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A Case of Whooping Cough or a Financial Atomic Bomb?

There is no more frightening word in banking than a "run" on the bank. Something like a century and a half ago Walter Bagehot wrote that, if the question is merely asked whether a bank is sound, that is enough to condemn it. For the art of banking consists of lending out many times as much of other people's money as you still have left in your vaults. Not surprising therefore that *The New York Times* should handle the subject like a hot potato (15/03, "Run on Big Wall St. Bank Spurs Rescue Backed by US" by Landon Thomas Jr.): "Just three days ago, the head of Bear Stearns, the beleaguered investment bank, sought to assure Wall Street that his firm was safe.

"But those assurances were blown away in what amounted to a bank run at Bear Stearns, prompting JPMorgan Chase and the Federal Reserve Bank of New York to step in on Friday with a financial rescue package intended to keep the firm afloat.

"The move underscores the extreme stresses that the credit crisis has imposed on the financial system and raises the one unthinkable prospect that major Wall Street firms might fail....

"News of the bailout ignited fears that other big banks remain vulnerable to the continuing credit crisis, and stocks tumbled in another rocky day for the markets. Financial shares led the way, with shares of Bear Stearns plunging 47%. Hours after the rescue was announced, another Wall Street firm, Lehman Brothers, said it had secured a three-year credit line from banks. Its stock fell 15%.

"As the Wall Street drama unfolded, Ben S. Bernanke, the Federal Reserve chairman, added fresh warnings Friday about a gathering wave of home foreclosures bearing down on American communities.

"President Bush, meantime, made his most striking acknowledgment yet of the country's economic troubles, even as he defended his administration's responses so far and warned against more drastic steps by the government.

"The rescue effort began late Thursday evening, when Alan D. Schwartz, Bear Stearns CEO placed an urgent call to James Dimon, his counterpart at JPMorgan Chase. Mr. Schwartz said Bear Stearns was struggling to finance its day-to-day operations, according to several people briefed on the negotiations, a situation that would threaten its survival.

"Because JPMorgan settles transactions for Bear Stearns as its main clearing bank, it was in a good position to assess the collateral that Bear Stearns could provide against a loan. But Mr. Dimon insisted on the support of Timothy F. Geithner, president of the New York Fed. Mr. Geithner quickly agreed to the plan.

"The size and terms of the credit line were not disclosed. JPMorgan will borrow the money from the Fed and the Fed will bear the ultimate risk of the loan."

Subprime Mortgages — The Kiss of Death on Wall Street

"Meetings between Bear Stearns and prospective suitors had already begun. Interested parties include J.C. Flowers & Company, the private equity investor, and Royal Bank of Scotland, according to people who were briefed on the discussions.

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The Mathematical Nihilism of a Subprime Economy

A subprime economy may be defined as one dominated by the fiction of "risk management." The concept of "risk" is enacted rather than properly defined in terms of what it might be, where, when, and for whom. Above all there is the privileged position of deregulated and globalized banking for whom the "bankers' exit" or the marketing of swaths of supposedly defined "risk" to naive third parties. That terminates the banks' own exposure with a positive gain at the expense of the ultimate investor.

The scenario was set up by the Cold War that climaxed under President Richard Nixon in the US with the abandonment in 1971 of the gold standard. The gold standard could hardly hold up under an explosion of stresses: the cost to the Western dominant states of the Cold War, combined with the deregulation and globalization of the financial system, the technological revolutions involved and the costs of the huge non-marketed physical and human infrastructures associated with these developments. Many of these costs came in the form of public services covered out of taxation. This new and rapidly expanding layer of costs, that most English-speaking economists tried explaining away by equilibrium theory had been the subject of questioning by an entire school of French economists.

With some mathematical training, and intense reading of economic literature in the Ricardo-Marx tradition, I was able to identify what Pierre Biacabe and other French economists had decided must exist, because in different countries and at different times they found that the price level often rose, when the volume of production fell rather than rose. With no acquaintance at the time of the existence of such conclusions by Biacabe and others, I associated it with the deepening layer of taxation that was collected by the state and entered price as *a layer of costs that was not market-determined*. That I called the *social lien.* This led to the publication of a 60-page manuscript sent out blindly to 30 academic publishers throughout the world. It was published in *La Revue Économique* of Paris in May, 1970.

Among other results, this led to my close relationship until his death in 1987 with François Perroux, who provided insight into another important aspect of the process that was reshaping the economies of the world, but that was denied recognition by economists of officially recognized schools. This was the notion of the "dominant revenue" that by its volume and rate of reward of a privileged class is identified with the welfare of society as a whole. In the given instance this took the form of elevating interest to the position of the sole means of fighting "inflation" identified with any price level above a perfectly flat one.

The French Concept of the Dominant Revenue

Ever since the banking legislation under President Delano Roosevelt in the US in 1933 that eventually became the model for banking legislation in other lands, there had to be at least two distinct ways in which central banks tried controlling the tempo of their economy. For if there were only a single one, it would endow a privileged revenue with a dominant position – to use a nomenclature of which Roosevelt's economists had never heard. Under Roosevelt's banking legislation, the central bank published the benchmark interest rates at which one bank could borrow from another bank for overnight loans – the Federal Funds Rate in the United States, or at the Discount Rate at which banks could borrow from the central bank itself, usually at a somewhat higher rate. Or alternatively or as a supplement to the manipulation of the benchmark rates, the statutory reserves required that the banks redeposit with the central bank a percentage of the deposits they received from the public, and on this the central bank paid no interest. This had the effect of supplementing the use of the benchmark interest rate or replacing its use entirely. It also provided the government with a cost-free source of funds, and it supplemented or wholly eliminated the manipulation of the interest rates as the sole regulator of the pace of economic activities. Interest, after all, is the prime revenue of money-lenders and speculative money, and attributing a monopoly position to the benchmark interest rates was tantamount to endowing finance capital with a monopolist position over the economy. Central bankers mistake what I called the "social lien" for the price effects of too active an economy, i.e., inflation. In

fact they elevated interest to what François Perroux had had defined as the "dominant revenue" of a new era that was dawning.

The Dominant Revenue — The Compass for Understanding History

Perroux defined as "dominant revenue" the privileged revenue, the rate and volume of which is taken as an index of the well-being of society as a whole. This may seem so under a given power distribution. As that passes from the hands of one class to that of another, the revenue of another class takes over. Thus under feudalism it was the non-monetized economy of the warriors that was dominant. After the Napoleonic Wars, in Britain the highly protected large landowners were privileged. With the removal of the protection of the Corn Laws, the industrialists who profited from the lower wages resulting from cheaper food costs succeeded the landowners.

Then with the deregulation and globalization of banks that permitted them to take over the other "financial pillars" which had been forbidden them under the Roosevelt banking legislation, power shifted to speculative finance. But with the deregulation of the banks beginning in 1971 that allowed them to take over stock brokerages, insurance and mortgage firms, they acquired access to the cash reserves that each of these maintained for the needs of its own business. Once the banks acquired access to these, it applied them as the monetary base for the bank multiplier. In 1946 the bank multiplier amounted to the banks lending out of a multiple of about 10 to 1 of the cash in their vaults. But with deregulation and globalization, this grew rapidly as layer upon layer of cash reserves of the non-banking financial pillars were taken over by the banks as money and then the banks created a growing amount of near-money – interest-bearing – by lending it out.

And then for the next storey, this newly created near-money was again traded as though it were legal tender and served to support a further mixed storey of near-money and legal tender created by being loaned out. There was a constant confusion of near-money with legal tender. This process gradually created a *subprime* economy before economists were aware of what was overtaking our society.

In this process the distinction between legal tender and interest-bearing loans and investments tended to disappear. By 1998 the ratio had risen to 380 to 1, while the denominator of the fraction tended to vanish completely. But that would leave us with a zero denominator. Because of this, the statistic that COMER compiled – to avoid a zero denominator to the ratio which would transform it to a meaningless infinity, we made use of the cash in the banks' tills and what was kept for its ATM machines and the other needs of its customers. That, however, was not available for supporting the banks' spreading speculations. For once banks could no longer freely provide change for a $10 bill, runs on banks would take over.

That is when COMER started warning about the deregulated and globalized banks flooding the world economy with near-money earning interest as high as possible that craved ever higher speculative returns. That was the beginning of the subprime banking that has deluged the world. *Economic Reform* started warning against this 5 and 6 years ago as it appears in the second and subsequent issues of *Meltdown* just now appearing in a series.

William Krehm

The New York Times Goes onto the Dangerous Brink of the Smoking Volcano

In its issue of 2/03, *The New York Times* ("What Created This Monster" by Nelson D. Schwartz and Julie Cresweel) continues onto the very lip of revelation: "Like Noah buildings his ark as thunderheads gathered, Bill Gross has spent the last two years anticipating the flood that swamped Bear Stearns about 10 days ago. As manager of the world's biggest bond fund and custodian of nearly one trillion dollars in assets, Mr. Gross amassed a cash hoard of $50 billion in case trading partners suddenly demanded payment from his firm, PIMCO.

"And every day for the last three weeks he has convened meetings in a war room in Pimco's headquarters in Newport Beach, Calif., 'to make sure the ark doesn't have any leaks,' Mr. Gross said. 'We come in every day at 3.30 am and leave at 6 pm.... These are extraordinary times.'

"Even though Mr. Gross, 63, is a market veteran, who has lived through the collapse of other banks and brokerage firms, the 1987 stock market crash, and the near-meltdown of the Long-Term Capital Management hedge fund a decade ago, he says the current crisis feels different – in both size and significance."

A Period of Hollowed-out Skulls

And here again the *Times* is led close to the hub of the entire situation without really getting there because the economic theory of the past four decades has been restructured to avoid society's most crucial relationships.

"'The Federal Reserve not only has taken action unprecedented since the Great Depression – by lending money directly to major investment banks [rather than to those *commercial* banks who belong to the Fed system], but also has put taxpayers on the hook for billions of dollars in questionable trades these same bankers made when the good times were rolling. Bear Stearns has made it obvious that things have gone too far,' says Mr. Gross, who plans to use some of his cash to bargain-shop. '*The investment community has morphed into something beyond banks and something beyond regulation. We call it the shadow banking system.*'" (Italics are ours.)

It is all there in the passage that we have italicized. What is missing is simply the decades of our crucial economic history plus everything that had been learned about money creation during the Depression, WWII and some twenty years of the successful postwar reconstruction. Ours, as a result, is a period of "hollowed-out skulls."

"It is the private trading of complex instruments that lurk in the financial shadows that worries regulators and Wall Street and have created stresses in the broader economy. Economic downturns and panics have occurred before. Few, however, have posed such a serious threat to the entire financial system that regulators have responded to as if they were confronting a potential epidemic.

"As Congress and Republican and Democratic presidential administrations pushed for financial deregulation over the last decade, the biggest banks and brokerage firms created a dizzying array of innovative products that experts acknowledge are hard to understand and even harder to value.

"On Wall Street, of course, what you don't see can hurt you. In the past decade. there has been an explosion in complex de-

rivative instruments, such as collateralized debt obligations and credit default swaps, which were intended primarily to transfer risk.

"These products are virtually hidden from investors, analysts and regulators, even though they have emerged as one of Wall Street's most outsized profit engines. They don't trade openly on public exchanges, and financial services disclose few details about them."

The Official Advice — Use Nonsense Judiciously

"Used judiciously, derivatives can limit the damage from financial miscues and uncertainty, greasing the wheels of commerce. Used unwisely – when greed and the urge to gamble with borrowed money overtake sensible risk-taking – derivatives can become Wall Street's version of nitro-glycerin."

All that remains is for us to insert the question, that when governments taken over by the empowered financial sector have expunged the work of just about every great economist who contributed to our understanding of the Great Depression and the reconstruction from the havoc it caused, how could anything so powerful as derivatives – the exponential function that is the mathematics of the atomic bomb – be used "judiciously"?

"Derivatives are buried in the accounts of just about every Wall Street firm, as well as major commercial banks such as Citigroup and JPMorgan Chase. What's more, these exotic investments have been exported all over the globe, causing losses in places as distant from Wall Street as a small Norwegian town north of the Arctic Circle.

"With Bear Stearns forced into a sale and the entire financial system still under the threat of further losses, Wall Street executives, regulators and politicians are scrambling to figure just what went wrong and how it can be fixed.

"But because the forces that have collided in recent weeks were set in motion long before the subprime mortgage mess first made news last year, solutions won't come easily or quickly, analysts say.

"Derivatives are buried in the accounts of just about every Wall Street firm, as well as major commercial banks like Citigroup and JPMorgan Chase. Normally, only commercial banks, not investment banks belong to the Federal Reserve System and are thus subject to its rules and support when their solvency is under stress."

If there were one single place where so much of the heavy lifting was done in figuring out how economic theory had failed so miserably in staving off a Great Depression and an equally great war, it would be Cambridge University. Such expectations contrasted with my experiences at a conference on heterodox economics that I attended there two or three years ago. At a plenary session on derivatives, three economists who were introduced as holding a critical view on derivatives spoke on the subject. One was a distinguished economist from whom I owed my first critical acquaintance with derivatives. However, he was now on the United Nations staff.

From the floor I asked whether derivatives should be subject to control. The answer came back from all three, that they are not – reasons unspecified – likely to be. From the floor I reminded the speakers that I had asked not whether they will be regulated, but should they be. All three, somewhat flustered still avoided answering that question. Today the answer to it has come in the increasing paralysis of the world economy.

But let us mine further into the lode that the *Times* article offers: "Two months before he resigned as chief executive of Citigroup last year amid nearly $20 billion of write-downs, Charles O. Prince III sat down in Washington with Representative Barney Frank the chairman of the House Financial Services Committee. Among the topics they discussed were investment vehicles that allowed Citigroup and other banks to keep billions of dollars in potential liabilities off their balance sheets – away from the scrutiny of investors and analysts.

"The Congressman recalled that Mr. Prince said that not doing so would put Citigroup at a disadvantage with Wall St. investment banks that were more loosely regulated and were allowed far greater risks. (A spokeswoman for Mr. Prince confirmed the conversation.)

"It was at that moment, Mr. Frank says, that he first realized just how much freedom Wall Street firms had, and how lightly regulated they were in comparison with commercial banks that come – should they choose to join the Fed system.

"'Not only did Wall Street banks have more freedom, but it gave commercial banks an incentive to try and evade their regulations,' Mr. Frank says. When it came to Wall Street, he says, 'we thought we didn't need regulation.'

"During the late 1990s, Wall Street fought bitterly against any attempt to regulate the emerging derivatives market, recalls Michael Greenberger, a former senior regulator at the Commodity Futures Trading Commission. Although the Long-Term Capital debacle in 1998 alerted regulators and bankers alike to the dangers of big bets with borrowed money, a rescue effort engineered by the Federal Reserve Bank of New York prevented the damage from spreading.

"Speaking in Boca Raton, Fla., in March 1999, Alan Greenspan, then Fed chairman, told the Futures Industry Association, a Wall Street trade group, that 'these instruments enhance the ability to differentiate risk and allocate it to investors most able and willing to take it on. Risk measurement schemes,' he added, 'are less simple and less accurate than banks' risk measurement models.'"

Derivatives Holy and Hence Untouchable

"Supported by Phil Gramm, then a Republican senator from Texas and chairman of the Senate Banking Committee, the legislation was a 282-page amendment to a far larger appropriations bill. It was signed into law by President Bill Clinton that December.

"Mr. Gramm, now the vice-chairman of UBS, the Swiss investment banking giant, was unavailable for comment. (UBS has recently seen its fortunes hammered by ill-considered derivatives investments.)

"With profit margins shrinking in traditional businesses like underwriting and trading, Wall Street firms rushed into the new frontier of lucrative financial products like derivatives. Students with doctorates in physics and other mathematical disciplines were hired directly out of graduate school to design them, and Wall Street firms increasingly made big bets on derivatives linked to mortgages and other products.

"The group's conclusion, in a 153-page report, was that the chances of a systematical upheaval had declined sharply after the Long-Term Capital bailout. Over all, they concluded that overall financial markets were more stable than they had been just a few years earlier.

"Few could argue. Wall Street banks were fat and happy. Money flowed easily as corporate default was almost nil. Innovative products designed to mitigate risk were seen reducing likelihood of a financial cataclysm putting the entire system at risk.

"One of the fastest-growing and most lucrative businesses Wall St. in the past decade has been in derivatives – a sector

that boomed after the near collapse of Long-Term Capital.

"It is a stealth market that relies on trades conducted by phone between Wall Street trader desks, away from open securities exchanges. How much changes hands or who holds what is ultimately unknown to analysts, investors and regulators."

The Risk of Wandering into the Derivative Forest

"Credit rating agencies, which banks paid to grade some of the new products, slapped high ratings on many of them, despite having only a loose familiarity with the quality of the assets behind these instruments. Mr. Blinder, the former Fed vice-chairman, holds a doctorate in economics from MIT but says he has only a 'modest understanding of complex derivatives. But if you presented me with one to put a market value on it, I'd be guessing.'

"Such uncertainty led some to single out derivatives for greater scrutiny and caution. Most famous, perhaps, was Warren E. Buffett, the legendary investor and chairman of Berkshire Hathaway, who in 2003 said derivatives were potential 'weapons of mass destruction.'

"Behind the scenes, however, there was another player who was scrambling to assess the growing power, use and dangers of derivatives.

"Timothy F. Geithner, a career civil servant who took over as president of the New York Fed in 2003, was trying to solve a variety of global crises while at the Treasury Department. As a Fed president, he tried to get a handle on hedge fund activities and the use of derivatives on Wall Street, and he zeroed in on the credit derivatives market.

"Mr. Geithner brought together leaders of Wall Street firms in a series of meetings in 2005 and 2006, to discuss credit derivatives, and he pushed many of them to clear and settle derivatives trading electronically, hoping to eliminate a large paper backlog that had clogged the system.

"Even so, Mr. Geithner had one hand tied behind his back. While the Fed regulated large commercial banks like Citigroup and JPMorgan, it had no oversight on activities of the investment banks, hedge funds and other participants in the burgeoning derivatives market. And the industry and sympathetic politicians in Washington fought attempts to regulate the products, arguing that it would force the lucrative business overseas.

"'Tim has been learning on the job, and he has my sympathy,' said Christopher Whalen, a managing partner of Institutional Risk Analytics, a risk management firm in Torrance, Calif. 'But I don't think he is enough of real practitioner to go *mano-a-mano* with these bankers.'

"In a May, 2006 speech about credit derivatives, Mr. Geithner remarked: 'Perhaps the more difficult challenge is to capture the broader risks the institution might confront in conditions of a general deterioration in confidence in credit and an erosion in liquidity. Most crises come from the unanticipated.'

"When increased defaults in subprime mortgages began crushing mortgage-linked securities last summer, several credit markets and many firms that play substantial roles in those markets were side-swiped because of a rapid loss of faith in the value of the products.

"Two large Bear Stearns hedge funds collapsed because of bad subprime mortgage bets. The losses were amplified by a hefty dollops of borrowed money that was used to try to juice returns in one of the funds.

"All around the Street, dealers were having trouble moving exotic securities linked to subprime mortgages, particularly collateralized debt obligations, which were backed by pools of bonds. Within days, the once-booming and actively traded CDO market – which three short years ago had seen issues triple in size to $486 billion – grounded to a halt.

"Jeremy Grantham, chairman and chief investment strategist at GMO, a Boston investment firm, said 'Treat this as a dress rehearsal. Stress-test your portfolios because the next time or the time after, the shot will not be across the bow.

"'It was like watching a slow-motion train wreck,' Mr. Grantham says. 'After all of the write-downs at the banks in June, July and August, we were on a full-fledged credit crisis with CEOs of top banks running around like headless chickens.

"Finally last week, with Wall Street about to take a direct hit, the Fed stepped in and bailed out Bear Stearns. It remains unclear exactly, what doomsday scenario Federal Reserve officials consider themselves to have averted.

"The market's growth has exploded exponentially since Long-Term Capital almost went under. Now the outstanding value of the swaps stands at more than $45.5 trillion up from $900 billion in 2001. The contracts act like insurance policies designed to cover losses to banks and bondholders when companies fail to pay their debts. It's a market that remains largely untested. Bear Stearns held default swap contracts carrying an outstanding value of $2.5 trillion, analysts say.

"There is an emerging consensus that the ability of mortgage lenders to package their loans as securities that were then sold off to other parties played a key role in allowing borrowing standards to plummet.

"Mr. Blinder suggests that mortgage originators be required to hold on to a portion of the loans they make with the investment banks who securitize them also retaining a chunk. 'That way they simply do not play 'hot potato.'

"Rating agencies have similarly have been under fire ever since the credit crisis began to unfold, and new regulations may force them to distance themselves from the investment banks whose products they were paid to rate."

The Curse of Exotic, Toxic Securities

All of which is very good, but misses the central point – the importance of preventing the private banks to acquire interests in the non-banking financial pillars – stock brokerages, insurance companies, and mortgage companies. The reason: each of these other pillars maintain a legal tender liquidity pool for the needs of their own businesses. Allow them access to these reserves as the basis for their application of the bank multiplier, and you end up by the repetition of that exercise with a skyscraper version of banks creating money by lending it out rather than the government creating most of it by spending it for the society's own essential needs. That is why the federal reserve banks in the US are confined to dealing with commercial banks whereas investment banks that live by doing acquisition deals are not eligible to join the system. Start by having the fed bail them out in their hour of need, and they will have broken once against the basic principle of the Roosevelt banking legislation.

It is bad enough having had this wiped out from the official history taught in our universities and made available to our parliament. Mess it up with the subprime dodges like other subprime mortgages and it will push further the suppression of our history.

Need I point out that if the banks had not been allowed to get into mortgages, you would have had no subprime mortgage crisis?

William Krehm

Why Even the Experts Can't Grasp this Crisis

As a matter of fact, the actual author of the piece so captioned in *The New York Times* (10/03, author David Leonhardt) himself misses the key points of the genesis of that unholy mess. Let us begin with his version of its roots.

"Raise your hand if you don't quite understand this whole financial crisis. It has been going on for several months now, and many people probably feel as if they should understand it. But they don't, not really. The part about the housing crash seems simple enough. With banks whispering sweet encouragement, people bought homes they couldn't afford, and now are falling behind on their mortgages.

"But the overwhelming majority of homeowners are doing just fine. So how is it that a mess concentrated in one part of the mortgage business – subprime loans – has frozen up the credit markets, sent stock markets gyrating, caused the collapse of Bear Stearns, left the economy on the brink of the worst recession in a generation, and forced the Federal Reserve to take its boldest action since the Depression?

"I'm here to urge you not to feel sheepish. This may not be entirely comforting, but your confusion is shared by many of the people in the middle of the crisis.

"'We're exposing parts of the capital markets that most of us have never heard of,' Ethan Harris, a top Lehman Brothers economist, said last week. Robert Rubin, the former Treasury secretary and current Citigroup executive, said that he hadn't heard of 'liquidity puts,' an obscure kind of financial contract, until they started causing big problems for Citigroup.

"I spent a good part of the last few days calling people on Wall St. and in the government asking one question, 'Can you try explain this to me?' When they finished, I often had a highly sophisticated follow-up question, 'Can you try again?'

"I emerged thinking that all the uncertainty has created a panic partly unfounded. That said, the crisis isn't close to ending, either. Ben Bernanke, the Federal Reserve chairman, won't be able to wave a magic wand and make everything better, no matter how many more times he cuts rates and cheers Wall Street. As Mr. Bernanke himself has suggested, the only thing that will end the crisis is the end of the housing bust.

"So let's go back to the beginning of the boom.

"It really started in 1998, when large numbers of people decided that real estate, which still hadn't recovered from the 1990s slump, had become a bargain. At the same time, Wall Street was making it easier for buyers to get loans. It was transforming the mortgage business from a local one, centered around banks, to a global one, in which investors from almost anywhere could pool money to lend.

"The competition brought down mortgage fees and spurred innovations, much of which was undeniably good. Why should someone who knows that they're going to move after a few years have no choice but to take a 30-year fixed-rate mortgage?"

Too, Too Much of a Good Thing

"As is so often the case with innovations, though, there was soon too much of a good thing. Those same global investors, flush with cash from Asia's boom or rising oil prices, demanded good returns. Wall Street had an answer: subprime mortgages.

"Because these loans go to people stretching to afford a house, they come with higher interest rates – even if they're disguised by low initial rates – and higher returns. The mortgages were sliced into pieces and bundled into investments, often known as collateralized debt obligations, or CDOs (a term that appeared in this newspaper only three times before 2005, but every week since last summer).

"Once bundled, different types of mortgages could be sold to different groups of investors. Investors then goosed their returns through leverage. They made $100 million bets with only a million dollars of their own money, and $99 million in debt. If the investment rose only to $101 million, they would double their money. Home buyers did the same thing, by putting little money down on new houses. The Fed under Alan Greenspan helped make it all possible, sharply reducing interest rates, to prevent a double-dip recession after the technological bust of 2000, and then keeping them low for several years.

"All these investments, of course, were very risky.... But people – I'm referring to Mr. Greenspan, Mr. Bernanke, the top executives of nearly every Wall Street firm, and a majority of American home-owners – decided that the usual rules don't apply because nation-wide home prices had never fallen before. Based on that idea, prices rose ever higher. It was a self-defeating prophecy.

"The American home seemed like such a sure bet that that a large portion of the global financial system ended up owning a piece of it. Last summer, many policy-makers were hoping that the crisis wouldn't spread to traditional banks like Citibank, because they had sold off the underlying mortgages to investors. But it turned out that many banks had also sold complex insurance policies on the mortgage debt. That left them on the hook when homeowners who had taken out a wishful-thinking mortgage could no longer get out of it by flipping their house for a profit.

"Many of these bets were not huge. But they were also so highly leveraged that any losses became magnified. That's why a hedge fund associated with the prestigious Carlyle Group collapsed last week.

"This toxic combination – the ubiquity of bad investments and their potential to mushroom – has shocked Wall Street into a state of deep conservatism. The soundness of any investment firm depends on other firms having confidence that it has real assets behind it. So firms are now hoarding cash instead of lending it, until they understand how bad the housing crash will become and how exposed they are to it, The conservatism has gone so far that it is affecting many solid would – be borrowers, which, in turn, is hurting the broader economy. A recession that could have been based on over-exuberance is going bad as well.

"Many economists, on the right as well as on the left, now argue the only solution is for the federal government to step in and buy some of the unwanted debt, as the Fed began doing last weekend. This is called a bailout, and there is no doubt that giving a handout to Wall Street lenders or foolish homebuyers – as opposed to, say, laid-off factory workers is deeply distasteful. At this point, though, the alternative may be worse.

"Bubbles lead to busts. Busts lead to panics. And panics can lead to long, and deep downturns. That is why the Fed has been taking unprecedented actions to restore confidence."

What Mr. Leonhardt says he says very well. The trouble is that he leaves the major part of the tale in silence.

When President F.D. Roosevelt was inaugurated for his first term, 38% of the thousands of banks in the US had already shut their doors, so that one of the first steps he took as president was to declare a bank moratorium, closing the other 62% of US banks until he could learn what might be done about all this. When a single bank closes its doors, it can very easily start a run on all banks. Imagine then what the situation was when some 9,000 banks did just that! And months later Roosevelt had gleaned enough from bankers in his circle, and began bringing in legislation that became the model for banks in various parts of the world. This new legislation forbade the banks from acquiring interests in the non-banking "financial pillars" – stock brokerages, insurance and mortgages. The reasons were not dreamt up. In a matter of a couple of weeks what had happened had transformed the country from a land where US corporation chieftains were publishing articles in ladies magazines maintaining that there was no reason why every last American from shoe-shine boy up should not become millionaires, to a state of affairs where stock brokers were jumping out of windows of Wall Street skyscrapers.

Each of these non-banking "financial pillars" – stock brokerages, insurance and mortgage companies that Roosevelt barred to banks maintains its own liquidity reserves to meet the needs of its own business: the stock brokers to help their clients finance of their brokerage accounts, the insurance to meet the claims of policy-holders, and the mortgage corporations to meet clients' claims. The legendary goldsmiths of Milan and Amsterdam, the heroes of the tales of how banking arose, have simply buggered off with the entire assignment documents left with them in trust for carefully designated purposes.

It is enough to note that if that Rooseveltian legislation, the fruit of a decade of dreadful economic depression and six of war, and finally of two decades of successful reconstruction and catch – up had been continued as government policy, and taught as key economic doctrine in our universities, the present crisis could not happen. Until a couple of decades ago all this featured in the evidence collected by parliamentary committees. *Mortgages and banking, insurance and banks, and stock promotion and banks would have been set aside as items that must never be mixed, just as matches and high octane gasoline.* You have in this remarkable omission of the punch line, the most devastating evidence of who and what were responsible for this remarkable absence of the most important historical evidence.

Central banks had learned how to do the bulk of the government's capital financing. For whether the government is the sole shareholder – the case of Canada that bought out 12,000 shareholders at a good profit after less than four years' investment in the central bank shares – or whether private banks are the owners of the central bank as is still the case in the US, almost as much of the profits of the central bank finds its way back to the government – in the latter case as in view of the legal tradition of the ancestral sovereign's monopoly in the coining of precious metals – almost all the interest paid by the government on its loans from the central bank came back to the federal government – "seigniorage."

Relapsing into the Bad Habits that Brought On the Depression

It was only when the private banks were deregulated and allowed to take over stock brokerages, and the other private pillars – mortgage companies insurance – that the banks relapsed in the speculative high-jinx that had contributed to bringing on the Depression of the thirties.

From that period on – the takeover of the Savings and Loans in the US during the 1980s the banks lost heavily, and the government ransacked its social programs to fund the bank bailouts. Thus much of the planning of the off-book accountancy scams that brought down Enron led to our Canadian Bank of Commerce settling out of court the class action of Enron shareholders to the tune of $2.4 US million – part of which, however, was directly absorbed by the federal government as a recognized loss for tax purposes! The losses during high tech stock market bust in 2000 that humbled Nortel were of a similar order. And to restore the banks to replace the capital that they lost repeatedly, the Bank for International Settlements in 1998 brought in its *Risk-Based Bank Capital Requirements* in 1988, that declared the debt of developed countries risk-free and thus available to the banks to acquire without down-payment. In this way the Canadian banks increased their holdings of Canadian government debt by 300% from some $20 billion to $80B, at the same time that the same BIS was pushing interest rates towards the skies "to lick inflation." Whereas the Bank of Canada had held government debt of the federal government at a near zero net cost, the federal government beginning with the 1988 switched the bulk of its deposits to the reserves and borrowing to the private banks

All this as well as the current subprime

Our Pawnshop Economy

The Wall Street Journal cannot afford to be left too far behind in displaying a gift for skeptical prying demanded by the collapse of official economic policy. In its issue of 25/03 "There's More Life in This Bear" by David Gaffen we encounter this bit of enlightening irreverence: "Apparently there are two lenders of the last resort. The Federal Reserve is one. Pawn shops are the other. While banking giants access the Fed's discount window, publicly traded Cash America International Inc., a pawn-shop chain, boosted its first-quarter earnings estimate Monday, in part because of difficult economic times are hurting consumers' ability to borrow money.

"What Cash America does isn't much different from what the Fed does. Both, in a sense, engage in repurchasing agreements, in which a borrower pledges collateral, which later is bought back by the borrowers.

"No word whether the Fed is considering expanding the collateral it will accept to include watches, gold clubs, or trophies."

The reference is that central banks in Canada, the US and pretty well all over the non-Communist world, confined the security they would accept to permit them to expand their marketing of government bonds and other securities in legal tender. It was in this way that the Bank of Canada struggled to set up a race of bond traders who came to control the economy. What is central to central bank financing these days are the gambling tools that have gotten the banks and the economy into major troubles.

This also, of course, further pollutes the role of the central banks in financing virtual infrastructure – physical and human – on a virtual zero-interest cost to the federal government. Loading up the central banks with speculative derivative swaps hides further this crucial historical role of central banks. that is so crucial for getting the world out of its present monetary mess.

W.K.

mortgage breakdown would have been impossible if our banks had been kept confined to banking as they were to finance WW II and the highly successful reconstruction of the first two decades of the postwar.

All this – the most successful stretch of our history – has been wiped out from the history texts, our university courses in history and economics.

There is no way of recounting let alone setting aright the subprime mortgage curse that had taken over our economy without including its real origins. A fair beginning has in recent months forced its way into the news and editorial columns of our leading newspapers. But that is but the whiskers of the tale that must be told before we can claim to become functioning democracies again.

Canada's Bank of Canada Act Still on the Books but Disregarded

In Canada to add to the burden of our national disgrace, we still have in our law books but completely disregarded, the *Bank of Canada Act* that sets out the amount of funded and unfunded debt that the Bank of Canada can lend the federal government (subsections 18(c) and 18(k)), the provinces, and the municipalities. The municipalities – as "corporations" can borrow from the Bank of Canada, but for that they require the guarantee of either the federal government or of a province. The resulting dividend flow, of course, would be directed to the federal government, which has been the sole shareholder of the central bank since 1938. However, given the massive downloading of social programs from the federal government to the provinces and from the provinces to the municipalities – who are ultimately left holding the bag – negotiated agreements can and must be reached whereby adequate funds are assigned to the proper level of government to support the programs assigned to them.

To track and understand how the subprime plague has overrun the world, we must check the soundness of the logic taught in our universities today.

A central point of the subprime nightmare, is the notion of "inflation" which is used as a synonym for any rise in the price level. But whereas it is true that an excess of demand over supply will push up prices, one cannot reverse that or any other proposition where more than two independent variables are involved. Thus from the proposition that if a man hold a loaded trigger to his head and pulls the trigger, he falls dead. However, such propositions are not reversible precisely because there are more than two independent variables involved. In addition factor "gun" and factor "death," there could be "heart trouble." That at once invalidates simply reversing the proposition to run: a man fell dead hence he must have shot himself in the head. It could well have been that he fell dead because of a heart attack, having nothing to do with a gun. Or a scant million other independent possible. causes of mortality.

Likewise, prices may go up because society is rapidly becoming urbanized, and nobody – not even economists – who moves from a town of 20,000 to New York City expects their living costs to remain the same. You can of course – as economists did with great aplomb – box off environment, education, health as "externalities." But that just hastens the day when the multiple neglected independent variables run amok as they have with our debt management and banking and money supply today.

Until 1996 the American government wrote off its physical investments in the year they were constructed and financed and thereafter carried them on its books at a token dollar. However, after the Bank for International Settlements – a sort of war room for the banks' comeback to their deregulated glories of the 1920s – brought in its *Risk-Based Bank Capital Requirements* in 1988, which allowed the banks to load up with government debt in developed countries without any down-payment, the same BIS launched a campaign for immediate zero inflation, pushing up interest rates as the sole remaining means of attaining a perfectly flat price level. (The alternative to high benchmark interest rates – the statutory reserves had required the redeposit by the Banks of a adjustable portion of time deposits with the central bank on an interest-free basis. But in their complete mental seclusion the BIS Manager of the day Alexandre Lamfalussy and all the central bankers he had gather around his knees overlooked a detail: when interest rates go up, the market value of preexistent bonds with lower coupons goes down. And that happened in spades in 1994. To save a collapse of the world monetary system the US, the IMF and Canada got together a 51 billion dollar standby fund. But President Clinton's Secretary Treasurer of the day, Robert Rubin, realized that the day of sky-high interest rates, as in the days of Paul Volcker in the US and John Crow in Canada, were over. So he brought in something that a long line of auditors had pressured for in vain – accrual accountancy. For up to then the American and Canadian governments and indeed most central banks throughout the world while depreciating the cost of the capital assets acquired or built by the government, instead of amortizing their cost over a similar period, wrote off in a single year, and thereafter carried it on their books at a token one dollar. The advantages of that were numerous for those given to speculative gambles, or milking governments. For they showed a deficit that was not necessarily there. It also provided a false benchmark cost for privatizations. Canada followed suite and brought in such accrual accountancy beginning in 2002.

Cooking the Government Books

But that still left an even more important correction that awaits being made with human capital investments by the government. In the 1960s Theodore Schultz was awarded the Peace Prize of the Bank of Sweden for having reconsidered the faulty conclusion of himself and hundreds of other US economists sent to Japan and Germany, and by Washington, about how long it would be before the defeated powers could regain their prior export prowess. In the 1960s Schultz explained why he and his colleagues were so wide of the mark: they had concentrated on the physical destruction in the two defeated countries and overlooked that their highly educated and disciplines labour force had come out of the war essentially intact. From this he concluded that education and training are the most productive investment a government can make. Today the name of Schultz is forgotten as are his teachings.

As taught in our universities today economics is a highly misleading discipline Only since the subprime mess has taken over have outstanding newspapers started dealing with the troubles that are catching up with economists and their current beliefs.

Elsewhere in this issue I deal with the confusion caused between the essence of legal tender (today which is the debt of governments of developed countries) and private-sector debt. Both are assigned a negative sign, a particularly big and black one before the debt of the government. In actual fact that should have a positive sign because since 1971 it has replaced gold as the only legal tender that exists. Inflationary? Not in the least, since behind that debt stands every asset and the entire work force and its skills and education, and the cultural heritage, that is the basis for society's productivity and of its hope for survival.

William Krehm

Reviewing National Credit Institutions Requires Our Suppressed Financial History

Another article in the 11/03 issue of *The Wall Street Journal,* "US, However, to Revamp Credit Rules, Drawing from Crisis Lessons," has as author Damian Paletta, but it does not dig very deep.

"Washington – The nation's top economic policy makers plan to release today their broadcast blueprint for avoiding a recurrence of the credit crunch now threatening the economy.

"Their recommendations extend to nearly every niche in the credit markets – from mortgage brokers to Wall Street firms that package home loans into securities, to the credit-rating firms that assess the risk of those securities, to the regulators who police the system.

"Amid the housing market's deepening slump, mounting defaults by cash-strapped home-owners and an upswing in foreclosures have made investors wary of mortgage-linked securities and have made those securities increasingly difficult to value and trade. That has led to turmoil in global financial markets.

"We aren't singling out any group of market participants because there were mistakes made by all, including regulators, Treasury secretary Henry Paulson said in an interview yesterday. [It was] a day in which the stock market's euphoria over the Fed's latest initiative aimed at freeing up the flow of credit gave way to some caution.

"The Dow Jones Industrial Average shed 45.67 points to close at 12110.24, giving up gains as oil prices rose again. Oil ended the day up $1.17 to $109.92 in New York Mercantile Exchange trading. The dollar weakened. But the gap between mortgage-backed securities and US Treasury yields narrowed, as the Fed hoped they would.

"'Regulation needs to catch up with innovation and help restore investor confidence,' Mr. Paulson is planning to say today in a speech at the National Press Club here, but not to go so far as to create new problems, make our markets less efficient or cut off credit to those who need it.

"Mr. Paulson told *The Wall Street Journal* that the recommendations of the President's Working Group on Financial Markets, which he leads, include strengthening state and federal oversight of mortgage lenders and brokers. The group will also recommend implementing what he termed strong nation-wide licensing standards for mortgage brokers, a move that will probably require legislation.

"The group also will propose directing credit-rating firms and regulators to differentiate between ratings on complex structured products and conventional bonds; to disclose conflicts of interest and details of their reviews; to do more scrutiny of outfits that originate loans that are enveloped by various securities and if issued.

"And the panel will urge global bank regulators to revisit the latest version of bank capital requirements, known as Basel II for the Swiss city where they were negotiated, so that banks that take risks will hold sufficient capital, and refine standards of how banks manage liquidity."

The Miracle of Basel — The BIS from Candidate for Liquidation Becomes Boss of Banks' Comeback

There is enough about that Swiss city, Basel, to warrant Mr. Paulson pausing a bit over the background of Basel 1 and the institution that conceived it. Elsewhere COMER has repeated countless times the story of the Bank for International Settlements' origins. I will do it once more so that readers may grasp what happened to Basel 1 and why it was belatedly recognized to have it replaced by Basel II. The Bank for International Settlements was originally set up as a way to settle finally the problems of reparations that Germany was to pay France and Belgium for having smashed up the North Eastern portion of France and much of Belgium in WW I. Germany claimed that she could only pay in her own currency, because the French would not allow her to earn those reparations by sending German labour into France and Belgium to do the work. The French and Belgians turned that down, because they wanted the work for their unemployed and the profits of reconstruction for their businesses.

So the Bank of International Settlements was set up to receive the reparations in German marks and syndicate them into a stronger currency. In any case, the crash of October 1929, reduced all these reckonings to a pipe dream. BIS lingered on, with no clear purpose, but when the Nazi armies invaded Czechoslovakia, it surrendered to the Nazis a portion of the Czechoslovak gold reserves that the Prague government had entrusted to it for safekeeping as soon as they entered Prague.

And because of that at the Bretton Woods Conference held in 1944 to plan the postwar monetary system, Resolution Five moved by the Norwegian government-in-exile, called for the liquidation of the BIS at the first possible moment. As a result BIS in subsequent years cultivated the lowest possible profile hoping that the Allied powers would have forgotten about the existence of Resolution Five.

However, things did not work out that way. During WWII most of the Allied governments had promised their fighting forces a very different world from that of the Great Depression. But by the end of the war, the banks, after having been restricted to banking since 1933 and forbidden to acquire interest over the "other financial pillars," had regained their confidence and a bit more. They began to lust after to their glories of the 1920s, when they had been able to gamble their clients' savings in loans and partnership with corrupt Latin American dictators.

However, their past glories of pre-Depression had to be conducted outside existing governments and even against them. And a need arose for a low-profile institution that would serve as war room for the bankers' comeback. The BIS answered those specifications to perfection, because it had avoided the limelight in the hope that Resolution 5 of Bretton Woods would be forgotten. No elected official of government was allowed to attend its regular sessions. It became strictly a central bankers' club. The document mentions Basel 2 that dealt with the capital that banks were required to hold. Significantly there is no mention of Basel 1. This, also dealing on the capitalization of banks, declared the debt of developed countries "risk-free" and hence requiring no down-payment for banks to hold. All they had to do was clip the coupons.

And of course, that was supplemented with the phasing out of the statutory reserves, a portion of the deposits taken in by the banks from the public that they had to deposit with the central banks which could

be altered rather than the benchmark interest rates to accelerate investment or slacken it. On these the statutory reserves the banks earned no interest, since the payment of interest would decrease the leverage of this control of the pace in the business world would decrease the effectiveness of this important alternative to using the benchmark interest rates to encourage or slacken investment.

Basel 2 was a slackening of Basel 1 that allowed the banks piling up government bonds without putting up a penny of their own. But it is amazing that so much that came dreadfully close to the essence of what was up to now kept secret for so many years has now been recounted in a business publication. We have still to hear the Greens or the NDP pick up this crucial tale.

A Fiction Stretched Thin Enough to Become Transparent

There are further implications than the belief that if you leave it all to the good old market, the economy will take care of itself and of society too in the bargain. Of course, that was obviously not the case, but so long as the victims were the unemployed, the underpaid, those in the saddle with good and fine leather and horseflesh beneath them, the arrangement was declared ideal. Their one concern was that the self-balancing market be given enough freedom.

And now this assurance of perfect bliss and prosperity has blown up. The evidence in bits and pieces is scattered on the front pages of the business press. Thus in *The Wall Street Journal* (1-2 March, "Beware of Fannie's Help"): "Remember Ninja mortgages – no income, no job, no assets? And 'liar loans' 'with no check of borrowers' stated income? It all seemed so amusing in a slightly ribald way. No longer. The dangerous process of unbridled growth has put a question mark over the mighty banking system that seemed so capable of running over whatever got in its path.

"[Now] Staid old Fannie Mae and Freddie Mac, the US mortgage titans were supposed to have shunned such subprime excesses. Maybe they did. But Fanny seems to be going out on a similar lending limb.

"The company is offering borrowers who are behind with mortgage payments as much as $15,000 each to clear their arrears. The money comes – get this – as a 15-year unsecured personal loan. And 'verbal confirmation of financial capacity' is considered acceptable. To be fair, there are a few other criteria and it's billed as a way to help homeowners over a bump. But Fannie may benefit the most.

"[Fannie May and Freddie Mac] were originally government mortgage agencies, but have long been independent private corporate agencies that acquire mortgages to release the funds tied up in already sold houses to become available for financing new batches of homes. Over the agencies floats the impression that if one or the other got into trouble, the government would come to their assistance because of their original official government-controlled status. As the subprime mortgages mess is developing that impression is likely to be put to the test. Or, otherwise phrased, their qualification style anticipated the entire subprime mortgage mess, and how the state would once again be drawn into cleaning up the mess of speculative capital.

"For Fannie, the 'Homesaver Advance' program should help reduce the need to modify mortgage loans formally, a complicated and expensive process, and to foreclose, a bad result all around. But as it happens it will also reduce the number of delinquent loans Fannie buys back from the pool underlying mortgage-backed securities that it guarantees and the related losses it would otherwise have to take.

"For borrowers, Fannie says the program is a way to 'bring delinquent mortgages current and keep their homes.' That's true, provided they can afford the regular payments on their mortgages and those on the new loans, which kick in after six months. That may be fine for borrowers in truly temporary difficulty. But in the longer term, it's going to increase their debt burden."

In a sense the resulting prospect of the assisted parties calls to mind the lot of a Third World country finding itself at the mercy of the International Monetary Fund that by manipulating interest rates and due dates, sets the life style of entire countries via its manipulation of interest rates and due dates of debt.

"The program might also upset investors in the company's MBS instruments. They like the idea that Fanny must buy back troubled individual mortgages under certain conditions. If Homesaver Advance makes formerly delinquent loans look pristine, even though the borrowers are still struggling, it undermines that comfort.

"Overall, it could be Fannie that stands

Bringing Swaps into the Central Bank's Money-creation Process

The New York Times (30/03, "In Treasury Plan, a Reluctant Eye Over Wall Street" by Nelson D. Schwartz and Floyd Norris) sums up what is the Washington government's work: "The plan hands vast new authority to the Federal Reserve, doing virtually nothing to regulate the many new financial products whose unwise use has been a culprit in the current financial crisis.

"The plan hands vast new authority to the Federal Reserve, essentially formalizing what has been an improvised process over the last three weeks. But some fear that the central bank's role in creating the present mess, will undercut its ability to clean it up."

What is fatal in that summary is that it obscures and interferes what is a simple equivalence: since 1971, when the US abandoned the gold standard. debt of the federal government spent into existence and hence non-interest-bearing is the only legal tender in the land.

The use of the term "equivalence" rules out all other modifying dependence and influences except the greater or less availability of such money-creation.

Let me compare what would happen if such other factors would be inserted into physical relationships in engineering. Suppose when you were putting a furnace, instead of burning fuel (no matter whether coal, gas or oil), you inserted a swap with ice company down the road that substituted ice blocks for fuel.

Or in a massive refrigerator for conserving food, you introduced a swap trading ice for oil consumption, would it work?.

I trust there can be no disagreement. It would not. Well that is the exact equivalent of burdening the Federal Reserve in its virtual interest-free powers of money-creation with powers over other "products." The fact that there has been such a profusion of "new product" to "strengthen" the powers of the Fed suggests that the lobbyists have even stepped up their activities. The writers of the *Times* piece allude to that.

Spend a few moment to assimilate the point – when we are considering messing up the one central purpose of the Federal Reserve.

William Krehm

to reap the clearest benefits, at least in the short term. The company isn't saying how big the program might get. But bruised shareholders – and US taxpayers, who are implicitly on the hook – might wonder whether a collection of unsecured loans to overstretched borrowers could before long become a bit of a millstone."

"Far-out-of-the-money options are the bane of Wall Street. They offer revenue with very little chance of loss in normal circumstances. But if the market moves in favour of those who buy them, they can wipe out the firm who sold them. Traders found to be writing far out of the money puts are usually shown the door. It seems a bit odd that a firing offense on Wall Street has become one of the insurance industry's principal business strategies.

"Insurers say they are experts at managing just this sort of severely low-probability risk. They argue that insuring against floods, hurricanes and earthquakes has given them peerless expertise in managing it. "But since there is no market to acts of nature, insuring against them can not be modeled statistically, and the behaviour of complex finance instruments packed with assets that have little historical performance data, which frequently confounds statisticians.

"AIG isn't alone in falling for this false analogy between natural disasters and social catastrophes. And to its credit, the company pulled back from insuring structured finance collateralized debt obligations in late 2005, when underwriting standards for mortgages started plummeting. Still, the insurer has discovered that derivatives can be more destructive than hurricanes – at least to its earnings."

A day may yet come when the brightest and best on Wall Street will discover the deep insight of John Maynard Keynes who questioned when in such ever rigged markets, you can find in the statistics of the financial riggings of the past, the key to foretelling the riggings of the future. Even if it does pass under the title of the "self-balancing market."

W.K.

There is this about philosophical reflection. Even when pointed at the stars, once begun it increases its momentum, and before we know it – under the extraordinary circumstances that are upon us – it picks up depths and insights that before the present tangle of crises you would, certainly in recent years, search for in vain at a convention of academic economists.

The WSJ column cited, published courtesy of the most appropriately named breakingviews.com over the signatures of Richard Beales and Dwight Cass, goes on to even more startling conclusions. Here and there, economists' wits seems for the first time in almost a half century to be shaken up.

Our occasional commentary is in square brackets.

AIG's "Put" Problem

AIG is a huge international insurance trust, with a subsidiary specializing in mortgage insurance.

"American International Group calls the credit derivatives in the portfolio it just marked down by $11.2 billion "out of the money puts." [A "put" is the right to have somebody buy an asset, clearly when the market for it has dropped. The put has been purchased but the purchaser cuts his loss because of the right he has paid for selling it at his option at a predetermined price. In insuring mortgages that, mingled, by supposedly "risk managed" bits and pieces with other financial assets, the insurance can take the form of "puts" if the mortgage batch that he is insuring falls through the floor. In that case insurer cuts his loss by opting to sell the insured assets at the predetermined low price. If the value of the insured asset should move upward, he stays with it for his greater profit.]

"'Out-of-the-money puts' is an apt description. They guarantee the super-senior, or ostensibly the safest slices of collateralized debt obligations like 'put' options that only become valuable when the price underlying security declines sharply. It's very unlikely that AIG will have to pay out on these credit derivatives.

Bomb *continued from page 1*

"The Fed's intervention highlights the problems regulators face as they contemplate the prospect that investment banks saddled with toxic securities tied to subprime mortgages, are losing the trust of their lenders and clients – the kiss of death on Wall Street, where confidence has always been the most precious asset of all.

"Traditionally regulators have helped commercial banks in financial panics, but not investment banks, which do not hold customer deposits. But the 1999 repeal of the *Glass-Steagall Act*, the Depression-era law that separated investment banks and commercial banks, led to consolidation within the financial industry that has made such distinctions hard to make."

(This refers to the phasing out of the statutory reserves that banks had to redeposit with the central bank of a changeable portion of the deposits they took in from the public. This provided, amongst much else, an alternative to altering the benchmark interest rates to encourage expansion or restraining of the economy.)

"I don't remember a Fed action aimed at a non-commercial bank; this is the kind of thing you see in this post-regulatory environment, said Charles Geisst, a Wall Street historian at Manhattan College." (This likewise alludes to the deregulation of the banks that made subprime mortgage lending an irresistible way of speeding up the expansion of the economy.)

"The developments represent a devastating blow to Bear Stearns, which has carved a niche by mastering the financial arena of the mortgage market. But after two of its hedge funds that specialized in the subprime mortgage market collapsed last summer, Bear Stearns's area of strength became a millstone.

"As the smallest of the major Wall Street banks, Bear Stearns disdained the big bets that its larger competitors made and shied away from trendy markets like Internet stocks in the 1990s.

"But its core mortgage business flourished during the housing boom from 2003 to 2006. The demise of the hedge funds began a slow but persistent loss of market confidence in the bank. Such an erosion can be devastating for any investment bank especially which has a leverage ratio of over 30 to one, meaning it borrows more than 30 times the value of its $11 billion equity basis."

That in turn is, of course, a by-product of the deregulation of banks that allows them to acquire interests in the non-banking pillars – stock brokers, insurance, and mortgages – and gives them access to the cash reserves set aside in these non-banking pillars for the needs of their own businesses. That becomes translated into ever higher leverages in a financial sector that must go on expanding ever more rapidly.

It is significant how much of this basic material is starting to seep into the major business and general press. On the crucial knowledge that is finding the means of getting through, the future of our society depends.

William Krehm

Nothing Like a Bit of History for Tying Cause and Effect Together

For more years than I care to count COMER has emphasized the great political divide when our banks that had brought on the Great Depression of the 1930s by abusing the powers of legitimate banking. They lent out somewhere around 10 times the amount of legal tender in their vaults to acquire control of the other financial pillars – stock brokerages, insurance and mortgage corporations, and in that way acquired control of the cash reserves these firms kept for the need of their own businesses. And once in control of these legal tender reserves, they could use them as the base for applying the bank multiplier not once more but in infinite series. Lending out bookkeeping entries of indebtedness, they lost no time in acquiring still other non-banking institutions for repeating the same game. In no time flat, of course, they got themselves and the economy into trouble. But since they had picked up political power in the process, that not only allowed but necessitated them speeding up the process. At that point the purely speculative use of banking started backing up, because the stock brokerages, mortgage and insurance companies would find themselves without the liquid legal tender resources essential for their own businesses. There was no way that the process could be stopped or reversed. It could only be sped up, until only the military option remained to resort to. The media, parliament, the economic faculties of our universities has been carefully purged of any information of what was afoot, until it had reached disastrous proportions.

History treated in that way, develops a venomous bite. Learn what she has to teach us, and she will be as a caring mother. Treat here as a street-walker and sell her to the highest bidder, and she will she wreak her cruelest vengeance.

From all indications, we have reached that stage once again as in 1929.

RENEW TODAY!
(SEE PAGE 2)

Gretchen Morgenson, writing in *The New York Times* ("Rescue Me: a Fed Bailout Crosses a Line") sounds more than a little like COMER has for some decades now, warning sealed ears where the misuse of our central banks for bailing out the abusive banks was leading in Canada, the US and the world: "What are the consequences when regulators of a world in which regulators rescue even the financial institutions whose recklessness and greed helped create the titanic credit mess we are in? Will the consequences be an even weaker currency, rampant inflation, a continuation of the slow bleed that we have witnessed at banks brokerage firms for the past year?

"Or all of the above?

"Stick around, because we'll soon find out and it's not going to be pretty.

"Agreeing to guarantee a 28-day credit line to Bear Stearns, by way of JPMorgan Chase, the Federal Reserve Bank of New York conceded last Friday that no sizable firm with a book of mortgage securities or loans out to mortgage issuers could be allowed to fail right now. It was the most explicit sign yet of the Fed's 'Rescues' "R" Us' doctrine that already helped to force the marriage of Bank of America and Countrywide."

Why the Bear Had to be Saved

"But why save Bear Stearns? The beneficiary of this bailout, remember, has often operated in the gray areas of Wall Street and with an aggressive, brass-knuckles approach. Until regulators came along in 1996, Bear Stearns was happy to provide its balance sheet and imprimatur to bucket-shop brokerages like Stratton Oakmont and A.R. Baron, clearing dubious stock trades.

"And as one of the biggest players in the mortgage players on Wall Street, Bear provided munificent lines of credit to public-spirited subprime lenders like New Century (now bankrupt). It is also the owner of EMC Mortgage Servicing, one of the most aggressive subprime mortgage servicers anywhere.

"Bear's default rates on so-called Alt-A mortgages that it underwrote also indicate that its lending practices were essentially lax during the real estate boom. As of February, according to Bloomberg data, 15% of these loans in its underwritten securities were delinquent by more than 60 days or in foreclosure. That compares with an industry average of 8.4%.

"Let's not forget that Bear Stearns lost billions for its clients last summer, when two hedge funds investing heavily in mortgage securities collapsed. And the firm tried to dump toxic mortgages securities it held in its own vaults onto the public last summer in an initial public offering of a financial company called Everquest Financial. Thankfully that never got done.

"Recall, too, that in 1998, when the Long Term Capital Management hedge fund required a Fed-arranged bailout, Bear Stearns refused to join the rescue effort."

A Bailout Nation

"And so, Bear Stearns, a firm that some say is this decade's version of Drexel Burnham Lambert, the 'anything goes,' 1980s junk-bond shop dominated by Michael Milken, is rescued. Almost two decades ago, Drexel was left to die. 'Why not set an example of Bear Stearns, the guys who have this record of dog-eat-dog?' asked William A. Fleckenstein, president of Fleckenstein in Issaquah, Wash., and co-author with Fred Sheehan of *Greenspan's Bubbles: The Age of Ignorance at the Federal Reserve.* 'We are Bailout Nation…. After years of never allowing any of our financial institutions to fail, they have become so enormous that no one will be allowed to sink beneath the waves. Otherwise, a tsunami would swamp the hedge funds, banks and other brokerage firms that remain afloat.'

"If Bear Stearns failed, for example, it would result in a wholesale dumping of mortgage securities and other assets onto market that is frozen and buyers are in hiding. The fire sale would force surviving institutions carrying the same types of securities on their books to mark down their positions, generating more margin calls and creating more failures.

"As of last November 30 Bear Stearns had on its books approximately $46 billion of mortgages, mortgage-backed and asset-backed securities. Jettisoning such a portfolio onto a mortgage market that isn't operative can be a disaster.

"But who knows what those mortgages are really worth? According to Bear Stearns' annual report, $20 billion of them were valued using computer models 'derived from' or 'supported by' some kind of observable market. The value of the remaining $17 billion is an estimate based on 'internally developed models or methodologies utiliz-

ing significant inputs that are generally less readily observable.' In other word your guess is as good as mine.

"To some extent, what happened at Bear, of course, was a classic run on the bank. As fears about Bear's financial position heightened, its customers began demanding their cash and big hedge funds that were using that were using the firm as an administrative back office or lender moved their accounts elsewhere.

"In addition, institutions that had bought credit default swaps from Bear Stearns, insurance that protect against corporate bond defaults, were straining to undo those trades as the firm's ability to pay the claims looked dicier."

"For the government to print money at the expense of taxpayers as opposed to requiring or going about a receivership of any insolvent institution should be troubling to taxpayers and regulators alike.

Crossing the Line

"In the words of Graham Fisher & Company, an expert of mortgage securities, 'The Fed has now crossed the line in a very clear way on "moral hazard." They have opened the door to the view that they are required to save almost any institution through non-recourse loans – except the government doesn't have the money and it destroys the US's reputation as the broadest, deepest, most transparent and properly regulated capital market in the world.'"

It need only be remembered that when the International Monetary Fund was set up, the US alone was on the gold standard, and the other countries were on the US dollar standard. It was only US dollars that other countries could borrow from the IMF and they had to repay to it on blistering terms.

What effect a few relatively minor wars can have on the greatest of powers! How many well-capitalized institutions remain at the ready to take over those firms that encounter turbulence in the future? Banks just do not have the capital needed to rescue troubled firms.

W.K.

Protect Our Legal Tender — Money Spent by Government into Existence for Essential Public Investment is Clean of the Subprime Mess!

In its coverage of the subprime mess and the Federal Reserve's attempts to resolve it, *The New York Times* has done some fine reporting. It has even got to the very brink of what could be the ultimate disastrous improvisation. That is why we must clearly define what all this involves.

All serious monetary reform recognizes that the ultimate legal tender is the debt of a central government *spent*, *not loaned*, into existence, and hence bearing no interest. That is the case with the paper or bookkeeping entries with which modern governments pay their debts. The process is backed not only by the taxing powers of the government, but by its natural resources, the talents and education of its population, the current productive powers of the nation and those that can be developed. All that is available to a modern government without paying interest to anyone. The main purpose of selling bonds during an emergency is to absorb purchasing power when there may be too much of it, during a national emergency such as a war. All this was realized and made use of, not only to get the world out of the Great Depression of the 1930s, but in financing WWII and the 20-odd years of so of the reconstruction after WWII. To make that possible, since 1933 until the 1960s. the banks were not allowed to acquire interests in what were called the "other financial pillars" – stock brokerages, insurance and mortgage corporations. For each of these maintained a reserve of liquidity – legal tender – or short-term debt readily convertible into cash for the purposes of the companies own businesses. Allow the banks to get their hands on these reserves and they will use them as monetary base for their own near-money creation, i.e., interest-bearing debt that will vary inversely as interest rates move up or down.

In its article of March 16, *The New York Times* ("Fed Chief Shifts Path, Inventing Policy in Crisis" by Edmund L. Andrews) come close to the dangerous implications of this: "Washington – As chairman of the Federal Reserve, Ben S. Bernanke has long argued that a central bank should base its policies as much as possible on consistent principles rather than on seat-of-the-pants judgment.

"'Modern monetary policy-making puts a lot of weight on rules, but there is no rule-book for an economic crisis,' said Douglas W. Elmendorf, a senior fellow of the Brooking Institution and a former Fed economist."

Fed Tosses Out the Rule Book

"On Friday, the Federal Reserve seemed to toss out the rule book altogether when it assumed the role of white knight, temporarily bailing out Bear Stearns, with a short-term loan to help avoid a collapse that might send other dominoes falling.

"That came just days after the Federal Reserve seemed to toss out the rule book altogether: it assumed the role of white knight temporarily bailing out Bear Stearns, one of Wall Street's biggest firms, with a short-term loan to help avoid a collapse that might send other dominoes falling.

"The move came just days before the Fed announced a $200 billion lending program for investment banks and a $100 billion credit for banks and thrifts. In a move that would have been unthinkable until recently, the central bank agreed to accept potentially risky mortgage-backed securities as collateral."

We need go no further. Such a step puts in jeopardy the most productive policy that a government and a central bank can pursue – to make full use for the proper near-interest free legal tender spent not lent into existence by the investments – physical, social and environmental – spent interest-free, rather than loaned into existence by our banks to the government and private citizens alike. Moreover, government-created money is being put into a dependence on subprime mortgages and the status of dependence of collateral debt obligations. Of the high, degrading costs of these, we have not heard the last.

Now is the time to blow the whistle, clear and loud. The swindle of the deregulated, globalized control of the world by our speculative banks has brought the world to the brink of an economic collapse. This could and should bring us a renewed grasp of our economic history.

William Krehm

A Critical Look at Risk-taking as It is being Practised by our Bankers

We live in a period that is particularly not only prone, but dedicated to risk-taking. But for that approach to yield serious results it must begin with a serious definition of what risk is about. If we had perfectly shaped cubes of some homogenous substance, we could shake them in some container and on tossing them we could be fairly certain that one of the six faces would stand an equal chance of ending up on the top. The chances of that occurring for any particular cube face would be $^1/_6$. But if we erred in our counting of the faces the weight distribution within each cube, a greater probability would arise of one surface ending up on the top than the others. But in our imaginary counting of the faces to arrive at the risk, if our mind slipped and we used 5 instead of 6 as the denominator of the risk proportion, that would not be true risk or any risk, it would simply be an error in my imaginary counting of surfaces and mass distribution. *Correct risk calculation thus must take for granted a correct preliminary analysis.*

The risk must be based on a preliminary analysis of what is open to risk-taking, and what is not.

The Globe and Mail (23/02, "The guys who had a gut feeling for risk" by Boyd Erman and Derek DeCloet) put the dice on the table on which they propose to try out their sense of risk: "Risk has a price, just like anything else. For the right return, people will take almost any chance." Would that include that the cubes to be shaken and tossed had only five faces rather than six? Obviously not. That would violate the rules of fair gaming, and would result in some employee at least, high or low, being fired by the casino.

Mistaking Bad Analysis for Risk-taking

But let us stay with the article's definition a bit longer: "Until last summer, as the economy and credit markets boomed, investors were clamouring for risk-taking on more and more for less in return. Optimism ruled. The most tangible result was that market interest rates dove to record lows relative to government bonds, with even risky products such as junk bonds earning investors a scant premium to 'risk free' debt such as Treasury bills."

But what the bet was about was that interest rates would stay more or less constant so that the prevailing interest rates in the commercial world would not diverge too sharply from what they had been. But there were two wars on in Afghanistan and Iraq, bogging down in inconclusiveness even in their second decade. Interest rates were regarded as determined by the price level, and the price level in turn by the balance of supply and demand. And our banks had been allowed to take over the other financial pillars – mortgages, stock brokerages, and insurance corporations which had been forbidden them under President Roosevelt in

Could Banks Actually be Retreating to Banking?

You might actually get the impression that banks were taking our advice – to say nothing of F.D. Roosevelt's banking legislation of an earlier day and retreating from the other financial pillars. Thus *The Wall Street Journal* (11/03, "Grim Reaper of Jobs Stalks the Street" by Gregory Zuckerman and Peter A. Mackay) reports: "The Bankers' resumes are streaming into Wall Street recruiting company Opinions Group. On average, 100 are arriving each day. Three of them will lead to jobs.

"While Wall St. CEOs talk calmly about 'normal attrition,' the people in the trenches know the score. Big, painful firings are coming their way. Lehman Brothers Holdings chopped 5% of its employees yesterday. Many say privately industry layoffs will be worse than in the 2001-2 down cycle. Others are already invoking the early 1900s. The irony is that the process reinforces the very cycles that the Street is trying to prevent. An investment banker fearful of being fired in a downturn will furiously harvest cash when times are good. That creates a lot of dangerous incentives along the way, as bankers focus on short-term profits while neglecting long-term risks.

"In the meantime, the industry is going to eat itself. A passel of top Wall Street executives foresee layoffs as high as 30% for Wall St., which employs about 210,000 in NY State. If the layoffs are that severe, the job rolls would plunge to levels of the mid-1950s. US investment-banking fees are off 48% from the year-earlier period, according to Dealogic. Bankers' lending revenues have fallen a stunning 84%, merger work is off by half, and debt and equity levels are each off by 21%. Some bankers in the lending business are reporting to work two days a week. 'If they say they're busy, they're lying,' said one head of investment banking.

"Yet the numbers don't describe the full picture. Easy credit via bank loans, high-yield bonds and asset-based securities nourished the investment-banking ecosystem. A $10 billion dollar private-equity deal might beget $40 million in advisory revenue, plus $70 million in bank-lending fees for loans against real estate. That might create an IPO [initial public offering] two years down the line, generating an additional $60 million.

"Poof. That's gone. For seven months, Wall Street has been in denial about the task ahead, The expectation that the markets would clear by the spring or summer. And even if they didn't, it would be foolish to slash a work force before the inevitable recovery. But the longer the wait, the worse the news gets. Blackstone Group said yesterday that the credit mess wouldn't ease until next year. But during the dot.com bust of 2000 to 2003, New York State securities employment dropped by some 18%, and Banks weren't begging sheiks for capital back then. Today they're so strapped they are making margin calls on their best clients.

"Who is most likely to get the ax? A group of investment banking heads described their strategies, which generally consisted of saving 'coverage platforms' and jettisoning some of the banks' technical experts. That's Streetspeak for keeping the bankers with the best personal relationships, while booting the wonkiest types who actually execute the transactions."

W.K.

the 1930s. The reason for that was that once they are allowed to do that they will have access to the cash reserves of these other financial pillars. As a result they can use them as cash base to which to apply what used to be called the "bank multiplier." That referred to the increased ratio of loans the bank can make – with the only requirement under the definition of banking that they are able to honour every cheque or other claim drawn on a chequing account. If they manage that they are in clover as bankers. But if they should prove unable to do so a single time, there could be a run not only on the one bank, but on every bank in the land. And since our economies and banking systems have become deregulated and globalized, that would bring with it a real risk that it could produce runs on banks in other countries as well…. That could bring the skyscrapers of trust created by Deregulation and Globalization, tumbling down. As a matter of fact that is exactly what has been happening for at least a half year.

These are the equivalents to the banking risk corresponding to those of tossing a perfect cube and guessing which of the six sides is likely to turn out facing upward.

The *G&M* article cited leads us further into the mysteries of risk: "As markets flourished, financial institutions poured vast intellectual and electronic resources into creating fancy new products such as collateral debt obligations (CDOs). At the same time in a parallel universe also populated by PhDs and supercomputers, risk managers used statistical models in hopes of simulating what sudden market moves would do to the value of those securities and derivatives.

"Banks reeling from the massive losses are coming to realize that two of their key tenets of risk management – diversification and dependence on 'the normal distribution of events' – have been weighed in the balance of the credit crisis and found wanting."

With Globalization and Deregulation, the World Marches in Step

Surely the degree of non-diversification that this would seem to suggest has something to do with that unhappy result. That the subprime debt that caused so much of the pain would naturally have originated in the US, the birth place of Globalization and Deregulation and the rates of growth imposed by it. Surely the author of the article, to say nothing of the PhDs retained by the banks to do their risk management were not up to their task in their preliminary analysis.

Second thoughts can be wiser and sadder, if a little late: "Diversification has proved illusory because of a greater degree of correlation between asset classes and world markets than almost anybody expected."

That is not quite true. COMER had made the point in having a non-globalized and non-deregulated world so that the cycles of boom and bust would not exactly coincide in different lands and a variety of timing could temper the violence of the transitions. The analysis that must provide the assessment of risk had escaped the PhDs of Risk Management. Curtains.

W.K.

Ruffling Up the Fed's Cross Hairs

In the same issue of the *New York Times* (Sunday, 23/03, "In the Fed's Cross Hairs: Exotic Game" by Gretchen Morgenson) reviews the Bear Stearns mess for quite different implications. You cannot expect a newspaper, no matter how dedicated to shake out all the omnipresent implications of a cover-up that our central bank, our universities and our legislatures have been actively engaged perfecting over several decades. But the *Times* is doing a heroic job of whistleblowing that merits being followed up. For an industry like the newspaper business that is currently under its own critical pressures that adds up to a case of multiple heroism.

In the previous article of the *Times* reviewed elsewhere in this *ER*, we dealt with "the empires of shadowy investment vehicles that have come into the spotlight." In the one that we are now reviewing the emphasis is on the destructive damage being done to the traditional apparatus – especially the Federal Reserve – for sorting out fact from fiction in assessing the money supply of the land. "In the Fed's Cross Hairs: Exotic Game" by Gretchen Morgenson: "In the week or so since the Federal Reserve Bank of New York pushed Bear Stearns into the arms of JPMorgan Chase, there has been much buzz about why the deal went down precisely as it did.

"Its primary purpose, according to the regulators, was to forestall a toppling of financial dominoes on Wall Street, in the event that Bear Stearns skidded into bankruptcy and other firms started falling apart as well. But another look at the terms of this shotgun marriage, suggests another intriguing dimension in the deal. The JPMorgan-Bear arrangement and the Bank of America-Countrywide match before it, may offer templates that allow the Federal Reserve to achieve something beyond basic search-and-rescue efforts: taking some air out of the enormous bubble in the credit insurance market and zapping some of the speculators who have caused its wild inflation.

"Of course, it could be simple coincidence that the rescues caused billions of dollars (or more) in credit insurance on the debt of Countrywide and Bear Stearns to become worthless. Regulators haven't pointed at concerns about credit default swaps, as these insurance contracts are called, as reasons for the two takeovers (and Bank of America's chief executive, Kenneth D. Lewis, has flatly denied that his deal with Countrywide was at the behest of the regulators).

"Yet an effect of both deals, should they go through, is the elimination of all outstanding credit default swaps on both Bear Stearns and Countryside bonds. Entities who wrote the insurance – and would have been required to pay out if the companies defaulted – are the winners. They can breathe a sigh of relief, pocket the premiums they earned on the insurance and live to play another day."

The Surprises of Swaps

"Investors who bought credit insurance to hedge their Bear Stearns and Countrywide bonds will be happy to receive new debt obligations from the acquirers in exchange for their stakes. They are simply out the premiums they paid to buy the assurances. On the other hand the big losers here are those who bought the insurance to speculate against the fortunes of two troubled companies. That's because the value of their insurance, which increased as the Bear and Countrywide bonds fell, has not collapsed as those bonds have risen to reflect their takeover by stronger banks.

"We do not yet know who these speculators are, but hedge funds and proprietary trading desks on Wall Street are undoubtedly among them. The derivatives market is huge, unregulated and opaque because participants undertake the transactions privately and don't record them in a central market. And the potential for disruption, as a result of its size, has surely caused regulators to lose plenty of sleep.

"Credit default swaps were created as innovative insurance contracts that bondhold-

ers could buy to hedge their exposure to the securities. Like a homeowner's policy that insures against a flood or fire, the swaps are intended to cover losses to banks and bondholders when companies fail to pay their debts. The contracts typically last five years.

"Recently, however, speculators have swamped the market, using the derivatives to bet on companies they view as troubled. That has helped the swaps become some of the fastest-growing contracts in the derivatives world. The value of the insurance stood at $43 trillion last June, according to the Bank for International Settlements. Two years earlier the amount was $10.2 trillion.

"But before a contract can pay out to a buyer of the insurance, a company must default on its bonds. In both the Countrywide and Bear Stearns takeovers, the companies were saved before they could default. Both deals specify that the acquiring banks assume the debt of the target."

That had obviously become the overgrown tail that had come to wag the dog. If it were allowed to come to that the assets of Bear and Countrywide might have reduced JPMorgan and many other distinguished speculators to the status of booty.

Or as Morgenson puts it: "So consider all those swaggering hedge fund managers and Wall Street proprietary traders who recorded paper gains on their credit insurance bets as the prices of Bear and Countrywide bonds fell. Now they must reverse those gains as a result of the rescues. If they still hold the insurance contracts, they are up a creek – and the Fed just took away their paddles.

"Do the Bear Stearns and Countrywide deals represent a regulatory template? Both had the same type of winners and losers. Bondholders won, while stockholders and credit insurance owners lost. Although there aren't that many big banks left financially sound enough to buy out the next failure, it's a pretty good bet that future rescues will look a lot like these…. Had either Bear Stearns or Countrywide defaulted, the possibility that some of the parties couldn't pay what they owed to insurance holders passed a real risk to the entire financial system.

"It's pretty clear that some major losses are floating around out there on busted credit default swap positions. Investors in hedge funds whose managers have boasted recently about their astute swap bets would be wise to ask whether these gains are on paper or in hand. Hedge fund managers are paid on paper gains, after all, so the question is more than just rhetorical."

W.K.

The Answer to the Great Question: How Much of the Economy should be Nationalized?

It is not surprising that there should be wrangling in the monetary reform movement on how much of the economy should be nationalized or renationalized. There are those who say 100% percent, and that is what eminent economists of the left, center and right recommended in a an earlier day. Anything less would be immoral, saith a self-proclaimed prophet. Quietly, others had to point out that the proposals for 100% money had been made during the first bitter years of the 1930s Depression when 38% of the banks had shut their doors. After his first inauguration, President F.D. Roosevelt had to proclaim a moratorium during which all the banks shut their doors, until the government could decide how government guarantees and severely restricting them to the strict practice of banking carried on against a government-backed guarantee made that possible.

Others started looking for a magic number of the amount of economic activity that should be nationalized. But just the mention of "economic activity" is so thorny, debatable, that those who have not closely studied the brawling schools of economics haven't an inkling of what portion of our economy consists of activities that we would better be without. The election campaign that stares us in the face is not your usual electoral campaign with its easy if turgid flow of promises, but serious problems that arise from a society on the brink of collapse. That is because for decades the economy, our economic theory, and our educational system have been twisted pretzel-wise for maximum advantage of the deregulated financial sector.

A propos of all this it was heartening to receive a telephone call from Bill Hixson, one of the American founders of COMER, who informed me that having lost his wife since I last saw him at the first AMI Conference in Chicago, he is living with his son in Minnesota. I don't think there were two people closer to each other in the early founding days of COMER than Bill Hixson and I. However, the organizer of the first American Institute of Money and the alleged great issue separating of yellow-livered compromisers who as proclaimed by patented reformers 100% Money Reform in Chicago, was settled by Bill and myself in 1 minute flat. It ran so:

Hixson: Government-created money could be set at 50% of the entire issue of money and near-money [i.e., interest-bearing money lent by the bank into existence rather than being spent into existence by the government].

Krehm: Why not begun with the highest figure attained before the deregulation and globalization, and then increase the nationalized portion as it becomes an obvious need Then you would not be guided by anybody's dogma. There are details of granting and checking the granting of loans, that I and many others would not prefer having in government hands.

Hixson: Agreed.

It is obvious that the financial sector which is in full collapse should at once be confined to strict banking. The really heavy lifting will have to do with the immense work of catching up with the suppressed development of economic theory from the 1930s on. This has been cut out of the curricula of our universities and the staff who taught them was given early retirement. Without that the present collapse of our financial systems could never have been so steep and so massive. Hence what is needed is a standing committee of the House of Commons in Canada and of Congress, that will hold sessions examining what suppressed or otherwise missing stretches of economic thinking could have prevented the present world-wide financial disasters. So long as no distinction is made between the debt of the central government which is the only remaining legal tender, and the subprime debt and the collateral-back debt of the financial sector, we are headed down hill towards ultimate ruin and dissolution. And calling it "risk management" covers up the problem rather than contributes to its solution.

In 1994 this so-called "cash accountancy" – writing off investments in a single year – that would have exposed a private businessman to heavy fines or worse, almost brought down the banking system of the world. At the same time that the banks had

loaded up with bonds of their governments wholly on credit, the Bank International Settlements, a central bankers' club that acted as war room for directing the comeback of the banks to their pre-1930 glories, drove up interest rates into the skies to bring about "zero inflation." But all the central bankers of the world assembled together overlooked a detail: when interest rates are pushed heavenward all the bond hoards bought entirely on credit fall in value, and the banks go bust once more. The full story we have told elsewhere in this issue. It brought about the realization that the period of high interest rates was over for the banks could not forgo the privilege of clipping those mountains of government bonds that cost them absolutely nothing.

And we must finally learn to distinguish between government debt – which has the entire productive capacity as tax base behind it, and debt that is passed on in "bankers' exit," which means to a bigger fool.

There is not a federal election in which the party in power encourages questions on carefully controlled CBC TV programs asking how soon they will pay down or even entirely pay off the federal debt. For that would introduce a degree of deflation that our society could not survive. It doesn't matter that the PM – as in the case of Paul Martin – was previously finance minister who could not possibly not have known better. He must have been aware that gold ceased being money in 1971. But what are the voters for besides to be kept in ignorance and led by the nose?

Cash Accounting Prepares Ground for Privatization Rackets

The immediate consequences can be seen with the current Harper government putting up for sale invaluable downtown property of the federal government in the leading cities across the land – e.g., the entire southern block of Front St. west of Union Station in Toronto because "it could not afford to maintain the buildings properly." It was unlikely Mr. Harper applied for a mortgage from the Bank of Canada and was turned down. Then he should be driven out of his post, since the *Bank of Canada Act* is still the law of the land though utterly disregarded and lied about. Google will help you get it on the internet, and you need only consult section 18.

And to make things sweeter in the wholesale government property fire-sale, there is a lease-back feature whereby the government becomes tenant, not even for a century but for 25 years. The Toronto block is directly across the road from some of the most elegant modern construction – bank buildings – in Toronto, and the sites cannot fail to reflect this is their worth including in addition to any future infrastructure that no matter which of the three levels of governments are bound to undertake beside the most important railway station in the land. Al Capone walked and worked more smoothly than a coup like that. And not one of larger opposition parties have so much as challenged it.

It is no coincidence that none of the present world-wide collapse of our financial systems – which was foretold by COMER as long as five and six years ago and documented in particular in our last issue – was even vaguely foreseen by those allowed to speak freely at the first AMI Congress.

One thing is clear: no bank that had to be bailed out at government expense should be allowed to continue active in the non-banking financial pillars – stock brokerage, insurance and mortgages. That would be a natural first step towards restricting all banks out of the other "financial pillars" that was an essential part of the Roosevelt bank legislation. There is hope that with a free and courteous exchange of ideas we can thread our way out of this collapse of banking greed about us. Of course, that will have to move fast enough before the ever-present military options completely take over. For there is no other exit from such a financial madhouse.

William Krehm

THE SECOND IN A SERIES OF FIVE volumes of *Meltdown: Money, Debt and the Wealth of Nations* has now appeared with the remaining three volume scheduled to appear in three-month intervals.

In this volume you will find a clear prediction not only of the present submarginal debt – which is gnawing away at the entrails of the globalized and deregulated financial sector. There are also – written five years ago – detailed explanations of how the crisis is being used to devise further scams to prevent the use of our central bank for the social purposes for which it was nationalized in 1938.

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Overdue Questions Raised in the US Senate

The New York Times (27/03) reports curiosity about the bounty being shown to help Wall Street's bigger and brasher deals ("Senators Seek Details About Bear Stearns Deal" by Edmund L. Andrews): "Senior senators signaled their unease on Wednesday with the Federal Reserve's shotgun marriage of JPMorgan Chase and Bear Stearns, demanding detailed information by next week about how the $30 billion deal was reached.

"The challenge from Capitol Hill is the most striking shot in a rising political battle about whether the Fed's decision to provide emergency loans to major Wall Street investment banks should be accompanied by stricter regulation over their activities as is already the case for commercial banks.

"Treasury Secretary Henry M. Paulson Jr. defended the Fed's rescue of Bear Stearns in a speech on Wednesday and resisted calls by some Democrats for greater regulation of Wall Street. Recent market conditions are an exception from the norm,' Mr. Paulson said in a speech at the Chamber of Commerce of the United States. 'The Federal Reserve's recent action should be viewed as a precedent only for unusual periods of turmoil.'"

Could Secretary Paulson look out of the President's bedroom window to catch a glimpse of the end of the unusual period of turmoil? From where we sit nobody could have fully forecast the depth and viciousness of the subprime crisis.

"Though Mr. Paulson said that Wall Street firms should provide more information about their financial condition if they borrow money from the Fed, he said that investment banks were still fundamentally different from commercial banks and did not endorse any proposals for tighter regulation. But in the Senate, the two leading members of the Financial Committee raised questions about the policies by the Fed and the Bush administration in dealing with the credit crisis. Americans are being asked to back a brand-new kind of transaction, to the tune of tens of billions of dollars,' wrote Senator Max Baucus, Democrat of Montana and chairman of the Senate Finance Committee and Senator Charles E. Grassley of Iowa, the senior Republican on the Committee. 'Congress has a responsibility to look at whether the taxpayers will lose money here.'

"Senator Chris Dodd, chairman at the Senate Banking Committee, also announced a hearing on the Bear Stearns. The senators did not mention any specific suspicions about the deal, but the range of their requests suggested concerns about the motives of the various organization and the precedent for future bailouts. Lawmakers made it clear that they had questions about the government's broader response to the widening of the financial crisis and the soaring rate of home foreclosures.

"In the deal announced on Monday, the Fed agreed to lend JPMorgan Chase $29 billion and to hold as collateral what Fed officials estimated were $30 billion worth of mortgage-related assets owned by Bear Stearns. But scores of questions remain unanswered. No one knows the real value of the assets formerly owned by Bear Stearns that the Fed agreed to take as collateral. Mr. Dodd said the agreement 'raises serious public policy questions' about the role of the Fed, the Treasury and the Securities and Exchange Commission as the deal's facilitators."

Fed Opened to Investment Banks

"For the first time since the Depression, the Fed announced on March 16 that big investment firms would be allowed to borrow billions of dollars from the Fed's so-called discount window. The discount window is normally reserved for commercial banks and other depository institutions, which in exchange subject themselves to closer scrutiny and stricter capital requirements.

"Several leading Democrats in Congress are now calling for tighter regulation of Wall Street firms, saying they are getting some of the same protection as commercial banks without the same kind of regulation."

What is still missing in this sharpening discussion is the most crucial detail. Had the essence of the Roosevelt banking reform not been ploughed under, there would have been no subprime mortgages, for – to mention a simple barrier – banks were not allowed to acquire interest in non-banking financial pillars – stock brokerages, real estate mortgages and insurance companies.

There was good enough reason for that. Once the banks acquired access to the liquidity pools of the other pillars they would use them for their legal tender base on which they applied their "bank multiplier" to issue interest-bearing loans. The fact that we have a subprime crisis shows the wisdom of that restraint. This is the grand occasion when the connection between the control of the other financial pillars could be reversed and the banks brought back to banking. This would have to bring to the fore the crucial details of the reforms that brought the US and the Western world out of the Depression and make possible the financing of the Second World war at low interest rates. On the other hand the forced introduction of double-entry bookkeeping that recognizes and depreciates the physical (if still not the human) investments of governments over their approximate useful life, was brought into the US in 1996 and in Canada in 2002. And this provides a clearer idea of neglected government investments rather than just wasteful unbalanced budgets. *Without the distinction between investment and current expenditure no government budget can or should be balanced.*

The current crisis calls for separating commercial banks from investment banks. That is in fact another way of saying that the commercial banks must not acquire mortgage firms, market brokerages or insurance companies. For if they do they have become industrial banks and have no business with less severe scrutiny. The extent of the scandals that stemmed from the commercial banks having been allowed to take over the other pillars. availing themselves of their stocks of legal tender thus acquired to multiply the money the lend out by at least several hundred-fold. All that near-money ever famished for interest imposed subprime mortgages on the world. There is no way of diagnosing a serious illness without tracking down the source and nature of the infection.

The connection with the subprime mortgage mess, and the phasing out of the Rooseveltian legislation beginning on a stepped-up scale in the sixties, has since been paced at an accelerating speed. The privatization of government, roads, real estate, power companies was crescendoing at the very time that the government was confronted with the subprime lending clouds. *The next predictable step in this progression will undoubtedly be the central bank lending the banks the money to purchase valuable downtown real estate and leasing it back again.* Enough scandal has already emerged in the running of our banks including our central banks for critics to present the whole picture. For this is a crisis that will not be exorcised by talking out of one corner of our mouths.

W. Krehm

How an Academic of Mixed Talents Harnessed the Planet Warming to Fuel Up His Wall Street Train

The Wall Street Journal (13/03, "Economist Strikes Gold in Climate-Change Fight" by Leila Abboud) tells a tale of braided talents that assure us that the world is not running out of its policy confusions: "London – The planet is getting warmer. Richard Sandor, a 66-year-old economist is getting wealthier. His company, London-based Climate Exchange PLC, has carved out a key role in Europe's booming trade in 'carbon permits' – essentially, buying and selling the right to pollute. Since 2005, the European Union has required major polluters to either cut the amount of carbon dioxide they spew, or buy pollution credits in the open market.

"A big chunk of the action occurs on an exchange founded by Mr. Sandor, a one-time Berkeley professor who has morphed into a gregarious climate change entrepreneur.

"He's among the most successful investors trying to profit from rising environmental awareness, whether by speculating in energy commodities or launching wind-power companies. Last year, the total value of carbon permits changing hands – whether on public exchanges or in private, off-market transactionism where most still occur, nearly doubled to 40 billion euros, or about $60B, according to Oslo-based Point Carbon, a market research firm.

"Yesterday Climate Exchange stock jumped 16% after the firm reported as tripling in 2007 revenue to 13.6 million pounds sterling. That gives the company which handles 90% of the trading on carbon exchanges, a market capacity of about $1.31 billion. Mr. Sandor's stake is worth more than $260 million on paper.

"It's an unusual mix of market theory and environmentalism. 'The right-wing always suspects you of being a tree-hugging environmentalist and the left wing accuses you of being a money-grubbing capitalist,' says Mr. Sandor who back in the 1990s developed a market-based system to cut down on pollutants causing acid rain.

"Carbon trading is drawing intense interest from rivals. In January NYSE Euronext launched its own carbon exchange, bringing the total number to at least eight globally. Citing 'huge growth potential,' the New York Mercantile Exchange plans to enter the field in this year's first quarter.

"The next big battlefield will be in the US, where Congress is currently debating setting up a system for regulating greenhouse-gas emissions. Lawmakers are considering a system like the one created by the 1997 Kyoto Protocol, a global United Nations-sponsored accord that set emissions-cutting targets for the 175 nations that ratified it. Europe's program was an early test-run of the Kyoto Protocol, whose emission restrictions began hitting industry this year.

'The US hasn't ratified Kyoto. But all three leading Democratic and Republican candidates say they want the US to do more to fight climate change, and would likely set up a carbon-trading program."

Converting Pollution into a Negative Commodity

"Carbon permits are traded very much like physical commodities – gold, oil, or pork bellies. Each government-issued permit grants its holder permission to emit a ton of carbon dioxide into the air. Carbon Exchange makes money by taking a commission on each trade and by charging membership fees.

"Governments set emissions caps, and companies that beat them can trade their pollution credits to other firms willing to pay to pollute. Over time, the caps are lowered, making it costlier to choose to keep polluting.

"About 70% of carbon permits still change hands off the market, in private transactions between companies or financial institutions. Trading on an exchange is often more efficient than trying to find as buyer or seller alone. But for bigger trades, many companies and banks still prefer to do private deals so they don't tip off competitors or cause drastic swings in the still-nascent market.

"Still, Mr. Sandor's exchange is a key piece of the financial infrastructure underpinning the system. It gives these companies – mainly industrial giants like power generators, steel mills and cement makers – a clear idea of the market price well off into the future. It also let hedge funds and others investors speculate in the permits just as they would in other assets, such as gold or stock.

"Some economists argue for taxing polluters instead, including Nobel prize-winning economist Joseph Stiglitz, and former chairman of president Bush's Council of Economic Advisors, Gregory Mankiv. A carbon tax would be more transparent and less vulnerable to lobbying by industries trying to win higher caps for themselves. "Last month, a report by the Congressional Budget Office said a carbon tax could achieve the same emissions reduction 'at a fraction of the costs' of a cap-and-trade system.

"Other criticisms of carbon trading focus on the financial wizards – such as Mr. Sandor – who design and run the markets. 'Resources are being redistributed to the banks and traders rather than paying for technological innovations to cut emissions,' says Carlo Stagnato of the Italy-based economic think-take, Istituto Bruno Leoni, who just published a paper on the European Union's emissions-trading system.

"The system which has been up and running only three years in Europe, hasn't yet produced big reductions in emissions. But carbon trading has boomed – handing a tidy profit to banks, traders, and exchanges such as the one founded by Mr. Sandor. Power companies, and heavy industry trade carbon trade carbon continuously to make profit off price fluctuations and to hedge their future risk, as well as comply with the Kyoto rules.

"Robert Stavins, an environmental economist at Harvard's John F. Kennedy School of Economics, defends the role of financiers. 'The only way we can fight climate change is if there is an opportunity for businesses and individuals to make a fortune off of it,' he said.

"That's what Mr. Sandor has done. 'I am a capitalist who runs a business and has to deliver to shareholders,' he said during a recent interview at the Ritz Hotel in London. 'I consider myself to be an environmentalist, but I divorce those sentiments from my day job.'

"He first envisioned a carbon market long before many people had heard of global warming. In 1992 at the United Nations Earth Summit in Rio de Janeiro, he presented an academic paper on how markets might be used to reduce carbon emissions.

"He assumed the US would sign on,

too, so he founded the Chicago Climate Exchange in anticipation of a US carbon-trading boom. However, soon after taking office, the Bush administration declined to ratify Kyoto, arguing it would hurt US companies' competitiveness because developing countries like China and India weren't required to curb emissions.

Mr. Sandor's dream fizzled. With no treaty, US companies wouldn't be required to cut carbon emissions. He was left with a company that basically had no reason to exist. But rather than dumping it, he decided to convert the Chicago Climate Exchange into a system that companies could join to voluntarily reduce their admissions.

"By 2003, he teamed up with a friend in London, insurance executive Neil Eckert, to take everything learned in the US experiment and apply it in Europe, which was then gearing up its own trading system. So they set up a separate trading market in London, the European Climate Exchange.

"Mr. Sandor had an ace up his sleeve. He sat on the board of Intercontinental Exchange, or ICE, which operates Europe's leading energy exchange. The ICE affiliation immediately put his exchange in front of Europe's commodity traders.

"Europe's carbon market continued to grow, and with it, Mr. Sandor's company. In trading yesterday on London's AIM, the 16% jump in its share price to $28.89 followed the company's report that volumes grew on both the Chicago and London exchanges.

"Last December they signed a memorandum of understanding with China National Petroleum Corp. to explore setting an emissions-trading platform in Beijing. And in India the firm is exploring establishing a voluntary market like the one originally set up in Chicago a decade ago. 'We view ambiguity as an opportunity, not as a deterrent,' Mr. Sandor says."■

The IMF Speaks a Novel Language

Like the sewage backing up from the clogged plumbing of a badly built and wretchedly maintained house, the financial structures that took over the world economy over a half century ago are ever more deeply in trouble. What began as subprime mortgages packaged with an eye to being marketed before the innocent end buyers knew what the supposed risk-managed contents were to be, did not go as planned. They stayed very much around polluting the entire financial system. And as the financial institutions and the government agencies, national and globalized and deregulated, were left clueless to retrace the steps they had taken to run the financial system for their greater ease and profit. They have now reached the stage when the chief business publications are literally undoing the celebrated risk management that was to have brought us into a period of ultimate bliss and prosperity.

But let us get to *The Wall Street Journal* (13/03, "IMF Is Urging Members to Set Stimulus Plans" by Bob Davis) brings on this change of the bankers' hearts: "Washington – The International Monetary Fund urged members to make plans to increase spending to stimulate economic growth and rescue troubled financial institutions if the global housing housing-and-credit crunch worsens further.

"'Policy makers world-wide must think the unthinkable,' said the International Monetary Fund's deputy managing director, John Lipsky, because of the possibility of what he called 'a global financial decelerator.' Under that scenario, 'a downward credit spiral, driven by rising defaults of margin calls' might prompt the banks to stop making loans and sell the existing securities on their books at distressed prices. That, in turn, could reduce lending further and strangle the economy.

"Mr. Lipsky said he wasn't predicting an outcome. He said the IMF still thinks the economy will muddle through with slower growth but no outright recession. He said that governments need to prepare to deal with the 'low probability' of financial meltdown."

What is not provided by Mr. Lipsky is even a hint of an explanation why the IMF lost so little sleep or waking hours preparing to meet such "a low probability of financial meltdown." And this was at a time when some of the greatest economists the world produced had been emphasizing that it all lay on the road that the IMF was driving the world governments along. Instead, our universities were cleared clean of staff-members who warned about what awaited us ahead.

Now we are getting fragments of what should be weighing heavily on the conscience of the IMF and the other pious institutions.

IMF Changes Its Party Line

Or put in the words of the most distinguished of our business journals: "The IMF's warning contrasts sharply with its usual advice of balancing budgets, restraining government spending and counting on markets to lift growth. Since the credit crunch worsened last year, the IMF has generally stayed on the sidelines, applauding individual country actions to increase economic growth, such as the US stimulus package. The IMF rarely steps far ahead of its largest members as Mr. Lipsky did yesterday.

"The IMF staff has calculated that 'major' advanced and developed nations accounting for half the world's economic output 'have fiscal room to implement a discretionary stimulus, if needed,' Mr. Lipsky said in a speech at the Peterson Institute for International Economics in Washington, DC. In other words the budget situations in these countries would let them increase spending without fear of igniting steep inflation.

"A larger number of nations, accounting for two-thirds of global gross domestic product, are in adequately sound fiscal condition to let automatic stabilizers kick in if the economy turns down, he said. In many nations, welfare and social-security payments routinely increase when the economy worsens and people lose their jobs. During the past economic crises, the IMF has sometimes urged countries against using the full panoply of automatic stabilizers for fear of deepening inflation or creating a run on the local currency.

"Additionally, Mr. Lipsky specifically named China as a country that could raise government spending to spur growth, while tightening monetary policy to keep inflation under control. Oil exporters in the Middle East also are increasing spending, he said, but he said he was not advocating using taxpayer funds for any specific plans. He didn't lay down any specific plan, but in the past the IMF has urged governments to rescue banks that are critical to the economy, while insisting that a bank's shareholders take a hit, too. By the IMF line of reasoning, such a plan wouldn't amount to a bailout, a term Mr. Lipsky called politically loaded."

W.K.