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On Autism and Official Economic Theory

Under the heading "Is an Economist Qualified to Solve Puzzle of Autism?" *The Wall Street Journal* (27/02) carries an article by Mark Whitehouse that should indeed have been of great concern, if not precisely as seen by the author. Whatever the sins of some economists encroaching on other disciplines, the grossest autism of economists occurs within their own discipline.

"In the spring of 2005 Cornell University economist Michael Waldman noticed a strange correlation in Washington, Oregon and California. The more it rained or snowed, the more children were likely to be diagnosed with autism. To most people, the observation would have been little more than a riddle. But it soon led Prof. Waldman to conclude that something children do more during rain and snow – perhaps watching television – must influence autism. Last October, Cornell University announced the resulting paper in a news release headlined, 'Early childhood TV viewing may trigger autism, data analysis suggests.'

"Professor Waldman's willingness to hazard an opinion on a delicate matter of science reflects the growing ambition of economists – and also their growing hubris, in the view of critics. Academic economists are increasingly venturing beyond their traditional stomping ground, a wanderlust that has produced some powerful results but also raised concerns whether they're sometimes going too far.

"Ami Klin, director of the autism program at the Yale Child Study Center, says Prof. Waldman needlessly wounded families by advertising an unpublished paper that lacks support from clinical studies of actual children. 'Whenever there is a fad in autism, what people unfortunately fail to see is how parents suffer,' says Dr. Klin. 'The moment you start to use economics to study the cause of autism, I think you've crossed a boundary.'

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FOUNDING EDITOR
John Hotson 1930–1996

PUBLISHER–EDITOR
William Krehm
(comerpub@rogers.com)

CONTRIBUTORS Vol. 19, No. 3
William Krehm
Keith Wilde

CARTOONIST
Allen Good

INFORMATION SECRETARY
Herb Wiseman (herbwise@cogeco.ca)

WEBMASTER
John Riddell

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Autism *continued from page 1*

"Such debates are likely to grow as economists delve into issues in education, politics, history and even epidemiology. Prof. Waldman's use of precipitation illustrates one of the tools that has emboldened them: the *instrumental variable*, a statistical method that, by introducing some random or natural influence, helps economists sort out questions of cause and effect. Using the technique, they can create 'natural experiments,' that seek to approximate the rigor of randomized trials – the traditional gold standard of medical research.

"Instrumental variables have helped prominent researchers shed light on sensitive topics. Joshua Angrist of the Massachusetts Institute of Technology has considered the cost of war, the University of Chicago's Steven Levitt has studied the effect of adding police on crime, and Harvard's Caroline Hoxby has studied school performance. Their work has played an important role in public policy debates."

Economists Ignore Autism in Own House

But, oddly enough, the author of the article, omits similar havoc done within the strict bounds of their own profession, not by resorting to randomly chosen "instrumental variables," but by suppressing key variables relating to the economic activities of society. For example, the non-market responsibilities of the government financed by taxation rather on the market by private enterprise. The effect of such non-market activities on the market itself though not originating in it – say by the government and paid for by taxation – is growing ever more rapidly. Urbanization, investment in human capital by the government, and the undermining of repairs to the environment are proceeding apace. It is impossible to operate a modern economy without ever more highly educated consumers, let alone producers. But that requires a growing amount of public spending for post-secondary education; costly measures are needed to protect the environment and deal with longer life-spans – something that should be celebrated with fife and drum, since we all aspire to live long and comfortably.

To shed light on the point, let me refer to a once celebrated Dutch physicist-turned-economist, Jan Tinbergen, who developed what came to be known as "The Tinbergen Test," a perfectly rigorous useful rule in the economics of more than a half century ago. It required no more mathematics than the algebra we were all taught in the first year of high school, when we learned how to solve linear equations. If there were two unknowns, you needed two independent equations to solve them. If three independent variables were identified, it needed three independent equations to solve the problem. If you tried solving equations of three independent variables with the two or four independent equations, you were flunked and stood a good chance of repeating your year. Our economists today try solving the equations of an ever more complex economy involving ever more independent equations with a single variable – higher interest rates to keep the price level flat. But ours today is a mixed economy involving an ever greater number of independent variables, but it continues to be run with a single independent variable – higher interest rates. That too is an "instrumental variable" implanting the supremacy of the financial sector. It puts political power in its hands, by proclaiming interest the control button for just about every theory. But interest is the sole means of the central bank for controlling the economy – the basic revenue of money-lenders that also happens to be their bone-breaking weapon for preparing profitable takeovers of firms driven into bankruptcy. This control by the financial sector is so absolute that it amounts to another form of autism.

Something of this sort had happened in the 1920s, when Wall Street took over and led to the Big Bust of October 1929, that brought on a decade of deep Depression during which thousands of banks in the US shut their doors. One of the first things that President Roosevelt did on assuming office in 1933 was to declare a bank moratorium that had to be renewed, and led to the *Bank Act* of 1933.

The *Bank Act* introduced a few important restrictions that obliged banks to stick to banking. They were limited in the amount of interest they could pay or charge. Two major tools were provided them for influencing the economy. If it was judged overheated, with price indexes rising, the central bank could cool it by raising the benchmark interest rate for overnight lending to banks. If it needed stimulation, they could lower that rate. But interest rates hit everything that moved or stood still in the economy. Certainly the unemployed could not be contributing to inflation. Hence an alternative tool was provided.

Elsewhere in this issue I discuss in detail how the statutory reserve worked. Instead of changing the benchmark interest rates, the central bank could raise the statutory reserve – a portion of the deposits made by the public with the commercial banks, that had to be redeposited by the banks with the central bank. On such statutory deposits the banks were paid no interest. For if such interest were paid it would decrease the leverage and thus lower the effectiveness of such reserves for the purpose assigned to them. If interest were paid on them they would have to raise the reserve more to discourage further loans, because it is the difference in the banks' *net revenue* from more lending between what the reserves had been and what the net increase in the banks' lending would provide.

The other important provision of the *Bank Act*, that came to serve as a model in most non-Communist countries, was the prohibition of the banks to acquire an interest in other "financial pillars" – stock markets, insurance, and mortgage corporations. Each of these other financial pillars kept liquid reserves of cash or near-cash – that it needed for its own industry. Allow the banks access to these, and they would use them as money-base on which to apply the bank multiplier (the number of times an average bank is able to lend out the amount of the reserve it keeps with the central bank or in its own vaults). For that is the art of banking – a miraculously useful one, but like all miracles it does need to be kept under control. So long as banks are able to honour the cheques or withdrawal slips when presented, all is well. However, as soon as a single bank cannot meet a depositor's claim when presented, every bank in the country becomes suspect and threatened. That is what happened in October 1929 on the biggest scale and brought on a decade of Depression, and eventually the Second World War.

The Privatization of the Bank of Canada

In 1938, the Liberal government of Mackenzie King nationalized the Bank of Canada, founded in 1935 as a private institution with 12,000 shareholders. This had an immense importance for the country. For so long as the government did a substantial part of its borrowing from the central bank, the interest it paid such loans came back to it as dividends. When it does its borrowing mostly from the private banks the interest stays with them. During the Second World War as much as 16% of government borrowing was done with the Bank of Canada. By the mid-1970 that proportion exceeded 22%. That is why Canada was able to finance its part of the St. Lawrence Seaway, and infrastructures for the technological revolutions that transformed the country. We renewed the housing and other infrastructures after 10 years of depression and six of war, and assimilated a huge post-war, mostly penniless immigration. And with all that it reduced the federal debt from 160% of the GNP to some 22% at the same time. Restored to health by the disciplines inspired by the US *Bank Act*, the banks began hankering after the fleshpots of the twenties, when they were deregulated to gamble in ways incompatible with banking. And bit by bit the restrictions I have described were removed to allow this. In the 1980s in particular they got into real estate gambles in a huge way and lost most of their capital.

To cope with that, the Bank for International Settlements – a sort of central bankers' club – introduced a double-pronged rescue effort. It sponsored its *Risk-Based Bank Capital Requirements* that declared the debt of developed countries risk-free and thus not requiring down payments for banks to acquire. And on the strength of that the Canadian banks quadrupled their holding of federal debt to some $80 billion dollars. And to make that possible the government reduced the debt that they had held with the Bank of Canada accordingly. And in 1991, when the decennial reexamination of the *Bank Act* was due they phased out the statutory reserves over a two-year period. That left the benchmark interest rate set by the central bank as sole means of controlling the economy.

And because of the mass amount of increased bank lending that resulted from the banks loading up with government bonds, the central bank raised the benchmark rate into the skies to stave off what it called "inflation." In actual fact the price level may rise not because there is an excess of demand over available supply, but for quite other reasons. Thus a rapidly developing country requires new costly infrastructures and a more educated population. That means higher taxation which leads to a deeper level of taxation in price. But if you declare a flat price level an "instrumental variable" and ignore the other factors that can and must lead to a rising price level, your economic theory becomes as autistic as Professor Waldman's handling of the phenomenon of autism itself.

Moreover, the tale does not end there. So urgent was it to bail out the banks that the Bank for International Settlements had overlooked that its two remedies were incompatible. If you allow the banks to load up with government bonds and then push up interest rates to the skies, the value of the banks' pre-existent bond hoards bought on the cuff, sinks in value, and threatens to drive the banks to bankruptcy once more. This actually happened in Mexico, where the banks were nationalized again – after having been privatized from a previous nationalization a few years before. The peso lost some 40% of its value, and Mexico has still not recovered from the effects. To prevent the resulting bank crisis from bringing down the international banking system the US with the help of the IMF and Canada set up a standby fund – the largest to that date ever $51 billion US.

The Greatest Goof Ever in Central Banking

And to effect even more lasting repairs the US changed its very accountancy. As all governments throughout the world, the US up to that point had treated its capital investments as current expenses, writing them off entirely in the year when the money was laid out, and then carrying their book value at one token dollar, while the debt incurred to finance the investment was carefully recorded on the books and amortized over the probable useful life of the asset. That created the impression of a deficit that was not necessarily there. That, too, was a form of autism, very useful to the financial sector that considers investments of government in education, health and other social services a waste of money, Governments according to this brand of autism is unable to make investments. Only banks that governments must bail out frequently can do that. But the period for running the economy with sky-high interest rates was now still recognized with one eye shut. Even though beginning with January 1996, the books of the US government were redone to the year 1959 and turned up $1.3 trillion dollars of assets that had been ignored, these were not referred to as investment "assets" but as "savings." On other occasions economists use "savings" to designate assets in cash or readily converted into cash. The Canadian government continued its brand of autistic accountancy further, even though the Auditor general refused to give unconditional approval of two successive years of its balance sheets. Finally a demeaning concession was wrung from the AG by Finance Minister Paul Martin that said that since the new accountancy had brought no new funds into the Treasury it could not justify

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Some "Extraordinary Popular Delusions"

(The headline is a borrowing from the 1841 book by Charles Mackay, Extraordinary Popular Delusions and the Madness of Crowds. *Dr Hudson suggested that the title here should include "and their financial sponsors" – by which he means governments, who always sponsor bubbles at the behest of the financial elites who control them. A bit too long for the head of a column here.)*

Everything you thought you knew about economics is probably wrong. Worse, it is a deliberate lie. And worst of all, the people who persuaded you to believe in the lie are not even fully conscious of it themselves. Rather, they are "useful idiots" in the service of a ruling class of oligarchs. This ruling class has persuaded itself that by conspiring to augment their own wealth and power they are actually improving the general welfare. And they use their spending power liberally in efforts to make that belief universal. The success of this propaganda deters widespread recognition of reality, and the combination of reality with mistaken beliefs is destroying the middle class and reducing the working class to penury and virtual slavery.

I distilled this message from ongoing work of Michael Hudson, a specialist in finance, economic history and the evolution of economic doctrines.[1] In re-reading it a day or two later, I was struck by its similarity to the tone of newsletters issued by several financial analysts.[2] The most interesting aspect of the similarity is the quite different applications that the authors had in mind. The newsletters dispense investment advice to people who are sufficiently middle-class that they have some discretionary wealth to manage and to protect against the shifting winds of fortune. Personal policy is their focus. The professor's domain, in contrast, is public policy. Unless the current policy orientation and its supporting beliefs are altered, in his analysis, the middle-class is headed toward debt peonage.

Dr. Hudson is not alone in characterizing current circumstances as a bubble economy. The financial commentators generally agree we are blowing up a bubble. Even the pronouncements of central bankers lend support to the judgment. It is widely understood that financial bubbles are dangerous. One might expect, therefore, that there would be a focus on that problem in public policy discussions. None is visible, however. That is sufficient justification for financial gurus to base their advice on the premise that it is every man for himself. Governments seem to be compliant with that attitude. Instead of implementing regulations to deter the inflation of bubbles and their eventual collapse, they encourage everyone to participate in blowing them up by investing in financial assets. (Several governments address poverty with educational programs to teach citizens how to acquire a financial portfolio by saving out of meager and spasmodic incomes.[3])

The Gap Between Ideology and Reality

This hapless posture of public policy is a consequence, in Hudson's analysis, of almost universally shared but misguided beliefs about economics. He says that a big gap has opened up between reality and ideology, that there is a major disconnect between the economics of production and distribution and the economics of finance. Some commentators encapsulate this by saying that the economy has been *financialized*. This means that the real economy has been converted into instruments (claims, vested interests) that yield streams of liquid income. Instead of finance being an essential adjunct to the work of the world and the progress of technology, it has become a dominating, parasitical power over the real economy and is on course to destroy its host by consuming it. (Furthermore, every society in history that has built up an unrepayable structure of debts has defaulted on it.) Consider the following contradictory phenomena:

You may have heard that the way to gain wealth is to save up wages earned from doing useful work and to then start up and operate a profitable enterprise. If you tried that, you may have noticed that your net worth has grown much more by increases in the market price of your house or the premises of your business than it has by business profits. And if you are adventuresome in the pursuit of wealth, you must have noticed that many in the smart set are borrowing huge sums to buy various kinds of property on the expectation that the prices will rise. Their savings, out of business or personal income, amount to repayment of debt in the hope of a big gain when the property is sold. (Rental income is for paying interest!) Rising prices for assets have become more important to wealth accumulation than production and earnings. "The annual change in property values, stocks and bonds – and debts – far exceeds that of annual output and income, and most money is spent on these assets."

Run that by again. Rising prices are a source of wealth, even without improvements to the properties in question. The same quantity and quality of goods brings a higher money price. That sounds like the definition of inflation – but also like a good thing, if I could get some. This seems to contradict the insistence of monetary authorities (central bankers) that inflation is the enemy of a healthy economy and that their primary (even their sole) objective is to control it. Furthermore, it seems to contradict the attitude of monetarists toward government fiscal management: If big debts are the way for individuals and corporations to accumulate wealth, why is government debt condemned as inflationary and the enemy of a healthy economy? There are at least two elements in response. For one, if government invests importantly in social infrastructure (public goods), it reduces the influence and power of private financial interests. And if the government debts are incurred mainly for the adventures of princes and presidents in foreign wars, the relentless condemnation of debt encourages a sense of guilt among middle-class taxpayers that helps inure them to their fate of paying interest to the owners of government bonds.

Consequently, the focus of monetary authorities is on prices that diminish the value of assets. That means consumer goods and wages primarily. To the extent that they are successful, therefore, the money value of real estate, financial assets and monopolizing powers rises while the income of the average earner is progressively less adequate to grab a share of the increasing (inflating) wealth. To get title to a piece of the action (such as a house) requires the average earner to take on an expanding debt load as house prices increase. Once contracted, payments on the debt become the principal form of household savings. That may be OK if the market valuation (price) of your asset keeps rising or even holds its value until you are ready to cash it in, but if it falls significantly, some or all of your savings will be lost. From the side of wealth holders, the loss of a revenue stream is compensated by greater concentration of ownership.

Inflating asset prices are only a part of the *financialization* picture. Dr. Hudson has summarized his argument by setting out commonplace beliefs about economic systems and then contrasting these myths or fictions to their corresponding reality. The notion that the economy is about production and consumption is contradicted by noting that the money-measured volume of market transactions is heavily dominated by trade in financial assets.

Weath of Traders vs. Wealth of Nations

The goal of these transactions is to increase the wealth of the traders, but it is not an activity consistent with growth in the wealth of nations. The trade is in claims to a proprietary interest in streams of revenue that are of an increasingly ephemeral quality. The main point overall is that property and its associated financial operations dominate production activities and deter the potential benefits of advancing technology.

The following list is extracted with light editing from Hudson's own texts:

Myth: Wealth and economic development are mainly material and technological in character. Economic planning is essentially an exercise in industrial engineering.

Reality: Financial and property objectives determine production technology. Economic rent and interest grow as a proportion of direct production costs, even to overshadow them. Financial managers focus on balance sheets and their perspective comes to override that of production engineers. Wealth seeking becomes mainly financial in character. Among its manifestations are insider deals among a few owners and managers (e.g., disguising theft of shares as production costs) and political lobbying for special tax favors.

Myth: Political and cultural institutions are designed to encourage technological innovation. This line of causation enables scientific and material advance to transform society and politics in an upward and onward direction.

Reality: Debt and other financial dynamics promote the monopolization of property, and block the employment of optimum technology. As political power becomes centralized in the hands of creditors and monopolists it deters the economic interest of the majority from steering public policy. The control of political and fiscal processes by the perspective of narrowly-owned financial wealth progressively hollows out the real economy and polarizes economic classes. Labor cannot work with optimum technology because business (not to be confused with wealth-ownership) is progressively less able to afford it. (The fall of Rome remains the most notorious example.)

Fiction: All economic activity that earns a return is productive, in proportion to the money it makes, whether in the form of profits, wages, interest, rent or capital gains.

Reality: Some forms of earning income are more productive than others when measured by the increase of productive powers and economic expansion. The financial sector's gain is a loss for the real economy.[4]

Fiction: The economic system is fair in the sense that peoples' income and wealth are a reflection of their personal productivity. "There's no such thing as a free lunch."

Reality: Free lunches are available, and they offer the biggest, easiest, even lowest-risk payoff. In the hands of the financial managers, business investment is about how to obtain the proverbial free lunch, at the expense of the real economy.

Fiction: Finance promotes capital formation.

Reality: Instead of involving actual new spending on plant and equipment, the "capital" in "capital gains" is created increasingly by inflationary means – by monetary policy increasing asset prices.

Fiction: Finance and property produce services, for which interest and rent are payments.

Reality: Finance and property are extractive claims, and hence are parasitic on the "real" economy.

Fiction: Most credit is productive. It enables business borrowers to buy capital equipment, pay labor and earn the income to pay off their loans. Wage earners are thereby enabled as consumers to pay for the pleasure of buying now rather than later.

Reality: No economy ever has managed to repay its public or private debts. When debts are paid off it is most often out of income earned elsewhere.

Fiction: The economy's driving force is consumer demand. Consumer choice determines prices for goods and services, steering saving and credit into the most profitable marketing opportunities.

Reality: The exponential growth of debt and forced saving leaves less freedom of choice.

Fiction: Finance is in equilibrium with the economy, and helps establish its overall equilibrium, bridging present savings and resources with the future needs.

Reality: The exponential growth of interest-bearing debt is inherently destabilizing.

Fiction: Financially oriented wealth creation makes economies richer.

Reality: Asset-price inflation leads to *deflation* of wages and product prices as the finance-and-property sector drains income from the production-and-consumption economy.

Fiction: Regulation of finance is an inefficient intrusion into free markets.

Reality: Finance distorts the market in its own favor, headed by tax favoritism that inverts traditional social and political values.

Fiction: Economies are converging as globalization spreads modern technology and efficiency throughout the world.

Reality: The global economy is polarizing as creditor nations impose deadly austerity on debtors.

Fiction: Economic theory and statistics have become more scientific and realistic.

Reality: Economic theory has been warped into special-interest pleading. This is most pronounced in the denial of structural debt problems and the facilitation of free lunches for the FIRE sector. (Finance, Insurance, Real Estate)

Keith Wilde

1. Professor of Economics at Universities of Missouri, KC and Riga, and Senior Advisor to the Government of Latvia.

2. Examples are provided regularly in *The Daily Reckoning* by Bill Bonner and associates, and are reminiscent of the early 1990s book, *The Great Reckoning,* by Davidson and Rees-Mogg.

3. In Ottawa, the federally supported Policy Research Initiative made an extensive review of asset-based social policies in several countries and commented positively.

4. For an example of how gross these unnecessary costs can be, see Paul Krugman's column in *The New York Times* of 16 February 2007 ("The Health Care Racket"), about medical insurance in the U.S.A.

Autism *continued from page 3*

further money being expended for social programs. Oddly enough when the cost of bailing out the banks had in large part been downloaded by the Finance Minister onto the provinces that lost little time passing it onto the municipalities, programs were slashed because of the added interest the government was paying because of the transfer of much of its debt to the banks. But such logical anomalies are but an aspect of the autism of economic theory that is readily translated into autistic accounting and autistic state policy.

Economist really have no reason for invading the territory of other disciplines to exercise their talent for autism. They have been practising it for centuries to advance the interest of the group in power.

William Krehm

Are Our Governments Slipping into the Role of Subprime Borrowers?

My computer is a glutton. Particularly when I have completed the draft of an article already woefully behind schedule, it develops an appetite for swallowing what I have written without so much as a burp. So that after wasting hours trying recover the fruit of my labour, I finally resign myself to rewriting my vanished efforts even a third time. Too often the stint will be preceded by my wrestling with security pop-ups on my screen that drive me to hitting buttons, that I am invariably told would better have been left alone.

Yet not infrequently in this maddening rewriting of vanished efforts, a point is reached where my curses of Bill Gates give way to blessings. For it is of the nature of the ever more complicated relationships of this globalized, deregulated world, that no country is more immune to foreign takeovers than my computer screen is to security pop-ups that won't go away. And occasionally in the process of struggling with such problems, I gradually become aware of deeper implications than what I had grasped in those earlier drafts. And thus those unrelenting pop-up screens may turn out to have been perceptive editors forcing me to a more comprehensive job on relating international privatizations and takeovers that are reworking the world economic patterns and capitalism, itself – rarely for the better.

The latest such revelation involves astounding plans for the privatization of key urban blocks of downtown real estate in Canada. Thus *The Globe and Mail* (11/01, "Ottawa set to sell $1.5 billion in federal buildings" by Elizabeth Church, Toronto, and Daniel Leblanc, Ottawa): "Ottawa is preparing to sell $1.5 billion worth of office properties across the country as part of the first phase of a plan that will see dozens of federal buildings go to the private sector with the government as long-term tenant, sources say.

"The deal could hit the market within weeks and would be among the largest offerings of the government's office properties.

"Public Works Minister Michael Fortier refused to comment on the status of the plan, but made clear that the government's real estate portfolio is in for a shakeup.

"'As we speak, does the state need 372 buildings to offer its services to citizen through its employees? I think that is the most objective way of presenting the issue,' he said in an interview.

"The government is expected to use a process known as sale-leaseback" by which it sells the buildings to the private sector and then rents them back. As though ceding sovereignty over the economy to the financial sector that it has periodically bailed out at great cost to the land has not been enough, it now feels obliged to step into the role of the tenant of the same financial interests,

"The government is expected to use 25-year leases. Sources say. Mr. Fortier argued the government doesn't have the $4 billion needed to maintain adequately its portfolio of 6.8 million square meters of office space.

"Under the planned 'partnerships,' sources said, the private-sector companies would renovate the buildings at their cost and make money by renting them to the government."

We love the word "partnership." Try it on your private landlord when you are a couple of months behind in your rent.

"The government's 241,000 employees could thus work in better, more energy-efficient buildings."

The Cheeky Nonsense of Our Government not Being Able to Afford Maintaining Its Real Estate

Note how the virtuous "energy-efficiency" issue is dragged into the discussion by a forelock though it has nothing to do with the privatization being rammed through. Energy-efficiency is something that only the government can impose by making it the law of the land. And such legal standards once made law, would be carried out by private contractors, under government inspection, not by the prime minister. What then has this to do with selling key government real estate, that it would never ever afford to buy back as their value soared with further government infrastructural spending in the area?

As for our government being unable to finance such maintenance standards, note the following: since the Bank of Canada was nationalized by a Liberal government in 1938, our federal government has been able to borrow money from its own bank to finance far larger projects. For example 16% of the cost to it of World War II, and thereafter the transformation of Canada from a semi-rural country just come out of sixteen years of depression and war. What turned the trick was that the interest it paid its own bank, the Bank of Canada, for such loans, with the exception of minor overhead costs, came back to it as the Bank's sole owner in the form of dividends. Dividends are not "funny money," but a basic capitalist institution. It is odd that we should have to remind a Conservative government of so elemental a fact.

To suggest for a moment that the government can't afford to maintain its buildings, whereas the private speculators that have repeatedly been bailed out from their gambling losses in fields incompatible with banking can, is cheeky nonsense. And the fact that government spokesman can utter it without contradiction by the opposition parties or the media, indicates that not only has financial system has passed to the control of speculators and the banks, but as a result so has political power.

Two memorable writers – one undoubtedly the leading French economist of his day, and the other an economic historian in the US have dealt with this phenomenon.

The French economist, François Perroux (1903-1987), developed the most crushing rebuttal of the official fiction that has taken over our government and our universities today: that market economies are self-balancing. With a naive faith in differential calculus as a guarantee of scientific method, official economists have overlooked that differential calculus can be used to find the equilibrium points of a problem, only if all the actors – the variables in the mathematical equations summing it up – are of such vanishingly tiny size, that nothing they do or don't do individually can possibly affect the market and its prices. And mathematics in themselves can help find equilibrium points only if the empirical evidence gathered *beforehand* shows that they exist. Thus Newton developed differential calculus and with its powerful help deduced the laws of gravity, only because Kepler, using the astronomical observations of Tycho Brahe had ascertained that the planets circulated around the sun *in closed orbits*. Calculus alone – one of the countless tools of mathematics – could never have led them to the law of gravity.

Until the middle and latter parts of the 19th century when the working class was largely illiterate, economists, above all in Britain that had a near-monopoly of industrial development, were concerned mostly with the steep tariffs against food imports that kept wages higher (and hence industrial profits lower) than they otherwise would have been. To make the point economists like David Ricardo and his friend the clergyman Thomas Malthus, took it as a fact that wages would always be only enough to keep the workers' body and soul together. For they were convinced that any increase in wages beyond that would merely result in larger families, given the workers' incontinence. Such delicate matters economists felt free to discuss with little fear that the largely illiterate working class would pick up so unflattering a view of their future.

The Growing Literacy of Labour Forces Economists to Reverse Their Theory

And the fact that a stockbroker such as Ricardo had adopted the labour theory of value was of immense importance to Karl Marx and other socialists. For they considered the espousal by a stockbroker of the view that the value of a commodity was determined by the amount of average labour needed for its production, was a dramatic confirmation of their socialist goal. As for the largely illiterate working class, there was little danger of their picking up the anti-capitalist implications of such doctrines, for the workers were too illiterate to follow the debates. It was rather like parents discussing racy gossip unfitting for children's ears only after the youngsters had been put to bed. But the mechanics' institutes that had begun spreading literacy to the lower orders, changed all that. Rather than the kids having been put to bed, they were, on the contrary, awakening from their slumber.

And the disturbance on the continent between the revolutions of 1848 and the Paris Commune of 1871, gave the measure of the social perils latent in the labour theory of value. Therefore the need arose for a theory of value that would shift the determination of value from the sphere of production to that of consumption. Responding to that need marginal value theory arose almost at the same time in three different countries: Britain, France and Austria. Price came to be seen determined by the satisfaction given the consumer of the last unit purchased, rather than by the effort put into its production.

The Decisive Action Shifts from the Production to Consumption

Once the market rather than the factories became the decisive focus of economic theory, the stage was set for booms to be blown up to ever more fantastic proportions, punctuated with ever more shattering busts. Gambling with ever more dubious investments inevitably took precedence over less glamorous real production. The trend reached its climax in the Depression of the 1930s. Within months of the stock market collapse of October 1929, the breadlines three and four abreast circled entire Manhattan city blocks. And by the time Franklin Roosevelt was inaugurated president early in 1933, many hundred US banks had shut their doors and stockbrokers were jumping out of skyscraper windows.

That rerouting of economic analysis from sphere of production to consumption haunts us to this day. For there is an explosive physical limit to assessing aggregate value of the economic product if you tie it to marketing and consumption as do all these statistical pyrotechnics. Your very accountancy ends up subservient to the effort to distribute goods and services many of which are not useful. Thus much of the recent oil crunch had little to do with actual trading in barrels of oil, but rather with speculators playing a card game with the cards marked "thousands of barrels of oil." In some of those games little oil actually changed hands. But the price of oil was affected by the extent of the winnings and losses. Left to their own devices and not brainwashed with seductive advertisement, people would not dream that they needed countless items that keep the economy grinding. Nor can the planet support them. This does not stop with junky goods and services. It goes on to take in international property and political rights, and power positions ranging from parliaments to battlefields. as the "virtual economy" takes over. In the latter 1990s high-tech firms that had still to earn their first dollar in profit were accorded stock market valuations higher than that of General Motors – in its relatively more prosperous days. The logic on which such evaluations were based was "market shares" – i.e., by the time "market share" on which current market valuations were based would approach a monopolist market position, obviously real profit positions would rise for the victorious surviving corporation. However, such an eventual justification of marginalist economic doctrine only reduces the entire effort to absurdity. By no means the least harmful by-product of this development was the purging of our universities and libraries of the literature of the great economists, and of history itself. That strips society of the capacity of to learn from its errors.

In seeking to understand the troubled politics of our times, the American economic historian Duncan North developed an idea very akin to those of François Perroux, in a later period and without obvious influence from the French economist. In any massive redistribution of the national revenue a shift of political power to enforce and preserve it will ensue. One of the most striking instances of this was the case of Mexico. From the overthrow of the dictator Porfirio Diaz in 1910 to about 1928 civil wars took over, and the assassination rate of presidential aspirants reached dramatic levels. This was a period when US exploitation of the mineral wealth led to the invasion of the country by land and sea. But with the assassination President Obregon in 1928, all this to an abrupt end, as though someone had stepped on a brake. The distraction of Mexico's northern neighbour by the Depression certainly made its contribution, but from 1928 to the introduction of the North American Free Trade Alliance (NAFTA) the assassination of presidents and presidential candidates did stop. The broad political alliance of peasant organizations (ejidos), trade unions and national industrialists that had preserved the peace collapsed. The banks that had just been privatized from a previous nationalization that restored their solvency had to be nationalized once again. The domination of the economy passed to a new stock market group that even looked after the distribution of government bond offerings through TV auctions, And in no time flat, as though on schedule to confirm the Duncan North model, two presidential candidates were assassinated. The Mexican paradigm from Pancho Villa to Salinas in turn is not irrelevant to the Muslim terrorist response the redistribution of the wealth of the planet in the interest of speculative finance. Or to the Globalization and Deregulation that bestride the planet today.

But in order not to wander too far afield from what is relevant to the subject of this note – the speculators' grab of irreplaceable national real estate – we must refer briefly to how our banks were bailed out from the disastrous adventures that the first wave of Globalization and Deregulation that launched them on their present financial and military adventures.

The Open-mindedness of Democratic Governments in the 1930s

Elsewhere in this issue (page 3) we tell of the *Bank Act* passed under President Roosevelt in 1933. Hundreds upon hundreds of American banks had shut their doors when the new president took over, and one of the first things he did was declare a bank moratorium. The *Bank Act* that was brought in shortly afterward became a model for much of the non-Communist world. Ceilings were placed on the interest rate banks could pay or charge. An alternative was provided for the use of the benchmark interest rate that could be used to stimulate or restrain economic activity as might be necessary. We suggest the reader read those pages before proceeding with this article. They provide evidence of the ridiculous claim of our government that it has no way of financing the adequate maintenance of the irreplaceable buildings on key downtown sites that are being put up for sale. Canada used the Bank of Canada in 1938 and thus was able to finance 16% of its cost in fighting the war. After the war it was able to catch up with 16 years of neglect of maintaining its infrastructures, introduce new technologies, assimilate a vast and mostly penniless immigration from Europe, and still reduce its federal debt from about 160% of the Gross National product to less than 25%. It did this by financing its infrastructures substantially through the Bank of Canada. There is no reason why it cannot do so today since the Act is still on the books intact, but unused.

"The goal is to 'stop the bleeding and to manage the portfolio so that in five, 10, years, we are not faced with an even greater figure [to renovate the buildings] as we are facing now,' Public Works Minister Fortier said.

'"The plans still have to be approved by the Treasury Board and the cabinet, which will have to decide among a number of options being put forward by Public Works. That decisions will be made next week (sic), but others argue that an announcement is farther away,' some sources say.

"The recommendations have been made to the government, but no decisions have been made,' said Jean-Luc Benoit, the director for communications for Mr. Fortier.

"The process started last fall, when the government hired experts of BMO Capital Markets and RBC Capital Markets Real Estate Group to come up with recommendations for a sample of 40 federal buildings. [Note well that two of our large banks have served as advisers in planning the coup.]

"The study included properties such as the Lester B. Pearson building in Ottawa, the Sinclair Centre in Vancouver, and an office complex in the north end of Toronto.

"Individuals familiar with the 35 federal properties put their combined value at about $5 billion. They say the quality of the sites varies greatly, with some in need of vast amounts of work. The government's best sites – the ones that will attract most interest from investors – will likely be included in the first phase.

"Buyer interest in the properties is expected to be high, especially since they come with long-term government leases.

"Over the past five years, interest in the Canadian real estate market has grown dramatically., helped by a huge influx of cash from domestic and foreign pension plans that like the steady flow of income that the sector provides.

"The federal government has been wrestling for several years with a way to finance the repairs its property requires,. For years Public Works has tried to gain funds for such investments, but sources say it has been difficult to drum up interest in building maintenance when other issues such as health care, have topped the political agenda.

"Selling buildings and becoming a tenant is seen as a way to make maintenance someone else's problem."

(Be it noted that the RBC and BMO banks gain no advisers' fees for the government using its own central bank to finance whatever repairs may be needed for its real estate.)

"The previous Liberal government has considered privatizing the government's real estate holdings, but it explored solutions that could be applied to all buildings at once. The Conservative government has opted to approach the issue much more slowly."

(Until it is returned as a majority government, it appears the general policy to resort to gradualism to bring in its extreme rightist policies.)

The difference is not a moral one. They are both based on bad accountancy that hide what is really involved. The law distinguishes between grand and petty larceny. Petty larceny is the easier to get away with. It is one that the our Conservative minority government favours, and will help raise enough funds to win majority status in the imminent election. For that victory Canadians will pay through the nose for allowing their government, the sole owner of the Bank of Canada to be degraded to a subprime borrower status to pay the rent for properties whose value will continue to climb steeply because of government and private investments in infrastructures around most of these buildings. You would have to have two glass eyes in real estate matters to overlook this. And that is why the take-over artists are huddling around the Harper government in anticipation of deals unheard of up to now.

Significantly, *The Globe and Mail* article cited carries a photo of a block-long imposing classical building on the south-side of Front Street to the east of Union Station and smack across the road from some of the most dazzling modern architecture not only in the city, but in the world – the TD Tower and the BCE Tower.

That is not even alluded to by our politicians in the government or in the opposition. Such plunder of the public treasury is so monumental and shameless that it calls for a Royal Commission to examine the background of suppressed history – of banking, of economic theory – that has brought the public interest to this plight.

The Greatest Conquest of the Normanic Nobles was London Ground Rent

Let me trace the major turns of this road.

Norman feudalism organized their English conquest for a centralized permanency that simply had no equivalent in the France they came from. The centralized taxation that was their strength and glory was based in large part for their eye for strategic infrastructure and the growing increase in value of the Roman roads that could no longer be reproduced, let alone maintained. That is why sites in centres like London were rarely if ever sold or exchanged. If leased out it would be on century-long leases after which the site would revert to the lessor. None of the piddling 25 years stuff that our government is proposing with the leases in fact going the wrong way. The notion of improvements in the area enhancing the value of the lease was a powerful factor in this custom. Strange then that it should have escaped the attention of our government with its 25-year lease-back scheme that there is no protection against an increase in the rents to be paid by the government reduced to tenant. Even when Highway 407 encircling the greater Toronto area on the north was leased to a Spanish toll-road-leasing conglomerate after it was completely built and financed by a NDP provincial government had no restriction on the increase in road-toll rates.

Introducing the Semi-underground Bunker

This subject of unearned rents extracted from anything that can be sold or leased is the pinnacle of achievement in the new economy. Hence it was quick to catch on in the US – particular in large Eastern cities like New York. From his close observations, Henry George wrote his *Progress and Poverty* (1879), and on the strength of the enthusiasm it aroused, led to its author almost becoming elected mayor of New York in 1880. Today the notion of unearned income is being generalized by reformers to take in all unearned rents – patents under such plans would be purchased by governments and well paid for to their inventors, but would belong to the public domain. Patents stuck onto ideas commonly known and due to appropriation rather than invention would not be protected. The contribution for patents that have been stuck onto ideas or designs already known would be discontinued. J.W. Smith of Arizona and Michael Hudson of the University of Missouri have published epoch-making studies done independently along these lines.

It is clear that the world scheme for selling off government was prepared at the Bank for International Settlements (BIS). BIS itself requires more than a routine introduction. Set up to handle the syndication of the German reparations from World War I into hard currencies, its liquidation at the first opportunities had been called for at the Bretton Woods Conference of the Allies in 1944 under Resolution Five had been brought in by the Norwegian government in exile, and unanimously adopted. The unpopularity of BIS stemmed from the speed with which BIS had surrendered the gold reserve entrusted to it by the Czechoslovak government the moment the Nazi army entered Prague in 1938. Still other favours to the Nazis were alleged against it. Because of Resolution 5, BIS cultivated the lowest possible profile, and that in turn qualified it for the comeback that the world's banks – restored to health by the strict regime to which they had been subjected in the Western Allied lands, had straightened out their affairs, and with that came to long after the glory days of their unrestricted speculative adventures before the 1929 Crash. That low profile commended it as the semi underground bunker needed from which to direct the comeback of the banks. For the Allied governments had promised their armies and civilians a better world after victory. And thus the comeback of the banks to where they had left off in 1929 had not only to be carried out *outside* governments, but to an extent *against* governments. Thus elected officials of governments were not invited to BIS meetings.

Burdening the government with interest rates that it had not had to pay its own central bank left the government saddled with a load of interest payments at the very time that BIS, undoubtedly shaken by the volume of legal tender base for the banks' credit creation, set itself to pushing up interest rates to the skies to "lick inflation." And to guild the lily, the Canadian government – once more following the directives that the International Monetary Fund – was imposing on countries dependent on it for loans. A basic condition for granting such loans was that the recipient government do away with its statutory reserves. Canada had at no time been dependent on the IMF for its credit, but as a token of the servility to the IMF and the other Washington-run international bodies, the Mulroney government voluntarily complied with the treatment reserved for third-world debtor countries.

In 1991, with the decennial reexamination of the *Bank Act*, the provisions in it for the statutory reserves were phased out of a two-year period. These statutory reserves had required the redeposit with the Bank of Canada on a non-interest-bearing basis of anywhere between 8 and 12% of the deposits the banks had received from the public. Raising or lowering these statutory reserves had lessened dependence on moving interest rates up or down as the need was felt to fight perceived "inflation." The "interest-free" aspect of these reserves deposited with the central bank increased the leverage of the arrangement, and reduced the extent to which the mechanism had to be used. For the driving force was the net result of an increase or decrease in the revenues of the banks from the reserve being moved up or down. The phasing out of the statutory 1991-93 left interest – the basic revenue of money lenders and banks – as the sole mechanism of the central bank for directing the economy. Had the banks been crowned as monarchs of the realm the message could not have been clearer. They became living proof of the "dominant revenue" theory of François Perroux and of the reassignment of political powers that follows a basic redistribution of the national revenue.

Meanwhile, the very accretion of power that both Perroux and Duncan North have traced to such drastic revenue redistributions has meant ever further deregulation of our banks. And with this came an ever growing compulsion for the financial interest to embark on more sweeping adventures to earn the profits which rigged accounting has already incorporated into the exercising prices of the options granted their senior executives. The slightest failure to sustain their market growth rates would bring the whole jerry-built structure of unlimited greed to collapse.

Repeatedly, we have asked ourselves where BIS will find the resources for the next mega-bailout of the banks when the need for it arises. After all, the statutory reserves have already gone or, depending on the country, have become nearly meaningless. In the European Union for example the statutory reserves actually earn interest paid by the central banks, thus reducing the leverage of the statutory reserves – significantly called "bank seigniorage." Little relief can be expected from their abolition.

What BIS and the World's Central Bankers Overlooked

Moreover in 1995, a dreadful oversight of BIS was revealed. To help bail out the banks from their crushing losses, they had been allowed to load up with government debt, and at the same time BIS had called for actual zero inflation – no mere reduction to 1% or 2% would do. And rates were raised heavenward to enforce this. But BIS overlooked that when interest rates are raised drastically, the market value of pre-existent rates with far lower coupons drops drastically, bringing the market value of the banks' 100% leveraged government bond hoards crashing. That would bring the banks into distress again. It became necessary for the Mexican government to nationalize the banks once more, though they had only recently been privatized from an earlier nationalization. The problem was solved after a manner when the US government introduced accrual accountancy that it had resisted for years along with other governments throughout the world. Accrual accountancy – also known as "capital budgeting" depreciates the cost of investments over the probable life of the capital asset involved – a bridge, a highway, a building, a battleship. Cash accountancy, on the other hand, that had been practised by all governments with the exception of the Swedish for a limited period – had written such capital assets off in the year in which they were paid for. Their value was then carried at a token $1 to assure the auditor that the item had not been simply forgotten in a lapse of memory. But what has not been publicized is that this breach of double-entry bookkeeping – noted the still unamortized amount of the mortgage for the acquisition of the asset, while listing the fully depreciated asset value of the same asset value could only have a double purpose: (1) to create the appearance of a government deficit that was not necessarily there but served those in power as an argument for denying the most pressing social measures, investments in human capital, and environmental conservation; (2) to be in a position to sell the asset in question for a tiny fraction of its actual cost and real value to deserving bidders and thus provide a flow of take-over deals that have become so essential to our deregulated financial houses.

The incredible brass of what the government is proposing in selling off the government's irreplaceable real estate in the downtowns of our great cities without a roar of protest from the press, tells us how thoroughly democracy in this land has been reduced to a farce.

The US government taught the hard way that high interest rates are incompatible with bailing out the banks by allowing them to load up with 100% leveraged government bonds. As of January 1996, the Department of Commerce statistics on government savings were recalculated to accrual accountancy with the process carried back to 1959. This resulted in increased physical assets of some $1.3 trillion US. But these new statistics appeared under he heading of "Savings" rather than "Investments." But "savings" as used by economists refers to cash or first-class securities readily transformable into cash, whereas the physical assets "discovered" had long since been invested in steel, bricks, mortar, and concrete. Why the lack of frankness? It is true that a wink and a nudge to the bond-rating agencies was enough to convey the real fact and bring interest rates down. That saved the banks from another collapse. It also left unchallenged the carefully cultivated myth that governments are incapable of making investments. But there must have been a third consideration. The leading civil servants who tell elected politicians what must be done had obviously been asking themselves the same question as I had: how is the next bailout of our banks going to be arranged when their increasing load of subprime debt of every description continues collapsing. The reserves are gone, Interest rates must be kept low if the banks are not to lose their capital once more.

When the Canadian Auditor General in 1999 refused to give unconditional approval of two successive government balance sheets until accrual accountancy was brought in, a row ensued with then Finance Minister Paul Martin. The AG actually used the words "cooking the books." But after weeks of wrangling a demeaning compromise was reached during which the AG agreed that since no new money had come into the treasury the leap in recognized assets would not justify further programs. It was merely necessarily to properly estimate the adequacy of the rental charges attributed to the space occupied by research projects of the government. Obviously the terms of the next bank bailout – in the form of sale lease back of irreplaceable government real estate was already in the sights of the civil service. If ever there was a planned economy, this was it, but one that couldn't bear the light of day.

Disinter the Work of Theodore Schultz to Expose the International Public Real Estate Scam

Whatever they are called, the unrecognized government investments include its ever growing stake in human capital, that in the 1960s won Theodore Schultz the Bank of Sweden Nobel Prize for Economics for his reappraisal of the reasons for the astoundingly rapid reconstruction of both Japan and Germany from the immense physical destruction suffered in WWII. As one of hundreds of young economists sent by Washington to estimate the likely lapse of time before the two defeated countries could reappear as formidable competitors on world markets. Schultz concluded that the predictions of the American economists including his own at the time – were so wide of the mark because they concentrated on the physical destruction and vastly underestimated the importance of the human capital the high degree of education, skills and discipline of the work forces that came out of the war essentially intact. His conclusion: the most productive investment a country can make is in human capital. I remember the late former Governor of the Bank of Canada telling me that the Bank of Canada was so impressed by Schultz's conclusion that he was invited to Canada to enlighten the central bank further about it. That indeed was a different era. Today Theodore Schultz is a forgotten name amongst economists.

Whatever is not market-driven is likely to be dismissed by economists and governments as "externalities." Were it valued at its real worth – both the human and the physical investments – there is likely to be not only a balanced budget, but a surplus. But by the same logic, environmental conservation that should but has not been made must be booked not as "fiscal prudence" but as a budgetary deficit. Accountancy tends to become the footstool of the economic interest in control of the government through the civil service.

We have often asked ourselves what form the next bailout of the of our deregulated and expansion-driven banks would take, that the statutory reserves have been essentially exhausted on the previous bailout, and higher interest rates have shown their eventual destructive potential of the very banks. It is increasingly clear that the authors of government strategy in such matters – the high treasury civil servants – have asked the same question and decided that the wholesale despoliation of the public interest by corporative buccaneers is the answer.

Significantly *The New York Times* (01/12/06, "History for Sale: Needs Work France, Burdened by Upkeep, Puts Prime Properties on the Block" by Craig S. Smith) writes: "Paris – France is selling dozens of historic properties in Paris and in the provinces, using the proceeds to move the proceeds government bureaucrats into less expensive properties of Paris's golden age. Foreigners, primarily American pension funds and private American firms are the biggest buyers so far. For all their Gallic pride, the French seem happy to have anyone take the properties off the hands of the taxpayers."

The script could almost have been taken from the Toronto press, except that the government will not be staying as tenants because US corporations wish to occupy the properties. And there are more commissions and capital gains down the road to be earned with future tenancies of such properties left open. It would seem only a matter of time before the Louvre and arts contents is up for the highest bidder.

William Krehm

Resurrecting the Buried Great Economists

Without an ever evolving free discussion of economic theory, democracy becomes a lost cause. The great forgotten French economist François Perroux pointed out, that in every society, the revenue of the class in power is seen as the "dominant revenue" determining the welfare of society as a whole. That may appear so, he maintained, from the angle of vision of that ruling group But should power pass to another group, economic theory, too, would be rejigged to present *its* revenue as "dominant revenue."

The world has reached the point where the compulsion of ever accelerating growth, has become a requirement of the speculative financial sector. This is leaving little room for the survival not only for other social groups, but for society itself.

The suppression of the very memory of all the great economists of the past deprives society of the ability to learn from past mistakes. We have become a world of amnesics racing towards the final cliff.

COMER shall, within the limitations of personnel and budget, attempt to resurrect pertinent suppressed economic thinkers whose ideas are most urgently needed today. These will help us assess the official policies being rolled into place by those directing the current lurchings of the "Dominant Revenue."

The Take-over Frenzy

At the moment there is a surplus of loose speculative profits seeking appropriate investment. And ever mounting returns. Jacquie McNish (*The Globe and Mail*, 29/01/07, "With the amount of cash any deal gets done") writes: "The deal boom is part of a global buying spree fed by tides of cash coursing through the world's markets. Strong global economies, low borrowing rates, and a powerful new breed of demanding shareholders, have unleashed a frenzy for deals.

"They are pushing Canadian corporate icons into foreign hands and enriching investors with staggering takeover premiums.... The urge to buy is so intense that executives who once preached against overpaying now express regret when a competitor outbids them on the takeover field."

It is sweeping the world and not exempting the most hallowed national heritages. Thus *The New York Times* (01/12/06, "History for Sale; Needs Work. France, Burdened by Upkeep, Puts Prime Properties on the Bloc" by Craig S. Smith) writes: "Paris – For sale: history with a view. France is selling dozens of historic properties in Paris and the provinces using the proceeds to move government bureaucrats into less expensive properties and to help pay off the national debt. So far it has unloaded dozens of chateaus, villas and 'hotels particuliers' the stone mansion of Paris's golden age. Foreigners, primarily American pension funds and private equity firms, are the biggest buyers so far." Can the Louvre, complete with its art contents, be kept off this conveyor belt? And what is this going to do to French national pride, already subject to some humiliating trials? Or does that matter?

And just in case you should believe that our new Conservative PM thought up a similar program for Canada from scratch, you need only compare the date of the above article on France's clearance sale and the front-page article in the *G&M* (31/01/07, "Ottawa set to sell $1.5 billion in federal buildings. Sale is first phase of plan to lease back dozens of properties" by Elizabeth Church and Daniel Leblanc) informs us: "[This is] part of a plan that will see dozens of federal buildings go to the private sector with the government as a long-term tenant, sources say.

"Sources in Toronto and Ottawa said nine buildings are likely to go in the first phase of the sell-off, including properties in Vancouver, Toronto and Vancouver. The deal could hit the market within weeks and would be among the largest offerings of Canadian office properties.

"'As we speak does the state need 372 buildings to offer its services to citizens through its employees,' asked public Works Minister Michael Fortier.

"The government is expected to use a process known as a 'sale-leaseback' by which it sells the building to the private sector and then rents them. The government is expected to use 25-year leases,' sources said.

"Mr. Fortier argued the government doesn't have the $4 billion needed to maintain adequately its portfolio of 6.8 million square metres of office space."

Then why doesn't it borrow from its own bank, The Bank of Canada, that was nationalized during a depression in 1938 at great cost? That made it possible to finance first its Second World War, and then more than a quarter of a century of catch-up projects after ten years of depression and six years of war.

This included not only its part of the St. Lawrence Seaway, but the transformation of Canada from a semi-rural country to an urbanized one. It involved new post-secondary educational institutions coast to coast, and assimilating millions of penniless immigrants,. And after financing all this largely through the Bank of Canada between 1946 and 1975, the federal debt was reduced from somewhere between 150 and 160 of the GNP to well under 25%. By 1975. And it should be remembered that during all this while the federal government was writing off completely the new physical investments not organized as separate Crown Corporations in the year of their completion, and thereafter carrying them on its books at a token $1.

Low Interest Rates due to a Blunder by the World's Central Banks

Moreover, the low-interest rates that we and the US have enjoyed since 1996, were due to a ghastly blunder of the Bank for International Settlements – a central bankers' club based in Basel, Switzerland, in plotting the bailout of the world's banks from the Deregulation and Globalization frenzy of the 1980s. The US banks had been allowed to take over the Savings and Loans mortgage societies – had lost much of their capital in gambles far from their home territory. To that home territory they had been severely confined under the *Bank Act* of 1933.

To meet the emergency BIS had sponsored its *Risk-Based Bank Capital Requirements* in 1988. These declared the debt of central governments in developed countries risk-free, hence requiring no down-payment for banks to acquire. All they needed to do was cash in the coupons. And to that end there was a massive shift of government debt from the Bank of Canada to the private banks. And Government debt, be it noted is legal tender that can serve the banks – either directly or after being grossed up with the cash reserves of the stock brokerages, mortgage and insurance companies that they had meanwhile acquired in whole or in part. The result was that the federal debt held by the Canadian banks increased from $20 to $80 billion.

That was a pretty clear sign that François Perroux's "dominant revenue" from the entire economy with particularly emphasis on the profits of industrial concerns had moved, to the revenue of the banks, that are milking the economy today from all its dugs.

If that needed further confirmation, that was readily forthcoming in the complete stealth in which this and the other part of the bank bailout were executed – no debate in parliament, and nary a serious explanation in the media. And with the new power center – the recently near-bankrupt banks – the shift soon asserted itself in further largesse to the banks. In 1991 the *Bank Act* (to be distinguished from the *Bank of Canada Act*) was revised to phase out the statutory reserves which banks had to deposit with the Bank of Canada. On these the banks earned no interest, for such interest earnings would have blunted the leverage of the arrangement. The purpose, remember, was to fight "inflation" by increasing the portion of reserve that had to be redeposited with the BoC, and in the case of a depressed economy reduce them. These statutory reserves had provided the only alternative to replacing or supplementing a decrease or increase of the benchmark interest rate set by the central bank to stimulate or cool down the economy. There could not have been a more clearly revealed ascension of the basic revenue of our banks to the position of "dominant revenue."

An Unlimited Appetite for Gain Excludes Statesmanship

One of the perils of any "dominant revenue" is that the political and economic omnipotence it implies blinds the privileged of all responsibility for what they may be doing. And, an unlimited appetite is a bad guide in such matters.

But in the urgency of their task, the BIS people – which included the central bankers of the world – overlooked an important detail. If you raise the benchmark interest rate sharply, the price of pre-existing bonds will tumble, for example, the $80 billion worth of such assets that the Canadian banks were carrying – wholly on the cuff – would collapse and bring on their renewed collapse.

And indeed, in the same fateful year of 1991, Alexandre Lamfalussy, manager of BIS, alarmed at the explosion of assets and activities of the banks that they had just picked up from the floor and put in command of governments and their economies, panicked and announced that from now on BIS would not be satisfied with what he chose to call 1 or 2% inflation. From then on he would expect absolute zero. And interest rates shot up like the fountains of Versailles – with those of Canada a full 5% higher than the already high ones of the US. These murderous interest rates are what precipitated the collapse of Mexico's banks just a very few years after having been nationalized to bail them out of their previous troubles. The peso fell by 40%. Mexican living standards have not recovered fully to this day. This threatened to bring down the world financial system. Clinton, not even waiting to get Congress on board, with the help of the IMF and Canada got together what was at the time a record standby fund, to fend off the immediate spread of the Mexican troubles abroad. It did at least delay them, but they echoed in the South Korean meltdown of 1998, and in the Russian default on its debt shortly before.

Out of this came a historic move initiated by the US Treasury. Up to now, the US, as practically all countries throughout the world, had made no distinction between government current spending – say sanitary supplies for washrooms, and building a bridge or a school, or a battleship. All were written off in the year when the expenditure was made. This was known as "cash accountancy," and would land a private corporation in the defendant's dock for tax evasion. By redoing the government books in this sense to 1959, some $1.3 trillion of assets were recovered in the assets of the US government in the statistics of the Department of Commerce in January 1996. But in the light of the "dominant revenue" theory, it is clear why the statistics published by the Department of Commerce of the US put this under the heading of "Savings," which it was certainly not. Economists generally refer to cash or very short-term securities as "savings" and long-term investments already in the form of bricks and mortar, or steel, and not cash or readily transformed into cash. However the big dark secret of the federal civil service to which recent Liberals and Conservatives and even NDPs have respected as gospel is that governments are not capable of investment – only the banks that the government periodically bails out are to be trusted with that. Such is the logic of a "dominant revenue."

In 1999 when the Canadian Auditor General of the day was emboldened by the US change of its accountancy to insist with the Finance Minister Paul Martin that "accrual accountancy" be introduced before the unconditional approval of two successive balance sheets of the government would be approved unconditionally. During the dispute the Auditor General even used as nasty an expression as "cooking the books." But Martin did introduce accrual accountancy, but extracted from the AG a demeaning statement to the effect that such a change was to enable the government to assess more correctly the real cost of government research programs by including a more accurate figure for the cost of the working space occupied. Translated, this meant that the high cost of maintaining government buildings would not result in a recognition of greater government assets, but on the contrary in the higher cost of research programs that would thus become unaffordable. That presaged the plans for the privatization now being bit by bit announced.

A Depreciation of Government Assets

The real problem in fact is not the cost of upkeep of these most centrally located properties in the major cities of the land. The English moneyed aristocracy grew rich because they rarely sold their key properties. Instead they leased them on 99 year leases. For all the investment of a modern key city flows into the rising capital value of centrally located properties. The basic principles of real estate investment – it has long been said in the US – is location, location, and location. And that is why the British Norman conquerors made their greatest conquest by rarely if ever selling their urban properties. And that is why the writings of Henry George, a self-taught economist, whose masterpiece. *Progress and Poverty* (1879) barely missed winning him the mayoralty of New York the following year. It was a time of great economic distress. Significantly today two economists that I am aware of, have written works generalizing the appropriation of unearned income to having the public interest recoup the unearned income on land sites, to all unearned revenues: J.W. Smith of Arizona and Michael Hudson. Inventors, in this view, should be compensated adequately but their patents should be acquired for the public domain to keep unearned income out of the price level.

The massive sale of key government properties today is merely the latest phase of the depredation of government assets by the introduction of just enough accrual accountancy to bring down interest rates to where they do not bankrupt the banks through the loss of value of their 100% leveraged government bond hoards.

What is scandalously lacking is the openness and rounding out of the move to include investment in human investment, that happens to have been recognized by another forgotten great economist Theodore Schultz, as the most productive investment available to governments to make.

In the light of that, it is likely that any government that looked after the health, education, training and social welfare of its population, and took reasonable care of its environment, with a proper economic theory that would make possible meaningful double-entry accountancy, few governments would have a net debt at all. They would make sound and growing investments, and a central bank from which to borrow to finance what further capital assets – physical and human – they might need. But that of course would shift the "dominant revenue" of Perroux from the high-stake gamblers to society itself. That is indeed our program and the purpose of resurrecting our forgotten great economists that we propose.

William Krehm

Our Banks are Getting into Minefields

When Franklin Delano Roosevelt was inaugurated for his first term in 1933, US banks were going bust by the hundreds. So one of the first things the new president did was declare a banking moratorium: all banks shut their doors to give the new regime an opportunity to figure out how to get the country out of the hole. After consulting with just about any economist and banker with an idea on the subject – and watching the breadlines three or four abreast circling around entire blocks in Manhattan, the entire economy came to a standstill. When Roosevelt finally brought in his *Bank Act* a few months later, it had a few basic provisions that, had their very memory not been suppressed, could have prevented our banks today from moving into their next major crisis. This can be serious enough to bring on a global-wide depression and new military adventures.

These provisions of the 1933 *Bank Act* I refer to were fairly obvious.

The first was that ceilings were set on the interest rates that banks could pay for the money they borrowed, or charge their customers. The reason for that provision is no deep secret. The essence of banking is that the banks lend out a *multiple* of the actual legal tender in their coffers – today that legal tender is government debt since gold is no longer the money of any land that *must* be accepted for paying off debt. The art of banking, as it always has been, still consists of banks being able to meet the claims of depositors or those to whom they have assigned payment from their deposits whenever such claims are presented. The slightest failure in this respect will bring down not only the bank at fault, but will risk triggering a run on *all* banks. Hence, the provision of the 1933 US *Bank Act* put a low ceiling on what interest rates banks could charge or pay on loans.

Because of this basic vulnerability of all banking systems, high interest rates can breed mischief in two distinct ways. They can bankrupt debtors who were perfectly solvent in their businesses before the banks got greedy and raised their rates; *or* those bankrupted by the high rates were already poor risks and the high rates merely reflected the risks that the banks were taking in lending money to them in the first place. Governments have both the right and the responsibility to limit the rates of interest charged, because in the last analysis it is the implicit guarantee of governments and their credit that supports the public's confidence in the banks' solvency.

The Basic Wisdom of Ceilings on Bank Interest Rates

That is the only provision of the 1933 *Bank Act* that I will deal with because it is most relevant to the disturbing news about the US banks that today is increasingly troubling the financial media.

Let me quote *The Globe and Mail* (09/02, "US mortgage lenders rattle markets" by Andrew Willis, Toronto, and Barry McKenna, Washington): "After years of smooth sailing, the banking industry ran into stiff headwinds yesterday when the two biggest US mortgage lenders to high-risk homebuyers warned that costs from delinquent loans were swelling faster than they had expected."

"Europe's HSBC Holdings PLC and New Century Financial Corporation said they will have to put up more money aside to cover losses that stemmed from years of lending to the riskiest borrowers in America – customers with little credit history, or already heavy debt burdens. Their warnings sparked concerns that hundreds of billions of dollars in subprime mortgages may undermine the financial health of scores of lenders that have profited in the past few years from a booming economy and record demand for new homes.

"US banks and other lenders plunged on the news, dragging the benchmark S&P stock index down US from a six-year high."

With banks having to set aside reserve for their exposure to subprime debt, they are less willing to lend money to ordinary banking customers except at higher rates. The 1933 ceiling placed on the interest banks could pay or charge has long since been removed. In Canada, today, the only ceiling on interest rates is 60% a year under *criminal* law – there is no longer a ceiling at all under *civil* law.

But let us continue with the *G&M* report: "'We expect the problems in the second-lien business and portions of the first mortgages are going to get worse,' said analyst Simon Willis as NCB Stockbrokers Ltd. in Dublin. 'With the downturn in the housing market and the lagged impact of the rising Fed fund rate, the issue has hit quickly.'

"HSBC yesterday warned provisions for bad loans would be $10.6 billion (US), 20% higher than previous analysts' forecasts.

"The housing hangover comes after HSBC binged on home loans: its so-called 'second-lien' mortgages grew by more than 30% in 2005-6. On a second-lien mortgage, the borrower has already taken a previous loan that enjoys first call on a home.

"London-based HSBC announced it was replacing US executives and tightening lending requirements in the wake of an expected $1.6 new provisions.

"In a recent interview Toronto-Dominion CEO Ed Clark said the US banking industry is completely split 'between those who believe that the worst of the housing problems are now behind us, and those who say the worst is yet to come.'

"Along with the HSBC news, luxurious home builder Toll Bros. Inc. provided sign of further weakness yesterday. Toll yesterday announced a 19% fall in first-quarter revenue and a 39% decline in its backlog of orders.

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"The US Congress has grown increasingly uneasy about the rapid proliferation of subprime mortgages, or loans for riskier borrowers that carry inflated rates and steep fees. At a hearing yesterday in Washington, Senate banking committee chairman Christopher Dodd said reckless lending has created a crisis for millions of American homeowners.

"'The system is out of balance,' he complained, noting that 10% of subprime loans are now more than 90 days late – higher than at any time since the 2001 recession. But he stopped short of endorsing legislation proposed by some of the Democrats that would curb predatory lending and prohibit some types of fees for lending that have exploded in the US, fuelled by tax breaks that allow homeowners to deduct mortgage interest from their taxable income. The amount of these loans tripled to $650 billion (US) between 2000 and 2005, and they now account for 23% of all home mortgages."

The ghost-like pattern that haunts much conservative-inspired legislation is evident here – depriving the government of monies that could be used for vital national purposes ends up not being directed to the purposes for which it was intended, and finally brings the whole ideological edifice crashing.

"The amount of these loans tripled to $650 billion US between 2000 and 2005, and they now account for 23% of all home mortgages. Nearly one of five of subprime loans will end up in foreclosure, eventually causing 2.2 Americans to lose their homes and destroying $164 billion in household wealth, according to a study filed with the committee by the Center for Responsible Lending.

"Mortgage lenders and brokers, however, defended these non-traditional mortgages, saying they've led to record levels of home ownership.

"Canadian banks have little exposure to the subprime mortgage market. However, the sector is expected to expand in this country in coming years, despite the US experience. Where 24% of US mortgages qualify as high-risk loans, just 5% of Canadian home loans fit that description.

"Economist Benjamin Tal at CIBC predicts the Canadian subprime market will likely double in the next three years because of its profitability."

The economy is committed to increase its expansion rate, to earn ever expanding profits that are incorporated into prices, and executives' options beforehand, what is another big gamble in the ever expanding casino that our entire economy has become.

Meanwhile, the news every day brings us more reason for alarm.

Thus *The Wall Street Journal* (15/02, "Mortgage Hot Potatoes" by Carrick Mollenkamp, James R. Hagerty and Ruth Simon) writes: "As more Americans fall behind on mortgage payments, Merrill Lynch & Co., J.P. Morgan Chase & Co., HSBC Holdings Plc and others are trying to force mortgage originators to buy back the same high-risk high-return loans that the big banks eagerly bought in 2005 and 2006.

"Merrill demanded in December that ResMae Mortgage Corp. – which in 2006 sold it $3.5 billion in subprime loans, or loans to borrowers with poor credit records – buy back $308 millions of loans whose borrowers had defaulted in a filing this week for bankruptcy protection. ResMae said these demands 'crippled' its operations.

"As more subprime lenders face losses or bankruptcy, big banks also face another problem: many lent money to small firms like ResMae so that those firms could make more mortgage loans to borrowers. It isn't clear how much of these loans will be paid back to the banks. Wall Street firms are also increasing their own internal generation of subprime loans by acquiring smaller mortgage loan originators or processing companies.

"In 2005 and 2006, banks such as HSBC and brokerage firms like Merrill Lynch went on a buying spree, snapping up subprime loans from typically small mortgage banks that had lent money to homebuyers. At the same time, many lenders were loosening their credit standards and making riskier loans.

"In recent months, as home price appreciation fell and borrowers faced rising interest rates, more people defaulted on their mortgages. That prompted Merrill Lynch and others to exercise their contractual right to demand the sellers buy back the loans. Under mortgage contracts, mortgage originators must often repurchase loans that default very early in their term or that come with underwriting mistakes, such as flawed property appraisals."

The Irresponsibility of Using Interest Rates as the One Tool to Enforce a Self-balancing Market

Obviously lawyers will be the main beneficiaries of all this. What is emerging once more is irresponsibility of higher risk-taking to achieve higher interest rates. So much for higher interest rates as the one remaining "stabilizer" of the economy that resulted from the elimination of statutory reserves as the only serious alternative to raising the benchmark central bank rate to "cool" an "overheated" economy.

The prescription becomes all the more disastrous when the economy in question, rather than "overheated" – i.e., suffering from an excess of demand that available supply cannot meet – has a rising price level that merely reflects the greater investments in human and physical infrastructures that only government can provide. And such increased state services call for higher taxation that comes to make up a deeper layer of price.

By now this should have been realized long in advance, if the curricula of economic faculties had not been scrubbed squeaky clean of anything that didn't reflect the immediate interests of speculative capital.

William Krehm

Are Hedge Funds Getting "Old Hat" in the Great Casino?

If you combine novelty with bigness to a new dimension you make the mysteries of the sacred script pale into insignificance – for a while. The financial press is increasingly responding with a frightened yawn at the very mention of the word "hedge fund." And it would seem only yesterday that the mere uttering of those two ominous words caused currencies and even thrones to shudder and collapse.

Thus in *The Wall Street Journal* (12/02, "Hedge Funds Start to Look Like Risky Bets" by Justin Lahart) we read: "Last week's initial public offering of Fortress Investment Group – the $30 billion hedge fund and private-equity shop – shows these are heady times for Wall Street's financial wizards. The stock shot up on its first day making the principals very rich men.

"But some recent research points to trouble lurking for the $1 trillion hedge-fund industry. Hedge funds generally charge their clients – deep-pocketed individuals and institutions – fees amounting to 2% of assets and 20% of profits. Add in trading costs, and these lightly regulated vehicles need to generate gross annual returns of 18% to 19% to deliver a 10% return to investors, according to a Dresdener Kleinwort paper. These days that is no easy task.

"One worry relates to hedge fund trading strategies, which look low-risk but could be dangerous if the market turns quickly.

"Many hedge funds employ strategies that involve betting on one asset against another assets. One might bet on ice-cream stocks rising, winter-parks stocks falling and then pray for warm weather. Another might bet against government debt with low interest rates, invest in company bonds with high interest rates and hope corporate finances stay healthy.

"One catch. Brett Gallagher of Julius Baer Investment Management has shown that the difference in annual returns across stock sectors around the world has narrowed recently. James Bianco of Bianco Research has shown the same is true across the world stock and bond markets. That makes it harder to make money on hedge fund 'relative value' bets.

"Moreover, emerging-market and corporate-bond prices have run so high, it is hard to push them further.

"'If you're trying to impress on people that you deserve "2 and 20," it's really hard to do in this environment,' says Mr. Bianco.

The Uncertainty Where the Bigger Bang for the Buck will Hit the Investor

"Hedge funds can improve returns by adding to investments with borrowed money, getting more bang for their buck. Dresdner estimates hedge-fund borrowing ranges from $900 billion to $4.2 trillion. In other words, for every dollar they have received from their investors, Dresdner estimates hedge funds have added at least a dollar of borrowed money. Leverage makes for high returns, and big losses if things go sour.

"It is tricky to generalize about hedge funds. They employ so many different trade strategies. Some make bets on the direction of currencies, others on the outlook for corporate mergers or the direction of interest rates. The Dresdner analysts say that one common denominator is that many hedge funds have been betting in the direction of less market volatility.

"They liken hedge funds to individuals selling 'deep-out-of-the money' put options. A put option gives an investor the right to sell an assets at a prearranged price should its value fall. For the buyer of a put, it is a hedge against a down market. For the seller it is a way to a profit as long as the prices don't fall. Deep-out-of-the-money options look especially safe because prices have to fall a long to trigger them. When prices do tumble, the losses are steep. 'The slow virtuous cycle on the way up can turn vicious quickly,' says Dresdener."

And it adds little good will to the globalization exercise. Listen to Carl Mortished, columnist in *The Times* of London (09/02, "Furor shows leveraged buyouts are losing their lustre"): "London – They called them plunderers and locusts and now they are after J. Sainsbury PLC and a few people are asking whether private equity has reached the high water mark of public tolerance.

"Three big buyout firms, CVC Capital Partners Ltd., Kohlberg Kravis Roberts & Co. and Blackstone Group LP admitted to the London Stock Exchange last week their interest in the food retailer and it sparked a furor. Two further venturers, Cinven and Texas Pacific Group are believed to have sent sleuths down the supermarket aisles with a view to a rival offer. It has given a boost to Sainsbury shares and the company is now worth $17.7 billion US, suggesting an offer for the retailer could now top 11 billion pounds, a European record, even in the gazillion-dollar universe inhabited by the kings of leveraged finance.

"This company is just a grocer. It traces its origins back to 1869 when John and Mary Sainsbury opened dairy in Drury Lane. It is no icon of British engineering or pillar of empire trade. Its start has dimmed since its heyday in the 1980s when it was the unassailable leader of the checkout tills. Today, Tesco PLC dominates in scale and global reach, leaving Sainsbury to retain the affection of middle-class shoppers with fine food, such as organic produce and Fairtrade fruit.

A Tax on Leveraged Buyouts

"Nevertheless, the two biggest trade unions demanded audience this week at the Department of Trade and Industry to complain about debt-financed asset stripping. The GMB union and Transport & General Workers Union are threatening 'the ultimate showdown' over Sainsbury and they want Gordon Brown, the chancellor to abolish tax relief on loans used for leveraged buyouts.

"It was Franz Munterfering, the former German Social Democratic Party chairman, who dubbed the private equity merchants 'locusts,' accusing them of stripping the heart out of Germany's industrial heritage. Germany has never fully come to terms with casino capitalism, notably the takeover by Vodafone in 2000 of Mannesmann for 112 billion pounds.

"British attitudes are different – everything is potentially for sale – even the airports. Who cares, think the Brits, if foreigners are foolish enough to pay top dollar for a regulated asset, especially one that you can't take home with you. Yet private equity is beginning to strike an uneasy chord as it rolls its siege machines up to the bastions of British venerable brands, such as Birds Eye and United Biscuits. Who is behind these funds? Why are they so secretive and how much debt is shoring up these extraordinary transactions?"

So it would appear that Canada is not alone in asking these same questions. The Atlantic Ocean is no more protection against these midnight incursions than the Pacific. The plague, as we and others warned at its onset, is Globalization and Deregulation itself.

"Central bankers are beginning to fret about a private equity debt mountain, a tendency to highly gear the target vehicle to ramp up the equity return. Questions are being asked about corporate governance, the intimate relationship between owners and private equity managers leading to extraordinary payoffs and rewards for short-term gains. On the contrary, say the promoters of the big buyout who argue that privacy allows a business to be repaired and refocussed on a growth track without having to indulge the needs of the public stock market and its short-term horizons of quarterly performance.

"All of this misses the real point, which is the lack of disclosure and the tendency for private equity to view a business as a repair job or break-down opportunity, not a going concern. These are asset flippers, who invest on a three-to-five-year view after which the business is sold, or even returned to the stock-market laden with debt.... Financial markets have not yet lost patience with private equity but the political climate is changing. If the stock market, too, begins to lose momentum, the kings of leverage may find the exit route closed and their ownership horizon suddenly looking very long-term indeed."■

Belatedly, Auto Industry is Discovering Systems Theory

I remember that in the 1970s systems theory had its day in the sun amongst the more daring economists under Jay W. Forrester. I learned about it and extended what I learned to take in other useful concepts like entropy in a book on the subject.[1] Since its essence clashed the with the underlying assumption of equilibrium theory – that "the" market was self-balancing, it was not long before it would not find a ready reception amongst universities. For the essence of systems theory is that a system – say an automobile, cannot be satisfied with averaging out the various subsystems – say the brakes, the engine, the electrical and the electronic subsystems. Each of this must be reliable and functioning, or the car will not move safely. And hence each of the subsystems must perform. And that will often involve distinct and even contradictory matrices of the same variables. Either its contribution to the satisfactory performance of the system as a whole does not qualify it as a subsystem, or if it does, the demands of one subsystem on a given variable of the master system must be considered.

Economists' Brief and Forgotten Flirtation with Systems Theory

I remember attending a plenary session of the Eastern Economics Association in the 1970s where a grand debate took place between an orthodox economist who claimed that even though oil prices had risen drastically as a result of troubles in the Near East, the very high prices in good time would lead to more exploration and development and oil would become relatively cheap and plentiful again. The equilibrium model for the world economy as a whole, not excluding the oil industry, would be sound again thanks to the miracle of a free market. His opponent chose to consider the availability of new oil supplies depended on the geological subsystem, and the extent of its consumption by methods in use brought in another vital subsystem – having to do with the environment. That again brought in subsystems and inhibitions in what matrices of the variables in the master system might not be acceptable or even feasible. On the whole there was little doubt that the position of leaving it all to "the" market carried the day. For a while it seemed that the benign market had brought down prices, and that was accepted as a sign that the market was functioning efficiently and hence all would be well.

But systems theory's claim on the attention of conventional economists was doomed to be short. After all it implied constant active intervention of the government to make sure that the market pursuing its profit goals does not undercut the function of the very subsystems that must be in constant functioning order. That is hardly the self-balancing market of conventional economic theory.

My next recollection had to do with a paper that I read at a systems theory conference at what is today Ryerson University in Toronto. When I remarked that it was astounding that mine should have been the only paper on the economic aspect of systems theory at the conference, the organizer with a clear conscience informed me that there had been no other proposed. The Big Broom had already swept the university curricula squeaky clean of anything that might question the endless providence of the great self-balancing market. I published a book on the subject, that introduced the subject to entropy into the argument – the polar opposite of the self-balancing powers of the market.[2]

That is why on opening the 09/02/07 edition of *The Wall Street Journal* ("Big Dealer to Detroit: Fix How you Make Cars" by Neal E. Boudette) I was struck with the evidence that a bit of attention to the economic implications of systems theory and its economic implications in our universities could have saved the country and millions of workers and investors much anguish.

But let me lose no time in surrendering the lectern to Mr. Boudette and his incredible report.

"Michael J. Jackson, chief executive of the US's largest chain of auto dealers wants Detroit to change how it makes cars – and he may have the clout to succeed. At one AutoNation Inc. location in Delray Beach, FL, acres of 'orphan' vehicles have been sitting on the lot for months. One hulking Dodge Ram pickup has languished unsold for 237 days, an eternity by automotive standards. The problem? Chrysler equipped the truck with a V6 engine instead of the V8 requested by most buyers of big trucks.

"Parked nearby is a red Jeep Grand Cherokee with four-wheel drive, a feature popular in snowy climes, but not in sunny Florida.

"'No customer would have asked for these vehicles that way, and they never should have been built that way,' says Mr. Jackson. 'This has to change.'

"One of the toughest problems facing the ailing US car industry stems from Detroit's century-old business model, that dates to Henry Ford's mass production of millions of largely identical model Ts. Rather than build cars to customers' tastes, US automakers crunch out what makes sense for their plants, and then use incentives and rebates to lure buyers. The thirst for revenues to pay for mounting health-care and pension costs has further encouraged companies to keep plants running regardless of demand."

The Bothersome Subsystem of Excess Inventory

"In years past it was dealers who suffered as this excess inventory sat idly on their lots. But the rise of powerful dealership chains, exemplified by AutoNation of Mr. Jackson, has changed the equation. He has pushed Detroit to cut production more than it wants and has cut orders when it has not responded. Last year, when DaimlerChrysler AG's Chrysler Group pressured dealers to take thousands of unwanted cars, AutoNation and other chains led a revolt that forced the carmaker to backtrack.

"Officials at the big three companies are supportive of Mr. Jackman's efforts. Said Ford CEO Alan Mulally, 'when you have big inventories, you get further and further away from that customer dictation. Excess inventory hurts everybody.'

"However, adopting a system in which market intelligence drives manufacturing would represent a wrenching change for the industry GM has more than one million unsold cars in the pipelines. By contrast, Toyota Motor Co. has 320,282.

"The increasing clout of the dealers is one part of a broader restructuring of the US auto industry as it faces a historic crisis. Alongside the dealer pressure, suppliers are less willing to give car-makers price concessions, often because they are in bankruptcy proceedings or have been bought by hard-nose financiers. The combination has left domestic automakers in a painful financial crunch that that's forced them to close plants, mortgage assets, and rewrite labor pacts.

"Until the 1980s auto retailing was dominated by entrepreneurs who relied mainly on selling one Detroit brand. Traditional dealers couldn't match the economic power of GM or Ford, whose managers could make their lives easy, or very hard.

"Since then a new breed of dealer has emerged. These new auto retailers, some of which are publicly traded, own multiple stores in multiple cities and sell an array of models. Detroit's battered brands are often the weakest links in their portfolios.

"Big retailers like Wal-Mart Stores, Inc. and Target Inc. long ago learned to use information accumulated daily to influence manufacturers of food, cosmetics and clothes. Mr. Jackson's company has 334 showrooms, accounts for about 4% of new car sales in the US. It is in the vanguard of auto retailers starting to do the same.

"Because dealers borrow to buy their inventory, rising interest rates – after a long swoon – have increased the cost of handling slow-selling models. AutoNation's shares have doubled over the past five years, but have made little progress over the past 12 months. Its price to earnings ratio of 18.22 is higher than that of automakers and suppliers, but trails retailers such as Target to which AutoNation is often compared.

"'Mike's got to do this,' says H. Wayne Huizinga, the businessman who founded AutoNation and remains a major shareholder. 'Wal-Mart wouldn't operate this way.'

"The son of a refinery engineer and a homemaker, Mr. Jackson, 58 years old, grew up in Moorestown, New Jersey. At 13 he got a job shoveling manure at a horse stable, earning a dollar a stall. After getting a political science degree, he married, bought a used Mercedes SL roadster and drove to Cape Cod for the summer. When the car broke down in Hyannisport, Mass., Mr. Jackson scrounged a job at a Mercedes dealership to pay for repairs. His wife landed a spot as a cook, and the use of a bungalow at the nearby Kennedy compound.

"After the summer, Mr. Jackson got a job as a mechanic trainee, worked his way into sales and management, and eventually saved enough to buy a stake in a Bethesda, MD, Mercedes dealership. In 1989, Mercedes hired Mr. Jackson to run sales and marketing in the US.

"By 1992, he was president of US operations, and Mercedes was losing money and market share. Mr. Jackson dropped dumped inflated sticker pricing, stopped discounting and cut the number of dealers by 20%. By 1999 Mercedes was the top luxury brand by sales.

"'This is very difficult for people to understand, but you can sell more cars if you have less inventory and fewer dealerships,' Mr. Jackson says. 'By keeping the supply tight, your product becomes more desirable, and you create future demand.'

"In 2000 Mr. Jackson was hired to fix AutoNation, a company created four years earlier by Mr. Huizinga, the founder of Waste Management Inc., and Blockbuster Video. Mr. Jackson shut down its used car megastores, sold underperforming dealerships, added stores selling luxury cars and imports, and streamlined back-office operations.

"Still selling cars isn't the same as selling TVs or toothpaste. It takes up to three years for a company to design and build a new vehicle. Consumer tastes can shift almost overnight as gasoline costs rise or fall, or as one automotive fashion gives way to another.

"Mr. Jackson says lightening stocks is a critical step for the car manufacturers. 'They are used to selling what their factories can produce, not what the public is asking for.'

"AutoNation's Toyota and Honda stores typically carry enough cars to last 35 to 42 days. Its GM, Ford and Chrysler locations used to have 65 to 70 days of inventory. These days, as domestic manufacturers have continued losing market share, that number has climbed to between 80 and 120 days.

"AutoNation hired McKinsey & Co. and two other consulting groups with retail expertise to mine consumer data. The goal is to identify the few versions of every vehicle that are big sellers among the thousands of possible variations. GM's Mr. LaNeve says his company is seriously considering joining Mr. Jackson to create a 'predictive modeling' system."

In this way, hopefully, systems theory may come to our economics courses via the automobile industry, instead of vice versa, that would have saved the world economy uncounted billions of dollars and broken lives.

William Krehm

1. Forrestor, Jay W. (1971). *World Dynamics*. Cambridge, Mass: Wright-Allen Press Inc.

2. Krehm, William (1977). *Babel's Tower: The Dynamics of Economic Breakdown*. Toronto: Thornwood Publications.

Current Installment of Our "Great Economists Buried Alive" Series

Systems theory is nothing that we invented. In an increasingly globalized and deregulated world, where countless cultures come into contact, and ever more technologies affect so many different aspects of cultures and environments, unforeseen disasters in other subsystems can multiply. And that is why some four or five decades ago a significant group of economists and universities set up courses in system theory applied to economics.

I published *Babel's Tower: The Dynamics of Economic Breakdown* in 1977 as part of this movement.

It was dedicated to François Perroux, the great French economist, with whom I was in close contact. I acknowledged my debt to Professor Samuel Madras of York University, who actually contributed an appendix to my book where the method is applied to housing problems. Dr. Madras trained as a chemist, actually, but on retirement studied under Jay W. Forrester who in collaboration with Dennis Meadows had written a booklet for the Club of Rome entitled *Limits to Growth*. But, of course, what in those days was called "producer power" had no ears for the suggestion that environmental concern would impose severe limits on "growth." On the contrary, they were busy knocking down all other considerations concerning the environment and society itself that stood in the way of the incorporation of ever accelerating growth derivatives for running the show. That was enough to have system theory disappear even as a concern, let alone a discipline useful to economists.

I remember a session of the Eastern Economics Association at which Meadows predicted an increasing oil shortage with crippling effects on the environment and society, while his opponents argued that if oil prices rose high enough the supply of oil and other energy would be unlimited. The last conference of system theorists I attended was at Ryerson University in Toronto, and I was the only one who applied systems theory to economic problems.

It is a simple if powerful discipline, and I will cite a very elementary sample unrelated to economics. An automobile, of any make or model, qualifies as a perfect instance of a "system," by dint of the fact for the system as a whole to be in good functioning order, each subsystem defined by this definition of "system" must be in good functioning order, for the automobile to function safely. It will not suffice for the efficiencies of all these sub-system – the engine, the transmission, the electronic, the electrical to *average out* in efficiency. Each must function acceptably or the system as a whole will not work.

That means that the minimum number of independent variables to determine the dependability of the vehicle cannot be less than the number of independent subsystems identified, but in fact will be considerably more, since each sub-subsystem cannot have less than a single independent variable but may have several such.

Society as a whole is such a system – as is the environment – of a higher order, since something will survive even if our society ends up suiciding by making the planet unable to support human life.

Fighting Inflation with a Single Variable — Higher Interest Rates

Once you learn to put our major problems in such an analytical framework, the notion that fighting "inflation" by keeping market prices flat, is a non-starter – since if we concentrate on economic growth and ignore what we are doing to our atmosphere, the consequences will be disastrous. Thus any non-supportable pollution not dealt with in good time must be entered as a capital deficit – instead of as "fiscal prudence." Accountancy merely reflects the quality of the systems theory analysis applied.

To illustrate the point and the immense consequence for society's survival of the disappearance of the limited interest some economists and economics departments of a few universities had begun showing for systems theory thirty years ago, I will cite the consequences of its absence in analyzing a set of very simple problems – a single aspect of population controls.

To begin with let me begin with an anecdote. In the UK there is a remarkable person who on a tiny budget publishes a selection of articles of items of environmental, monetary reform, and other progressive ideas, including a good ingredient from COMER. It recently came a surprise when this excellent friend expressed his puzzlement that we should have run a piece on the deplorable drop in the Russian birth rate since the fall of the Soviet Union, with the average life span of males down about ten years, alcoholism rapidly rising, entire rural areas becoming depopulated. My good friend's reaction: "But don't you agree that from the point of view of the environment, there are too many people around?" But of course, that is reducing Society to the position of a subsystem of the environment, whereas since we are people, with an important heritage of culture and genetic wealth to preserve, alcoholism and the degradation and ultimate disappearance of one of the great cultures – the Russian – cannot be accepted a mere subsystem of the environment. It must be seen as a partner of a co-system made up of humanity and the environment with all that implies. Any application of system theory, precisely because it strives to an uninterrupted co-survival of the environment and human society calls for constant revaluation. The mere progress of technology will reveal new problems, that require the reshuffling of subsystem and co-system classifications. To the best of my knowledge the concept of co-system has been conceived just with this writing.

The tires and the auto engine have no particular purpose, if the automobile system of which they could be seen as subsystems ceased to exist. Not so the environmental system if man goes under. It could well survive to serve wiser races of living creatures. That qualifies it for the "co-system" rather than the mere "subsystem" category, and teaches us a bit of racial humility.

My intent in sitting down to write this piece was to show how ambiguous and hence sensitive to the possible need for reclassification is the relationship between co-systems, systems, and subsystems.

Population density in all its aspects is a good example. In a recent issue of *ER* we have already dealt with the fewer Chinese of working age the one-child policy introduced over a quarter of a century ago, and the increasing burden of retired people the active population will be called on to support – particularly since average life spans are increasing. The apparently unforeseen increase in the excess of males of males of mating age to the few females available was apparently largely unforeseen. Here is a whole neglected subsystem of the effects of the single-child limit that was not foreseen. Or in the distinction in classification between systems and subsystems that we have outlined mating – disregarded as a subsystem, is now turning out to qualify as a co-system. Thus *The Globe and Mail* (23/01, "China Battles Army of Unmarried Men" by Geoffery York, Beijing) informs us: "Fearing an explosion of social unrest from a growing army of unmarried men, China is vowing a crackdown on the rising epidemic of abortions of female fetuses.

"China will face an excess of 30 million men of marriageable age, compared with the number of marriageable women, if the trend continues to the end of the next decade, the latest projections show.

"Because of China's limit of one child to a family, combined with the traditional preference for boys, a growing number of couples are aborting their babies when an ultrasound reveals it is a girl.

"Chinese authorities are increasingly alarmed by the trend. 'People who conduct illegal gender testing of fetuses should face serious punishment,' China declared yesterday in a joint statement by its government and the ruling Communist Party.

"The gender unbalance, which continues to grow worse, is a 'hidden danger' that will affect social stability,' the statement warned. Among newborn babies in China there were 118 boys for every 100 girls in 2005. The ratio has dramatically worsened since 2000, when the ratio was 110 boys for every 100 girls. (By comparison, the ratio in industrialized countries is between 104 and 107 boys for every 100 girls.) The growing sophistication of medical technology has allowed Chinese families to take action on their traditional preference for boys – a preference based on rural ideas that men are the family breadwinners and inheritors of the family line.

"In the announcement yesterday, China promised to improve the proportion of baby girls. Anybody who kills, abandons or injures an infant girl should be 'severely punished,' the authorities said.

"Despite the gender imbalance, China vowed it would 'firmly' continue its one-child policy which has been in place for 33 years, and has prevented an estimated 400 million births. 'Only children' now number 90 million. China has pledged to limit its population to 1.45 billion by 2020. Compared with 1.3 billion today.

"In many quarters of the country, there is anger and resentment that some wealthy Chinese have been allowed a second child, because they have paid a fine or submitted forged documents." Here an overweighted subsystem sticks an elbow into another subsystem.

"Zhai Zhenwu, a professor at the Population and Development Studies Centre at Renmin University in Beijing, said the ability of the wealthy to have a second child could worsen social conflicts in China."

William Krehm

Our Mail Box

Action Needed to Halt Erosion of Workforce

Don Waffle, a correspondent with a sharp pen, has developed a proficiency for getting his and our views into the major media of the area. Blogging on the Internet is fine, but it cannot in certain ways replace the printed message. Below we carry a fine summary from the Windsor Star*, (17/02/07) of what Deregulation and Globalization has inflicted on major industrial areas of this land.*

Industry old-timers have observed while Windsor declined from a manufacturing dynamo of international stature as, over several decades, whole neighborhoods of shops and entire industries shrivelled and disappeared.

Into this century, Canadian manufacturing has been hammered by new challenges of historic proportions. What industry chief Perrin Beatty describes as "perfect storm."

Like the captain of the Titanic, no prime minister over these decades altered by one degree a trade course that would cripple Canadian manufacturing. A passenger on the Titanic stood a better chance of survival than a Windsor industry worker today.

It was at the time of greatest crisis that the Martin government removed import quotas designed to protect Canadian manufacturing from China's dragon economy. Imports from China, whether shirts or tooling for auto parts, rose in a flood. This was part of a free trade agreement with China directed by trade minister and ex-bank CEO David Emerson that, in return, gained Canadian banks full participation in China's finance sector. Too bad that thousands of excellent Canadian shops and factories, just like Bernard Mould, were washed away. Within a year up to 300,000 Canadian garment workers lost their jobs.

As China gets into full gear, all manufacturing, with Ontario's tooling and auto industries foremost, stand to be swept away in a trade storm of tsunami proportions, And now Canadian banks are there to provide the financing.

The immense efforts of Ottawa to keep the public from grasping this trade action is beyond the scope of this letter. With the collaboration of the media, jobs and industry have simply disappeared from the party platforms. Trade experts don't mention that domestic products boost Ontario's economy many times over imports. Where is the partnership of workers, industry and communities to save manufacturing and its jobs for this and the next generation?

Buzz Hargrove for autos and Alex Dagg for the garment industry directly or indirectly representing hundreds of thousands of workers, are two who found Ottawa and Trade Minister Emerson's doors closed.

When corporations close their doors to negotiations, workers take to the streets. One leader in particular with the potential to bounce Emerson and his storm on industry is Buzz Hargrove. His response to Emerson's closed door seems to be passing out life jackets (CAW news release of Jan. 4).

Is Windsor once again being a world manufacturing centre just an impossible dream? It is, unless workers, students, you and me, start taking action.

Don Waffle, Harrow

Monetary Mechanics

Dear William:

I would like to take issue with the following statement which appeared in your article "Hedge Funds Ride the Crest of the Economy's Compulsion to Grow" within the February 2007 issue of *ER*: "...but there was also the obligation for the banks to redeposit with the central bank a portion of the deposits they received from the public." This is a misleading description of how fractional reserve deposit expansion (FRDE) operates, or was ever intended to operate.

Whenever banks receive deposits from the public they also increase their stock of reserves by precisely the same amount. These reserves come from either (a) in the case of credit money, the bank from which the deposit was transferred, or (b) in the case of a purely cash transaction, from a transformation of the status of the cash itself. In the latter case, the receiving bank simply credits the depositor's account with the required amount (thus the money supply remains unchanged). While the cash – being now in the hands of the banker – has become part of the bank's reserves.

My point is that your description is only relevant to a cash economy, however almost all new deposits created today represent credit transfers. And the credit money transferred between public bank accounts is never re-deposited with the central bank (in fact, banks are strictly not allowed to unilaterally re-deposit or re-lend any funds entrusted to them by the public). Whenever part of the public's supply of credit money is transferred between two banks, there is a commensurate transfer of reserves between their accounts with the central bank. And that reserve transfer precisely matches the monetary transaction – never by a fractional amount. The word "fractional" used in FRDE actually refers to the volume of credit created by a commercial bank in relation to the magnitude of its liabilities.

Regards,
John Hermann, Adelaide, Australia

Hi, John:

There is no disagreement between us on the point you raise. As for banking deposits, the fractional reserve when and where it exists as an alternative to raising the benchmark interest rate is set by the central bank for its overnight loans to banks. When the purpose is to cool a rising price level, the leverage that the bank has for a multiple of near-money creation is decreased by raising the statutory reserve as a percentage of deposits the banks receive from the public. But when the banks are deregulated to acquire other "financial pillars" – i.e., stock brokerages, mortgage and insurance companies, they have control over cash and near-cash reserves that these non-banking corporations need for running their own businesses. That is why the Indicator that we have calculated from time to time to shed light on the near-money-creation leverage that the banks have acquired with progressive deregulation, we came upon a serious problem. There were no longer statutory cash reserves to serve as the denominator of our ratio of near-money creation by the banks as a multiple of the legal tender they held.

We could not, however, put that denominator at zero, because our Indicator would at once become infinity – i.e., meaningless for practical purposes. So I deliberately put in the denominator the cash that the banks held in their tills and ATMs, although that could not be used for meeting the banks' obligations without crippling the bank for their routine every-day business. Even with this deliberate and conscious understatement – that you correctly refer to and that I have always explained in presenting the Indicator – it rose from about 10 to 1 in 1946 to 404.7 in September, 1998, and then drooped a bit to 358 to 1 by June 1999 due to the shriveling of assets values with the approach of the high-tech bust.

I repeatedly referred to this as the "skyscraper" effect on the multiplier improvised to avoid the use of zero for the resulting bank multiplier enhanced by the banks being able to take over the other financial pillars. It actually understated the total multiplier effect, but there was no other way of dealing with the problem of zero turning up in the denominator. What you are telling me – correctly so – I explained that to my readers – was that the cash in coin and other legal tender that the banks held in their tills were essential for their ATMs and the conduct of daily banking. It was not available for paying over claims of the other financial pillars that the banks had possibly gambled away, without having to shut down their daily banking business.

We are in complete agreement.
All best,
Bill Krehm

CCPA Membership

Certainly you may use this Bill. Please note that I have had a second telephone conversation with Judy W. from the NDP wherein she backed away from the influence of CCPA on her position. She believes that she left me with the wrong impression and expressed openness to the ideas that we are proposing. She would like further discussion on the matter.

Our NDP Riding Association (supported by Kingston) proposed a motion to the federal convention in Quebec that there be a review of the *Bank of Canada Act*. The year 2008 will mark the 75th anniversary of the Act and 2013 will mark 75 years since the BoC was nationalized by the Liberals. Jack Layton was very keen on this motion and asked that I speak with Judy W., the NDP Financial critic, about that. She is also receptive to the idea but I was not able to converse with her about it before the convention.

However, the motion did not get priorized in Quebec City even though Adam Giambrone (then president of the federal NDP) chaired the resolutions committee and is well aware of the significance of the BoC from the time that he was involved in discussions with CAP when CAP proposed a merger with the NDP. Just before the convention, I had the pleasure of Adam's company in a drive both ways between Peterborough and Curve Lake during which I outlined the financial issues to him. At his request, I sent him Kingston's municipal options material.

When I spoke to Howard Hampton [the head of the Ontario NDP] about this on February 22, he rightly noted that the party's polling dictates the resolutions that get priorized which is another bizarre feature of the NDP and would upset many members if they understood that. I noted with him that I had talked with our pollsters and they do not ask the questions on the BoC so, of course, do not get indicators of what might be important to voters.

It is totally bizarre. The pollsters are very smug and believe that they (with caucus) know what the issues will be that are important to people and direct their questions on those topics ignoring what might not be known and what might be important. Not once has a pollster wanted to discuss with me how to frame questions about the BoC that they might sample public opinion on.

The question that I would love to see asked by pollsters would be something like the ones that Richard has used about buying/borrowing from yourself versus from the competitor/private bank. I have used that many times in discussions and find that it gets the point across.

Specifically I ask "If you owned one of two bookstores in your town and wanted to buy a book, from whom would you buy it? Your own store or the competitor's?" Most people (indeed only one exception) said from their own store. I then note that the Liberal and Conservative Governments own their own bank but borrow from the one down the street. Most are aghast at that action and invariably ask "Why do they do that?" My next follow up question from now on will be "Do you believe that they know something that you do not know?" Of course the answer is Galbraith's quote.

"The process by which banks create money is so simple that the mind is repelled. Where something so important is involved, a deeper mystery seems only decent."

If COMER had the funds for polling, this series of questions might be quite useful. Perhaps CAP does polling and has some funds. The Green Party might go down that route. The NDP should but their smug pollsters won't consider it.

Herb Wiseman