THE JOURNAL OF THE COMMITTEE ON MONETARY AND ECONOMIC REFORM

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$3.95 Vol. 20, No. 6 • JUNE 2008

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Are We Headed Towards a Subprime Central Bank?

It has been a virtuoso, if not a particularly virtuous, achievement. For a half century, whenever banks have gambled themselves into trouble, they have not only been bailed out by the government, but have been allowed still greater daring in larger areas with which they were hardly acquainted. The universities were cleared not only of staff but of curricula that challenged this pattern.

The one great exception to this prevailing pattern was the crash of October, 1929. That had come so suddenly and so smashingly, that the economy lay prone for years with scarcely a muscle twitching. When President Franklin Roosevelt was inaugurated for his first term, in 1933, the collapse of the system was so complete that some 9,000 banks in the US had closed their doors. British banking's great 19th-century chronicler, Walter Bagehot, had written that if the mere *suspicion* arises of a bank not being able to meet the claims on it, that bank, and the system as a whole is in trouble. Caesar's wife had an easier time of it. How then have they gotten away with ever more for the past half century?

The collapse of the banks in the 1930s had been so complete, that leading conservatives – among them major industrialists and economists concluded that banks could not be trusted with money-creation: they therefore subscribed to the idea of 100% money, where the banks could only lend out what they owned or was deposited with them – they were to be middlemen, nothing more. During the Great Depression that was the situation that actually existed. But with such an arrangement society would have been unable to manage those specially heroic stretching of society's resources: Europeans could never have crossed continents and oceans, to discover and take over what lay beyond. Though "100% money" can be in moments of economic collapse an alluring though deceptive alternative to abusive banking, without banking, properly regulated, society's development would have been stunted.

During the Great Depression of the 1930s, what was notable was the utter freedom of discussion of how banking could be reorganized so that the breakdown of the thirties might never recur.

Roosevelt encouraged that discussion and considered just about everything that was being proposed. Without the bankers having overplayed their hands so catastrophically, there is little doubt that there would never have been the freedom of discussion that led to the formulation of a banking model. that for several subsequent decades, allowed a more democratic distribution of wealth. And as prosperity came back, more democratically distributed than ever before, the banks came to sigh for their imperial command of the economy that had brought on the Depression. That initiated a process of come-back of the banks to the commanding position that they had occupied before October 1929.

Onward to a Subprime Central Bank

One of the key principles laid down by Roosevelt's banking reform, was to confine banks strictly to banking, preventing them taking over any part of the other "financial pillars" – stock brokerages, insurance and mortgages. There was good reason for that. Each of these other "pillars" kept a reservoir

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Email: comerpub@rogers.com
Website: www.comer.org

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

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

Publications Mail Agreement 40018485.
Postmaster, please send address corrections to:
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Pagecraft Computer Services
PRINTING AND DISTRIBUTION
Watt Solutions Inc., London
Printed in Canada on recycled paper.

Subprime *from page 1*

of liquidity (cash or securities readily convertible to cash), for the needs of its own business, Allow the banks access to these reserves and they would use them as the cash base on which to apply the "bank multiplier" – the lending out of many times the cash in their tills and vaults. That, legal tender, whether gold coins or paper money issued by the government, never earns interest. One handicap of interest-bearing reserves striving to replace legal tender, is that since they bear interest, their value drops whenever the central bank raises its benchmark interest rate. But though not legal tender, in the hands of the banks they will nonetheless serve as basis for the application of the bank multiplier making possible for the banks lending growing multiples of their money base in a many-storeyed way.

The resulting banking multiplier in Canada had jumped from 10 or 11 to one in the immediate post-WWII years to some 400 to one by 1998. By that time we stopped trying to track it because for the denominator of our grand ratio – the legal tender reserves supporting the structures – had really become zero, blowing up the ratio well towards infinity.

And to prevent that we had to use the bank's till money for the denominator of our ratio. However, refuse to distribute that as needed and there would be a run on the banking system. And all that money created by bankers clamoured not only for interest but for ever higher interest. That was the basic origin of our subprime mortgage crisis, now spreading to our very central banks on the verge of becoming subprime by trading the legal tender they create for subprime securities to bail out our financial institutions.

Sooner or later the very money-creation becomes "subprime." Whereas legal tender has the credit of everything in the country to support it since it is the government's tax-base, the market value of interest-bearing securities depends on the ability of the corporation that issued them making the payments contracted and redeeming the securities when due. In an economy every year more dedicated to expansion, these introduce the "subprime" characteristics to ever more of the economy since the Rooseveltian bank code was replaced to allow the banks to take over the other "financial pillars."

That explains the shocking way in which our subprime mortgage and other debt is being used as an opportunity for bringing in subprime central banking.

As in Virually All Bailouts by the Government, the Bailed-out Banks Acquire More Political Clout

The Wall Street Journal (7/05, "Fed asks U.S. Congress for new powers to battle credit crunch" by Greg Ip) reports: "The US Federal Reserve Board is formally asking the US Congress for authority starting this year – to pay interest on commercial bank reserves, in an effort to gain better control over interest rates and more leverage to battle the credit crunch.

"Senior central bank staffers broached the subject earlier this week with the congressional committee that oversees the Fed, people familiar with the conversations said. Fed chairman Ben Bernanke is expected to request the new authority in writing soon.

"The people familiar with the matter said that key Democratic and Republican law-makers probably would greet the request favourably, but warned quick passage of the measure isn't guaranteed, given the political sensitivity of any steps that might aid banks.

"In 2006, Congress gave the Fed permission to pay interest on reserves. [The US did not abolish the statutory reserves completely as did Canada in 1991. The Canadian move left interest-rates the only tool to expand or contract the economy – that meant that money-lenders, notably the banks, had become uncrowned monarchs of the land. In the US the statutory reserves continue only during banking hours but as soon as the banks close their doors money from reservable accounts are automatically shifted into non-reservable ones, so that the rate of statutory reserves has been reduced to a modest fraction.] Congress delayed the effective date of the legislation until 2011 to postpone the cost to the Treasury.

(Even though the Federal Reserve is still privately owned, almost as high a percentage of its net profit goes to the government as "seigniorage" – the monopoly of the ancestral sovereign in coining precious metals which has been transformed into the power of the Fed to create legal tender by spending it into existence.)

"Having the authority to pay interest would solve two technical headaches for the Fed. 'If they earned interest from the Fed, banks would have no incentive to lend out excess reserves for less. That would make the Fed's benchmark federal funds rate, which banks charge on overnight loans to each other, less likely to plunge below the Fed's official target – now 2 per cent – when the banking system was awash with cash.

"In addition, the Fed could then combat the credit crunch by buying securities or extending loans without limit, without causing the federal funds rate to fall to zero, something that could fuel inflation or distort markets."

In short, from providing loans to banks to see that *commercial* banks are adequately provided, the Fed would enter the financing of *investment* banking which is not what the Fed was established for. That is another way of officially wiping out the prohibition of the Rooseveltian banking law of banks acquiring interests in the other "financial pillars" – notably stock brokerage, insurance and mortgages. That falls under the heading of investment as contrasted with commercial banking. If you finance the deals of investment banks you must be ready to accept their assets or their shares in settlement when they cannot keep up with the terms of their transaction with the Fed. Poor Roosevelt must be writhing in his grave.

"Paying interest on reserves [as is done by the central bank of the European Union that arose under the rightist influence of De Gaulle] would reduce the sum the Fed remits to the Treasury each year from earnings on the central bank's portfolio of Treasury securities and loans. When the 2006 legislation passed, the Congressional Budget Office estimated the move would cost the government $1.4 billion (US) over five years."

The 2006 provision passed without controversy. But now, some lawmakers might argue that moving up its effective date would be a gift of the sort that precipitated the current crisis.

And some might push for concessions from the Fed on other matters. The White House is almost certain to support the Fed's request.

The Fed manages interest rates by purchasing securities or making loans to banks and securities dealers. When the Fed buys Treasuries or makes loans directly to banks, it supplies financial institutions with cash. In effect, it prints money. The cash ends up in circulation, or in banks' reserve accounts at the Fed. Since the reserves earn no interest, banks lend out cash that exceeds their required minimum reserves, putting downward pressure on the federal funds rate.

"To combat the credit crunch, the Fed has replaced half the roughly $800 billion of Treasuries it held last July with loans to banks and securities dealers.

"If the Fed used up all those Treasuries, it could purchase more, but in the process it would create large quantities of excess reserves. As banks lent out those excess reserves, the federal funds rate would fall to zero. By paying interest on reserves, the Fed could put a floor under the funds rate and expand its balance sheet to deal with the credit crunch. The Fed, however, has not cited that as the immediate objective of its request."

How the Bankers Diddled President Truman for Control of the Fed

FOMC Alert (20/3/01) recounted how the banks, healed from the 1929 Crash by being forced during the war and early postwar to stick to simple banking, contravened the wish of the President of the US to continue the pegging of interest rates that had been so helpful in financing the Second World War. The "peg" had been discontinued behind President Truman's back, at the very time that American troops were pouring into Korea. "I was given assurance at this meeting in January 1951 with the NY Fed Open Market Committee to the White House to resolve what NY Fed President Allan Sproul termed 'a period of confused and confusing attempts to reestablish a working formula for debit management and credit policy.'

"After the meeting, Truman announced that the central bank had agreed to resume the peg. I was given assurance at this meeting that the Fed would support the Treasury's plans for financing the action in Korea, Truman wrote in his memoirs, 'and when they left I firmly believed that I had their agreement to cooperate. I was taken by surprise when subsequently they failed to support the program.' Thirty-two days after the meeting, Truman's Treasury okayed an Accord on the Fed's terms."

In the light of this, and abundant other experience, it is not a daring conclusion that the freedom of discussion on money creation – in the media, in our universities, and in our parliaments, has been possible only when the banking system lay *hors combat,* prone on its back. I certainly do not wish that to happen, but there is plenty of evidence that it is on its way. Would this not be an excellent time to recover what we once had learned at a savage cost during the Great Depression?

William Krehm

The Perils of an Economy Headed for Greater Depths

There are no winners amongst the automobile world biggies. Like the plans of mice, the sweeping plans of Ford and General Motors for a turn around a couple of years down the line with non-oil guzzlers have already bit the dust, as have their more successful Japanese and other Asian competitors.

The Wall Street Journal (29/05, "With Ford Turnaround off-track Mulally seeks job cuts" by Jeff Bennett and Matthew Dolan provide the tale of early disappointment: "Ford Motor Co. is looking to cut more than 2,000 white-collar jobs in the US, a person familiar with the matter said.

"The job cuts come in reaction to a decline in truck sales that is squeezing the Detroit automakers as well as some of their European-owned competitors.

"Less than a week ago failing truck sales prompted Ford to announce that it no longer expects to meet its goal of returning to profitability in 2009. The company that depends on pick-up trucks and sport utility vehicles for most of its profit, also outlined dramatic cuts in truck production for the second half of the year.

"Ford's move comes as General Motors Corp. is preparing cuts of its own. Ford, GM and Chrysler LLC are losing money and have been idling plants and downsizing over the past three years. Collectively they have eliminated tens of thousands of factory jobs in the US.

"'They're all concerned because of what the market looks like now,' said Ron Harbour, a partner at Oliver Wyman, a global consulting firm that publishes *The Harbour Report* on auto production.

"Ford's job cuts represents a setback for chief executive Alan Mulally. Last month he was hailed after Ford unexpectedly reported first-quarter profit of $100 million.

"In April Mr. Mulally said the company was on track to make money in 2009, and made no mention of a changing outlook at the annual shareholder meeting earlier this month. But about 10 days ago, the executives that plan auto production months in advance became worried about reports that pickup sales were failing more rapidly than expected. Mr. Mulally and others gathered two Sundays ago to hammer out a plan of response, according to one person briefed on the matter.

"They concluded Ford had to abandon its forecast of making money in 2009, slash truck production in the second half of the year and look for other ways to cut costs, these people said."

The oil crisis, the subprime monetary mess, the environmental disasters, and the deepening industrial slack concur to darken our society's prospects. Would it not be an appropriate time to learn from the 1930s how we finally managed to tame the Depression, and bring in a quarter of a century of sound recuperation? Not even the element of warfare has gone missing to allow the financial sector to hang on to the domination of our economy.

The near-decade of involvement of the United States and allies in the near East, in such a context can readily become a rehearsal for far greater use of the military option because desperate efforts along similar lines to come – for the military option is the only one that remains to governments caught in a desperate economic bind of their own making.

While remaining reserves – of food, fresh water, fuel and useful institutions, of the lessons of the most successful stretches of our history, have been buried to satisfy the coddled appetites of an enthroned financial sector. The most recent victims of that have been our very central banks that have now been enlisted to relieve the investment banks of their subprime assets. We are thus threatened with subprime central banks and subprime legal tender.

For since 1971 when the United States went off the gold standard, pulling the rest of the world along with it, the only legal tender has been the non-interest – bearing debt of governments to their central banks. Now that the world is rapidly sinking into a structural crisis, we are threatened with central banks loaded with subprime debt like our investment banks. Then the major peril is that an enhanced military option will beckon our government irresistibly. Undoubtedly the leading argument in support of such adventures will be that the questionable achievement in a decade of such efforts in the Middle East – have in comparison with the financial record of that same years turned out brilliant. And certainly a nation at war is easier to control to one suffering from unemployment and famine. Unless freedom is restored to our Parliament, our media and our universities in good time, the future is indeed grim.

K.

Municipal Cash Crunch

The municipal infrastructure deficit is now estimated to be between $60 billion and $100 billion because we can't find the money to do what needs to be done. While municipalities are starved for money to pay for infrastructure, our public bank – the Bank of Canada, which could provide financing through our governments – is not used.

For example, if a given capital acquisition (e.g., subway, sewers, water system, etc.) costing $100 million were amortized over 20 years at 6 percent (which is what a private lender, bank or developer might charge) the cost would be about $8.5 million per year.

If the facility has a life span of 50 years the payments, using the Bank of Canada, could be amortized over 50 years and would amount to $2 million a year plus the cost of administering the loan – less than 1/2 of 1 percent. In this example, financing public infrastructure with our public bank would reduce annual payments by about 70 percent.

Government response to using the Bank of Canada to finance public debt has been that that would cause inflation – a position that completely ignores our history. From 1939 to 1974, the government used the Bank to finance a significant portion of public debt.

In 1950 the inflation rate was 2.8; in 1971 it was 2.9. Then it began to rise as a result of the big increase in the cost of oil. One of the tools used to contain inflation was the statutory reserves. These were removed by Brian Mulroney and would have to be reinstated to keep inflation under control.

There are some who argue that "there is no free lunch," implying that using the Bank in this way is trying to get something for nothing. They are right. There *is* no free lunch, and we don't expect it. The money borrowed is paid back – but at a lower interest rate than private lenders charge. If you were shopping for a mortgage and had a choice between one at 6 percent and another at 3 percent, which would you take?

There are other more cogent reasons for the government's reluctance to use the Bank of Canada to finance public debt, although the government hasn't mentioned them in its correspondence with us. One is that our chartered banks, wealthy financiers and some pension funds would howl at the loss of easy, guaranteed income from lending to the government.

Another is the free-market ideology of Milton Friedman and the Chicago School of Economics, which has been influencing economic policies worldwide since the 1960s, and was more or less adopted in Canada by 1974. This ideology promotes the view that regulations which reduce a company's profits should be removed and government services or assets which could be run at a profit should be privatized. Borrowing from the private sector while reducing the government's use of the Bank of Canada to carry public debt and removal of the statutory reserves reflect these views. As a result, the federal debt increased over 3,000% from $18 billion in 1974 to $588 billion in 1997.

A third is the Bank for International Settlements, which organizes meetings of the heads of central banks (like the Bank of Canada) where banking policies are formulated. A fourth, I suspect, is the fear that if Canada's monetary policy should differ substantially from the free-market ideology, world financial interests would come down hard on Canada.

The fear of repercussions is like a straight jacket limiting the actions of politicians. To get out of the free-market straight jacket requires politicians who recognize both the problem presented by the way the Bank is currently used and the strength which would come from using the Bank as it could and should be used. Canada has natural resources and a well-educated work force. Through its Bank, it could finance infrastructure renewal, education, health services and other community needs.

The spin-offs from such activity would stimulate the private sector. So far, we don't have any parties with seats in Parliament who will talk about this. It's not because they don't understand it, they do. They just don't talk about it.

Because the reluctance of our currently elected politicians to advocate use of the Bank to carry public debt is costing all of us money, Kingston COMER has decided to direct our attention to university and college students. We are focusing on the debt that 60 percent of them have to carry when they graduate ($4 billion every graduating year), how the misuse of the Bank of Canada is contributing to their debt and the changes that are needed.

We will ask the leaders of all the parties which have seats in the House plus the Green Party, the Canadian Action Party and other parties who wish to participate, specific questions related to this issue. Their answers will be published on line and elsewhere for students and anyone else who is interested. We hope the students will see that they can help themselves and help to change the way the Bank of Canada is used by voting for politicians who are committed to making the needed changes. To see our message to the students, go to bankslovedebt.com. (Other addresses: comer.org; www.monetaryreform.com/MR.)

We used the Bank of Canada before to finance public capital projects and we can do it again. We have the resources; we lack only the political will. This is a good time, politically, to raise this issue. Politicians are more inclined to listen to proposals from their constituents when faced with an election.

Richard Priestman
President
Kingston Chapter Committee on Monetary and Economic Reform

A Tailless Monkey in Search of Its Tail

The Wall Street Journal of 29/05 is a most remarkable issue. In its "Ahead of the Tape" Column by Mark Gongloff ("Buckle in For Longer 'Crunch' Ride") it announces that the financial "crunch," rather than being over, is actually entering a more painful phase: "Throughout the joyless Space Mountain ride of the credit crunch, the brokerage sector has been the kid in the front car who screams first, signaling the dangers ahead."

Is that not merely another way of saying that the financial sector has taken over the control of the economy? It is doing the driving, but that does not mean that it knows where it is headed.

The column continues: "Many investors have been thinking lately that the ride is over. But listen carefully, and you will hear more screaming.

"Since the end of April, Lehman Brothers Holdings stock has fallen 19%. Merrill Lynch and Morgan Stanley are each down 13%. Goldman Sachs Group is off 10%.

"These folks have a lot in common, including leverage – or borrowing to build up investment positions – a dependence on short-term funding, and exposure to the risk of others defaulting on their debt. Such unfortunate traits led Bear Stearns nearly to the abyss in March, when the credit crisis was going full throttle.

"When the Federal Reserve shoved Bear Stearns into the arms of J.P. Morgan Chase, market worries eased. Brokerage stocks rallied and costs fell sharply because of derivatives that would pay off if the brokerages defaulted on their own debts.

"But the cost of buying such credit default protection in swaps markets has risen again. Lehman's is the highest it has been since March.

"This week marks the end of the fiscal quarter for most brokerage firms. Michael Peterson, director of Paena Investment Management, says recent market moves might not be signaling another wave of credit mayhem. It might just be a quarter of old-fashioned bad earnings. Paena owns shares of Lehman, Merrill and several financials.

"The credit market more broadly is showing other signs of stress lately. The Market CDX IG 10 Index, which measures the cost of protecting defaults by a wide range of companies, has edged up again.

"Credit crises don't happen in vacuums. Their lagged impact on the real economy affects the credit quality of many companies, which reverberates back to Wall Street. More stomach-churning rounds of write-offs could be coming."

The Only "Risk" that There Is No Attempt to Control — The Appetite of High Finance

In the column alongside the one just cited is a longer report "SEC Pushes Ratings Firms on Risk" by Kara Scannell and Aaron Lucchetti. Once again there is a busy sound of dicing and slicing and tying up to peddle custom-ordered risk as in the case of the subprime mortgage innovation that contributed so richly to the ongoing mess. What is notable is that the American Government then as now feigns complete knowledge of what makes the economy run, limp, or fall. No need to reexamine the validity of the "self-balancing" market creed. Just cutting it up in different patterns and tying it together in new patterns must do.

What is excluded is a rethinking of the underlying creed that determines where an ever-greater portion of the national income is directed. The only open dimension for that is an increase in the portion of the national income that ends up with the financial sector, and, of course, the driver's seat. Extending the notion of "risk" to bring in relationships that have been so carefully excluded, is out of the question.

Thus the utter futility of the SEC current effort to break up the risk ratings into several separate categories: "The staff of the Securities and Exchange Commission is expected to propose rules for credit-ratings companies would require a new set of risk ratings for complex financial instruments – a move opposed by rating entities, investment banks and others.

"The move would distinguish these so-called structured products, which have been blamed for the recent financial crisis, from more traditional corporate and municipal debt. Rating companies have been widely blamed for giving overly rosy ratings to mortgage-related securities, and for being slow to downgrade those assessments when the housing market turned.

"The SEC is expected to vote on the change June 11 as part of a broader proposal revamping how rating companies work. The move is backed by SEC Chairman Christopher Cox. 'I'm convinced that the commission will formally consider [the idea] at the proposal stage and it would not surprise me if it were included in the proposed rule,' Mr. Cox said in a recent interview.

In the current ratings system, triple-A is the top mark and means there is nearly no chance the bond will default – and even if it does, investors will get most of their money back. Many investors almost entirely depend on ratings in deciding where to put their money. The system under consideration would give the highest-rated product a rating of triple-A, S or V, for structure or volatility respectively.

"The concept of distinguishing between different ratings is being debated, with critics saying the problem isn't the rating scale but the quality of the ratings. The SEC regulates these companies, which include Moody's Corp's Moody's Investors and Services, and Fimalac SA's Fitch Ratings.

"Four lobbying groups, including the Mortgage Bankers Association and the National Association of Realtors, sent a joint letter to the Senate banking committee, calling the idea 'counterproductive' and said 'it will serve to further undermine rather than restore liquidity' in the market.

"The American Securitization Forum, an affiliate of a Wall Street lobbying group, has met with SEC and Capitol Hill staff and sent a letter to the SEC saying that a different scoring system would be 'cosmetic' and would result in increased costs without any benefit. The group support regulators' moves to encourage more disclosure to improve methodologies, or transparency, in the process.

"Meanwhile, raters are pursuing their own efforts to improve methodologies and procedures.

"S&P is planning to seek comment as soon as Thursday on a plan to add postscripts to its letter-based finance ratings, though a person familiar with the matter said the company doesn't support the more drastic move of adopting an entirely new scale.

"The separate ranking is one of several ideas the SEC commissioners will consider next month. Among other proposed changes are adding disclosure requirements about ratings methodologies and past ratings performance, and banning common industry practices, such as having the ratings companies involved in the structuring of the securities."

It smacks of Shakespeare, having written Hamlet, trying to learn the alphabet.

William Krehm

Paying Through the Nose for Buryng Our History

So incredible has the collapse of the Globalization and Deregulation been, that the sophisticated business press is still trying to figure out on their fingers and toes that how leaving all to the markets has proved a curse compounded of hitherto unknown, deadly ingredients.

Thus in *The Wall Street Journal* (30/05, "Fed's Fireman Feels Some Heat" by Ian Talley, Ann Davis, and Gregory Meyer) wrestle with the problem of putting in some relationship with the known past record of the Federal Reserve in periods of boom, and even during the Great Depression. For example, the strange detail of the Fed utilizing its influence to allow one large Wall Street Bank J.P. Morgan Chase & Co. to take over a another large if somewhat smaller bank – Bear Stearns Cos. for a song badly out of tune. So badly that the deal was restructured with the sales prices raised from $2 billion to $10 billion, when the public stunned as though they had been hit on the head with a giant sledge hammer while the owners felt confirmed in the conviction that the financial world had been taken over by crooks. The fact, however, was that the Fed was not designed or intended to serve as an institution for bailing out banks. That has been particularly the case since 1971 when the US went off the gold standard leaving only government credit as legal tender. Then it became even more absolutely so, especially since the private banks had taken over the lucrative responsibility of providing most of the circulation medium by lending it for interest out into existence, instead of the government spending it interest-free for its needs.

The key point of the tale is that the Fed is responsible for the soundness of the currency, though much of the medium of circulation today takes the form of interest-bearing bank loans. The Fed has not been in the position to bail out banks who have become involved in acquiring and even emitting subprime debt, whose value though certified by insurance companies organized for the purpose, has been an active agent in the present financial muddle. Even the least bright Fed official understands that nothing can be allowed to stand between the Fed and the medium of circulation. That is why, for example, the one means of controlling the pace of the economy for the past fifteen years or so has been the benchmark interest rate which sets not the rate at which the Fed will lend money – even over night – to a bank that finds itself short, but the rate at which one banks may borrow from another overnight, to meet its obligations to the central bank. There is a far less frequently used discount rate, which is higher, to signal that banks only in real trouble will make use of it because it advertises that they are having problems coming up with convincing assets, by having to go to the Fed for the actual money.

With this brief introduction, let us proceed to the amazing tale in *The Wall Street Journal:* "New York – As the credit crisis batters Wall Street, Timothy Geithner has been the Federal Reserve's man on the front lines. The president of the Federal Reserve Bank of New York has worried more about the economic impact of the crisis than most of his colleagues and has pressed hard for aggressive action, say people close to the central bank.

"His involvement culminated in the March rescue of Bear Stearns Cos., which is expected to be taken over by J.P. Morgan Chase & Co. in a deal brokered primarily by Mr. Geithner and Treasury Secretary Hank Paulson.

"Controversy over that move has Mr. Geithner feeling some heat. Some say he averted a catastrophic loss of confidence. But criticism over the rescue has lingered.

"Many argue that the deal created so-called moral hazard: it could encourage the market participants to take more risk because they expect the Fed to rescue them if they fail.

"In April, 17 Republican congressmen called for a hearing on the bailout, saying it exposed the American taxpayers to unknown amounts of financial loss.

"Mr. Geithner, 46 years old, has had a hand in financial crises for nearly 15 years – first at the Treasury Department, and since 2003 in his current post at the New York Fed.

"Fed Chairman Ben Bernanke has set the Fed's overall strategy during the current crisis and Mr. Geithner has been instrumental in executing it.

"In an interview at his office in lower Manhattan Mr. Geithner, who looks younger than his years, slouched in an armchair, clicking his pen, shifting his feet, and running his hand through his dark brown hair. He said that the impetus for action often came from him, but not always.

"In August, Mr. Geithner mediated a dispute between mortgage lender Countrywide Financial Corp and Bank of New York Mellon that could have cut off Countrywide's access to vital short-term credit. At other time, he has kept to the sidelines, turning down pleas from bankers to assist in a bailout of insurers that guarantee complex mortgage bonds."

Unprecedented Move

"But more than any other government action, it is the Fed's unprecedented move to save Bear Stearns from bankruptcy by lending $29 billion to aid its takeover by J.P.

Morgan, that bears Mr. Geithner's personal stamp…. Final judgments about that move could make or break his reputation.

'Mr. Geithner, whose father worked for the US government and the Ford Foundation, was raised in the US, Asia, and Africa. As key international aide to Treasury Secretary Robert Rubin, then to Lawrence Summers, Mr. Geithner was involved in bailouts of Mexico, Indonesia and Korea.

"After a stint at the International Monetary Fund, Mr. Geithner was recruited to become president of the New York Fed. He was an unusual choice in some ways. He had never been a banker or trader, and lacked a Ph.D. in economics.

"He assembled and informal advisory group that included Mr. Rubin, Mr. Summers, former Fed chairman Alan Greenspan, and Paul Volcker, former New York Fed President Gerald Corrigan. After the credit crisis began last August, Mr. Bernanke assembled a war room composed of Mr. Geithner, Fed Vice Chairman Donald Kohn, who had been Mr. Greenspan's top adviser, and Kevin Warsh, a Fed government and former investment banker and White House aide.

"At first, Mr. Bernanke looked for ways to restore confidence other than simply cutting interest rates, such as expanding loans to banks through the Fed's discount window. Mr. Geithner cautioned that such moves might not be enough to solve the problem – but could sow fear among investors about the stability of the financial system. He stressed to get the 'right ratio of drama to effectiveness.'

"As the crisis deepened, Mr. Bernanke began to cut interest rates sharply, with Mr. Geithner's firm backing. The New York Fed became instrumental in designing new lending programs for banks. *Investment banks which weren't entitled to such loans and aren't regulated by the Fed, began asking Mr. Geithner to persuade Mr. Bernanke to open the discount window to them as well.* [Italics are ours – for this is the crux of the tale.]

"Mr. Geithner says he told them all: 'We have not done it since the 1930s. The moral hazard of doing it is hugely significant. We would not want to do it unless we got to the point we really felt it was the best of a set of bad options."

(Since the point of "moral hazard" has been repeatedly mention, we might ask whether it was not "moral hazard" to bail the various categories of banks out from their heavy losses from their progressive deregulation and globalization such as their acquisition of Savings and Loans – in essence mortgage trusts and stock brokerages. The relaxation of safeguards against "moral hazard" came largely through the Bank for International Settlements – as did the 1988 bank capital requirements that declared the bonds of central governments in developed countries, "risk free" and thus requiring no down payment for banks to acquire. All the hokum around that point can be summed up in dizzily high interest rates in the early 1990s, when BIS was advancing "zero inflation" in the most literal sense – except that "inflation" was badly defined as though it

Another Big Shoe About to Fall

We quote from *The New York Times* (15/05, "Collateral Foreclosure Damage" by Christine Haughney): "Many of the numbers compiled on home sales specifically exclude condos, which account for one of eight homes in the nation. And the missing data may be masking just how weak the housing market really is. Sales of existing condo units were down 26% in March from a year earlier, compared with an 18% decline for single-family homes, according to the National Association of Realtors.

The title of the *Times* piece is nothing less than brilliant, because we have here in bricks and mortar the exact equivalent of the problem in legal documents – "Collateral Debt Obligations." This has tied into knots the nose not only of real estate, but of the economy as a whole. It is the equivalent of the packets of mortgages sliced and diced to meet the buyers' risk desires, with the buyer discovering too late that he is hopelessly tied to risks over which he has no control.

"The pain in the condo market, mostly in urban areas, may not only be deeper than in the rest of the housing market during the downturn but more prolonged. Bargain hunters say they are reluctant to buy into a building even when the up-front cost seems low because they may have to pay unexpected fees as distressed neighbours default on their mortgage or just stop paying the association fees covering everything from taxes to pool maintenance and air-conditioning repairs.

"Marcus & Millchap Real Estate Investment Services, based in Encino, Calif., estimates that nearly 202,000 condo units will be added to the pool of 574,000 totted up during the last five years. Next year will bring 94,166 more units onto the market.

"The shabby condition of some condos means potential buyers insist on especially steep discounts on foreclosed units. Alessandro Comoglio, a 34-year-old investor from Italy, recently visited six apartments in a Miami building with a real estate broker. He was surprised to find worn-out hallway carpeting and orange foreclosure stickers partly scratched off the doors in such a new building.

"His willingness to spend stopped short of $200,000 for the condo units, which once sold as high as $700,000, according to the broker, Peter Zalewski. Mr. Comoglio also wants a written guarantee that he would not have to pay more fees. 'Nobody knows how much prices will continue to drop.'

"Rosa Rodriguez, a resident and property manager at Parkview Point Condos in Miami Beach, says her former neighbours have left her with so many problems that she would never buy a condo again. The 38 foreclosures in her 244-unit building and unpaid dues nearly cost the residents running water because the building could not pay its bills. The building abruptly stopped repairing the ceiling of the lobby and left its wiring and ducts exposed when the board ran out of money.

"Still, Ms. Wilson worries that the expected sale of the foreclosed unit at about $94,000 will hurt neighbours who paid or refinanced their units for three times that price. She dislikes going to the monthly condo board meetings, and asking her neighbours to pay an extra assessment of nearly $220. 'Here they are going through a hard time, and you have to ask them to pay.'

"So far the Manhattan market has been largely spared, in part because of foreign owners who never sought a quick profit. By the end of the year, about 15,000 condo units will have been added during the five-year condo boom, according to Miller Samuel, a real estate research firm. Jonathan Miller, the company's chief executive said that foreigners who bought up to a third of these new condos, typically put in more cash and plan to hold for some time – ten years or so."

Meanwhile all this is an added burden not only for many still unforeclosed owners, but for the economy as a whole.

W.K.

were possible to educate the young generation to present-day technological needs, take care of the increase in average life span, while keeping the price level flat, or face interest rates that touched and exceeded 20%.)

"The speed at which the crisis enveloped Bear Stearns caught Mr. Geithner off guard. Late in the evening of March 12, New York lawyer Rodgin Cohen, chairman of Sullivan & Cromwell, called Mr. Geithner on behalf of Bear Stearns on behalf of Bear Stearns CEO, Alan Schwartz. Mr. Cohen told him the firm was deeply concerned about its situation. according to people familiar with the matter. 'If Alan is worried, he needs to call me,' Mr. Geithner responded.

"Mr. Schwartz called Mr. Geithner the following day and told him that Bear Stearns had retained an investment bank to seek a permanent financing solution. That day a full-blown run began, with customers and lenders yanking billions of dollars from the firm. That night officials from the Security and Exchange Commission told Mr. Geithner that they saw no option but to file for bankruptcy protection the next morning.

"Mr. Geithner's staff worked through the night to map the consequences of a Bear Stearns failure. If Bear Stearns sought bankruptcy protection, lenders would get back collateral instead of cash, and they might sell the collateral en masse, and pull back on trillions of dollars of similar loans to other investment banks. Bear Stearns had trading positions with some 5,000 other firms.

"Around midnight, Mr. Geithner slipped away to a nearby hotel to grab an hour and a half of sleep, then he returned to the office. At 5 a.m. he initiated a conference call with Mr. Bernanke, Mr. Kohn, Treasury Secretary Henry Paulson and other regulators and staffers to talk about what to do. Their main options: let Bear Stearns and try to mop up the damage by pouring cash into the financial system, or extend a loan just long enough for Bear Stearns to pursue a merger.

"By Sunday night, Bear Stearns had struck a deal to be sold to J.P. Morgan for $2 a share, and the Fed had agreed to lend Bear Stearns $30 billion, backed by assets on its balance sheet, more than it had ever lent to any institution. The Fed said it would open its discount window to investment banks, a step that Bear Stearns officials complained would have saved their firm had it come a few weeks earlier.

"One week later, J.P. Morgan agreed to raise the price to $10 a share, in part to address complaints by Bear Stearns shareholders resisting the deal. Mr. Geithner got J. P. Morgan to assume the first $1 billion in potential losses on the $30 billion loan."

Averted Disaster

"To many on Wall Street, the actions spearheaded by Mr. Geithner helped avert an industry-wide disaster, 'Thank God the capital markets had him,' says Richard Fuld, chief executive of Lehman Brothers Holdings Inc.

A Haunting Heritage of Soured Oil Bets

The *WSJ* (23/5, "Bad Oil Bets Come Back to Haunt Speculators" by Ann Davis) recounts how unforgiving a bad bet on anything so explosive as oil futures can be: "Surging energy prices are wreaking havoc on producers and speculators who made bets on lower oil prices, forcing some to buy oil to exit their positions. That in turn is helping push up oil prices." The punishment of a lost bet can come not in single but in multiple format.

"Producers who long ago struck deals to sell oil in future years are finding they locked in prices at as little as half what oil fetches in today's red-hot market.

"Other market players, particularly speculators who mistook the top of the market, are being forced to buy oil futures to close bad bets. Those who tough it out are being hit with crushing margin calls, requiring them to pony up more cash because their trade has gone deeper into the red."

That has been a main factor in the powerful upward surge of oil prices, which in turn has clobbered much of the auto industry. The deregulation of banks, allowing them to extend their dominion over the other "financial pillars" has undermined the economy in multiple restructured ways.

But that still does not begin to cover the various strands of mismanagement of the global economy contributing to the wild upsurge of oil prices. On page A13 of the same issue of the *WSJ* ("Oil is Up Because the Dollar is Down" by David T. King, a former chief of the New York Federal Reserve) has this to say: "Back in December 2002, one dollar equaled one euro. But that exchange rate didn't last. The dollar was on its way down, a trend that had started more than a year earlier and has lasted, with occasional oscillations, to this day.

"On the day in 2002 that the dollar was exactly the same as the value of a euro, the price of a barrel of oil was therefore, the same in dollars and euros: about 25. Since that day, it's like the two currencies had traded on different planets. Certainly energy prices have risen, regardless of what currency you use. In Europe, the price of oil has risen by 50 euros in the past five-and-a-half years. It now stands at about 75 euros per barrel, three times what it was then. But in the US, the price of oil has risen to over $120 per barrel, and is now almost five times what it was then.

"The sole reason for this enormous difference is the incredible appreciation of the dollar against the euro. From one to one at the end of 2002, it now costs nearly $1.60 to buy a euro.

"The chorus of complaints about the price of gasoline gets louder every day, and is even becoming a campaign controversy both across and within parties. The same old solutions we have heard for years are being proposed – conservation, increased domestic exploration, manipulations of the tax on gasoline. But no one is pointing to what is by far the greatest reason for today's $60 fill-ups. The collapse of the dollar exchange rate, alone, explains at least half of the increase of the pump price of gas over the past five years. If it wasn't for the falling value of the dollar, the price of gasoline wouldn't be an issue.

"Will the market, accommodated by hands-off policy makers, now say we need more depreciation to offset the inflation that depreciation itself has created? We don't need gas tax holidays. Exchange rates can be managed. We need exchange rate policy."

It is even more complex than that. You cannot conduct almost a decade of wars, while financing the greatest wild gaming policy and call it an economy. The US free trade policy has as one of its goals to bring in not only cheap consumer and industrial products, but also to keep wages down in the US, to give greater scope to our financial sector. But so many fragmented goals inevitably lead to incoherence, on an ever mounting scale. And above all, it does not do to attribute the resulting disasters to a supposedly self-balancing market.

W.K.

"On April 3 Mr. Geithner, with dark circles under his eyes, appeared before the Senate Bank Banking Committee with Mr. Bernanke, SEC Chairman Christopher Cox and Treasury Undersecretary Robert Steel to explain the action. 'An abrupt and disorderly unwinding of Bear Stearns,' he said, 'would have added to the risk that Americans would face lower incomes, lower home values, higher borrowing costs for education, other living expenses, lower retirement savings and rising unemployment.

"Although fears about a full-blown financial crisis have begun to recede, scrutiny of the Fed's role continues. On April 8, at a meeting of the Economic Club of New York, Mr. Volcker, the former Fed chairman, told the gathering that the Fed had gone to 'the very edge of its lawful and implied powers, transcending long embedded principles and practices.' Many interpreted it as criticism, although Mr. Volcker said in a later interview he did not mean it as such. When Mr. Volcker was done, Mr. Geithner buttonholed Columbia University economist Glenn Hubbard, the club's chairman, and asked to address the same group about some issues. Mr. Geithner will get his chance on June 9."

Though the traditional and legal purpose of the Federal Reserve, to safeguard the value of the currency by setting overnight borrowing rate between commercial banks, and only in dire need actual lending money at a higher discount rate limited accommodation – once again members of commercial banks, the net effect as Mr. Volcker carefully pointed out has been to open the coffers of the Fed to investment banks – a goal that the banks in question have long striven to attain.

But it has always been the very thumbprint of the relations of the Fed with the investment banks, that each time they are bailed out from their quite regular speculative adventures, they profit by their connections to increase their power position in the land. The present crisis is obviously no exception.

What is missing in the testimony of the multiple experts and the reporting of the best press is that this time as well the growing sway of speculative finance as "dominant revenue" of the land has not only been respected, but enhanced.

Otherwise, somewhere, some economic professor would have come up with the silent but crucial detail: the whole ongoing mess – ongoing because the enhanced power positive with which the investment banks emerge will inevitably result in still greater bank losses and bailouts and further and deeper deregulation.

A Forgotten Detail to Avoid Moral Hazard

And all this might have been neatly avoided by bringing back the restrictions brought in by F.D. Roosevelt that forbade the banks from acquiring interest in the other "financial pillars" – stock brokerages, insurance and mortgage firms. The logic: each of these other "pillars" maintains their own cash reserve for the purposes of their own businesses. Grant access to these to the investment banks, and they will use those reserves as cash base to which they can apply the bank multiplier. That from a value of about 10 to 1 where it stood in 1946, had by the turn of the millennium become practically unlimited, since it had become a proportion with a vanishing denominator that was speeding towards infinity. Without the chain of bailouts and accompanying enhancement of speculative finance's political power, there could have been no subprime mortgages, subprime insurance agencies providing useless insurance against risk, and no unconscionable subprime promotions on our stock market. Why is there no mention of the legislation that eventually helped the world out of the Great Depression, the financing of WWII and a quarter of a century of a more humane and prospering economy?

William Krehm

Myanmar's Children Survivors Face New Martyrdom

The New York Times (18/05, "Myanmar's Children Face New Risks, Aid Groups Say" by Seth Mydans) reports on a whole deck of further disasters that await the children rescued from the Cyclone Nargis disaster: "The young suffered greatly from the very beginning. Relief groups estimate that they made up about one third of those killed by the devastating cyclone on May 3. Now, they say, children constitute about one third of survivors. Many are orphans or are lost, surrounded by strangers in crowded refugee camps.

"Because many of Myanmar's children are undernourished, their immune systems are weakened, said Kate Conradt, a spokeswoman for Save the Children in Bangkok. So, with storms drenching the survivors, food and clean water scarce and aid slow to arrive, children are likely to lead a wave of death from waterborne diseases that many experts expect.

"And as time passes, the relief groups say, the children are increasingly at risk of forced recruitment into sexual labor and the armed forces. Myanmar has one of the world's highest rates of recruitment of child soldiers, who are often purchased, kidnapped or terrorized into joining the country's army. Some are as young as 10, according to a recent report by Human Rights Watch, based in New York.

"The report, issued in October, said that military recruiters and civilian brokers scour train stations, markets and other public places for boys and coerce them to volunteer. The new chaos of refugee camps offers particular opportunities for such brokers.

"The school year starts in two weeks, but relief workers say that 85% of all schools are in ruins and that many of the teachers are gone. The destruction of schools illustrates the scale of the challenge. 2,700 schools will have to be rebuilt, according to Unicef.

"In the shelters, many children must fend for themselves. 'It's survival of the fittest,' said Fred Bemak, a professor of counseling at George Mason University of Virginia, who was in Yagon raining counselors when the cyclone hit.

"Many children are wandering around, separated from the families and communities, and they are highly vulnerable. The youngest may not know their surnames, or the names of their villages, Ms. Conradt said – and no system for reuniting families exists.

"Child protection workers are trying to offer some refuge by setting up what they call child-friendly spaces where children can mingle safely. 'They get a bit of informal education and they play with each other and have fun, 'said Alex Kreuger, a child protection specialist with Unicef.

"Citing a UN estimate Friday, Unicef said that as many as 40% of those affected were children 'there may be as many as one million children in urgent need of assistance. Based on a different United Nations estimate of 1.6 million people who have been 'severely affected,' World Vision estimated that half a million children survived the cyclone and urgently needed help."

K.

A Peek Behind History's Curtain to Understand the Bizarre Handling of the Myanmar Disaster

The gigantic two natural disasters in Myanmar and Western China would not have left hundreds of thousands of victims, had there been less disregard for some crucial lessons of history.

In *The Globe and Mail* (13/05, "Myanmar's generals are ruled by paranoia") Marcus Gee writes: "To the outside world, the reaction of Myanmar's military regime to last week's devastating cyclone, seems not just obscene, but inexplicable. Instead of rushing to help its desperate people, the regime of General Than Shwe all but shut off the country from foreign assistance while pushing ahead with a referendum on a new constitution.

"But to those who know the regime, its reaction is perfectly in character. Myanmar's government is among the most xenophobic in the world, deeply distrustful of outsiders and all they represent. So the idea of letting foreign aid workers and even foreign soldiers into the country, if only to deliver aid, fills the leaders with dread.

"'They believe the countries of the outside world are eager to defeat them and take over their country,' said Josef Silverstein, a Myanmar watcher and retired professor at Rutgers University in New Jersey.

"'The regime's xenophobia has its roots as far back as 1824, the beginning of clashes with colonial Britain that would end with Myanmar (then Burma) being incorporated into British India in 1886. They are still living in the 1820s,' said Professor Silverstein."

The arbitrary way in which the British rulers on withdrawing from their colonies disposed of subject peoples and their cultures runs like a bloody motive through history, right to the very arrangement for granting independence to its former Indian empire after WWII. We need only remember the mass slaughters between Hindus and Muslims that could only have been acerbated by Lord Mountbatten' shifting of populations. These included Burma, attached to what for a spell was known as East Pakistan. So there is a thread of cause-and-effect in the independence arrangements left behind, with little regard for the people they had ruled. Such antecedents can be found in Iraq, India, and, of course, closer home in Ireland. History is rarely a consoling study, but it can teach us something about the errors made a generation or two or ten back, that may still be twisting our current views of entire nations or even of ruling cliques.

The Wall Street Journal (05/15, "US Support for Myanmar Dissidents Hinders Aid" by Patrick Bata and Krishna Okharel) sounds yet another note, that in no way justifies the Myanmar Governments obstructing aid to the tsunami victims, but it does illustrate how the aggressiveness of US policy in the area has made its contribution to the quite insane response of the governmental clique to the crisis.

As Though the Government Competed with Nature to Do More Harm to Defenceless Humans

It is as though the regime were competing with nature to see who could inflict the greatest damage on their fellow men.

"Funds from the US government helped finance an underground campaign in Myanmar to persuade voters to turn down a new constitution that critics say is designed to boost the power of the junta. The results of the vote, held last Saturday in most parts of the country, aren't yet known. But a big vote in favour of the constitution is expected. In the bland circumlocutions of the American business publication, we can sense an effort to tone down the critical character of the report. That fingers a cause of the incredible sacrifice of further tens of thousands of people left homeless and without food or drinkable water, in a setting of decaying corpses, while relief is being turned back. In a restrained way the *WSJ* reports: "In the aftermath of Cyclone Nargis, the US is offering aid to the same government whose position it tried to defeat. That helps explain the junta's reluctance to allow entrance to foreign aid workers. Myanmar officials are concerned that a foreign influx could stimulate a desire for democracy and give political opponents an opportunity to spread anti-regime messages.

"Myanmar says there are at least 34,273 dead and 27,838 missing. The International Red Cross estimated Wednesday that the death toll could reach 127,990. Aid groups and Western officials estimate as many as two million people are vulnerable in the Irrawaddy River delta. The government has continued to block most foreign aid workers from entering the country and has restricted the movements of those who do arrive.

Returning to *The Globe and Mail* piece cited: "There was a brief democratic flowering after the Second World War when Burma, one of the richest and most promising countries in South-East Asia, looked outward. But the country turned inward again in 1962 when the army seized power, expelled most foreigners, cut trade ties with other countries and embarked on the 'Burmese way to socialism': a strict form of self-reliance that has kept Myanmar in a hermetically sealed capsule ever since.

"The regime's fear of the outside world has deepened as the outside world, outraged at the years-long detention of democratic leader Aung San Suu Kyi and last year's bloody repression of a monk-led uprising, has stepped up the criticism of and sanctions against it.

"So the idea that foreign aircraft might be shuttling into their airspace and foreign ships arriving in their ports makes the regime's leaders nervous.... Than Shwe, 75, leader of the regime since 1992, has spent his career steeped in the paranoia and isolationism of the military culture."

"In that culture, the military is seen as the only force that can keep the country together, safe from the twin threats of chronic ethnic unrest and foreign hostility.

"After joining in the military's fight against ethnic insurgents in the late 1940s and early 1950s, Than Shue rose steadily through the ranks under Ne Win, the country's long-time military chief. 'He has overseen at least three purges of other military officers,' Professor Walsh said. 'Used to supreme power, he doesn't listen, he tells.'

"Prof. Silverstein and other experts say that Gen. Than and his colleagues in the military are poorly educated, not well-travelled and ill-informed about the outside world. They send their children to elite schools and often live apart from the general population even moving their capital from Rangoon to the isolated redoubt of Naypyidaw or 'Abode of the Kings,' in 2005.

"Accustomed to unquestioned control, they bridled at the thought that foreign governments and humanitarian organizations might deliver aid independently."

K.

CDOs Arrive in Australia with a Marsupial Spring

In all the hubbub connected with the collateralized debt obligations (CDOs), the subject had not warranted a mention in the media. Clearly a higher authority onside the clouds that separate us from our economic history had ordained this unmentionable. However, truth will out, and notably from Australia, where hyperactive banks and brokerages have operated in even closer embrace to produce two of the world's largest mining concerns.

Under Roosevelt, whose first term as president was spent largely in binding the wounds of the nation, with open ears to learn from even odd-beat economists what might be done to prevent a repetition of the economic disaster that eventually brought on the Second World War.

What he came up with was the legislation that forbade the banks from acquiring even an interest in the other so-called "financial pillars" – stock brokerages, insurance and mortgage companies. The reason was clear: each of these "other pillars" keeps a reserve of cash to meet the needs of its own business.

I allude to this important removal of the Rooseveltian banking laws elsewhere in this issue, so we will confine ourselves to noting the new evidence of the wisdom of the restrictions put on banking. Unfortunately, they were completely removed in the early 1990s. This was achieved by arranging the repeal of all the essential legislation that had been adopted under Roosevelt, in particular the ban on banks acquiring interests in those other "financial pillars."

The Wall Street Journal (25/04, "Heavy Borrowing Comes Back to Haunt Australia Brokerages" by Laura Santini) informs us: "Freewheeling borrowing to buy stocks has led to brokerage collapses in Australia, fueled by broad-ranging margin-calls in a rocky market.

"Two brokerage firms – Opes Prime Stockbroking Ltd. in Melbourne and Lift Capital Ltd. in Sydney – have been forced into receivership – the Australian equivalent of bankruptcy – after nervous creditors withdrew their support. A third brokerage, Tricom Equities Ltd., is staggering under similar debt burdens. Traders expect more firms will go under.

"Victims include the brokerages' customers. The expansion-minded brokers borrowed heavily, using customers' shares as collateral. When the market went south, the lenders liquidated the customers' holdings in an attempt to minimize their own losses.

"The brokerage creditors, Australia & New Zealand Banking Group Ltd., the country's fourth biggest lender by market capitalization, and Merrill Lynch & Co., together dumped more than two billion Australian dollars (US $1.9 billion) in shares they held as collateral.

"The mess has provoked a series of investigations and threats of lawsuits, and has shaken confidence in Australia's stock market. The root of the problem is a loophole in Australian regulations that allows brokers to put up customers' shares as loan collateral, without identifying the customers. The investors apparently didn't know their shares had been pledged against the loans until it was too late.

"In the US, brokers are forbidden from dipping into a customer's account for their own purposes. Opes, which began operating in 2003, disclosed in documents to investors that it could do this. But many customers now say they had no idea their stock had been so pledged.

"The brokers used the loans to expand their margin-lending activities. Margin lending can be quite profitable for brokers, who earn interest from the borrowings."

When the Market Falls, Truth Outs

Such a loan supported by another derivative loan is a perfect CDO of the sort that has roiled the world in their multiple forms.

"That setup worked fine so long as the Australian market rose. During its five-year run, the A&P/ASX 200, Australia's benchmark index climbed 130%. But since hitting November 1, the index has dropped 18%, joining a global market rout. Suddenly the brokers were hit by margin calls of their own from ANZ and Merrill.

"Some customers have lost millions of dollars in equity as ANZ and Merrill sold off these shares. Two directors of mineral-resources company Paladin Energy Ltd. had their stakes sold without their consent, the company said in a filing with the stock exchange. These directors are planning to sue, the filing said.

"The tumult is not confined to Australia. In Singapore, the management-led buyout of an engineering concern called Jade Technologies Holdings Ltd., fell apart after the CEO, Anthony Soh, had his stake sold from under him. Mr. Soh's shares had resided in an Opes account.

"The investigations are mounting. The Australian Securities and Investments Commission and the Australian Securities Exchange have launched probes into possible fraud. Singapore's white-collar-crime unit has started its own enquiry.

"ANZ faces a public-relations nightmare for its involvement. The bank is conducting an internal enquiry to uncover whether any of the bank's employees breached risk controls or ethical standards.

"The impact of the margin-lending imbroglio likely will be widespread, as the nation's market participation is huge. Australia's 20 million people are the world's biggest investors per capita, with a pool of assets well above $1 trillion."

We are not conversant with the restrictions on the handling of stock put up as margin for stock purchases in the US. But I do know from the experience of a Canadian friend:

1. Some of the stock put up as margin for purchases with Canadian brokers, is lent out for interest. There is nothing to prevent the borrower from using it to short the very shares that the owner who bought the stock on margin. The broker lends out the stock that is his security without asking further questions, but it is obviously against the interest who bought the stock from the broker. When stock sold cannot be delivered for weeks or whatever when the buyer on margin has resold it would be a good start for such an investigation.

2. The same friend was out of the country when his account was undermargined, and some of his stock was sold out. But had the broker the right to chose for sale shares that were on the market at less than the $2 limit at which they become marginable and hence did not serve as margin but were left there for convenience, and it turned out, rose sensationally, shortly after they were sold out.

In the corridors of brokerage houses, strange encounters and dubious decisions take place. In connection with the current subprime crisis, it would be helpful for our authorities to look into how the elemental ethics of a free and fair market are faring.

William Krehm

Mistreated Nature Growls in Chorus with Perverted Institutions

The New York Times (11/05, "As Gazprom Goes So Goes Russia" by Andre E. Kramer) tells a weird tale about the intertwined dance-like steps of the heads of government and of the officialdom of a gigantic gas and oil company.

"Gazprom certainly had reason to party: its chairman, Dmitri A. Medvedev, was riding high on the Russian campaign trail as the hand-picked successor of President Vladimir V. Putin…. The opportunity for the company, the world's biggest producer of natural gas, to have its own man installed as Russia's next leader was priceless.

"Mr. Medvedev was sworn in as president on Wednesday, after winning the election in early March. His ascent confirms that in today's Russia, the line separating the business and the state is becoming so fine that it's almost non-existent – until you bump into it.

"Gazprom and government have long had a close relationship, but the revolving door between them is spinning fast this year. Mr. Medvedev, 42, replaces Mr. Putin as president; Mr. Putin becomes prime minister, replacing Viktor A, Zubkov, and Mr. Zubkov is expected to take Mr. Medvedev's place as Gazprom's chairman at a general shareholders' meeting in June.

"'P. Medvedev and Mr. Putin are as close to a dream team as Gazprom could ever hope for,' said Jonathan P. Stern, a British energy analyst and author of *The Future of Russian Gas and Gazprom.*

"It's hard to overemphasize Gazprom's role in the Russian economy. It's a sprawling company that raked in $91 billion last year; it employs 432,000 people, pays taxes equal to 20% of the Russian budget and has subsidiaries in industries as disparate as farming and aviation.

"The company is a major supplier of natural gas in Europe, and it is beginning to become an important source of gas to fast-growing Asian markets like China and South Korea. In 2005, at the urging of the Kremlin, it bought Russia's fifth largest oil company from tycoon Roman A. Abramovich. If crude oil and natural gas are considered together, Gazprom's daily production of energy is greater than that of Saudi Arabia.

"With energy prices continuing to hit record highs, Gazprom is more influential than ever, both at home and abroad. Gazprom says that before 2014 it will surpass Exxon Mobil as the world's largest publicly traded company – a goal Mr. Medvedev himself endorsed before he became president.

"When Mr. Putin was still president, he used Gazprom's wealth and economic might to fight political enemies inside Russia, to reassert influence over former Soviet republics, to gain leverage over Western European countries and to wrest energy assets back from foreign companies."

Seeking to Reclaim Soviet Clout

"Now that Russia is seeking to reclaim its geopolitical clout of Soviet days, it is wielding its vast energy resources, rather than missiles, to assert itself. More often than not, its most potent artillery is Gazprom itself.

"When Mr. Putin was still president, he used Gazprom's wealth and economic might to fight political enemies inside Russia, to reassert influence over former Soviet republics."

Seen from a strictly military point of view, it might appear a successful arrangement. But a shift of office between the political leader of the land and the head of a mammoth corporation leaves a few vital bases uncovered. Russia, for all its energy wealth, is faced with a shrinking population. And scourges like widespread alcoholism are not only in themselves a blight, but the symptom of even more basic social disarray. It is unlikely that having the heads of government determined by a mammoth energy trust is the best vehicle for handling such problems.

"The Yuzhno-Russkoye field alone has proven reserves of 800 billion cubic meters of natural gas, or enough to meet the gas demand in the US for more than a year, and it is only the first of half a dozen huge developments planned in the north.

"Over the next two years, Gazprom plans to triple its capital outlays in it core business of exploring, extracting, and transporting gas – just to maintain present production levels. Investments will rise to 969 billion rubles or $45 billion, in 2010 from 330 billion rubles, or 14 billion last year.

"To help finance a heady expansion into the Arctic, Gazprom is working on ways to push up natural gas prices in Russia and in the export market. Last year it floated the idea of creating a cartel for natural gas, similar to OPEC's cartel. Iran supports the idea, but Algeria, Qatar and others are uncommitted. A gas cartel would allow Russia to increase its influence in global energy markets, but at this point it is unclear how hard it will push the concept.

"Gazprom's ties to the government are already paying dividends in the domestic market. Under a policy championed by Mr. Medvedev when he served as deputy prime minister, Russian consumers are going to have to pay starkly higher prices for natural gas. Prices are set to start rising about 25 percent a year starting this year with the goal of reaching parity with world energy prices by 2011.

"Policies like this mean that average Russians won't continue to enjoy their traditional access to cheap energy. They offer a stark example of the government's willingness to give Gazprom a leg up – regardless of the social fallout.

"Back in the 1990s, Gazprom was the archetype of the unreformed Soviet enterprise. While all companies were being privatized and sold to Russian, and even to foreign investors, Gazprom stayed intact and under government control. It bankrolled many of the Kremlin's pet projects and the high-rolling lifestyle of a generation of company executives.

"Now Russian leaders consider Gazprom the template for a new industrial policy. In a globalized world, their thinking goes, strategic Russian companies should be controlled by the government, yet open to the capital and the skills of Western investors. It is a throwback to the Soviet model, with an emphasis on gigantism and economies of scale and faith in the pricing power of monopolies.

"Rich as it is, Gazprom faces big challenges in the Medvedev era. Rising price for steel, equipment and labour have caught the company at the outset of its largest capital program in two decades. Like other Russian companies, it invested little money maintaining or upgrading equipment in the 1990s. But the days of coasting on Soviet-era infrastructure are over, as output declines from fields first tapped in the 1970s.

"To meet export commitments to Europe as well as growing demand at home, Gazprom will have to spend at least $75 billion to bring its two largest fields in the Arctic into production within the next decade, according to Cambridge Energy Associates.

"Yet exploring and extracting gas in a region where temperatures dip to 50 degrees below zero is technologically challenging as well as expensive. Gazprom must build pipelines, gas processing plants, liquefied natural factories and a full panoply of supporting infrastructure like roads, railroads and ports.

"Critics say that Gazprom muscled its way into the ranks of the world's energy giants with blatant and often ham-handed tactics, particularly during the Putin years. The Yuzhno-Russkoye field, which Gazprom points to an example of its resurgence as an example of its resurgence is a case in point.

"Richard W. Moncrief, a Fort Worth oilman, says he is the rightful owner of 40 percent of the field, which he says he bought in a series of agreements with Gazprom about a decade ago. But he says Gazprom didn't even recognize his contract, instead granting BASF, a German company a 35% stake in the field. Mr. Moncrief is suing Gazprom in Berlin, contending that his stake is worth $12 billion.

"Gazprom maintains that the agreement was not binding.

"'Nobody has ever gotten a Russian company into a court that could enforce a contract,' Mr. Moncrief said in a telephone interview. 'In the end the Russians are going to do exactly what they want to, and they're going to ride the back of Western commerce to fund their country.'

"Mikhail D. Delyagin, a former economic officer to President Boris N. Yeltsin, is skeptical of Gazprom's ability to deliver the new gas on time or on budget. 'Gazprom's resources have been tapped for so many political and sideline business ventures that it is becoming a financial company rather than an energy company – threatening capacity to continue pumping gas,' said Mr. Delyagin.

"'Gazprom was turned into the Kremlin's wallet,' he said. 'You can't drill a hole with a wallet.'"

Energy in a land that over many generations has accumulated many unfulfilled needs. Russia is unlikely to escape what the West will be facing.

W.K.

Like Thieves in the Night

"Backstage at a Bank Funeral" is the title of an article in *The Wall Street Journal* (5/05, by Damian Paletta). We summarize. "Staples, Minnesota – At 7 p.m. Friday, Mayor Chris Etzler walked through the back door of the First Integrity Bank. The lobby should have been closed for the weekend, but dozens of strangers in dark suits were bustling about with laptops and file boxes. Someone had just delivered 32 pizzas.

"Dan Walker, a top official with the Federal Deposit Insurance Corp., a Washington, DC, bank regulator, had summoned Mr. Etzler to explain what was going on. The FDIC had just taken over First Integrity. 'All the deposits are safe,' Mr. Walker tried to reassure the mayor.

"It isn't easy for 75 federal officials and contractors to slip into a small town undetected and liquidate an 89-year-old bank without anyone knowing. But that's just what happened in this old railroad town, population 3,200. It's a scene that's likely to repeat itself across the country as banks struggle through a credit cycle, overwhelmed by troubled mortgages and soured construction loans.

"First Integrity, which had two branches and $55 million in assets, was the fourth FDIC-insured bank to fail this year – one more than during the entire three-year stretch leading up to 2008. Some analysts predict that as many as 150 banks, mostly small and medium-sized, could fail over the next three years."

It should be added that banks that are big enough are not only bailed out by the government, but are provided with the income by government shifting its borrowing from the central bank – where the bulk of the interest on loans comes back to the government by virtue of the ancestral monarch's monopoly in coining gold and silver, which has been surrendered to the banks. In the US the Federal Reserve is still owned by private banks. In Canada, where the bank was purchased from its private shareholders in 1938, the logic is even simpler – the interest returns as dividends. The main flaw with that arrangement is that while small banks in trouble get shut down, the really big ones are not only bailed out of their gambling losses by being allowed to invest in mortgage firms, stock brokerages, and insurance companies. That is how the present subprime mortgage crisis, and subprime bank crisis came to pass. And the largest banks in trouble are able to get their subprime mortgages traded for good legal tender by courtesy of the central banks. During the Depression in the US 9,000 banks shut their doors when banking legislation barred banks from having anything to do with the other "financial pillars." That led to successful refinancing of WWII and the reconstruction of a badly war-smashed world. But gradually the Rooseveltian separation between banks and the other "financial pillars" was abandoned because with every bailout the corrupt complicity of the government in allowing these repeals grew greater. As we reported elsewhere in this issue J.P. Morgan Chase was able to get a $10 billion loan to take over the Bear Stearns bank which it had acquired for $2 billion. This, however, involved the Federal Reserve accepting from the larger bank its subprime collateral debt obligations that came with its purchase of Bear Stearns. That is an added reason for banks to seek mergers, and strive to grow bigger and bigger as quickly as possibly. If they grow big enough the government is ever there to replace their capital losses in their ever more daring gambles.

But let us return to the plight of the tiny banks servicing small communities in difficulties because of the subprime crisis.

"At a bank funeral secrecy is paramount to prevent a run on the bank. That could lead to runs on neighbouring institutions. And then there follows a fair description of what banking is about that rarely appears in present-day university textbooks and the press: banks only retain a percentage of their deposits in cash and use the rest for things like loans. That means they haven't enough money on hand if everyone demanded their deposits back at once. Created after the Great Depression to prevent such scares, the FDIC insures deposits at more than 8,000 banks covering up to $100,000 in most cases.

"To keep a low profile, FDIC officials often use personal credit cards while in town. Many will curious strangers they work in insurance. In the case of First Integrity, Mr. Walker rented a conference room in a town 30 minutes away for a meeting of "Robinson & Associates." And a sign near his hotel's front door welcomed the fictitious company.

Such is the protocol of a Bank Funeral.

K.

An Honest Man Speaks Out When Others Eat Their Tongues

The Globe and Mail (15/05, "Police psychologist equates RCMP with Putin's Russia" by Gary Mason).

It could be the financial plight of our printed press beset by blogs, or the cracking sounds from the deregulated globalized economy, that is producing vastly improved newspaper coverage in our midst. We can only hope that this new trend, and, of course our newspaper themselves will remain with us for long to come. In any case, we seem to be getting coverage of important matters that not so long ago would be hushed up in the deepest silence.

We quote: "Someone else might have resisted the temptation, especially knowing that he might be blackballed as a result. But Mike Webster has never operated in that way. And so, when the respected police psychologist testified this week at the BC public enquiry into the use of tasers, he didn't parse his words when asked about the Mounties' decision to zap an unarmed Robert Dziekanski last October, and more recently, a pen-knife wielding 82-year-old man lying in a hospital bed in Kamloops.

"'I'm embarrassed to be associated with organizations that taser sick old men in hospital beds and confused immigrants arriving in the country,' said Mr. Webster, considered one of the top police psychologists in the world. Even as the words spilled from his mouth, Mr. Webster knew they had the potential to cause him much trouble with the RCMP. He knew because of a chilling incident late last year that still hangs over his association with Canada's national police force.

"Mr. Webster is a registered psychologist who deals exclusively with law enforcement agencies. His expertise in conflict resolution has been sought to help resolve some of the most volatile situations in recent years, including the showdown with Branch Davidian followers in Waco, Texas, in 1993. He was widely credited with helping avert a bloodbath with native protesters at Gustafson Lake, BC, in 1995.

"He has worked on a contract and fee-for-service basis with the RCMP for more than 30 years. Since the September 11, 2001, terrorist attacks, much of his work with the Mounties has been in the area of intelligence gathering. After Mr. Dziekanski died at the Vancouver International Airport last October, media outlets in BC sought Mr. Webster's opinion on the incident. He thought it was a disgraceful display of policing. The officers had blasted the troubled Polish immigrant without making any attempt to resolve the matter peacefully.

"In early December, Mr. Webster says he received a call from Richard Bent, chief superintendent of the RCMP E Division in Vancouver. When the senior Mountie asked Mr. Webster if the two could have a meeting. Mr. Webster knew something was amiss. He wanted to know immediately what it was about.

"'That's when he said it was about the nature of my comments to the media about Dziekanski incident,' Mr. Webster revealed in an interview yesterday.' He said, 'You've upset some of the members here and they're saying things.' "Like what?" I said. 'Well, they're saying that may be you shouldn't be getting any more work with the RCMP.'

"Mr. Webster nearly dropped the phone. 'It was a clear threat.'

"Mr. Webster said he told the Chief that he didn't respond well to threats. And that they wouldn't change his mind in any case. After stewing about the matter over Christmas, Mr. Webster articulated his anger in a letter to Gary Bass, the RCMP's top man in BC. In it he reiterated how offended he was by Chief Supt. Bent's comments, which he considered a blatant form of intimidation.

But he did begin hearing from friends within the force. He said that one relayed to him that Mr. Webster's outspokenness cost him a small fee-for-service job. One of his friends was told, 'Don't be hiring Webster. He is in shit with us for being disloyal.' Another told him to expect a top RCMP official in Ottawa who was going to fly out to talk with him. "Two weeks later he was having lunch with an RCMP inspector who scolded him for his Dziekanski comments. He suggested the psychologist was being disloyal to an organization that had been good to him over the years. He said Mr. Webster should have waited until the RCMP had concluded its investigation into the incident before giving any kind of opinion on it.

"'I told him that I didn't need any more than 25 seconds of video that we all have seen over and over again to offer my analysis,' Mr. Webster said. I really gave him a blast. The expectation is that if you work for the Mounties, you align your value with the corporate culture and if you don't that's being disloyal, and is unhealthy.

"Chief Spt. Bent said in an e-mail yesterday that he did phone Mr. Webster because of concerns he was making statements to the media about the RCMP's guidelines for handling potentially violent situations that he felt weren't accurate.

"He confirmed that he told Mr. Webster that other RCMP members were upset and didn't want the Mounties to give the renowned intervention specialist any more work. He says it wasn't intended as a threat.

"To Mr. Webster, his run-in with the Mounties reflects a serious and systemic problem inside the organization, one [already] recognized in the report into the RCMP pension fund scandal. That report suggested the force was a troubled organization that did not abide dissent of any kind. And those who did offer opposing views were shunted off to dead-end jobs and forced to wave promotions goodbye.

"'As a psychologist, I know it's not healthy for people to live in such an oppressive climate,' Mr. Webster said. 'Being a member of the RCMP today is like being part of Putin's Russia; they don't tolerate any opinion that doesn't reflect the party line.'

"A devastating charge. Mr. Webster currently has a one-year contract with the Mounties. After it expires next April, he has no idea if more work will be offered him.

"'I find it offensive that I'm expected to park my morals at the door if I'm going to be part of the organization,' Mr. Webster said. 'If that's what it means, I won't do it. I just won't.'"

What could one add to that? The situation he describes is incompatible with democracy. For decades the Mounties have pursued their whims and pleasure in enforcing their view of how the world should be run. Mr. Webster in this era of rethinking has set a great example of what democratic citizenry is about.

W.K.

An Energy Vision for Canada

The Globe and Mail (26/05, "Energy Superpower? Only if we find a champion" by Clement Bowman) presents us with a new energy vision for Canada.

Mr. Bowman, as a former executive of Imperial Oil, and former head of the Alberta Research Council, is above suspicion as an advocate of big government for big government's sake. He will be receiving the $1.3 million dollar Global Energy International Prize in St. Petersburg on June 3 for his work on the development of highly efficient processes of oil extraction.

We quote some key parts of his article: It contains some little-known information for focussing an energy-friendly both on the environment and society. That is essential for formulating a national energy policy.

"Prime Minister Stephen Harper committed Canada to becoming an energy superpower at the 2006 Summit in St. Petersburg. A better vision for Canada would be to become a sustainable, environmentally sound energy superpower. In any event, a vision without a plan is but a dream. It's not about walking away from fossil fuels and closing down coal plants. It's about learning to work with what nature has given us, without using the environment as the dump for waste products.

"Canada has an opportunity to provide global leadership in addressing the collision between energy and the environment, the dominant issue facing this planet in this century. We lack only one ingredient – the national will. In the past our big achievements were conceived and led by champions. The railway across Canada, the construction of our airport system in the midst of the depression, the massive James Bay generating facility, the unlocking of the deeply buried oil sands – in each case there was a champion who provided leadership and who created a sense of public purpose. Where is Canada's champion to lead our energy vision? Stephen Harper came very close in 2006, comparing the oil sands to building the pyramids or the Great Wall of China. We have not seen many environmental advances yet, mainly just studies, and then more studies.

"More than 100 energy experts, under the auspices of the Canadian Academy of Engineering, have proposed that Canada undertake the following three national building projects:

"1. Gasification of coal and biomass (to produce hydrogen, electricity).

"2. Greenhouse gas management(carbon dioxide capture, followed by transportation, long-term storage and/or use)

"3. A National Electrical Highway (upgrades to electrical infrastructure with improved local access for wind and other renewable energy sources). Coal gasification is not combustion with the accompanying release of massive emissions of carbon dioxide at low concentrations. New coal/biomass gasification technology produces hydrogen, electricity, and a concentrated stream of carbon dioxide that can be recovered and stored underground.

"The oil sands, a major contributor to Canada's future wealth are not usable until the bitumen is upgraded by the addition of hydrogen. The existing practice of producing the needed hydrogen from natural gas (a low carbon footprint fuel) is not a viable long-term solution. Coal and oil sands need to be seen as an integrated resource.

"Greenhouse gas capture, transportation and storage are natural pathways for Canada. We are already injecting carbon dioxide into conventional oil reservoirs to promote enhanced recovery. We have almost unlimited future storage capacity in deep underground saline aquifers. The carbon dioxide is not stored as a high-pressure gas, in danger of sudden release. It is stored as a liquid in the pore space, just like the original petroleum.

"Electricity is a provincial responsibility. Each province has developed its own electricity sector in accordance with provincial electricity policies and prevailing economic forces. This has typically resulted in stronger north-south than east-west connections and in many provinces has left a legacy of significant use of fossil fuels for the generation of electricity.

"Canada has renewable energy sources such as water and wind, in addition to uranium and nuclear reactors that can provide electric power with very low greenhouse gas emissions over their life cycle. Significantly strengthened and new east-west ties to form a robust national power grid would encourage interprovincial trade in electricity, provide improved grid access by renewable sources, and enhance reliability of supply.

"There is a made-in-Canada model for the appropriate type of project management. In the 1970s, former Alberta premier

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How the Present Crisis of Our Auto Industry was Foreseen Some Six Years Ago

While proofing volume three of Meltdown, I noted how well COMER had foreseen the depths to which our automobile industry was headed. Obviously our view of the economy enabled us to foresee what the government, our central bank and the industry economist had shut their eyes to, as they are doing once again. From Economic Reform *of October 2002 we reproduce the following:*

Have we Already Begun Blowing the Next Bubble?

The soap suds are stirred, the clay pipe is at hand. The clay gods who preside over the ritual are intact at their altars. The world has not begun coping with the last bubble-burst, and Wall Street is busy preparing the next.

To understand its compulsion, an introductory word. No one has to be told that the world has become terrifyingly complex except orthodox economists. The key way in which they avoid recognizing that unpleasant fact is by the liberties they allow themselves with the time dimension. Time is what links our past and future with the present. That means that we must distinguish what took place in the past from what is taking place in the present. And of the future we have at best only imperfect knowledge. And yet the future is the happy hunting ground for securities salesmen, bagmen and promoters. The least we can do is get a firm grasp on how the future feeds into the present. And on what might occur in the future that can conscientiously be presented as a present asset, Graphically this could be shown by arrows: one directing from the past to the present, the other from the present to the future. This is the simplest instance of one-dimensional analysis. And it is one that, scandalously disregarded, has contributed to the world's current crisis. If you distort the way in which the future affects our present, you are blowing soap bubbles. And hardly with the innocence of a child.

Instead of arrows leading from the past to the present, and from the present to the future, we end up with a dot that has no dimensions, Otherwise expressed, instead of analysis, we are lost in number-crunching that essentially ignores that great spoiler – the time dimension. Let me give you a couple of examples.

The Treatment of Capital Investment in the Public Sector

Rather than writing investments off over their period of economic usefulness (depreciation) and noting the repayment of the monetary cost (amortization), public investment was until recently wholly written off as a current cost in the first year after it was made. If this were done in the private sector, most companies would appear bankrupt, and corporations would certainly be prosecuted for avoiding taxes.

As for households, it would be equivalent to calculating your net worth by recording the mortgage on your home as a debt, but omitting the asset value of the house to offset it.

If similar "cash accountancy" were done by households, the householders net worth would record the outstanding balance of the net value of their mortgages as a debt, omitting the value of the house to offset that.

Contrast this with the practice of corporations capitalizing not only their anticipated flow of earnings in the future, but also their anticipated market share. Especially in the case of high-tech corporations, it didn't seem to matter whether that market share has been achieved by selling their products at a loss. Corporations founded their plans for success by their conquest of market shares.

Contrast that with the practice of automobile corporations capitalizing not only their anticipated flow of future earnings, but their anticipated future market share. The assumption is that after achieving a dominant share – say a modest 100% – the competition will be stone-dead and then your firm's prices can be raised to bring in handsome profits. This obviously is a grotesque new instance of John Maynard Keynes's "Fallacy of Composition": the story-line, if realized, might work for the victorious corporation, but it involves all the competition going broke. Hence passing from the individual to society as a whole, the result would be disastrous. Today we are witnessing the hopelessly deflated market for fibre optical inventories which has left no victors.

The Wall Street Journal (9/9, "While Auto Makers Sputter, their Dealers Go Full Throttle" by Karen Lundergaard): "At a time when Detroit's big auto makers are scrambling to slash costs to rebuild razor-thin margins and are watching their stocks get hammered, many car dealers are prospering.

"With auto makers pumping money into the costly promotions that have consumers thronging to dealerships, retailers are enjoying some of their best years ever, Stocks of the big publicly traded dealership groups such as AutoNation Inc., based in Fort Lauderdale, Florida, and Dallas-based Group 1 Automotive Inc. have more than doubled during the past two years, while auto makers shares are down as much as 50%.

"The divergent fortunes of car dealers and car makers add up to a striking anomaly of today's shaky economy. In past downturns, when car-makers saw demand sliding, they cut production, and even, in some cases scaled back discount deals to ride out the storm. Car dealers suffered along with the factories.

"Now auto makers face a different landscape. Even with strong sales, the North American auto industry, including the overseas plants that feed it, still can make about 20% more vehicles than the 17 million or so than they can sell each year. Any producer that pulls back risks a long-term loss of market share, if rivals choose to fill the gap."

In short with their present profitless production, automakers are just keeping warm their chairs for future profit-making.

"For Detroit's Big Three, scaling back production doesn't save much on labor anyway, because union contracts in the US make labor a fixed cost in effect. And cutting production means less cash coming in the door to finance growing pension obligations."

In the Greek legend, Sisyphos in Hades rolled his rock uphill each day, only to have it roll back each night for all eternity. But at least, he didn't have to worry about meeting a payroll and keeping his bank at bay.

"So the car makers have been poring over the discounts to keep production moving, and customers have been snapping up the output in a surprisingly robust level of spending.

"But as the Big Three have used ever-deeper discounts to protect market shares, they have seen their profit margins shrivel. GM says its deals this summer cost the company at least as much as the sweeping

0%-financing it rolled out as an emergency measure to resuscitate sales after 9/11…. Despite the sales boom, the Big Three have announced plans to cut more than 50,000 jobs and suppliers are facing new demands to lower prices.

"And Toyota and Honda have cut dealers' margins over the years – charging them more for the cars."

"Also manufacturers foot the bulk of the marketing bill to sell cars. AutoNation's Mike Jackson estimates that the manufacturers spend about $2,500 on incentives and $500 on advertising and other marketing, while AutoNation is spending just $300 per vehicle. At the same time – low interest rates keep down inventory expenses – one of dealers' biggest costs.

The day after carrying this report, *WSJ* carried a story (10/9, "Ford Expects to Post 'Small Profit' for Third Period, Beating Forecasts" by Joseph B. White and Norihiko Shirouza) with the following incredible tidings: "Ford's market capitalization of $9.7 billion is less than the $24.9 billion in gross cash the company has on its books. That means investors are effectively assigning a negative value to Ford's $131.5 billion a year automotive and finance business." More gloomy epitaphs are rarely found on tombstones. And this tombstone is over an economic system rather than over any particular exponent of it.

And into this china shop, Governor Dodge of the Bank of Canada has barged with higher interest rates – yesterdays rule of big-toe for fighting "inflation."

"The publicly traded dealerships have spent the past couple of years trying to distance themselves in the eyes of Wall Street from the ailing car makers. They present themselves to analysts as specialty retailers, along the lines of home improvement chain Lowe's Companies Inc. rather than auto companies."

What this amounts to is another derivative bubble. The dealerships are a derivative of an already-bursting bubble – the auto companies. They are packaging a future that cannot survive the disappearance of the supporting bubble – the auto companies. Obviously, when the bankers of the manufacturers force the auto companies to throw in the towel and write off their bad loans, there will be no one to make up the deficits that are fuelling the dealership boom. Once again – as in the case of the fiber optics conglomerates, there is no serious communication between the two.

William Krehm

P.S. There is an important corollary to this simple exercise in one-dimensional analysis. The collapse of the international financial system leaves society with a numerous tribe of highly overpaid people with no other skills or training than buccaneering on as highly manipulated world securities market. No economic revival worthy of the name can be fashioned around the priority of finding gainful employment for jobless high executives at the lofty remuneration to which they have become accustomed.

Deregulation and Globalization was conceived with little concern for the tens of millions that were deprived of their livelihood and even of their savings. In reshaping the world to more sustainable activities, more humanity should certainly be shown in helping these unhappy unemployed high executives to more useful careers.

But ways of achieving must be undertaken at once. Returning infrastructural assets to the state where privatized companies are in trouble can be helpful in this respect. Significantly, the British government has bailed out British Energy PLC to the tune of $998 million to help it meet its immediate financial obligations which include 82.4% of Bruce Power. The share power of the mother company fell 65% in a single day. And it seems that there is desperate need for deprivatizing the eight nuclear reactors in Ontario rather than having the financial markets take over further public assets.

But first and foremost that involves rethinking what has passed for economic theory over the past quarter of a century. For that is now exposed to have been little more than the battle hymn of the world's stock markets elevated to the dominant economic group.

Statistics Can Lie, But Stray Dogs Tell The Truth

Embellishments of facts have poured out of Russia – as of other lands in varying degree – so it is reassuring to read in *The Wall Street Journal* (20/05, "It's a Dog's Life, But in Moscow That's not Bad" by Mark Schoofs): "Affluence has brought ease to many strays, saving a bone for later." The details bespeak a talent for living in peace and prosperity well shared with their peers, that could serve as a wholesome example for human kind: "Like human commuters, the city's stray dogs can often be spotted traveling on the subway, waiting patiently for a train to pull in and its doors to slide open.

"In Soviet times, dogs were barred from Moscow's metro. Today, however, they are common there – curling up on empty seats, nuzzling their neighbours, lounging in stations – there is even a Web site devoted to them: www.metrodog.ru.

"A tiny group of zoologists study Moscow's stray dogs and how they're adapting to a rapidly changing city. Among them is Alexei Vereshchagin. He set out to study wolves – 'such a romantic creature' he says – but as science funding crumbled with the Soviet government, he couldn't.

"So the 31-year-old, rusty-bearded Mr. Vereshchagin started studying strays instead, and loved it. 'The behaviour of stray dogs is like theater,' he says.

"As the number of cars in Moscow has exploded, and their speed increased from the days of Soviet clunkers, strays have learned to cross the street with pedestrians. They can also be seen occasionally waiting for a green light. [Dogs are colour-blind, so researchers theorize that they recognize the shape or position of the walking man signal.]

"Back in the lean Soviet era. restaurants and the now ubiquitous fast-food kiosks were scarce, so dogs were less likely to beg and more likely to forage through garbage, the zoologists say. Foraging dogs prospered best in the vast industrial zones of Moscow, where they lived a semi-feral existence. Because they relied on people to throw out food, and less on handouts, they kept their distance from humans.

"Now, old factories are being transformed into shopping centers and apartment blocks, so strays have become more avid and skillful beggars. They have developed innovative strategies, zoologists say, such as a come-from-behind ambush technique. A big dog pads up silently behind a man eating on the street and barks. The man drops the food. The dog eats it.

"Key is the ability to judge which humans are most likely to be startled enough to drop their food. Strays have become master psychologists, says Andre Poyarkov, 54, the dean of Moscow's stray-dog researchers. 'The dogs know Muscovites better than Muscovites know the dogs.'

"One of their chief tactics made possible by their increasing comfort in crowds, is to lie in a busy subway passage, where thousands of people pass by, and wait for someone to toss them something. The dogs get fed without even having to go to the trouble of nuzzling a leg.

"Mr. Vereshchagin strolls through a market area near a metro station, pointing out that even though there are more strays than ever in Moscow, the dogs don't have a lean or hungry look. The leader of this area's dog pack, whose coat is dirty-white with black patches, stretches lazily before a butcher stop. He stands outside for just a few seconds before a meaty bone is tossed at his feet. He carries it off, but just nibbles at it.

"Unlike the strays he studies, Mr. Vereshchagin can't afford to be so picky. The city has provided funding for sporadic dog censuses, the last in 2006, which estimated the population of stray dogs at about 26,000. So Mr. Vereshchagin, who has yet to finish his thesis, makes ends meet by training people's pets and working as a paramedic.

"Adaptations by individual dogs have added up to a dramatic shift in canine culture. Begging is a submissive activity, so today there are fewer all-out-interpack wars, which sometimes used to last for months, according to Mr. Poyarkov. Within packs there are more stable hierarchies that allow the whole group to prosper.

"Still, there are occasional attacks on human beings, like one in April in which a 53-year-old man was killed by a pack of strays living in a rambling and overgrown park. Mr. Vereshchagin says that dogs living in forested areas aren't as familiar with people and are more likely to aggressively defend their territory.

"The death has reignited a controversy. Even while the city has allocated the equivalent of $63 million mainly to build animal shelters and related programs, some people are calling for a return to the Soviet practice of culling strays.

"Many Muscovites feed the strays and build simple winter shelters for them. Older people particularly seek companionship in Russia's capitalist economy, which can be ruthlessly dog-eat-dog."

This brief reportage of what dogs have learned from humans in the country that has undergone the most drastic changes in recent times, invites people – not just Russians – returning the compliment by learning from the strays how to get along better with our own kind and the Good Lord's other creations.

W.K.

When Beauty Spots Get Too Big

The New York Times (11/05, "The Dollar: Shrinkable But (so Far) Unsinkable" by Peter S. Goodman) handles the subject with great delicacy: "If the US were any other country, these would certainly be days of panic and austerity. With debts spiraling higher, a trade deficit exceeding $700 billion a year, and its currency plunging for years, the government would be forced to cut spending and jack up interest rates in a frantic bid to attract investment.

"But, for more than half a century, Americans have enjoyed a unique privilege in the global economy: the dollar has been the world's dominant currency, the money used in most transactions and the repository for the national savings of many countries including China, Japan and Saudi Arabia.

"Come what may – a financial crisis here, a military misadventure there – Americans could count on money sloshing up thick on their shores. Virtually limitless demand for American products and loans abroad has supported the dollar's value, and kept interest rates down. Americans have been emboldened to spend in blissful disregard of their debts. This dynamic may be so deeply embedded in the workings of the global economy that it could endure many years to come.

"But what are the chances that a day of reckoning is coming, when the dollar would be so weak that America would have to play by the rules that apply to every other country? Recent signs do suggest some fraying in the American relationship with its many foreign creditors. The balance of trade has gotten so lopsided and the question marks hovering over the American economy so thick that some governments are beginning to hedge their bets on the dollar.

"Russia has been diversifying its hoard of foreign exchange, plunking more into other currencies like the rising euro. In the oil-drenched world, signs suggest a slight shifting to other flavours of money. And markets have been parsing every utterance from Beijing for hints that China may moderate its voracious appetite for dollars."

But at the mention of Russia and China, the writer of the article, seems unaware that he has jumped rails. At the root is another deep trait of the American political and economic tradition: Charles Beard and other American historians have called it the tradition of the frontier. From earliest colonial times when the American settlers ran into an economic crisis, instead of battling it among themselves, they simply "went west" – they merely moved where there was an abundance of virgin forest to be cleared for farming. And when that process took them to the Pacific, they simply made a left turn and moved into Mexican lands and kept going south. And after that taking over Caribbean islands. They were economic missionaries, and brought their model to any part of the world where a profit beckoned.

That brings us to Russia. When the Soviet regime crumbled and Gorbachev and then Yeltsin took over, the Americans moved in to advise – for adequate fees – that a completely free private market must be brought in at once – even though there were no capitalists trained to the role available and little private capital around – only crooks and ex-Secret Service operators. And around some state – owned industries in remote wastelands it was the state industry that provided what there may have been in the way of social infrastructures – schools, hospitals and so forth. Do away with state-ownership in one sweep. to make the policymakers and economics professors in the US happy didn't make sense. For it left the field open to the gangsters who took over. Yet it read well in Washington. To an extent it was the frontier syndrome that had taken over US foreign policy once again. Obviously that dreadful mistake in US foreign policy will hardly promote patience with Washington's domination of the international currency market. As will the purposes for which much of its current trade deficits were incurred – the conversion of the rest of the world to its view of a globalized and deregulated world.

As for the Chinese, they learned from the Japanese the wisdom of keeping their currency low to promote their exports. The Japanese erred in investing much of their excess dollar earnings in American real estate, and the Chinese were strongly pressured to let the Yuan rise to blunt China's price advantage on world markets. It is a sad sequel that the American banks should be looking to sovereign investment funds from China and the Gulf states to save its banks from succumbing to the subprime banking crisis.

The article ends on an unfocused note. "Yes foreigners have been lending alarming amounts of money to Americans."

W.K.

The Subprime Engulfs Small Business Loans

In a well-regulated economy banks are strictly confined to banking and the central bank issues the money that the government spends into existence as exchange medium for the entire economy. And that debt spent into existence rather than loaned goes to finance essential government infrastrucures: schools, roads, universities, hospitals. It is backed by the taxation powers of government over all resources, physical and human, the cultural heritage of the land. Though listed as debt, it is actually an asset for it can be spent into existence for anything within the country. That is why, having nationalized the Bank of Canada in 1938, Canada was able to finance its Second World War through its central bank to a greater extent than the US or the United Kingdom. And for a quarter of a century of the peace, it could catch up with the lack of maintenance for its infrastructures during a decade of depression and six years of war. Whatever was available within the country the government could purchase with money it could spend into existence interest-free. That is why the latter years of the war were more readily financed than the first year or two, even though the product of the effort was destroyed at the front.

We must then come to see that the debt of our country, though it is debt, is virtually interest-free since the interest that it borrows from the Bank of Canada comes back substantially to it as dividends as sole shareholder of the Bank of Canada.

Though the United States to this day owns no shares of the Federal Reserve system, it was in the United States and Britain that much of the banking techniques were developed that taught the world how to avoid the recurrence of the Depression. The fact that the banking system in the US had collapsed nearly to the point of non-existence led leading industrialists to advocate "100 money," limiting the banks to lending out what money they actually had in their vaults. The fact that the banks were in the doghouse made it possible for Roosevelt to consult economists freely in seeking a way of allowing the banks to recover. The formula was simple enough: have the banks stick strictly to banking and not acquire interests in the other "financial pillars": stock brokerages, insurance and mortgages. The reason? Each of these other "pillars" maintains pools of cash for the needs of their own business. When a house burns down, insurance companies must come up with the cash of the insurance they have sold. Stock brokers must keep the customer's account available to handle future purchases, and as for mortgages, even a casual reading of the press this past year should have given you an idea of the trouble that banks can get into by claiming to manage risk, when in fact the major source of their risk has been putting together supposed parcels of risk, and selling it to borrowers without even serious scrutiny of their credit record. It came to be considered a greater efficiency to leave that to salesmen who sold the package of mortgages, diced and sliced supposedly to the buyers' tastes and for the banks that organized the exercise to take the "bankers' exit" selling the product to the legendary "bigger fool." But that convenience ran out and the banks themselves found no buyers or sold to mortgagees without the know-how to administer such complex and dubious debt. However, it was on such rickety foundations that the great housing boom was based.

Small Loans are Becoming Harder to Get and Dearer

Rising house prices were depended on to cover the supervision and credit investigation left undone. But a boom is a great eraser of mistakes made and corners cut. The spirit of derivatives, feigning a fully guaranteed knowledge of the future, had taken over.

Now there is talk of the central banks in the US and Canada and in other lands being brought in to buy – at a discount – the mortgages and other subprime debt. But the debt of central banks since 1971, when the gold standard was abandoned, has been the only legal tender in the world. You mix it with some of the subprime debt that went to prop up the mortgages, and what you are doing is debasing the credit of the central bank – the only legal tender that we have. That would at once cause interest rates to rise, to cover the dubious quality of the debt that had been unloaded onto the central bank. That could only deepen a depression that already seems to be closing in on us. That of the 1930s led the world into the Second World War. We have already had wars in the Gulf Sates, with no end in sight.

Just how the subprime phenomenon spreads appears clearly from an article in *The Wall Street Journal* (13/05, "Latest Groans: Small-Business Loans" by Robin Sidel and David Enrich). It recounts how elusive surplus income that may have been saved for a few months quickly disappears, leaving holes of insufficiency in the finances of small businesses.

"The turbulent economy is exposing yet another type of credit where bankers let their guard down: small business loans. Missed payments and losses on small business loans are surging at banks throughout the country that were so eager to pad their profits that they essentially threw typical un-

Vision *from page 15*

Peter Lougheed, faced with minimal interest by the international oil companies in the deeply buried oil sands, established a cross-sectoral management board to spearhead the required field demonstration projects.

"His initial $100 million 'signal' to industry led to a $1 billion to $3 billion (in today's dollars) joint government/industry program. The concept of a cross-sectoral management board to meet our current challenges has been proposed by both the recent Canadian Academy of Engineering Energy Pathways report and NRCan's commissioned Powerful Connections – also known as the Bruneau report.

So why are we not running our energy system this way now? The technologies are largely new and have not been tested on a full commercial scale. Canada has unique coal and biomass feedstocks. Processes that have been demonstrated in other countries need to be validated and 'tuned up' for use in Canada.

"The opportunity is huge, the plan has been strongly and widely endorsed, and an appropriate management structure has been proposed. The prize is unparalleled economic and social wealth in Canada over this century. This should be our moon shot? Where is the champion?"

On quite other political grounds – to revive our sense of being a sovereign and socially sensitive nation, these promising considerations seem to be just what we need to energize not only our power lines but our sensitivities as a nation cherishing its environment, our society and our independence.

William Krehm

derwriting methods out the window. Some lenders doled out small-business loans as though they were credit cards, relying solely on the personal credit scores of borrowers.

"That meant that many loans were made without assessing a company's strategy or finances, even by banks that avoided subprime mortgages. Now the economic slowdown is leaving lenders with little or nothing to collect on many small-business loans in case of default.

"The mistakes already are haunting lenders from Bank of America Corp. to Sun Bancorp, a Vineland, NJ, bank with 70 branches. 'We wanted to give them access to capital faster,' says Thomas Geisel, Sun's chief executive. 'At that point in time, the economy could support it.' Rising charge-offs, including most of the $1.2 million hit Sun took on bad loans in the first quarter, prompted the bank to revert to traditional underwriting practices.

"Borrowers now are required to put up collateral and wait several weeks before finding out if they were approved. Under the loosened loan terms, small-business borrowers could walk into any Sun branch, fill out an 'express' one-page application and get as much as $100,000 in 24 hours."

Collateral for Mortgages is Now Being Investigated — The Loans are Dearer

"At that time, Bank of America held about 22% of bank deposits by US small businessmen, but only an 8% market share of loans to that group, according to the bank. So bank executives began wooing holders of Bank of America small-business credit cards, encouraging them to seek credit lines and other types of loans.

"Entrepreneurs were also enticed with free online payroll services and easier access to health insurance.

"Under the new loan program, borrowers seeking less than $50,000 didn't have to provide financial documentation – the equivalent of 'no doc' mortgages that have burned residential real estate lenders.

"By early 2007, Bank of America's small-business loan portfolio was up 30% from a year earlier to $14 billion. On April 1, Bank of America discontinued the Business Credit Express program and began steering customers to other small business products, such as credit cards and other lines of credit.

"Overall, a survey released this month by the Federal Reserve found that about half of US banks are tightening their standards on loans to small firms, compared with about 30% that reported doing so earlier this year. And nearly two-thirds raised the rates charged on these loans.

"'Money is simply less available,' Lawrie Hollingsworth, chief executive of Asset Recovery Technologies Inc., an eight-employee company in Elk Grove, Village, Ill., told a House subcommittee last month. 'When it is available, it is at a new premium and cost for less money and more lending covenants.'"

K.

Exaggerating the Diversity of the Subprime Banking Mess by Bad Reporting?

The Wall Street Journal (16/05, "Barclay's Doesn't Budge" by Neil Shah and Carrick Mollenkamp) reports: "Barclay's PLC stopped short of a wide move to raise capital, leaving the British bank with one of the industry's thinnest cushions against losses at a time of great uncertainty in the economy.

"The UK's third largest bank by market capitalization, Barclays said it turned a profit of £1.7 billion ($3.3 billion) in write-downs in the first quarter despite losses on mortgages and other investments.

"While the bank left the door open for a capital injection, it decided for the time being not to join rivals such as Royal Bank of Scotland Group PLC and HBOS PLC, that have turned to investors for funds to help them weather the financial crisis.

"In an interview, Chief Executive John Varley rattled off various spending choices – from hiring teams of former ABN – Amro employees to buying a bank in Russia – that demonstrate how Barclay's capital level isn't slowing down its business.

"'We understand how much capital we need at any given time,' he said."

Famous last words out of the banking mess in the USA. The subprime nightmare of bundled diced and muddled securities to be peddled and imitated throughout much of the world, has simply not been allowed to rob many British Bankers of their sleep.

"Barclays' decision to hold back left analysts concerned that Mr. Varley could be underestimating the bank's difficulties and missing an opportunity to shore up its finances at a time when the UK government has been pushing banks to attract the capital to keep lending.

"RBS, HBOS and mortgage lender Bradford & Bingley PLC have announced plans to raise a total of more than L16 billion through rights issues, in which they sell new shares at a discount to shareholders."

Bank in Denial?

"Barclays appears to be 'in denial,' said Tom Rayner, a banking analyst at Citigroup. Mr. Rayner also said Barclays' write-downs seemed meager compared with its peers, given the size of its portfolios of troubled assets. Barclays has said direct comparisons aren't valid, because it holds a different mix of assets. In London, Barclays' shares fell 2% to 418.75 pence.

"People familiar with the bank think Barclays could build up cash by selling assets. Barclays is keeping all options open."

However, the situation could degenerate further, making it more costly to raise the capital that could be needed to tide it over. "A weaker UK economy is likely to boost the number of consumers defaulting on their debts."

"European banks have so far taken more write-downs, and have been slower to raise capital than their peers in the US. As of last week, credit losses at European banks stood at $158 billion, compared with 153 billion at US banks, according to a research report by Joseph Quinlan, an analyst at Bank of America's Investment Strategies Investment Group in New York. But European banks have raised only 67% of that amount in new capital, compared with 88% for US banks."

That could mean more trouble ahead for the European banks, whereas the American banks have looked reality more closely in the face.

"If Barclays ultimately chooses to raises capital, it can do so through a rights issue, or by selling shares to a sovereign wealth fund or other investor. Last year, it issued shares to China Development Bank and Singapore state-owned investment company Temasek as part of its unsuccessful bid to buy out Dutch bank ABN Amro. "Barclays didn't announce specific first quarter figures, but said profit was down from a year earlier."

W.K.