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SPECIAL ISSUE — WHITHER THE SUBPRIME MESS?

Groping for Ties with the Past and the Future

The business press coverage of the subprime reveals answers to questions that the general press left unasked rather than the ones it was asking. The past as well as the future remain closed books of derivatives that nonetheless claim to have an intimate knowledge of what lies at the rainbow's end. Let's take the front-page spread of *The Wall Street Journal* (12/12, "US Mortgage Crisis Rivals S&L Meltdown" by Greg Ip, Mark Whitehouse & Aaron Lucchetti): "The home has long been the bed-rock asset of most American families. Now, its value has become the biggest question-mark hanging over the global economy and financial system.

"Over the past decade Wall Street built a market far more than $2 trillion in securities sold globally and backed by loans to homeowners on two long-accepted beliefs and one newer one. The prevailing logic: the value of the American home would never fail nationwide, and people would almost always make their mortgage payments. The more recent twist: packaging mortgage loans and turning them into securities would make the global economy more resilient if anything went wrong.

"In a matter of months, however, much of the promise of the new financial architecture – together with its underlying assumptions – has proven a mirage. As house prices fall and homeowners default on mortgages at troubling rates, the pain has spread far and wide. An examination of the resulting crisis shows that it is comparable to some of the biggest financial disasters of the past half-century.

"So far, the potential losses look manageable compared with the savings and loans crisis of the 1980s and the tech stock crash of 2000-2. But the housing debacle could yet take years to work out, due to the sheer complexity of it. Until the mess is cleaned up, investors will remain jittery and banks will hold back on all kinds of lending – a credit crunch that is already damping global growth and could tip the US economy into recession."

Let us pause to bow in awe before we go further globalizing and deregulating the economy. If you are packaging your maybe-certainties, that is all the more reason for not globalizing your entire world market. Before that was done, a single country in trouble had a chance to come up for breath and take advantage of the difference in the phase of their market cycle. Now most of the world seems smothered with the same dubious investment trash at the identical time. And there has been so much pre-empted "growth" in the formula that there was no possible way of telling what it was that was growing – an asset or liability of unascertainable negative value.

But getting back to the *WSJ:* "The new financial system shifting risk from banks to securities markets, has worked 'pretty well' up until now according to the former Federal Reserve Chairman Paul Volcker. We are going to find whether it works well for a major-league crisis."

All we need to add is while all this game of financial hide-and-seek goes on, seemingly endless wars are also going apace, and triple rivals in "bigness" in this age of exploding size on a shrinking planet are

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Farewell to the "Perpetual Student" Who Learns Nothing

The part of the overhead title in quotes I owe to *The Globe and Mail* (14/12, "The perpetual student's parting questions" by Heather Scoffield: "When David Dodge first started working in the public serve 35 years ago, he saw a shackled economy where civil servants beavered away to control prices, propped up sagging companies and often resisted change.

"Slowly but surely he set about helping to remove the shackles, using his various government positions over the years to streamline taxes, eliminate the deficit, promote productivity and entrepreneurial spirit, moderate inflation, and allow the economy to be free and prosper.

"Now as the 64-year-old Governor of the Bank of Canada prepares to step down January 31 and hand down his position to former investment banker Mark Carney, he wonders whether the liberty now enjoyed by financial markets is out of control.

"'I think that when we look back [at these times] we'll say "Wow, that is incredible innovation." But in retrospect, the financial engineering and innovation may actually have gotten ahead of the markets' ability to deal with it,' Dodge said.

"'In the last few months monetary policy ceased to have the influence it is supposed to, and central bankers will have to change their ways to make sure that markets and economies get back on track. For much of the past 15 years, central banks have relied on the credit markets to be their conduit for implementing monetary policy."

That has left us wondering what track Governor Dodge was talking of, and where he thought his train was headed.

"The central banks set their target interest rate, and government securities trading in the overnight credit market trade at that rate."

Let us pause here for a comment. It is very fine talking about financial engineering, but there are two key features about engineering that we will rub out our eyes searching for the equivalent of in central bank policy over the past forty years. The first: engineers must know a fair amount of mathematics and how to use it. And they are immensely empirical folk. They must keep up on what past experiences have been with a particular theory or method, and what the record of failure and success with it has been. They do not monkey around with facts. They are not politicians. If they were, half the buildings and bridges in existence would have collapsed.

Can the same be said of our central banks for the past near half century? Hardly. In his *War Finance and Reconstruction: The role of Canada's Department of Finance, 1939-1946*, Professor David Slater wrote: "In terms of economics, the war despite all its sacrifice, was the road from depression to prosperity. The potential productivity and income of the Canadian economy turned out to be much greater during the war than they had appeared at its beginning. The potentialities after the war were even larger than those of wartime, despite the reduction in peacetime of several advantages of scale and specialization. Underestimates of potential early in the war curbed the war effort. But after the fall of France, Canada made all-out commitments and gradually achieved and sustained them."

What our Financial Engineers have Erased from the Record

During the war and the quarter of a century of the peace, the vast new infrastructures needed to absorb not only a vast and near penniless immigration from Europe and introduce radical new technologies were financed to a growing extent by the federal government through the Bank of Canada. Our central bank had been nationalized for such purposes in 1938. Interest paid by the federal government for financing of capital projects through it came back to the government almost wholly in the form of dividends. At their near peak in the early 1979s some 22% of the government debt was financed in this way. However, the full effects of this arrangement were hidden from the public view by the resistance of our government – along with almost all governments in the world – to introducing serious double-entry bookkeeping in reporting capital projects undertaken by it.

The value of the asset was written off as a current expense in the year in which it was completed, so that in Year 2, its "depreciated" value appeared on the asset side of the government ledger at a token one dollar. The debt incurred for its creation, however, was carefully "amortized" over many years.

The result was that a hugely unbalanced budget appeared that was not really there. That exaggerated or largely invented deficit was tremendously useful to governments wishing to refuse government programs, especially those for social services, education, and environmental conservation. Several royal commissions and Auditors General had strongly urged that capital budgeting (also known as "accrual accountancy" or "capital budgeting") be brought in, with no success. A private taxpayer who reported his equity value of his home in this way would be punished.

Financing the war had educated Canada for the new world of the peace when it came. There had been 16 years of, first, Depression and then war, during which little in the country had been maintained. So the Bank of Canada (nationalized in 1938) put Canada in a category almost of its own. But the banks that had in the twenties gambled themselves into near bankruptcy had been slimmed back to health and confined to banking during the Depression and the war. They were forbidden to acquire any interest in the other "financial pillars" – stock brokerages, insurance and mortgage corporations. For good enough reason. The essence of banking, a socially usual art if kept under control, is the lending out of a multiple of the money they have in their coffers. Grant them access to the cash reserves of the other "financial pillars" that these need for their own businesses, and they will use them as money base to rear multi-storeyed structures of credit by applying the "bank multiplier" to each in turn. That is how the proliferation of near-money (interest-bearing debt) seeking investment of any sort came to create subprime mortgages and other debt that is currently putting economies over the entire world through the wringer.

Up to 1998, *ER* calculated the ratio of the credit created by our banks to the actual cash in their possession, using Bank of Canada statistics. After the war it had been about 11 to 1. By 1998 when we abandoned our calculations, because the proportion our banks creation of near-money (i.e., is "lent out" into existence rather than non-interest-bearing legal tender "spent into existence" by the government) had exceeded 402 to 1. Until a disastrous crisis, the collapse of the Mexican banking system, brought it down to 363.5. Since the denominator of the ratio that produced these figures was rapidly approaching zero in value, the ratio was heading into the heavens. Moreover, what I was using for the denominator for this critical ratio was the legal tender that the banks needed for stocking their ATMs and meeting the customers' requests for cash. Use that up elsewhere and there would be a run on the banks – a scenario that haunts the slumbers of every banker, and seems finally to have come to pass.

The Rooseveltian legislation that prevented the banks from acquiring interests in the other "financial pillars" had been repealed, and in the 1980s the US banks had taken over the Savings and Loans (essentially mortgage trusts). By the late 1980s many of them had lost their shirts in mortgages and in land development and even house-building to work off the land that had come with the bankrupt S&Ls. Eventually the government had to take over the bankrupt and near-bankrupt banks, pay off some $400 billion in debt and once restored, sell them off again. The same happened in Mexico shortly after the introduction of NAFTA there.

To replenish the banks' lost capital, two main measures were brought in on the initiative of the Bank for International Settlements.[1]

The first, issued in 1988, declared the debt of governments of developed countries risk-proof, hence requiring no down-payment for banks to acquire. As a result the Canadian chartered private banks were able to increase their holding of Canadian federal government bonds from $20 billion to $80 billion without putting down any money of their own. The revenue derived from that, with interest driven into the sky "to lick inflation," thus had a powerful purpose: the desperate need of the banks to recoup their lost capital, and in the power that the very scale of the bail-out scam they were able to get away with bestowed on them.

The other bailout measure was the phasing out over a two-year period starting in 1991 of the statutory reserves that the bank had to redeposit with the Bank of Canada from the deposits received from the public and which earned no interest. This not only represented a great and growing saving in bank interest for much of the government's funding of capital projects, but those statutory reserves had been the only alternative policy instrument for guiding the pace of the economy. That left the BoC's control of the benchmark interest rates in a monopolist position for controlling just about everything in the economy.... An early result of this new arrangement was interest rates five percentage points higher than those in the US, which, however, pursued a not dissimilar policy. Clearly, it was not only "licking inflation" that inspired the wildly high interest rates of Canadian banks of this period – contrasting with the miserable dribble that banks paid their clients on their deposits. They were gathering the capital for their next and hopefully more successful conquest of the entire financial sector and then more deregulation and globalization to conquer the world. The basis was being laid for the involvement of at least three major Canadian banks not only with the execution of Enron's off-balance sheet scams that led to out-of-court settlements to avoid years in prison for some of their executives. One of Canada's banks actually planned certain of Enron's off-balance sheet scams.

It also led to the high-tech boom and bust, and with further globalization and deregulation, gave us the subprime mortgage crisis that is crippling the world economy today. The logic of engineering, if applied for anything more than as a rhetorical adornment, would have noted that prices could and did rise for at least one of two quite different causes. There could be a real excess of demand that could not be satisfied by available supply. That would be real inflation. But prices may go up for quite other causes.

Nobody who moves from a town of 20,000 to New York City, is fool enough to expect his living costs to stay the same. How then, can economists and the head of a central bank expect living costs to remain the same when humanity as a whole makes such a move? That is a factor making for a higher price level unrelated to the real inflation we have just mentioned.

Even to equip a person as a consumer these days requires a bit of higher education – to make use of computers, for example.

The Greatest Goof in the History of Economics

The increasingly erratic weather associated with planet warming and thousands of other details, that more and more scientists are attributing to entropy – the using up of the differences of energy levels without which the cosmic sources of energy are less available for harnessing. The notion of conventional economists that higher interest rates – of all things! – are enough to set this ongoing problem right is bizarre, let alone the head of a central bank describing it as "financial engineering."

That point was clearly made in 1996. when BIS and the central bankers of the world that it had gathered about its knees

had probably made the greatest goof in the history of economics.

To replenish the American banks' capital losses BIS had declared the debt of developed countries "risk-free" and hence requiring no down – payment. for banks to acquire. This allowed the chartered banks throughout much of the developed world to load up with government bonds 100% leveraged. But at the same time, undoubtedly alarmed by the likely increase in bank credit with this renewed capacity for lending bestowed on the banks, the same BIS urged central banks to push up their benchmark interest rates until absolute zero "inflation" were attained. Nothing less would do!

But the manager of BIS, Alexandre Lamfalussy, overlooked a detail. When you have an already existing hoard of bonds – especially bought with no down-payment – any drastic increase in interest rates – will bring down their market price with a thud. And that is precisely what happened. The Mexican peso lost some 40% of its value, and the result flowed through to bring the world economy tottering. Hastily, President Clinton improvised a standby fund – the largest to that date – put together by the US, the IMF and Canada. But the gaffe of the BIS had a lasting affect that contributed to our current subprime mortgage crisis.

For decades Washington resisted all proposals of its auditors that it treat its investments in accordance with double-entry accountancy as explained in some of our earlier paragraphs. Now it became clear that loading up the banks with government debt is incompatible with higher interest rates. The Secretary of the Treasury, Robert Rubin, decided that it was necessary to bring down interest rates, and the best way to do so was simply to bring in accrual accountancy, and enter the value of the government physical investments – buildings, bridges, roads, and so forth at their properly depreciated value rather than at a token dollar. But of course, by the official creed, governments were incapable of making investments. Only banks that had been bailed out from their gambling losses by the government more often than once a decade were considered capable of that. Hence, when calculations for the ignored real depreciated investments were made and carried back to 1959, with the result of a newly discovered $1.3 trillions of assets, they appeared in the Department of Commerce figures under the heading not of "Investments" but of "Savings." The word "savings" as used by economists refers to asset values that can readily be converted to cash. This 40-year-old buildings and roads most definitely were not. However, a nudge to the bond-rating agencies, already acquainted with such ruses, did the trick, and interest rates came down vastly, giving Clinton his second term and Wall Street its lengthy high-tech boom and bust.

Canada benefitted substantially from the lower interest rates resulting from this improvement in Washington's accountancy, but its government avoided ferociously following its example. That is even more amazing since the government in the late 1980s had taken steps to convert its books to accrual accountancy, and Paul Martin, still Finance Minister in the Chrétien cabinet, had made it a priority in his 1995 budget. But that was strictly window dressing, for a couple of years later – in 1999 in a document entitled *Budget 2000 New Era...New Plan*, a report of the Standing Committee on Finance chaired by Mauricio Bevilacqua, as member of Parliament close to Mr. Martin, made no mention of it. Weeks of harsh argument ensued between Paul Martin, by then prime minister, in which the AG actually used the expression "cooking the books."

A Demeaning Compromise

It ended up in a demeaning compromise in which the AG agreed to a statement that although some 50 billion dollars of ignored assets had been come to light, it brought no new money into the treasury and hence would not warrant new spending programs. The $50 billion to begin with is a gross under-statement. Usually the ratio of 1:10 is fairly close to the size of Canada's economy in comparison with that of the US. American adjustment to accrual accountancy, worked back to 1959, led to some $1.3 US. Given Canada's more scattered population and northern weather, it can be taken as assured that the proportion of infrastructural investment would be greater in Canada than in the US. Particularly since it has been a Canadian tradition for at least the past 50 years for the government to provide more social services than Washington.

That is why our federal government transferred many of its social programs to the provinces and of course slapped a Goods and Service Tax on consumers' purchases. These two moves merely filled the vacuum that the first bank bailout had left in the federal government's revenues. The provinces lost no time in passing on the compliment to the municipalities.

Today, starting with Toronto, Canada's cities are potholed from roads and city transport to education and hospitals.

There is no reason why the municipalities with the guarantee of either the federal government or the provinces should not be financing its capital programs through the Bank of Canada. The interest paid the Bank of Canada would – substantially – find its way to the federal government – not to the provinces or to the municipalities for they are not shareholders of the BoC. However, given the origins of the federal deficit which led it to download social programs onto the provinces, once the facts were brought into the open, the federal government would be morally obliged to put into effect the provisions of the *Bank of Canada Act*.

But would the BoC be authorized to make such loans for capital purposes to the municipalities? Perhaps a couple of dozen municipalities over the years to our knowledge have enquired of the BoC and have been informed it is not authorized to make such loans. That, however, is not the case if the *BoC Act* as it was drawn up after the federal government had bought out the 12,000 shareholders in 1938. Indeed one of its earliest acts was to help Prairie municipalities avoid bankruptcy. Moreover, the subsections that made this possible are still in the Act. What the Act does not do is authorize the Bank or its officials to misinform the public about what the Bank may or may not do.

For those of you who have a computer, use Google to go to the *Bank of Canada Act*, get to the actual text, starting first with subsection 14(2) which will tell you in its own words that if the Minister of Finance and the Governor in their monthly meetings can arrive at no agreement on a matter of basic policy, then the Minister who holds all the shares of the BoC for the Queen of Canada, shall deliver to the Governor in writing a written statement of the policy to be followed in the disputed matter And the Governor shall comply within thirty days.

The Finance minister would have to tell the Governor, referring to subsection 18(k) of the Act, which reads in part "the BoC for the purpose of its open-market operations, may buy and sell the open market securities…without endorsement of a bank."

"Buy and sell" implies "hold."

The interest paid by the municipality under those circumstances would end up automatically not with the municipality, for it has no BoC shares. But it would find its way as part of the dividends to the federal government. And given the moral responsibility of the government in down-loading programs to the provinces because it was

repeatedly bailing out the banks from the gambles that banks should never have been allowed to take part in. But for this to happen the public must learn its history, and of the continued existence of the *Bank of Canada Act* still intact on these vital matters. Much of the bailout legislation that put an end to the statutory reserves had been in the *Bank Act* not the *Bank of Canada Act*.

The Merits of our Departing BoC Head

And with this brief review of the background of these farewell rites of the departing governor of our central bank, we can better assess the merit of his self-congratulations.

We have already noted the dubious basis for his claiming the rank of "financial engineers" for his central bank. It should be noted that there is no engineer, no physicist that believes that energy, heat, water or anything else will flow or run up hill without an increasing expenditure of energy. Housewives knew of the principle when they were aware that you can warm any dish or pot by bringing it into contact with some that is hotter, not colder. In fact it was a French army engineer, Sadi Carnot who discovered the principle as universally valid in 1827 in trying to understand how a steam engine works. The name, entropy, however was first applied by a German physicist, Rudolf Clausius, in 1868. Energy in all its forms will only run down hill from higher to lower levels, and to reverse that requires the expenditure of increasing amounts of energy. It is by reversing the process of say Niagara Falls just falling rather than rising from the lower to higher levels would require the expenditure of increasing amounts of energy. The Falls are in fact slowly retreating to lake Erie from with the Niagara River, and when they eventually reach Lake Erie there will be a cataclysmic partial emptying of that Lake, and a huge jump in the entropy of the continent.

I would strongly recommend to my readers the book *Entropy – a New World View* by Jeremy Rifkin, with Ted Howard, and an afterword by Dr. Nicholas Georgescu-Roegen as a guide.[2] The first law states that it is impossible to produce or destroy energy in the universe. The second law the entropy law goes on from there: it states it impossible to reverse the downward flow of energy. Once used for a given goal the downward flow of energy can be reversed only by the expenditure of a greater amount of energy than it was used up bring it down to its current level. An amount of energy irreversibly expended will always be lost. It is by conceiving this process to its origins that cosmologists formulated the theory of the "Big Bang" with which the universe was brought into existence. We know little more about it, but we do know assuredly that once a given amount of energy has been expended, it becomes beyond our reach for reuse, expect through the expenditure of a yet greater amount of energy to bring it back to its original level. It is the height of the upper falls at Niagara over the lower as well as the amount of water making the drop that measures the amount of energy generated. That "entropy law" pervades all human affairs.

In the light of this, how are we to judge the remark of Governor Dodge in his interview: "In the past few months monetary policy has ceased to have the influence it is supposed to, he said, and central bankers will have to make sure markets and economics get back on track."

The Far-reaching Entropy of Economics

That is markets and economics flow up hill rather than down. For when Mr. Dodge raised its one controlling lever – his benchmark interest rate – prices were expected to go down rather than up. That and the notion of a "self-balancing" market on which price levels go down because Mr. Dodge *raises* interest rates is anti-entropic. When it was tried in 1914, the expenditure of energy required to start the economy purring again was the 1st World War. And to an extent that recurred in 1939 with the Second World War. They fit perfectly into the entropy pattern. As does the not so mincing steps towards World War III today.

It is amazing that our self-proclaimed engineer Dodge should be unaware of the inescapable entropy pattern. But that is not the entire shortcoming of Mr. Dodge and the BoC during the past forty years or so. No engineer, not even a "financial engineer" that Governor Dodge speaks of would think of trying to solve a linear equation with two independent variables by using only a single variable, let alone thousands of independent variables as there are active in a modern economy. But that is precisely what Governor Dodge and the BoC have proposed doing since the statutory reserves were done away with in 1991-93. It is astounding that this hasn't disturbed the Governor's mood of self-congratulation.

On the contrary, in his interview he remarks, "It's always nice to be really wise in retrospect. but that (2003 to 2004) was the time we really were starting to work on the efficiency of financial markets." That was in effect that the groundwork was being laid for the subprime mortgage mess when in the name of "risk management" mortgages were packaged without critical appraisal and then the "risk" packaged in swaths.

However, rather than leave the rites of praise to an interviewer, Governor Dodge writes his own paeans (*G&M,* 17/12, "What's been done, and what's to come" by David Dodge): "There were many factors that combined to create the market dislocation, but a lack of information was certainly an important contributor. The problem of valuing highly structured financial products continues to contribute to the uncertainty and market turbulence."

I don't know whether the Governor would or would not term the attempt of our central bank to solve a complex of an ever increasing number of equations with a single independent variable – or whether the benchmark interest rate is lowly or highly structured. The fact is that it is simply mathematically illiterate. For it excludes a lot of vital information concerning why the grading of subprime mortgages into swaths of varying risk management had no basis for the claim of being "management" of any kind.

An important part of the missing information that the Governor bemoans – the hoards of government debt acquired with no down payment risked dropping in value when the central bank pushed interest rates up risking bankrupting our banks once again. The Governor, hopefully, will one of these days discover the importance of knowing our history to understand how we can work our way out of the present mess by returning to the provisions of the *Bank of Canada Act.* That Act is still intact on our law books, but completely ignored. And above all the *Bank Act*, which was drastically gutted to allow our banks to get into the "non-banking pillars" is needed to bring the BoC back to its great period. Ignoring all this the BoC rushed blindly into a period of accelerated entropy accumulation that can only lead us via military options to final disaster.

William Krehm

1. The Bank for International Settlements was originally set up to syndicate the German reparations to France and Belgium from WW1. Germany claimed that it could only pay in German marks that no country wanted, so the final settlement was they would be paid in marks by the Bank for International Settlements. This, indeed, was set up as a body of central banks entrusted with the task. The reparations, the plan was, would then be syndicated into stronger currencies and paid to France and Belgium. The crash of October 1929 intervened and that syndication came to naught. The BIS, however, lingered on to render the Nazis some services. That is why at the Conference of Bretton Woods planning post-war international finances

Resolution Five was adopted on the motion of the Norwegian government-in-exile delegates, calling for the liquidation of BIS at the earliest possible moment. That gave BIS good reason for cultivating a very low profile. That strangely enough guaranteed its survival to play a very influential if not particularly positive role in the councils of international banking.

During the war, to preserve the fighting mettle of its armies, the Allied governments almost without exception had promised their fighting men a very improved world once the war were won. The banks, however, kept strictly to banking, had recovered their solvency, and were chafing at the bit to get going on taking over non-banking activities – an extension of the activities that had in fact brought on the Depression. But given the commitment of the victorious Allied governments to more social-minded programs, such come-back campaign of the world banks had to be organized outside and to an extent against the governments in the saddle. And for such a planning and war-room the banks had need of a low-profile organization properly oriented. BIS, with Resolution 5 of Bretton Woods over its head, was providentially there, seeking to escape as much attention as possible.

2. Copyright © Foundations of Economic Trends, 1980. The Newtonian View conceived of natural laws as valid read back to front as well as front to back. It was established by an examination of the closed orbits of plants by the astronomer Tycho Brahe and the physicist Kepler and analyzed mathematically by Isaac Newton. Rifkin and others associate it with an earlier economy when energy was provided by wood in renewable forests, whereas the entropy age began with the shift to coal deposits that have a non-renewable life span (Rifkin, p. 19).

A Special Art Form to Go with Our Subprime Debt?

Ours is an epoch so special that inevitably it must birth a special art form to articulate its soul And according to *The New York Times* columnist Maureen Dowd, President Bush is the gifted troubadour chosen by whoever presides over such matters to set the model. We will quote from her inspired column of 5/12 ("Seven Days in December") and then show how the same inspiration has already planted its standard in other areas of our troubled affairs.

"Washington – At the White House news conference yesterday, the Chicago Tribune's Mark Silva gingerly snuck upon a state-of-mind question. 'I can't help but read your body language this morning, Mr. President,' he said. 'You seem somehow dispirited.'

"The President did look like a kid who just had his toys taken away. He said that the breathtaking and embarrassing reversal in the National Intelligence Estimate about Iran's nuclear capability – from 'high confidence' in 2005 that the mullahs were developing a nuke to 'high confidence' that they stopped the program in 2003 – somehow made it clear he somehow was right.

"H.W. can somehow shape the intelligence to match his faith-bound beliefs, as with Iraq, then he will believe the intelligence – no matter how incredible it is. If he can't shape it to match his beliefs, as with Iran, then he will disregard the intelligence – no matter how credible it is.

"Even though Sy Hersh claims that the top echelon of the White House has long known of the conclusion that Iran had stopped its nuke program, and that Dick Cheney 'has kept his foot on the neck of that report,' the president says he was briefed on it only last week. Others conspiratorially speculate that the president had to have green-lighted the report to take the air out of the hawks' Iran push.

"Just because the facts on which he based his rhetoric on Iran were debunked possibly sparking World War III have been debunked, W. said with his usual twisted logic, why should his policy change?

"George Tenet helped hawks like Mr. Cheney and Mr. Bolton overstate the case on Iraq WMD [weapons of mass destruction]. Then, when things went wrong, W., Cheney and Condi made Tenet the fall guy.

"After getting Iraq wrong and Iran wrong in 2005 and almost every other big thing wrong since the nation began spending billions on intelligence every year, the burned spooks may not have wanted to play the patsy again while W., Mr. Cheney and the neocons beat the drums for an Iran invasion.

"The man who oversaw the new estimate is Tom Fingar, a former State Department intelligence officer who was smart and brave enough to object to the cooked-up intelligence on Iraqi WMD.

"The way they used to do business was to write estimates so they said, 'We may not always be right, but we're never wrong,' said Tim Weiner, the reporter on the *Times* who wrote the award-winning book on the CIA, *Legacy of Ashes*. This is a slam-dunk reversal, admitting error. Now when they play poker, they show their hands to each other so that the don't get another curveball.

"The president, who has shut out reality for seven years, justified continuing in his world of ideological illusion by saying that he would not be 'blinded' to the realities of the world. You can't get more Orwellian than that."

Foreign Policy from the Gut

"W. loves to act as though psychology is voodoo, even though his whole misbegotten foreign policy has been conducted from his gut, by checking the body language of his inner circle and by looking into the hears and souls of dictatorial leaders.

"If I were looking at the latest fiasco from a Psych 101 point of view, I'd say it was just another daddy issue for W.

"Poppy Bush, who was once CIA director, and who liked to signs notes 'Head Spook.' The CIA headquarters bears his name. W., by contrast has voiced contempt for the intelligence community. In 2004, he dismissed a pessimistic National Intelligence Estimate that didn't match his sunny vision that the analysts were 'just guessing what the conditions might be like.' When W.'s history is written, he will be seen as the rebellious teenager crashing the family's station wagon into his father's three most cherished spots – diplomacy, intelligence and the Gulf."

Now it falls to us to match this with something in another area of public policy that will show a like haughty disregard for fact to respond to a deep gut craving of the privileged few. We do not have to use a telescope to find a huge embracing parallel close enough for our purpose. All we need do is shift our probe to the submarginal mortgage mess from the Federal Reserve and the CIA. Do that and it is as though someone had already dragged the required symbol across the desktop of our computer right to where we wanted it.

Central to the great Rooseveltian bank reform of the 1930s was the principle that the banks must not, never, ever, acquire interests in the other "financial pillars" – to wit, stock brokerages, insurance and mortgages companies. Allow them to, then as they did in the 1929s they would use the cash reserves that these other pillars kept their own business as money base for their eternal itch of near-money creation – lending out their mere bookkeeping entries to acquire kingdoms and empires, stacked on top of the other, until the inevitable crash. So now we have it in spades, and have even buried our history that might have given us some clue about how to get out of the mess. That is why further military options are showing up more and more on the horizons of our blood-red sunset.

William Krehm

How to Get Out of the Upsurging Mess

The first step towards that goal is to assess it properly. That means to assess it as completely as we can with the help of the specialists involved at any moment. To allow economists and politicians to play around with the notion of an ever-expanding economy in an environmentally threatened planet is like encouraging 3-year-olds to play with fire.

This requires a non-political accounting institute that must be kept beyond the reach of politicians. The recent farce of the Bali conference on planet-warming must help make the point.

For generations a few lone voices, like those who later founded COMER and the auditors-general of many countries, advocated the introduction of double-entry accountancy into government ledgers, let alone in the relationship between all governments and their natural habitat. However, as the speculative financial sector took over, the world has developed an ever accelerating dependence on a semblance of growth. "Semblance," because it created the illusion of "growth" by omitting ever more basic factors of destruction that can only reproduce on a universal scale what we are currently witnessing in the undermining of our government accountancy. This was as thoroughly pre-packed according to alleged risk-swaths. and as meretriciously insured and vouched for by fake insurance companies as any subprime mortgage. Our broader relationships within what is recognized as the economy, and between human societies and the environment are largely based on similar fiction.

Our current subprime mortgage and Collateral Debt Obligation experiences emphasize the need for a whole set of new institutions. These would assure the ready availability of the best scientific information. to help set the standards that government must meet.

This will eventually require a new degree of freedom and security for staffs of our universities, and those of the world at large. Tenure of scientific teaching staff must be carefully protected by boards independent of governments and administered by inter-university boards. That may be a staggering task to guarantee the availability of the best factual knowledge to support rather than to impair an adequately informed political process. But it has become clear that there is no alternative.

The establishment of such neutral information sources and security for academics will take a long time. The most urgent beginning could well deal – at once – with the accountancy on which our government statistics are based, and possibly a general history department.

The details of how the world was drugged into its present subliminal path to ultimate disaster is told on pages 2 and 3 of this issue. We will avoid repeating ourselves but it should be read to understand why we have a need for a politically neutral information bureau to safeguard the availability of information in our universities, media and Parliament.

How necessary such a reliable, non-political source of information on economic data and policy, and history is, should be evident by the recurrent question that popped up in the CBC's coverage of recent federal election campaigns. Almost inevitably someone in the carefully assembled audience for such productions would ask whether the Minister of Finance or the leader of some of the other parties would reduce or pay off the debt.

Invariably, the answer would come, avoiding mentioning that there is no other legal tender in Canada since 1971 than government debt. What would the government pay it off in? Paper bills of a different colour? It is with such evasions that we have arrived at subprime debt – and if the truth be told, subprime government.

Obviously we have need of such a neutral fact-providing, non-political institution made up of scientists in the field, but accountancy is an urgent and obvious area to begin with. For without reliable accountancy, we are out at sea on no matter what problem we wish to address.

Note well: Such a non-political information bureau would not have the right or duty to make decisions on major issues, but to assure the public of a full, correct amount of basic information to the important issues is met.

Without such information we are embarked on a road to disaster.

William Krehm

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War Finance and Reconstruction, The Role of Canada's Department of Finance, 1939-46

We came by this interesting volume in a bizarre way. After months of negotiation the Executive of the Ontario Federation of Agriculture arranged a debate between Jack Biddell and myself for COMER and two champions of Bank of Canada policy. To defend its policy the Bank of Canada chose William Robson and David W. Slater, a prominent Keynesian. Even knowing the current scarcity of career opportunities for Keynesians, I was intrigued by the choice of Slater to defend a key position of the people who managed to do away with the Economic Council of Canada he had once headed.

We were informed that he was a last-minute substitute for David Laidler. Slater opened the debate by reading a document that seemed to betray the fine Italian fist of the other David, Laidler not Slater. I referred to the BoC's citing the German hyperinflation of 1923 to warn us what we would be in for if we neglected even a small amount of inflation.

Connecting the two situations implied some miraculous retroactive effect: had Germany only pushed interest rates high enough, it apparently would have not lost the First World War, the Allies would not have exacted crushing reparations, the French would not have occupied Germany's industrial heartland, the Ruhr, there would have been no virtual civil war in the Ruhr, and indeed throughout Germany. During an intermission chat with me, Slater remarked, "Of course, I taught monetary policy for many years, and always emphasized that there was no connection between what happened in Germany in 1923 and our problem in Canada."

There were other patches of common ground in our private chat. And shortly after, Slater sent me his book that sheds light on the brightest period of Canadian economic policy.

Who could sum up matters better than Slater in the first chapter of his book? "In terms of economics, the war, despite all its sacrifices, was the road from depression to prosperity. The potential productivity and income of the Canadian economy turned out to be much greater during the war than they appeared at the beginning. The potentialities after the war were even larger than those of wartime, despite the reduction in certain advantages of scale and specialization.

The war showed what could be achieved by a fully employed economy, compared with the output during the unemployment of the 1930s. That is hardly the song the Bank of Canada had been singing, and that the author joined the colours to defend.

Rethinking the Musty Certainties of the Banks

The Slater book recounts the efforts of the Finance Department to whittle down the aid requested by the besieged allies to what it felt we could prudently afford. "Despite the primitive, uncertain, and incomplete state of national income accounts, the government used them as the basis for determining what the country could afford to contribute to the Commonwealth Air Training Plan.

The method was to forecast national income for 1940 and subsequent years, and determine the proportion that could be devoted to all government purpose including the military effort. The calculation was based on a 10% increase in the national income. Finance and the Bank's macroeconomic argument did take account of a number of factors that made the air training plan as good fit for Canada's war capacities: large uncluttered spaces, plenty of lumber and building materials; experienced and underemployed road-building firms, a large supply of rough carpenters off the farms; romantic interest in the air inherited from the Canadian aces in WWI and the epoch of bush pilots opening up the north. And the men involved in the errors of judgment included the first Governor of the Bank of Canada, Graham Towers, and Clifford Clark, the guiding spirit in recruiting the young mandarins who were to run the Bank of Canada during its most brilliant period. Eventually it became the watchword of war finance that anything that could be produced or devoted to the war effort could be financed."

Slater provides thumb sketches of the group responsible for rethinking the musty certainties of the banking community. A few like R.B. Brice and A.F.W. Plumptree had studied under Keynes at Cambridge, others at Oxford and the London School of Economics. Clark set rigorous tests on monetary topics for applicants both at Finance and the BoC. Graham Towers, the first Governor of the BoC, was one of the few people in the banking community with a university degree and a good grounding in economics. He understood credit creation not only in the practical way of bankers, but in the broader social sense of monetary economists.

"The seekers of more effective economic policies in Canada were also convinced of the need for constitutional change. They regarded the relief programs that were the main response by governments to unemployment as inadequate, inefficient and unfair. Tax and expenditures policies and public works programs to improve income and employment were inhibited by the political structure as by worries over debt. Though the successful launching of the BoC had equipped the country with an improved financial structure and policies, the BoC was deeply concerned with debt problems of Canadian provinces and municipalities.

"Taken together all the wartime tax changes amounted to a virtual revolution in taxation policies. Canada moved from a regressive to a progressive system, from one in which only a minority paid income taxes to one in which the majority paid them, from one in which the provinces and local governments collected the majority of tax revenue to one in which the federal government collected the most."

"The ratio of gross national debt to GNP, as we know it, peaked at 170%, much higher than the 70% that became so worrisome in the early 1990s after years of large government deficits.

"The price controls imposed in November 1941 were the most severe that any country used during the war. They froze every individual retail price at its level two months earlier. When the war began, wholesale prices were about 26% below pre-depression values. The cost of living was about 17% below pre-depression level. Canada's GNP increased by more than 65% between 1939 and 1944.

"Maintaining low interest rates was the kingpin of the government's strategy against inflation. "The government was committed to maintaining low interest rates into the postwar period, as Towers stated in the Bank's 1944 annual report. This implied government willingness through the BoC to support the price of government bonds if the public began to sell them heavily. The government was also committed to maintaining the consumer price ceiling at the 1941 level into the transition period, and to gradual and orderly price and wage control thereafter.

The government believed in the interdependence of these policies. If inflation mounted, a spending spree could ensure, fueled by the liquidation of wartime savings. If the interest rate was to be held in such circumstances, the BoC would have to acquiesce in a further inflationary expansion of money and credit. But if interest rates were not held, the market value of the public's holdings of government bonds would fall, perhaps triggering a sell-off. The resulting success of Canada's restraint of inflation contrasted with the hasty deregulation of price control in the US."

Slater's book has the immense merit of disinterring much that was crucial at a key moment in our history. Significantly it is self-published, and when the above extract was made could be obtained from Prof. David W. Slater, 199 Crocus Avenue, Ottawa, K1H 6E7

W.K.

Our Monetary Crisis is Deeper and Broader than the Subprime Mortgages

It was just as though somebody had already dragged the symbol you needed across your computer desktop to just where you wanted it. So the subprime mortgage crisis was just the big crooked toe of something much greater.

The Wall Street Journal headline on the front page of its Money and Investment section (26/12, "Credit Downturn Hits the Malls" by Kemba J. Dunham and Jennifer S. Forsyth) provides a new depth to the subprime tale. What is really subprime in a superlative way is the condition of our governments' economics: "The credit crunch triggered by the downturn in the housing market is creating problems in commercial real estate, driving down prices of office buildings, shopping malls, shopping malls and apartment complexes, and leaving some owners scrambling for cash.

"One victim is Centro Properties Group, the fifth largest owner of shopping centers in the US. The Australian real-estate company saw its share price fall by 90% in two days last week as it struggled to refinance short-term debt it took on to fund its $6.2 billion acquisition of New Plan Excel, one of the biggest owners of strip malls in the US.

"Centro had planned to pay off the short-term loans by selling long-term debt via the commercial mortgage-backed securities market, but the lack of buyers forced it to get a two-month extension from its creditors. Commercial mortgage-backed securities, or CMBS, These are pools of loans that are diced and sliced up and sold to investors as bonds. Residential mortgages are packed and resold in much the same way, but so far the CMBS market hasn't had any significant problem with defaults.

"In another high-profile case, the clock is ticking for Harry Macklowe, the New York developer, who is struggling to raise financing by February to replace $7.1 billion in short-term money he borrowed to finance his heavily leveraged acquisition of seven Manhattan office buildings this year.

"The predicament facing Centro, Mr. Macklowe and numerous others underscores the state of the once unflappable commercial real estate market. The number of major properties is down by half, and many worry that the market will continue to deteriorate as property sales remain slow, prices continue to drop and deals continue to fall apart."

Where the Fog Is

"The CMBS market was the engine that drove the commercial real estate boom. Over the past few years the issuance of CMBS allowed banks to get rid of the risk on their books, lend with cheaper rates, and looser terms and that made it easy for private equity firms to do huge real estate deals.

"Between 2002 and 2007, CMBS issuance arose to an estimated $225 billion from $52 billion, according to *Commercial Mortgage Alert*, a trade publication that compiles its own statistics.

"Real estate investors aren't the only ones feeling the pain. Many big banks issued short-term loans and planned to sell them off later much as they do with loans made to private equity buyout shops. But the banks have gotten stuck with an estimated $65 billion in fixed and floating rate loans on their books, according to J.P. Morgan.

"Lower prices, however, haven't appeared, though much like residential, there is often a period where buyers stop buying but sellers refuse to lower prices.

"'There is 'cognitive dissonance' between buyers and sellers, says Dennis Russo, a real-estate attorney for Herrick Feinstein. There's a period when the seller cannot psychologically move his price down. They have not accepted what has happened in the market.' So few deals are getting done that many market experts don't know how to put a value on many buildings right now – but almost everybody is in agreement that prices are dropping.

"According to Real Capital Analysts, sales of significant office properties plummeted to $7 billion in November a 55% drop compared with November 2006. The commercial real estate market was still soaring in early 2007 long past the peak of the residential real estate market. But a combination of frenzied deal-making, high prices and credit worries sank the sector.

"In April, Moody's Investors Service said lenders underwriting standards had become too lax during the run-up of prices. The warning scared investors and prompted bankers to raise interest rates and required borrowers to put up more of their own money into deals."

Timing of the Hit

"Then the whole screechy, fear-struck orchestra of yesterday's heroes started playing.

"Now its lenders, primarily Australian banks, [who] are pressuring Centro to sell assets before they will consider refinancing. Credit was plentiful when Mr. Macklowe purchased his Manhattan office buildings from Blackstone, he only needed to put up $50 million of equity to secure $7.1 billion in debt, which included as a bridge loan. people familiar with the deal say."

But now London's, Melbourne's and Manhattan's bridges have tumbled, not unlike the physical one in Minneapolis.

W.K.

Correspondence

A reader writes asking how we would interpret the following C.D. Howe study published by Reuters on December 4. "Ottawa – The Bank of Canada may have overstepped its legal powers during the summer credit crunch, and legislative changes are needed to clarify its role in future financial market crises, an independent report said on Tuesday.

"From August 15 to September 7, the central bank temporarily suspended its list of collateral used when conducting open-market operations to boost liquidity and reintroduce its target for the overnight interest rate.

"The bank stepped into 'questionable legal territory ' when it began accepting commercial paper, foreign bonds and corporate bonds in addition to the usual government securities, bills of exchange and promissory notes, argued Paul Koning of the C.D. Howe Institute, a think tank."

Right here, let us pause to note a rare sign of modesty when the C.D. Howe Institute describes itself as a "think tank." Rather like the Good Lord Himself describing Himself as a "think tank, for he did think everything up. The very choice of the name C.D. Howe, carries a hint of the same message. C.D. Howe was essentially not a politician but a gifted engineer who during the Second World took this semi-rural land in which little infrastructure had been maintained during a decade of depression, and by putting next to everything under control – domestic and foreign currency, what manufactures were still being produced, transformed Canada into a nation of roaring industry that not only equipped and trained its own armed forces – but some of our allies. No sign of modesty then, with the C.D. Howe Institute adopting a name like that.

The Bank of Canada had been founded by a Conservative government as a private institution with 12,000 shareholders in 1935. These were bought out at a good profit some three years later. That meant huge economies of the government *spending* its money into existence, rather than have the private banks *lend* it into existence that had never really been tried in peace time, but showed its effectiveness in organizing the war effort. And the government promised the electorate that the troops would come home to a different and better world.

In that postwar context, the name C.D. Howe Institute, however, was misused to imply reversing just about everything that Parliament in its folly might pass. It breathed primordial belief in the freedom of markets and minimal constraints on the really big economic shakers. Especially all the social legislation would have to go that had been promised to the armies and labour force equipped and directed by the original C.D. Howe. That, too, the Howe Institute has perfected to high art.

I recounted an early sampling of that high technique the experience in the June 1995 issue of *Economic Reform*, which appeared in volume 1 of *Meltdown*, page 172, in part: "A tactical retreat is underway by the Bank of Canada to duck a hailstorm of misfired prophecy. The latest proof of this comes from David Laidler and William Robson, *Don't Break the Bank! The Role of Monetary Policy in Deficit Reduction*, published by the C.D. Howe Institute. Though the book suggests moderation, it is essentially a camouflage of moderation until the Howe Institute can resume its 20-year rampage. 'Because the Bank appears to have become inadvertently tight during the second half of 1944, somewhat easier policy now would probably not put its 1 to 3% targets at risk.' We love that 'inadvertently.' Whose inadvertence? Given the series of unsoft economic crashes during the past twenty years, it was not difficult for COMER to predict a stubborn recession when the short-term rate of interest had been doubled in less than one year in 1994. The inadvertence was wholly that of the BoC, and of those academics and editors hoodwinked or suborned by a network run at public expense.

"Laidler and Robson warn that Ottawa should look to its own spending, not to the BoC, for a solution to its fiscal woes.

"But over one third of the government's spending is for interest imposed by the BoC. As late as 1980 the BoC had held 19.5% of the federal government's funded debt, but by 1994, this had dropped to 5.4%. When the central bank holds federal government debt, the interest reverts to that government as dividends to its sole shareholder. When private banks hold it, it doesn't. If L&R really wanted to reduce government spending, they should begin by looking into the arrangements that had made this possible before but is impossible today – the phasing out between 1991 and 1993 of the statutory reserves that the banks had to deposit with the central bank (4 to 12% depending on how short term the bank account in which they are held and whether the central bank was using these reserves to stimulate an economic recovery or repress an economic boom). And in 1988 the Bank for International Settlements had declared the debt of developed countries risk-free, and hence requiring no down-payment for banks to acquire. [On statutory reserves the banks paid no interest in order not curtail their leverage for cooling or stimulating the economy in one case or the other without raising or lowering interest rates. It was a more benign alternative to the use of interest rates for the purpose. Interest rates hit everything that moves in the economy especially the unemployed who cannot be contributing to inflation.]"[1]

Correspondence

Just after the Ontario budget came down I saw John Tory on Pulse24 news criticizing McGuinty very strongly for expensing the entire budget item for TTC expansion into one fiscal year. That immediately reminded me of your comments on appropriate capital budgeting. I've found the following on this specific point on the Internet at www.paymoregetless.ca/resources/ECOTspeech.pdf on page 5.

Michael Sinclair, Toronto

"Take a close look at the budget document – and you will see the $1.2 billion being set aside for the Toronto Transit expansion will not be expensed in the year the money is to be actually spent, but will, for political purposes be expensed in the fiscal year that ends this week. A budget is supposed to detail how you spend money for the coming year. This budget instead is booking money this year – for work that will not be starting for years to come.

"This government is borrowing money today for work that will not be taking place for a long time. You do not take out a mortgage today for a house you will buy three years from now. In business, you would be answering to the authorities, if you artificially depressed one year's results in order to finance a future-spending spree.

"Liberal sources already admit that – for political purposes – The finance Minister wants to balance the budget next year – so he's intentionally leaving a deficit in place – a growing debt in place – and higher interest payments in place – all in the name of political gain."■

Three years earlier – in 1988 – the Bank for International Settlements – a cozy central bankers' club based in Basel, Switzerland, whose sessions elected officials of government are not invited to attend – had sponsored the *Risk-Based Capital Requirements.* Theses declared the debt of central governments of developed countries risk-free and hence requiring no down-payment for banks to acquire. That helped them replace the capital they had already lost in their gambles.

At the same they were further deregulated so that they could acquire interest in the other "financial pillars" – stock brokerage, insurance companies, and mortgage firms. That gave them access to the cash reserves kept by such corporations to meet the needs of their own business. Banks were thus free to apply in turn the "bank multiplier" to the reserves of these other pillars, and build up virtual many-storeyed financial skyscrapers equipped with one-way elevators that can only go up – until they crash. This in fact is largely the origin of the excess of subprime mortgages and other rickety debt (Collateral Debt Obligations – CDOs) that underlies the present deepening world financial crisis.

William Krehm

1. The *Bank of Canada Act*, as altered after the nationalization of the central bank in 1938, permits the federal government, as sole shareholder, to borrow certainly for capital projects at a virtual interest-free basis – since the interest paid on its borrowing will – less the handling costs of the BoC – come back to the federal government as dividends.

There are also provisions for lending to the provinces, but of course, the interest on provincial loans will substantially end up with the federal not the provincial government, for they hold no BoC shares. However, the federal and the various provincial governments have a ready means of collaborating – for other considerations such as covering the federal share of social or other programs. The federal government could return some negotiated part of the interest paid the BoC to the province that did the borrowing. There is even a provision for the municipalities to benefit similarly, with reference to bonds guaranteed by the federal or provincial government – the BoC may buy and sell securities issued or guaranteed by Canada or any province (subsection 18(c)). Above all subsection 14(2) gives, in the event of a disagreement between the federal Finance Minister and the Governor of the Bank of Canada, the former may given in writing a statement of the policy to be followed, and the Governor shall comply.

A Crisis Long Foretold

The New York Times (19/12) heads its lead editorial "A Crisis Long Foretold" but in its post-telling leaves out the punch-line of this sad tale.

"A truism of crisis management is that most seemingly out-of-the-blue disasters could have been prevented if someone had paid attention. An article in the *Times* on Tuesday by Edmund L. Andrews leaves no doubt that the twin crises of the subprime lending mess – mass foreclosures at one end of the economic scale and credit-squeeze affecting the financial system at the other – are rooted in the willful failure of federal regulators to heed numerous warnings.

"The Federal Reserve is specially blameworthy. Starting as early as 2000, former Fed Chairman Alan Greenspan brushed aside warnings from another Fed governor, Edward M. Gramlich, about subprime lenders luring borrowers into risky loans. Mr. Greenspan's insistence, to this day, that the Fed didn't have the power to rein in such lending is nonsense.

"In 1994, Congress passed a law requiring the Fed to regulate all mortgage lending. The language is crystal clear: the Fed 'by regulation or order, shall prohibit acts or practices or, connection with (A) mortgage loans that the board finds to be unfair, deceptive or designed to prevent, to evade the provisions of this section, and (B) refinancing of mortgage loans that the board finds to be associated with abusive lending practices, or are otherwise not in the interest of the borrower.'"

Now let us pause to point out that shortly before that date something took place that was basically against the interest of borrowers of all classes. Under the Rooseveltian banking legislation brought in shortly after the expiry of the moratorium on all banking, because 38% of the banks in the land had become bankrupt, banks were to acquire no interest in the other "financial pillars" – stock brokerages, insurance and mortgage firms. The reason, as happened during the boom preceding the 1929 crash that brought in the Depression, was a clear one – allow banks access to the cash and near-cash reserves that the other financial pillars need for their own business and the banks will use them as a money base on which to apply the bank multiplier – i.e., the multiple of near-money, interesting-bearing loans lent into existence by the banks instead of being spent into existence by the government.

This, if any one thing, was the key to the Rooseveltian banking arrangement that to one degree or another became the model for banking systems throughout the non-Communist world. But there was yet another agreement directed against allowing interest becoming what the late great French economist François Perroux called the "dominant revenue." This Perroux defined as the revenue in a given society seen as the one that by its volume and rate is commonly taken to indicate the welfare of society as a whole. Roosevelt, who I am sure had never heard of Perroux, instinctively reached similar conclusions. Special pains were taken not to depend exclusively on interest rates. Hence, again the Americans were imitated in this – the statutory reserves were brought in. These were a percentage of the deposits left by the public with the banks to be redeposited with the central bank. That lessened the dependence of the Fed on interest rates to stimulate the economy when the Fed judged that necessary or to calm it down when it wished to fight "inflation." But the banks, having recovered their capital due to the severe controls just mentioned, longed to get back to the succulent fleshpots of the 1920s that brought on the Depression that brought on World War II.

Be fair to Alan Greenspan, he will have to explain to his Maker when, we hope, he somehow gets to heaven. But his main fault was to possess more sensitive political nostrils than most of his critics. He read clearly that the gig of the Rooseveltian age for which Roosevelt was loathed so thoroughly by most of the wealthy, was up. The end of the statutory reserves – actually in the US they were reduced to near-impotence rather than abolished outright. During non-banking hours in the US such redeposits of reserves are automatically shifted to reservable accounts that pay no interest, and then when the banks shut their doors they go back to accounts that do pay interest. But before a country can receive financial aid from the IMF it must agree to end its statutory reserves. Canada had done away with them altogether, though it has never applied for IMF help.

So the Fed was left with the 1934 legal provisions, but the machinery for limiting the powers of the prowling money-lenders had been weakened, or taken away. So Alan Greenspan was left with a cops-and-robbers situation but no police cars or credit to enforce what was expected of him. It was not for nothing that Mr. Greenspan was just short of deified. Don't be too hard on him. He knew why he was hired, and by whom.

William Krehm

Who will Insure Against So Much Risky "Risk Management"?

So much misfired "risk management" calls for insurance. And with the government having concentrated on financing the losses of our deregulated banks in their ever spreading gambles, it is not surprising that it was left to Warren Buffett to meet the need. *The Wall Street Journal* (28/12, "Buffett moves into bond insurance business" by Karen Richardson) informs us: "Warren Buffett, seizing an opportunity to take advantage of turmoil in the US credit markets, is starting up a bond insurer to make it cheaper for local governments to borrow and is likely to be tough competition for those already in that business.

"The billionaire investor's Berkshire Hathaway Assurance Corp., a new company dedicated to guaranteeing the bonds that cities, counties and states use to finance sewer systems, schools and hospitals and other projects, is set to open today. The Berkshire venture, backed by an almost certain triple-A credit rating, is likely to be cheered by municipalities and holders of municipal bonds across the country.

"The venture, which won swift approval yesterday from the New York State Insurance Department, is sure to worry the industry's embattled incumbents, including Ambac Financial Corp., and MBIA Inc.

"Rating agencies have warned that some of these companies risk losing their coveted triple-A credit ratings because the increased risk of the mortgage-related bonds they insure could lead to massive losses.

"Mr. Buffett said in an interview that initial interest appears high enough for the company to seek licensing in the states with the highest amount of municipal debt insurance. [After New York] Mr. Buffett's insurance businesses will seek approval to open for business in California, Puerto Rico, Texas, Illinois and Florida.

"'Ideally we'd be licensed in every state, but there's a limit to what we can do,' Mr. Buffett said. 'We can't guarantee everything, and we will not take risk that is not prudent for us.'

"The risk to Mr. Buffett's business is that municipal governments decide that its prices are too high and opt to issue debt without insurance. The widespread loss of confidence in bond insurers on the part of both investors and municipal bond issuers created an opening for Mr. Buffett. For years, Mr. Buffett has criticized bond insurers for being so eager to write new business that they priced their insurance too low to reflect the bonds' underlying risk.

"'We felt that the prices they were charging were inappropriate,' Mr. Buffett said. 'As long as people were willing to accept that, there was no point in trying to offer something else.

"All of that changed about two months ago, when ratings firms Fitch Ratings, Moody's Investor Services and Standard & Poor's announced they were reassessing the triple-A ratings of all the bond insurers, which insure about $2.4 trillion in bonds, the bulk of which are issued by municipalities.

"Most of these companies, also known as 'monolines' or financial guarantors got their start decades ago by providing insurance or 'wraps' in the industry parlance, on bonds issued by municipalities seeking to borrow from the public at lower interest rates. The fee paid the guarantor would effectively extend to the issuer the guarantor's triple-A ratings. That allowed governments to pay lower interest rates on the bonds, saving tax-payers money."

Risk Management as the Great Divide

"Few such bonds ended on the default list over the past 30 years, making the business highly profitable. Like many on Wall Street, however, got caught up in the housing boom lured by large profits and higher growth rates, some expanded their businesses in the 1990s to insurance on 'structured products,' which include bonds backed by cash-generating assets like mortgages and credit cards receipts.

"In recent years they started insuring collateralized debt obligations, which pool bonds backed by home loans to high-risk borrowers. The added protection they provided made the CDOs even more attractive.

"Now, with record volumes of risky multiple subprime mortgages going bad and thousands of mortgage bonds and CDOs including some triple A-rated securities being down-graded, some insurers are in a precarious position.

"The new company will charge more, Mr. Buffett says, than other bond insurers to wrap municipal bonds because of what he calls the 'moral hazard' inherent in bond insurance. Governments that have insurance could take advantage of it by spending far beyond their means to repay, and simply default, leaving the insurer on the hook.

"Moody's credit analysts Stan Bouver and Jack Dorer said last month that the introduction of a new player in the bond insurance industry would put further pressure on the existing guarantors' imperilled ratings if the new firm threatened to take away a big chunk of market share."

All this, though very serious and logical from the participants' view raises a troubling question. The banks in the United States during the depths of the Depression in 1933, had shut down as a result their smashing losses in areas which they had no business, and part of the Roosevelt program was to introduce bank deposit insurance. Without that they could never had dreamt of reopening their doors. Of course, though organized by the government, it was the banks that paid the premiums, and I understand still do.

But that happens with most government revenue. These are public moneys that the banks are taxed for a specific purpose. How then does one type of bank insurance then relate to the present one being discussed by Mr. Buffett? Most of the answer revolves around the other restrictions introduced under Roosevelt that made banks stick to banking, since they were forbidden to acquire any interest in the other "financial pillars" – insurance, brokerages, and real estate mortgages. Without such restrictions it is doubtful that the government would have been prepared to set up the deposit insurance and the banks could not have reopened their doors.

Obviously if the banks had not intrigued to have the restrictions imposed on them to stick to banking lifted, there would have been no subprime mortgages or any of the far too cunning off-balance sheet mega-scams that have caused our Canadian banks to settle class action claims out of court at immense losses to the Canadian treasury.

This is not to question Mr. Buffett's good faith or impugn his reputation as a successful businessman and philanthropist. But the public interest cannot put a few insurance patches on a morally rotten situation where our banks have planned their comeback in a world of off-balance sheet skullduggery.

William Krehm

Has Our Whole Economy Become a Subprime Debt?

One of the simplifications of the subprime era has been that its victims were to be found only among the more impoverished sections of society. But now analysis proves that the damage extends far beyond that group of principal envisaged quarry.

Let me refer to *The Wall Street Journal* (3/12, "Subprime Debacle Traps Even Very Credit-Worthy" by Rick Brooks and Ruth Simon): "One common assumption about the subprime mortgage crisis is that it revolves around borrowers with sketchy credit who couldn't have bought a home without taking out a mortgage with punitively high interest rates. Subprime mortgages would seem to stop only a trifle short of being a benefaction to the most miserable and lonely. But it turns out that plenty of people with seemingly good credit are also caught in the subprime trap.

"An analysis for the *WSJ* of more than $2.5 trillion in subprime loans made since 2000 shows that as the number of subprime loans mushroomed, an increasing proportion of them went to people with credit scores high enough to often qualify for conventional loans with far better terms.

"In 2005, the peak year of the subprime boom, the study says the borrowers with such credit scores got 55% of all subprime mortgages that were ultimately packaged for securities for sale to investors as most subprime loans are. The study – by First American Loan Performance research firm, of San Francisco – said the proportions rose even higher by the end of 2000 to 61%. The figure was just 41% in 2000. Even a significant number of borrowers with a top-notch credit signed up for expensive subprime loans.

"The numbers could have dramatic implications for how the banks and US regulators address the meltdown in subprime loans. Major banks, mortgage companies and investment firms have been rocked by billions of dollars in losses on shaky subprime loans – which typically carry much higher, or rising, rates and other potentially onerous costs – and have increasingly gone into default. Many analysts expect hundreds of thousand loans could go bad over the next several years. The Bush administration and major financial institutions are working on a plan to freeze interest rates of certain subprime loans in hopes of avoiding an even bigger meltdown.

"The surprisingly high number of subprime loans among the more creditworthy borrowers shows how far such mortgages have spread into the economy – including middle-class and wealthy communities where they once were scarce. They also affirm that thousands of borrowers took out loans – perhaps foolishly – with little or no documentation, or no down payment, or without income to qualify for a conventional size they wanted."

The Urgency for Economics Students to Take Obligatory One-year Courses in Mathematics and Physics

Here I must allow myself a basic observation that I and other have tried making for at least a half century. Official economic theory for a good century and a quarter has been strung tightly on interest rates as an ancient minstrel's lyre on the guts on which he sang of the gods and fate. You have it in future evaluations of income streams, in calculating the supposed equilibrium points of supply and the demand that by marginal theory taught in our universities for at least a century, in pensions, in option trading, in hedge funds, and now in mortgage and other risk management calculations. Interest rates confront you everywhere, swaths of risks are put together by mixing up degrees of risk – who pays for what percentage of a batch of a mess of mortgages, absorbing what percentage of the first losses in return for a larger percentage of what portion of the profits – if there should be any – finally left in a batch that can contain thousands of individual mortgages, that are all jumbled together and it can take months or years to even tell what their individual collection records might be.

We shall draw our conclusions as we go along beginning right here. Having had a bit of university training in maths and physics I said and wrote many, many decades ago – along with greater authorities – that the use of the calculus by equilibrium economics – the theory that the market is or could be self balancing is swindle. And our first conclusion is that economics students at our university should be obliged to take a mathematics and a physics course in their undergraduate training, to prevent mistaking any mathematics for anything more than a powerful tool for scientific research of anything – whether astronomy or physics. It itself contributes no empirical content to any science. But it is – properly used – the most powerful means of analyzing empirical content gathered by other specialties – whether astronomers or economists.

"Many borrowers whose credit scores might have qualified them for conventional loans say they were pushed into risky subprime loans. They say lenders or brokers aggressively marketed the loans, offering easier and faster approvals – and downplaying or hiding the onerous price paid over the long haul in higher interest rates or stricter repayment terms."

Here we are going to change the format of our article to highlight the close parallel with the fiscal system of our central governments over recent decades. Whenever a conclusion in this sense emerges we shall use italics to bring it to the fore.

This parallels exactly the fight against alleged "inflation" by distorting the very sense of the word "inflation" to mean invariably any increase in the price level, no matter whether it is real inflation – created by an excess of demand over available supply – or something quite different: modern urban high-tech life requires ever more government investment and this through taxation turns up abundantly – twice in effect – once in the cost of the private sector's taxes and one paid by the consumer to the government directly on a base that already includes the taxes paid by the producers of the governments' supply of goods and services. And by a cunning pattern – the write-off of government's capital assets in a single year – "cash accountancy" – that continued in the US until January 1996 and in Canada until 2002 and was treated as current expenses and hence written off entirely in a single year – the year when the financing was arranged. On the other hand the financing of the same government investment was amortized over more or less the useful life of the government asset built by the government or acquired. This created a deceptive fiscal debit that was not necessarily there. In Canada at least one Royal Commission decades ago, and countless auditors-general had recommended the adoption of "accrual accountancy," also known as "capital budgeting," that employs the double-entry accounting that the Crusaders were said to have brought back from the Holy Land. An ordinary taxpayer trying to get away with that sort of anti-accountancy for his tax purposes, would be risking a heavy penalty, but the next conclusion that we cannot

escape is that this anomaly was clung to for so many years because it served well those wealthy taxpayers who are determined that not only the vast disparity of income between those at the top in our society and those at the bottom continue but go on widening.

What was Learned and Forgotten in Depression and War

However, they are not necessarily as bright as they are rich, and they struck out badly in what might be called an early version of subprime economics and subprime government.

During the 1920s the American banking community ran amok rather than sticking to simple banking. That is already complicated enough, since it involves lending out what used to be some 10 times as much money as the banks actually own in liquid form, and still be always able to honor a depositor and come up with the funds that he has left with you and calls for its return. However, in the 1920s, the bankers of the US lent money that was rarely their own to Latin American dictators who too often failed to repay. That sort of thing contributed to the crash of October 1929 and a decade of deep depression that led directly to the Second World War. By the time President Franklin Roosevelt was inaugurated for his first term, 38% of the banks in the US had shut their doors, and one of the first things the new president did was to declare a bank moratorium, which was then renewed. When the banks reopened for business a month later, the government had to guarantee their depositors, and the banks were restricted strictly to banking, and prohibited from acquiring any interest in the other "financial pillars" – stock brokerages, insurance and mortgages. There was good enough reason for this. Allow the banks access to the cash reserves that these "other pillars" held for the needs of their own business, and they would use the money as basis for applying the banking multiplier – the amount of credit banks can create on a single dollar of cash that it owns or controls.

There was an elementary justice in the arrangement. The banks could open their doors again under Roosevelt because the government had guaranteed the deposits they took from the public. Accordingly it was only fair as well as workable for the government to determine what the banks can do with money not theirs but guaranteed by the government.

The arrangement worked and took a bit of the cutting edge off the Depression, though only the outbreak of World War II actually brought that to an end. During the war the banks in fact stuck to simple banking, and healed well from their extravagances of the 1920s.

Recovery Leads to Forced Amnesia

But as they recovered they began lusting after the fleshpots of the 1920s. But Allied government had promised their armies better lives in a better world, and in reasonably democratic countries they more or less tried keeping their word. That meant that the grand comeback to Deregulation and Globalization that the banks planned had to be directed against the early postwar governments. From this they needed an external war room, that would cultivate the lowest possible profile, to plan the campaign.

Providentially one appeared that met those specifications. It was the Bank for International Settlements that had originally been set up in 1929 to handle the German reparations from World War I. Germany could pay these only in German marks, that nobody wanted. France and Belgium insisted on German reparation payments in a strong currency.

While the haggle went on and on the crash took place and BIS that had been set up to receive the payments in German marks and then syndicate them into dollars and other acceptable currencies. However, with the Depression the syndication became impractical and BIS lingered on to no particular purpose. When Hitler's army marched into Prague, BIS practically fell over itself in its eagerness to surrender to the Germans the Czechoslovak gold reserve that the Prague government had left with it precisely to keep it out of German hands. That is why at the Bretton Woods Conference in 1944, Resolution 5 was adopted for the dissolution of BIS at the earliest possible moment. After that BIS cultivated the lowest of conceivable profiles in the hope of surviving by being forgotten.

But that answered the world bankers' need for a war-room for planning and directing the comeback of the banks to even more deregulation and globalization that they had enjoyed before the Depression. In the 1980s American banks took over the Savings and Loans, essentially mortgage trusts. Losses after they became landlords and land developers have been estimated as high as $400 billion. During the Depression, we have already noted Roosevelt guaranteed bank deposits to allow the banks to reopen for business. *Now there was no trace of any reciprocity. Every time that the banks suffered monumental losses, the government stepped in to bail them out, and the banks invariably went on to more brainless speculations, which at the present has climaxed in the subprime mortgage crisis. But since power itself has shifted to the banks, there is no possibility that the process will stop there. And that, leading to ever largely scale to allow the gambles to grow in size, that lead to still greater losses.*

This was a clear indication that the discipline of economics had been twisted and pulled out of shape to serve as an art of apologetics for the financial sector. It is the social programs of the countries involved that have footed the bill.

A Major Bailout Leads to the Surrender of Political Power

Thus the two main measures that were introduced to recapitalize the American and Canadian banks after their losses from their heavy losses with the Savings and Loans – and in Canada taking over junior banks and mortgage trusts, were two. In 1988 BIS issued its risk-proof bank capital requirements. This declared the debt of governments of advanced countries to be risk-free and thus requiring no down payment for banks to acquire. All they had to do was cash the coupons. The banks in Canada quadrupled their holding of Canadian government debt – from roughly $20 billion dollars to $80 billion.

And, in 1991, an amendment of the Bank Act was passed by the Canadian Parliament phasing out the statutory reserves that the Canadian banks had deposited with the central bank as a percentage of the deposits left with them by the public. Depending on the length of time of the deposit, this varied from 3 to 12 percent, and on these deposits the banks received no interest. That not only referred to the monopoly in coining precious metals that the ancestral monarch had surrendered to the banks, allowing them to create near-money – i.e., interest-bearing notes and bookkeeping entries that were lent into existence. The interest-free feature not only made for a more stable way of cooling an overheated economy and stimulating a depressed one – it diminished the encouragement of the banks to increase or diminish the leverage of the use of these reserves as an alternative to altering of the benchmark interest rate that influence many of the shorter interest rates in the land by any changes the central bank made in the overnight rate at which banks could lend each other funds.

With the repeal of the statutory reserves (1991-3), the benchmark interest rates overnight applicable to chartered bank borrowing from each other to meet their reserve

requirement *vis-à-vis* the central bank. With that interest rates were raised to the one lever for the guidance of the economy. But interest is not only the basic revenue of the money-lenders. It is also, when driven high enough the arm-breaking collection device which can create bankruptcy bargains for money lenders to profit from.

Our banks over the period of a half century, step by step employing ever greater government subsidies for their ever more daring gambles, brought this country shame. Three of our banks were involved in the off-accountancy schemes in the malodorous Enron case. One actually planned the off-balance sheet escapade that sent several Enron employees to prison. It settled out of court for some $240 million in a class action, and had further involvement along with two other Canadian banks. All this was paid for by our government slashing social programs or downloading them to the provinces, who passed on the compliment to the municipalities. That is why our municipalities, coast to coast, are in such potholed condition from roads to schools, to public services today.

Why the Subprime Mortgage Mess will Lead to Further Surrender of Power

Now let us sum up this episode of our banks' adventures and lead you to a better understanding of the rise to supreme political power of our banks that made possible the present subprime crisis.

The declaration of the debt of developed countries to be "risk-free" and thus requiring no down payment for the stressed banks to acquire we have noted quadrupled the holdings of our banks in such Canadian government debt to $80 billion. *But at the same the then manager of BIS proclaimed a new campaign to bring down the "rate of inflation" to absolute zero, by raising the Bank of Canada's benchmark interest rate into the skies. However, in his zeal, the Manager of BIS, Alexandre Lamfalussy, overlooked a little but vital detail. When you raise interest rates brusquely, hoards of pre-existent bonds with lower coupons will fall in value. And that is what happened in 1993, when the crisis that the heavy handed imposition of the North American Free Trade Agreement had precipitated a 40% crash of the peso, and the shooting up of interest rates threatened to spread that crisis to take in the world. At that time the US Treasury came forward with a praiseworthy plan insofar as it eased the world crisis that was shaping around the Mexican collapse, contributed to the plethora of money that has contributed to the subprime mortgage crisis.*

We have already noted that our government, as practically most others, treated government investments – even though they were bridges, roads and buildings that would last for generations – exactly as current expenses and wrote their cost off entirely in one year. At the same time it carefully amortized the debt incurred to create them. And the two contradictory ways of treating two aspects of the same acquisition created the illusion of an imbalance in the government fiscal position that did not necessarily exist. It was to remedy this that the Clinton cabinet turned desperately, and in the Department of Commerce figure on "savings" for January 1996 for the first time, a item of some $1.3 trillion was thus recovered after working back the correction to 1959. *But this was not labeled for what it was* – government investment not properly depreciated. For governments in these circles are not supposed to be capable of making investments. Only of bailing out the banks from their losses in their investments more often than once a decade, the message was easily conveyed to the bond-rating agency, and resulted in a drop in interest rates that give Clinton his second term, the stock market its high-tech boom and bust, and a plethora of economic activity and near-money creation which made possible to the subprime mortgage crisis.

Thus we see that the subprime mortgage mess must be tracked down to its real origins.

William Krehm

Letters from J.W. Smith

Private Banks Creating Money

Hello, William Krehm.

Good job on the write up on Bromsgrove. But here is something for you. www.informationclearinghouse.info/article18913.htm.

Finally someone has explained exactly how private banks have been creating money and not one of those money theorists have been saying this. What is amazing is it was created by fraud (slipping bad debts into a package of good debts and rating it triple A).

I had read the story that banks were creating money by packaging debts and selling them. But nowhere did they say bad debts were involved. So I rejected that story, all they had effectively done was convert mortgages to a bond. But when you put debts in there that obviously will not collect 50 cents on the dollar and those supposedly triple A bonds rise in price you have temporarily created money. But only for a short while. That money which really never was there in the first place has disappeared.

So the books showed created money, but it is now proven that it was only stated that value was there, and that proves it was never created in the first place. If that created money had been real, the system would have continued working. The bottom line is, money was not created, investors only thought so. Many more of those debt instruments (derivatives, etc.) will prove to also be made up of fictitious values. So this has been going on in every boom and this time around they decided to apply the scam to what are effectively bonds.

Have fun.

J.W. Smith

The Supply of Money

Flash: As I was writing you all last night, it came over the wires that the Fed Reserve chairman, Bernanke's, warning as the credit crisis began of a $100 billion bank loss due to subprime mortgages has just been upped by analysts to possibly $1 trillion.

There is no talk of banks creating any money to replace that which, of course, as I continually point out, they cannot do. A loss of $1 trillion for the major banks means trillions of dollars will be unavailable for loans as the circulation of money (the determinate of the money supply) slows as those major banks both retrench to cover their off-books losses (derivatives, etc.) and refuse to loan money for fear of not getting it back.

Knowing all this, the legal minds have cleared the way for the Federal Reserve to take the place of those banks and loan to anybody (which, of course, will be the previous customers of those major banks). Money they create will be base money and the circulation of that money (which is the money supply) will refill those banks' coffers.

That one can stop a crash in its tracks if one has a federally owned bank chartered to create federal reserve notes, which we do, is right by my book. They will at first be throwing that money at the ethereal world of high finance (derivatives, etc.) instead of

the real economy also right by my book. Of course right quick they will also have to throw money at the real economy (automakers, etc.).

But not all central banks will be authorized, nor will they be positioned, to do so. Example: The EU does not yet have a central bank except to the extent Germany has been filling that position. It has not been determined yet if Germany can, or will, finance other parts of the EU. As they have no choice, it is either print or crash, my bets that all central banks will quickly be authorized to fill the funding gap left by the retrenchment of the bigger banks. (But lets say that all across Europe they go by their training, other nations within the EU refuse to print money, and Germany prints money to protect all of Europe. Of course it can be done. America has proven that by printing trillions of dollars and spreading it all over the world. But will that not be interesting? Through printing her currency Germany now has a mortgage against the industries all across the EU. If the crash cannot be staved off, Germany and whichever other central bank jumped in to help (likely England) will essentially own Europe.

If all works well, the crash may well be averted, again right by my book (except they will be throwing most the money at the corrupt ethereal end of the economy instead of the real economy). But there are many sinkholes and much quicksand between this start of the collapse and safely getting through it all. It can work if all central banks fall in line and print that money. But doing so is against everything they have been taught and practiced in the past.

Just as I point out over and over that the beliefs of the masses cannot be changed until they and their children are cold and hungry, you are already seeing the change of beliefs of the money masters as their world falls apart. It is they who will be (rhetorically) living on the street first.

Respectfully,

J.W. Smith

Groping *continued from page 1*

starting to cast shadows over the land of the little house-owner.

And over it all hangs the clear answer to the key unasked question. With all the certainties that led Wall St. to step out while on a mission in space and time, how did it happen that the Washington-Wall Street masters of risk management failed to foresee the unlimited risks they were taking on?

W.K.

How Banking's Secret System Broke Down — Financial Times Analysis

This explains a little more. One thing I don't understand is this guy's explanation of 85% of money to purchase those SIVs and CDOs amounted to created money. I don't believe that. Real money had to be paid to the banks which put those packages together, not promises to pay. Enjoy. J.W.

Out of the Shadows: How Banking's Secret System Broke Down

By Gillian Tett and Paul J. Davies, published December 16, 2007, last updated December 16, 2007.

When the New York markets open on Monday, all eyes will be on Wall Street's banks. As the US Federal Reserve, in a bid to ease the liquidity crisis, holds a novel type of money market auction to inject some $20B of funds into financial institutions, investors and policymakers will be watching closely to see how many large banks bid for how much cash – and what that, in turn, indicates about their state of health.

Yet while investors are scrutinizing some of the industry's best-known names, a spectre will be silently haunting events: the state of the little-known, so-called "shadow" banking system.

A plethora of opaque institutions and vehicles have sprung up in American and European markets this decade, and they have come to play an important role in providing credit across the financial system. Until the summer, structured investment vehicles (SIVs) and collateralized debt obligations (CDOs) attracted little attention outside specialist financial circles. Though often affiliated to major banks, they were not always fully recognized on balance sheets. These institutions, moreover, have never been part of the "official" banking system: they are unable, for example, to participate in Monday's Fed auction.

But as the credit crisis enters its fifth month, it has become clear that one of the key causes of the turmoil is that parts of this hidden world are imploding. This in turn is creating huge instability for "real" banks – not least because regulators and bankers alike have been badly wrong-footed by the degree to which the two are entwined.

"What we are witnessing is essentially the breakdown of our modern-day banking system, a complex of leveraged lending [that is] so hard to understand," Bill Gross, head of Pimco asset management group recently wrote. "Colleagues call it the 'shadow banking system' because it has lain hidden for years, untouched by regulation yet free to magically and mystically create and then package subprime loans in [ways] that only Wall Street wizards could explain."

By any standards, the activities of this shadow realm have become startling. Traditionally, the main source of credit in the financial world was the official banks, which typically forged business by making loans to companies or consumers. They retained this credit risk on their books, meaning that they were on the hook if loans turned sour.

However, in the past decade, this financial model has changed radically. On the one hand, banks have increasingly started to sell their credit risk to other investment groups, either via direct loan sales or by repackaging loans into bonds; at the same time, regulatory reforms have permitted the banks to reduce the amount of capital that they need to hold against the danger that borrowers default.

Vehicular Financing Gathers Speed

The net consequence is that the western financial system embraced what Paul Tucker, head of markets at the Bank of England, has described as the age of "vehicular finance." This system has given banks huge incentives to pass on their loans to new vehicles, either by creating these themselves or by sponsoring outside fund managers to run them.

The role of such entities in creating credit has increased vastly in the past three years. For example, the asset-backed commercial paper market, which supplies the lion's share of funding to SIVs and conduits in the form of cheap, short-term cash, saw a step-change in growth at the end of 2004. The volumes of such paper in issue had fluctuated between $600B and $700B for at least four years; at the market's peak this summer they stood at almost $1,200B.

"The shadow banking world has expanded at an amazing rate," says Bob Janjuah, credit analyst at Royal Bank of Scotland,

who estimates that these shadow banks could have accounted for half of all net new credit creation in the past two years in the US.

Because these vehicles typically borrow heavily to finance their activities, they have also been a key reason why leverage – or debt levels – across the financial world has risen so fast without regulators, or ordinary investors, being fully aware of this boom.

The involvement of hedge funds, themselves highly geared as providers of the equity at the foundations of this system, illustrates why shadow banking can have such an outsized impact on the supply of credit. Satyajit Das, an author and derivatives industry expert, cites an example where just $10M of real, unlevered hedge fund money supports an $850M mortgage-backed deal. This means $1 of real money is being used to create $85 of mortgage lending – credit creation far beyond the wildest dreams of high-street bankers.

Since SIVs and CDOs have never been in the business of gathering deposits from customers, their significance to the economic and financial system has not been widely recognized by regulators and policymakers. However, the huge expansion of the SIV and conduit industries in particular was fuelled by short-term debt bought by so-called money-market funds. Retail investors, schools, hospitals and pension funds have placed billions of dollars in such funds, yet none of this system comes under bank regulations.

The problem now is that the business model behind parts of this shadow banking world looks increasingly shaky, particularly among the SIVs. There is huge concern in the US that some of these money-market funds might not return all the money people have entrusted to them. "You have a whole pool of investors who have been putting their money into SIVs thinking that they were as safe, or even safer, than real banks," says the head of investment banking at one big financial institution.

The role of regulators in this world was to a great degree replaced by the credit rating agencies, which awarded high, ultra-safe ratings to the debt issued by SIVs and other vehicles on the basis of historical analysis of the probabilities of defaults and losses across the shadow banking system.

However, this year's credit turmoil has brought rating downgrades to many of these instruments. "It's clear that we can no longer solely rely on an investment's credit rating when making management decisions," says Alex Fink, chief financial officer of a state fund in Florida that was recently forced to freeze withdrawals after investors pulled out $13B amid concerns over its exposure to securities backed by subprime mortgages. The securities had held top-notch ratings.

But it is not just in Florida or even the US where such pain has been felt – money-market funds run by BNP Paribas and Axa of France were among the first to freeze withdrawals back in August. It is a process that some regulators, such as Axel Weber, the Bundesbank president, liken to an old-fashioned "bank run" – albeit one that is now happening in the shadow bank sector rather than at visible high-street names.

The result of this is that the shadow banking sector is now shrinking at an even faster rate than it grew. The SIV sector has seen assets fall in value by as much as $150B from a peak of more than $400B, while the asset-backed commercial paper market itself is almost $400B off its peak in July.

The almost inevitable demise of the SIV is unlikely to trouble many regulators in the long term, but in the short term it leaves policymakers and bankers with a big problem.

Precisely because the sector has been so widely ignored in recent years, there has been relatively little debate about who might be responsible if it ever ran into problems. After all, SIVs – like other parts of the "vehicular finance" world – do not have any right to call on central banks as lenders of last resort, since they are not part of the official banking system.

Most of these vehicles, and the shadow banking sector as a whole, is supported by back-up liquidity lines with "real" banks – promises to lend money that bankers never imagined they would have to deliver on. Only now are these private-sector "lenders of last resort" being fully tested, as can be seen in the moves by HSBC and Citigroup, among others, to take tens of billions of dollars of lending back on to their balance sheets. Such rescues are taking place in spite of banks" continued protestations that they have no legal responsibility to act.

This illustrates the huge level of uncertainty about exactly what banks will do and when – uncertainty that is compounded by the opaque nature of the vehicles themselves. For investors, regulators and central bankers – let alone for politicians – it is impossible to predict how this process will play out.

"As 2007 comes to a close, banks are having to deal with an expansion of their balance sheets, via an unwinding of SIV assets or retention of loans that banks are currently unable to sell," says David Brickman, analyst at Lehman Brothers.

This uncertainty has sparked money markets tensions – prompting the Fed's action on Monday. But it is also creating concern about whether banks will soon cut their lending to the real economy – thus hurting growth.

Some investment bankers insist that the outlook is not so dire. After all, while the subprime mortgage-linked world has seized up – in Europe as much as the US – activity in other parts of corporate lending remains relatively robust. Indeed, investment vehicles linked to corporate debt, such as collateralized loan obligations (CLOs), remain a bright spot in the broader securitization markets.

Proposed Solution — A Less Risk-oriented Bank System

But central bankers are clearly concerned. The BoE's Mr. Tucker referred in a speech last week to a series of recent papers by the US economists Adrian Tobias and Hyun Shin, which argue that the credit cycle will be amplified by the kind of balance-sheet management employed by the shadow banking sector and modern banks themselves. "When the music stops, the process [of credit expansion] can be reversed as falls in asset values, leverage and liquidity feed on each other," said Mr Tucker.

One thing that is clear is that regulators are facing mounting pressure to change their attitude towards these "shadow" banks. Hector Sants, chief executive of the UK's financial watchdog, said last week that regulators' ability to monitor the financial system had been hampered by banks' use of "opaque" off-balance sheet financing and that this "needs to be addressed."

There is also growing debate about whether a system that relies so heavily on non-bank lenders should also have some kind of "buyer of last resort" to stand behind the markets, much as central banks do for the banking system.

"Lending has become disintermediated to the extent that in many sectors the majority of lending is done not by banks but by investors. So if there is a run on the markets through the evaporations of liquidity, who is there to step in and provide that liquidity?" asks Alexander Batchvarov, head of structured product research at Merrill Lynch. "Previously we saw a similar situation with the collapse of LTCM. Today it is structured

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Curtains Closing for Globalisation and Deregulation?

It may be hard to believe the extent of the refashioning, not only of individual fortunes, but of the overweening empires that promoted the creed of "bigger is better." In corporation size it is as in the sweep of political empires. Could the new trends in process launched by the American sponsorship of Globalization and Deregulation end up as a modern equivalent of the break-up into minute feudal domains?

The very timing of the new tidings in the outgoing week of the old year has something portentous about it.

Not only did the concept of Deregulation and Globalization blow out of New York and Washington, as did the high art of derivatives as the designer of the world to come. As did the conceit that economists could peer into the distant future without even the need of the economic equivalent of Galileo's telescope. It was simply assumed that distances in time and space would yield to the intensity of greed taken to an ever higher degree. Double-entry bookkeeping was simply cast overboard when it came to government handling the infrastructures of the planned empires of Deregulation and Globalization.

The Romans at least had the good sense to build durable highways over which their conquering legions could march to their conquests. And when the conquests were no longer to be achieved they turned their road-building skills into the building of walls to protect what they might possibly be able to defend. And they sent the sons of their senatorial class to the modest Greek island of Rhodes to pick up an acquaintance with Greek literature and mathematics.

Clearly not the age of President W.G. Bush.

Such concerns have, up to now, not troubled the White House nor Wall Street.

That is why the Xmas day issue of the Business Day section of *The New York Times* is replete with tidings of trends that foretell the dependence on tiny states that fate had spared the temptations of worldwide empire and its misleading allurements. Page one of its Business Day (25/12, "Merrill Lynch Sells as $5 Billion State to Singapore Firm" by Eric Dash) starts as you do with the biggest suddenly humbled: "Merrill Lynch became the latest Wall Street bank to grab a financial lifeline from a foreign government, agreeing on Monday to sell $5 billion of new stock to an investor from Singapore and a smaller stake to a domestic firm, as the fallout from the mortgage mess continues to spread.

"The move comes as analysts predict that Merrill, the nation's largest brokerage, will write down its mortgage investments by an additional $8 billion or more in the fourth quarter. Such losses could force the firm to raise ever more capital. The deepening red ink from the turmoil in housing-related affairs has left banks and policy-makers struggling to contain the damage to the financial system and the broader economy."

Tiny Singapore to the Rescue

Let us pause in our reading from the Xmas edition of the *Times*, to note a striking difference between tiny Singapore, a pipsqueak domain with little if any good agricultural soil, notable for the attention it has paid to providing excellent government housing for its workers, superb public transport.

However, it at no time had dreams of conquering the world, for its announcements of such plans would have caused outbursts of laughter. It consists of a tiny cluster of islands and a bit of mainland, a former British colony that became a major port in the world. It has four official languages, English, Mandarin, Malay and Tamil. It chose to leave the local federation of largely Malay inhabitants, introduce birth control amongst its local population, build an excellent public transport system, provide public housing for its large population, educate them. It sought neither military glory nor supremacy in any other part of the world. And here it is stepping in to buy a not inconsiderable part of one of the largest if not the largest US bank-brokerage.

Obviously it has no subprime mortgage scheme of its own to trick investors at home or abroad. Public investment is not only pursued but there is plentiful government revenue to allow the government to provide what it is better at than stock market companies to slip the rest of the world into their back pockets.

Getting back to the *Times* article: "As the [subprime] losses mount, cash-rich investment from the Middle East and Asia are cutting as wide swath through Wall Street. Since late October they have spent more than $22 billion in Bear Stearns, Citigroup, Morgan Stanley and UBS.

"At Merrill Lynch, talks to sell stock to Temasek Holdings, Singapore's sovereign [i.e., state-owned] fund began this summer. but gathered steam in recent weeks John A. Thain became Merritt's chairman and chief executive on December 1.

"Mr. Thain, who revitalized the embattled New York Stock Exchange, is moving quickly to shore up the once-proud firm, long known for its 'Thundering Herd of stockbrokers.'"

As explained elsewhere in this issue, had the Roosevelt restriction confined banks strictly to banking continued, the Thundering Herd of Merrill Lynch, bankers, would not have been allowed to invade mortgage and brokerage, and end up deep in the brine. Singapore, on the other hand which allowed government-owned housing, transport and much else kept its feet dry, and is thus able to acquire significant portions of Wall Street with which to fund its public infrastructures and services.

"Merrill Lynch also agreed on Monday to sell most of its commercial finance business, Merrill Lynch Capital, to General Electric Company in a deal that would raise about $1.3 billion for other parts of its business.

"To raise $5 billion, Merrill Lynch will sell new stock to Temasek at a discount to the present market price.

"It will sell an additional $1.2 billion of discounted shares to Davis Selected Advisers, a big money-management firm based in Tucson. Together, these two firms will gain a stake of less than 10% in Merrill. Neither will have a role in management of the firm nor any presence on its board.

"Merrill may have to strengthen its capital position further, given the likelihood of widening losses in its mortgage investments. While the news of Monday's deals lifted the stock, the shares quickly wiped out their gain to close down 2.65% in a holiday-shortened session. By selling new stock, Merrill will dilute the stakes of existing shareholders.

"When Merrill hired Mr. Thain away from NYSE Euronext, it offered him a sign-on package that could be worth more than $120 million if Merrill stock rises more than $40 a share in the next two years."

"Clearly, Wall Street to pursue its globalization future of such rewards must harness the increasingly sober and ever more local achievements of sovereign-fund compe-

tence. Otherwise Mr. Thain will miss that promised mega-bonus."

However, let us move on to the next mega-globalization player and the unforeseen saviour he has discovered in the most unexpected area. Obvious beggars – no matter how mightily world-sweeping they once were – cannot pick their saviours if they aren't more careful about their schemes for bringing home the planet earth as a contractual bonus.

We pass on to the subsection of *The New York Times* piece entitled "Price Range for Morgan Stock." "Shanghai – Morgan Stanley, the investment bank and the Chinese government said Monday that the bank had determined the range of prices to be used when China's international investment fund converts $5 billion in securities into Morgan Stanley stock.

"The Chinese Investment Corporation agreed last week to buy Morgan Stanley securities that will be convertible into up to 9.9 of the bank's stock in 2010, at a price of no more than 1.2 the 'reference price' that was confirmed Monday. The reference price would be $48.07 to $57.

"The Chinese investment will help soften the blow from mortgage-related debt that led the bank to report a $9.4 billion write-down in the quarter that ended November 30. Morgan Stanley reported a $3.6 billion net loss for the quarter."

Up to now in partnerships that Western corporations negotiated with Chinese government firms, it was entry into the potentially vast Chinese market that was the motive for the US or other foreign firm, whereas the Chinese had their eye on acquiring Western industrial or commercial technology. I am sure the terms they found the subprime mortgage technology could hardly be something that the Chinese will be eager to learn or copy.

However, deregulated American banks

China — Land of Clogged Roads and Lungs

China may be moving rapidly towards winning the race for what is deemed the greatest growth and prosperity, but for that it is paying an unenviable price. *The New York Times* (6/12, "Trucks propel China's Economy, and Foul Its Air" by Keith Bradsher) paints an unlovely picture of the situation there.

"Guanzhou, China – Every night, columns of hulking blue and red trucks invade China's major cities with a reverberating roar of engines and dark clouds of diesel exhaust so thick that it dims headlights.

"By daybreak in this sprawling metropolis in southeastern China, residents near thoroughfares who leave their windows open find their faces stiff with a layer of diesel soot.

"Trucks are the mules of this country's spectacularly expanding economy – ubiquitous and essential, but highly noxious.

"Trucks here burn diesel fuel contaminated with more than 120 times the pollution-causing sulfur that the US allows in most diesel. While car sales in China are growing even faster than truck sales, trucks are by far the largest source of street-level pollution.

"Tiny particles of sulfur-laden soot penetrate deep into residents' lungs, interfering with the absorption of oxygen. Nitrogen oxides from truck exhaust, which build all night because cities limit truck traffic by day, bind each morning with gasoline fumes from China's car fleet to form dense smog that inflames lungs and can cause coughing and asthma.

"The ten million trucks on Chinese roads, more than a quarter of all vehicles in this country, and a major reason that China accounts for half the world's. Sating their thirst helped push the increase in oil consumption, and oil prices to nearly $100 a barrel, before a recent decline, and has propelled China as the world's largest emitter of global warming gases.

"Yet cleaning up the truck pollution presents complex problems. For instance, regulators have begun raising emission standards for new trucks, but have left millions of older ones belching black smoke. Forcing businesses and farmers to buy more expensive vehicles could put a drag on the economy, which already faces inflationary pressures from rising food prices and other costs.

"The fear of inflation – not to mention political and social unrest – has led Beijing to prevent the country's mostly state-owned oil companies from increasing diesel prices at the pump in pace with global oil prices. Raising fuel prices for farmers, whose incomes have lagged behind those of city-dwellers and who need diesel for their tractors, is one concern. Lower diesel prices also essentially subsidize every manufacturer in China's export machine.

But price controls create a vicious circle. Oil giants like Sinopec, losing money on every gallon of diesel they refine because of the low sale prices, upgrade refineries slowly, if at all. And they seek out cheap crude which has high levels of sulfur.

"Low diesel prices frequently make trucks more cost-effective than trains which pollute less. Sales of large freight trucks in China outpace those in the US. Demand for diesel at service stations is so great, and supplies of it are so tight, that rationing and shortages of diesel have become common. Truck drivers idle for hours only to be allowed as little as five gallons of fuel.

"This has created myriad problems from gridlock that chokes China's cities to hundreds of thousands of premature deaths from heart and lung problems, according to the World Bank.

"American regulators have labeled diesel soot a likely carcinogen. A growing body of academic literature blames tiny airborne particles from diesel exhaust, coal-fired power plants and other sources for up to 90% of all deaths from outdoor air pollution, because the particles penetrate so deeply into lungs. Diesel engines also emit large quantities of nitrogen oxides, which react with gasoline fumes to produce photochemical smog when hit by sunlight.

"Mainland Chinese atmospheric scientists concluded in an analysis in the *Journal of Environmental Sciences* that, here in Guangzhou, particles were the pollutant farthest out of line by the widest margin with air quality norms 226 days a year.

"New tests by Chinese and American researchers in Tianjin in northeastern China found that diesel engines in trucks and buses accounted for 93% of all nitrogen oxides in China and 97% of all particles.

"Sulfur clogs emissions control equipment. And China lacks an effective control equipment, and the more advanced the equipment, the more vulnerable it is to sulfur damage. Truck drivers tend to fill up in rural areas with less expensive, high-sulfur fuel.

"Two dozen truckers said in interviews in Guanzhou and in Shenzhen that fuel shortages had become chronic, with trucks idling for hours as they wait in line."■

may lead to any point of the compass, and China has the added motive to keep the yuan from rising to reflect its very favourite trade surplus with the US.

It has, in fact, been under considerable diplomatic pressure from Washington to let its currency rise. As an added bonus in this deal, they have the assurance that Washington will not chew its ears off objecting to a yuan kept low because such deals are pulling top banks literally out of the gutter. The Germans have a term for it "Schadenfreude." Never has it come so cheap.

W.K.

Even the Hedges, Princes of High Finance, are Feeling the Subprime Squeeze

We must apologize to our readers for dwelling on so many aspects of the subprime earthquake – for it is nothing less. And that conclusion shaping under our eyes needs some overview. You cannot leave it to the BIS and Wall Street that had their heads so deep in the ground to do the final summing. up.

The Wall Street Journal (28/12, "Hedge Funds Feeling Pinch on Credit, Too" by Gregory Zuckerman and Alistair MacDonald) bring yet another aspect of the monetary devastation unloosed upon the world with the utter innocence that only unlimited greed can inspire: "It isn't just consumers who are having a harder time getting credit from lenders. It's hedge funds, too."

Pardon my tears.

"Investment banks are cutting back on loans to hedge funds, eliminating some clients and raising borrowing fees to others. The lenders are slimming their balance sheets after heavy losses in the debt markets in recent months. And after taking multi-billion-dollar write-downs, they also are becoming more cautious as the economy slows, according to people familiar with the situation.

"'Banks aren't in a position to be accommodating at the moment,' said Michael Hintze, CEO of CQS, a London-based hedge fund with $9 billion under management. If the change continues, it could put some pressure on the profits of the prime brokerage units of the major banks, which make big money by lending to hedge funds, as well as by helping the funds manage their cash and short stocks by borrowing and selling as a bet on falling prices."

That is quite a repertoire for the one song-book, and the inevitable consequences our central banks and government had completely failed to foresee.

"The move also could put pressure on the returns of some hedge funds, which often rely on healthy doses of borrowed money, or leverage, to boost returns."

"'Leverage definitely drives returns,' says David Gold, an executive at Watson Wyatt Worldwide, which works with corporate pension plans on their hedge-fund investments.

"In particular, Mr. Gold says quantitative funds – those that trade using certain computer models – are seeing their borrowing ability reduced, on the heels of the uneven performance of some funds this year. He says the move by the banks will have the biggest impact on the smaller hedge funds."

For, as the lullaby goes, everything must expand faster and faster in this ever shrinking world.

Thus the article continues. "'Groups like Morgan Stanley and Goldman Sachs will feed more leverage to their biggest, better clients,' says Mr. Gold.

"Firms are turning away more potential clients and scrutinizing newer hedge funds, worried about their ability to repay borrowed money, even though most hedge funds have had a good year, rising 12% through November.

"Prime brokers like Morgan Stanley, which has one of the largest business catering to hedge funds, have made repurchase agreements so expensive that some funds are going to rival firms to borrow money, according to people familiar with the matter.

"Hedge funds often borrow money through 'repo' operations, a financial arrangement in which the hedge fund sells securities to banks in exchange for cash, while entering into an agreement to [get] them back at a later date when they pay the money back. The interest rates that hedge funds pay for this borrowed money has shot up in recent months.

"One example: Morgan Stanley, which has written down more than $10 billion of mortgage assets, has been asking for as much as one percentage point over the London Interbank Offered rate [Libor] to enter into a repo agreement using 'junk' bonds as collateral, in recent weeks. That is up from just 0.10 point before the summer. Some rivals have raised their own rates, but not as much, says one investor. Morgan Stanley's rate on investment-grade debt is as high as 0.40 percentage point, up from less than 0.10 percentage point, these people say.... The market is putting as new price on risk."

Formerly it was cut up and wrapped up with the other groceries just like a few slices of baloney.

"The biggest players catering to hedge funds in recent years have been such as Morgan Stanley, Goldman Sachs, and Bear Stearns. These firms don't take deposits as a retail bank does, so they have less cash on hand. Large banks such as Citigroup Inc., UBS AG and Credit Suisse have large low-cost deposit bases, and some say they may be able to take some market share from the investment banks.

"Still, Jacques Mechelany, managing director of Geneva-based hedge fund Heritage Fund Management SA, points out that banks like Citigroup and the UBS have felt deep pain recently and may be unwilling to take risks with their balance sheets and will show more caution when lending to hedge funds."

W.K.

Analysis *continued from page 17*

finance. Tomorrow it will be something else. Maybe we can study this crisis and come up with some form of structure that in future can perform that liquidity-providing, buyer-of-last-resort role."

In some ways, the coordinated actions of the central banks in coming days are already supplying funds for this – but on a very modest scale given the size of the problem. Consequently, in the months ahead regulators and financiers will face mounting pressure to make the system of "vehicular finance" less complex and opaque. One result of the 2007 credit shock, in other words, is that the shadow banks will become less shadowy in the future.

As Pimco's Mr. Gross notes: "Investors should anticipate that the shadow's successor will be a more conservative, less risk-oriented banking system."

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