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World Coal Bin Empty?

If you break up the sundry problems of a world economy into independent parts and mix them up as though they were a helter-skelter body of subprime mortgages, if you do not understand what those problems are and where they interrelate and run into each other, you haven't a clue of what the real risks might be, or how to manage them.

Nothing better makes the point than the world coal crisis now coming at the rest of the world largely out of China. *The Wall Street Journal* (12/02, "China Spurs Coal-Price Surge" by Shai Oster in Beijing and Ann Davis in Houston) has this to say: "China is doing for coal what it once did for oil: pushing prices to new highs, adding more pressure to the creaking global economy.

"China has long been a huge supplier of coal to itself and the rest of the world. But in the first half of last year, it imported more than it exported for the first time, setting off a near doubling of coal prices throughout the world. The capper came in late January when a winter of punishing snowstorms and power shortages led Beijing to suspend coal exports for at least two months.

"Just since then, Asian prices have shot up another 34%. Last week, coal benchmarks hit all-time highs in the US, Europe and Asia. That's added to worries over global inflation already stoked by prices rising for everything from crude oil to cattle feed. 'The velocity of the change has been remarkable,' says Thomas Hoffman, senior vice-president for external affairs for US-based coal supplier Consol Energy Inc., which he says is considering holding off on strong commitments to supply coal to see if prices rise even further.

"For the world which uses coal for about 40% of its electricity. the result is similar to what happened after China became a net importer of oil in 1993. But the Chinese factor is unfolding much faster with coal. It wasn't until China's industrial development shifted into overdrive this decade that that the nation began to shake global petroleum markets. Oil's big surge came after widespread brownouts in China in 2004, forced factories there to buy diesel fuel for backup generators, increasing the country's oil demand.

"China's need for coal is rising as other factors around the world are putting severe strain on the supply of the fossil fuel. Flooding at major mines in Australia since mid-January has dramatically stunted that major coal exporter's shipments to Asian markets. For more than a year, meanwhile, Australia's overloaded ports have been choked with cargo vessels, forcing ships to wait in long lines to dock to get their coal. Power shortages and blackouts in South Africa amidst rising demand there have curtailed exports to Europe. In Russia, another major coal producer, railcar shortages have frustrated attempts to meet growing world demand. Japan, one of the world's greatest importers, is burning even more coal since an earthquake damaged a nuclear reactor last year. Longest-term pressure comes from India, which has mounted a major expansion of coal-fired electricity plants that is driving up the country's coal imports, despite its large domestic reserves. Indonesia has been moving this past year or so to divert more of its coal stores to domestic use, as the coal industry there has been depleting its higher quality coal reserves.

"Even US coal producers are ramping up coal exports to Europe as buyers who a few years ago had no interest in American coal

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Coal Bin *continued from page 1*

are scrounging there for supply.

"'There is a butterfly effect, with issues inside China pushing up demand and prices for the fuel from other producing nations,' says Vic Svec, a senior executive Peabody Energy Corp., the world's largest private-sector producer at St. Louis, Missouri. 'Demand in Beijing can ripple back to Queensland, Australia, or Gillette, Wyoming.'

"The China-driven coal-boom has pitched up wages for US coal workers as well as for port and rail workers – a twist on the recent industrial jobs from the US to China. 'We've never before as an industry seen such a dramatic upturn,' said Bennett Hatfield, chief executive of International Coal Group Inc., another US coal producer. Thermal coal price of Australia's coal at Newcastle port, finished at $125 a metric ton Monday, according to globalCOAL international trading platform. That was up 34% since 34% since January 25 and up 143% from January 2007.

"On Monday Central Appalachian coal futures on the New York Mercantile Exchange for delivery in March stood at $75 per US ton. That's double its price at the start of 2007 despite weak domestic demand and above-average stockpiles due to a mild US winter."

Growing Share

"Some experts say coal prices could remain high or even keep climbing through 2009 and beyond, weighing on the already slowing world economy. Even though coal is a leading source of atmospheric warming, greenhouse gases, its share of the world diet is increasing – which could help keep its world price up during a recession. Although the use of cleaner alternative burning fuels is increasing, fast-growing energy consumption is expected to increase. Still a relatively cheap – and relatively abundant alternative source of energy to oil, coal is sought in Brazil, India, and Vietnam as well as China.

"The demand for steel in developing countries is putting coal used for steel at historic highs, as well as the thermal coal used for power. New coal-fired electrical plants under construction in the US also should add 50 million tons of new coal demand a year. almost a 5% interest above the current demand, say natural resources portfolio managers at US Global Investors.

"To be sure, some of the factors boosting coal's price are temporary. China's worst snow storms in 50 years have both increased demand and hampered delivery from the mines of northern China to the power plants in the north of China and the western region. China has been methodically closing down thousands of unsafe and inefficient coal mines until enough new and refurbished mines can be opened. And China has freed domestic prices to rise with demand, but has capped electricity tariffs. This led to power plants ordering less coal leaving them short when the storms hit. [But] other factors are not likely to change soon.

"China's demand grew 9% last year, raising China's share to one quarter of the world's consumption. Its coal industry rose from 2000 to 2006, but that growth slowed to about 6% last year. Five years ago China exported 83 million tons of coal more than it took in. Last year that surplus fell to 2 million tons. The rapid loss of 80 million metric tons to the world market amounts to about 12% of the traded international market.

"This year, predicts Gerard Burg, minerals and energy economist of the National Australia Bank, calculates that China will become a net importer of about 15 million tons."

Supply Worries

"Coal was assumed by many in the energy industry to be immune to worries about the stability of supply that had help push oil to record heights. Coal reserves are more evenly distributed in the world, and it is consumed close to where it is mined. Coal prices enjoyed a bull run in 2004 and 2005, but today's boom is bigger and is causing more concern.

"As recently as 2003, China was a critical coal supplier to Asian countries like Japan, which relies on China for 10% of its coal. But around that time China's economic expansion began to accelerate sharply, especially in heavy industries that guzzle electricity including auto-making and chemicals. Coal exports began to dwindle and imports to rise.

"Beijing began to close coal mines in 2005 to address a horrific safety record. In addition China was adding hundreds of coal-fired power stations – enough to power all of Australia in 2006 and again in 2007. According to the China Electricity Council, China's power-generating capacity rose by 18% just from last July to December, most of it fueled by coal.

"In northern China's coal belt, there were massive expansions on key rail-lines to keep the supplies flowing. But by mid-December last year last year, cracks in the coal-supply

chain started to appear. On December 11, the huge city of Chongquing announced it would ration electricity for the first time during the winter. Government officials said the overworked generators were breaking down, and there was a shortage of coal.

"By early January, the government said it had closed 10,412 coal mines and still planned to close 1,100 more. Coal prices, freed from government control two years earlier, were steadily rising. But the government was keeping caps on electricity rates to hold down inflation, at an 11-year high. Power producers began lobbying for high tariffs. They began shutting down some plants because they were unprofitable to run – and let their coal stockpiles run down to just 10 days supply, according to the Ministry of Railways.

"The worst blizzards in decades started to pummel an immense swath of central and southern China, leading to huge shortages. The vice-governor of one of China's most economically important provinces, Guangdong, publicly chastised power operators for chasing excessive profits."

Coal Shortage Hurts China's Metal Output

"A day later, Xiao Peng, the vice-general manager of China's Southern Power Grid, said the region had shut down 5% because a shortage of coal – the worst electricity shortage in five years. Other provinces reported power plants had stopped reporting electricity because they could not afford coal supplies until ordered back on line. Later in the month came the ban on coal exports.

"The coal shortage has rippled through other markets, hurting China's production of steel, copper. zinc, and aluminum, as electricity is being diverted to domestic industry and heat' China's largest copper producer, Jiangsi Copper Co., shut down some plants, contributing to high US copper futures. Jim Thompson, editor of *Coal & Energy*, a daily market news letter on the coal industry, said if global coal prices remain high, it's possible that utilities could run low on fuel too."

What we had here could serve as a nightmarish synthesis of the mayhem of the Russian Five Year Plans of the 1930s, the Enron hyper-scandal in which three of them were involved one of them leaving much of its previous bailout moneys to settle out of court with the American government courts for having planned the off-the-corporation books scam that sent high Enron officials to long terms in prison; and the nightmare of an environmentalist. It certainly could not have happened without Globalization, and Deregulation, and of course the self-balancing-market dogma.

And as for the now deeply-tooled faith in central banks' solving such a cluster of basic problems ("externalities") for most of which they haven't had the time of day. Meanwhile there may be an unexpected revival of the newspaper business just to count transmutations that the subprime mortgage business to allow the banking system to complete its risk management by derivatives to which it was aspiring.

There is an emergency need for repossessing our history especially what we learned as a result of the Great Depression, financing the Second World War, and during the first positive decades of the postwar. Our universities have been swept clean of that. It is time to deal with issues for which systems theory had promisingly been brought onto economists' horizons. That would include Keynes, Kalecki, Douglas, and any thinker with a sign of a conscious and constructive curiosity. The very concept of "debt money" – the basis of the subprime mortgage in its endless echoes and mutations is witness to that. What we need is a Royal Commission to set the enquiry on the right paths, and we need it soon. Why don't some of the opposition parties pick this up to run with in the coming elections?

William Krehm

China's Coal Mine Crisis Is the World's Problem

Though our new Bank of Canada head may not realize it, China's vast but problem-ridden coal mines are the world's problem. Both its cost in human lives on the sites and in the pollution it is sending across continents and oceans cannot be considered a strictly Chinese problem. The other megapowers and potential megapowers, with the exception of India, come with plentiful actual or potential fuel resources – the United States, Russia, Brazil. That is why the Chinese coal mines have begun receiving attention in the international press.

Thus *The New York Times* (02/09, "As Most of China Celebrates New Year, a Scramble Continues in Coal Country" by Jim Yardley) reports: "Datong, China – In China, Thursday marked the Lunar New Year and ushered in the Year of the Rat. For Chinese families, especially those of migrant workers, the holiday offers an annual opportunity to reunite. Yet for miners here in coal country, Thursday was just another workday. Vacations have been cancelled. China is too desperate for coal to allow them a day off.

"This Lunar New Year will always be remembered in China as the Year of the Storm. Freak snow and ice storms left millions of people without power in southern China, stranded millions of migrant workers trying to get home and exposed the fragility of the country's transportation system and power grid.

"The crisis is now abating, but the storm also underscored China's heavy dependence on coal, which accounts for 80% of its electricity; China has shown itself to be one large storm away from major problems.

"Faced with electricity shortages in more than half the country, the Communist Party responded with an old-style mobilization campaign. Roughly two million military personnel were mobilized to provide relief aid, help restore power and get trains moving again so that many, if hardly all the stranded migrant workers could get home by Thursday.

"Last week, President Hu Jintao visited the Tashan mine and ordered all state-owned mines to produce more coal, and produce it faster, to guarantee supply for power plants in the south.

"China's central planning agency, the National Development and Reform Commission, stated that certain closed mines would be allowed to reopen to help meet demand.

"But the short-term emphasis on production glossed over the complexity of the coal situation and raised questions about whether the government was signalling that unsafe mines would be reopened. China has the world's most dangerous mines and the government has closed thousands of small mines since 2006 to reduce the number of fatalities by consolidating the industry into larger more efficient operations."

World's Highest Fatalities

"Last year the number of mining fatalities dropped by one fifth to 3,786, still the highest figure in the world. This week, officials in Beijing insisted that the government's

new announcements were not a retreat from its safety priorities. But the Chinese media quickly found operators of closed mines who were recruiting workers and trying to reopen. Meanwhile 21 miners died in two separate accidents last week, an ominous development for an industry operating at full throttle.

"For decades Datong has been one of China's busiest coal capitals, and is known for producing higher quality coal used in power plants. The region is dominated by the Datong Coal Mining Group, one of the country's largest state-owned mining corporations, with more than 200,000 employees. In his visit last week President Hu Jintao of China descended to the floor of the Tashan mine in a spotless mining jacket and exhorted black-faced miners to dig out of patriotic duty.

"Practically speaking, that means that has meant that the state-owned mines are working overtime. At one of Datong Coal Group's other main mines, the regular quota is 150,000 tons of coal a month, according to one worker. But officials are now asking the workers to quadruple that to 600,000 tons a month.

"'We'll do it,' said Wang Ku Kui, 53, who has worked in the mine in 53 years. Mr. Wang usually gets three days off for the Lunar New Year. But his leave is now cancelled. He earns about $200 a month and lives near the mine in a mud and brick, two-room house with his wife, daughter-in-law, and grandson. And Mr. Wang is considered fortunate because he has a job at a larger, safer, state-owned operation.

"At the Hudong freight yard, the tracks are jammed with trains transporting 200 or more coal cars to the port city of Quinhuangdao. From there the coal is loaded onto ships and taken to power stations in the south.

"Mr. Hu's directive focused exclusively on the large state state-owned mines that dominate the landscape around Datong and elsewhere in Shanxi Province. Yet from the hilltop outside the view of the bleak, pocked landscape around Datong also revealed smaller operations tucked into ravines and gullies. Some of these mines lack required approvals, but are protected by local officials in exchange for a financial stake.

"A Chinese journalist who focuses on mining estimated that there were thousands of illegal mines operating in Shanxi Province despite central government edicts. Often, these mines enable the country to meet rising demand for coal as the economy continues to grow. But while the largest mines use sophisticated mechanized diggers, some small mines use mules to haul coal.

"Mr. Zhang, the energy analyst, said there was a clear correlation between small mines and accidents, but he also noted that planners might have underestimated the role of small mines to market supply. China will need more and more coal in the future, even as it tries to replace smaller, more dangerous mines with larger ones.

"Electricity rationing was already under way in several provinces because of shortages of coal reserves at power stations, Economists partly blamed pricing flaws for the problem: fearing inflation, the government capped electrical prices even though power companies must buy coal at rising market prices. Coal reserves at power stations were already at historic lows before storm knocked out rail and truck deliveries."■

Foretelling the Subprime Mortgage Mess — 2

While proofing Volume 3 of COMER's Meltdown *book series we came across this striking bit of prophesy of what was taking shape in that particular type of marvel well over five years before it happened. We quote from the October 2002 issue of* Economic Reform.

The Next Generation of Irridescent Bubbles

A high-school student will tell you that if the mother planet has gone up in smoke, there will be no gravitational force to keep that planet's moon in orbit, but economists shun raising such obvious details. They would needlessly complicate the sale of stocks and bonds. Today that conclusion can be detected across the world economy. Thus *The Wall Street Journal* (10/09, "Foreclosures Reach Record Level" by Queena Sook Kim) deals with the soft underbelly of the housing boom that has been hailed as one of the guarantees against a "double-dip recession." In recent years, the housing industry has bent over backwards to allow people to buy houses they couldn't possibly afford. Lenders require smaller down-payments and allow buyers to devote more of their income to mortgage payments. And many borrowers are being lured by adjustable rate mortgages with lower teaser rates that quickly climb, pushing up house payments.

"Now the bill is coming due. In the second quarter, a record of 1.23% of all home loans were in the foreclosure process, above the first quarter's tally of 1.10%, and surpassing the previous record of 1.14% in the first quarter of 1999, according to a report of the Mortgage Bankers' Association of America. The same report found 77% of all home loans outstanding were at least 30 days delinquent. That's one of the highest rates of the last decades though well below the record delinquency of 6.07% in 1985 [at the height of the Savings and Loans super-mess].

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

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

"Part of the reason the housing market got so hot is that lenders rushed out loans designed to cut monthly payments so that buyers could get bigger homes. It is some of these very loans that are now experiencing problems. One indication: conventional adjustable rate mortgages, popular with budget-stretched customers, have a 5.29% delinquency rate vs. a 2.75 rate for conventional fixed-rate mortgages. "The real motivation of such plans is to use the customers' credit card elbow room [another bubble in the process of coming apart] to stave off the house builders' bankruptcy with too many of the buyers merely patsies victimized as fodder to keep the derivative boom going."

William Krehm

Australia on the Interest-rate Tight Rope

The Wall Street Journal (02/25, "Amid 17-year Boom, Australia Walks Fine Line" by James Glynn) reports: "Sydney – Australia's 17-year-old economic expansion has reached a boiling point, leading policy-makers to intensify their war on inflation.

"Since mid-2002, the Reserve Bank of Australia has raised its benchmark interest rate 11 times to 7%, the highest to 1996. And it may raise rates by another percentage point by year end.

"With the world economy slowing, some Australians worry that the rate increases could go too far, ending the longest sustained period of prosperity in 50 years."

A legitimate question-mark when Australia, though blessed with mineral wealth has plenty of environmental and social problems nor should it trifle with the overstrained economy by adding to high metal prices by abusing a final tool – the high interest benchmarks of monopolist deregulated banking that put much of the rest of the world under compounding tribute – the underdeveloped countries, already cast as devotees to juggernaut deregulated, monopolist banks who have just presented the world with a master mess of greed and incompetence that still awaits disentanglement.

"'They do need to be careful,' says Bernie Fraser, who was governor of the RBA between 1989 and 1996.

"So far, however, the problem seems to be the opposite. The tightening measures haven't had much effect on the inflation rate, which could hit 4% on a year-to-year basis, in the first quarter, well above the 2% to 3% which is the central bank's target.

"Australia's economy, the fifth largest in Asia." Ouch! Australia is a proud continent on its own, not part of Asia. The *WSJ's* proofreader must have been utterly disoriented by what was passing for monetary policy, as though the Aussies were digging even deeper for their economic policy than they do for the world's metal ores.

"Australia's economy is about $^{1}/_{15}$ the size of the US has withstood past upheavals just as the Asian financial crisis in the 1990s and the US technical bust in 2000. Today it is insulated to some extent because of the rapid emergence of China and India and their hunger for Australian commodities.

"But with core inflation[1] at 16% it is in an unusual position: it is raising interest rates when many other central banks, including the Federal Reserve, are cutting rates or holding them steady.

"Much of the Australian economy is roaring strong. Unlike American consumers, who are struggling under heavy debt loads and pulling back, the Australians have kept on spending.

"Export revenue, meanwhile, is surging as coal and iron-ore producers lock in price increases of as much as 70% from steel mills and energy suppliers in Japan, China and South Korea, Nicole Hollows, CEO of MacArthur Coal Ltd., based in Queensland, expects the good times to continue as Russia and Brazil emerge as major buyers of energy products.

"In addition, farmers are benefitting from the arrival of La Nina weather patterns, which are ending years of drought. The summer grain crop is projected to rise by 40%, while the winter wheat crop is expected to set a record just as world prices surge. Farmers could add A$8 billion (US $7.4B) to the economy this year.

"The central bank and the new center-left government are determined to bring inflation under control. Prime Minister Kevin Rudd has labelled inflation the government's No. 1 challenge, pledging deep spending cuts when he unveils the government budget in May.

"The RBA said last week that it considered raising its target for the cash rate, its main monetary tool, by 0.5 point at the February 5 policy meeting but decided instead on a 25 percentage point increase because of global uncertainty."

Fighting Inflation with High Interest Rates Amidst Mounting World Deflation

"That has some onlookers warning that, as the US economy sinks into what many fear could be a severe recession. Australia's war on inflation should be tempered. Bob Gregory, a member of the central bank board between 1985 and 1995, says there is an increasing risk that the central bank's rate increases will 'overshoot.'

"'You do get locked into the potential for overshooting, because you get frustrated at the lack of success,' he says."

Otherwise said, you persist in a policy because it doesn't work. What an epitaph for a possible tombstone for our civilization!

"Mr. Gregory warns that Australia's growth is uneven, with mining states fueling growth. Using the blunt instrument of interest rates could harm other parts of the economy, he says.

"The central bank said in its latest policy statement that it expects annual non-farm growth to slow to 2.75% from a 4% pace in the third quarter of 2007. There are signs that the rate of increases may be starting to take a toll. Sentiment among some business and consumers is falling as their debt-service costs rise. Exporters – particularly those outside the resources sector – may have a tougher time as interest costs rise, pushing up the Australian dollar.

"In addition, banks are confronting rising funding costs. The heads of two major banks have warned that their costs have risen and their customers may end up bearing the burden.

"Too much tightening would be disastrous for the economy But too little could fuel the kind of inflation that in the past required a severe recession to smash."

Why then don't the Australians invest their surplus revenue for essential public investments – ecological improvements, education health, education and treat those investments for what they are – the soundest investments that a nation can make. Then you would not have to pay our banks from bailing them out of problems that their greed played a key part contributing to? Of course, since such advice – known and applied in our part of the world has been ploughed under with disastrous effects at home, we do have plenty left to export abroad. What we need in every part of the globe is to reclaim the most successful parts of our own history, and what we learned at a crushing cost in the 1930s and in World War II. And now the military option – where word of what did work has been banished from our university curricula, there remains only the military option, which has been busily applied for a disastrous decade and more.

W.K.

1. "Core inflation" is a classification, ever more senseless that the financial establishment refused to trash though it cripples any serious analysis of what is afoot in the world economy. It removes oil and food prices. When last heard from, everybody prefers eating and heating their homes in winter and cooling them in summer, as well as receiving more of what they consume brought to them across oceans because of globalization and deregulation.

Meeting Canada's New Central Bank Head

Canada has herself a new central bank head, but the question that the first public talk that the gentleman in his lofty new post raises is, how different is he from his recent predecessors? Unfortunately, not very. And that can be a serious defect in a country where the very words "banking" and "debt" have lost much of their meaning when packages of subprime mortgages, in which no one amongst lender, the borrower nor the agent driving the deal was aware of what might be afoot, and the whole was nevertheless dubbed "risk management." Rather than explaining to the pubic how such a nightmare was possible, the first official public appearance of our new Bank of Canada Governor, Mark Carney, as reported in *The Globe and Mail* (19/02) suggests that this land is not likely to be led out of the woods, by our new head central banker. In this opening address he crossed the Pacific to give China the benefit of his banking wisdom. "China shares blame for crisis, Carney says" by Heather Scoffield, Ottawa, and Wendy Stuek: "Vancouver – China should be held partly responsible for the subprime-mortgage meltdown." Surely he could have saved a lot of car-fare if he concentrated to begin with on the portion of the blame honestly earned right here at home.

Or was it that he wanted to proclaim his servility to Washington? For just two days later in *The Wall Street Journal* and probably in just about every newspaper of significance across the globe came the article "Harsh Climate in Washington Ices 3Com Deal" by Matthew Karmitchschnig, Greg Hitt and Bobby Whie: "A closely watched Chinese investment in a US network technology company has fallen to political pressure in Washington, revealing new limits for deal-makers who expected foreign buyers to invigorate a foreign deal market.

"The tech company 3Com Corp., which agreed in September to be acquired by private-equity firm Bain Capital LLC and China-based Huawei Co. for $2.2 billion, said the three had withdrawn an application to the Committee on Foreign Investment in the US or CFIUS, a 12-agency government panel that reviews the national security implications of foreign-led deals. The decision signals that the government wouldn't have approved the deal, according to people familiar with the matter, fearing that Huawei's influence could have put government secrets at risk.

"The company makes telecommunications and computer gear and supplies the US government with some security software. Under the deal Huawei would have held a passive 16.5% stake in 3Com with Boston-based Bain owning the rest.

"The reverberations of the decision could be significant for deal-makers, who are increasingly reliant on foreign capital for acquisitions as the debt-fueled buyout cycle has petered out. US authorities have allowed banks, including Citicorp Inc. and Bear Stearns Cos. to accept billions of dollars in Chinese and other foreign funds to help shore up their balance sheets in the wake of the credit crisis. But the rejection of the 3Com transaction is a clear rebuke of Chinese designs on US technology companies in some sensitive industries. Had it succeeded the deal could have served as a blueprint for similar transactions by Chinese companies."

More Pro-American than the Yanks Themselves

It is into this fray that our new head of the Bank of Canada has plunged in his first public address in that capacity – even to the total exclusion of the tangle of absolutely surrealist problems that have snarled up our financial system. Is this a complete return to the good old days of Brian Mulroney, when our top officialdom often turned out to be more pro-American than the Yanks themselves. Then Governor Carney continued, "China should be held partly responsible for the subprime-mortgage meltdown that has dragged North America into a slump and repeatedly rocked financial markets around the world.

"In his first speech as Bank of Canada Governor, Mark Carney said interest rates will have to fall further in Canada to fend off the slowdown from the US. His forecast for slow growth in Canada was in line with the expectations of his predecessor David Dodge. But Mr. Carney saved much of the focus in his academic-style speech for the economies of emerging countries especially China. By insisting on fixed exchange rates, China and other emerging markets have become a main exporter of capital to such an extent that that they have been significant drivers of lower global long-term interest rates."

There is something about this initial statement that verges on the absurd at a time when the leading master-banks are depending so utterly on loans and investments by "sovereign funds" of the developing countries including China, Singapore, the Gulf Emirates. To track it to its origins requires that we take our readers for a brief tour of how the Bretton Woods Conference that determined the post WWII international monetary system. Initially John Maynard Keynes, heading the British delegation, outlined his own very different model for the economic relations of nations after the war. However, Keynes had no alternative but accept the American views that reflected the deteriorated position in which drained Britain was left after the war. Even individual parts of its own empire that was breaking up had to be repaid for their war loans to Britain let alone the US.

Earlier Keynes had advanced a model for placing the responsibility for the longer-term balancing of any obstinate accumulation of indebtedness between nations on both the creditor and the debtor countries, rather than on the debtors alone. Either the creditor countries would have to increase their investment in the given country or that country would be allowed to export more to the creditor nations. And if the debt had not receded in a given period, it would fall forfeit to the future international body of nations to be used for philanthropic ends. Nothing came of the Keynes plan and Keynes had enough practical sense to grasp that he had nothing to pit against the unmatched political power of Washington. Under the policy finally adopted, the US alone decided the gold value of the US dollar, and the other nations dealt only with the exchange value of their currencies in dollar terms. The US dollar became effectively as it were, the subprime gold standard for those without gold. In this many of the under-developed and supposedly "developed" lands were dependent on loans from the International Monetary Fund that placed severe conditions for granting such loans – e.g., doing away with the statutory reserves that they had required their banks to redeposit with their central bank that would permit their governments to achieve a better command of their debt. The abolition of these interest-free funds made available to the local government via its central bank combined with the progressive increase of prevailing interest rates prevented most underdevel-

oped nations from even making a dent in the debts that they incurred with the IMF. Such IMF debts were chains that grew ever heavier, never to be shaken off.

That is why China and other Asian governments were greatly influenced by the remarkable new model for its foreign trade that Japan had developed after its defeat in World War II. Its goal was to reorient its entire future export trade to leave a greater net residue of the foreign exchange it brought to Japan in that country rather than having to be spent to pay for the raw materials and machinery that went to manufacture the exported items. Before the war, Japan's exports were largely textiles and the raw cotton for that had to be imported, since it is not produced in Japan. The Japanese veered step by step to this new export model that would leave them with a greater net percentage of the gross foreign currency from its foreign trade. Starting with earth-moving machinery, it passed on to heavy machinery, and ultimately won for themselves a supreme position in the export of automobiles.

And part of the plan was to avoid having their commercial successes drive up their currencies, since that would choke off their key exports. That was avoided by investing their surplus foreign currency abroad. The Chinese carefully studied this aspect of Japanese policy and to a significant extent are imitating it. This they judge vital for handling their vast social and environmental problems. Whatever bargaining may take place between the Chinese and Canadian governments, it is foolish and irrelevant for our new Governor to highlight China's share of the blame for our troubles. Our government, taken over by our speculative financial sector has been completely servile to Washington's whims. Mr. Carney's maiden effort as governor is only another instance of that and bodes ill for what may lie ahead. And to bail our banks out from the consequences of their resulting adventures, our government has repeatedly despoiled our national treasury and vital social programs, which were unloaded onto the provincial governments without adequate funding. The provinces, for their part, lost no time in passing on the kindness to our municipalities, who were left holding the ultimate bag. And of course, no less foolish is the impression left by our new BoC head that low interest rates per se are at fault for Canada's monetary disasters.

Our central bank has had done violence to its very genetic code of central banking in Canada. That, of course, is its charter, the *Bank of Canada Act*. To it Mr. Carney would have been well advised to give his initial attention. For that lies entirely within the control of the government of Canada and its appointee as Governor of the BoC as set forth in subsection 14(2) of the *BoC Act*. The Governor must obey the written instructions of the Minister of Finance after having received them. This Act was adopted when the Bank of Canada was nationalized in 1938 when 12,000 private e shareholders were bought out at a good profit within 4 years of the bank's founding. That charter is still on our law books and can readily be reached via Google on your computer. In it is clearly set forth that the government may finance the federal and provincial governments by trading (and hence holding) their funded debt or their unfunded debt – up to one third of the annual budget of the federal government and up to one quarter in the case of a province, of unfunded debt that must be rolled over each year as is done by private banks. The case of municipalities – included under "other corporations" – is covered in subsections 18(c) and (k) of the Act – their needs can be financed by the BoC only with the guarantee of either senior level of government.

The Immense Advantage of a Central Bank Used as the Government's Banker

When that is done, the interest paid on any loan to the federal government comes back to it substantially as dividends. In the case of the provinces, the interest on a loan extended to them by the central bank would not go to them since they are not shareholders of the central bank. It would go, as do all dividends, to the federal government. However, the provinces and the municipalities have some very cogent arguments for negotiating a settlement with the federal government that would divert to them part of the interest paid by them on loans from the central bank. The provinces lost little time in passing on the compliment to our municipalities where it remains recorded in the potholes in the streets of our richest cities, the rise in crime and the decay of our schools and hospitals. And the unrelenting climb of our university fees, and much, much else.

The private banks had been repeatedly recapitalized from their heavy losses in real estate and gas and oil, by the federal government quadrupling its deposits with the private banks from $20 billion to some $80 billion, at the same time as interest rates were pushed into the skies by the BoC. And the statutory reserves which had to be deposited into non-interest-paying accounts on all short term deposits. These gave the government the non-interest-paying use of legal tender to repay it for some of the bailout costs and the guarantees our government offered bank depositors. As well it was considered an extension of the monopoly of the ancestral monarch in the coining of precious metals, replaced today by plain bookkeeping entries, backed-up, however, by the tax-base of the government – that is by all the wealth of the nation And during that time the Bank for International Settlements – a sort of international central bankers' club operating from Basel, Switzerland, raised interest to as high as 20% "to lick inflation."

But what all the central bankers assembled in Basel had overlooked *to the last man* is that when interests rates go up, the market value of pre-existing bonds with lesser coupons crumbles. Of course, that would include the mountains of government bonds our banks were allowed to hoard without putting up a penny of their own money, because they were allegedly "risk-free," and were needed to replace the capital that our deregulated banks had lost in gambles incompatible with banking.

That not only brought the Mexican banking system to ruin – to the point that it had to be nationalized again though it had been privatized only a few years earlier. The crisis echoed in Eastern Asia and Russia and threatened to flatten the world monetary system. At that point President Clinton's Secretary of the Treasury Robert Rubin came up with two solutions. One was a standby rescue fund of $51 billion – the largest ever to that date to which the IMF and Canada as well as the US contributed. But Rubin, an old Wall Street hand, grasped that the day of high interest rates was over, since there was no question of depriving the banks of their bond hoard acquired entirely on credit. He brought accrual accountancy, also known as "capital budgeting," into the books of the federal government. Up to then the investments of the federal government – say bridges, buildings, roads, heavy equipment that would last years or generations had been written off in a single year and from Year Two carried on the government's balance sheet at a nominal one dollar. But on the other side of the ledger the debt incurred to finance the acquisition or building of the facility was amortized over its likely useful life. What resulted was a deficit that was not really there. But it served an important class purpose, and

hence the government had turned a deaf ear to its auditors' insistence that serious double-entry bookkeeping be introduced. Now it realized that the days of sky-high interest rates were over, almost surreptitiously the government brought in accrual accountancy for the government's physical investments. As of January 1996 it began depreciating them over their likely useful lives. In this way, carrying back the accrual accountancy readjustment to 1959, well over one trillion dollars of neglected physical assets were recouped. But they were not called "investments" because governments were not supposed to be able to make investments, Only banks which governments had to bail out every seven years or so were capable of that. So it appeared under the heading of "Savings" which usually refer to cash or near-cash, which 50-year-old bridges or buildings definitely are not. But in such matters it is the disguise and the war paint that prevail, rather serious bookkeeping or logic.

With that – a wink to the bond rating agencies who knew the score and the practice – completed the job behind the backs of the electorate. The improved ratings that the new figure – even with the misstatement of what was really involved. The improved rating that resulted brought down the interest the government paid for its borrowing. Those lower interest rates gave Clinton his second term and prolonged the high tech boom until it led to the high-tech bust early in the new millennium.

That helped provide the plethora of inexpensive money that Governor Carney referred to as responsible for the subprime trouble. It was not the low interest rates, but the further and ever more brainless gambling that the banks were encouraged to indulge in that led to the multi-layered skullduggery that gave rise to the subprime economy.

Actually there remains a rich and growing layer of further public investment that is still being ignored though it had been brought to light almost a half century ago. That is human capital represented by the stock of knowledge, education in the population and hence in its health and psychic well-being, and its state of peace with its environment. This was another instance of something discovered and celebrated and then ruthlessly buried because it does not advance the interests of the group in power. After WWII, Washington sent many hundreds of young economists to Japan and Germany to estimate how long it would take before the two great defeated powers would become formidable competitors on world markets again. In the 1960s Theodore Schultz, one of these, at the University of Chicago, published his final judgment which ran more or less as follows: "It is remarkable how wide of the real mark we were. The reason: we concentrated on the physical construction and ignored the fact that the work force, highly skilled and dedicated, had come out of the war in both these countries essentially intact. Conclusion: the most productive investments a nation can make is in human capital." For this he received a prize from the Bank of Sweden, was briefly celebrated, but was then ruthlessly forgotten. His important conclusion belongs to the huge bulging library of buried – because inconvenient – great economic truths."

The Immense Value of the BoC as Government Banker

The interest paid on these cost-free returns – less overhead costs of the bank – came back to the government in the form of dividends. During World War II great use was made of this clause, and Canada did more of its financing of its part in that war in this way than either the UK or the US, both of whose central banks were still privately owned. But even then almost the same proportion of the interest paid by the central government on its borrowing from the bank – the monopoly of the ancestral sovereign in coining precious metals come down to the current government in its current form of creating government-backed credit. It should be made clear that interest paid to the BoC loans to the provinces and the municipalities do not in any way come back to them, except by some arrangement with the federal government who is the sole shareholder of the BoC, and alone ultimately responsible for its basic policy (subsection 14(2)).

Since being deregulated in order to engage in non-banking financial activities, which had been prohibited since the crash of 1929, more often than once a decade the banks have been bailed out from the loss of much of their capital in gambles incompatible with banking. The non-financial pillars that banks were prohibited from entering under the laws passed under President Franklin Roosevelt beginning in 1933, did not allow them to acquire any interest in stock brokerages, insurance and mortgage corporations. The reasons are evident from American history in particular. Allow them access to the cash reserves of these corporation needed for their own business and they will irresistibly use them as the legal tender for applying the bank multiplier – confusing legal tender – debt of the central government that bears no interest – just your coins and bills in multiples of dollars, and interest bearing debt of banks that do bear interest and are loaned into existence rather than spent into existence as happens in the case of legal tender issued by the government itself.

There you have the founthead of the present mess. Cash – which is the money issued by the central bank – is payment of government obligations and does not bear interest. Such legal tender is *spent* into existence by the government, rather than *lent* into existence when issued by private banks. Not bearing interest, legal tender or "cash" does not move inversely to the movement of interest rates as do loans issued by private lenders. You sense that right there were are drawing nigh to the very root of the present submarginal mortgage mess. The notion of central government – backed debt that has the entire credit of the central government, of every taxpayer, and every material resource available to central governments, but is still a debt is a closed book to economists these days. Banks have purged from their minds the very notion of legal tender being a debt that is not to be packaged with other debts and assessed for the risk involved. The very notion of the government having its cash assets in asset form not bearing interest is intensely revolting to speculators, as well as confusing and unprincipled. Hence the mania for privatizations and a capital asset is recognized as such – the sanctifying ritual as it were is that it can throw off revenue or better still be traded for an immediate capital gain.

However, no matter how intense such emotional prejudice against restricted financial markets may have grown to the utter disregard for the realities of production, we have reached a point where the economic incoherence of the producing economy has been breeding dysfunction in our economic plans and thinking. Our central bank heads and our Finance Ministers have become incapable of sorting what needs sorting out and adding what should be added up.

Now it would seem that the good Lord above seems Himself concerned about the state of humanity's economic affairs. That is the most likely explanation for some remarkable coincidences and revelations of what those in power here below have gone to. Earlier in this article I remarked that the *Bank of Canada Act* setting forth the powers of the Bank of Canada to lend money not only to its one shareholder the Govern-

ment of Canada, but to the provinces and with the guarantee of either the federal or a provincial government, even corporations which would include municipalities. I also drew attention to how a disproportionate amount of the speculative losses endured by our banking system has ended up with a downloading of vital programs by the feds and the provinces without the resources to pay them. As a result from time to time dozens of municipalities over the years have contacted the Bank of Canada enquiring about getting a loan for some urgent capital facility, a school, a bridge, a firehall. The answer is always the same and thoroughly misleading – the Bank of Canada is not empowered to provide such loans. But we have already quoted chapter and verse of the *Bank of Canada Act* which you can – courtesy of Google – reach on the internet. How is an Act that is violated by the government and the Bank of Canada every day of the week allowed to go on existing providing evidence that some of our very highest officials elected and appointed deny its existence, let alone provenance. How did this come to pass?

The answer is that Prime Minister Mulroney was so subservient to Washington that he wanted to outstrip it by putting into our Constitution, which was drawn up in 1982, provisions that Washington imposes on Third World countries but would think several times before putting into its own basic laws. One is zero inflation as a norm that must not only be approached but actually realized at all times. And the independence of the Bank of Canada from the government – notwithstanding that it was the government that purchased all the shares in 1938 when money in the depression was scarcer than hen's teeth. How did they get into our law books though they almost did make it to the Constitution that requires special measures to remove once it were included. The answer for the mystery is that in the early 1980s the Brian Mulroney government did try putting these two items into our constitution, but his own caucus of the Finance Committee of the House of Commons turned him down on the matter. After that Mulroney didn't raise the matter again. That explains why the *Bank of Canada Act* providing for financing of all levels of government is still unused in our law books.

But the powers on high, apparently shocked at what goes in our official circles have not allowed matters to rest there. Though I am not a theologian, I have the conviction that it is far from an accident that the KarlHeinz Schreiber case should have blown up again accusing Brian Mulroney of having been paid variously reported as $100,000 to $300,000 in cash for non-performed lobbying services. But Mulroney will be in the witness box. I am sure that the Powers have made him available so that we can query extraordinary pains to hush up to get Brian Mulroney in the witness box to ask where he got the idea of putting the two measures in the Constitution of Canada where the US did without them. On whose initiative and under whose pressure was Canada pressured to be holier than the Pope?

Until we resolve the matter of getting our central bank to provide the services for which it was founded in 1938, it will bumble along to provide ever greater freedoms to gamble away crucial resources of this country.

William Krehm

How Irrelevant Can Central Bankers Get?

The Wall Street Journal (02/22, "Many Factories in China's South Sound Last Whistle" by Mei Fong in Beijing and Sky Canaves in Hong Kong) reports two days after Mr. Carney's strange introductory talk which seemed intended to show how irrelevant central bankers can be to anything but currying favour of a master class.

In his introductory talk he had taken China to task for keeping interest rates lower than they should be. The article printed by the *WSJ* just two days later revealed China losing its industries because of the competition of other cheaper Asiatic countries, rising interest rates and major rivalries with other parts of China and some of its cheaper neighbours. The purpose of Mr. Carney's introductory excursion would seem to be primarily to curry favour with the powers that be in Washington rather than anything that can be honestly related with the formally acknowledged business of a central banker: "China's Pearl River Delta – the southern coastal area that in the past two decades has become the world's factory floor for low-end goods – is losing thousands of factories.

"Rising costs and tighter regulations are making the region less competitive than other Asian manufacturing hubs, including other parts of China. New Labour laws and higher taxes for foreign-invested companies, combined with tougher environmental rules and a strengthening Chinese currency, are squeezing Chinese companies that make labour-intensive products such as toys, clothing and furniture.

"This year 'will probably mark the year (China) manufacturers were finally forced to take a general hit on profitability,' UBS AG economist Johnathan Anderson said in a note Monday.

"'The Federation of Hong Kong Industries estimates 10% of the 60,000 to 70,000 Hong Kong-owned factories in the delta region will close this year – likely the highest rate of closures in 20 years,' says Deputy Chairman Stanley Lau. Some of these operations have been closed for good, some moved inland and some relocated outside China.

"In the past year more than 1,000 shoe factories and suppliers have closed in Guang-Dong, which is home to the Pearl River Delta and which has provided about one third of China's exports. That is roughly 10% of the footwear manufacturers in the province, says Li Peng, Secretary-General of the Asian Footwear Association.

"Douglas Sheridan, president of Hong Kong-based sportswear supplier Net69, says 'it is the first time I have seen so many elements hitting us at once in China. At a recent trade fair in Munich, Germany, everyone was talking about who they are working with in South China, and whether they'll still be in business,' says the 25-year industry veteran who is now setting up a joint venture in Vietnam and scouting other locations outside China.

"The changes buffeting low-end manufacturing are likely to be long-lasting. They are driven in part by the Chinese government's effort to redress some of the imbalances brought about by decades of breakneck growth such as poor working conditions and pollution. Beijing also changed its corporate tax rates this year to phase out tax breaks given to foreign companies, which dominate the export sector. And rising prices for oil and other commodities have added to the pain, as has China's strengthening yuan, which gained nearly 7% last year against the dollar, making Chinese goods more expensive to buyers in the US."

Chinese Yield on Exchange Rate

The Chinese have already yielded to the pressure from other countries to allow a degree of increase in the exchange value of their currency. You might expect the head of a central bank to keep abreast of such details unless his goal is to assure his popularity with Washington.

"The shift in China's light manufacturing sector is sending ripples around the world. Factory owners are looking beyond Guangdong and the Delta – where the cost of living and hence wages have become relatively high – to new locations deeper inside China. They are also turning to poorer countries with lower wages levels – countries like Vietnam and Bangladesh – and possibly longer, and more complex supply chains for the buyers such as the Wal-Mart Stores Inc.

"Prices have already been rising at a quickening pace in recent years in the financing of day-to-day operations.

"On Monday, the US toy company Hasbro Inc. said it expects goods it sources in China to jump 14% to 15% this year.

"China retains a number of advantages in manufacturing. The current pain is concentrated among producers of inexpensive, labour-intensive goods, whereas the majority of Chinese exports now are machinery and electronic goods like auto parts or computers.

"Beijing has encouraged manufacturers to switch to such higher value goods, in which labour costs are less a driving factor. China also boasts roads and other infrastructures superior to many other developing countries. This means China will remain a force in manufacturing for years even if its traditional advantages in light manufacturing along the coast erode.

"Perhaps the biggest catalyst is a labour-contract law that took effect January 1. Employers say the law has shifted bargaining power in favour of employees. The number of cases filed for arbitration has been increasing at a rate of more than 25% a year since 2002.

"China's leadership is also bolstering efforts to combat rampant environmental damage from decades of almost unfettered manufacturing that that has polluted skies and rivers in the region."

This synopsis of a much longer article reveals a far, far more complex situation than the one that our new central bank chieftain summed up as addiction of Beijing to low interest rates.

W.K.

Inflation Casts a Disturbing Shadow Over the Near East

By now many of our readers will know that when we use such terms as "inflation" we refer to something far better-defined than any rise of the price level. The price rise that *The New York Times* reported in its issue of 25/2 ("Rising Inflation Prompts Unease in Middle East" by Robert E. Worth) fitted substantially into a sloppy all-embracing use of the term. Certainly no great funds have been spent for educating the ordinary run of Allah's faithful, male or female, for health or science with the exception of a very few areas such as the United Arab Emirates. Some of these are not only providing what is lacking in this respect across most of the Muslim Near East, but are so adept at that as to have begun playing bankers in their hour of need to the Western lands run ineptly by their traditional bankerdoms.

The *Times* piece comes up with some very focused details. "Here in Jordan, the cost of maintaining fuel subsidies amid the surge in prices forced the government to remove almost all the subsidies this month, sending the price of some fuels up to over 75% overnight. In a devastating domino effect, the cost of basic foods like eggs, potatoes, and cucumbers doubled or more.

"And in Saudi Arabia, where inflation had been virtually zero for a decade, it recently reached an official level of 6.5%, though unofficial estimates put it much higher. Public protests and boycotts have followed, and 10 prominent clerics posted an unusual statement on the Internet in December warning of a crisis that would cause 'theft, cheating, armed robbery, and resentment between rich and poor.'

"The inflation has many causes, from rising global demand for commodities to the monetary constraints of currencies pegged to the weakening American dollar. But a key cause is the skyrocketing price of oil itself, which has quadrupled since 2002. It is helping push many ordinary people toward poverty even as it stimulates as new surge of economic growth in the gulf.

"'Now we have to choose: we either eat or stay warm. We can't do both,' said Abdul Rahman Abdul Raheem, who works at a clothing shop in a mall in Amman and once dreamt of sending his children to private school. 'We're not middle class any more; we're at the poverty level.'

"Some governments have tried to soften the impact of high prices by increasing wages or subsidies on foods. Jordan, for instance, has raised the wages of public sector employees earning less than 300 dinars ($423) a month by 50 dinars ($70). For those earning more than 300 dinars, the raise was 45 dinars, or $64. But that compensates only a fraction of the price increases, and most people who work in the private sector get no such relief.

"The fact that the new inflation is coinciding with new oil wealth has fed perceptions of economic corruption and economic injustice, some analysts say."

Riots Over Food Prices

"In a few places the price increases have led to violence. In Yemen, prices for bread and other foods nearly doubled in the past four months, setting off a string of demonstrations and riots in which at least a dozen persons were killed. In Morocco 34 people were sentenced to prison on Wednesday for participating in riots over food prices, the Moroccan news service reports.

"Inflation was also a factor – often overlooked – in some recent clashes that were seen as political or sectarian. A confrontation in Beirut between Lebanese Army soldiers and a group of Shiite prisoners that left seven people dead started with demonstrations over power cuts and rising bread prices.

"In Bahrain and the United Arab Emirates, inflation is in the double digits, and foreign workers, who constitute the vast majority of the work force, have gone on strike in recent months because of the declining purchasing power of the money they send home. The workers are paid in money pegged to the dollar and their salaries – translated into Indian Rupees and other currencies – have dropped significantly.

"'The Middle East's heavy reliance on food imports has made it especially vulnerable to the global rise in commodity prices in the past year,' said George T. Abed, the former governor of the Palestine Monetary Authority and a director of the Institute of International Finance, an organization based in Washington.

"'For many basic products, we don't have free market prices, we have monopoly

prices,' said Sumer Tawil, a former minister of national economy in Jordan. 'Oil, cement, rice, meat, sugar: these are all almost exclusively imported by one importer each here.'

"In the oil-producing gulf countries, governments that are flush with money can soften the blow by spending more. The United Arab Emirates increased the salaries of public sector employees by 70% *this month*. Oman raised them 43%. Saudi Arabia also raised wages and increased subsidies on some foods. Bahrain set up a $100 million fund to be distributed this year to people most affected by rising prices. But all this has the unfortunate effect of increasing inflation, economists say."

There the economists and the journalist reporting their concerns trip into a trap of economic dogma. Prices can go up because of genuine inflation – more tidily defined as an excess of demand that cannot be met by an insufficient supply. But they can also go up for a variety of quite distinct situations – society may be evolving from a rural economy to a highly urban one which called for all sorts of public services that results in a deepening layer of public services, that are not marketed but paid for through taxation. And that results in a deepening layer of taxation. Raising interest rates can shatter the economy and lead to deflation. The situation may be worsened if the public infrastructures are treated as a current expense and written off in a single year, while the money paid to procure them is carefully amortized over more or less the useful life of the infrastructure that they have paid for.

Once the Islamic governments embark on the current Western fixation on high interest rates to force down prices in Islamic lands, they are looking for major trouble and will have, indeed, found it. For Islam singles out the taking of interest (if repeated) as a mortal sin. When Islam broke through to the Mediterranean the only Christian power that would trade with them – and vice versa – were the Venetians.

To be able to so, the Doges devised a special form of association between the merchant who travelled with his goods and the financial partner who shared the risk with him. That cleared them with Islam because the financier of the expedition shared the risk of the entrepreneur. Our current public policy in the west has moved in the opposite direction, and made of high interest rates the only recognized means of combating rising prices. There is no foretelling how that singling out of higher interest rates as the only way of fighting inflation – mistaking any rising price that might reflect not an excess of demand over supply but purely structural changes in the care we take of the environment, or increase in average life spans, or planet warming. Put together the real economic relationships and the bad economics that the Arab lands have had foisted on them by the West, and you have a neglected factor that has added needlessly to the blood and hatred between our two cultures.

We must bring back to light and discussion what has been suppressed in our universities and governments since the 1960s. The penalty for failing to do so, can be fatal for the prospects of the civilization as we have known it, and to our relationship with other cultures.

William Krehm

The Tangled Roots of Our Money Crisis

The accelerating pull of technology can cause difficulties in society keeping up with resulting institutional changes. That is particularly so when the interested group who may be riding society bareback enter an area of inhibitions. This can be identified in their most different concerns. At the moment in the midst of the US presidential election the public is clearly at a loss whether to see in Hillary Clinton a pioneer female aspirant to the presidency or simply lady of a previous president engaged in reclaiming the White House to give it a good house-cleaning.

But that is the merest bauble in comparison with the seemingly endless varieties of debt that have suddenly come to stand between citizens throughout the world and the money that is rightfully theirs, but subject to the far from small detail that it has suddenly become unavailable. Ever since 1971 when under President Nixon the United States. departed the gold standard, the only remaining legal tender – i.e., what had to be accepted for the settling of accounts – was the debt of the central government, logically enough since that amount owing the government had a call through taxation and all other resources of the land. That, however, obviously clashed with the narrower interest of money lenders of every degree of evolution from village usurers right to world bankers. But the debt of government had to be spent into existence by the government if it were to serve as money. Since both coins and paper bills incurred no interest as did bank or private loans their value did not move inversely to the prevailing interest rates. The characteristic trait of that near-money is that it was not *spent* into existence but *lent* into existence. And every time the official bank rate moved the value of pre-existent interest-varying bonds moved in the opposite direction from that of current bank debt.

And by 1971 the banks had come out of the doghouse where they had been confined strictly to banking and had been forbidden to acquire interests in the so-called "other financial pillars" – i.e., insurance and mortgage companies and brokerages. As we have explained elsewhere in this issue of *Economic Reform*, the reasons for this were compelling enough. Each of these other financial pillars, maintained its own pools of liquidity for the needs of its own business. Allow the banks to lay their hands on that and they would use it as the legal tender basis for further money creation. That, indeed, is precisely what happened above all in the 1970s, the 1980s and 1990s. That was one of the sources of the plethora of money that served as the kick-off for the current collapse of money markets. That multiplied the money supply frantically seeking investment throughout the world.

Money created by bankers demands interest. During the latter part of the Depression of the '30s, the World War, and above all in the quarter of a century after the war, the banks were excluded from the other financial pillars. When the banks were allowed to enter these in the 1970s many did in fact lose much of their capital every seven years or so, since they lacked experience in those fields, and creating both the base legal tender and the application of the banks multiplier to this money base, the limits between the two became vaguer and vaguer. So that by the end of the millennium the ratio of interest-bearing money that had been lent out by the banks to the cash they owned that had amounted to about to about 10:1 of the legal tender in the banks' possession, by 1998 that ratio had reached 400:1. Moreover, rather than preserving the walls between legal tender that bore no interest, and near-money that did, by 1990 the US banks had brought in interest-bearing che-

quing accounts that eradicated them. Less and less was a clear line drawn between the legal non-interest bearing cash or calls on such cash that the banks owned, and the ever-higher skyscrapers of interest-bearing debt that arose on that foundation.

A Change of the Monetary System Never Fully Recognized

Such was the reality. But equally important was the distinction between non-interest-bearing debt of the government which was the only true legal tender and the interest-bearing money reared on top of it was not. That was lost, leaving a stench of cooked off-book accounting behind it.

Not only did the government allow the banks to take over creation of interest-bearing near-money, but the bailing-out of the banks from their ever greater losses laid a weft of complicity with the banks. Substantial election funding came as a matter of course. University textbooks and staffs were purged of everything and everybody that might remind the public that the gold standard had ended in 1971, and only the debt of the central government remained as legal tender in the land.

Thus during the election that confirmed Paul Martin, former Finance Minister of Canada as Prime Minister, a specially rigged audience was gotten together by the government broadcasting chain, CBC, to ask questions of Mr. Martin. One of the inevitable questions carefully scheduled of these was "How much will you reduce the national debt? In all earnestness the former Finance Minister replied, his government would reduced its debt by 25%. Not a mention that would be deflating the economy, since no other money existed. Nor did the former Finance Minister shy from saying just how long it would it would take to retire the entire debt. I remember his answer was 25 years.

Without this grossly misleading answer we would not have had the multifaceted debt crises that it has become keeping track of debt in this land. Debt of any sort, but most of all government debt was earmarked as the villain. But meanwhile debt was created almost entirely by the banks but never in sufficient quantity because not only banks even more than other enterprises had to go on expanding at an ever accelerating clip. Moreover, the volume and the rate of acceleration of the expansion had to increase at an exponential clip so that the executives' stock options would not become worthless. And then it turned out that the process of repaying it had seriously stalled. First came the great revelation of something that had escaped the notice of the Bank for International Settlements, a sort of central bankers' club in Basel, Switzerland: if you allow the banks to bail out from their losses by declaring the debt of advanced countries risk-free, and hence requiring no down-payment, they could load up with such debt without slapping down a dollar bill, and simple cash the coupons. But what the central bankers of the world overlooked was that when you load up with government bonds bought entirely on credit and then raise interest rates to the skies to "lick inflation," you are going to have a collapse of the market price of the hoards of bonds issued earlier. But that is what happened and almost brought the world financial system to a collapse in 1994. The Americans saved the situation by introducing double-entry accountancy in booking their physical capital investments. Previously they had written it off in a single year, and this had shown a huge debt that was not necessarily there. Now they brought in accrual accountancy – depreciating the debt over the probable useful life of the asset, but amortizing the debt in a similar way. Any private corporation that had used the earlier anti-accountancy would have been fined or worse. But the false deficit that it created helped immensely in keeping down wages and taxes. Carried back to 1959 it turned up well over a trillion dollars of capital assets that had been ignored. Though – characteristically – this is misnamed "savings," since savings usually refers to cash or assets readily transformable into cash – not bridges, buildings, highways, and so forth, that was inevitable because governments according to the creed of the financial sector in power were not supposed to be able to make investments. Instead it was the banks that governments bailed out every seven years or so who could.

But it was enough to show the bond rating agencies the item with a nudge and a wink, and they understood the game that was being played, and interest rates came down substantially.

The Fiction of Risk Management

And that contributed to the excess of money at low interest rates that took over, craving investment, any investment. "Risk management" packaged all grades of home mortgages together and then from it cut out the alleged combinations of risk to the client's wishes.

It was thus a systematic pairing of hard fact with convenient fiction, that led to the present overstocking of problematic debt. It all stems from hiding the fact that our money is basic debt – but of central government – and the only legal tender in the land. When you issue bonds that are not redeemable or cannot in fact be redeemed into this highest category of debt – government debt called "cash" – you are asking for bubbling trouble. And since the different sort of non-government debt gets packed together and then sold with nobody left in charge to supervise the payments of the debtors, the headaches are already under way. Once the banks became involved in further adventures of this and many other sorts incompatible with banking, you are well on the way to ever greater problems. With banks unable to avail themselves of the "banker's exit," i.e., "finding a greater fool," they have to resort to ever cheekier improvisations to fill the gap. For they can hold subprime mortgages because they were told that their risk had been managed by derivatives, or the banks – run out of their own cash – can organize auctions at irregular intervals to determine the rate of interest that will bring the bidders to enable the bank to pay back the cash received to cover the holder of the debt. There is debt and debt of different virtues and shortcomings that no one suspected a year ago – insured debt, but the insurance company may have been down graded from three AAA rank to just two. There are special ways of raising cash for student loans – at no bargain prices – or for insuring municipal's payments for public works, auctions to cover short-term debt running much longer but renewed by auctions run by banks for the borrower to save some interest and the banks filling a gap in its capital. Sometimes the longer-term investor may save a percent or two, but at other times the end result can only be described as obscene. The Business Day section of *The New York Times* of 15/02 carries a photo of the Metropolitan Museum of Art with the subtext stating that it is paying 15% of its debt refinanced in auctions.

And to think that a central government like ours could have financed that directly at a near zero net cost to it and have passed the advantage on to the people, instead of using it to bail out the banks from their huge gambling losses in unknown fields. That would have spared the Metropolitan and our university students and our municipalities from paying the usurious rates wrenched out from them by the banks for their next gambles.

W. Krehm

As We Go to Press

The Wall Street Journal (29/02, "Dow's 4-Day Win Streak Ends On Concern About Banks, Oil" by Peter A. McKay), like so much else, indicates that we are not at the end of our growing concern about the off-balance involvements of our deregulated and globalized banks: "The Dow Jones Industrial Average ended the day down 112.10 points, of 0.9%, off 5.1% this year. One of the Dow's weakest components was American International Group, which slid 4% ahead of its fourth quarter earnings report, reflecting investors' persistent worries from the fallouts to come from financial firm's bad bets on mortgage securities."

That factor will not be put to rest so long as governments and central banks stop shutting their eyes to the fact that since 1971 the only legal tender in the world has been debt, but of a special, unique kind – the debt of the central government behind the credit of which stands the entire tax base and credit of the nation. That, however, has been proscribed, as the one type of credit that has been less and less used for capital investment of nations, because bigger and juicier profits can be made by selling of public investments at clearance price, and that government credit has been used not for essential investments in physical human substructure of nation but for bailing out the private sector gambles.

Until the banks are re-regulated and deglobalized, and confined to legitimate banking, the scandals and their costs will continue mounting.

Alongside the above item, in the same issue of *WSJ* ("Tight Credit, Low Saving: Less Spending" by Mark Ganloff) tells us: "The economic outlook hinges on the health of US household income growth. If individuals bring home enough money, they'll keep spending and keep the economy growing. But the foundation looks shaky."

In our language the one form in these skyscrapers of debt that have been thrown up for the greater glory of speculators, the one solid form of debt more liquid and sound than any private investment, because it has taxation powers in the last resort of those private investments as well is the credit of the state. Because that has been down-graded to a means of bailing out the ever more irresponsible private gambles, the whole debt structure is in the process of keeling over.

"Adjusted for inflation,[1] after-tax incomes have contracted in two of the past three quarters. To keep spending households have effectively stopped saving. Many were happy to do that during the housing boom. It was easy to borrow against their appreciating homes instead. Now that credit is tight and home equity is evaporating, plain old income will become much more important.

"The Commerce Department today releases numbers on January personal income and spending. Economists expect to see a 0.2 gain in income for the month, less than the 0.5 increase in December. There are signs that the trend could be lower still.

"Joseph LaVergna, chief of US economist at Deutsche Bank, crunches the Commerce Department's daily reports of the money it takes in from payroll withholding, a timely measure of income. In the third week of January those numbers fell off the table, he says, from a year-over-year growth rate of about 7% early in the money – a fairly normal pace to about 3% through to the end of the month. In February, the rate sank to 2%.

"This is the worst falloff in tax receipts since the 2001 recession. Consumer spending, which accounts for about 20% of economic output, didn't shrink during the 2001 recession, even though income growth weakened. That helped make the economic downturn short and shallow. With credit

Figures Don't Lie But Liars Do Figure

There have always been some strange oddities about some key official statistics. For example, keeping food and gasoline out of "core inflation" at a time when the central bank's eye has been peeled to detect the slightest trace of "inflation" identified with "core inflation." At least it can be said that both irrational definitions do serve the same weird purpose as does the proposed revenue for a good forty years whacking the slight rise in core inflation with higher interest rates. But to these traditional oddities of our price statistics globalization has added a new momentum.

But globalization is adding a new batch of such classical statistical nonsense. *The New York Times* (16/02, "Buy Less but Pay Lots More, and Get a Misleading Rise in Sales" by Floyd Norris) adds some important gems. "Faced with tightening credit and a slowing economy, America's consumers are being forced to scale back their purchases, but high prices of necessities are keeping their overall purchases rising at a reasonable strong rate.

"The retail sales report for January showed overall retail sales that were stronger than many economists had expected, and was well received by the stock market on Wednesday, the days it was released.

"In total, retail sales are running more than 4% above the level of a year ago, an increase above that of the overall inflation rate and much stronger than when the last recession began in early 2001.

"But the overall change is misleading. One reason for its strength is that the prices of necessities are up sharply over the past year, meaning that those items consume more and more of the household budget, leaving less for other things.

"Over all, Americans are spending nearly 13% more on food and energy now than a year ago. The biggest cause of that increase is gasoline, of course. Americans are spending 33% more at gasoline stations than they did a year ago. Food costs are up nearly 6%. But the necessities of food and energy were growing at a much slower rate, and that rate was falling rapidly. Those declines in prices helped to offset the impact of the downturn on consumers.

"But the situation is less bright now for many categories of retailers. One chart shows the combined sales of general merchandise shares stores, like department and clothing stores and discounters like Kmart. The figures include shoes and jewelry, and show that total sales are now up less than 4%, a lower rate than in 2001.

"Although not shown separately, department store rates are declining at a rate of nearly 3%. But other general merchandise stores are doing better, better reflecting decisions of some consumers to save money by shopping at discounters.

"Sales of furniture and appliances are down, including electronic equipment. That is no surprise given the fall in home sales, but it may come as a surprise that sales in computers are now falling by 5%."

William Krehm

tight now and household in need of building up their savings, a deeper spending slowdown could be on the way this time."

In its 3/01 issue the *WSJ* ("Wave of Write-Offs Rattles Market" by David Reilly) brings in a flood of gloom from quite another direction: "The massive write-downs that financial firms are posting have begun to spur backlash [note – mixed metaphor is not ours, but we must note that where everything gets mixed up and stood on its head, metaphors are the most innocuous thing to mix] among those investors and executives who are blaming accounting rules for exaggerating the losses and are seeking new more forgiving ways to value investments.

"The rules – which last made headlines back in the Enron era – require companies to value many of the securities they hold at whatever price prevails in the market, no matter how sharply those prices swing.

"Some analysts and executives argue that this triggers a domino effect: the market falls, forcing banks to take write-offs, pushing the market lower, causing more write-offs. The rules supporters, however, make a stark counter-argument.

"They can help prevent the US from suffering the kind of malaise that gripped Japan in the 1990s – as banks there sat on mountains of dud loans for years without writing them down.

"The debate gained new urgency Friday as the Dow Jones Industrial Average fell 315 points or 2.5%. Driving stocks lower was insurance giant American International Group Inc.'s announcement of an $11.1 billion write-down that led the firm to post a $5.3 billion loss for the fourth quarter, the biggest loss in the firm's 89-year history.

"No one, including the chairman of the Federal Reserve, Ben Bernanke, knows with certainty what would be a better approach than using market prices for valuing holdings like these. I don't know how to fix it,' Mr. Bernanke added that, 'I think that accountants need to make the best judgment they can.'"

When last heard from up to holdings of 20% of an issue of a given share that Canadian banks may hold is the historic *purchase price* that is used in appraising the value of a given bank.

W.K.

1. This is misusing the term because higher prices, though it may mean that there is too much demand for goods and services than the government can produce, may mean something quite different: the urbanization of the world's population requires ever more costly physical and human infrastructures, that require an increase in public investment that results in a deeper layer of taxation, especially when it is not recognized as investment, but written off as a current expense in a single year.

Washington Prepares in Odd Ways for a New Wave of Bank Failures

The Wall Street Journal (26/02, "FDIC readies for a Rise in Bank Failures" by Damian Paletta) informs us of how Washington is readying its team for handling a new wave of bank failures: "If you hired a bunch of second-class comedians to mock the sad reality of the process it chooses for the great emergency, you would in the end have your audience carried away with a medley of tears and laughter.

"The Federal Deposit Insurance Corp. is taking steps to brace for an increase in failed financial institutions as the nation's housing and credit markets continue to worsen. [So] the FDIC is looking to bring back 25 retirees from its division of resolutions and receiverships. Many of these agency veterans likely worked for the FDIC during the late 1980s and early 1990s, when more than 1,000 financial institutions failed amid the savings and loan crisis."

This is an admission that the only thing the Government learned from the decision was to throw out the Banking Law brought in under Roosevelt to keep the banks strictly to banking and ban them from other financial fields like mortgages, stock brokerage and insurance. The Savings and Loans were mortgage trusts that had used the deposits collected in that capacity to raise the money for mortgages, dollar for dollar, from the market. Once the banks got into that field they used the cash reserves of the S&Ls as money base for creating loans on the cash bases acquired, and then put all that near-money out in mortgages – eventually 30 or 40 times greater than the cash provided by the S&Ls in mortgages, the market was flooded with mortgage funds that had to be put out, and that was the main source of the subprime mortgage boom that has tainted the mortgage business throughout much of the world today.

But instead of digging into that costly experience, Washington is replaying that scratched and broken record a second time. Wouldn't it have made more sense, rather than hiring the same head personnel, for the government to have gotten its biggest ladders and climbed as high as possible and fired people still around in responsible positions who have already organized the reply of the S&L episode by repeating it in even more virulent forms. And held classes both in our universities and for our government staff top level to research how the same bag of tricks of our deregulated banks brought in the Depression of the 1930s that brought n the Second World War.

But back to the *Times:* "FDIC spokesman Andrew Gray said the agency was looking to bulk up 'for preparedness.' The division has now 223 employees, mostly based in Dallas. It insures accounts at more than 8,000 institutions, is also seeking to hire an outside firm that would help manage mortgages and other assets of insolvent banks, according to a newspaper advertisement.

"Meanwhile, regulators have worked discreetly behind the scenes to closely monitor the growing number of troubled banks and thrifts considered at risk.

"Regulators are bracing for well over 100 bank failures in the next 12 to 24 months, with concentrations in Rust Belt states like Michigan and Ohio, and the states that are suffering severe housing-market problems like California, Florida, and Georgia, said Jaret Solberg, Washington policy analyst for financial services firm Stanford Group. In job postings on its Web site, the FDIC said it is looking for people with 'skill in performing duties associated with a financial institution closing, such as receivership management, resolutions and/or asset disposition; knowledge of the resolutions process as it relates to complex financial.' Such positions would require 'very frequent overnight travel,' the posting said, and would pay up to $180,770."

The punch-line of the tale: "'The notion of bringing back some people who have been through it before is very smart,' said William Isaac, who was FDIC chairman from 1981 to 1985. All told, the FDIC has brought 4,600 employees, far fewer than the about 15,000 it had as recently as 1992."

It would have been a lot smarter than bringing in people to clean up a greater version of the 1980s mess, to have learned not to repeat making it on an ever wider scale.

W.K.

Is the World Conducting Its Finances to a Bush Level of Literacy?

In reading of "Ottawa's focus on driving down the debt" by Heather Scoffield (*The Globe and Mail,* 1/03) the thought came to me that we – and the rest of the world – are running our finances on a sub-Bushian level of literacy.

Scoffield writes: "The government is obsessed with paying down the debt. Taking this budget and the October, 2007, mini-budget together, Ottawa has announced $2B in new spending for the fiscal year just coming to a close, and $4.8-billion in tax cuts, but $10-12 billion in debt-reduction.

"The debt payment is…surprisingly large at a time when the economy is slowing. The payment will drive the federal debt down to $457.1 billion, or up 29.9% of the gross domestic product. That's down from a peak of 68.4% in the mid-1990s."

"'Further debt reduction is necessary to better situate Canada to deal with the pressures of population aging,' the budget explains. Paying down the debt now frees up debt servicing costs down the road – money that could be spent on health care for the elderly. In 2007-8 Ottawa is spending $33.1 billion to service the debt, or 13.6 cents for each federal revenue dollar, the lowest level since the 1970s. Some other debt factoids in the budget: Canada has had the smallest debt burden of all the Group of Seven industrialized countries since 2004."

But the Ministry of Finance can't be unaware that Canada and the rest of the world went off the gold standard in 1971, so that the only legal tender is the paper money or bookkeeping entries that bear no interest and are *spent* into existence by the government. So these passages from the official release should be followed by the explanation that such government debt is the only legal tender since the country went off the gold standard in 1971.

Ignoring that basic fact has two consequences: (1) prices fall creating unemployment, and we sell our goods and services abroad at less than their real value. (2) When that debt of the federal government is owed to domestic creditors, the government can and should borrow from the Bank of Canada the money needed to pay its Canadian creditors. For since 1938, when the Government bought out the 12,000-odd shareholders of the central bank, when it borrows from the Bank of Canada, the interest it pays comes back to it almost entirely as dividends. Hence it is a near-free loan. Contrariwise, when it borrows from a private bank the interest it pays the banks stays with the banks.

Unfortunately, since the mid-1970s the government has borrowed not from its own bank, but from the private banks, because these, ever more thoroughly deregulated have gotten themselves into trouble and need the government's charity to replace their huge capital losses

But beginning seriously in the 1960s the restrictions imposed on banks under Roosevelt during the Depression forbidding them to acquire interests in the other "financial pillars" – brokerages, real estate companies, and insurance, were removed so that the banks could resume the gambling that had precipitated the Depression in 1929. That US legislation became the model throughout the world. That rigorous regime allowed the banks to recover and plan for a return to the heady state of free gambling with other people's money that had brought on the Great Depression.

The campaign for that program was directed from the Bank for International Settlements – a sort of private central bankers' club located in Basel, Switzerland. In 1988 to help bail the US banks out from the vast losses from their having taken over the Savings and Loans – American mortgage trusts – by declaring the debt of developed countries risk-free and thus requiring no down payments for banks to acquire. In this way, in 1988 the Canadian banks increased their holdings of Canadian federal government debt from some $20 billion to $80 billion while the Bank of Canada allowed its holdings to fall from some 20% to under 6%. And in 1991-3, the statutory reserve – the portion of the deposits banks received from the public that they were obliged to redeposit with the central bank on an interest free-basis. Between the two – depending on how high the BIS pushed up interest rates – that could not have represented less than

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Debt Circus Our Economies Have Become

We are certainly getting our fill of debt these days. Open the business section of almost any major newspaper on just about any major or minor continent and you will not only find mention of many completely new types of debt that you may not have known even existed, with the gloomy after-note that this new type, too, is not working. That makes banks and governments all the jumpier about having to make ordinary loans or expenditures. Amongst the many debts that are not being paid is a very central one of which all the others to an extent are just the unruly progeny. That was the obligation not only for proper accountancy, and elementary decency to inform its citizens as often as necessary – in the schools, the universities, the media, that the only legal tender or basic money left in the land since the US went off the gold standard in 1971 has been the debt of the central government. That debt is still owing and at the root of our debt troubles.

Thus, *The New York Times* informs us (15/02, "Municipalities Feel Pinch as Another Debt Market Falters" by Julie Creswell and Viras Bajas): "The credit crisis paining Wall Street is reaching out across the nation, afflicting municipalities, hospitals, and cultural touchstones like the Metropolitan Museum of Art. In recent days another large but obscure corner of the financial world has come under acute stress. Alarmed by the running turmoil in the debt markets, investors have refused to buy certain loans that not long ago many regarded as equivalent to cash.

"Even though the securities are long-term, banks hold auctions periodically to set the interest rates. During the last three days, almost 1000 of these auctions failed because there were not enough buyers. The banks that marketed the instruments, known as auction-rate securities, also declined to buy.

"The port Authority of New York and New Jersey now finds itself paying a rate of 20% on $100 million of its debt, almost quadruple its costs a week ago. The Metropolitan Museum of Art is now paying 15% on auction securities. It is unclear how long such rates will persist, or when the market for these instruments will revive if at all."

Let us pause here. If public museums, harbours, states or municipalities financed their deficits through the central banks, as the *Bank of Canada Act* still explicitly provides (subsections 14(2) and 18(c) and (k)), the interest paid on such debt would end up with the Bank of Canada as dividends. All or part of such interest charges could be shared or entirely remitted to the municipalities or the public services institutions. For the background is that to bail out the banks from their speculative losses particularly in taking over mortgage companies and stock brokerages and insurance companies in the 1980s, the Bank for International Settlements, a central bankers club in Basel, Switzerland, had in 1988 had declared the debt of advanced countries – like Mexico that went bust in 1994 because Washington not only talked it into joining NAFTA but in shorting its own currency by giving the subscribers to its *tesobono* issue in pesos, but with the option of receiving payment in US dollars when the bonds are due! And then in 1991 over a two-year period the Canadian government scaled down the statutory reserves – the portion that banks had to redeposit with the Bank of Canada on an interest-free basis was phased out of existence over a two-year period. In the United States where the basic idea had been developed under Roosevelt when 38% of the banks had closed their doors by the time of his first inauguration in 1933, the statutory reserves have been reduced substantially – interest must be paid on the statutory reserves there only during banking hours, but when the banks close their doors such reserves are automatically shifted to non-interest-paying (non-reservable) accounts.

In both countries banks during much of the Depression, WWII and for a quarter of a century after the war, banks were prohibited from acquiring interests in the non-banking "pillars." This was to prevent the banks from getting control of the cash reserves that these other "financial pillars" – stock brokerages, insurance and mortgages – they would use their cash reserves as base money to which to apply the bank multiplier and then gamble their heads and solvency away with it. That happened in the 1980s, again in the 1990s in high tech in the 1990s and now in mortgages and miscellaneties once again. To bail them out from these losses the government shifted their debt massively – from $20 billion in 1991 to $80 billion three years later. At the same tie the BIS who planned the bank bail outs pushed up interest rates."

But then the complications really started multiplying. The BIS, despite its free reign over the central banks of the world for planning and supervising the bank comeback from the freedom to gamble in just whatever and wherever they wished that was a major factor in bringing on the phasing out of the strict regime brought in by Roosevelt that confined them to sticking to plain banking – i.e., applying a bank multiplier of at most 10 to 1 to the scant amount of cash they actually had in their vaults. But since borrowers were too frightened to borrow and banks to lend, very little desire was shown by the banks to get back even to simple banking. It was only after the war period of plain banking – lending against government bonds as security and a quarter of a century of an expanding economy with government infrastructure renewal providing the stimulus, that the banks resumed hankering after the fleshpots of the 1920s. But the BIS had been chosen to supervise the comeback campaign.

W.K.

Literacy *continued from page 15*

an average $10 million a year, paid to the private banks that they could have obtained almost interest – free from their own central bank.

The Scoffield article goes on to cite the debt retirement program of the present minority Conservative government: "The Conservative government has plans to pay down a total of $50 billion, if it stays in office until 2012-3.

"Big tax-cuts and a slowing economy prevent Ottawa from meeting its commitments to pay down $3 billion a year on this debt in 2008-9 and 2009-2010. Even so the Conservatives are on track to meet their commitment to reduce the debt burden to 25% of GDP by 2011-2012."

What is missing here is the fact that the *Bank of Canada Act* still remains intact on our law books, unused and forgotten.

In the Scoffield article there is no recognition that in a period of an undoubtable stalling of the economy, running a deficit – the backlog of environmental and other non-market investments – should be stepped up. When that and countless neglected investments in human capital are addressed, the country will be put back to work on very essential if very neglected capital projects. What we have to do is amend the government's accountancy.

W.K.

Misinformation re: EMU

Our planet seem to be shrinking under economic policies and appears to be spinning ever faster. That, indeed, may be the source of much of our troubles. Big, prestigious newspapers do not come more seemingly reliable than *The New York Times*. And that is why if you want some information on the president of the European Central Bank Jean-Claude Trichet and what he is likely to do about interest rates as the mortgage troubles continue to wrench and squeeze, you might be tempted to trust *The New York Times* to be an utterly reliable source of information.

And in fact the headlines were reassuring under the circumstances. "Europe's Central Banker Engineers His Economics" (5/02, by Mark Landler), and this is what we found: "Frankfurt – The day after the [US] Federal Reserve's interest rate cut two weeks ago, Jean-Claude Trichet went before the European Parliament to deliver perhaps the most eagerly awaited speech of his four years as president of the European Central Bank.

"It was a dense, technical presentation, packed with meaty thoughts on how Europe's financial system could navigate the credit crisis spreading in from the United States. But his audience cared only about one thing: Would Europe's central bank follow the Fed's cut?

"The answer, which Mr. Trichet saved for the end of the talk, was no. Fighting inflation, he said, was still the bank's cardinal goal – the 'needle of our compass' was his well-worn phrase, which did not mean, of course, that he would never cut rates again.

"It was a vintage performance by the world's other most important central banker, showing off both Mr. Trichet's coolheaded response to the world's turmoil and his iron resolve that Europeans chart their own course in reacting to the troubles in the US.

"By comparison, bank watchers say, the Federal Reserve chairman, Ben S. Bernanke, has looked wobbly.

"In this situation, we're lucky to have a genuine son of Brittany, Alexandre Lamfalussy, former head of the European Monetary Institute, a forerunner of the central bank of the Monetary Union central bank, the French-born Mr. Trichet.

"Navigating in choppy waters is something that a Breton knows well.

"But now Mr. Trichet, 65, may be tacking into even heavier seas. If the United States tumbles into a recession, most experts agree, growth will slow across Europe, perhaps sharply. Some countries like Ireland and Spain already face a collapse in housing prices not unlike that in much of the US. And with inflation running well above the central bank's threshold of 2%, Mr. Trichet fears that labour unions in Germany and elsewhere will use higher prices to extract big pay increases.

"This danger has led Mr. Trichet to warn that the bank might actually raise, rather than cut, rates but some argue that it has put itself in a box, at a time when it needs all the flexibility it can get.

"If all this is not enough, there are nagging questions about Europe's own banks. Many have yet to disclose their full exposure to the subprime market, and experts say the risk of a banking crisis is more acute than it was last August, when the European Central Bank won praise for its timely injection of millions of euros into the financial system.

"The question is: Will that be soon enough for Europe to ward off the economic chill from the US?

"'They're beginning to fall a little behind events,' said Thomas Mayer, chief European economist at Deutsche Bank in London. Mr. Mayer attributes this dichotomy, in part, to Mr. Trichet, who he notes was trained as an engineer, rather than as economist as his colleagues in the UK and the US.

"'Trichet was very good when the banking system had a bout of indigestion,' Mr. Mayer said. 'He intuitively realized that there was a plumbing problem to be fixed. Mr. Bernanke was much slower in realizing this, while Mervyn King, head of the Bank of England, was worrying about moral hazard.'

"The engineer's approach is 'show me the facts; what is there to fix?' Mr. Mayer says there are serious problems brewing. 'I have to do something about it now.'

"Mr. Trichet orchestrated a $139 billion injection that analysts say helped head off a calamitous seizing up of the market. Since then the bank has periodically pumped more cash into the system often in tandem with the Federal Reserve. Analysts say Mr. Trichet has cultivated close ties with Mr. Bernanke.

"The European Central Bank's effective response was partly because of institutional advantages. At that time, it accepted a wider range of securities as collateral for cash than the Fed or the Bank of England, which allowed it to marshal more resources.

"Still, the swift response was a milestone for the bank. It proved the mettle of a ten-year-old institution that critics once said would be hamstrung by the collective nature of its leadership.

"The question, he said, is whether Mr. Trichet will be able to keep control, especially if more banks get into trouble. With Europeans recoiling at the price of bread and milk, inflation is a real threat."

High interest rates and more subprime mortgages and unemployment will hardly bring down the price of bread and milk, short of bankrupting the farmers. Notably Mr. Alexandre Lamfalussy who is cited applauding Mr. Trichet, during his term as head of the Bank for International Settlements almost brought down the international financial system by criticizing the likes of Paul Volcker in the US and John Crow in Canada for not having brought down the rate of "inflation" to absolute zero.

A far better-balanced view of the European Central Bank was offered by Alain Parguez, of the Université de Franche Comte and the University of Ottawa, which appeared in *Economic Reform* of June, 1999, and will appear in a volume of *Meltdown* shortly.

The Myth of the European Union

"Readers of *Economic Reform* are aware of the crusade for a North American Monetary Union conducted by many Canadian economists from the Fraser Institute to the Finance Minister of Quebec, these gentlemen never tire of invoking the miracle of the European Monetary Union, for the sake of which the member states of the Union have renounced their monetary sovereignty to embrace a new common currency, the euro.

"However, in Europe the true content of the treaties leading to the euro – the Treaty of Maastricht (1992) and the Treaty of Amsterdam (1997) – has been kept from the public. Very few people realize that the euro was planned to impose an economic and social order enslaving Europeans to the worst aspect of the ideology of austerity, and raising the rentier to supreme power.

"The EMU is the ultimate achievement of a plan that can be deemed Central Bank Doctrine. It was drafted in the 1920s by advisers of the Governors of the Banque de France, the Reichsbank and the Bank

of England, above all by Jaques Rueff who in 1938 became chief economic adviser of General de Gaulle. Rueff and others wanted to impose the supreme rule of the central banks over Europe to maintain the gold standard through monetary, fiscal, and wage deflation. The rule of the united central bankers required monetary union, which was thus the protection of the last resort against unsound money-addicted democracies.

"The Treaties of Maastricht and Amsterdam have thus realized a plan drawn up eighty years ago!

"Some time was needed to unravel this whole post-second War welfare state, the impact of Keynesian ideas, even in their bastard version, and democracy itself.

"This time was necessary for the rentier class allied with the large trans-European corporations to become the 'dominant power' to quote the life-long opponent of opponent of Rueff, the celebrated economist François Perroux. The master-mind of the EMU was French President François Mitterrand, for whom the Socialist Party merely served as a tool.

Under the Control of the Mighty ECB

"As provided by the Europeans, the whole EMU is under control of an absolutist central bank, the European Central Bank. ECB is independent of any level of institutional power. Never has it to explain its policies; it rules over Europe in full secrecy. Its one mission is to enforce a zero-expected inflation and to impose a perfect flexibility of prices, especially of the wage rate. It means that the ECB must convince wealth-holders that there will never be inflation even in the remotest future. Because of this, institutions controlling financial investments will prefer to hold euros rather than dollars, and the euro will become the world's dominant currency.

"The sole constituency of the ECB is what is deemed to be financial markets which is the 'politically correct' code-word for European banks. Europe, especially France and Germany, has the most concentrated and powerful banking sector in the world, and one of the greediest.

"Never has any European government or the competitiveness-obsessed European Commission raised the least objection to banks merging. The Central Bank is therefore obliged to convince the ruling banks to invest in Europe. This then is the Euro Paradox: how can the ECB control the currency to attain zero inflation when it is obliged to get the support of the all-powerful profit-seeking banks?

"According to the European Treaties, it can impose reserve requirements, and such reserves have indeed been imposed. It can also prescribe ratios of equity to deposits. But this kind of equity ratio is ineffective since the banks control the value of the their equity by creating money to finance mergers and other speculations. Having need of the banks' support, the ECB raises no objections to the obvious fact that most of the newly created money helps increase the value artificially in such a context, the 2% rate of required reserves means nothing mostly because financial credits are not counted in the determination of the reserves, and because being the faithful supporter of the banks, the ECB is de facto their slave.

NEIRU Replaced NAIRU

What then remains of the ECB's ability to get zero-expected inflation? According to the so-called "Growth and Stability Pact" enshrined in the Treaty of Amsterdam, the ECB has to enforce enough deflation of aggregate demand to arrive at what could be called the "zero-expected" inflation rate of inflation rate of unemployment: the NEIRU which could be called the non-expected rate of inflation. This is worse than the old NAIRU (the old non-accelerating inflation rate of unemployment, since it is the amount of unemployment that convinces the banks that they have no reason for fearing future inflation. The whole EMU is rooted in the absolute necessity of high unemployment to keep banks happy. Enough NEIRU would impose what is called "the culture of stability" among bankers fearing unions and social laws as their adversaries.

The Central Bank has to convince bankers of the need for higher profit rates obtained by increasing the stringency of credit-worthiness rules on non-financial loans, and increasing the interest rates charged on borrowed reserves and exempting loans financing speculation from reserve requirements. Equity controls are but another way to raise their profits by deflating productive expenditures. It is no big detail calling high interest rates the "prohibiting government borrowing natural equilibrium" rates.

There is another rule for helping the Central Bank impose deflation. By the Treaty of Maastricht and its official interpretation by the European Commission, the Central Bank is forbidden to create directly or indirectly money that might finance state outlays. This means that the state can never finance its programs by asking its former national central bank, now become a local branch bank of the ECB, to create money at zero interest. Instead it must ask private banks to grant it credits at whatever rate is their pleasure. The ECB is even forbidden to buy state bonds through open-market operations, because that would be a way of financing state spending.

This prohibition is tantamount to the absolute privatization of money which enslaves member states to the almighty private banks. It will be a cornucopia for the banks since it will generate gigantic revenues without increased risks – states cannot go bankrupt. The portion of interest payments in state spending will be increased and member states will be obliged to cut productive spending or increase taxation in view of the constraints imposed on deficits and public debt. And since banks are adverse to non-euro-market expenditures, will impose either dramatic credit-worthiness rules, thus lower social spending, or charge higher interest rates than is charged in the private sector.

To enforce the control of the banks over the state and suppress any possibility of escaping deflation, the European Treasuries impose a strict set of constraints over fiscal policies. These are codified in the Growth and Stability Pact: (1) all member states must target a fiscal surplus, the amount of which is fixed by the European Commission and the ECB; (2) surpluses are to be dedicated to reducing the public debt; (3) the burden of taxation is to be shifted from corporations to households. While the US Congress has rejected the balanced budget amendment, members of the EMU have *de facto* amended the constitution to get a permanent surplus. Squeezed between the surplus norm and the enormous increase in interest payments to the banks, all member states will be obliged to savagely slash social and structured spending while lover-taxing average households.

In France a majority of the people opposed the EMU, whatever their motives. We must never forget that the self-proclaimed Socialist Party under François Mitterrand engineered the EMU, thereby achieving the dream of the right-wing oligarchy of the 1920s and 1930s. If a lesson is to be learned from the EMU, it is how the dominant powers of banks can be implanted at the expense of growth, employment and welfare.

Alain Parguez
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When Insurance Confronts Risk Management

There is a clash between insurance and "risk management" of mortgages and other collateral debt obligations. For if you could, in fact, really manage risk rather than unloading it onto the legendary "bigger fool," there would be no need.

But the last bumpy year should have taught us that "risk management" has too often been a confidence game with the collateral security bound into tight packages to defy timely analysis. It is enough for the bank or other creator of these packages to be quit of them to have no curiosity about their further fate. And as for "the greater fool" on whom they were unloaded, he usually doesn't even have a clue on how to keep track of his mortgagor's performance.

Only when collateral debtor is some institution highly likely to be around for a long time – for example municipalities – is there greater assurance that such collateral security will perform as expected. Municipalities borrowing for roads, schools, waterworks are pretty safe bets, but having an insurance company sign a statement to that effect sets the auditors at ease.

But all this undergoes speedy change in terms of legal tender.

Since 1971, when the gold standard was abandoned, there has been no other legal tender that simply has to be accepted in payment for a debt if it were not to be cancelled than the debt of the sovereign state in which the debt was incurred. That had to do with the ultimate state power, for the municipalities are creatures of the provinces that in turn are the middle link in the hierarchy of governments. To most people that was a confusing concept – to most people "debt" is a negative concept, hard to reconcile with the concept of money.

But there was more to add to this confusion. As the new postwar economy had been set up there were two main policy levers that allowed the Bank of Canada to keep the economy on an level keel. It could raise or lower the benchmark interest rate at which the Bank of Canada set the interest rate at which one bank may borrow from another to help meet its obligations at the Bank of Canada. Or it could increase or diminish the statutory reserves – a part of the deposit left with the commercial bank by its client that it must deposit with the central bank and that earns the depositing bank no interest. These statutory reserves provided an alternative to using the benchmark interest rates. For interest is the basic revenue of money lenders and banks and hits everything that moves or stands still. Particularly the unemployed. In 1991 a bill was passed phasing out the statutory reserves over a two-year period. This left interest rates the sole control of the economy – a clear sign that the financial sector had taken over. More amazingly this was one of the several measures that had bailed Canada's banks out of their massive losses from their speculations during the 1980s in acquiring the Savings and Loans in the US – essentially real estate trusts. Three years earlier in 1988 when American and Canadian banks had lost a considerable part of their capital, the Bank for International Settlements, a central bankers' club based in Basel, Switzerland, had declared the securities of developed countries "risk free" and hence requiring no capital for private banks to acquire. In actual fact it was the crisis of banks in developed countries that helped bring on the banking crisis.

A Role Sanctioned in Heaven

The very word "hierarchy" is Greek for a rule sanctioned in heaven. That for some centuries was reflected in the fact the monarch alone could coin precious metals, and even when the need arose, melt down those coins and coin them once again with less precious metal content. That was in fact a form of taxation particularly apt for the merchant town folk, often the only ones who were literate enough to handle money. The rest worked for their living as serfs on the domains of the great feudal lords.

But then came the period of the great explorations when gold was discovered and black slaves were transported to the Americas to scrabble for it. And in that way the ground was ultimately prepared for the industrial revolution.

And because the roads that the Romans had built were now infested with brigands and there were neither police nor armies around, it had become risky for merchants to travel carrying the money to pay for purchases in other cities and lands. So instead they learned to carry a note to a trusted goldsmith promising to pay some other merchant bound in the opposite direction with his goods who could redeem the note left in the town and settle such complicated transactions in which goods and people voyaged together but money stayed at home. From such circumstances the great art of banking arose, destined to conquer the earth and the spaces above, if not quite the heavens. For months the main hero of this plot lay inert. It could very well be lent out for interest without its rightful owner even knowing the difference – the national guardian the "hierarch," blessed by God, alone could coin precious metals. Anyone else caught doing so was lucky in some countries for having just a hand rather than his head chopped off.

But it was the ultimate power of banks when industry and trade, and especially trading in money itself developed, that provided the inspiration for future banks on an ever more grandiose scale. The essence of their role was no matter how much more loans were made than the actual coin on hand, they must always be in funds when the rightful owner of the deposit turned up. with palm outstretched. The drama of the banker has been ongoing and ever increasing in volume and impact. It is too tempting for it ever to stand still. Its principals were the Lord's chosen, but never for a moment do they fail to bear the Devil on their backs whispering into their ears that pushing the banking multiplier ever higher would bring the key to heaven into their power. All in all it is a position of ever growing temptation, a constant hunger for ever more money to be created. Of ordinary goods a surplus can always develop. Of money never.

The mere recounting of the plot of this unrelenting temptation of a role of trust being converted by the Evil One into the Supreme Temptation makes clear what the role of the monarch and his republican heirs must be. Certainly not heaping further temptation on the bankers already overburdened by the Evil One urging him to exercise this miracle ever a bit more. On the contrary, governments should apply the full authority of the law, to strengthen the bankers to resist the temptations that reek of sulphur. Nor is there a compelling reason why the mere shadow of that inert money belonging to somebody else, should not be driven to perform even greater miracles, because it casts no shadow. True he may have reared multi-storeyed structures with mere bookkeeping entries to support them. And when they collapse as happened on a an epic scale in 1929, the whole market system

and 38% of the banks in the US eventually closed their doors. Then – rather late in the day – it became a period of sack-cloth and penance. Leading economists, like Milton Friedman and business magnates like Thomas Edison and Henry Ford came out for 100% money. According to this gospel, banks could only lend out what they actually had in their vaults, that is they ceased being banks who maneuvered with their banking multiplier, and they became mere middle-men who gather in other people's deposits and lent them out again at a higher interest rate, dollar for dollar for what had been deposited with them.

For three and a half years governments. bankers sought a way out of the mess that would start the world economy spinning once again. They finally under the leadership of John Maynard Keynes and others reached the conclusion that the key to getting the economy functioning once more was to keep the banks strictly confined to banking. That is why almost as soon as Franklin Delano Roosevelt was inaugurated president of the US in 1933, he declared a bank moratorium, until he had sorted out these critical matters, upon which the souls and bodies of bankers and lesser mortals depended. It was a time, our history tells us when brokers who had been predicting an endless plateau of prosperity for Wall Street, suddenly took to jumping out of skyscraper windows. From that and the soup kitchen lines that three abreast covered entire city blocks, wise economists and eventually President Roosevelt when he was inaugurated in 1933 reached the conclusion that bankers must shake the Devil off their backs, and must never ever be allowed to acquire an interest in brokerages, or the other non-banking financial pillars. For if they ever should, the Evil One who never naps would resume tempting the bankers into mischief. For though our political leaders may erase our history from their memories, the Devil never does for it gives him the complete record of human frailties.

And indeed, it was by that wise prohibition the banks were brought back strictly to banking. And they were immensely helpful in financing the purchase of war bonds and in otherwise financing the war effort.

But in Canada the government went further. In 1938 the Liberal government nationalized the Bank of Canada that had been founded with 12,000 private shareholders less than four years earlier. That was a clear sign of the Lord's outstretched hand. For it meant that when the federal government invested in capital projects the interest that it paid on its loan from the central bank found its way back to the government almost entirely as dividends. That if anything was a clear sign that the Devil had been driven back to his hell-fire and was leaving decent folk, especially bankers, in peace. The essence of the solution was that banks, precisely because of their charming habit to lend out several times the amount of money they actually had in their till must not be allowed to acquire interests in the other financial pillars, to wit, stock brokerages, insurance and mortgage companies.

Reasons for Banks Sticking to Banking

The reason? For each of these different financial establishments kept its own liquidity pool, tempting liquid cash and near-cash that was required to serve the needs of its own business. When the banks were allowed to lay its hands on these reserves of the "other financial pillars," and use them as legal tender base to which to apply the banking multiplier, the banks themselves could lend out many times the reserves that the insurance company needed to meet an insurance claim, or that the broker held to purchase shares clients had ordered the insurance company to purchase. That could cause not only much confusion, but have inflationary effects on the entire economy.

If you allow the banks to acquire any or all the other three non-banking pillars, they are likely to lose sight of the important distinction between legal tender (which since the end of the gold standard 27 years ago has been only the debt of our federal government) and lesser debt, say the debt of private mortgagors, especially of those with bad paying records. So there you see there was a bridge, though a very rickety one that is in the process of collapse that gave rise to a vast excess of house buyers without the means or discipline to make payment and retain the houses that they have begun allowing to go into default. Indeed, the mortgages seemed to have been designed to make it easier for the mortgage agent to conclude the deal, pocket his commission and get on to the next thing without troubling his head about how sound the subprime mortgage left behind might be.

In 1935 the Bank of Canada was founded as a privately-owned central bank, but in 1938, the Liberal government under William Lyon Mackenzie King under pressure from G.G. McGeer, the former Mayor of Vancouver, and a member of the House of Commons, and then of the Senate, the Liberal government nationalized the Bank of Canada. That involved buying out some 12,000 shareholders who had bought their shares only a bit more than three depression years ago at a good profit. Now it was no longer necessary to depend only on the right of *seigniorage* – the monopoly of the Crown to coin gold and silver. Now it became crystal clear that essentially all the net profit of the central bank came back to the federal government simply as a dividend, since it was the single shareholder of the bank.

That made possible for the Bank of Canada to fund at essentially on an interest-free basis some 16% of Canada's cost of the Second World War – a considerably better record than the UK and the US both of which at the time still had privately owned central banks – the US has that to this day. And those advantages of a publicly owned central bank played a considerable part in enabling Canada to catch up with the neglect of the maintenance of its infrastructures let along bringing in the new technologies that had passed it by during the 1930s, and assimilating an immense largely penniless immigration from devastated Europe the first three decades of the postwar.

Our banks, in short, kept on a strict diet of banking without wandering into alien fields. But by the 1960s our banks had recovered sufficiently to have forgotten the painful lessons of the Depression. They hankered after the unrestricted gambles that banks had been allowed to engage in using the banking multiplier to lose their capital and even more. And bit by bit they were allowed to succumb to the Devil's temptations.

Firstly, by consenting to the suppression of just about everything that economic theory had making in getting the world out of Depression and financing World War II, and the postwar reconstruction. There was a complete discarding even of the mention of the revolution that had transformed economic theory that finally lifted the world out of the Depression. And amongst most unforgivable crimes a government that should keep alive rather than suppressing the lessons that brought Canada and most of the Western world out of the Depression the worst crimes that a government can commit is suppressing its own history especially that which taught it how it might have avoided the Depression that gave us both Hitler and WWII. The scope of that transgression would be hard to exaggerate.

William Krehm