when that plan concluded in 2005, sulfur dioxide pollution in China had increased by 27%.

"But if China is having a hard time cleaning up its nitrogen and sulfur oxides – which can be done relatively cheaply by adding scrubbers to the smokestacks of coal-fired power plants – imagine what will happen when it comes to asking China to curb its CO_2, of which China is now the world's second largest emitter, after America. To build a coal-fired power plant that captures, separates, and safely sequesters the CO_2 into the ground before it goes up the firestack requires either an expensive retrofit or a whole new system. The new system would cost about 20% less electricity, according to a recent MIT study, *The Future of Coal.*

"China – which is constructing the equivalent of two 500-megawatt coal-fired power plants every week – is not going to pay that now. Remember CO_2 is an invisible, odorless, colorless gas. Yes, it causes global warming – but it doesn't hurt anyone in China today, and getting rid of it is costly and has no economic payoff. China's strategy right now is to say that CO_2 is the West's problem."

The "China Price" — Nub of the Solution

"So now we come to the nub of the issue. Green will not go down Main Street America unless it goes down Main Street China, India, Brazil. And for Green to go Main Street China in these big developing

countries, the prices of clean power alternatives – wind, biofuels, nuclear, solar or coal sequestration – have to fall to the 'China price.'

"'The China price is the fundamental benchmark China pays for coal-fired electricity today because China is not prepared to pay a premium now and sacrifice growth and stability, just to get rid of CO_2 that comes from burning coal,' says Curtis Carlson, CEO of SRI International, that is developing alternative energy technologies. 'Because if the Chinese have to pay 10% more for energy, when they have tens of millions of people living under $1,000 a year, it is not going to happen.' Carlson went on to say. 'We have an enormous amount of new innovation we must put in place before we can get to a price that China and India will be able to pay. But this is also an opportunity."

Father Greed as Powerful as Mother Nature?

And it at this point that Thomas L. Friedman, the distinguished journalist hits the shockingly low point of what is in many ways a most revealing article on an inadequately explored issue upon which human survival depends: "The only way we are going to get innovations that drive energy costs down to the China price is by mobilizing free-market capitalism" and then comes the nugget of nuggets: "The only thing as powerful as Mother Nature is Father Greed."

The comparison limps on either leg. Mother Nature as disclosed by science goes her way and does not change the rules of the game for a bigger quicker profit. However, Father Greed, if he senses a disaster, will see a profit potential in that as well and go out and buy himself a derivative for "risk management." As for the "collateral risk" of the seller of the risk management derivative evaporating, that is ideally covered by "banker's exit" which is "selling to a bigger fool." The latter is always assumed to exist because it makes the prime actor the smartest lad on all the block.

And the dumbest is always the government, because it not only bails out the banks, but deregulates them further so that they can they can gamble bigger if not better with all the allegedly great resources of "risk management." That is the unwritten government commitment for bank bailouts as prepared by the Bank for International Settlements – a sort of bankers' private public club that had been responsible for formulating the bank globalization and deregulation at closed session to which no elected officials of government are invited. As a result if you wish to know what central banks can or cannot do, in recent decades, you must consult not the laws of the sovereign country dealing with the particular activity, but the edicts uttered or implied of the BIS. *Never since the lordly coach-and-four has there been a case of a driver sitting so high and wholly outside the vehicle driven.*

That is why the case of Canada is so important internationally. Although, the *Bank of Canada Act* is still on the law books setting forth that the Bank of Canada, all of the shares of which have been owned by the government of Canada since 1938 when a Liberal government paid out good money to buy out the 12,000 shareholders. And it sets forth that the BoC may purchase and hold unfunded and funded debt of the federal government or any province in what quantity in the case of each, and when it does so the interest paid by the level of government thus financed ends up with the federal government as dividends. The municipalities, too, as corporations can with the guarantee of the federal or any province borrow from the Bank of Canada as well. It so happens – especially with the privatizations of public utilities that have become the rip-roaring fashion in recent years that the provision of both power and water has increasingly been left as a provincial and even municipal responsibility without the funds to pay for them.

That is what most of our political rancours are about. Thus the entire subject of public utilities has been down-loaded onto the municipalities that have repeatedly been turned down by the Bank of Canada, that brazenly informs them that financing such public services are not in the power of the Bank of Canada, despite what the *Bank of Canada Act* might say. (Note subsection 14(2) of the *BoC Act* gives the Finance Minister of the federal the right to instruct the Governor of the BoC written instructions on what basic monetary policy to follow within 30 days or resign.)

The reason that our Bank of Canada is still intact on our law books is that Conservative PM Brian Mulroney attempted to put into the Constitution of the country two items sponsored by the Bank of International Settlements but that the government caucus of the Progressive-Conservative Party of the House of Commons Finance Committee turned down. After which the government along with its successors did not dare tamper with the *Bank of Canada Act.* That gives Canadians a head start for putting the Bank of Canada to work for the job for which it was nationalized.

During the 1980s the US banking sector took a bath in acquiring the Savings and Loans – real estate mortgage establishments, and ended up dropping a major part of their capital in a field that for good reason had been banned to them by the US *Banking Act* of 1933. To reconstitute their capital they were allowed to acquire central government debt that had been declared "risk-free," requiring no down payment to be hoarded by banks. This among other things led to a massive shift of Bank debt from central banks where its profits largely returned to the borrowing government to the private banks where they paid not only going rates, but at a time when rates were being pushed into the skies to "lick inflation."

What the BIS overlooked was that pushing up interest rates causes the market value of existing bonds to fall with a thud, threatening what solvency remaining in the banking world. To deal with that new crisis that threatened to bring down the world banking system, the United States brought in for the first time accrual accountancy in handling its capital investments.

Real Accountancy Can Help Us Attain the China Price at Once

Up to then no government in the world – with the exception, for brief periods Denmark and Sweden, had properly amortized the debt incurred by governments. Instead governments applied "cash accountancy," i.e., violated the basic principle of double-entry bookkeeping by not depreciating the value of the assets acquired by government through a government investment over its useful life, but writing off the asset value of a government investment in the year when it was acquired.

However, the debt thus incurred for the acquisition was amortized over more or less the usefulness of the asset. This created a deficit that was not necessarily there. That drove up interest rates, caused Friedman's Father Greed to flourish but brought us much farther from the China price for cleaning up the CO_2 pollution of the atmosphere. However, to avoid a renewed monetary collapse internationally the United States actually brought in accrual accountancy for its physical investments, beginning in the Department of Commerce figures for January 1996, and working the change back to 1991 but under the misleading heading

of "savings."

That was, however, misleading for the term as used by economists refers to assets in cash or first-class quality short-term securities, while the retrieved physical assets were in land, buildings, bricks, mortar cement, steel, and general equipment. Nothing useful for paying off debts, unless a government has a privatizing bee in its bonnet and wants to please speculative interests with sensational buyout opportunities.

But a wink to the bond-rating agencies conveyed the situation – the government to curry favour with speculative capital did not want to admit its ability to make investments. Those who know about things deemed it possible to bail out our banks on a regular basis. But the government investment in human capital – specifically for the subject of this article, the basic research and education of technicians to cope with the achievement of the China price for eliminating excess CO_2 from the atmosphere, certainly qualifies if anything every did as an investment to be depreciated over almost any period you might wish. You are after all dealing with the planet as a continued host for the human race.

The conclusion to be drawn is about resources that Father Greed has hidden even from concerned journalists like Friedman. But first let us complete our summary of what Friedman has to say on the China price: "The world's biggest retailer woke up several years ago, Wal-Mart's CEO Lee Scott told me and realized that there were higher expectations for us with expectations of the environment than we ourselves had. So Scott initiated a program to work with Wal-Mart's suppliers to reduce the sizes and materials used for all its packaging by 5% by 2013, The reductions they have made are already paying off to the company. Wal-Mart is the China of companies, so, explained Scott, "if we place one order we can create a market" for energy innovation.

Reexamining what we have done to denature the central banking of the West and the crooked accountancy of governments would bring us a huge leap ahead in attaining the China price for eliminating CO_2 in the atmosphere. It is necessary to have Father Greed respect the rules of accountancy as private ordinary citizens must do. And there is no time to waste in getting it to do so. That alone would bring us far closer to the China price. Let all of us concerned about the planet that our grandchildren will have to live on get cracking at that task.

William Krehm

The Iraqi Adventure Is Not the Only Mess that Blair Shares with Bush

The Wall Street Journal (10/05, "Borrowing Binge Fuels UK Economic Woes" by Poellen Perry) recounts a deluge of consumer debt in Britain that yields nothing to the subprime mortgage mess in the US: "With inflation at a ten-year high and interest rates set to rise as soon as today from their current 5.25%, concerns about Britain's borrowing binge are gathering momentum. Personal insolvencies in England and Wales last year hit a record 107,288, up almost 60% from 2005. In the first quarter, insolvencies were up 24% from a year ago. Concerned Treasury officials announced in January that they're considering a nationwide financial education program. The consumer squeeze is particularly worrying for the economy, reliant as it is on consumption for nearly two-thirds of its output.

"We see the potential for a significant slowdown, primarily for the housing market and the consumer.' Says Danny Gabay, a director at London-based Fathom Financial Consulting.

"Such a slide in one of the developed world's most robust economies would be bad news for Prime Minister-in-waiting Gordon Brown, the man who, as Chancellor of the Exchequer, has overseen much of Britain's expansion. Yet it is in its 15th year of uninterrupted growth. And the UK in recent years has weaned itself from some of its dependence on the consumer, as business-investment growth has far outpaced consumption growth, says Ross Walker, the economist with the Royal Bank of Scotland in London. The International Monetary Fund earlier this year forecast the economy will grow by 2.9% this year – not sizzling, but still the fastest in the Group of Seven.

"Yet immigration, which has helped propel growth is set to slow. The government's six-year spending spree is about to end, and cracks are showing in the property market.

"Debt has helped power the British economy's ongoing success, and consumers have spent even as growth in their disposable income has stagnated. Debt, however, is at the heart of the present uncertainty. Personal debt topped $2.6 trillion in March. According to the Organization for Economic Cooperation and Development, UK household debt as a percentage of disposable income hit 159% in 2005 – the last year for which it is available – compared with 135% in the US.

"British banks lost a record $13.6 billion in bad consumer debt last year and are tightening their lending standards. Market leader Barclays PLC says it now declines half of all credit applicants. For the first time since the early 1990s, credit card spending last year fell, by 2.2% from the previous year's level.

"Skyrocketing home prices have, in effect, force-fed the debt. Home prices have more than tripled over the past 15 years. In the first quarter of this year Britain's house price to income ratio reached 6.1, the highest since records began in 1980 according to lender Nationwide Building Society."

House Prices and Repossessions are Soaring

"Major mortgage lenders have been doling out mortgages to up to six times a credit-worthy customer's annual income. That's comparable to US standards for high-quality borrowers. Still, with homeowners stretched, home repossessions in 2006 jumped 65% to hit a new high of 17,000. That's still low by historical standards, but experts expect the number to rise.

"'More and more people's money is tied up in servicing mortgages,' says Chris Tapp, associate director of Credit Action, a debt-education non-profit institution. 'That means that people are having to borrow more and more for just ordinary living expenses.'

"From 2000 to 2006, boosts in public sector employment and wages growth to an inflated-adjusted 4.5%, more than double its long-run average. The government plans to halve that rate in coming years.

"But even as public-spending growth slows, taxes will remain high, further squeezing consumers. To finance its largess, in recent years the government has been 'looking to raise any tax they could think of,' says Michael Saunders, an economist with Citigroup in London ticking off rises in sales, property and energy taxes among those pinching consumers' pocketbooks.

"A slowdown on immigration may also

outweigh future growth. When the European Union expanded eastward in 2004, France, Germany and others made it difficult for the new European states to enter their labour markets. Britain, by contrast – along with Ireland and Sweden – opened its doors. A sudden influx of 600,000 immigrant workers from Eastern Europe, particularly from Poland, propped up growth. It also helped the housing market.

"The British government, however, has said that it won't welcome immigrants from the newest EU members, Romania and Bulgaria, as easily. In recent quarters, national statistics showed work-force growth slowing.

"The British housing market may also have begun to sputter. Some surveys have shown a small downturn in the pace of home price appreciation, though rates remain in double digits.

"[The U.K. is faced] with the so-called 'buy-to-let revolution.' The phenomenon took off in 1996 with a law that made it easier to buy property to rent out. Since

Are Banks Becoming More "Efficient" Running Stock Exchanges?

It took and very painful stretch of history to get the world out of the Depression of the 1930s. Financing the Second World War, and thereafter the reconstruction of the world battered out of shape by ten years of Depression finally brought to a close by six years of the Second World War, and then a generation of reconstruction and catch-up. What turned the trick was restricting the banks severely to banking, with ceilings imposed on what rates of interest they could pay or charge. Above all they were forbidden to acquire positions in the other "financial pillars" – stock brokerage, insurance, and mortgages.

The reason was obvious enough. The art of banking – that can so readily slip into black magic – consists of lending out several times the money in the banker's vaults, or even possession, and yet being able to honour the claims of those who have deposited their spare funds with them. Obviously the first time a banker fails that test, there is a danger of a run on all banks. That is why the notion of a deregulated, and globalized bank is an engraved request for first-class trouble.

That invitation has not gone unanswered. The banking system in the US at this very moment is wrestling with syndicated parcels of mortgages, which can be purchased supposedly packaged according to the risk involved. That, too, was peddled as an efficiency since, it saved the banks in their new roles as mortgage-writers; under the new system they felt it unnecessary to check the financial data on the loan application. It appeared to save oodles of money by skipping all that. That multiplied the "lie loans." Since a single bank – the Bank of Montreal – does 9% of the banking in the Chicago area alone, the mortgage business as well as the banking of the two countries are closely interlinked.

However, not only have our banks taken over by far the greater part of the stock brokerage firms in Canada, but they are now setting up their own stock exchange. By settling trades amongst their own clients, a group of six large banks are working together on the project of settling stock trades originating with the clients of the group. They will be able to spare the commission of the Toronto Stock Exchange and other such independent exchanges. Lower commission prices are equated with greater efficiency, but putting such "alternative stock exchanges" under the control of the banks inevitably increases the interpenetration of banks and the stock market, just as the sub-prime mortgages has done between the inadequately processed mortgage risks and the banks, and the continued rape of our environment is multiplying insurance hazards of insurance to unaccustomed heights. Add up these things and their intertwining and the structural and moral strength of our banks crumbles.

That is why the words "greater efficiency" when it relates to banking should be used with extreme caution.

Now let us go to *The Globe and Mail* (3/05, "Canada's big banks to set up rival to TSX" by Sinclair Stewart and Soyo Erman): "Canada's six largest banks are banding together to create a new stock trading platform that will compete directly with TSX Group Inc. and potentially redefine the way the country's large institutional investors trade equities. The group, led by the brokerage arm of The Royal Bank of Canada, hopes to launch its Alternative Trading System next year, according to officials briefed in the matter.

"The banks will appoint a separate management team to operate the ATS, and are expected to commit approximately $100-million in capital to get the system running.

"'This is about reducing the cost of trading,' said one financial executive familiar with the plans in Canada. 'There will be a big pool of capital there, and they will throw their trades into it.'

"Bank-owned dealers typically avoid exchanges and try to save money on trade-matching internally – taking buy and sell orders that come to their desks and matching them. They carry out the remainder on an exchange.

"By grouping at least six dealers together to match buy and sell orders, the firms believe they can substantially cut down the fees they must pay for the trades they route through the Toronto Stock Exchange.

"It's not the first challenge the TSX Group backed by banks. Pure Trading, a venture for Canadian Trading and Quotation System Inc. that has investors such as UBS AG, has been working for about a year to get its ATS up and running but has hit numerous roadblocks. The move to ATS models mirrors similar efforts in Europe and the US that are electronic markets that match, buy and sell orders.

"Last summer TSX cut trading prices as a pre-emptive strike, betting that the rising volume would outweigh the lower per-trade revenue. The TSX is also trying to get a piece of the action by launching its own order-matching system known as ATX as soon as it gets approval from the Ontario Securities Commission.

"Some veteran equities professionals aren't so sure this latest challenge will do much to undermine the entrenched position of the TSX.

"In the US, the systems are known as electronic communications systems (ECN). There has been an explosion in the number of these alternative markets because of the relative ease with which they can be set up. Archipelago, an early entrant, was recently acquired by the New York Stock Exchange. But for every ATS that an exchange buys, eliminating competition, another pops up, often backed by banks."

William Krehm

then, red-hot housing price gains, shaky government pension plans and the promise of a steady supply of tenants in the form of immigrants or young professionals priced out of the property markets have made buy-to-let landlords a fundamental feature of the housing market.

"Today buy-to-let owners make up 9% of mortgages outstanding by value. Last year they accounted for more than 11% of mortgage lending. If they start selling, it could trigger the long-feared price tumble in the broader British housing market.

"Now in parts of London's gritty, immigrant-heavy east 'To let' signs are as common as Kebab shops, testament to an apartment glut. The number of calls to Britain's largest debt-advice charity, the Consumer Credit Counseling Service, increased by nearly 50% from 2004. To almost 300,000 last year.

"Some of the recent spike in British personnel insolvencies may come from an April, 2004 change that shortened the amount of time people spend in bankruptcy from three years to one. But increasing numbers of struggling Britons still recoil from bankruptcy. They are opting instead for a Voluntary Individual Arrangement. Introduced in the 1980s, IVAs were originally designed for small business owners. The practice lets borrowers write off as much as 75% of their debt and pay back the rest over five years. They are attractive also because they stay behind the lace curtain, and aren't public. Local newspapers routinely write news about bankruptcy filings.

"As debt levels have risen, so too has the popularity of IVAs. Last year they totalled more than 40% of individual insolvencies. Despite British banks' increasing reluctance to sign off so much bad debt, analysts say they continue to see the IVA numbers continue rising. In the first quarter of this year, IVA totals in England and Wales rose almost 50% compared with the same period last year; bankruptcies rose 10%."

Our readers will note the aggressive recent stance of some key British banks, whereby IVA is feeding a serious factor of hype into British banking statistics and thence into the world financial picture that has escaped the attention of most analysts and commentators. This must be added to the basic picture in assessing the significance of the world-wide move of governments to "privatize" key government real estate.

Our financial masters are well advanced in preparing the next bailout of our high-flying world banking system.

William Krehm

On the Immense Relevance to the Economy of Systems Theory

Economists of the official school work on the assumption that our economy is self-balancing, For at least four decades there has been an intense effort to free corporations from the very considerable restrictions that were put on them to get the world out of economic crises and major wars. Most of this effort was planned and driven outside democratic process.

That at least is the way the official script runs. However, if we examine any of the major problems that beset the world, we find that rather than a tug of demand against supply, what we encounter is a whole hierarchy of conflicts of the most varied sorts. Some of these are strictly material like the pollution of our atmosphere and waterways with a variety of pollutants. These in turn often result from conflicts of interest in human society with one group of people profiting from the neglect of the environment, while another is left most exposed to the toxins released.

There is no way of fitting such a situation into the simplistic tug of war of a generalized supply and demand. Instead to pick our way through this tissue of conflict we have need of a far more complex model, of the sort that analysts in science and engineering have used for many decades. It is called "systems theory," and it deals not only with systems, but with subsystems that go to make up the systems. A subsystem is defined as subordinate unit of the overall system whose proper functioning is essential for the system as a whole. It is not enough for the efficiencies of the various subsystems to average out to a satisfactory figure. The contributions of the subsystem are not only quantitative but qualitative.

A crude example, of a system might be the automobile. For the vehicle to function safely, every one of its subsystems must be in operative shape. If that is not a necessity, the subassembly simply does not qualify as a subsystem. High average efficiencies of subsystems are not enough. Each is defined by the indispensability of the basic service contributed. Depending on the average efficiency of subsystems will not do, for it could leave subsystems not performing adequately.

Subsystems, however, are not confined to material relationships but come equipped with nails, teeth and claws, because they reflect the interests of human groups., That complicates matters further, since humans with their conflicting motives and ambitions have a way of standing between society and the timely appreciation of physical laws – even when they have learned to understand them. They may be ignored in the interest of narrower individual advantage, or of their very distinct cultures. What results is a welter of conflicting interests. This reduces the notion of society being directed by the overall confrontation of aggregate demand and supply, within a nation or even within the world, to an evasion. Systems theory is never a completed and closed guide, but is ever open-ended. In this respect it is the polar opposite of the self-balancing market model which shuts the mind and throws away the rusty key.

Using Systems Theory to Better Understand Our Economy

Having outlined the broad schema of systems theory let us attempt to use its perspective to understand what is happening in crucial areas of the world today.

In recent weeks *The Wall Street Journal* has on two occasion (26/2 and 10/40) dealt with the current ways in which the various power companies of Texas are trimming their strategies to meet the changes in the fuel situation in that great state, once the source of the oil and gas resources that drove the equipment and warmed and lit up much of the United States. Today, however, it has become increasingly dependent on other power resources. But the running down of its gas and oil resources is but one of many subsystems at work in the fuel situation as it is shaping today. Far away – in Mexico to be precise – a drama was enacted involving matters quite distinct from gas and oil, but nonetheless having a most definite bearing on the Texan drama having to do with atomic generators in Texas.

Let us refer to *The Wall Street Journal* to see how they interlock (2/26, "Power Play: Bidders Try to Pre-empt Gridlock in TXU Deal" by Rebecca Smith, Dennis K. Berman and Henny Sender): "Private equity firms once shunned utilities as capital-intensive, regulated and low-return businesses. But now in a world of cheap debt, their steady

and predictable cash flows have made them desirable targets."

And thereby hangs a little known tale of just how the period of "cheap debt" happened to be ushered into the world.

The US banking system had gotten itself into first-class trouble in the 1929s financing Latin American dictators and electrical trusts in the United States. And just when the system seemed to have taken off with every shoe-shine boy playing the Wall Street stock market, and the secret of permanent prosperity seemed to have been discovered, it all went poof and collapsed. By 1933 when President Franklin Roosevelt was sworn in 38% of the banks had shut their doors, and the first thing the new regime did was to declare a bank moratorium. Later in the year the *Banking Act* was brought in that set ceilings on the interest that banks could pay or charge, forbade banks to acquire an interest in the other "financial pillars" – i.e., the stock market, insurance, and mortgages companies. The reason: those companies each kept their own cash and near-cash pools for the needs of their own businesses. Allow the banks to get their hands on those resources and – as they had in the 1920s – they would use them as the money base on which to extend their credit creation. For that is the essence of banking: to create money by lending out a multiple of the cash actually in the banks' coffers, but nonetheless never to be caught short, unable to honour a check or withdrawal slip presented to the bank by a depositor claiming his deposit. It is a bit of black magic, that has been – between disasters – immensely useful to society. Hence like all miracles it has to be severely controlled or it could turn into crime – as indeed happened in October 1929, that brought on brokers jumping out of skyscraper windows, and in no time at all produced breadlines in Lower Manhattan three abreast that circled entire city blocks.

Elsewhere in this issue we recount the severe provisions of President Roosevelt's *Banking Act* (1933) that compelled the banks to stick strictly to banking. And how after the war, restored to health, they had gone on to achieve deregulation, so that today they are gambling bigger and better than ever.

That having been done, the North American Free Trade Alliance was promoted by Washington. There was even a concerted effort made to bringing a "common currency" with the US. The Mexicans even allowed themselves to be talked into issuing special bonds that gave the purchasers the option of being repaid for his investment in US dollars. At the same time currencies became free to cross frontiers. As a result the Mexican peso fell some 40%. Unemployment spread, and the massive illegal migration of Mexican labourers began into the US, that has now led to preparations for the construction of a wall to keep them out – quite the reversal of John Maynard Keynes's remark: People "should have the right of free movement across frontiers, but the goods we consume should be homespun. We send the Danes our cookies, and they send us theirs. Wouldn't it make more sense to exchange recipes?" Made seventy years ago, Keynes's phrase has grown wings in this age of pollution of our atmosphere and congestion of our air fields and airways.

But the greatest case of BIS's blindness was still to come. When the Mexican peso collapsed, it almost brought down the world monetary system with it. And alarmed by the amount of bank credit produced on the expanded money-base acquired from the other financial pillars, BIS raised interest rates to the skies "to rein in inflation." But it and the central bankers it had gathered around its knees overlooked an important detail: when you raise interest rates across the board, the market value of preexistent bonds with lower coupons plummets, and the banks who had accumulated such bond

On 100% Money

I notice that Stephen Zarlenga is busy recruiting the dead to support him in his espousal of 100% money. He would be better advised to hold workshops with the living. Why was the matter not even raised let alone a worshop devoted to such subjects as had been promised me for the 1st Chicago conference?

Bill Hixson still very much among the living. And in a book of his that COMER published and can still plentifully supply, he gracefully sidesteps the issue more or less as follows: "I don't know whether the central bank should create all the money supply, but I do know that it should be creating a lot more of it than it has been doing in recent years!" Does that sound like 100% money?

The truth of the matter is that Comer in the 1970s and 1980s was painfully putting together the pieces of the problem. We had to discover the Canadian legislation that had done away with the statutory reserve over a two-year period. We had to dig up the BIS *Risk-Based Bank Capital Guidelines*. We had to dig up what the BIS was about. That took years, and during all that time when we learned that Milton Friedman had espoused 100% money our interest was to confront Friedman and other later monetarists with the fact that they had recognized the need for the central bank to create money supply, not to insist that it produce *all* the money supply and in essence replace private banks entirely in private banking.

Stephen will get things in better perspective when he remembers that on Roosevelt's first inauguration 38% of US banks had shut their doors, and one of the first acts of the new presidency was to declare a bank moratorium, which was renewed when it expired. When a single bank shuts its doors that has been known to start a run on all banks. Imagine then the situation when 38% of the thousands of banks in the US shut their doors. Does that not explain why industrialists such as Henry Ford and Thomas Edison came out for 100% money?

That was because the banks were non compos to do banking. As soon as they regained their capital and health as banks under the Roosevelt *Banking Act* of 1933, all these gentlemen who had written off private banking returned to advocating not only less than 100% money, but the abolition of all the other no-nos of the Roosevelt regime – the prohibition of access of the banks t the liquidity pools of the other "financial pillars" – stock brokerages, insurance and mortgages, because the banks would take over their liquidity pools and use them as money base for money creation. All of which has happened. The fact is that at the time none of us had the familiarity with banking and the legislation that was smuggled in to change its character to even state the case for and against 100% money in adequate historical terms.

At no time did John Hotson propose 100% money. Nor at any time did anyone in COMER oppose it. When Hotson found out about Friedman and others having advocated it during the Depression he made abundant use of that not to advocate 100% money, but to attack the monetarist position of that later day that would reserve all the or nearly all the money creation to the private banking system.

Bill Krehm

hoards to make up for their capital losses, were pushed to the verge of bankruptcy once more.

That was the origin of the low interest rates referred to in the earliest *WSJ* article on the Texan nuclear generators we cited. This was managed in stealth due to an irregularity in the accounting of the US government which was to be found in the accountancy of just about ever government in the world. When Washington built a bridge, a road, a school, a battleship, it depreciated the asset value of the investment in a single year, but amortized the debt incurred over the approximate useful life of the investment. That creates a deficit when a deficit is not necessarily there. But the illusion of one helps immensely in the denial or the slashing of already existing social programs.

A Flawed Correction of Bad Accountancy

When the Mexican disaster almost led to the collapse of the international financial system, the US Treasury realized that the sky high interest rates "to lick inflation" were incompatible with the banks' hoards of government bonds that replaced their lost capital. And the solution embarked on was to introduce accrual accountancy, also known as "capital budgeting," to replace the "cash accountancy." Working their way back to the year 1959, the US federal government in this way recouped well over one trillion dollars. But instead of calling this by its real name, it appeared in the Department of Commerce statistics as "savings" which it most definitely was not since that term is usually reserved for cash or short-term securities and these assets had long since been invested in bricks steel and mortar.

But a nod to the bond rating agencies did the trick, and interest rates came down on the basis of the highly improved balance sheets of the government. That ushered in the period of low interest rates that the *WSJ* article refers to in the first article cited. This tense drama was first of hopelessly skewed government accounts, and then the semi-conspiratorial presentation of the remedy when produced. This hides the real meaning of the solution in order to avoid facing the bad accountancy that was the basic root of the mess. Everything is prepared for the distortions of the complete systems analysis that would provide a way out of the confusion. This constitutes a subsystem of the systems analysis of the nuclear power project in Texas that we are reviewing.

Before proceeding, we should note that the introduction of "accrual accountancy" under the misnomer "savings." is not the only remaining flaw in the US federal government's accountancy. At the end of WWII, Washington sent hundreds of young economists to Germany and Japan to prepare forecasts of how long it would take those two countries to recover from the destruction of the war and resume their formidable role as competitors on world export markets.

Some twenty years later one of these Theodore Schultz of the University of Chicago was awarded the Bank of Sweden's Economic Prize for his conclusion that the predictions of those economists were so wide of the mark because they had concentrated on the physical destruction and had not considered that the investments in human capital in the two major defeated lands had come through the war essentially intact. From this Schultz concluded that human capital was the most productive investment a nation can make. That, too, is not irrelevant to our Texas fuel tale.

In its oil industry human capital was so little regarded, that when oil prices a few years ago started moving upwards after years of slump, junkyards had to be searched for parts of discarded equipment, since the use and facilities for producing new equipment and the skilled labour for doing so had fallen into ever shorter supply. Now something similar has happened with the profusion of different types of nuclear power plants that must be approved and authorized, before Texas's supply of power is assured.

To complete the tale of this subsystem, we need only mention this: no country in the world has yet recognized in its accountancy the massive and increasing investment in human rather than physical capital. The latter was recognized by Washington in 1996, and by Canada in 2000 after its Auditor General refused to approve the government's balance sheet unless this were done. Yet in the 1960s Theodore Schultz was awarded a Bank of Sweden prize for proving from the rapid recovery of both Germany and Japan from the physical destruction of WWII that human capital is the most productive investment that a government can make. Since this however, would be a powerful argument for investing much needed funds in education, health and social services, the name of Schultz celebrated briefly in the 1960s is today next to forgotten. That, however, merely increases the menace arising from the precariousness in the supply of crucial investments in human education and skills Particularly, as in the case of Texas's energy supply, since there is a welter of rival technologies and financial schemes competing for the role of providers of Texas's power needs.

One by-product of the Texan power situation is that it is remaking the behaviour-code of the investment funds, notorious for quick profit realizations of their takeover and rapid departures for the next, even better deal. From the individual's point of view this might be taken as greater efficiency, identified with his or her personal accrual of wealth. From a social point of view it is a serious drain on the already insufficient supply of trained engineers and scientists. On this, the earlier *WSJ* piece has this to say: "A total of six firms – led by Kohlberg, Kravis, Roberts & Co., Texas Pacific Group and Goldman Sachs Group – are close to signing a deal to buy utility powerhouse TXU Corp. for $32 billion plus more than $12 billion in TXU debt, according to people familiar with the matter. In a creative twist, the firms have moved quickly to pre-empt opposition from powerful environmental groups while seeking support from various regulators and politicians. Already, the buyers have promised to cancel plants to build most of the 11 coal-fired plants under development. And they have sought to placate consumers with rate reductions.

"The deal marks a quantum leap in the political sophistication of the buyout world, and may signal a broader re-making of private equity's image in the utility industry. [Italics are ours.] Buyout firms have generally received a chilly reception from utility regulators because they're seen as temporary, profit-driven caretakers not answerable to public shareholders or sensitive to customers. If the prospective TXU buyers can overcome that perception, they could potentially open the door to more private equity investors. But it's far from a sure thing. Regulators at all levels of government could trip the deal. It may also be subject to complaints from consumers who regard reasonably priced services as a basic right.

"Twice before, two of the private equity investors, involved in the deal – KKR and Texas Pacific – have tried to buy utilities and come up short after running into a buzz saw of criticism from state officials and consumers.

"The firms are attempting to get out in front of TXU's many detractors and make concessions early so that dislike of TXU's operating practices does not taint the deal.

"On Saturday two big environmental or-

ganizations that had fought TXU's plans the new coal-fired operations in Texas agreed to support the deal on the assurance that the buyers would cancel most of the plants.

"There is an element of stage-craft at work, too. TXU already plans to cut six of these plants, said someone familiar with the company's plans. The plants that remain on the drawing board are responsible for the lion's share of the profits of the entire 11-plant project, said another person close to the company."

From the perspective of systems analysis, we must note that subsystems of strictly political strategy become dependent variables in new subsystems that must be considered to foresee the probable outcome of Texas's quest for a reliant energy supply.

The article goes on spooling out ties from other essentially political subsystems. "In 2003, Texas Pacific announced its attention to buy Enron Corps Oregon utility's Portland General Electric. The deal attracted widespread opposition because Texas Pacific was seen as a short-term carpet-bagger that would raise prices and gouge consumers. Among the firms Texas Pacific had acquired were Burger King, Continental Airlines, and retailer J. Crew. Texas Pacific told investigators in 2005 that its returns, before taxes, have averaged 55% a year. The Oregon utilities commission eventually nixed the Portland General deal.

A Novel Element of Popular Assent Appears

"This time around, it was clear that the buyers needed a more strategic approach. At the heart of the potential new owners' campaign for support lies Texas Pacific representative, a former administrator of the Environmental Protection Agency under former President George H.W. Bush. Mr. Reilly became the public face for the buyout group largely because of his reputation among environmentalists. David Bondman, co-founder of Texas Pacific Group, has a similar reputation. He is touting his board membership of World Wildlife Fund as evidence that the group will behave responsibly."

And hence the organization of new subsystems to allay any distrust aroused among activists protective of the popular interest that was once entrusted wholly to government agencies.

"The buyers will need all of the goodwill they can get and must address more than just the environmental issue. Consumer resentment of TXU runs high in Texas, where under deregulation the company has aggressively moved to raise power prices that are now among the highest in the nation. In a bid to win over consumers, the private equity buyers have put out the word to Texas lawmakers that they plan a 10% rate reduction.

"Already some lawmakers [after being briefed by the aspiring buyers] seem unimpressed, Thus Sylvester Turner of Houston says he believes rates should drop at least 30%. He says the sale is causing him to re-evaluate the 'market we created in 1999. 'I have serious questions about the direction we're headed and the impact on consumers who never wanted deregulation to begin with.'

"On Tuesday, TXU is expected to show record earnings for 2006. In the first nine months of 2006, it earned $2 billion on operating revenues of $7.5 million, nearly double the profits as year earlier on a slight increase in revenues.

"Insiders have described Mr. Wilder, the CEO of Texas Pacific, as 'brilliant but tone-deaf' to the niceties of the utility business. Regulated utilities, traditionally are generous community givers and are solicitous of politicians. Erle Nye, the longtime CEO whom Mr. Wilder replaced, typified the courteous utility chief; Mr. Wilder seemed brusque by comparison. TXU did not return our calls seeking comment.

"Dallas Mayor Laura Miller said TXU has communicated poorly with elected officials. She's never met Mr. Wilder and said he has refused to meet with critics to discuss a long list of grievances that range from coal plants, which she opposes to nagging problems like perpetually burned-out street lights of downtown Dallas, undermining a $100 million redevelopment effort."

In our perspective Mr. Wilder is simply shutting his eyes to the new public relations subsystems that have arisen in energy matters. Attention and price concessions if anything will be necessary to head off the re-regulation that seems in the cards. However, given the problems of energy supply and pollution, it is hard to envisage energy utilities being restructured as a romping ground for hedge funds.

William Krehm

Water *continued from page 1*

icized the government for not moving faster. 'You've got a big a big problem with lead and you've got a bigger looming problem with water quality because the infrastructure is not getting funding needed,' he said."

Without clean drinking water our babies risk never reaching the retirement age. Perhaps daddy is not even putting the money in the bank but using it to finance all-night poker games with snazzy friends. Ridiculous? But no more so than our government talking about reducing the debt, when they are in more ways than you can count undermining the chances of human society itself surviving. And this they call "fiscal prudence."

The *G&M* article continues: "This week, politicians and staff in the Ontario legislature were told not to drink the water because lead has been detected in the building's tap water."

And this happens when we send missions to Mars to check on its water supply!

But can our government afford it? Elsewhere in this issue (on pages 2 and 3) we explain how the *Bank of Canada Act*, still intact in our law books, that incorporated the nationalization of the central bank that took place in 1938 made possible the financing of Canada's part in World War II, the catching up of the neglected infrastructure and technology of ten years of depression and six of war, and then of the reconstruction of the country from a semi-rural land to a highly urbanized one, could use that very same financing to give our people clean water. In the *Bank of Canada Act*, it is clearly set forth that Ottawa can borrow money from the central bank on a virtual interest-free basis. Not funny money, mind you. Rather. as the sole shareholder of the central bank since 1938, all the interest the central government pays on its borrowing from the central bank comes back to it as dividends. For in that year the government bought out some 123,000 private shareholders at a good profit. Moreover, subsection 14(2) of the Act sets forth how the Finance minister in the event of a basic disagreement on basic monetary policy, can give the Governor of the Bank. But for the past quarter of a century or more the government has shifted its borrowing from its own banks to the private banks, to bail our banks out from their speculative losses. And whenever it has done that it has deregulated our banks to allow them to gamble bigger if not better. By hiding what is on our law books, our government is undermining the basic principle of democratic government. To function Parliament must have access to full information, to our history, and to what is on our law books. And the media and our universities must be pen for discussion of such matter. That is what we must remedy to get clean drinking water for our citizens.

William Krehm

What Is Governor on the Public Payroll For?

As though he felt that he was doomed to act out his surname, Governor Dodge, who recently gave us the unlamented assurance that he would not stand for a second term as head of the Bank of Canada, increasingly makes pubic announcements quite incompatible both with his present position as outgoing Governor of the central bank and even more so with his imminent retirement. Last March in a New York speech at the Council of the Americas he attacked all Latin American countries, but particularly the Argentine for "for pushing back into a high-inflation environment." He was referring to the Argentine having abandoned its disastrous policy of an earlier regime not to issue any currency of its own, without having an equivalent amount of US currency in its central bank to back the Argentinean pesos issued. All that was still necessary was to engrave the famous likeness of President Bush on the Argentine currency. He could just as well have written a cheque for the amount of currency issued and sent it to Washington.

The dollars that the Argentine had sopped up in this way would have cost Washington nothing. The US had already spent them into existence. During the apogee of Britain's empire when its colonies used the British currency, that currency was most of the time fully backed in gold – so that the colonies did not undergo the degree of strictly monetary exploitation as when the independent Argentine backed its currency with US dollars. But where did Canada find a governor of its central bank sufficiently clued out – or as we shall note from his subsequent utterances enlisted – to speak such nonsense? There is nothing about the economic or geopolitical position of the US today that should convince even a random reader of the press, let alone a central banker, in the strength of the US dollar that would warrant any sovereign nation to adopt it directly or indirectly "to fight inflation." Skipping the detail of what "inflation" might be, and whether any country can get itself involved in major wars present and future, without price, export, monetary, credit and other controls. You can hardly open a newspaper these days without the question being asked how long the rest of the world will tolerate the US running up a deficit as the world's main reserve currency. And its dependence on oil guzzling for its life style, let alone the endless losses of lives and prestige in Asia Minor and now points further east, plus the energy-vulnerability and the economic ascent of even more populous countries of cultural pasts that adds another set of question marks over its short-lived career as lone superpower. Why would any Canadian, let alone the head of its central bank, unless he has ambitions of brilliant professional promotion by being an early pioneer in servility to Washington, espouse a common currency with the US at such a point?

Others, some out of a sense of mistaken "internationalism," like Tom Courchene at Queen's, and Thomas D'Aquino of the Fraser institute, engaged in a period of raucous advocacy of a "joint currency" (!) with the US. But they abandoned that leaky canoe two or three years ago. Now Mr. Dodge is back at it. *The Globe and Mail* ("Dodge says a single currency 'possible'" by Barrie McKenna, Washington) realizes that the need for a "common currency" is more acute, essentially for the same reasons that the US needs it all the more. It is all made very vague and iffy. "Bank of Canada Governor David Dodge says North America could one day embrace a euro-style single currency. But to get there, Canada the US and Mexico must first tear down barriers which he pointed out yesterday 'have gotten a bit thicker' in recent years."

Washington's Misrepresentations Brought Us NAFTA

Precisely because the North American Free Trade Alliance which was a masterpiece of deceit by the Americans telling the Mexicans that the Canadians were languishing for it and the Canadians that the Mexicans were swooning for it. The reality that the low-skilled manufacturing that was outsourced to northern Mexico was negotiated so ferociously by American manufacturers with the still cheaper Chinese competition lurking in the background, that the tax concessions extracted from the Mexicans ruled out proper servicing of the new manufacturing areas that sprang up on the American border of Mexico. And as the still cheaper workers came for jobs there from central and southern Mexico, they naturally kept on going legally or illegally over the border, so that al neighborly brotherhood ended up with a wall being built to keep out the good neighbours, while armed vigilantes were there to welcome them with rifles. But what did have instant application was not only an open frontier for currency, but Mexican government bonds issued ("tesobonos") that gave the buyers the option to be paid in US dollars or pesos, as they might choose. As a result – perhaps the most militantly nationalist country in Latin America became one of the most servile with a former head of Mexican Coca Cola the president of the country. At the same time 85% of the Mexican banking system, after being renationalized again and reprivatized once more, ended up owned by foreign bankers. At the same time the aggressive involvements of Washington in former Yugoslavia and Latin America were disclosed and the revelation of the greatest possible weakness of a world superpower – an insensitivity for other cultures and the resulting inability to learn from the same errors it had made in Vietnam and in the former Soviet Union.

And it is to that star that Governor Dodge wants to hitch Canada's destiny, exactly at a time when Canadian fuel resources have become more important than ever to the US, and our major concerns are being gobbled up by the hedge-funds – based as often as not in the US. Moreover, as NAFTA stands, we are already tied to commitments that no one heard of before the treaty was signed, that has already cost Canada money to compensate US firms for losses resulting from Canadian legislation that deprive American firms of business activities that netted them profits before the signing of NAFTA. And other that give the US the rights to share scarce supplies (as in oil sands and uranium and water) in the same proportion and at the same prices as our own population enjoy. Apparently Washington, particularly in view of the increasing defensive assertiveness of other key resource-endowed countries, is in ever greater need of our oil, gas and other resources. And the entire economic wisdom of recent Bank of Canada governors has been that what gets greatly demanded gets priced highly and automatically produces a greater supply. If not of resources then of Canada's neighbourly servility.

The reference to the European Union likewise hardly makes much sense. The central banks of the various member countries of the European Union are strictly bound by the deficits they can run up (read the "public investments" they can make). Mr. Dodge's innocence of what is afoot in Europe seems to match his ignorance of the Canadian scene.

W.K.

Big-boy Letters

Economists of the official school work on the assumption that our economy is self-balancing, For at least four decades there has been an intensive effort to free corporations from the very considerable restrictions that were put on them to get the world out of economic crisis and major wars. Most of this effort was planned and driven outside democratic process, nor can it always be attributed to the commanding will and winds of prevailing markets. Yet, if we examine any of the major problems that beset the world, we find that rather than a tug of demand against supply, what we encounter is a whole hierarchy of conflicts that lead to the final results rather than a market of any recognizable sort. Some of these are strictly material like the pollution of our atmosphere and waterways with a variety of pollutants. But when we come to enquire how this could have been allowed to happen to a degree where it endangers the survival of human habitation, we are confronted with a whole web of intertwining causes. These in turn result from conflicts of interest in human society with one group of people profiting from the neglect of the environment, while another is left most exposed to the destructive effects released.

With Globalization and Deregulation taken over, anything that can be identifiable with a "pure and perfect" or indeed any sort of a market is largely absent. *The New York Times* (22/05, "Side Deals in a Gray Area" by Jenny Anderson) gives us a pretty climactic instance of the ultimate mockery of the free market or a market of any identifiable sort presiding over major commercial proceedings. "Global deal making is on a tear, accompanied by a surge of insider trading cases. While regulators have focused on the buying of options or stocks on leaks about deals before they become public, there is another, more subtle way by which big investors can trade while possessing information that the market does not have.

"And it is – for now at least – all perfectly legal. This little-known leeway comes in the form of 'big-boy letters' – letters between buyers and sellers that say, in essence, 'We are all big boys here, so let's not sue each other.'"

The implication is clear: The "pure and perfect market" doxology that monopolizes the curricula of our universities and media today is strictly for the birds. Or more precisely for the sparrows, and in no way commits the eagles.

"Big-boy letters are typically used when an investor has confidential information about a stock or bond and wants to sell those securities. By signing that letter, the buyer effectively recognizes that the seller has better information but promises not to sue the seller, much like a homebuyer who agrees to buy a house in 'as is' condition.

"But what happens when that security is then sold in the market and then plummets in value? Put another way, what if that house collapses soon after it is sold to another buyer? The use of big-boy letters is about to face its first significant legal challenge in a lawsuit set to go to trial next month: a Texan hedge fund contends it was on the losing end of such a letter in 2001, when Salomon Smith Barney, now Smith Barney, sold more than $20 million dollars of World Access bonds to the Jefferies Group, the investment bank, using a big-boy letter.

"Jefferies, in turn, flipped the bonds to the hedge fund R2 of Fort Worth, through the First Group, a service that matches trades. When World Access, a telecommunications company, announced that it was out of cash two days later, the bonds plummeted 30%, leaving the hedge fund holding the bag. In a world of rapid trading, complex and arcane derivatives and secretive traders, the contours of what makes a level trading field for investors is sometimes difficult to see."

To put it mildly.

"Lawyers agree that big-boy letters do not technically shield either party from insider trading laws, but rather protect the two parties from suing each other. Still, the letters are widely used and have not – until now – been legally challenged. (The Securities and Exchange Commission has not weighed in on the letters.)

"And lawyers do not agree on what happens when the securities at issue in big-boy letters are then put into the market with trades that might otherwise be deemed illegal. Typically, insiders are barred from trading on significant information they have agreed to receive in confidence that gives them an advantage over other investors.

"'With big-boy letters, we have a situation where the public at large can be exposed to tainted claims without knowing about it,' said Edward S. Weisfelner, chairman of the bankruptcy and corporate structuring practice group at the law firm of Brown Rudnick.

"In another case involving big-boy letters, Barclays, the British bank, recently disclosed that the SEC was considering a civil enforcement action against it. According to government filings and a related lawsuit brought by Michael Econn, Barclays' employees traded debt while sitting simultaneously on bankruptcy committees, giving them non-public information about the value of the debt. According to Mr. Econn's lawsuit, Barclays supervisors told the employees the trades were acceptable because the bank was using big-boy letters, even though only a few big-boy letters were ever drafted. In the lawsuit brought by the R2 hedge fund, which is scheduled to go before a federal jury in Manhattan, the issue is whether Smith Barney and Jefferies worked together to unload toxic securities into the market and whether Jefferies was obligated to disclose the existence of the big-boy letters to the fund."

Hopefully the day will eventually come when governments and universities will be prohibited from discharging their functions on the assumption that our markets are made up of agents and chief actors so tiny in size and influence that anything they do individually – including obtaining big-boy letters will in no way affect the price and transaction level on the "pure and perfect market." And that no staff member can be given early retirement by our universities for questioning such an assumption.

W.K.

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Murdoch Rattles Carefully Propped-up Self-esteem of the Media

If the unsustainable official system of accelerating economic growth and expansion in a shrinking, ever more scarred environment, had to have a name and a LBOer (Leverage Buyer-Outer), a leading candidate would be the Australian media super-tycoon Rupert Murdoch. And in pursuing what appears his destiny, he has thrown up some very carefully erected screens to allow his empire to hang on to an essential quota of self-respect. Let us begin by quoting evidence of the commotion he is currently causing by casting his long shadow over some of the most respected media icons.

We quote from *The Globe and Mail* (04/05, "Murdoch's offer chills newsrooms" by John Ibbitson): "Journalists at America's most respected business paper are not-so-quietly appalled by the news that Rupert Murdoch, proprietor of some of the world's schlockiest newspapers and broadcast outlets, was offering to buy Dow Jones & Co., which owns *The Wall Street Journal*, for an enticing sum of $60 a share.

"'What will happen to the paper if Mr. Murdoch's News Corp. succeeds,' Professor Arlene Morgan, an associate dean at the Columbia University School of Journalism, wondered. 'Are we going to have girlie-girlie pictures on the front?'"

A Shiver Sent Through Newspaper Board Rooms

"Probably not. Mr. Murdoch is after the *Journal* because of its street cred. It would be rank folly to damage the brand that he is willing to spend $5 billion to acquire.

"Nonetheless, Mr. Murdoch's gambit has sent a shiver through posh newsrooms in the US because it reflects the current vulnerability of upmarket newspapers to outside buyers.

"Although there are exceptions, the better American broadsheets generally fall into two categories. There are those that are majority-owned by families, who shepherd some of the world's great English-language dailies: the Bancrofts of the *Journal* (who have rejected Mr. Murdoch's bid, though there could be defections); the Sulzbergers of *The New York Times*, the Grahams of *The Washington Post*. Profits of the great family-owned papers are generally modest or non-existent, and circulation is stagnant or in decline. Increasingly, minority shareholders and impatient children are demanding improved returns on investment, which makes the family-owned papers vulnerable to sweet-talking outside buyers.

"In most cases newspapers in the second group, those that are owned by shareholders and investors, are also under pressure as returns fail to live up to expectations.

"*The Philadelphia Enquirer* announced last month that Citizens Bank would henceforth directly sponsor a new column in the business section. Editorial independence remains assured, but no one expects the paper's new management expects that column to take on the banks.

"Increasingly, people turn from news websites that scalp from newspapers to the peer-to-peer opinions and reports found on blogs and You Tube. Bloggers and their ilk are generally not trained in journalism or subjected to the rigours of editing. Newspaper websites while popular with readers generate 7% of US newspaper advertising revenue. Putting out a good newspaper and pleasing the stock market have become mutually exclusive propositions. If so, it may be girlie-girlie in *The Wall Street Journal* after all."

There are even more serious threats to the quality of the printed word than "girlie-girlie." Though as a distraction from such concerns, Murdoch knows best what works. I refer to altering the basis of appraisal of the value and cost of given policy, while appearing to merely add up the columns of costs and returns as laid down by some unquestionable economic science.

The history of officially recognized doctrine is the struggle of hungry dogs for a chunk of meat. Adam Smith elaborating this view wrote before the industrial revolution where it was the division of labour rather than the still non-existent steam engine that was the principal source of greater productivity and production. Society had still not moved far from its historical predecessors. Reflecting that Smith used not one but three alternate theories of value – not only the amount of embodied average labour but the cost of production theory, and the amount of commanded labour – the relationship between average prices and the labour power they could purchase. But with the development of the steam engine and factory production relationships tightened up.

That was reflected in the career of David Ricardo who led the struggle as an economist and as a member of parliament against the Corn Laws that afforded the landowners a protective bonus at the cost of higher wages that had to be paid by industrialists. For Ricardo the trenches were deeper and more simply placed than for Adam Smith. Higher wages, he held along with his clerical economist friend, the reverend Thomas Malthus, would net the workers little or nothing. For lack of abstemiousness they would only result in greater indulgence and greater families. And would bring wages down to where they were, unless the Corn Laws were removed. It did not occur to Ricardo that a more numerous, healthier and better educated working class might enhance the prosperity of the land. On the other hand Karl Marx seemed to be so flattered that Ricardo, a stock broker, shared his faith in the labour theory that he regarded him his worthiest forerunner.

Since the working class itself was largely illiterate these grand debates on economic theory were over their heads. The economic discussions in the days of Adam Smith were in a sense like the off-colour gossip that parents may exchange concerning friends after the kids have been put to bed. But here the children were awakening rather than being put to sleep. It was a time when mechanical institutions were teaching workers to read and write. A need was felt for a different angle of vision than that of official economic theory. It was provided by the marginal theory schools – three of them arising almost simultaneously in three different countries – Britain, France, and Austria. This transferred the point of perception from the factories and what went on there, to the shopping plaza and the consumer. The concern shifted from the amount of average labour embodied in a given product to the satisfaction obtained by the customer in consuming a given product.

Obviously that was an even far greater subjective matter than the amount of children a better paid worker might beget.

Mr. Murdoch's ambitions in acquiring the highly sophisticated press is a further adaptation of that sort.

W.K.

Light Out of Detroit?

We don't generally associate Detroit with great revelations that help humanity conduct its affairs in more humane and sustainable ways. However, so difficult has the fate of its huge automobile industry become, that its stakeholders are showing desperate cooperation never seen before. And most surprising, the new spirit of compromise, holds some promise of effecting the complete transformation of the industry to make a rescue possible. The basis of such compromise must be a common all-embracing accountancy, eventually shared with the government itself. Otherwise, neither the industry, the government nor the taxpayer will have a notion of what lies ahead. Without some common ground on such basics, rather than a solution the only possible result will be a quick getaway of the supposed saviour with some fast profits.

Perhaps the most amazing aspect of the solution in the making is that a hedge fund has inspired it. It was the private-equity fund Cerberus Capital Management LP, in return for 80.1% has "set the table for a potentially far-reaching restructuring of Detroit's faltering auto giants" (*The Wall Street Journal,* 15/05, "Chrysler Deal Heralds New Direction for Detroit" by Gina Chon, Jason Singer and Jeffrey McCracken).

Cerberus was of course the dog in Greek mythology that guarded Inferno. You may have wondered why the bards of ancient Greece should have given the canine guard three heads. It may have been that they foresaw the complexity of Chrysler's problems, in an economy dedicated to growing every faster in a world increasingly contaminated by the degree of its effort.

And having come away with that insight we are well launched on an understanding of the economics, politics and corporative affairs of DaimlerChrysler.

Profit Regardless

In essence it consisted of bridging the chasms that separate the producers and would-be producers, and those who under the existing system stand to profit on an ever mounting scale from both the failures and the successes of the systems. "The New York Investment firm and German Auto company have set an ambitious goal: to work with the powerful United Auto Workers Union to restructure the $18 billion that Detroit's No. 3 auto-make will eventually owe for the UAW retiree health-care benefits. Daimler, Chrysler's German parent, was unwilling to shoulder that burden.

"Many big airlines and steelmakers have chosen to file for Chapter 11 bankruptcy to bring such s liabilities under control. If Cerberus can devise a formula for doing so outside of bankruptcy court, Ford Motor Co. and General Motors Corp. would also almost certainly try to follow suit, potentially affecting some $95 billion in total retiree health-care obligations. 'Discussions are under way at the highest levels,' one person familiar with the situation says.

"Daimler's deal with Cerberus, announced yesterday, represents a watershed moment for both the US auto industry and the burgeoning private-equity sector that is transforming global finance. Detroit's Big Three have been struggling for years to cope with the fierce competition and retiree and health costs. Private-equity firms like Cerberus, which often buy public companies and slash costs, have amassed large war chests of capital and have been aiming for bigger and bigger targets.

Testing Taste for Risk

A couple of days later (*WSJ,* 17/05, "Chrysler Deal May Test Appetite for Risk" by Serena BG and Jason Singer) the same publication goes into the financial complexities of this reshuffling of assets and applications – all under the gun of the bankruptcy alternative. "With the landmark sale of Chrysler Group to a New York buyout firm, the world's exuberant debt markets are being put to an unusual new test.

"Bond investors and lenders have ponied up hundreds of millions of dollars to fund the takeover boom. In this case, DaimlerChrysler AG's sale of the struggling US auto maker to Cerberus Capital Management LP depends on a complex set of financial maneuvers that will require its majority owners to raise $62 billion in debt in the weeks ahead. The transactions come with a host of quirks. Daimler will be retiring – at a huge expense – one set of bonds 90 years before they are set to mature. Also, at a time when many companies are getting loaded up with debt in takeovers, Chrysler's struggling auto-making operation could still end up with a cleaner balance sheet than its Detroit rivals after the financial jockeying is done.

"Daimler will be getting rid of the iconic car company and Chrysler Financial which extends auto loans to people buying Chrysler cars and trucks. Daimler has to keep on paying off much of the debt already on the books of the two units – more than $38 billion in all – which it has guaranteed. Under Cerberus, Chrysler needs to borrow more money to compensate Daimler and to run the businesses. That entails raising as much as $50 billion at the finance unit by selling junk bonds and asset-backed securities, which in this case will be bonds whose payments are backed by Chrysler Financial auto loans. It also means raising up to $12 billion in new loans for the auto operation, less debt than General Motors Corp. and Ford Motor Co.

"Five Wall St. banks – J.P. Morgan Chase & Co., Bear Stearns Cos., Goldman Sachs Group Inc., Citigroup Group and Morgan Stanley – have committed to provide the financing, and they are expected to sell the bulk of the debt to thousands of investors in the coming months by issuing a combination of loans, bonds, and asset-backed securities. The banks underwriting the debt could book more than $300 million in fees, according to estimates from Thomson Financial and Freeman & Co.

"The deal marks an unusual test for the world's debt markets. Abundant credit and modern ways of accessing it by hedge funds and other investors have been the fuel that has driven the private-equity buyouts. Investors have exhibited little worry about default itself in the process. But in this case they will be getting behind a specially wobbly business. 'Here we are concerned about product quality, and the company's plan for its health-care benefits and how it will reduce debt in the future – matters that we don't see in a traditional buyout.'"

Emerging with Some Strength

"Daimler, which has a strong credit rating, guaranteed Chrysler's debt when it bought the company in 1998. It plans to pay most of it down with funds it receives from Cerberus. The exception is the $1.8 billion in 100-year bonds issued by Chrysler in 1997. These bonds will be redeemed, costing Daimler a prepayment penalty of around $850 million.

"Daimler says the new Chrysler comes out of this in strong financial standing. DaimlerChrysler's CEO Dieter Zetsche, said in a conference call earlier this week that the new Chrysler may get a BB credit rating, the highest 'junk' rating and above Ford and GM's B mark."■