THE JOURNAL OF THE COMMITTEE ON MONETARY AND ECONOMIC REFORM

COMER

$3.95 Vol. 20, No. 12 • DECEMBER 2008

CONTENTS

4 The Meltdown as Opportunity
6 China — Two Traditions Produce Startling Results
8 F.D. Roosevelt Did Not Go Out Looking for Insurance
9 A Greatly Mistimed Slashing of Services for Elderly and Disabled
10 Like a Breastplate
11 Even the Great Buffett Gets Buffetted by Derivatives
12 Playing the Bailout of Private Financial Empires by Ear
13 On Heroes and Demi-heroes
14 Bank Bailout — Credit Crunch — Infrastructure Renewal
14 Housing Crisis Keeps Aged Out of Retirement Homes
15 Our Empty-Bottle-Return Federal Elections
16 Letter to President-Elect Obama
17 Optimism Is a Hardy Weed
18 The Fed Sorts Things Out a Bit
18 Will the Next Version Prove Better?
19 Investment in Human Capital
20 Fiction in Banking

Suppress Our History and Your Policy-Makers are Left Groping in the Dark

They used to be called "subprime assets," but that was not doing justice to their destructive power. Now the terminology has shifted to the more deadly "toxic assets." "Seek Roadway to Solvency by Eric Dash in *The New York Times* (11/25) states the case: "One bailout was not enough for Citigroup. And it may not be enough for other big banks.

"While Citigroup's second multi-billion rescue hit Washington like a shot of adrenalin on Monday, many analysts worried that the jolt would soon wear off. Citigroup has been stabilized, but the outlook for the financial industry as a whole is bleak.

"With the red ink deepening, other banks may eventually turn to the government to soak up some of their losses. Taxpayers could end up guaranteeing hundreds of billions of dollars of assets. Treasury Secretary Henry M. Paulson Jr. is expected to announce a new plan on Tuesday to bolster the consumer-finance market.

"On Monday, Wall Street put aside its worries at least for a day.

"Citigroup's share price which had plunged to a mere $3.77 on Friday, shot up to $5.95. Shares of its biggest rivals – banks, which, with the government's help, are emerging to dominate the industry – also soared. Bank of America jumped 27%, JPMorgan Chase leapt 21.2% and Wells Fargo gained nearly 20%."

It seemed that sensing the polluting of the country's legal tender with subprime acquired by the government to bail out the private banks, there is growing sense of an urge to take our currency back towards the gold standard that was abandoned in 1970. Hence for a few days the gold prices strengthened, and it could hardly have been due to a sudden buying spurt of jewelry sales. This is certainly not the time for that.

"In the short term, the latest effort to steady Citigroup has removed the risk that a sudden failure of the giant bank would send losses cascading through the financial industry.

"But longer term, the new bailout could haunt regulators and taxpayers. The move ultimately could encourage banks to take more risks in the belief that the government would step in if they ran into trouble."

We Need Our History

To get our bearings in all this, we have need of our history. But that is not available in what is being taught in economic courses at our universities, or reported in our press. When President F.D. Roosevelt was inaugurated for his first term in January 1933, 9,000 banks in the US had already shut their doors. One of the first things the new president did was to declare a bank moratorium, and for a month all banks shut their doors.

The one advantage that the new president had was his readiness to listen to everyone who had a suggestion to make. When the banks opened for business once again, under the *Glass-Steagall* legislation, that was passed, the banks were confined strictly to banking. They were prohibited from acquiring interests in the non-banking financial pillars – that is stock brokerage, insurance, or mortgages. There was good enough reason for that. Each of these other

Continued on page 2

FOUNDING EDITOR
John Hotson 1930–1996
PUBLISHER–EDITOR
William Krehm
(comerpub@rogers.com)
CONTRIBUTORS Vol. 20, No. 12
William Krehm, Richard Priestman, Keith Wilde
CARTOONIST
Allen Good
INFORMATION SECRETARY
Herb Wiseman (herbwise@cogeco.ca)
WEBMASTER
John Riddell

Economic Reform (ER)
(ISSN 1187–080X) is published monthly by COMER Publications
245 Carlaw Avenue, Suite 107
Toronto, Ontario M4M 2S6 Canada
Tel: 416-466-2642, Fax: 416-466-5827
Email: comerpub@rogers.com
Website: www.comer.org

COMER Membership: Annual dues (includes *ER* on request plus 1 book or video of your choice), in Canada CDN$50, foreign US$45

***Economic Reform* Subscription only:** One year, 12 monthly issues, in Canada CDN$30, Foreign US$35

Send request and payment to:
COMER Publications
245 Carlaw Avenue, Suite 107
Toronto, ON M4M 2S6

***ER* Back Issues:** CDN/US$4, includes postage; additional copies same issue, $2; additional issue same order, $3. Send requests for back issues to Herb Wiseman, 56 Robinson Street, Peterborough ON K9H 1E8.

Copyright © 2008
COMER Publications
All rights reserved

Permission to reproduce is granted if accompanied by:
"Copyright © 2008 COMER Publications. Reproduced by permission of COMER Publications"

Publications Mail Agreement 40018485.
Postmaster, please send address corrections to:
COMER Publications
245 Carlaw Avenue, Suite 107
Toronto, Ontario M4M 2S6
LAYOUT
Tony Koch (comer@pagecraft.org)
Pagecraft Computer Services
PRINTING AND DISTRIBUTION
Watt Solutions Inc., London

Printed in Canada on recycled paper.

History *from page 1*

pillars had its own reserves for the need of its own business. The insurance business had to honour claims. The mortgage companies had to provide mortgage loans, and so forth. Allow the banks to acquire an interest in these other pillars, and they will use it as the basis for doing the banking thing – lending out perhaps 10 times as much legal tender in their possession.

The number of other financial pillars has multiplied vastly since the 1930s. You would have to add to the three non-banking pillars of that day, credit cards, car loans, purchase cards of commercial firms, air-mile traffic as a bonus for any number of commercial purchases. Provide a bank access to these other credit sources, and they will utilize that credit as cash base for applying the bank multiplier.

Elevators Run in One Direction

So the end result is a many-storeyed structure with elevators running only up, that cannot stop growing at ever-increasing speed in order not to collapse. Note well, those near-cash reserves of the other financial pillars are not intended as cash reserves to support a currency, so meanwhile it gets lent out until it is needed for its prime purpose, to bring in as good a short-term return as possible. That could disqualify such funds to serve as legal tender supporting a currency. And then there is the pursuit that could have come out of the Old Testament to go out and multiply like the sand of the shore. With enough, ambitious, and insatiable greed around a globalized deregulated financial system is bound to get into trouble. And in doing so, its every compulsion is to go on growing at ever greater speed.

There is another detail. The other financial pillars did not leave their reserves to lie idle. They were lent out short term for interest. Whatever earned interest, was no longer strictly legal tender, but only near-money. For the value of such funds would be influenced by what rate of interest could be lent out at short-term. In crisis times, that becomes a disadvantage.

And when a crisis is upon the land, every borrower becomes suspect, and legal tender is something to clutch even at the risk of its quality becoming subprime. Enough bailing out under such circumstances and the legal tender of the land threatens to become subprime. The result is not only subprime mortgages but subprime credit of every description.

And when the government bails out a stricken mega-bank it has only the vaguest idea of what it is receiving as security from the assets of the bank that it is rescuing. Remember that the only backing for the legal tender of the country is the credit of the government. If in the process of rescuing banks it accepts too much subprime collateralized obligations, debt whose value depends to a large extent on the collateral debt, for which there may be no market to attest its value. Or the collateral might be a sliced and diced amount of mortgages supposedly representing the mortgagee's risk preferences.

Subprime Credit of Every Description

What resulted was a piling up of money-creation several times, utilizing not only superimposed layers of interest-bearing money – also known as "near-money" – because every time interest rates move up, interest-bearing bonds forfeit part of their value. In contrast the notes of the government bearing no interest are less affected by movements of interest rates. Private banks created interest-bearing money, involving increasing proportions of interest-bearing debt on an ever slimmer basis of diluted legal tender, and became ever more vulnerable.

Especially after the abandonment of the gold standard in 1970, this process accelerated. In 1946 the ratio of money creation to the legal tender in the banks' possession had been 10 or 11 to 1. By the end of the millennium, it was just under 400 to 1. What was still more serious was that, utilizing derivatives that claimed to be able to foretell rates of interest and growths of a future that was unpredictable because of the drastic changes in just about every aspect of the economy lifting the restrictions on what banks were allowed to invest in, the globalization and deregulation of just about every aspect of banking, trade, and even of accountancy.

Private and corporate taxpayers are required to use double-entry bookkeeping, that was supposed to have been brought to Western Europe by the Crusaders, about a thousand years ago. In any case it had been adopted through much of Italy and was spreading into all of Europe by the mid-14th century. Poets and philosophers including the great German poet Goethe proclaimed double-entry bookkeeping one of the greatest creations of the human spirit.

This required a double-entry into a businessman's books of every transaction. Once as the *cost* of the transaction, "amortized"

roughly over the expected useful life of the investment, and again as the *value* of the investment, that was similarly "depreciated" over its useful life. But this so-called "accrual accountancy" – a.k.a. "capital budgeting" – was until 1996 in the US and 2002 not used by governments consistently in any land. At times one or the other of the so sanely crazy Scandinavian countries used it briefly but it could hardly stick when the big makers and shakers of Europe and the United States were headed in more exciting, overwhelming and eventually underwhelming directions.

Exit Glass-Steagall

But then something shatteringly impossible to deal with occurred. During the 1980s, the banks in North America had been deregulated to allow them increasing freedom to enter the very areas that the *Glass-Steagall* legislation had barred to them – the other financial pillars – stock brokerages, insurance and mortgages – the very areas that is causing such irremediable damage to our financial system today.

In 1988 because of major grief encountered above all by the US banks in taking over the S&Ls (Savings and Loans) – essentially mortgage trusts. To help the banks out of that problem the Bank for International Settlements, that served as a sort of war room for the great world-wide drive of banks to regain the unrestricted freedom denied them by the Rooseveltian *Glass-Steagall* legislation. They were allowed to acquire as much debt of the governments of developed lands without down payment, since it was "risk-free" – a wonderfully permissive phrase that allowed the banks to make the fullest use of the uninterrupted deregulation that they were undergoing.

Yet at the same time the same BIS – alarmed, we must supposed by the inflation that such deregulation was producing, raised interest rates into the high teens. In their zeal to get the banks out of one pickle they unwittingly bought them into a far greater one. For the BIS, even with all the wise central bankers gathered around its knees, overlooked that when interest rates go up, all earlier-issued debt with lower interest rates collapses in value.

This happened on a scale that almost collapsed the international monetary system. In an ultimate desperate attempt to deal with a near-hopeless situation, the Clinton government introduced accrual accountancy for its physical investments. Working its books back in this way to 1959, they were able to turn up well over one trillion dollars of additional physical investments that had not been entered as *investment* assets on their books.

This was called "Savings" in the Department of Commerce figures, an inapt term since the latter implies either cash or assets readily convertible into cash, and what was involved here was such things as bridges, century-old buildings. But a nudge and a wink to the appraisal agents transmitted the true fact and brought interest rates down massively. That made possible the high-tech boom that went on to the stock crash at the end of the millennium.

We Stumble Onto Something Potentially Great and Positive

At this stage let me pause to pay my respects to my computer. I am increasingly convinced that much of the structure of our thinking is based on the technologies we are forced to use. Since computers to me in my mid-nineties is an alien beast, I will never have the ease of jumping around on the computer that my grandchildren have. But the mixture of technologies of widely different ages from the Greeks to the British economists, the railway-building age in which the young Marx grew up, the relativistic age of Einstein, globalized atomic age, occasionally afford a very few surprisingly peepholes for revelations – surprisingly positive ones. These must be pursued for all they are worth.

And this is what in these difficult circumstances is the vision that suddenly opened to me. What the extension of our government's recognition of the investments made by it in *physical capital* to *human capital* would provide a ready-made exit out of the current subprime mess. And since the job was done once – though in semi-stealth without adequate public explanation with respect to applying double-entry bookkeeping to our government's physical capital, doing the same for the government's investment in human investment would be a mere cookie-cutter job.

It would be repeating mostly what was achieved by recognizing government investment in physical capital in the US in 1996 and in Canada in 2002. It was done in semi-stealth but it worked. And as a bonus, we will have a lesson on the highly ruinous costs of suppressing our history.

It leaves us with no means of learning not to repeat the same errors on an ever mounting scale. In return for being bailed out with the credit backed by the until recently unrecognized government investments, the government should require that the banks rescued in this way invalidate a portion of their investments in the non-banking pillars that the *Glass-Steagall* legislation had banned to banks. Proper legislation to this effect of a fair and not vindictive sort could be enacted to avoid the fatal rhythm that in recent decades paired bank bailouts with an extension of their powers to take over the non-banking "pillars" from which the *Glass-Steagall* legislation had banned them.

The Very Nature of Investment

But allow me to emphasize that expenditures on educating and preserving that investment by conserving the vessels that hold it must be considered by their very nature an investment itself. The children of educated people tend to be better and more easily educated, the children of gifted people more gifted, and the capital of what level of government taught Shakespeare to read and any of the Bachs how to unlock the staves of music and Einstein to think off the beaten path is still producing a blessed return that no stock market can match. And even if our government spending on education does not encounter first-class genius, educating humans to appreciate the beauty and power of language, literature, is a rich human heritage that any well-spent social program opens to us.

This also translates into physical needs essential for opening up the human heritage to flourish and grow. Those who can service a modest mortgage on their home should be enabled to do that with an rearrangement of the mortgage – chargeable as a fair loan against the prepaid human capital that backs government credit. Those who cannot – should be provided with good rental housing financed again by government credit based in the prepaid credit in human capital, just as the prepaid physical capital opened up by bringing in serious accountancy into the government books. The rental housing must be accompanied with adequate schools, libraries, landscaping so that the children of immigrants or First Nations children growing up there will be supported in making full use of their native talents.

When we have made adequate use of expenditures on investments in human capital, then we will have a country and a world in better peace with itself and the environment.

William Krehm

Book*Store*

Available from COMER Publications
245 Carlaw Avenue, Suite 107
Toronto, Ontario M4M 2S6

Price excludes postage and handling.

Hazel Henderson

- *Building a Win–Win World — Life Beyond Global Warfare*, $15
- *The United Nations: Policy and Financing Alternatives: Innovative Proposals by Visionary Leaders,* Editors Harlan Cleveland, Hazel Henderson, Inge Kaul, $10

W.F. Hixson

- *It's Your Money,* $10

William Krehm

- *Towards a Non-Autistic Economy – A Place at the Table for Society,* $10
- *Babel's Tower: The Dynamics of Economic Breakdown,* $10
- *The Bank of Canada: A Power Unto Itself,* $5
- *Democracies and Tyrannies of the Caribbean,* second English and third Spanish editions available, $15
- *Meltdown: Money, Debt and the Wealth of Nations – Volume 1* (ed. by W. Krehm) $25
- *Meltdown: Money, Debt and the Wealth of Nations – Volume 2* (ed. by W. Krehm) $30
- *Price in a Mixed Economy – Our Record of Disaster,* $15

COMBO OFFERS:

- *Meltdown* plus either *The Bank of Canada* or *It's Your Money, $35*
- *Meltdown, Democracies* (English or Spanish), *Price in a Mixed Economy, Babel's Tower, The Bank of Canada* and *Towards a Non-Autistic Economy – A Place at the Table for Society,* $90, postage included.

The Meltdown as Opportunity

As the financial meltdown brings leading economies ever closer to stagnation and deflationary depression, some economists believe that the great tangle of bad debts should simply be allowed to collapse, unpaid. They see it as an opportunity for a beneficial restructuring that is long overdue.

In the words of Michael Hudson:

"The great fiscal benefit of letting the bad debts go is the opportunity it provides to reshape the tax system so as finally to achieve the classical economic objective of taxing the free lunch of land rent rather than labor and capital. This would save the rent from being pledged as interest and thereby raising property prices. A rent tax is difficult to introduce under conditions where the rent already has been fully pledged to bankers as interest, because that would cause financial default. But today's financial system already has defaulted. A debt write-down provides a path of least resistance for classical tax reform that would prevent recurrence of a debt bubble.

"Unthinkable as it might seem at first glance, a debt cancellation would wipe off the trillions of dollars in 'bad savings' that the Bush-Paulson bailout has created. Without an annulment, these financial claims on the economy threaten to vest a new oligarchy of the sort that Europe spent nearly a millennium trying to replace with a freer and more purified industrial capitalism. That was the aim of classical political economy and its doctrine of economic rent – and it was to oppose that political drive that the vested interests mounted their anti-classical 'neoliberal' reaction that has culminated in today's 'socialism for the rich' and shifted economic power from governments into the financial sector. Its lobbying aims at making an alternative fiscal and financial reality appear 'unthinkable.'

"Today's bubble provides the best opportunity in more than half a century to start thinking about it."

A more extensive rationale for this proposal is scheduled to appear in *Harper's Magazine* early in 2009. In the meantime, Hudson is drafting a letter with a colleague in England which they will circulate among academic economists, seeking their signatures on the proposal.

The authority of knowledge for this proposal is Professor Hudson's lengthy career as an observer and historian of financial practices and of economic theories – including direct experience with Wall Street firms. His general perspective is that laws designed to protect the general welfare are consistently, persistently eroded by the pressure on lawmakers and justice systems from persons intent on securing a greater share of the social surplus for themselves. The more of it they already have, of course, the greater is the influence they are able to exert on constitutions, laws and regulations. That is part of the explanation for the speed with which the bubble economy of the past 30 years has emerged, featuring deregulation of finance and the inflation of paper asset values in preference to investment in productive industry.

The foregoing quotation makes reference to the classical economists in Britain, who made efforts to turn back the process of eroding the access of citizens to resources traditionally accessible as a commons. (Cf. the recent article in *ER.*[1]) But that is only a recent example of the process. It was also the dynamic which impoverished and expropriated farmers in the Roman Empire as wealth concentrated at the top and land was aggrandized into *latifundia*.

The system eventually collapsed from within for lack of a vigorous society of producers and defenders. A Dark Age of serfdom and isolation ensued, in which direct power relationships regulated material life, without the mediating lubricant of commerce via credit and money. This experience of the Empire was a degeneration from efforts in the prior Republic to make resources (especially land) broadly acceptable to citizens. The pattern was replayed in England after the Norman Conquest when its resources and people were organized into a system of capitalism by and for the King.

"However, as the surplus controlled by individuals grew, the wealthier mercantile class managed to break free of public control. This counter-dynamic is seen in the Magna Carta, the Revolt of the Barons, and the 1688 Glorious Revolution. Finally, in the 19th century, the limited liability joint-stock corporation emerged as a fully free mode of private-sector corporate organization. The privatization of wealth and power has produced a drive for dismantling the public regulatory state. The ultimate objec-

tive of the privatizers, today as in antiquity, is to gain control of the public sector to serve their own economic interests."[2]

Professor Hudson pursued this pattern of wealth concentration and erosion of common rights to resources as far back as the pre-history of the earliest known civilizations of the middle east. Between 1994 and 2000 he organized four colloquia of The International Scholars Conference on Ancient Near Eastern Economies at universities in New York, the Oriental Institute at St. Petersburg and at the British Museum. These specialists in antiquities have in very recent years made discoveries that refute the supposition that property is by nature and origin private (e.g., the rationale of John Locke).

That finding undermines a favorite theme of Chicago School economists that the ideal socio-economic-political system is a free market for the exchange of absolute property rights. (Efforts to impose state controls on the extraction of rents and interest by private individuals are condemned as contrary to Nature.)

The antiquarians find instead that the earliest stable societies in Mesopotamia featured periodic proclamations of debt relief (annulment), to avoid having a dispossessed, impoverished population with no interest or capacity to produce more wealth for the overlords or to serve as soldiers in the defense of the regime and its territory. The Year of Jubilee mentioned in the Bible, in which debts were forgiven and families were allowed to return to their farms and orchards which they may have lost to foreclosing creditors, appears to have been the application of an old principle from its near eastern neighborhood.

An implication of this process is that the private accumulation of capital that accompanies Progress in technology and total output also leads via the serfdom of excessive and unrepayable debts – to Poverty.

Do you know of university economists who may wish to sign the proposed letter? Professor Hudson can be reached via his website, at www.michael-hudson.com.

Keith Wilde

1. Angus, Ian (October 2008). The Myth of the Tragedy of the Commons. *Economic Reform.*

2. Hudson, M. (1994). The Dynamics of Privatization, from the Bronze Age to the Present. In M. Hudson and Baruch Levine (Eds) *Privatization in the Ancient Near East and Classical World* (p. 57*)*. Cambridge, MA: Peabody Museum of Archaeology and Ethnology, Bulletin 5.

On the Meltdown as an Opportunity as Proposed by Wilde

Systems theory would have taught economics reformers as well as those who live happily under other banners that social solutions cannot be chosen for their simplicity achieved by running on an already set-up monorail. What should have shocked us into a realization of this is that the technologies of military repression have long since hopelessly outstripped the persuasiveness of peaceful democratic process. On the blackboard of my mind written in screeching white chalk is Pere Lachaise cemetery in Paris where one of the most brutal repressions of the day – the Communards were executed with simple gunfire at barricades thrown up across much of Europe in 1848. Or newspaper photos of the Nazi army entering Paris in 1940 with horse-drawn artillery.

Let no one then talk glibly about "the great tangle of bad debts should simply be allowed to collapse, unpaid." It will be the unemployed across the world that would be the first to suffer. And the ultimate recourse of those in power will be still more of the military option than we have been regaled with for a very bad decade.

We need systems theory to match the intertwining of the world's problems with a balancing interweft of solutions.

Historically, accountancy – notably doubly-entry booking that is said to have been brought back from the Holy Land by the Crusaders, was mangled to play a huge part in privileged groups' avoiding even-handed accountancy.

In this way while certain Crusaders – supposedly the Templars – brought back the notion of even-handed accountancy that entered in the ledgers the cost of a merchant's investment and at the same time the asset value of what the monetary indebtedness or cash had obtained for the investor. From there on, the two items plied their independent courses, open to inspection by the tax-collectors of whatever other authority, In the marvel of medieval Venice it served as a the basis for friendly accommodation between the Christian and Muslim worlds, and made of aristocratic mercantile Venice a uniquely tolerant society where Christians and Muslims traded in peace, and nobody, Jew, Christian, or Muslim was burned for his faith.

In more recent times, double-entry accountancy, also known as "accrual accountancy" though rigorously applied in private or corporate ledgers, has been unknown in the ledgers of governments themselves. This introduced another dimension of deceptive pseudo-information that led to accountancy fraud in the areas of taxation and privatization. Wilde writes, "A debt write-down provides a path of least resistance for classical tax reform that would prevent recurrence of a debt bubble." How is that when the dogs of war have been far from inactive over a very bad decade? This is far too late in the night to be naive on such matters.

On the other hand accrual accountancy was the only way by which our governments could wiggle out of a gross credit scam in 1996 in the United States and 2002 in Canada. But that still leaves unaccounted what was recognized in the 1960s as the most productive investment a government can make – in human capital.

That is the big-bass drum that should be pounded. For undoubtedly – we have here *prepaid* enormous assets that should be recognized and used – not to "bail out" our banks but to have them in return surrender the right to engage one by one in the "other financial pillars" from which they were banned by the *Glass-Steagall* legislation, and get back to simple banking. That can be arranged to increase this "most productive of all government investments" – supported by the massive prepaid investment that is still ignored on our government books. We will on several accounts moving in the desired directions, without gambling on a write-down of bad debts doing the trick.

I had hoped to meet Michael Hudson at a recent conference in Virginia, but did not have the pleasure. I invite him to join in a discussion of COMER's proposal in the columns of *Economic Reform*. We hold that at this very late date relying on everything on its own turning out for the best, is underestimating the death-grip that speculative finance has on society's jugular.

William Krehm

China — Two Traditions Intertwining Can Produce Startling Results

I am increasingly under the spell of different national traditions interacting to produce unexpectedly surprising results. The most striking instance of this is offered by China where the basically supplanted orthodoxies of Communism have been replaced by a thriving capitalism that on occasion owes much, good and bad to the Communist traditions that have on the whole been shelved.

The Wall Street Journal (11/11, "China Bets Highways Will Drive Its Growth" by Andrew Batson) brings us a most amazing example of this interplay: "Qijiang, China – As more of the world falls into financial turmoil, China is hoping that an infrastructure spending spree can help sustain the long record of expansion and rising prosperity," introduced – in theory at least – during the years of orthodox Communism. The transfer of resources from the waterlogged private sector in the west and the government seems readily bridged.

"Much of the $586 billion stimulus China unveiled this week will go toward building highways, railroads and airports. Already, according to official estimates, infrastructure spending has been increasing by an average of 30% annually for the past 30 years – a tried and true engine that has helped power the Chinese economy's explosive growth. The results are evident in this hilly corner of China's south-west. where a new expressway has cut travel times to the big city of Chungqing to 45 minutes from more than two hours. That has inspired local businesses and outsiders to look for weekend retreats. Many villagers are now resurfacing dirt roads to improve connections and ease travel further. Rather than selling their crop of Sichuan peppercorns from baskets on their backs, local farmers are loading them by the sackful onto trucks. Average annual incomes here reached about 4,100 yuan ($600) in 2007, up from 3,030 yuan three years ago.

"The new road is part of the backbone of China's national highway system, scheduled for completion this year. Twelve major routes cross the country north to south and east to west, connecting millions to the wider world and showing the kind of impact China wants from its huge new spending program.

"The speed of China's motorization is stunning – some 30,000 miles of expressways were built in the past decade. Plans call for China's highway system to stretch 53,000 miles by 2020, surpassing the 47,000 miles of interstate roads in the US currently. China has roughly the same land area as the continental US.

"Unlike the golden era of the American highway – which started in the 1960s – this road boom is taking place in a poor, largely rural country where only about. 10% of the population have their drivers' licenses.

"Skeptics of China's infrastructure spree worry that new roads and buildings are going to go unused and will be a waste of money. In the poorest areas, some highways are often empty but for the crops farmers spread out on them to dry in the sun."

Chinese Expansion of Transport Structure Far More Often Contributes to Growth than Responds to It

"But China's expansion of transport infrastructure is often intended less to respond to growth than to stimulate it. Indeed, while China's is often seen as driven by exports, domestic investment contributes far more to growth in recent years, spending on everything from public works to housing to factory equipment has accounted for about four to six percentage points of China's 10% average annual growth. Such investments tend to be more stable than housing to factory equipment and have accounted to about four to six percentage points of China's 10% average annual growth in recent years.

"Most forecasts call for China's growth to slow to 9% or so this year, and around 8% next year. By comparison, the world's advanced economies, including the US, Europe and Japan, are expected to grow by little more than 1% this year, and to contract in 2009, according to IMF forecasts.

"'Investment puts a pretty high floor on growth. It acts as an economic stabilizer,' says Ken Peng, an economist for Citigroup in Shanghai. One worry is: infrastructure is growing so fast it may be hard to accelerate it further."

There is both an easy answer and a criticism of these problems. Starting with the second alleged problem. It is only since 1996 that the United States belatedly and most reluctantly began to treat the government's physical investments – roads bridges, buildings, buildings as investments. Prior to that date it had written them off entirely in the year they were completed. A private corporation or citizen trying to do that would have heard from the tax-authorities and been penalized. But the government did so until 1996, because it had run into tremendous problems by writing off the value of its physical investments in a single year, while carefully amortizing the debt incurred or the expenditures made to make these possible. But in the 1980s the restrictions that President Roosevelt put on the books – the *Glass-Steagall* legislation – forbade the banks to acquire a share in non-banking "financial pillars" – stock brokerages, insurance, and mortgage companies. There was good reason for that. The Depression of the 1930s had been brought about because the American banks had taken over such other pillars, and used the cash reserves they held for their own businesses as base money for applying the bank multiplier, not once but as many times as they could repeat the gambit. What resulted was a skyscraper of money creation by the banks that spurred on speculative activity that led to the great crash and the Depression of the 1930s. By the 1980s, the banks had gone far in having the *Glass-Steagall* legislation ignored. and ultimately repealed.

In the 1980s the bank speculation of the day was taking over the Savings and Loans, yes the mortgage trusts. That should sound familiar. They lost much of their capital, and the Bank for International Settlements – a war room of central bankers of the world to bring back unrestricted banking much as it existed in the 1920s. BIS brought in two measures. The banks were allowed to acquire as many government bonds of advanced countries without down payment, since they were allegedly "risk-free." Shortly after this. BIS initiated a wild increase in interest rates, on the grounds that any price increase over zero would bring on dangerous inflation. In its fervour BIS overlooked that when interest rates go up sharply the market value of preexistent bonds with lower coupons drop in market value. This led to a credit crisis that threatened to bring down the financial system.

In retrospect it might be regarded as a bit of practice for the current widespread mess. It was resolved, not only by the US, the

IMF, and Canada putting up a standby fund to meet emergencies – $51 billion dollars worth – the largest standby fund of the sort to that date. It did not have to be actually used. But this episode shows how that crisis was resolved. And that in turn which could bring our governments a perfect prefabricated solution for resolving the present crisis that has so screechingly gotten out of hand.

Up to then the governments of the world – with the temporary exception of Denmark for a brief period – did not use double-entry accountancy that a Crusader Order – the Templars, I believe – were said to have brought back from the Holy Land a thousand years ago. In any case it was very much practiced in Italy in the 14th century. That required every transaction be entered twice in the ledgers of investment – once the cost paid for it or the debt incurred and this was amortized over the useful life of the investment. The other entry covered the asset value of the resulting investment, which was written off (depreciated in a single year) while the debt incurred financing it was "amortized" over the investment's useful life. Commercial firms have long been held to such "accrual accountancy." Amortizing the debt incurred in a single year had a most definite result – since the asset acquired was written off to $1 in year 2, it left an unbalanced budget that was not necessarily there.

Enter Accrual Accountancy, Wearing a Wig and Mask

But that false hole in the budget served immensely to argue against expenditures for social purposes. The second was this: with a ridiculously low figure in the books for government assets, plus the false deficit, the table was set for some very lucrative deals in which government assets could be sold by the government to deserving corporations for a pittance and still seem to be bringing the government budget into better balance.

In that way President Clinton brought in double-entry bookkeeping for physical investments, and working the figures back to 1959 retrieved well over a trillion dollars. But the motivation that had inspired the bookkeeping skullduggery lived on Instead of clearly this latter as the value of the investment, it was carried in Commerce Department figures as "Savings" which it most certainly was not, since it was not readily transformable into cash.

However, a wink and a nudge to the appraisers indicated what was involved and interest rates came down and contributed to the high-tech boom that lasted into the new millennium.

There are so many ambiguities deliberately inserted in our government books, that it requires a special breed of "appraisers" and interpreters to translate their figures for officially recognized purposes.

What has that contributed to the US government's present seemingly interminable problems with bank credits?

We must go back to the end of the Second World War. Once it was over Washington sent hundreds of young economists to Japan and Germany to predict how long it would be before those two defeated powers would once again become the formidable competitors on world markets that they had been. Twenty years later one of these, Theodore Schultz of the University of Chicago, wrote that it was remarkable how far from the facts their prediction had been. The reason, he said, was that he and his colleagues had concentrated on the physical damage, and had paid little attention to the fact that the highly educated and disciplined labor force had come through the war essentially intact. From this Schultz concluded that investment in human capital – education, social services, the environment – are the most productive investment that a government can make. For this discovery – one of the great positive revelations that came out of the Second World War – Schultz was briefly feted, decorated, and within a very few years completely forgotten. For his conclusion was nothing that the banking community, by then gorged with political power, wanted to hear.

But this Law of Schultz is precisely what is lacking for the governments of the world to finally solve the problem of subprime credit and all that mess. Without spending a further penny, but merely recognizing the immense and growing investments that the governments of the developed world are making, they would (a) have the resources and (b) the orientation to make use of them. Because recognizing this vast investment would not only establish the perfect ability – using the capital value of these non-recognized assets would provide perfect government security – and the debt of the government is the only legal tender in existence since the gold standard was abandoned by the US in 1970. First of all I must make it clear that it would not be necessary to redo the books completely before use could be made of this immense ignored capital worth of our governments, just to establish such an inventory of human capital investments. There are nations like India that are woefully lacking in widespread education, and that shows up in the productivity of their economy.

Moreover the rate of depreciation of this human capital is proverbially *a very slow and very enduring process.* The children of educated parents tend to be easier to educate, healthier, and better adjusted. The very process of investing further in human capital would provide the money and the earnings of the educators, doctors, trainers, would provide a further need for legal tender which is only the debt of the central government. With a figure on the governments' books for this up to now ignored investment, it will be in a position to finance – to the extent that it may be necessary – housing, for sale and build its own residential rental units for families who have not enough credit or will to acquire houses; money for university, with fees reduced in order not to impede the government investment. Whatever the universities earn in students fees is overshadowed by the public investment represented by the students' education. Likewise the environment.

The work of Schultz is precisely what our hapless governments have need of to get out of the plight described in *The Wall Street Journal* (11/10, "Paulson, Bernanke Strained for Consensus in Bailout" by Jon Hilsenrath, Deborah, Solomon and Damian Paletta). "Washington – Amidst the confusion, policymakers lost critical time. 'The ability to communicate to the public how the plan was going to work was muddled from the very start,' says Anil Kashyap, a University of Chicago business school economist. Between September 18, when Mr. Bernanke and Mr. Paulson first went to Congress and Oct. 3 when the plan legislation was approved, the US stock market lost roughly $1.3 trillion in value."

All would have been necessary was the Auditor General's approval of the government books showing a huge balance by virtue even of a partially completed inclusion of human capital investment. And that investment increased because of slack in the economy will increase both the security of the government and lessen the number of unemployed.

The key to our great present problem is not the lack of money – that the government can create for essential human investment with the stroke of a pen, *but straightening out the accountancy of government and our economic theory.* And for that time presses.

There are too many political entrenchments on those hillsides.

William Krehm

When F.D. Roosevelt Coped with the Great Depression He Did Not Go Out Looking for Insurance

No, he dealt with real things if on a puny scale, until World War II loomed as the ultimate solution. He dealt in labour camps, hydro-electric and waterway projects. The banks went bust on a scale that led even industrialists like Henry Ford and Thomas Edison to come out for "100% Money," that is reduce the banks to intermediaries. I quote from *The New York Times* (25/11, "Another Crisis, Another Analysis" by Floyd Norris): "Guarantees that could not be honored thrust the world financial system into its worst crisis since the Great Depression. Will a guarantee by the US government finally restore confidence in the financial system?

"Only a week after Treasury Secretary Henry M. Paulson Jr. said the government bailouts had stabilized the most important financial institutions, plunging stock prices forced the government to step in again, to make another direct investment and guarantee that losses would be contained from $300 billion in possibly toxic assets on Citigroup's balance sheet.

"The move sent stock prices soaring Monday, with financial stocks leading the way. But those gains did not come close to erasing last week's losses, and left open the possibility that a renewed sense of concern about the safety of other banks with still more bailouts in coming weeks.

"One lesson may be that it is perilous for the government to even hint that it thinks it is through bailing. That can renew fear about banks, driving down share prices and forcing the government to do the opposite of what it had intended. Since the government has a printing press, it need never be short of dollars. *That makes this guarantee much more credible than the ones, from bond insurers and other companies, that helped persuade banks and others to take what turned out to be huge risks. Many of those guarantors, it turned out, could not honor their obligations.* [Italics ours.] The government feared financial chaos if there was a string of collapses….

"And as the nation's obligations run into the trillions, at some point investors may begin to question whether a government running huge deficits can also credibly promise that the dollar will not lose its value."

Let's pause here for a while because that is a key thought. What is being impugned is the legal tender of the land. That is the monetary equivalent of "Lights out!" Not all the bogus insurance of financial outfits that are themselves – like the fancy mathematical swaps they peddle without even understanding – bluff, packed and repackaged and adding to the castles in Spain rather than eliminating them.

"But those are problems for another day. Now the priority is to keep the financial system from collapsing. The problems of recession, constricted lending markets and falling real estate prices will remain even if everyone concludes that the big banks are safe.

"In the latest bailout, the government injected an additional $20 billion into Citigroup, on top of the $25 billion it invested a few weeks ago. It also said that it would cover 90% of the losses on those $306 billion in securities after Citigroup absorbed the first $29 billion of losses."

Engineered Complexity and Obscurity

"The fact that it was necessary to guarantee so many assets – about one sixth of the $2 trillion in assets that Citigroup reported at the end of September – was another indication both of the complexity and the opacity of the securities that were engineered in the great wave of innovation.

"The assets in question – described by the government as 'loans and securities backed by residential real estate and commercial real estate, and their associated hedges' – must be valued at current market value before the guarantee kicks in, but the banks have yet to agree on those values.

"That phrase 'associated hedges' captures the fact that Citibank like many other banks had sought to guarantee itself against losses with a variety of transactions including insurance, only to learn that the losses were overwhelming those who had promised to pay.

"The boom of the first half of this decade will be remembered as a time that financial innovations overwhelmed the capacity of both regulators and banks to assess risk. (Italics ours.)

"The collapses of Bear Stearns and Lehman Brothers, both of which were primarily regulated by the Securities and Exchange Commission, served to focus attention on the agency, which was effectively forced out of the financial soundness regulation area after the Federal Reserve assumed oversight of several of the large companies for which it had been responsible.

"But Citigroup has always been under Fed regulation, and the need for repeated bailouts there shows both that the regulation was ineffective and that even after the crisis began, the government underestimated its severity.

"At first, the Fed hoped that just making more loans available to banks would reassure markets. Then, as losses mounted, the government tried capital injections. In both cases, investors first showed relief, then grew afraid again.

"The newest bailout includes more than the guarantee and the capital injection. It enables Citigroup to treat the guaranteed assets as being relatively safe, thereby improving the capital position.

"It could need all the reported capital it can get. David Hendler, an analyst at CreditSights, pointed out that Citigroup's other assets included $91 billion in credit card receivables, $272 billion in non-US consumer loans, $163 billion in corporate loans and a net $104 billion in assorted derivatives. Those assets, he wrote, are not immune to weakness in the overall economy."

Enter Swaps

"Insurance on the assets was issued both by the bond insurers and by others who wrote what were known as credit-default swaps, which amounted to insurance, but were not regulated in the same way. Those who wrote large amounts of such insurance are now in trouble, either negotiating to play claims for less than promised, in the case of the American International Group, still in business only because of a government bailout."

But note well. The author quoted has not even mentioned the great important concerns that troubled the Roosevelt government and made it possible in a limited way of leading God's own land – still unblessed by the invention of derivatives – out of the Depression:

1. The prohibition under the *Glass-Steagall* legislation of banks to acquire an interest in the non-banking financial pillars

– stock brokerages, insurance, and mortgage companies.

2. The recognition of the backlog of the physical investments made by governments that had been written off in year 2 to a token $1 value. This occurred in 1996 in the US and in 2002 in Canada when double-entry accountancy – also known as "capital accountancy" had been introduced in those two country after the governments had resisted bringing it in as urged by auditors general and in Canada several royal commissions.

3. The urgent need to introduce accrual accountancy to put on the government's books assets of human investments already made, which was convincingly identified by Theodore Schultz of the University of Chicago as the most productive investment a government can make. As we develop elsewhere in this issue, this point, if recognized by our government, would do the heavy-lifting in an area now critical that was accomplished in the case of assets of the physical investments dealt with elsewhere in this issue. This would put projects to better educate and re-educate our population, improve their health care, better look after the environment – all of which constitute investments in human capital.

Lessons from World War II

I would like to spend a few paragraphs before parting with my readers to raise a few rare characteristics of government spending on investments of human capital.

Schultz arrived at his conclusion that government investment in human capital is the most productive investment a country can make stemmed from his having been one of the hundreds of economists sent to Japan and Germany at the end of World War II to predict how long it would take before the defeated powers would again become ferocious competitors on world markets.

Twenty years later, he published his final view that he and his many colleagues had come up with the wrong answer because they had concentrated on the physical destruction, and paid little attention to the fact that the highly educated, trained and disciplined work force of these powers had come through the struggle essentially intact. From that he concluded in the 1960s that investment in human capital is the most productive investment a country can make. That – undoubtedly one of the key positive results of World War II – resulted in Schultz being celebrated, decorated, and feted for a very few years. At the end of which he and his great conclusion were systematically buried. COMER – with which I am associated – is one of the few organizations that remember his great achievement. Precisely because it suits our most acute needs in the present unrelenting currency crisis. That is why it was swept from memory and the curricula of our economic courses at practically all universities. It contradicted the interests of those who were convinced that speculative banking must inherit the earth beginning with the heaven overhead.

In our next issue we will enlarge on several unique features of government investment in human capital.

W.K.

A Greatly Mistimed Slashing of Services for Elderly and Disabled

In our letter to the President-Elect in this issue, we note that now is the time to wheel out a vast unacknowledged of human capital already paid for, but that does not appear on the books of the pertinent government levels. The precedent was established in 1996 for the United States and in 2002 for Canada to introduce double – entry accountancy for all physical investments, just as it is required by law in the case of corporations and individual taxpayers. In the absence of that before the above-mentioned dates governments carefully "amortized" the debt incurred in making a physical investment in the public sector, but "depreciated" the physical result of the investment in a single year, and then carried it on its book at a token dollar.

By amending this to roughly similar treatment – "amortizing" the debt over the useful life of the investment and "depreciating" the physical assets resulting from the investments, a truer picture of the value physical investment assets belonging to the government. Elsewhere in this issue, we deal with the problem and the distortions of what the government can afford.

However, that distortion of accountancy was made only for physical investments, and that helped our government pull the banks out of their gambling debts, to enable them to gamble bigger if not better. And now the ever-expanding speculative expansion into non-banking as well as banking fields, has brought on the worst financial crisis since the great depression of the 1930s.

We have mentioned the once celebrated work of Theodore Schultz that led him to the conclusion that the investment of human capital is the most rewarding investment that a country can make. Introducing accrual (also known as "double-entry accountancy") which already showed its powers as a far easier and more helpful way of helping put the finances of government in order, than anything else attempted. We have then a successful precedent for bringing in accrual accountancy in reporting the physical investments of our government. What remains to be done is to do with human capital investment by all our government levels just what was done with the physical assets of government investment with the investments of human capital. And many trillions of dollars of such investments have been made in the US and corresponding large quantities in Canada.

Instead the tidings out of the US, run in quite the opposite direction. *The Wall Street Journal* (11/20, "States Cut Services, For Elderly, Disabled "by Philip Shishkin) informs us: "Faced with widening budget shortfall, several states are rolling back support services for the elderly and disabled. The move is making it tougher for them to continue living on their own, advocates say.

"At least fifteen states, including Alabama, Virginia and Massachusetts, are targeting such funding mostly for programs that show low-income shut-ins to receive personal care – like cooking, cleaning and basic health services – in their own homes, according to the Center on Budget and Policy priorities, a liberal-leaning Washington, DC, think-tank that studies state budgets.

"That leaves the low-income elderly and disabled to dip into their meager incomes to hire their own help, reach out to family or charity or seek more restrictive and expensive care in a nursing home, advocates say.

"Services for the elderly and disabled are just one of the areas facing cuts. But the cuts hit hard because the population is especially vulnerable. 'The call volume is increasing exponentially and the people are desperate' says Sarah Lightfell, chief operating officer at Senior Resources Alliance, which uses state funds to provide home care services to the elderly in central Florida."

Obviously all levels of government have priorities standing on their heads.

W.K.

Like a Breastplate

As a breastplate let us apply the obvious solution – the one closely akin to one that proved most effective when brought in a few years ago recognizing the *physical* investments of government. That put at our government's beck fresh resources paid for in advance against the ills that threaten to bring our civilization to its extinction. However. what is needed is not to waste these resources in even greater stock-market gambling. but to make good use of these vast and pre-paid resources opened to us but serious double-entry accountancy. That would allow our government to use these valuable prepaid social investments for lasting social benefit.

Double-entry accountancy is believed to have been brought to Europe by Crusaders from the Holy Land roughly one thousand years ago.

Its principles were powerful and fair. Every investment, made between two parties was carried in the ledgers of either *twice*: once noting the money outlay by the buyer. This was "amortized" over the approximate life expectancy of the investment and on the other side – the value of the investment assets acquired, was noted, and likewise "depreciated" over its expected useful life. And from that moment, each of these entries went its independent way, informing both the investors – be they individual, corporations or the government – of the progress of their investment, and of the debt incurred for the acquisition.

But governments tend to become dens of privilege. Despite several royal commissions in Canada, and repeated urging of Auditors General in the United States and other lands, the debt incurred for such investments when made by the government were carefully "amortized," but the value of the asset acquired was written off in a single year. This created the mirage of a debt. But that was very useful for the ruling classes in more than one way. To begin with, an isolated debt with nothing to show for it on the asset side of the government's books, was highly useful in keeping the earnings of the lowly work force and social services low. And of course holding valuable public assets on the government's books at a token one dollar made for some marvelous privatization coups. The acquirer of government assets carried on the books at a token dollar, could well afford to pay a thousand times "book value," and walk to his bank loaded with booty, with the gait of a philanthropist.

This came to an abrupt, fiery end as far as physical assets of the state are concerned in 1996 in the United States, and in 2002 in Canada. The banks whose gambling had reached casino proportions brought down the entire economies in 1929. So violent was the crash that by the time F.D. Roosevelt was inaugurated for his first term in 1933, 9,000 US banks had already shut their doors. Almost the first thing the new president did was to declare a banking moratorium. By the time they opened their doors again a month later, the *Glass-Steagall* legislation was on its way to being adopted. Its main thrust was to ban the banks from acquiring interests in the so-called non-banking "financial pillars" – stock brokerages, insurance, and real estate mortgages. The reason? Each of these "other pillars" carries its own cash and near-cash reserves that they need for their own businesses. Allow the banks to obtain control of these and they will use them as legal tender base for their own purposes – to lend out at the time as much as ten times the money base. And that money was not kept by those other "financial pillars" as strict cash – today the debt of the central government. No corporation allows cash – even for the short-term – to remain uninvested. That means that it does not necessarily have to be the debt of the government since 1970, that became the only legal tender when the gold standard was abolished. It may have been lent out for minimum return and already become questionable, especially these days with the supposed dicing and slicing of mortgages and other debt so that the bank acquiring such debt was already working on an increasingly risky base.

Enter "Risk-based" Fiction

The goal was putting together these supposedly "risk-based" debt packages and unloading them quickly on innocent souls. Many of the mortgages were provided to house-buyers without serious investigation of their earnings and credit records. That was deemed a risk-managed arrangement. In fact often no one examined or even asked for the claimed income – that was deemed an "efficiency," which may have been the case when it could count on the "bankers' exit," a synonym for finding a "greater fool." But when the packages of portions of bits and pieces of various mortgages changed hands, there was no way unbundling and not even a chance of even selling them on a wildly clogged market. And hence there was no way of having their value properly appraised.

The process which had to continue growing because it didn't dare stand still, and thus backed up and spread across oceans and continents. And that brought us to where we are today.

The S&L Disaster

The 1980s when banks in the USA were deregulated and allowed to take over the Savings & Loan mortgage trusts, led to disastrous deals especially resulting from the economic union of the United States, Canada and Mexico. Thing got so bad for the Mexicans that the government was reduced to issuing special "tesobono" bonds that, though bought for pesos gave the buyer the option of asking for their redemption in US dollars. This, of course, was a pre-taste of the "united" currency that was being peddled in Canada at that time. Imagine, if you can, the equivalent of "tesobonos" that would give Americans the option of receiving on maturity US dollars for bonds that had been subscribed in Canadian dollars and you will grasp the swindle of many Washington-hatched "unified" continental schemes.

The situation of US banks became so bad, with the end of restrictions on banks acquiring S&Ls, that the Bank for International Settlements (BIS) brought in its *Risk-Based Capital Requirements*, that allowed banks of advanced countries to acquire hoards of bonds without down payment. Because of that provision, Canadian banks were able to quadruple their holdings of government bonds without down payment – from approximately $20 billion to $80 billion.

At the same time the BIS, in its determination to flatten the world price level to "lick inflation." In doing so this war room of central banks overlooked two details. You cannot turn around a relationship and take for granted that it remains valid. Only a simpleton moving from a town of 20 thousand inhabitants to New York City will assume that his cost-of-living will remain the same. How then can BIS expect that this can be done when much of humanity is making a similar move? In their haste to achieve that goal, BIS overlooked another important detail: when interest rate go up drastically, hoards of pre-existent bonds will drop drastically. And that indeed is what happened

initiating rapidly spreading chain bankruptcies throughout the financial world.

This threatened to bring down the world financial system, and, since the distressed banks needed those hoards acquired without down-payment, the US Treasury sought another way out of its dilemma: it brought in double-entry bookkeeping (a.k.a. accrual accountancy) – depreciating the physical assets of the government over their likely useful lives. This, carried back to 1959, brought to light well over a trillion dollars of prepaid assets. rates that gave President Clinton a second term and extended the high-tech boom until the end of the millennium.

So much for the background that provides us with a perfect example of prepaid investments having been recognized and, unfortunately, misused to finance bigger if not better gambles.

That, plus a better acquaintance with our history reveals a still greater prepaid resource that the governments of the developed world have to draw on to get the present unending economic crisis under control.

To appreciate that carefully we need a bit of history. At the end of World War II, Washington sent hundreds of economists to Japan and Germany to predict how long it would be before they could once again become the formidable competitors they had been on world markets. Some twenty years later, one of these, Theodore Schultz of the University of Chicago, published a paper explaining why he and his colleagues had been so wide of the mark in their prediction. "We concentrated on the physical destruction and underestimated the importance of the highly educated and disciplined work force having come out of the war largely intact."

From that Schultz concluded that investment in human capital is the most productive investment a government can make. For this he was for a very few years celebrated, awarded the Bank of Sweden Nobel Peace Prize for Economics, but since forgotten. His conclusion was not what the powers in the saddle wanted to hear. That is why that prepaid capital resource is still available in all advanced countries today. It is not preassigned, cut up and bundled with subprime debt. To totally assess it, will take years of research, but there is no reason why it could not be brought into the governments' balance sheet in swatches, to equip them to finance with it further massive investments in human capital. Of course, that will include the environment, since society lives or dies on its bosom.

There we have a ready prepaid financial resource to allow the leading nations to head off the Depression into which the world is sinking.

Only one further feature should be added to such a bailout arrangement for our banks. For each successive bailout that a bank might have to be brought through, the bank bailed out by using the government's credit backed by its investment in human capital, should forfeit the non-banking activities that banks had been barred from during the depression – stock brokerage, insurance or, real estate mortgages. This would leave their shareholder's interest otherwise intact but bring the bank in question closer to the provisions introduced under Roosevelt in the US and closely copied in Canada and other lands. That would make for healthier banking by excluding much gambling.

William Krehm

Even the Great Buffett Gets Buffetted by Derivatives

Whatever the success record of Warren E. Buffett, chief Executive of Berkshire Hathaway might be, the means towards it was not short on self-promotion. An article in *The New York Times* (25/11, "Buffett to Offer Details on Derivatives" by Michael J. de la Merced) tells a strange tale: "Warren E. Buffett has long been a proponent of transparency and a critic of murky financial instruments. Now, as his investment firm's stock takes its worst beating in years, America's avuncular prophet of capitalism is promising to shed some light on his own opaque instruments.

"Shares of Mr. Buffett's Berkshire Hathaway, a sprawling empire of companies and stocks with the highest possible credit rating, have tumbled 36% since Oct. 1. And the cost of protecting Berkshire against default – a measure of investor confidence in a company – has doubled over the past two weeks, often associated with ratings near junk status.

"The primary concern is Berkshire's involvement in two types of derivatives, instruments that became increasingly taboo after the declines at the American International Group, Lehman Brothers and other financial institutions. While Mr. Buffett once derided derivatives as 'weapons of financial mass destruction,' investors were concerned about bets he made that assume four stock market indexes, including the Standard & Poor's 500-stock index would rise to certain levels by 2019.

"On Monday, Mr. Buffett said he would disclose in the next annual report more information about how Berkshire Hathaway calculates losses on such investments.

"To say Mr. Buffett is among the world's most respected investors is an understatement. Thousands descend on Nebraska every year to listen to his observations at Berkshire's shareholder meeting, and dozens of books have been written about his buy-and-hold investing strategy. Companies acquired by Berkshire are considered best-in-breed – Goldman Sachs and General Electric sought such prestige when they announced investments in September and October. During the 2008 presidential campaign, to secure his support, his name was invoked by both candidates as a bipartisan totem, meant to assure voters that the economy would get better.

"But Mr. Buffett's primary business, Berkshire, has been tarnished. Class A shares in the company, whose core business is insurance, fell for nine straight days through Thursday and are down 38% for the year.

"That decline has struck hard at Mr. Buffett's personal fortunes a third of which is tied up in Berkshire stock.... In a recent interview on the Fox Business Network, Mr. Buffett professed little worry about Berkshire's steep stock drop. 'It's happened to me three other times in my life, too.'

"On paper, Berkshire's core business appears to be performing in line with the rest of the market. The company's third-quarter profit fell 77% from last year, hurt in part by the impact of two hurricanes on its insurance business and drops in the value of many of its stock investments. Still Berkshire avoided the risky bets that sank rivals like AIG, and its wide array of portfolio companies could help insure that at least some of its businesses are doing well.

"Nonetheless, investors had become increasingly nervous about Berkshire's derivative bets – in particular those that gambled on targets for four major stock market indexes by 2019. Berkshire sold those private contracts to unknown investors, reaping $4.85 billion up front. Because of accounting rules, Berkshire has already had to mark down the value of those contracts by $6.73 billion."

W.K.

Playing the Bailout of Private Financial Empires by Ear

There is one thing that the founding fathers or even the authors of economic textbooks could never have even conceived: that the various offices of government had to twist bend, and improvise to preserve even the semblance of a functioning economy.

The Wall Street Journal (11/10, "Paulson, Bernanke Strained for Consensus In Bailout"): "Washington – Federal Reserve Chairman Ben Bernanke reached the end of his rope on Wednesday afternoon, Sept. 17. Lehman Brothers Holdings Inc. had collapsed. American International Group Inc. had been effectively nationalized with $85 billion of Fed money. Investors were stampeding out of money-market mutual funds. Credit markets were reeling, stocks were wobbling and bank failures loomed.

"Mr. Bernanke called Treasury Secretary Henry Paulson. The Fed chairman, a Princeton academic with an occasional quaver in his voice, leaned towards the speaker-phone and spoke unusually bluntly to Mr. Paulson, a strong-willed former college football player and Wall Street executive. The Fed had been stretched to its limits and couldn't do it any more, Mr. Bernanke said. Although Mr. Paulson had been resisting such a move for months, Mr. Bernanke said it was time for the Treasury secretary to go to Congress to seek funds and authority for a broader rescue. Mr. Paulson didn't commit, but by the next morning, he had.

"In public, Messers. Bernanke and Paulson marched in lock step. Behind the scenes, the two men and their lieutenants sometimes tussled – over the fate of Lehman Brothers, how to handle Congress and the limits of the Fed's authority. At times, each man felt handcuffed by legal limits on his own power, and consequently pushed the other to move more aggressively. Their differences helped define the government's approach to the crisis.

"The debates helped shape an ad hoc strategy that at times sowed confusion about Washington's approach and sparked criticism of the nation's two top economic physicians at a time when restoring confidence was a top priority.

"Pressing tasks for President-elect Barack Obama's new economic team – to be announced in the coming days – will be to calm markets and decide which of the Bernanke-Paulson decisions to endorse and which to seek to alter, and how to manage the relationship between the Treasury and the White House and the Fed after the inauguration.

"Mr. Paulson will be leaving, but Mr. Bernanke whose term extends until 2112 will remain. A key player will be Timothy Geithner, either continuing as president of the Federal Reserve Bank of New York or as Mr. Paulson's successor. Mr. Geithner, one of the Fed's key crisis managers, is among a handful of people on Mr. Obama's short list to run Treasury.

"The Fed and the Treasury had operational styles that mirrored their bosses. Inside the Fed, there were running debates resembling academic seminars. with Mr. Bernanke running discussions but offering few opinions. The Treasury was run in command-and-control fashion, with Mr. Paulson the general, listening to his troops, making decisions quickly, and often calling to check on the status of a request just hours after issuing it. The two men rarely allowed daylight to seep in between them in public.

"Their decisions have left many questions. Why did they let Lehman Brothers fall just six months after deciding its smaller rival, Bear Stearns Cos. couldn't be allowed to collapse? Why didn't they go to Congress sooner? When they did go, why did Mr. Paulson argue against an option pushed by the Fed – putting capital into banks – that he ended up embracing a few days later?

"The following account of pivotal moments during September and October is based on interviews with government officials, lawmakers and others.

The Lehman Crisis

"On Tuesday, Sept. 9, a day after the government nationalized mortgage giants Fanny Mae and Freddie Mac, Lehman was on the brink of failure. Potential acquirers were circling, but to many of these, Mr. Paulson had a message 'There's no government money here,' he told several CEOs in telephone calls. Some pushed back, saying the government couldn't let Lehman fall. Mr. Paulson was unwavering.

"One day later he called Mr. Bernanke and Mr. Geithner and told them that he wouldn't support using government money to save Lehman.

"Fed and Treasury officials figured that they were in a better position to handle the collapse of an investment bank than they had been back in March, when the Fed interceded to prevent Bear Stearns from failing. The Fed had new lending mechanisms that investment banks could themselves tap for short-term funds if Lehman went under and credit markets froze up.

"Senior government officials told reporters that Mr. Paulson had drawn a line in the sand. There would be no public money spilled to rescue Lehman. Some Fed officials, including Mr. Geithner had spent much of his career attending to financial market fires. One of his mentors, Clinton Administration Treasury Secretary Robert Rubin, had taught him the value of 'preserving optionality' – not limiting your choices. The Treasury, some officials believed, was breaking that rule.

"That Friday night, Sept. 12, when Wall St. CEOs gathered at the Federal Reserve Bank of New York, Mr. Geithner warned them that there was no political will for a bailout. 'I think there was a lot of pressure on them to stop intervening, to see if the market worked,' said Barney Frank, the Massachusetts Democratic House Financial Services Committee Chairman.

"Mr. Paulson's strategy was to pressure other Wall Street firms to help rescue Lehman. They needed to collectively figure out a way to save Lehman or to facilitate an orderly wind-down of the firm. Mr. Paulson would say a day after Lehman collapsed that he 'never once' considered putting taxpayer money on the line. But that weekend, some Fed officials believed Mr. Paulson was prepared to do just that, despite his public stand against it. But Lehman was in worse shape than Fed Officials had realized. Rivals pored over Lehman's books that weekend and concluded its assets could be overvalued by more than $30 billion.

"Bank of America opted to buy Merrill Lynch & Co. British regulators balked at quickly blessing a proposed deal with Barclays. To open for business Monday, Lehman needed broad debt guarantees from the US government, something that officials felt they couldn't do. The Fed can make emergency loans, but only against good collateral.

"Messers Bernanke and Paulson felt they had run out of options. Mr. Paulson, Mr. Bernanke and Mr. Geithner all understood that the market was in for a severe shock. Mr. Geithner spoke with Mr. Bernanke 'about spraying foam on the runway' to

soften the blow of Lehman's crash.

"Conversation in Mr. Geithner's office turned to a broader rescue. Fed and Treasury staff members had been studying options for buying Wall St.'s bad assets and injecting new capital directly into banks.

"The Treasury secretary didn't think he'd be able to persuade Congress to approve spending billions of dollars unless the crisis got significantly worse. Now with the imminent failure of Lehman arose. 'I want a proposal right away,' Mr. Paulson told his staff that Sunday night, Sept. 14.

"The Fed was pushed to its limits by the collapse of Lehman Brothers and the bailout of AIG, an [insurance] firm it didn't regulate. Short-term lending markets were freezing. Fed officials believed the problems required more than what a central bank was designed to do – provide emergency loans to healthy institutions. The Fed wasn't set up to rescue failing institutions – that was for the Treasury and Congress to handle."

By this time I am sure that my audience is asleep, but the hankering around continued rather than dealing with the main point. What will be left of the clear purveyor of legal tender if the discussions revolve about rescuing failing ones, possibly with the acquisition of some of their dubious assets.

Yet all the while untouched was an obvious opening for putting new clean assets into the Treasury which would allow a revival of the economy without in any way polluting the assets of either the central bank or the Treasury. The precedent had already been handled successfully in the introduction of accrual accounting in putting on the government's balance sheet the physical investments of the government. A reputable body of economists had honored and hailed the author of the notion of human capital being treated in like fashion. Not only would that mark a great advance in economic practice, but fitted as a glove the unending and deepening crisis that has taken over. But never had so clear a policy to avoid a recession already upon us and provide the credit based on government investments already made and long since paid for but simply left off our government books. with not even so much as a mention. The timing could not be better and the amount of clean credit for investments long since made would allow society to catch up in every area *and revive the economy in a way that nothing else mentioned towards that end could do.* Nothing subprime about that, but a great deal is subprime about the politicians and financial experts who have been in charge of the mess.

There are penalties for covering up our history, and we are in the process of paying them, interest upon interest and all.

William Krehm

On Heroes and Demi-heroes

There are heroes in the tough battles with all sorts of below-belt targets. And those who will speak the whole truth needed for the salvation of the tribe or nation, no matter what the cost in employment or profitable position in the world as it is, merit our highest esteem. But there are as well those, who, while being quite aware of the main truths of situations that threaten society, would undoubtedly speak the whole truth, but they have wives, children, or parents to provide for and the whole truth since it is ruled out by the those in power, has been declared unspeakable, and thus dangerous. Let us reserve our greatest gratitude to our complete heroes, but not underestimate the role and value of these "semi-heroes." A half-truth, when all truth is frowned upon by the mighty, can open minds if not forums to the entire truth needed to save society.

Thus my tribute to Paul Krugman – a distinguished economist turned a still more distinguished journalist, and listen approvingly as we would to a bus that leaves us waiting yet for another bus that always seems to be coming on a cold wintry day, but never quite arrives. And yet the scene becomes more rather than less urgent when the business world in all climes and on all continents seems to be coming apart.

Mr. Krugman heads his piece in *The New York Times* "Franklin Delano Obama?" and begins it with a huge half-truth: "Suddenly, everything old is New Deal again. Reagan is out; F.D.R. is in. Still, how much guidance does the Roosevelt era really offer for today's world?," asks Mr. Krugman.

"The answer is, a lot. But Barack Obama should learn from F.D.R.'s failures as well as from his achievements: the truth is that the New Deal wasn't as successful in the short run as it was in the last run. And the reason for F.D.R.'s limited short-run success, which almost undid his whole program, was the fact that his economic policies were too cautious."

That is a half-truth that more than matches the immediate semi-successes of Roosevelt's policies. But there is a difference between what Roosevelt left undone, and what Krugman leaves unsaid in his article.

Much of what Roosevelt left unsaid had already been said by our prophets, but many crucial points Krugman omits in this article had already been said, and boldly embodied with great success in our institutions. Only subsequently have they been repressed and forgotten. For example: what became of the *Glass-Steagall* legislation that forbade the banks to acquire interests in "other financial pillars" – to wit, stock markets, insurance and mortgage companies? And there was good enough reason for that. For from the earliest appearance of banking, its essence has been that the goldsmiths, who later became bankers, learned to lend out several times the gold and silver that they held on deposit for travelers to and from the dangerous outer world.

And it was not long before the goldsmiths found out that he could safely lend out a good portion of what was deposited with them, and collect interest on it. Allow the bankers access to the cash or near-cash reserves that these other "financial pillars" hold, and the bankers will use that as money base to serve for further near-money creation. The "near-money" alludes to the fact that interest is collected on such loans, legal tender spent into existence by the state earns no interest and hence its value does not move inversely to the rate of interest. That is a virtue in the legal tender of a country.

Obviously, Mr. Krugman could never have managed so distinguished a career either as economist or as journalist, without becoming aware of this basic fact that shaped Roosevelt's great eventual successes, and the eventual failure of a long line of later presidential regimes. For the bankers become general financial overlords, suppressing the knowledge of these facts not only of modern financial economics, but of our history. And today those humbled financial magnates being bailed out by the state – with a mammoth insurance company and countless mortgage firms included in the assembly of financial behemoths on the verge of keeling over, would never have ended up in such a plight. And the government that Mr. Obama on taking over would not have been saddled with the task of learning and embodying them in the law books once more.

W.K.

Bank Bailout — Credit Crunch — Infrastructure Renewal

The $75 billion bank bailout has been justified by the Minister of Finance, James Flaherty, as necessary to ease the credit crunch facing Canadian banks and make consumer and mortgage loans cheaper and more available. It does nothing to help those who have lost their jobs or whose jobs are in jeopardy of disappearing. Even those with "secure" jobs are thinking twice before going further into debt.

Instead of buying $75 billion of bank-held mortgages, it would have been a far better use of the $75 billion to invest it in upgrading the nation's infrastructure – including such things as roads, bridges, sewers, water treatment, health services, education, housing and environmental restoration. Invested in this way it would result immediately in good paying jobs for thousands of workers – from construction workers to engineers, accountants, managers, office personnel, nurses, doctors, lawyers, teachers, scientists and others. The wages received by these people would quickly find their way into the banking system, easing the credit crunch by providing the money base which banks need to make loans. As Mark Carney, Governor of the Bank of Canada said, the solution to the credit crisis is to get more capital into the banks. The money would also end up in the local grocery store, car dealer, theatre, clothing store etc, further stimulating the economy.

Municipalities are facing a $130 billion infrastructure deficit. The government's current plan for upgrading infrastructure consists of $33 billion spread over seven years – less than $5 billion per year – and two billion of that would be absorbed by the annual increase in the deficit. Compare that to the $75 billion for the banks which could go a long way to erasing that deficit, especially when coupled with provincial and municipal funds.

And where did the $75 billion come from? Was it borrowed, and if so from whom? It could have been borrowed from the Bank of Canada at zero interest cost, but the government has maintained for years that to do that would cause inflation. Without information to the contrary (information which has been requested) I have to assume that it was borrowed from the market – part or possibly all from the banks themselves. If even part of the money was borrowed from the banks then the banks would be making money on the interest received by first creating the money (which they do with the stroke of a computer key) and then lending that newly created money to the government so it can buy the mortgages from them. The billions of dollars in interest which would subsequently be paid to the banks every year is the real bailout, and it goes on without end. So the tax payer is on the hook for ever – unless a government is elected which reforms the system. So far, none of the current crop of parties holding seats in parliament has shown any interest in reforming our financial system.

Faced with high unemployment, unions should be pressing for reform of our financial system. This would be good for their members and for the community as a whole. Their strength is needed to press government to invest the $75 billion (or what is left of it plus more as required) in infrastructure renewal, and to borrow the necessary funds from the Bank of Canada – not the chartered banks – to do it. The Bank of Canada can create money as easily as the chartered banks can, and it won't be inflationary as long as it is invested in assets of equal value such as the infrastructure. In contrast, money borrowed from chartered banks is inflationary because it carries an interest charge which is added to the cost of everything.

Richard Priestman

Housing Crisis Keeps Aged Out of Retirement Homes

The housing crisis has a way of snaking into every cranny of life problems of rich and poor alike. *The New York Times* (22/11, "Unable to Sell Homes, Elderly Forgo move to Assisted Living" by Jack Healy) reports: "The housing crisis has kept thousands of older Americans who need support and care from moving into retirement communities or assisted-living centers, effectively stranding them in their own home."

Like playing the tragedy of the young unable to acquire a home with the main actors standing upside-down – on their heads.

"Without selling their houses or condominiums, many cannot buy into retirement homes that require a payment of $100,000 to $500,000 just to move in. So they are stretching themselves on waiting lists, canceling plans with packing services just to move in houses that fitted well 30 years ago, but that over the years have become lonely, too lonely or too treacherous to navigate.

"Facilities that have watched their waiting lists wither and their occupancy rates fall in the last year are now scrambling to bring people through their doors.

"The Cedar Community, which provides a range of housing for the elderly in West Bend, Wis., has seen independent-living occupancy rates drop by 4% this year. There were so many people for their homes to sell that the facility decided, in some cases, to let new residents pay month-to-month until they could unload their houses and use the proceeds on the facility's entry deposit."

Meanwhile, physical tragedies do not wait on a stagnant market.

"For people like Ruth Scher, 85, selling their home is a critical first step before moving on, or moving anywhere. In the 34 year since she moved to South Florida, Mr. Scher's husband has died, the siblings who moved south from New York to join her have died, and her friends have moved away. She is recovering from a fall that broke her clavicle and suffers from arthritis in one shoulder and she says it is time to move back.

"There is no way to say how many older Americans are in similar straits, as no statistics track how many of America's 4.27 million unsold homes are owned by people 65 or older.

"There are signs some families and retirees are turning to adult day care services as a stopgap. Providers say their business has spiked as people look for an alternative to continuing care or home aides to provide food, companionship and therapeutic services. But Mr. Williams of the Assisted Living Federation said that people who need more day-to-day care, those who have trouble getting up stairs or who need someone to check on them, were taking a risk by staying at home."

Society's seemingly unending financial woes have a way of embracing rich and poor, old and young in one murderous bear hug.

W.K.

FROM MELTDOWN, VOLUME 3, AVAILABLE IN JANUARY 2009

The Next Generation of Iridescent Bubbles

In our piece in this issue [October 2002] on the automobile dealership boom coinciding with the near record auto manufacturing slump, we introduced the concept of derivative speculative bubbles: moon bubbles spinning around aspects of the earth speculative bubble that has in fact already burst. A high school student will tell you that if the mother planet has gone up in smoke, there will be no gravitational force to keep the moon in orbit, but economists shun raising such obvious problems. They would needlessly complicate the sale of stocks and bonds. The pattern can be detected across the world economy. Thus *The Wall Street Journal* (10/09, "Foreclosures Hit Record Levels" by Queena Sook Kim) deals with the soft underbelly of the housing boom that has been hailed as one of the few guarantees against a "double-dip recession": "In recent years, the housing industry has bent over backwards to allow people to buy houses they couldn't previously afford. Lenders require smaller down payments and allow buyers to devote more of their income to mortgage payments. And many borrowers are being lured by adjustable rate mortgages with low teaser rates that quickly climb, pushing up house payments.

"Now the bill is coming due. In the second quarter, a record 1.23% of all home loans were in the foreclosure process, above the first quarter's tally of 1.10%, and surpassing the previous record of 1.14% in the first quarter of 1999, according to a report of the Mortgage Bankers Association of America. The same report found 4.77% of all home loans outstanding were at least 30 days delinquent. That's one of the highest rates of the last decades, though it's well below the record delinquency of 6.07% in 1985 [at the height of the Savings and Loans super-mess].

"If the delinquency rate worsens, lenders could tighten lending standards, making it harder for many potential home buyers to get financing and resulting in a weaker overall housing market. That would be bad news for the economy since surging house prices are a big reason that consumers have kept spending even as the stock market slumped.

"The derivative aspect of the housing boom, is that it was fueled by a growing problem of the house builders – their ability to move their housing without luring buyers into taking on financial commitments that many simply can't afford in a crumpling economy. The cheerful house-buying boom has been based largely on the already deeply insecure housing market. That confirms our new category of a 'derivative boom' that sets its foundations in an already collapsed bubble.

"Part of the reason the housing market got so hot is that lenders rushed out loans designed to cut monthly payments so that buyers could get bigger homes. It is some of these very loans that are now experiencing problems. One indication: Conventional adjustable-rate mortgages, popular with budget-stretched customers, currently have a 5.29% delinquency rate vs. a 2.75% rate for conventional fixed-rate mortgages.

"In the San Diego county town of Vista, the Mullins think their brokers steered them into a home they couldn't afford. The couple, who are in their 30s, had racked up $20,000 in credit-card debt after buying their first home in 1999. Mr. Mullins figured that monthly mortgage payments on the Vista home would eat up about 60% of their take-home salary and exceed the 36% of gross income that once was the banking industry's usual limit.

"The couple say that their broker, Patty Villanueva, steered them towards a 'stated income program,' which allows borrowers to simply write their income on an application without submitting tax returns. The interest rate on a state-income program is between an eighth of a percentage point and one percentage point above the conventional rate."

The real motivation of such plans is to use the customers' credit card elbow room (another bubble in the process of coming apart) to stave off the house builders' bankruptcy, with too many of the buyers merely patsies victimized as fodder to keep the derivative boom going.

William Krehm

When the Circus Came to Town

A memory from my remote childhood was when my school class was taken to watch the circus come to town. Arriving by train they were marched through the streets towards the exhibition grounds, a sort of Noah's ark in reverse gear. A literal-minded believer could take it as the ultimate proof of the Scriptures; an evolutionist as a broad proof of Darwin. But what stuck in my little mind was the way the trunk of one elephant

Our Empty-Bottle-Return Federal Elections

In the Ontario liquor system to keep empty bottles out of the garbage collection, beer stores redeem empties at a couple of dimes or so each, strictly to keep them out of the municipal garbage containers. We can think of no other inspiration for the federal elections that seem to be on the verge of being sprung on us.

Canada's constitutional crisis is complex enough, but it is shelled peanuts alongside the monetary and economic crisis that has engulfed the entire world with no suggestion of letting up. The contrast of two crises is that there is no notion of any nexus relating the two. And yet of the five opposition parties involved in the elaborate schemes not only to unseat Stephen Harper, the most daring *constitutional* strategies have been explored, Where they stop abruptly is that nothing that might give the electorate the slightest help toward understanding the most complex credit crisis experienced on this planet is provided even as an illegible footnote. We are puzzled about what can be left of democracy when issues that decide the food, shelter, healthcare, and employment of our nation and of the world are simply taboo.

Surely the livelihood of the nation and of the world is highly relevant to any central political process, especially when it is likely to determine what political party rides in the saddle for years to come. And especially when two of the parties involved in the strategies were deeply involved in the nationalization of our central bank in 1938. As for the Greens unless our political process regains some relevance to the restoration of the environment, and the preservation of the environment is recognized as a capital investment of government our political process will continue an empty farce.

W.K.

clutched the tail of the one ahead, the whole resulting in a tidy chain. It gave you a sense of a world properly organized according to whatever script you chose.

Somehow that came to mind when I read *The Globe and Mail* story (27/08, "US solidifies its ranking as the world's biggest jailer" by Miro Cernetig): "The US has cemented its status as the world's No. 1 jailer, with a record 6.6 million behind bars, on probation, or paroled last year.

"These latest statistics published yesterday by the Department of Justice, mean one of every 32 adult Americans is in the penal system – six times the incarceration rate in Canada.

"The growth of that figure slowed last year to 2.6% from an average annual increase of 3.6% over the previous five years." But the US is far from losing the championship. "Civil liberties groups believe US prisons have become a weapon against the poor, especially against blacks.

"Blacks represent more than 45% of the prison population, even though they comprise only 12% of it.... On any given day, 'one in nine black men between the age of 25 and 34 are locked up,' said Marc Mauer, assistant director of the Sentencing Project, a Washington-based advocacy group. 'In 2001, the US had 1.3 million people in prisons, and 631,240 in jails, 3.9 million people on probation and another 731,147 under parole supervision. The US incarceration rate is five to eight times higher than in other democratic nations.'"

Here the first interlacing of the elephant's trunk with his colleague's tail makes its appearance: "One consequence for the world's most powerful democracy: about 4 million US citizens can no longer vote, because a felony conviction means a lifetime ban on casting a ballot.

"Mr. Mauer said 'enough prisoners have been stripped of their voting rights to sway several key states, most notably Florida which President George W. Bush won by a few hundred votes in 2000.'

"It wasn't always so. In the 1950s, the US put people in prison at a rate more in line with other Western countries. But in the sixties, the violent anti-Vietnam War protests and President Richard Nixon's first salvo in the war on drugs in 1968 started a trend towards tougher sentencing." Of course, like the interpretation of the elephant chain of the arriving circus, there are always a couple of juries out on such issues. One has the connections that count, the other doesn't.

"It soon became good politics to implement harsher sentencing for drug crimes, a trail blazed [of all people!] by New York Governor Nelson Rockefeller. In 1973 he imposed 15-year mandatory sentences for possession of small quantities of drugs. Policies further hardened in the 1980s and 1990s, culminating in the so-called three-strikes law that put people away for a minimum of 25 years if convicted three times on

A Letter to the President-Elect, Barack Obama

27 Sherbourne Street North, Apt. 1
Toronto, ON Canada M4W 2T3

9/11/08

Barack Obama
President-Elect of the
United States of America
Washington, DC

Dear Mr. President-Elect:

I am a Canadian citizen. For the past 20 I have edited *Economic Reform,* the publication of the Committee on Monetary and Economic Reform. I am taking the liberty of sending you this note because in the present plight of your and our credit systems, we seem to be unable to get our banks to perform their tasks without serious breakdowns, real or threatened. I would like to bring to your attention that in 1996 a not dissimilar crisis was brought under control by a very simple device: introducing accrual accountancy where physical investments of your government were concerned. Prior to January, 1996, when your government built a bridge, a building, or a road, its cost was carefully amortized over the likely useful life – approximately – of the asset, but the asset value was completely written off (i.e., "depreciated") in a single year.

However, as of January 1996 accrual accountancy was brought into your books for such physical investments, with the results showing up for the first time in the Department of Commerce figures of January 1996, under the heading of "Savings," which of course, they were not since that usually refers to cash balances or balances readily translatable into cash. Carried back to 1959, this brought to light considerably more than one trillion dollars of neglected assets with dramatic results in bringing your financial results into good order.

There is thus successful precedent for taking identical steps with your government's vast investments in human capital. At present these are treated as current spending, and thus depreciated in a single year.

However, at the end of World War II, your government sent hundreds of economists to Japan and Germany to study the extent of the damage and on the basis of such studies predict how long it would probably take for those defeated powers to regain their formidable trade positions on world markets. In the 1960s, Theodore Schultz, of the University of Chicago, wrote a paper noting how wide of the mark their predictions had been. This he attributed to have written off the human capital invested in the education, and health the health, environment, and social well-being as current spending, whereas the very figures showed that such human capital is the most productive investment a government can make. For a very few years Schultz was feted, awarded the Bank of Sweden's Nobel Prize for Economics, but then, together with his work, forgotten.

Now, Mr. President-Elect your government, making full use of his great work, would put your government in a position to keep our financial system and in particular our banks full employed dealing with neglected human infrastructure. It would, Mr. President, make a keenly needed and equally glorious complement to the great achievement in racial fairness that your election as President represents.

Let me point out that corresponding to the need to head off what seems an incipient depression, it would not be necessary to complete the complete entry into your books of the investments in human capital already made. This could be achieved over, say, a ten-year period, with enough of these neglected assets book to keep ahead of the actual reinvestment in physical and human capital to head off the menace of a serious depression.

I should be prepared to come to Washington at my own expense with documentation which, of course, we can begin sending by mail.

Most respectfully,
William Krehm

relatively minor felonies." Second interlacing of trunk and tail.

Some might find these massive statistics on the jailed a striking contrast with the couple of photos of manacled Wall Street high-flyers taken into custody that have recently received such prominent play in the media. However, it does keep down the number of officially unemployed in the land.

"In 1980 there were about 40,000 people in prison for drug offences; today it's about 450,000.

"Experts believe the incarceration rate shows no sign of reversing soon, even though there has been no major upward trend in crime rates."

William Krehm

Optimism Is a Hardy Weed

Most amazing is the stubborn optimism with which traders persisted in raking over a wilting market. As recently as 10/12 ("White House Overhauling Rescue Plan for Economy" by Edmund L. Andrews and Mark Landler), *The New York Times* reported Mr. Henry M. Paulson Jr. refusing to say whether the capital infusion program for banks would be bigger than the original plan to buy troubled assets. Yet a couple of days later Mr. Paulson announced that he hoped to make the first capital investments within the next two weeks. That would be earlier than any government purchases of unwanted mortgage-backed securities. One reason for Mr. Paulson's rapid reconsideration was that global financial markets have been going downhill faster than anyone had seen before.

"Credit markets seized up and all but stopped functioning, making it impossible for most companies to borrow on more than an overnight basis. Investors panicked as the House initially rejected the bailout bill on Sept. 29. They panicked even more after Congress passed a bill on Oct. 3 that was packed with sweeteners that added $110 billion to the price tag.

"By the closing bell last Friday, the Standard & Poor's 500-stock index had suffered its worst week since 1933. A growing number of analysts argue that what Mr. Paulson originally called the Troubled Assets Relief Program would have been unhelpful and possibly unworkable.

"As envisioned the Treasury or its agents would hold so-called 'reverse auctions' in which financial institutions are invited to compete against each other in offering to sell their mortgage-backed securities at a low price.

"Though auctions are common for all sorts of products, experts said that mortgage-backed securities would pose difficult headaches because they are extraordinarily complex, difficult to value, and come in almost limitless variety.

"Investors panicked as the House initially rejected the bailout bill on Sept. 29. They panicked even more after Congress passed a bill on Oct. 3 that was packed with sweeteners that added $110 million to the price tag.

"By the closing bell last Friday, the Standard & Poor's 500-stock index had suffered its worst week since 1933. A growing number of analysts argue that Mr. Paulson's original plan, called the Troubled Assets Relief Program, would have been unhelpful and possibly unworkable. Some noted that Mr. Paulson presented to Congress a proposal that was only three pages long and that Treasury officials have yet to provide details how the auctions will work.

"As envisioned, the Treasury or its agents would hold so-called 'reverse auctions' in which financial institutions are invited to compete against each other in offering to sell their mortgage-backed securities at a low price.

"Though auctions are common for all sorts of products, including electricity that utilities sell one another, experts said that mortgage-backed securities would pose difficult headaches because they are extraordinarily complex, difficult to value and come in almost limitless varieties."

A Hardy Weed Chopped Up

"The bonds for a single pool of mortgages are divided into more than a dozen 'tranches,' or slices, which have different seniority, different credit ratings and different rules for being paid off. The performance of the underlying mortgages varies greatly from one pool to another, even if both pools are made up of seemingly similar loans.

"'I am not aware that the Treasury Department presented any evidence on auctions that have been successful when they are used for assets that are so heterogeneous,' said William Poole, who retired in August as president of the Federal Reserve Bank of St. Louis.

"Because Fannie Mae and Freddie Mac, the mortgage giants, buy and sell mortgage securities every day, they could absorb some of the hard-to-sell securities without going through the untested auction process.

"The Federal Housing Finance Agency, which last month seized the companies and placed them into a conservatorship, lifted capital restrictions on them last week and effectively gave them a green light to buy more mortgages of all types, including those backed by subprime loans given to borrowers with weak credit.

"The companies have a lot of money: Congress authorized Treasury to lend them as much as $100 billion each as part of the rescue plan created for them. That could free up money in the separate $700 billion bailout plan for injecting capital directly the banks…. People familiar with the early planning efforts for a systemic bailout said that it would be easier and more efficient to inject capital directly into the banks because they were ideologically opposed to direct government involvement in business.

"'The crisis in confidence goes way beyond the actual losses that will be incurred from debt securities,' Mickey Levy, chief economist for Bank of America said in an interview on Friday. 'It is truly incumbent on policy makers to address that crisis.'

"Treasury officials began canvassing banks and investment firms about the possibility of having the government buy stakes in them. The new bailout law gave the Treasury the authority to buy up almost any kind of asset it wanted, including stock or preferred shares in banks.

"Industry executives quickly told Mr. Paulson that they liked the idea, though they warned that the Treasury should not try to squeeze out existing shareholders. They also begged Mr. Paulson not to impose tough restrictions on executive pay and golden-parachute deals for executives who are fired."

In his remarks on Friday Mr. Paulson noted that the government would acquire only "non-voting" shares in companies. Of course, the question remains where the government will obtain the money for funding the acquisition of the available stock.

Continued on page 20

The Fed Sorts Things Out a Bit

Through all the tsunamis of confusion that the near-collapse of the world's basic monetary system, an odd glimmer of light is blinking through. The confusion begins from the detail that abusive debt is the villain, multiplied by jungles of derivatives. At the same time debt – of the central bank and/or the Treasury is also the legal tender of all developed and developing lands. You cannot go trading legal tender – i.e., central government debt for dubious gambling debts or badly timed automobile company obligations without getting into greater trouble than what is already overwhelming the world.

It is with some relief that we find someone in the upper echelons of the US central bank that is staying true to an open formulation of this distinction.

Thus in *The Wall Street Journal* (11/13, "Fed's Kohn Wary of Industry Aid" by Sudeep Reddy) we read: "The Federal Reserve may need to take more steps to relieve strained credit markets, a top central-bank official said Wednesday, while pushing back against the idea of Fed aid for specific industries.

"In a speech in Luxembourg Fed Vice Chairman Donald Kohn said 'central banks should distance themselves from decisions about the allocation of credit among private parties' except in extreme cases when financial markets break down and 'systemic risk reaches unacceptable levels.'

"The comments came as law-makers stepped up calls to support the ailing auto sector. Fed officials have resisted suggestions that the central bank lend directly to auto makers, indicating that Congress and the Treasury should be responsible for channeling credit to specific firms or industries. Still, the Fed has expanded its reach in the past year to the securities and insurance industries amid concerns about broader financial stability.

"In his speech Mr. Kohn said some special landing facilities, such as a program for the commercial paper market, are clearly emergency operations only and would be wound down. Some of the Fed's temporary lending programs such as currency swaps with other central banks and auctions for credit at the Fed's discount window, might become permanent, he said.

"The Fed could develop more lending programs, Mr. Kohn indicated. 'Although we have seen signs of improvement, financial market functioning remains impaired in many ways, and we will need to continue to consider whether additional steps are needed to reopen credit flows and supports

The Old World is Being Pulled Apart, But Will the Next Version Prove Better?

I have held the view that even our greatest social reformers have unawarely been deeply influenced by the new technologies of their day. Thus I have related Karl Marx's views of society's pilgrimage to the great railway-building age that he grew up in: the lines of progress with stops at preordained intervals leading up to the grand climax in which all passengers leave the train at the great terminal – socialism – with joy on their faces. Or as my late friend Marshall MacLuhan summed up in four immortal words: "the medium is the message."

To these seditious developments, e-blogs advancing and pushing the printed press off its rusty throne certainly contribute. To the version of the White House having organized the Twin Towers job on their own, and it is charged that version as true and implies that those who cast doubt on anything so obvious are conventional cowards or worse. To uncover the real suppressed facts of financial scandal or the suppressed teaching of the works of great economists in our universities. To catch and credit newly created myths on the fly actually provides an easy substitute that society has need of to get out its economic mess.

Thus *The New York Times* (8/11) publishes an editorial, "Money Really is Fungible," that illustrates what a bit of preliminary literacy in the field would achieve in bringing a necessary knowledge of suppressed historical criticism. I remember some twenty years ago when I used the term "fungible" to describe the exact equivalent of all units of a given currency, a critic felt that I was posturing with fancy words. I am happy that it has entered common parlance, because it is one of the qualities that characterize legal tender from the sub-prime substitutes that are our economy is being buried in.

I quote from this *Times* editorial: "Just weeks after the Treasury Department gave nine of the nation's top banks $125 billion in taxpayer dollars to save them from unprecedented calamity, banks are salting money away in billionaire bonus pools to reward themselves for their performance.

"Outraged? The bankers (who didn't anticipate the subprime crisis) were ready for that. So they are assuring everyone that this self-directed largess won't be paid with the same dollars they got from the taxpayers. They'll use other ones.

"What we want to know is will they be marking the bills so they can be sure which is which?

"Meanwhile, other ways should be explored to recover undue reward, New York's attorney general, Andrew Cuomo, sent a letter last week to all of the banks that got money from the Treasury Department asking for information about their bonus pools. He already has used laws on fraudulent payments to convince the American International Group, the insurance giant, to suspend some bonuses.

"Banks cannot simply do away with all bonuses for past performances. Many are cooked into contractual agreements."

"This isn't just an issue of fairness; it's sound business practice. It is about tempering bankers' intemperate appetite for risk, which has led this country into the most desperate financial crisis since the 1930s."

Unfortunately that leaves the really major elements that are missing for the restoration of world banks to socially useful institutions. That would require the restoration of the *Glass-Steagall* legislation introduced under Roosevelt that barred banks from acquiring interests in the "other financial pillars" – stock brokerage, insurance, and mortgage firms. These are at the heart of the current plights in the US and internationally.

It is a knowledge of history. Obama may be wise and gifted, but unless he lets light into what has been suppressed from our law books, and our universities, there is no way in which succor can be brought to this stricken planet.

William Krehm

the economy,' he said.

"In remarks about productivity and innovation in the financial sector, Mr. Kohn acknowledged the Fed's shortcomings in understanding the effects of the financial turmoil, but he indicated the faults are broadly shared.

"Both lenders and borrowers 'badly misunderstood risks,' and those views became embedded in financial instruments, Mr. Kohn said. A quarter century of strong economic performance – as long period of growth and no low inflation, punctuated by a few mild recessions – helped create the assumption that house prices would only go up, problems servicing debt would be short-lived and financial markets would always be liquid, he said. 'Complacency, in turn, contributed to the unwillingness of many financial-market participants to enhance their risk-management systems sufficiently to take full account of the new – perhaps unknown – risks they were taking on.'

"Though policy-makers during the financial boom worried about overpricing of houses and underpricing of risk, he said, 'we were only partly successful in identifying the circumstances and channels that have seemed to trigger the most distress.'

"The remarks came as government officials re-evaluate their approach to the credit market turmoil. Wednesday Treasury Secretary Henry Paulson announced he would alter plans for a $700 billion financial sector rescue to consider new approaches to support consumers' access to credit. At the same time, the Fed joined with other regulators in leaning on banks to maintain lending in providing guidance on their dividend policies and management compensation.

"'Banking organizations should strive to maintain healthy credit relationships with businesses, consumers, and other credit-worthy borrowers to enhance their own financial well-being as well as to promote as sound economy,' the Fed said in a statement with the bank regulators.

"The bank regulators also said bank supervisors would be aware that tightening credit could worsen the economic downturn and that they would encourage the practice of 'economically viable and appropriate lending activities.'"

Particularly notable is the statement "central banks should distance themselves from decisions about the allocation of credit among private parties' except in extreme cases when financial markets break down and 'systemic risk reaches unacceptable levels.'"

Keeping the Country's Legal Tender Unsoiled

In other words he is saying that the Fed will in normal times handle government debt as though it were legal tender, and not confuse it with government credit to private corporations which must be considered a strictly emergency measure. Failing that ever-present distinction, you will have the legal tender of the land degenerate into yet another dirt-trick box that has led the world into the current crisis.

Having clarified the official position on what the central bank can and must not do in order to prevent our currency become subprime, we can extend the discussion and once again emphasize the need to introduce double-entry accountancy in handling the governments investments in human capital, just as the US did to get out of a crisis in 1996, and Canada finally did in 2002, without acknowledging publicly what was involved. This will give both the US and the Canadian government such a vast backlog of assets at present ignored, that they will be able to extend such human investments – education, health, environment, as well as physical ones to head off the depression that is closing in on us internationally. But that we enlarge upon elsewhere in this and previous issues of *ER*.

William Krehm

A Closer Look into Social Investment in Human Capital

The New York Times (5/12, "Many Children Lack Stability Long After Storm" by Shaila Dewan) enlarges on some of the basic hidden problems of investment in human capital in these difficult times: "Baton Rouge, LA – Last January, at the age of 15, Jermaine Howard stopped going to school. Attendance seemed pointless: Jermaine living with his father and brother in the evacuee trailer part known as Renaissance Village since Hurricane Katrina in 2005, had not managed to earn a single credit in more than two years.

"Not that anyone took much notice. After Jermaine flunked out of seventh grade, the East Baton Rouge School District allowed him to skip eighth grade altogether and begin high school. After three semesters of erratic school attendance, he left Baton Rouge in early spring of this year and moved in with another family in a suburb of New Orleans, where he found a job with Dairy Queen.

"A shy, artistic boy with a new mustache, Jermaine is one of tens of thousands of youngster who lost not all of their belonging to Hurricane Katrina, but a chunk of Childhood itself.

"After more than three years of nomadic uncertainty, many of the children of Hurricane Katrina are behind in school, acting out and suffering from extraordinarily high rates of illness and mental health problems. Their parents, many still anxious or depressed themselves, are struggling to keep the lights on and the refrigerator stocked.

"For others, like Roy Hilton, who stands a head taller than his third-grade classmates, recovery may lie in the neighorhood school near the New Orleans duplex where his family has finally found a home.

"The families profiled in this series were among the last to leave Renaissance Village when the Federal Emergency Management Agency closed it in May. The government was trying to nudge the poorest, least-educated and sickest evacuees towards self-sufficiency – or at least toward agencies other than FEMA.

"More than 30,000 former trailer residents landed in apartments paid for by the federal government until March 2009, a small portion are in the hands of private charities or paid for by the federal government until March 2009, a small fraction are in the hands of private charities or government housing programs for the disabled, and thousands more simply traded in their trailers for other temporary quarters. Case managers promised by FEMA to help these families find permanent homes have yet to start work in Louisiana.

"Many of the adults are at least partly victims of their own poor choices. But the children are another matter. For them the experts prescribe the one thing that has been hardest to obtain: stability. Their parents sometimes work against that goal.

"Jermaine's father, Joseph Griffin, had trouble holding on to steady work and said he didn't see much value in his son attending school this semester because he had missed so much class. 'If he doesn't get no credits for it, what sense does it make for to sit up in there? I was going to try to get him a job.'

"Forty-two percent of the children, who lived in trailers laced with dangerous levels of formaldehyde, had allergic rhinitis or an upper respiratory infection, the study found.

"More than half of those ages 6 to 11 had a behavior or learning problem, yet in the East Baton Rouge School District children can wait for as low as two years to be tested for learning disabilities….

"The key to giving these children a future, doctors and educators have long said, is providing them with a sense of stability – a home that seems permanent, a school where they can put down roots.

"After months of looking, Laura Hilton, who is functionally illiterate, finally found an apartment in New Orleans for her and her two sons, George, 17, and Roy, 11, that was within walking distance of Roy's school. Laura's husband was murdered in New Orleans after the storm, and at the trailer park the Hilton children attended school only fitfully. Roy was known for being both endearing and utterly ungovernable.

"Now Roy, who is at least three grades behind and needs special education, tutoring and counseling, can hardly be persuaded to leave school when the last bell rings. He helps teachers on their work days and shows up for Saturday detention even when he has not misbehaved. He fights less, and recently volunteered to sit in the principal's office at recess to keep from getting into trouble. and losing his field-trip privileges.

"Roy has received special attention from a male role model, Edward Williams, the football coach at Johnson. On a recent morning, Mr. Williams went into Roy's classroom to find him sulking at his desk while the other children practiced a dance routine.

"Drawing Roy aside, Mr. Williams told him: 'You got to get up and move around. You got to try.'

"Moments later Roy was dancing."

That is certainly putting the most rewarding investment a government can make on short rations.

W.K.

Optimism *from page 17*

Borrow them from the banks? Obviously that would not make sense for a variety of reasons. But in this context the introduction in the booking of the investments of the government in human capital would serve an additional purpose. The net positive balance on the government books as a result of the progressive booking of the investment in human capital and infrastructure would provide excellent security for the financing of a reasonable amount of the salvage project being planned.

William Krehm

Orders for *Meltdown* Volume 3 can be placed now at an advanced price of $20.

(Postage in North America at $12 maximum.)

On Reinforced Fiction in Banking

We have enough bizarre encounters of fact and fiction in our home-grown banking system, powers that enabled our governments to cope and eventually get out of the Great Depression. Things that should have been remembered have been forgotten and matters that have been forgotten that have ended up in control of our banking system. And if that can happen within a democracy, imagine what can happen in countries that have been under either direct dictatorial regimes, or even their next-door neighbors.

That is why the experiences of tiny Latvia, that for decades was part of the Soviet empire provides a colorful instance of how banking and democracy in the variety of surprising ways in which fact and fiction that can come together in defining banking in a period of troubled times.

The Wall Street Journal (12/01, "How to Combat a Banking Crisis. First, Round up the Pessimists" by Andrew Higgins paints a picturesque case in point): "Riga, Latvia – Hammered by economic woe, this former Soviet republic recently took a novel step to contain the crisis. Its counterespionage agency busted an economist for being too downbeat.

"'All I did was say what everyone knows,' says Dmitrijs Smirnovs, a 32-year-old university lecturer detained by Latvia's Security Police. The force is responsible for hunting down spies, terrorists and other threats to this Baltic nation of 2.3 million people and 26 banks.

"Now free after two days of questioning, Mr. Smirnovs hasn't been charged, but he is still under investigation for bad-mouthing the stability of Latvia's banks and the national currency, the lat. Investigators regard him of spreading 'untruthful information.' They've ordered him not to leave the country and seized his computer.

"Finance is a highly touchy subject in Latvia, one that the state tries, with unusual zeal, to shield from loose tongues. It is a criminal offense here to spread 'untrue data or information' about the country's financial system. Undermining it is outlawed as subversion.

"So, when the global financial system began to buckle this autumn, Latvia's Security Police mobilized to combat destabilizing chatter about banks and exchange rates. Agents directed their attention to Internet chat rooms, newspaper articles cell phone text messages and even rock concerts.

"Just one problem: much of the speculative buzz now turns out to ring true.

"After insisting its banking sector was healthy, Latvia last month took over the largest locally owned bank, Parex, to save it from collapse. After denying it needed aid from the International Monetary Fund, the government is now in talks with the IMF.

"Finance Ministry officials acknowledge that secret police won't save the country from economic crises. But they do believe Security Police Vigilance makes the public think twice before spreading uninformed gossip about banks.

"Mr. Smirnovs says he will certainly be 'more careful' about voicing his opinions in future. But he scoffs at the use of security agents 'as a medicine that only makes people more worried.' Until his detentions, his bleak view was known only to his students and readers of small newspapers in his hometown of Ventspils.

"'Now everybody knows who I am and what I think,' he says. The ingredients of Latvia's troubles are much the same as elsewhere: a credit crisis, a slump in property prices and a severe economic slowdown. But in a tiny nation long wary of big neighbors, primarily Russia, but also Sweden, economic woes are never just about money.

"'It is regarded unpatriotic to criticize,' says Alf Vanags, director of the Baltic International Centre for Economic Political Studies.

W.K.