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We Haven't See the Final Chapter Yet

Have we seen the final chapter of the subprime mortgage mess? Hardly. To believe so, is to diagnose the root of the problem as having to do with mortgages, whereas it centers rather on the very concept of what money itself might be. Since 1970 the only legal tender in the world has been the debt of central governments and, of course, all debt is symbolized by a minus sign. However, the debt of the central government is in fact legal tender. It is not interest-bearing, since it is not *lent* but *spent* into existence by the government of one developed country or another.

But here comes the rub: our banks were deregulated in the 1960s and 1970s to enable them to take over the non-banking financial pillars: stock brokerages, insurance and mortgage companies. These had been forbidden them under the US legislation adopted when 38% of the banks had shut their doors by the time Roosevelt was first inaugurated as President. However, by 1993 the governments switched the bulk of their borrowing from their own central banks, where it had cost them practically nothing, to the commercial banks. These not only charged them interest – but since interest had become the only recognized means of fighting inflation, central banks vied with one another in pushing their benchmark interest rates into the skies. The banks were allowed to cover their gambling losses – resulting from their deregulation that permitted them to take over the financial pillars mentioned. The trouble then is this: *the debt of the central government, the only legal tender, carries a minus sign that makes it appear as just another sort of debt* – the sort that the banks in particular dislike most, because it undercuts them in financing governments.

Government debt, for domestic purposes, must then be treated as though conceptually it carried a positive, not a negative sign. That is what legal tender signifies. Until people are made aware of that, above all our central banks, money matters will always end up standing on their heads. Particularly since the phasing out of the statutory reserves – the requirement of central banks that banks redeposit with them a modest amount of the deposits they took in from the public, and on which redeposits the banks earned no interest.

Interest Attains a Monopolist Control

That elevated interest rates to the role as the banks' only way of stimulating or restraining the economy and, thus, to the commanding position in the economy.

With the above in mind we are better equipped to understand the front-page article in *The Wall Street Journal* (21/04, "Smaller Banks Begin to Pay Price For Their Boomtime Expansion" by Robin Sidel): "Phoenix – Pennsylvania's Sovereign Bancorp grew in two decades from a tiny savings and loan into a regional bank with branches from New Hampshire to Maryland. Then, in 2006, seeking faster growth, it drove all the way to Phoenix.

"Concentrating on auto loans, Sovereign offered some of the best terms around to car buyers in Arizona and eight other states far from Sovereign's home branches. 'They came on like a tidal wave,' says Steve Dancy, finance director at Mel Clayton Ford here. 'It was a car dealer's dream.'

"Now, two years after the expansion push, Sovereign has quit making auto loans outside

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FOUNDING EDITOR
John Hotson 1930–1996
PUBLISHER–EDITOR
William Krehm
(comerpub@rogers.com)
CONTRIBUTORS Vol. 20, No. 5
David Gracey • John Hermann • William Krehm • Keith Wilde • Robert Zimmerman
CARTOONIST
Allen Good
INFORMATION SECRETARY
Herb Wiseman (herbwise@cogeco.ca)
WEBMASTER
John Riddell

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245 Carlaw Avenue, Suite 107
Toronto, ON M4M 2S6

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245 Carlaw Avenue, Suite 107
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LAYOUT
Tony Koch (comer@pagecraft.org)
Pagecraft Computer Services
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The Only Useful Field for Exploration and Application — Credit and Money

I was working at the extraction of essential details about creditary economics for application to municipal finance when I was stopped in my tracks by a comment circulated by Michael Hudson, on February 21: "Anwar [Shaikh] and I reach similar conclusions, although in different ways. I have written a long history of theories of trade and finance, dealing extensively with Ricardo. My approach is to treat the historical development of these theories. Shaikh bases his view on a theory of the domestic economy and competition. My point is that theories of the domestic economy were developed largely to be "plugged into" the theory of international trade – for example, Ricardo's rent theory. There's no disagreement there, just a different starting point. The theory of free trade was developed as a means of establishing unequal exchange favoring Britain over other countries."

I am getting used to having my neck twisted by Michael Hudson, but even though I have read his *Trade, Development and Foreign Debt* quite carefully, I was stunned by this statement. The notion that theories about international trade might have preceded and called forth compatible theories about domestic economies had never occurred to me.

On the other hand, it was immediately plausible in the case of two very prominent examples in the history of economic thought. Adam Smith was quite frankly intent on changing the orientation of economic policy away from the mercantilist doctrines. To do so he inserted his emphasis on the burgeoning domestic industrial system as a critical step to re-conceiving the role of external relationships in building the wealth of the nation. Jumping ahead 150 years, domestic economic management was changed fundamentally again through the focus of John Maynard Keynes on international financial and monetary institutions and practices.

Nevertheless, I was startled and wondered if I was alone in not having perceived a regularity of sequence in the evolution of economic theory. Why had my thinking always been centered around micro issues involving the allocation of real resources, with money and international relations as nuisance factors that unfortunately call for serious attention – by someone? Was the content of my education deficient or had I simply not paid careful attention to the recommended reading? Maybe it was the socioeconomic background of my youth, the nature of my work experience, or just a personal perversity?

The focus of my applied work had always been optimal management of public resources, where relevant literature includes theories of welfare economics and principles of public finance. Having given no serious thought to their provenance, I just assumed that these were special applications of standard economics – meaning neoclassicism.

An Inside-to-Outside-to-Internal Sequence

Reading titles and some tables of contents on my bookshelves, and flipping a few pages in old textbooks reassured me that my impression of an inside-to-outside-to-external sequence was not totally unjustified. Still cautious, however, I checked with some well-versed colleagues. To my relief, they agreed with my perception of how economics was taught to our generation, reinforcing the link between public sector economics and the economics of welfare. That includes regulation in general, public utilities and natural resources as well as direct government services. I have always been immersed in public sector issues and so taken it for granted that that was the only conceivable application of economic theorizing. Political economy. Economics for public policy purposes is egalitarian by democratic necessity. That is, any recommendation for change that involves redistribution of benefits must be able to show that winners can compensate losers – and the policy cannot be judged successful unless the compensation is actually paid.

But it is not true that all applications of economics are for public policy. The very word is linked etymologically to household (hence business) management. (And now there is "freakonomics.") And given the focus of creditary economics on the origins of financial techniques for facilitating trade

and production it is easy to conceive of practice preceding theory and for theory to be focused on issues that were of concern to the most ingenious practitioners. *Political* economy seems to have been a very recent development, emerging at a time when kings found themselves forced to submit to financiers in order to carry out their programs of dominance by warfare. According to Hudson's analysis of the Roman empire, its dominant figures and policy arbiters never did get a clear understanding of how to make it prosper in a collective sense. To focus on making the domestic economy hum as a pathway to "the wealth of nations" is therefore a novelty in the evolution of political thought.

Political economy for maximum collective benefit was a step forward therefore, just as an idea. Its content evolved as refinements were made to develop economics as objective science and especially to demonstrate that proposed policies would be an improvement to general welfare. As already noted, the transition to neoclassical logic was motivated in part by discomfort with the classical implication that there are free lunches – unfair distributive institutions. The literature of welfare economics evolved from J.B. Clark's demonstration (mathematical fantasy) that everyone gets what they are worth (value of their marginal product) in a free market system. Its furthest development seems to have been the criterion that reallocations of resources cannot be judged a success unless winners in the distributive effect actually compensate the losers. That also was a less than satisfactory message for free market fundamentalists.

They consequently launched a counter-attack against Depression-induced regulations and the taxation and spending implications of Keynesian counter-cyclical fiscal policy. Those features of the Keynesian Revolution called for particular effort to assure prudent and beneficial management of public resources and so were an incentive to refinements in welfare economics, public finance, and methods to improve accuracy and objectivity in measuring benefits and costs. These were not sufficient to satisfy market fundamentalists, however, and those critical functions of economics were progressively scuttled by governments in the 1970s and thereafter. Governments did not desist from doing favors for the partisan groups that supported it, however. The partisan influence simply became more naked.

The defeat of public sector economics seems to have been engineered by the ingenuity of financial practitioners with ideological support from neoclassical monetarists. I remember editorials in the Wall Street Journal arguing that specialists in public sector economics should not be hired to conduct their analysis within government departments – or at least they ought not be permitted to make suggestions about resource allocation. That kind of input to public policy should come only from political interest on the outside. The economists' job is to just make the policy preferences work as dictated by legislation and executive order. The success of that campaign is captured in this recent comment:

Quote: I have just finished Jeff Faux's *The Global Class War*, subtitled "How America's Bipartisan Elite Lost Our Future and What It Will take to Win It Back." The concise and definitive moment of truth: "Except for the golden parachutes at the top, winners in the brave new world do not compensate the losers. That is the point of winning." Ouch. End quote

Coincident with decline of public economics functions, the FIRE sector has grown enormously to where it substantially surpasses real production activities by some measures. It blew a great bubble of financial assets that is now deflating and threatens to bring the real economy down with it. For without the facilitation of credit, production and trade of real goods cannot be conducted.

These developments seem to reduce the role of economists to either special pleading or, if they insist on general welfare issues (including resources and environment), to focusing on the nature and behavior of the large and increasingly complex financial industries.

Keith Wilde

The Hair of the Dog that Bit Our Central Bank

The subprime mortgage plague can be traced to the encroachment on the central bank's basic function of creating interest-free legal tender by having the central government spend it into existence. Just as the gold or silver coins of an earlier age earned no interest, neither do the paper dollar bills or the computer entries that have replaced them. The government simply uses computers and accountancy to finance its capital needs, providing at the same time the legal tender that the economy needs as medium of circulation.

In 1938 – three years since the central bank had been founded with some 12,000 private shareholders under a very Conservative regime under R.B. Bennett who loved doing everything just as the Conservative Government did in Britain. To such a degree that when he was defeated by the Liberals under William Lyon Mackenzie King, in 1935, Mr. Bennett, become Lord Bennett, went on to become a member of the British House of Lords, while the Liberal government back home determined to do something serious about the depression that reduced our society to bloody tatters. In this he was prodded by a remarkable former boilermaker become in sequence mayor of Vancouver, a member of the House of Commons and finally of the Senate. But most important of all he put Canada a good step ahead of Britain and of its celebrated reforming economists like John Maynard Keynes and gave Prime Minister Mackenzie King little peace until he had nationalized the Bank of Canada.

It was the Liberals, the Canadian Co-operative Confederation, and the Social Credit movement of Alberta that provided the pressure to bring into Canada the basic reforms that President Roosevelt sponsored to prevent the banks from acquiring control of the non-banking financial industries and getting their hands on their cash reserves. These the "non-banking pillars" – stock brokerages, mortgage and insurance companies – needed for their own businesses. The Great Depression of the 1930s was brought on when that had taken place. For the art of banking consists of lending out a multiple of the legal tender in the banks' vaults. So long as they can meet claims for depositors' money when presented, all goes well. But if they are unable to do so in a single instance, it is enough to start a "run" on every bank in the land. For banks operate to a greater extent on public confidence than on their stock of legal tender. Successfully controlled that is a great social asset; if not controlled, it is subject to devastating abuses that led to the Great Depression.

The reforms under President Roosevelt had reorganized the banking system to prevent a recurrence of that. The legislation he sponsored had two principal ways of

guiding the economy in avoiding over-stimulation or depression. One, the traditionally recognized main tool of central banks, was to combat over stimulation by raising the benchmark overnight interest rate at which banks belonging to the Federal system can borrow money from another, and another by which the Federal Reserve Bank will in extreme cases lend legal tender to banks at a higher rate for just under a month.

But interest rates are the basic revenue of all money-lenders. To leave that as the sole control of economic activity is to surrender the command of the economy to the financial sector – the very thing that had brought on the Depression. So the Rooseveltian reform – that to one degree or another spread to most developed lands in the non-Communist world – included a second control system to avoid having the banks take over the world economy. This was the statutory reserves by which deposit-taking banks redeposit with the Bank of Canada on a non-interest-paying basis, a modest portion of the deposits they take in from the public. And to stimulate or restrain the economy – as the need may appear – the central bank may supplement or use only the increase or decrease of the statutory reserve instead of the benchmark interest rates.

The reason for forbidding the banks to acquire interest in the other "financial pillars": were the banks to get their hands on these pools of legal tender, they would use them as basis for applying the "banking multiplier" to support an ever-higher structure of bank-credit that gave rise to our current subprime financial asset problem.

Still more incredibly, the present crisis has served the banks not to retreat to banking proper, but to reform the central bank to be even more subservient to their interests.

The distinction between what banks had been allowed to engage in and what was not, found its way into the contrasted distinction between commercial banks that were not allowed to invest in stock markets, mortgage or insurance companies, and "investment" banks that were and accordingly could not enjoy all the support and services of the central bank.

But the very subprime mortgages are accelerating the process of debasing and corrupting the central banks by having those institutions provide financial aid not in legal tender or in what could be mistaken for such. The distinction between investment and commercial banking is based on this contrast. For once you are separated from its redemptibility into legal tender, you are on the deep, tossing waves of structured speculation.

Ever-soft Footings

That makes more remarkable that the present ever-deepening subprime crisis that only began with bum mortgages, but involved not only questionable insurance policies, appraisals and the whole profile of our financial sector. There was thus no visible prospect of the banks once again getting solid ground under foot. On the contrary the large banks around the world are engaged in debasing the very legal tender currency in which the central banks do their business.

For although the subprime mortgage crisis has aroused some genuine fright, it has been seen by others in financial institutions and in central banks as a heaven-sent occasion for opening up the entire economy including the central banks to deregulation, i.e., to subprime and/or collateralized assets – rather being confined to dealing in legal tender – i.e., with the credit of the central government itself.

It is no small detail that the new governor of the Bank of Canada appointed in the midst of the subprime mortgage tsunami should be a former Goldman Sachs investment banker rather than an alumnus of the Bank of Canada itself as most of his predecessors have been – with the odd exception coming from an international public institution like the IFM.

Thus *The Globe and Mail* (25/04, "Carney warns rate relief will be slow to reach consumers" by Heather Scoffield and Kevin Carmichael, Ottawa): "Turmoil in global credit markets is hindering the Bank of Canada's efforts to reduce borrowing costs for individuals and companies.

"In its latest assessment of the economy, the central bank warned that even if it continued to lower its benchmark rate, the rates lenders charge on mortgages and loans may rise. Commercial lenders are paying more to get credit themselves in markets that remain reluctant to share money, the Bank of Canada in its Monetary Report Policy said.

"Since the credit crisis kicked off last summer, banks have recovered only about three-quarters of their increased borrowing costs by charging higher rates to their customers.

"The central bank's acknowledgment that it can only do so much to keep borrowing costs low signifies a change in a relationship that many borrowers have come to take for granted over the past decade."

Our banks and our central bank itself have come to deal not exclusively in legal tender, because they have gotten into the those once forbidden "other pillars." As was the big attraction were they have laid sticky fingers on their cash reserves which they could use as legal tender base for applying their "bankers' multiplier," one storey over another until the whole topples over and the central bank must come to their rescue. That explains why our governments have slashed social programs to find the means to bail out our banks at close to stately seven-year intervals – perhaps echoing our banks' faith in their policy of let's get bailed out, merge to get strong and bigger and we'll surely have better luck next time. When the deregulation of our banks began on a serious scale in the 1980s the Bank of Canada sent a team across the land explaining that they needed to be deregulated and be allowed to merge to meet the competition of those tremendous Japanese banks that were conquering the world. The truth was that several of those powerful Japanese banks had already lost their capital and had ceased doing any lending.

And so it went. The latest chapter is that our banks have the cheek to choose this moment when their entry into the once forbidden mortgages, insurance, and stock brokerage fields is reducing our banks themselves to subprime status, that are trading good legal tender for questionable securities.

"Most people assume that when the central bank cuts its benchmark, their own variable-rate mortgages will fall by the same amount.

"That relationship is breaking down because commercial banks can't access credit at the low rates available before the collapse of the US subprime mortgage market last summer.

"Many people were backing their loans with securities linked to those mortgages.

"Those assets are now essentially worthless, leaving the banks that held them with weaker balance sheets and riskier to pay the yield on any bonds they issue."

W.K.

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Panic at the Central Banks

The pillars of international finance are cracking and threaten to crumble. How did this latest threat to the financial system develop? Is there a better way for a financial system to function?

The purpose of any financial system is managing the creation and distribution of money which fuels the economy. Money is a convenient medium of exchange and a useful store of value. Money is anything accepted as such. The common practice today is for nations to manufacture their own money called legal tender (cash) which is "good for the payment of all debts" in that nation. A growing economy must have a growing money supply too. How does needed new legal tender get into circulation?

Nations pay for the costs of government by collecting taxes of various sorts and borrowing money. A nation's legal tender is only manufactured by its treasury. All nations have a Central Bank responsible for the oversight and management of its money supply.

In a wonderful process the US borrows money from private banks by selling them treasury securities, debt of the nation. From time to time the US Central Bank, the Fed, buys these treasury securities paying the private banks with legal tender, cash, it obtains from the US Treasury. In effect the US borrows money from its Central Bank paying interest on the loan to itself!

New legal tender is now in circulation adding to cash reserves of private banks upon which they can make more loans further increasing new money in circulation. One duty of a Central Bank is oversight of private banks which are given limited authority to also manufacture money – but not legal tender. Private banks are authorized by the Central Bank to make loans up to some multiple amount of the legal tender they hold in their vaults.

By this wonderful practice called "Fractional Reserve Banking" the money in circulation is increased many times beyond the legal tender in circulation. This practice must be carefully managed for it is only legal tender which is good for the payment of all debts – not checks drawn on a private bank account or personal credit cards. If all bank loans were paid-off using bank checks drawn on deposit accounts, the money in circulation would be reduced to only the legal tender resulting from Central Bank purchases of government debt – treasury bonds and notes. If the national debt were then paid-off buying it with legal tender there would be scarcely any money left in circulation!

Over the years management of national money has often been inadequate. The usual circumstances are that private banks joined by other private financial actors produce far more money than the actual legal tender in circulation can support. A tower of bank debt grows until it collapses. The Great Depression resulted in many new laws designed to prevent this phenomena. Banks and ever new financial actors always invent ways around these constraining laws.

Working Full Steam to a Bigger and Better Depression?

One of those basic laws was the *Glass-Steagall Bank Act* of 1933 which restricted private banks to basic banking. They were not to sell stocks and bonds and insurance but just make loans and hold deposits. The invention of the credit card made possible a new way for banks to create money by allowing card holders to essentially print their own money by "charging it." Banks have great freedom in how they manage card holders. The Comptroller of US Currency has sounded alarms over excessive credit card debt for years but private banks find these poorly regulated loans highly profitable. Credit card debt is another part of the Tower of Debt now threatening international finance.

The present financial crisis developed from subprime mortgages cleverly evading eroding bank regulations. Other contributors are over-leveraged actors like Hedge Funds which suffer no government regulation and operate in secrecy. With the cooperation (collusion?) of banks, Hedge Funds leverage their money to great heights and control extraordinary amounts of money. Making big "bets" they can destabilize large corporations and nations. The *Glass-Steagall Bank Act* was repealed by the US Congress in 1999 *(Gramm-Leach-Bliley Act)* at the behest of out-going US Treasury Secretary Robert Rubin on his way to Citigroup.

It seems that people who do not study history are condemned to repeat it. Unfortunately many highly educated people who have studied history have not understood it. The latest Chairman of the US Federal Reserve Board of Governors, Prof. Bernanke, claims to be an expert on the causes of The Great Depression yet he seems to have drawn wrong conclusions from his studies judging by the "medicine" he prescribes. Of course he inherited an awful mess much of which was caused by the inept management of his predecessor Fed Chairman Alan Greenspan. And before him, Fed Chairman Paul Volcker fought rising prices with 20% interest rates. Farmers in Iowa committed suicide when they lost their farms; other farmers drove their tractors to Washington to protest Volcker's medicine. Foreign investors with cash were buying Iowa farms at big discounts. Remember Adnan Kashoggi in his jumbo-jet flying office?

A conclusion one can draw from this history is that government management of the nation's money creation and its distribution must be diligent and ever alert to new evasive financial inventions. But government management and supervision must be by people who understand money creation and are free from ideological constraints. Alas, that is an ideal which may never come to pass.

The purpose of business might be characterized as producing something which society values and can be sold for money. Private business which manipulates money as the end itself is a powerful force which will resist any government supervision. If this manipulation brings down the world financial system, strong public reaction as in the Great Depression could force government to change the system.

What might a new US financial structure be like? Legal tender (liquidity) must be continually increased to support a growing economy. A reasonable amount of additional money created by private bank loans against bank reserves of legal tender is appropriate. The present circuitous route of putting new legal tender into circulation should be abandoned. The US budget should be paid for by directly spending new legal tender from the US Treasury. There would be no government borrowing money from private banks or the Federal Reserve Central Bank and paying interest to either with legal tender!. There would be no more national debt. Federal taxes and tariffs would be used to implement policy not to raise operating funds. Income taxes, sales taxes, and property taxes would be used only for funding state and local governments.

The US budget appropriations pay for services and materials deemed essential to governance and the promotion of the general welfare. These are broad categories which engender endless argument. The government has always funded activities Congress

favors. These tend to be activities promoted by heavy campaign contributors. Local issues which are favored generally pertain to job creation. Under direct payment from the Treasury, these appropriation practices are unlikely to change.

The Military has always been well funded. No so with other important functions of government. Public health requires many government activities from inspecting food, disease control, air and water quality enforcement, and drug approval, to the unresolved issue of universal health care. Public education has always been a government responsibility. With direct government payment from the US Treasury medical care for all would probably be approved.

It has only been in times of war that government is allowed direct management and funding of the US economy. WWII was not debated on the grounds that there was no money. Creating and funding NASA to put a US citizen on the moon and bring him back was on the scale of funding a war. Like a war effort it produced great economic activity, advances in science and technology and put great amounts of new money into circulation.

If the developing world financial crisis does indeed bring the structure to collapse, a better world financial system must be invented.

Robert W. Zimmerer

Threading the Needle or Needling the Thread?

The old lady of Threadneedle Street is accustomed to handling runs on banks and other such woes. But what Wall Street plotted and achieved with its Globalization and Deregulation of the banking system went far towards converting the world into a single market that had its booms and busts at the same time. That left no room for rescue squads, fire hoses or ladders.

The Wall Street Journal (22/04, "Bank of England swap plan aims to break credit logjam" by Joellen Perry, Natasha Brereton and Adam Bradbery, London) reports: "The Bank of England's sweeping plan unveiled yesterday to swap government bonds for banks' hard-to-sell securities comes at a steep price for banks."

Let us note right here that the government of the UK or Canada can borrow directly from the central bank virtually interest-free, since as sole owner, the interest the government pays its central bank on such borrowing returns to it substantially as dividends. However, under the new arrangement it will be trading the distressed banks the interest in legal tender – money created by the government in the process of spending it not lending it.

In return it will receive the banks' "hard-to-sell securities" the poor quality and expectations of which are obvious from the discount that the banks will be receiving in the "trade." No bargain there. The Bank of England like central banks throughout the world including our own Bank of Canada have been bailing out their banks from financial adventures they were allowed to get into by their systematic deregulation and globalization for decades. Such bailouts have taken place since the 1960s on the average about once every seven years. But that interval is the only hint of good luck the banks have had in the so-called "non-banking financial pillars" – stock brokerage, insurance and mortgages. Those restrictions on our banks were imposed because by the time Roosevelt became president in 1933 some 9,000 American banks had shut their doors. Had the banks not been released from these restrictions, there could have been no bum-mortgage bank crisis – it was as simple as that. Banks would have continued barred from engaging in the mortgage business. Allowing them to do so, resulted in a complete confusion of the cash reserves of the mortgage, insurance and stock brokerages, that these other "financial pillars" needed for their own business with legal tender to which they were free to apply the "bank multiplier." That is what led to an ever greater excess of money in the hands of the banks, that simply clamoured to be loaned out in just about any adventure that could be passed on to an unsuspecting public.

But will Banks Lend Freely to One Another?

The present world-wide bank crisis then is a by-product of the banks having been decontrolled and allowed to gamble with the loans based on the reserves acquired from those "other pillars." That must ever be kept to the fore in designing ways out of the subprime mess. Failing that, we will be led deeper and more hopelessly into the same mess again and again on an ever more vicious scale. Very much the same result occurred in the 1920s where the banks were largely responsible for the Wall Street boom and crash that ushered in the Great Depression that led into World War II. Now the BOE and the other central banks are mixing up the credit of the central government which is backed by all the productive capacity of the given country, the talent and education of its people, its natural resources, with the credit of globalized deregulated banks that function as little more than crooked casinos.

But will this solve the problem? Let us return to *The Wall Street Journal* for the answer: "Even if banks accept the central bank's offer, the next looming challenge is whether it will ease bankers' fears about lending to one another and, in turn, unclog the logjam that has threatened to restrict the flow of credit across the British economy.

"Wary of other banks' credit-worthiness and anxious to keep cash on hand for their own needs, British banks since August have been unwilling to lend to one another for longer periods of time. That reluctance pushed up the rates they charge on loans to one another.

"The BOE's new program has overtones of the US Federal Reserve's recent initiative to swap government debt for hard-to-sell securities in the US. But there are several key differences, including the fact that the British central-bank plan lets banks swap hard-to-sell mortgages for government debt for a year with the option to renew the swap for as long as three years. The Fed's recent program, by contrast, limits swaps for US government bonds for 28 days."

Most significant is the detail that there is no awareness of the role that the deregulation of banks played in taking positions in the mortgage, insurance, and stock market fields. On the contrary, the interplay of these incompatible activities has become tighter than ever – as tight as a package of mortgages that the banks put together to start and feed the subprime mortgage scam with supposed "risk management" in the first place. So long as the banks were able to sell the risk package put together to the unsuspecting ultimate buyers the business boomed. Now without regulation and de-globalization, there is bound to be a replay of the entire scam on a still greater scale.

W.K.

The Mess in the US

For the past two months I have been living in Arizona. In addition to the wonderful weather, this has given me a ringside seat from which to observe the ongoing financial implosion and listen to the media commentary thereon.

At the centre of the financial mess is a fundamental paradox that begs resolution. The media, for all its millions of words and dollops of righteous indignation, doesn't get it. Let me elucidate.

There is no doubt that the current financial crisis was brought on by an orgy of dubious lending in many cases bordering on outright fraud. Subprime mortgages, CMOs (collateralized mortgage obligations), ABCP (asset-based commercial paper), adjustable rate mortgages, and a host of other devices were used by the financial system, at great profit, to increase mortgage debt to astounding levels ($13.3 trillion at the end of 2006). The resulting housing bubble allowed homeowners to withdraw about 90% of the increased equity. This orgy of borrowing was facilitated by financial deregulation and by the very accommodating stance of the Federal Reserve (see Fleckenstein and Sheehan *Greenspan Bubbles*, McGraw-Hill, 2008). The financial sector effectively turned the US housing market into a system of Ponzi finance. Now the bubble has collapsed, foreclosures and bankruptcies have skyrocketed, and the mortgage banking sector have lost about $1 trillion.

It is important to understand what has really happened. Almost all the growth in the US economy since 2002 derived from an increase in debt derived from the housing sector. The current recession results from the liquidation of much of this debt, and the failure to devise an alternative mechanism for creating more debt, i.e., more money and demand, to replace that which has been lost.

What has been the policy response? Despite a lot of hand wringing and moral indignation, nothing has been done for the mortgage holders, and it is unlikely that anything will be done. Opinion polls consistently show that the majority opposes assistance to those unfortunates, on the grounds that they are the victims of their own stupidity. However, the Fed has moved swiftly to bail out the banks, even taking the unprecedented step of extending it to unregulated investment banks, and accepting securitized mortgages as collateral for loans. Media commentators generally deplore such moral hazard *The New York Times* characterizes it as a system that provides stellar rewards when investment strategies do well yet puts a floor on losses when they go bad (21/03/08). But no one is suggesting these bailouts should stop. Why is this?

Every student of banking knows that a pyramid of assets (loans) and deposits is built on a slender base of capital. If, due to bad loans, a bank must pay out its capital, it must retrench, i.e., call in some existing loans and make fewer new loans. This is called a credit crunch but it really means that the vital process of debt creation is stalled. The policy-makers understand this but the public does not. The media commentators don't understand it either, but they like to repeat catchy phrases like credit crunch emanating from the experts So the bailouts will continue, the banks will be rescued from their own folly and greed, and perhaps normal functioning of the credit system will be restored.

Debt Creates Money

Or will it? This brings me to the paradox that I referred to at the beginning of this article. The US economy (like the Canadian) operates on debt creation. Financial deregulation means that almost all money comes into existence as debt via borrowing by consumers, businesses and government. For the economy to grow, total debt must grow. In fact, the stats from the last three business cycles show that debt must grow even faster than overall economic growth. The motive behind the bank bailouts, therefore, is to get the credit (debt creation) mechanism working again. It was the collapse of the banking system in 1930-31 that caused the Great Depression. The Fed Chairman Ben Bernanke, a student of the Great Depression, understands this. No matter how bad it looks, the Fed understands the critical importance, in a debt-based economy, of getting the banks up and running. Even one failure could bring the whole shaky edifice tumbling down. The media consensus is that this enterprise must succeed.

But there is a problem. For the credit mechanism to work banks must be solvent but they must also find viable borrowers. The US government has run up debt at a phenomenal rate some $4 trillion since 2000 but it seems unlikely it can continue that rate without grave injury to the US dollar. The question is, can the overstretched and heavily indebted consumer be persuaded to take on even more debt? The statistics are not encouraging. Total US debt has risen astronomically and now exceeds 350% of GDP; household debt accounts for almost a third of that. The real estate bubble facilitated the increase in debt needed for the last (now departed) expansion. Prior to that the tech stock market bubble performed the same function. Both those bubbles were created (quite deliberately, in my view) by the easy money policies of the Fed. Clearly the Fed will try to repeat this scenario but can they pull it off? How much debt will people take on?

There is no doubt that the Fed appreciates this dilemma. That why they are working so hard to save the banks, but don't expect them to come clean anytime soon. The consequences would be too awful to contemplate. The financial system has derived enormous power and profitability from the debt-based system. An informed public would demand the re-regulation of the financial system; as our ancestors did during the Great Depression. There are calls, notably from the Democratic presidential candidates, for more regulation, but given the power of the financial interests, it is unlikely to happen.

Many media commentators and bank economists try to downplay the debt problem by citing the debt to asset ratio. If assets are increasing as rapidly as debt, they tell us, there is no need to worry. This comforting line ignores the reality that asset values can fall off a cliff. The current precipitous decline in house prices is a case in point. The debt remains however and can only be reduced by defaults, bankruptcies, and liquidation. That is what happened in the Great Depression. The ratio that really matters is debt to income, because the interest on the debt must be paid. That ratio has been deteriorating for many years: household debt in the US now exceeds 115% of income. How high can it go?

The outlook is not encouraging. The financiers may be able to persuade people to borrow and spend again, but there is surely a limit to the amount of debt the US economy can sustain. Barring major reform, this tale will end badly.

David Gracey

A Monetary Education for MPs

A Parliamentary document from 1939 may be the most illuminating exposition of fundamental money and banking principles and operations that I have encountered. It is the Minutes and Proceedings of the Select Standing Committee on Banking and Commerce, Eighth Session. A few contextual details add significance to the proceedings:

The Bank of Canada opened in March of 1935, under a Conservative government. In August of 1935, Albertans elected a full slate of members from the newly formed Social Credit party. Then a federal election in October defeated the Conservatives and elected 171 Liberals. Only 39 Conservatives were returned. The Social Credit party had 17 of its candidates elected, 15 from Alberta and 2 from Saskatchewan. The CCF won 7 seats. The new government nationalized the Bank in 1938, buying all of its shares from the private banks that were its original owners. Early in 1939, the Bank submitted its annual report to the new owner, and on February 20, 1939 the report was referred to the Standing Committee on Banking and Commerce. The Committee was convened to begin its task on March 8 and reported back on June 1, 1939. *The Minutes of Proceedings and Evidence Respecting the Bank of Canada* runs to 858 pages in 25 volumes, recording the proceedings of thirty sessions. Most of the content appears to have been generated through interrogation by members of the principal witness, Bank Governor Graham Towers.

Two Decades of Turbulence in Monetary Thought

The 1930's had been a period of exceptional popular interest in monetary policy. Not only was the Great Depression a potent motivator; groundwork for concern had been building on the inside and the outside of financial institutions since the end of the Great War. Economic impacts of the War stimulated the thinking not only of J.M. Keynes (*Economic Consequences of the Peace, Treatise on Money,* and finally *The General Theory of Employment, Interest and Money*) but also of C.H. Douglas, founder of Social Credit, who made extensive appearances as expert witness in this same House of Commons Committee in 1923 and in a committee of the Alberta legislature in 1934. Meanwhile, Graham Towers was on a fast track of learning and influence within Canadian and international banking circles, with a special interest in the purposes and functions of central banking. The Great Depression intensified a focus on monetary issues that had been building since the postwar depression. And one of those captivated by the subject was Gerald McGeer of Vancouver, who was elected as a Liberal MP in 1935. As a BC legislator and mayor of Vancouver he had already associated himself prominently with monetary and banking issues, notably with a critique of the Royal Commission on Banking and Currency in 1933, headed by Lord MacMillan to address the Depression conditions and particularly the advisability of a central bank. By the time he was sent to Ottawa as an MP, McGeer had completed a book on monetary policy, *The Conquest of Poverty,* that became instantaneously influential among monetary reformers in English-speaking countries, not under McGeer's own name but rather as words attributed to Abraham Lincoln. (This confusion has been explained previously in issues of *ER*.) Given this context, the rather electric quality of the Proceedings should be no surprise. (And the moment passed. Within a few months Canada was at war, an election had increased the government's majority, the Social Credit presence had shrunk to 10 MPs, and a commitment to fiscal policies to maintain full employment had taken the wind out of monetary reform.)

The expert witnesses were Graham Towers and Clifford Clark, Deputy Minister of Finance. Most of the content of the minutes is the grilling of Towers by committee members, the most aggressive of which were McGeer and a couple of Social Crediters. Towers appears to have been present to answer questions through the whole of it, as was Clifford Clark for most of it. The Minister, Charles Dunning was also present on many occasions.

As the first witness, Clark provided descriptive and quantitative details about the Canadian currency and its development in decades prior to 1935. That didn't take long, and then Towers took the chair to explain the field of credit and the role of banks and banking. It is my impression from having read about half of the minutes (painfully, on poor quality microfiche) that they should be made accessible more widely as a virtual textbook of money and banking fundamentals as they used to be. I went to the National Archives to consult these Proceedings in order to verify some statements attributed elsewhere to Towers. I did find them, and noticed that they had been elicited by a Social Credit member and by McGeer, as follows:

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Question from Landeryou (SC from Lethbridge): "Ninety-five percent of all our volume of business is being done with what we call exchange of bank deposits – that is, simply book-keeping entries in banks against which people write cheques?"

Towers: "I think that is a fair statement."

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Question from McGeer: "When you allow the merchant banking system to issue bank deposits – with the practice of using cheques – you virtually allow the banks to issue an effective substitute for money, do you not?"

Towers: "The bank deposits are actually money in that sense."

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Question from McGeer: "But there is no question about it, that banks create that medium of exchange?" [i.e., bank deposits]

Towers: "That is right. That is what they are for."

McGeer: "And they issue that medium of exchange when they purchase securities or make loans?"

Towers: "That is the banking business, just in the way that a steel plant makes steel."

Fishing for Concessions

One of the infrequently heard members observes on p. 400 that "McGeer and the social credit people are circling around 'debt-free money.'" McGeer affirmed that his purpose was to persuade the Committee that there is a costless (or at least lower cost) way of mustering the money (finance) to get men and materials into operation for important productive activities. (Towers freely acknowledged that although an "easy monetary policy" had been in place for several years, there was still plenty of underemployed labor and materials. He defined "easy money" as no need to impose bank rate restrictions or cash reserve requirements on banks – they had plenty.) McGeer kept returning nonetheless to this question: Why should a government with the power to create money give that power away to a private monopoly? And especially, why should it then borrow from the banks and pay interest? Towers' response: "Parliament can change the way the banking system operates if it wishes to do so."[1]

The physical difficulties of reading

the microfiche version of the Proceedings prompted me to consult the biography of Graham Towers, commissioned to celebrate his contribution as the fiftieth anniversary of the Bank approached. The author, Douglas Fullerton, was a well-established Ottawa figure who had worked directly with Towers in non-Bank contexts, and he was given access to Bank staff and records for research on the book. The tone of quoted passages from his book is fully consistent with what I heard of Towers from senior officers who had worked under him, when I was an employee of the Bank in 1965 and 66. And comments about the performance of both Towers and McGeer are supported by my own impressions from the 1939 hearings before I had opened the biography.

The Unwavering Tower

From *Graham Towers and His Times* (Toronto: McClelland and Stewart, 1986), pages 88 to 93: "The depression broadened interest in central banking among students and businessmen, and the number of the initiated gradually increased. Canada's continuing economic troubles also created a new group that was skeptical about all aspects of the conventional approach to money creation. As Towers noted in a speech to Queen's University students, the phrase "sound money" came to be almost a form of reproach. In 1939 he appeared before the Commons Standing Committee on Banking and Commerce, which had a principal goal of educating members of Parliament and the public about the Bank. In his appearances before the committee, Towers was soon drawn into battle with monetary dissidents and self-styled reformers, particularly those of the Social Credit persuasion.

"Bruce Hutchison describes the scene vividly in *The Far Side of the Street.* Gerald McGeer had begun as 'an ignorant boilermaker' but made himself 'a King's Council, a Biblical soothsayer, a scourge of Canadian politics, a piercing thorn in Mackenzie King's side.' Hutchison says McGeer 'stumbled by accident on the science of money. Inflamed by the discovery, he perfected a fool-proof monetary system of his own.' Hutchison's own 'economic illiteracy' led him to become an 'unpaid press agent and travelling companion' to McGeer – 'a third-rate Boswell to a second-rate Johnson.' As soon as [McGeer] arrived in Ottawa, he made himself a pest about monetary matters. He filled the pages of hearings on banking with his unorthodox monetary views; he cross-examined all the witnesses, and often tied them in knots. That is, until 1939, when he confronted Graham Towers. As Hutchison noted: Hour after hour, day after day, [Towers] answered Gerry [McGeer], the prosecutor, in such perfect diction that it could have been published verbatim as a book. Gerry used his blustering questions like a club. Towers' thrusts were delivered with a rapier. A western giant and an eastern giant-killer had met in death grapple while the committee watched in admiring stupefaction but without comprehension.

"In 1949, F.C. Mears of the Montreal *Gazette* had this to say: [Graham Towers'] parliamentary performances won't be forgotten. The times he has appeared before the banking committees of House and Senate, always in an atmosphere heavily charged with political controversy, if not acrimony, the Governor of the Bank of Canada has been exceedingly effective. Back in 1939, when the Bank of Canada was only four years old, he was obliged not only to explain but also actually to defend the institution. The rapid fire of questions and answers on fairly intricate monetary questions, the magnitude of the issues involved, and the prominence of the man on the stand, made it mighty hard for party whips to hold a quorum in the House. Towers could never be trapped into exhibiting heat, could never be caught off base. At the same time he had to be nimble and quick, for there were legislators who had done a lot of homework on the banking problems. There was dignity, there was an apparently inexhaustible resourcefulness, a flash of good humour when the moment required it, sometimes the measured reply, never a retreat. The long duration of these appearances, the wide variation in the quality of the questioning, the repetitiveness in the answers, and the perennially difficult problem of dealing with half-truths and misconceptions required enormous concentration and patience. What helped sustain him was his recognition that most of the questioning was inspired by the government's failure to deal satisfactorily with the problems of the depression. An even stronger motivation for standing up under extended parliamentary committee fire without bridling was Towers' compulsive drive to straighten out his questioners, to tell the truth as he saw it, to counter charges with the best arguments he could muster. He accepted this task as almost a holy commitment. He worked at it; if his replies were to have an impact, then they had to be simple and clear and without holes. It was Towers the educator at his best."

Towers' principal response, in my reading thus far, to the complaint that a government with sovereign power of monetary policy should have given it to a private monopoly, was that banks didn't simply have a key to the candy store. He continually stressed that when banks create deposits they are creating a liability for themselves which they then have to protect themselves against in some way. The promissory note of the borrower is only part of it; they buy other assets as well, using cash from depositors and credits transferred from other institutions. As a veteran British banker and theorist put it recently, banks create money *for their customers,* not for themselves.

Keith Wilde

1. This point is expressly confirmed in the *Constitution Act*, which may be read in full at http://laws.justice.gc.ca/en/Const/c1867_e.html#distribution.

Paragraph 91 under section VI on the distribution of legislative powers includes the following provisions: [T]he exclusive Legislative Authority of the Parliament of Canada extends to all Matters coming within the Classes of Subjects next hereinafter enumerated; that is to say (14) Currency and Coinage; (15) Banking, Incorporation of Banks, and the Issue of Paper Money; (16) Savings Banks; (17) Weights and Measures; (18) Bills of Exchange and Promissory Notes; (19) Interest; (20) Legal Tender. (29) Such Classes of Subjects as are expressly excepted in the Enumeration of the Classes of Subjects by this Act assigned exclusively to the Legislatures of the Provinces.

Editorial Note

I have decided to publish Keith Wilde's research because it pays due tribute to the performance of Graham Tower, a former high official of the Royal Bank and first Governor of the Bank of Canada in a fair presentation – the best defence of legitimate banking – referring what had not been legislated to Parliament since it was, he readily conceded, entirely within the jurisdiction of Parliament to make. We could do with the talents, the honesty, and frankness of a Graham Tower to defend the banks' legitimate activities. Instead, these have been overshadowed by endless difficulties to make possible their impossible goal of endless expansion of banking to take over the entire financial sector to permit its ever-accelerating growth in a shrinking, abused environment. Nor does the description of McGeer as a "second-rate Johnson" or as having begun as an "ignorant boilermaker" hold water, though these quotations do not originate with Wilde. There was nothing second-rate or "ignorant" about McGeer. He began as a boilermaker, and a high-school dropout with an unusually enquiring mind who in a matter of a few years surpassed John Maynard Keynes in reaching a model that had the government arrange the financing through the central bank which he had

convinced Mackenzie King to nationalize in 1938. A natural follow-up to that great step was for the central government to use its own bank to finance increasing amounts of its own capital investments, since the interest it paid on such loans would come back less overhead as dividends to the government as sole shareholder. Because of this prewar nationalization of our central bank, Canada was able to surpass the percentage of their WWII costs that they were able to finance virtually interest-free through its central bank. The detail can be found in *War Finance and Reconstruction: The Role of Canada's Department of Finance 1939-1949* by David W. Slater with two chapters by N.B. Bryce. Both authors were high officials of the Finance Department, and the book was actually financed by the government of Canada, but the government's desire to put the contents into the public domain did not extend to obtaining a commercial publisher or publishing it itself. That however increases rather than diminishes its credibility.

Keynes, on the other hand, was born into a distinguished Cambridge don's family, had the eminences of the self-balancing market school close friends of the family. That undoubtedly had considerable bearing on the lateness of his abandoning marginal value theory – as "scientific." Some of his closest collaborators, D.E. Moggeridge, for example, have written that these family ties delayed rather than helped him reach the point of questioning the magic of the self-balancing market. His real iconoclastic genius was directed against political leaders rather than the eminences of marginal theory. He never developed his model beyond the view that in a slump the government should spend more than its revenues, and in a boom less.

The idea of using a nationalized central bank for the government to finance its capital investments at a virtual zero interest rate – the interest it paid came back to the government as dividend, he never arrived at.

All this notwithstanding, I have decided to publish Wilde's research, because, given what the lads and lasses with academic tenure and in government have done to the economy and the world, it is clear that we have need of drop-outs which include John Stuart Mill. Mill actually was not even a drop-into the school system since his education came entirely from his father James Mill.

W.K.

The Versatile Ways in which Our Dominant Interest Rate Variable Serves Speculative Capital Today

The second volume of COMER's *Meltdown: Money, Debt and the Wealth of Nations*, which has just been published, by its title acknowledges our debt to Adam Smith as a great forerunner. In our analysis we look into the very special interests of different classes, and make use of systems theory to that end.

For this we have need of systems theory of the sort that has been used by engineers and scientists for decades. By contrast Adam Smith, a much underrated economist, dealt with different problems by turning to a set of at least two other value theories. His *An Inquiry into the Nature and Causes of the Wealth of Nations* explored the tighter reckonings of merchant, manufacturer and tax-collector. In doing so Smith was significantly anticipating the system theory of today. However he dealt with them in a rather isolated way rather than in their dynamic interweaving.

When Smith is concerned with basic human relations, he reaches back to "that early and rude state of society that precedes the accumulation of stock and the expropriation of the land" to formulate a labour theory of value: "If it usually costs twice the labour to kill a beaver as it costs to kill a deer, a beaver will usually sell for twice as much as a deer."

Elsewhere he draws on two other value theories. One is a cost-of-production theory that sees value as the sum of its components – wages, profit and rent. In yet another instance he uses as a measure of value not "embodied labour" in a commodity's production, but labour *commanded* by a commodity, i.e., the equivalent in wages at the current rate. (See Krehm, William (1975) *Price in a Mixed Economy – Our Record of Disaster*, p. 122.) Clearly this last angle of vision is most critical today in grasping the commercial relations of the Western world with China.

However, the whole matter can be perceived from a quite different angle, from a politician's eye-view. In this production and distribution are not an end in themselves, but rather a means to electoral success. What results is a political rather than an economic space.

This can be seen by a simple pinch of mathematics.

In any economic reckoning of distribution, the recipients appear in the denominator of the ratio, while the goods to be distributed, the *distribuendum,* make up the numerator. In a political space the situation is up-ended. There it is the voters who make up the *distribuendum* and all calculations are made accordingly. As a result what should be in the denominator of society's reckonings makes up the numerator. Inevitably the economy may end up standing on its head.

Field theory was developed by physicists to handle problems of such complexity. It seeks to explain the behaviour of a particle or charge not only by its own properties or those of a particular neighbour, but by the whole environment. That environment in turn is determined by the characteristics and distribution of all other particles and charges in the field.

Applied to our economy, the field concept has this significance: the price of a loaf of bread today and of thirty years ago must be put down not only to "inflation." In significant degree it must reflect the changes that have occurred in the society in which the loaves have been baked. Into the present price will go the taxes that pay for the higher public expenditures on education, health, the greater equality between classes, races and nations, our urbanization, social insurance, and so forth. Price has become pluralistic price reflecting the growing complexity of our world. In actual fact the complexities of field theory – even Newtonian – are so great that only certain special cases lend themselves to complete mathematical solutions. And in such solutions boundary conditions – i.e., external constraints expressed as constants of integration – play a key role. Such boundary conditions are empirically given and help determine such things as the constants of integration.

With a better idea of what mathematics and science are about, economists could utilize discernable boundary conditions for similar ends.

The use of he field-system approach would help immensely in weeding out political shenanigans from real inflation.

William Krehm

Like a Trodden Ant Nest

The New York Times (1/05, "Fewer Latinos in US Sending Money Home" by Julia Preston) alerts us to quickly changing migration patterns. To the stalled building projects throughout much of the US, we can add that famous wall on the Mexican border to keep out the Americans' Mexican partners in NAFTA. With shrunken employment possibilities there are few jobs available in the US, less money to send back home, and in fact the US suddenly becomes a much less desirable place to live in – with or without due documentation: "In a sign that the economic downturn is hitting hard among Latino immigrants, more than three million of them stopped sending money to their home countries during the last two years, the Inter-American Development Bank said on Wednesday.

"Growing numbers of Latino immigrants are also considering giving up their foothold in the United States and returning in response to a slump in low-wage jobs and the crackdown on illegal immigration, the bank reported in a survey of 5,000 immigrants from Latin America. The survey found that only half of the 18.9 million Latino immigrants in this country now send money regularly to relatives in their home countries, compared with 73% two years ago.

"'The major dynamic that is holding them back from sending money is fear,' said Sergio Bendixen, a Miami-based pollster who conducted the survey. 'They don't know whether they won't be able to get a job anymore.'

"In the first quarter of this year, transfers to Mexico dropped 2.9% from the first quarter of 2007, Mexico's central bank reported on Wednesday, the first significant decline since Mexico began tracking the transfers in 1995."

US Immigration Documents No More So Highly Cherished

"For Latin America as a whole, the amount of the money transfers remain virtually flat over the past two years, the development bank reported. It estimated total remittances to the region at $45.9 billion, an increase of $500 million over 2006.

"Latino immigrants said life had become more difficult for them here. Of those interviewed, 81% said it is harder to find a good-paying job. Almost 40% said they were earning less this year than the previous year. The largest group of immigrants worked in construction, which has been especially hard hit in the slowdown.

"As a result of the difficulties, among immigrants who had been here less than 5 years, 49% said they were thinking of returning home.

"In 2001, the last time a similar survey asked a similar question, about 20% of Latino immigrants said they were thinking of going home, said Mr. Bendixen, who conducted that survey as well. However, Mr. Bendixen said that immigrant workers who participated in focus groups as part of the survey said they were not ready to leave the US quite yet. Before taking the drastic step of moving back home, immigrants said that they were taking jobs at lower wages or sometimes working two jobs to try to maintain their income.

"'These are resourceful people who will do whatever job is available,' said Mr. Bendixen.

"The economic pressure seems to have fallen equally on illegal immigrants and those authorized to be in the US. A huge majority of those who were American citizens said discrimination had become a major problem for them.

"In an interview in Phoenix on Wednesday, Yolanda, a 45-year-old illegal immigrant from Mexico, said that she had started to think of going home, after 18 years in the US. 'We can't keep up with expenses and also send money,' she said in Spanish. 'If you can't even eat, what's the point?'"

In a way, it would seem, globalization has been homogenizing the world, if not exactly to the specifications of its promoters. In its "Business Day" section of the same date *The New York Times* does a parallel job on how globalization has treated even its native middle class ("Squeezed in Europe – For Middle-Class, Stagnant Wages and a Stunted Lifestyle" by Carter Dougherty and Katrin Bennhold): "Les Ulis, France – When their local bakery in this town south of Paris raised the price of a baguette for the third time in six months, Anne-Laure Renard and Guy Talpot bought a bread maker. When gasoline became their biggest single expense, they sold one of their two cars.

"Their combined annual income of 40,000 euros, about $62,500, lands Ms. Renard, a teacher, and Mr. Talpot, a postal worker, smack in the middle of France's middle class. And over the last year, prices in France have risen four times as fast as their salaries.

"At the end of every month, they blow past their bank account's $900 overdraft limit, plunging themselves deeper into a spiral of greater resourcefulness and regret.

"'In France, when you can't afford a baguette any more, you know you're in trouble,' Ms. Renard said one recent evening in her kitchen, as her partner measured powdered milk for their 13-month-old son, Vincent. 'The French Revolution started with bread riots.'"

When Middle Class Europeans Start Feeling Declassed

"The European dream is under assault, as the wave of inflation sweeping the globe mixes with the continent's long-stagnant wages. Families that once enjoyed Europe's vaunted quality of life are pinching pennies to buy necessities, and cutting back on extras like movies and vacations abroad.

"Potentially more disturbing – especially to the political and social order – are the millions across the continent grappling with the realization that they today have lives worse, not better, than their parents.

"'I have this feeling that there is a wall in front of us,' said Axel Marceau, a 41-year old schoolteacher living outside of Frankfurt."

Amazing how the symbolism of the "wall" in its contrasting significance haunts humanity over the ages. The wisdom of the Romans who knew how to build stone roads that their successors cherished and established their great cities at the crossing of Roman roads that they themselves could not duplicate. But a moment came when those wise Romans shifted their gift as builders from roads to protective walls that recognized where their genius for conquest had touched its apogee. They replaced the lust for conquest with transmitting a cultural heritage that has kept the cultural inheritance of Rome and its own debt to Greece burning brightly in countless once barbaric tongues and literatures. Everything pertinent to the soul of a culture somehow seem to be symbolized by the purposes for which and when they built their walls – aggression or defense.

"Axel Marceau's concerns are well-founded. A study by the German Institute in Berlin found that the broad middle of the German work force, defined as workers making from 70 to 150 percent of the me-

dian income, shrank to 54% of the population last year from 63% in 2000.

"Mr. Marceau's father had a teaching job that afforded the family upward mobility, from owning a home to fancy ski vacations. But today, Mr. Marceau says, a new class of bankers, executives and other high earners has taken over. 'I feel like we've been in a slow process of losing to the people up on top,' he said.

"'No one thought during the 1980s that they could possibly belong to a group of people who slide down the social scale,' said Markus Grabka, an economist at the institute for economic research. 'No one had existential angst of the sort you have today.'

"To be sure Europe's middle-class is still larger than the number of people at risk of falling into poverty – and, by many measures, more protected than the American middle class. But policy-makers worry that could change as the European economy starts to feel the drag of an American slowdown and high inflation.

"'The problem,' said Julian Cubero, chief economist for Spain for BBVA, a leading Spanish bank, 'is that if your salary rises more slowly than the cost of products you buy on a daily basis, you feel poorer every day.'"

The Various Styles of Declassifications in the European Union

"That simmering concern turned into anger last week in Britain. Striking teachers closed schools for the first time in two decades, protesting pay packages that did not keep pace with the soaring cost of living. Proposed raises were about 2.5%, while food has risen 7% and oil costs have surged 20% in Britain since this time last year.

"The teachers rallying cry was just the latest to echo across the continent. German workers from several industries waged a series of strikes last month demanding a greater piece of the economic pie after years of being asked to make salary concessions – flexibility that, some economists argue, has helped a leaner, meaner Europe stave off recession so far.

"Inflation-adjusted incomes rose from 1% to 2% in the late 1990s, but more than one million Germans lost full-time jobs during and after a recession in 2000 and 2001. Subsequently work weeks got longer without extra pay, and from 2004 through 2007, inflation outpaced income increases for the average family.

"In France, the 35-hour work week kept average annual pay increases below 1 percent for nearly a decade, said Robert Rochefort, the director-general of Credoc, an organization in Paris that researches living standards. But big-box French hypermarkets that dominate the retail market – kept prices high, he said. Stagnant pay and soaring prices have hit Italy hardest. Recent statistics from the country's main shopkeepers union showed consumer spending down 1.1% in January from a year earlier, the biggest drop in three years. Leisure and recreation spending fell 5.5%."

Undoubtedly the European Central Bank that has limited the budgetary deficit and has a different background from that of Canada and even from of the US, and actually pays interest on the statutory reserves that banks put up with them. And there is, of course, the fact that "inflation" cannot be applied to designate any increase in the price level. The basic logic employed in the vocabulary of economics as taught in the world's universities, and used by policy-makers must be reviewed. When there is too much demand to be covered by available

Fiscal Doxology

By decade-long evasion of laws already on the government books misinformation has piled up like mountain ranges. To clear our minds, let us reduce the factors to their very essentials to a trinity in the hope that the Lord Himself will look down on our effort and assist us with a smile.

This can be done as follows:

1. The credit of our central government is the only legal tender of the land.

This must be kept pure and not adulterated with the debts or aspirations of other actors. Just as anyone in olden days anybody found adulterating gold or silver to coin adulterate money. would earn himself – unless he had been crowned monarch – having a hand, or even his head chopped off. He most certainly must not be chosen our next prime minister.

2. The credit of anything else other than the central government that alone can "spend legal tender into existence" rather than "lend it for interest" into existence, must not to be confused with nor mixed up with that of the central government. The rules of accountancy – double-entry bookkeeping – were brought home from the Crusades by the Templars, legend has it. But it still had not reached the ears of our government until very recently, and then most imperfectly.

Until 1996 (US) and 2003 (Canada) governments were still "writing off" the physical investments of our central governments in a single year, while "amortizing" their financing over the approximate period of usefulness of such government investments. The result was a deficit that did not necessarily exist. It was only by such scams practiced against the recommendation of the government's successive Auditors General and several Royal Commissions that the legend of paying "down" and paying "off" the government debt arose. If you pay off the government debt, when central government debt is our only legal tender, you leave the country without legal tender – i.e., increasingly deflated. And if beginning with Year Two you carry valuable government real estate on the government books at a token dollar you multiply the opportunities for crooked privatizations.

The vast and ever increasing investments of our government in human resources: education, and hence health, and social services are still totally ignored. Our governments still considers it "financial prudence" to go on building prisons rather than enough schools, though the cost of prisons – to build, run, and keep filled to brimming, is by far the greater of the two.

3. All debt other than that of that of our federal government is of a steeply lesser quality that must never be confused with that of the central government. The latter has a call on all the assets, the human, and natural resources, and on the heritage of the land.

Since all the assets in existence have a cost, there is a confusion of negative signs, and what receives the maximum concern for its negative sign is in fact the government debt which is or should be considered an investment. To run our land as a serious democracy, the public must be re-educated to consider the debt of the federal government as a "positive" rather than a "negative item." which it would certainly become if the investments – physical and human – were properly handled in the government books.

Without the above three basic principles, our subprime accountancy will guarantee us subprime fiscal policy.

W.K.

supply, price traceable to what can legitimately be called "inflation."

The Intellectual Tools that Got Us into the Subprime Mess won't Get Us Out of It

But you cannot reverse propositions and consider them to remain valid. Prices may move up not because of inadequate supplies, but because of the notable increase in longevity of the average population, or because of the tremendous increase in urbanization. Anyone who plans to move from a town even of 50,000 to New York City and counts on his living costs remaining the same would be considered an idiot. How then have our officially installed economists in the Bank of Canada and our universities got away with such nonsense? Not once but in a multiple way. The laws of logic, let alone economic theory, have been reconstructed to reflect the commanding position that the deregulated financial sector has assumed. Undoing the damage calls for the cooperation of experts in logic, mathematics, physics, and in our own history, which have been excluded from the economic curricula in our universities. Or the little detail that for the past decade we have had almost incessant wars in which the United States notably have been involved. World War II was not only financed to a very substantial extent by our governments borrowing a growing amount of the cost directly from their central bank. When that is done the interest paid on such financing, in countries where the central bank had been nationalized, came back to the government as dividends, and even where the central bank – as in the US and Great Britain where the central bank was privately owned – a substantial portion of the interest on such financing from the central bank returned to the government as seigniorage – the monopoly of the ancestral monarch in coining precious metals, now entrusted to the central bank.

Systematically since the 1960s, the thinking processes of economists have been directed to the belief that the economy of the world can be understood and directed by manipulating benchmark interest rates.

To get to the bottom of the subprime economic mess we must examine the intellectual tools that were designed to establish the very supremacy of the globalized and deregulated banking system that underlies the shift of national income to the speculative financial sector. For this we will have to revisit and renew carefully the subprime logic in the light of mathematics, economic history and economic doctrine of several centuries. It is a daunting task but not so much as the effort to deal with the subprime mess with the crippling logical tools that brought it on.

W. Krehm

CORRESPONDENCE

More on Bank Reserves

Confusion abounds over the matter of bank reserves. In the US and some other countries "reserves" are defined as the sum of cash held in bank vaults and tills and deposits held with the central bank. The situation is somewhat different in Canada, Australia, New Zealand, South Africa and the UK. That's because the so-called "statutory reserves" (meaning compulsory deposits in the central bank, together with whatever is defined to be its equivalent) were largely abolished in these countries following the changes to banking practice which were implemented in 1988 (known as the Basel I accord).

However it is important to recognize that there remains in these countries a residual statutory requirement for central bank deposits. In Australia, for example, there are non-callable deposits (NCDs). These are funds compulsorily lodged by commercial banks with Australia's central bank, the Reserve Bank of Australia (RBA), and are liabilities of the RBA. They are the equivalent to about 1 per cent of each commercial bank's liabilities (excluding capital). The NCDs were introduced in 1988 to replace statutory reserve deposits, and the reserve deposits were at that time transferred to the NCDs.

In Australia, the word "reserves" is not often used in regard to commercial banks these days, because it is increasingly identified with the now obsolete statutory reserves. However the commercial banks hold considerable amounts of cash, and the big banks retain considerable positive balances with the central bank (RBA). Cash holdings are essential because the public has an ongoing need for it, and it is an important "prime asset." The prime assets, which are an indication of liquidity, are comprised of:

(a) Cash held in tills and vaults;

(b) Balances with the RBA, other than NCDs;

(c) Commonwealth securities (bonds, treasury notes).

Strictly speaking, only the NCDs are the equivalent of bank reserves. However many economists continue to refer to "any" positive balances with the central bank as reserves.

And since cash and commonwealth securities are interchangeable with RBA balances, the various prime assets may also be thought of as being "reserves" – used in a loose sense of the word. In an even broader sense, commercial bank deposits in other banks may be thought of as being "reserves" – the justification for this statement being that many smaller banks can effect clearances directly with larger banks via adjustments to their inter-bank deposits.

The table below provides asset figures for Australia's four biggest banks (for June 1998; RBA statistics). This gives an idea of the relative amounts involved.

John Hermann

Commercial Bank Assets

Web reference: http://www.rba.gov.au/Statistics/AlphaListing/alpha_listing_b.html

The following set of figures for the assets of Australia's four biggest banks (for June 1998; RBA statistics) gives an idea of the relative amounts involved (the numbers shown are measured in $ millions):

Bank	Cash Holdings	NCDs	Public sector securities	Deposits in other banks	Loans to other bodies	Other lending (incl housing)	Total Assets
Westpac	653	762	3,786	689	–	59,215	91,146
ANZ	479	620	1,813	408	1,812	50,032	82,529
NAB	1,270	928	3,626	1,069	1,251	71,796	112,584
CBA	770	824	2,213	1,187	1,509	68,429	97,064

Brief Course on Capital Budgeting for Parliamentarians

The article reproduced below, written five years ago, first appeared in Economic Reform *of April 2003. Even the reference to "subprime debt" – very much the belle of today's ball – might be cited as a feat of foretelling, were it not that in all such appraisals, the point must be asked and answered: "for whom?" That aspect, best developed by the late French economist François Perroux holds that in every society there exists a "dominant revenue," the volume and increase of which is taken as index of the welfare of society as a whole. In Britain, after the Napoleonic wars it was the income of the landowners sheltered behind the high tariffs protecting agricultural products filled that role. With the repeal of the Corn Laws, it became that of the industrialists, who profited from the resulting drop in the price of foodstuffs that made possible a drop in money wages and higher profits. There was even a reason in that pious Christian land for not passing on the benefit of cheaper foodstuffs to the wages of those who laboured in the factories – given their lack of forbearance that would only result in still greater families – a view spread by the reverend Thomas Malthus, a much revered economist and not in disagreement on this point with his great friend and correspondent, the still greater economist and stock broker, David Ricardo.*

Not necessarily fully aware of what they are up to, Perroux held that most writers and institutions act under the spell of buttressing the dominant revenue. Very often, with the help of a bit of politics, this ends up in the suppression rather than in the unruly pursuit of less relative truths.

In the deepening problems developing as the ever more deregulated, globalized interest rates came to be the one driving control of the economy, what was increasingly forgotten was that in an urbanizing, high technology society, the ability of central governments to borrow directly from the central bank is an available source of interest-free money created by the central bank since the interest paid on such loans returns to the central government as a dividend if it owns the central bank, or as the monopoly of the ancestral monarch in the coining of previous metals. Anything that stands between the central bank and the government in the flow of legal tender from the central bank to the government is prejudicial and unsustainable. Particularly as, impelled by the need to grow exponentially the banks have an unsullied record of getting into ever greater speculative losses. Allow them through any form or agency, to get between the central bank and the government and in the long run that leaves only the military option for a desperate regime to play.

After forty years of evasion our government took a great step in bringing serious accountancy onto its books. Kudos for that to Auditor General Denis Desautels who in July 1999 refused his unconditional approval of the government books unless accrual accountancy (a.k.a., "capital budgeting") was adopted. Desautels was one of a long line of AGs who, along with three Royal Commissions, had raised the point. He, however, dug his toes into the effort. Against crushing odds, some of the founders of this humble newsletter, long before it appeared, had fought for such a move. Without it, bottom lines can become a mousetrap. Misleading statistics for debt and deficit block programs essential for society.

Dumbing-down Parliament

Most Non-Government Organizations avoided the matter like the plague, arguing that it was too complicated for the public to understand. You could have used the same logic against exposing the scams of Enron and other stock-market pin-ups, who also kept what counted off their balance sheets.

Letting those in power dictate what the public is too stupid to understand is the ultimate surrender. Today governments, beating the war drums and their economies in tatters, have begun acknowledging some off-book assets to be able to borrow more. But that has caught our Non-Government Organizations unprepared. In the peculiar society that has evolved, legislatures will make it their business to understand only what concerned citizens won't allow them to ignore. The educational process in public affairs is from the bottom up, not from the top down. For it is at society's bottom that the victims are buried. Our NGOs themselves have moral accountancy to rethink. For lack of it, they have flubbed a rare opportunity.

After a couple of days of vague references to the novelty of accrual accountancy that justified a modest amount of overdue program spending, the editorials and the parliamentary discussions reverted to the old number-crunching – the "spending binge." "Can we afford it?" Accrual accountancy had been trivialized to meaninglessness.

In calculating your personal worth you include the value of the house in your assets and not just the mortgage on it in your liabilities. If you didn't, you would pay through the nose for further credit. Besides, the government might crack down on you for tax evasion, and other misrepresentations. Had other NGOs joined us in educating more people to the anti-accountancy on which key official statistics are based, the government could not have misrepresented the purpose of capital budgeting even while adopting a limited version of it.

What you must do to prevent this happening again is go through the list of NGOs to which you write a cheque each year, and ask why they had not forewarned the public about this mother of all government scams. Our problems will never be resolved without an informed public backing up the AG on the matter. Yet a beginning has been made. On bringing down his budget, Finance Minister John Manley even tried explaining accrual accountancy to his uncomprehending caucus. Yet it was essentially the same caucus that had passed the bill bringing in accrual accountancy in 1999.

Exactly the same thing happened in 1991 when the *Bank Act* was amended to do away with the statutory reserves that banks had to leave with the Bank of Canada as collateral for the lucrative money creation assigned to them by the Government. No explanation was given to parliament. No debate took place. Nary a press release was issued. I have met former cabinet ministers who were not aware of the bill two or three years after it became law. Continue along these lines and all our males will be wearing obligatory moustaches like that of the Governor of the Bank of Canada – some future one since Mr. David Dodge is bare-faced.

One of the most vicious forms of usury is known in the trade as "subprime debt." That is plied by "money shops" in lending to those who have no bank account, or "no documents." They are uneducated people, some with little English. They are not told, nor does it occur to them to ask, what the rate of interest will be. Their only concern is how much their total monthly or weekly payment will be. Not how long it will go on. In short, like our government

in its own books until recently, neither they nor the shark that exploits them, make the distinction between capital and interest. Our financial institutions, having lost boodles of their shareholders' money on mega-gambles incompatible with banking, are today expanding their involvement in sub-prime debt.

The government invites them to do so by having no ceiling in civil law on interest rates – in criminal law it is 60%. But what does it matter if their victims are too "dumb" to understand? Perhaps night-school courses could be opened to explain to such people how to defend themselves against such abuses. Members of parliament too must become conversant with the distinction between capital and current spending. For basically our government for the convenience of our banks has been running its affairs as "non-prime debt."

The government, and most of the provinces, had made no distinction in their books between the government's treatment of the wax they use in polishing their floors and of the floors themselves. Their buildings, bridges, roads, and all the other physical investments that last for decades, and the land beneath the buildings that is likely to appreciate in value over the years – to say nothing of the human investment by government in education, health and social insurance – are depreciated in a single year. By year two of their acquisition, such assets are carried on their books at zero value. But the debt incurred to acquire these vanished assets, more than anything else, occupies our editorials and political debates.

Yet it is impossible to balance such books, without subjecting the country to severe deflation. Even the attempt to do so must leave a deeper layer of taxation in price than is necessary. On top of that, for its one blunt tool "to lick inflation" the central bank has chosen a high enough rate of interest. And yet it is no secret that moneylenders with the slightest encouragement tend to become predatory. Not for nothing have several great religions committed usurers to eternal hell-fire.

To establish a monopolist role as an anti-inflation tool for interest rates, the *Bank Act* was amended in 1991 to do away with the statutory reserves. These had provided a complementary method of combating inflation, real or perceived. The statutory reserves required a modest portion of the money deposited by the public in chequing accounts to be deposited with the central bank. That earned them no interest. The availability of these funds to the government was a modest consideration for the monarch's assigning to the banks most of its ancestral monopoly in coining precious metals known as *seigniorage*. Since government credit has been the only backing for legal tender since the early 1970s, that seigniorage had grown wondrously – the cost of producing a dollar bill or a computer entry is far less than the former costs of creating gold and silver coins. The statutory

The Monumental Nonsense of Swaps in our Subprime World

The "risk-managed" high finance literally stuns true believers with its sky-high mathematics. In actual facts it can hardly withstand the rigours of a freshman examination in logic or mathematics. But let me bring in *The Wall Street Journal* on the subject of "swaps," probably the most obvious bit of nonsense in Wall Street's glories and disasters. In its issue of 04/01/08 ("Swaps Hold Huge Corner Needing Focus" by Scott Patterson and Serena Ng) we read: "As policy makers plot out a grand redesign of financial-market regulations, one huge corner of the marketplace ought to get a lot of attention: credit-default swaps.

"These financial instruments which don't trade on exchanges, are like disaster insurance on debt defaults. Investors who buy these swaps get a big payment if a bond or loan defaults. In return for the protection, the investor has to make regular payments to the seller of the swap.

"The market has become immensely important, yet regulators still haven't figured out how to deal with it. The Bush administration's planners curiously had almost nothing to say about it.

"Credit-default swaps were a factor in the recent troubles of Bear Stearns hedge funds and other firms that were on the other side of credit default swap trades with Bear tried to enter from their positions and pass them on to other brokers. That set off a broader panic about Bear's health as a counter-party, which pushed the firm to the brink.

"Swaps also played a deciding factor in the Federal Reserve's dramatic intervention. If Bear went down, others could have been dragged down through their exposure to the firm through swaps.

"Many firms have no way of knowing about problems of their counterparties in these trades.

"And yet – such swaps were written against $45 trillion of underlying debt as of the first half of 2007, according to the International Swaps and Derivatives Association. In many instances there are far more of these swaps written than there is actual debt that swaps are meant to insure.

"The market is important for other reasons. The explosion in these derivatives occurred at a time when corporate defaults were near record lows. Moody's Investor Service expects the junk bond default rate to climb to a range of 7% to 7.5% from just 1.5% now."

The number of non-performing swaps contracts is so hugely unbalanced with the relatively tiny number of countrparties that have simply written swaps as a source of fictitious capital, that the repercussions in the event of a major credit crisis is likely to be wildly amplified. as a source of "growth" that is simply not there.

"'We haven't gone through a massive default cycle,' says Gregg Berman, co-head of the risk management Group. 'I don't believe the market is remotely prepared for the fallout if that happens.' One problem for securities regulators: because these can be considered private contracts, and not securities, it's even not clear if traditional securities laws apply to them.

"Large commercial banks do need to file regular reports on their derivative exposures with the Office of the Comptroller of the Currency. The Depository Trust & Clearing Corporation also has set up an information warehouse that stores records of CDS trades. And the Federal Reserve Bank of New York has been pushing dealers and other firms to confirm and process trades more quickly. Last week, large dealers unveiled plans to centralize settlement of their credit derivative trades by September. But credit default swaps have become too important for the wattle and daub approach regulators have given them in the past few years."

What they have been trading is a minus sign against a plus sign with little concern for what accompanies these signs in real life. Only in a casino – where there is hope of real money behind the credit of the casino and the customer exists is there anything like it. It is like a caricature of today's high finance, but driven to the obviously ridiculous.

W.K.

reserves had enabled the central bank to cool an overheated economy without raising interest rates or raising them less than would otherwise be necessary. All it would have to do is increase the reserve that would lessen the money base on which the banking system can create its multiple of near-money (i.e., interest-bearing credit). Using interest rates instead of this hits anything that moves or stands still in the economy, not only those who may be investing or consuming too much.

Software of Debt Slavery

The resulting bogus deficit and debt figures are the software that imposes debt slavery.

Amongst the military, such unfocussed destruction of the innocent is known as "collateral damage." And great effort is made to avoid it. The Bank of Canada, however, glories in the extent to which it inflicts such destruction. It is testimony to its omnipotence. I have searched the *Bank of Canada Act* and have found nothing that might authorize our central bank to be more indifferent to innocent victims than the armed forces we train to kill. I invite our government to bring to our attention anything that I may have overlooked.

I found in the preamble, Chapter B-2, that the central bank was established "to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the

The Ultimate in Outsourcing

When Clive and others conquered an Indian empire for England little could they imagine what the transmission of English speech on a several-century grounding would lead to. *The New York Times* (24/04, "From Cubicle in India Come Please for US Debtors to Pay" by Heather Timmons) informs us: "Gurgaon, India – In a glass tower on the outskirts of Delhi, dozens of young Indians are on the telephone calling America's out of work, forgetful and debt-stricken and asking for cash.

"'Are you sure that's all you can afford?' one operator in a role of cubicles asks politely. 'Well, how do you take care of your every day expenses?' presses another.

"Americans are used to receiving calls from India for insurance claims and credit car sales. But debt collection represents a growing business for outsourcing companies, especially as the American economy slows and its consumers struggle to pay their purchasers.

"Armed with a sophisticated automated system that dials tens of thousands of Americans every hour, and puts confidential information like social security numbers and credit history at operators' fingertips, the new breed of collectors is chasing down late car payments, overdue credit card debt and lapsed installment loans."

At the other end, interrupted at mealtimes, or working hours, it seems like revenge for the conquest of their country centuries ago that perhaps would better be directed to the Queen of England.

Debt collectors in India often cost about one quarter of the price of their American counterparts, and are often better at the job, debt collection company executives say.

"'India will be the only place we grow this year,' said J. Brandon Black, CEO of the Encore Capital Group, a debt collection company based in San Diego. India is the company's largest operating area with about half the company's collection force of more than 300.

"Mr. Black said collectors in India 'are very polite, very respectful, and they don't raise their voice. People respond to that.'

"Companies like Encore buy bad loans from banks and credit card issuers for pennies on the dollar and pocket the cash they collect. The delinquent borrowers often owe at least a thousand dollars.

"So far just a tiny fraction, may be 5% of American debt collection is done outside the country, industry executives estimate. But new business is in the pipelines. Financial services clients are saying, 'We want you to collect my debt, to analyze it and change the way we sell the loans,' said Tiger Tyagarajan, executive vice-president of Genpact, the business processing company spun off from General Electric that has roots in India, Genpact which works with lenders to get customers to pay, rather than buying loans directly like Encore, employs thousands of debt collectors in India, Romania, Mexico and the Philippines, and is hiring in all those locations.

"In the past, the prevailing wisdom about wringing money from late payers has been 'if you're calling the Midwest, you want someone in the Midwest to twist their arm,' said Mark Hughes, an analyst with Sun Trust Robinson. That theory is changing as the pool of trained phone professionals in India and other locations deepens, and companies look outside the US because of lower costs."

"'This is really a sales job,' Mr. Hughes said. 'You are paid on your ability to collect.' Like many sales teams, Encore's collectors in India gather for a daily pep talk before their shift. In one recent session, they were schooled on the intricacies of American tax policy.

"One hundred thirty million US families will get a tax rebate this season as part of the new economic stimulus package. Those who qualify for the rebates will get as much as $600 a person or $1,200 a household. The IRS is going to pay this money in May.

"Once the calls start flowing, Encore's Gurgaon office resembles nothing less than the headquarters for an enthusiastic fund-raising telethon. Just minutes after collectors have put on their headsets, as superior yells out 'Rajesh, for $35 for three months,' all employees respond enthusiastically respond by clapping their hands and Rajesh is first on the day's sales board. "Encore – which also operates as Midland Capital Management – also files sheaves of lawsuits against customers who do not respond.

"Sometimes the debt is so old that the statute of limitations for filing a suit has passed, and it may have already vanished from the person's credit report. If the debtor makes a new payment, though, the statute of limitation starts all over again.

"Manju Muddanna, 27, who uses the name Michelle Green when she is on the phone, is one of Encore's best collectors. With laced-up stiletto sandals, wood bangles and a wad of chewing gum, she wheedles work and cell phone numbers out of debtors' relatives to track them down. Ms. Muddanna's telephone voice veers to the school-marmish, her learned American accent into Blanche DuBois territory. When people on the other end of the phone mumble, she upbraids them politely, 'Ahhhh just cant understand you, ma'am.'"

Given the trends of society and the economy, this may be the last refuge of the lost art of conversation in America.

W.K.

scope of monetary action, and generally to promote the economic welfare of Canada." Note that it is directed to mitigate...fluctuations in production, trade, employment as well as prices. That means deflation as well as inflation, unemployment as well as an overheated economy in which not enough workers can be found. It is not then just "collateral damage" that is at issue, but the very chosen target that defines what collateral damage might be.

Nor can our government wash their hands of responsibility for what the BoC does. Section 14(2) sets forth unequivocally: "If there should emerge a difference of opinion between the Minister and the Bank concerning the monetary policy to be followed, the Minister may give the Governor a written directive concerning monetary policy, and the Bank shall comply with that directive."

That makes the government the accomplice of the Governor for the illegal target he has set the Bank. With the world sinking into deflation, BOC Governor Dodge has raised the bank rate a second time, with a third boost promised because the unusually cold winter, the impending Iraq war and the Venezuelan strike have pushed up oil prices. Does he really believe that will improve the weather or bring peace to Iraq?

And to come away with clean conscience for the dreadful damage inflicted on our society by its "one blunt tool," the Bank and the government would have to examine the underlying economic theory that made such massive misfire possible. Not only has this not been done, but also anything that might resemble meaningful examination of alternative economic models has been eliminated from our universities and the media.

Elsewhere in this issue ("Economics and the Question of Falsifiability" by a new contributor, Dix Sanbeck), you will read about the work of Karl R. Popper: "There can be two reasons why a hypothesis must be discarded as false. The foremost one is failing when tested against observations. For instance, a hypothesis about a flock of swans, claiming they are all red, will be labeled false if an observation returns the report that they are, in fact, all white. But according to Popper, a hypothesis must also be discarded as non-scientific if it is not falsifiable, that is capable of being tested conclusively against observations.

This is the case if a hypothesis is couched in an open-ended language so that no matter how many false observation reports one gets, the hypothesis cannot be gotten rid of. 'Some swans are red' is unscientific because even if all known observations come back with the result 'false,' it is not possible to get rid of the hypothesis by confronting it with these observation reports. The person questioning the hypothesis can never be sure that there might be some red swans somewhere that just have not been seen yet."

That is precisely the pattern of our central bank policy over the past three decades. The damage inflicted by interest rates high enough to win the battle against "inflation" led to widespread bankruptcies. The banks, once bailed out by the government, were deregulated further to allow them to seek the Holy Grail of a self-balancing "pure

RENEW TODAY!
(SEE PAGE 2)

Could Moses, Mahomet and Jesus have been Outsourced to Low-cost Lands?

It is not hard loving one's neighbours, except when they show their special foibles. And the Americans as a nation tend to fill that bill.

In *The New York Times* (20/04, "How Scientific Gains Abroad Pay Off in the US"), the offending zing-word is "pay off": "At as time of economic belt-tightening, might cheap science from low-wage countries help keep American innovators humming? Americans have long profited from low-cost manufactured goods, especially from Asia. The cost of those material inputs is now rising. But because of growing numbers of scientists in China, India and other lower-wage countries, the cost of producing a new scientific discovery is dropping around the world,' says Christopher T. Hill, a professor of public policy and technology at George Mason University. American innovators – with their world-class strengths in product design, marketing and finance – may have a historic opportunity to convert the scientific know-how from abroad into gains and profits. as an unrecognized bonus for American creators of new products and services.

"Mr. Hill's 'insight, which he first described in a National Academy of Sciences journal article last fall, runs counter to the notion that the United States fails to educate enough of its own scientists and that 'shortages' of them hamper American competitiveness. The opposite may be true. By tapping relatively low-cost scientists around the world, American innovators may actually strengthen their market position.

"We shouldn't fear the rise of science in Asia and other poorer countries."

The Americans can afford to pay billions in rewards for Wall Street CEOs, but did overpay scandalously when they imported Albert Einstein for $35 a week during the Depression, because Adolf Hitler created a cheap source of Jewish and non-Jewish geniuses in Europe. Must it happen again?

"Optimism about scientific globalization is a wrinkle on the familiar story of outsourcing, just as the US companies have contracted out physical production, they can do so by tapping relatively low-cost scientists around the world, American innovators may actually strengthen their market positions."

Imagine what an increase in wealth, and hence in glory, England would have reaped if instead of producing Isaac Newton, they had imported an equivalently trained genius from Asia or Africa! What is missing in these ruminations? The notion that around Newton and Britain's entire bevy of great scientists a culture arose, that is not to be weighed or measured by stock market quotes. It contributed to how first England and then the world looked, at their fellow men and the heavens.

Perhaps it is history, and the history of cultures that the Americans lack and cannot be outsourced. The Romans had these advantages over President Bush. First they not only built roads for their legions to march on to further conquests, but they sensed when the time had come lay off building for further conquests and instead started building walls to protect the empire they were capable of defending. And behind those walls, and indeed before they were thrown up the senatorial class sent their sons to the humble Greek Island of Rhodes to learn Greek and Greek literature. They did not seek cultural bargains for those who might do such things for them more cheaply.

W.K.

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and perfect market." They got deeper into ever more speculative ventures incompatible with banking. The pattern was that of the gambler with a doting uncle who simply cannot leave the casino until he wins back his losses and takes home the pot. That purpose flowed over into the bailout of the early 1990s. Without the micro-cooked books of non-accrual accountancy, the surrender of our banking institutions to the stock market could not have taken place.

At the same time the very suggestion that a flat price level (identified with zero "inflation") might be an impossibility in a rapidly urbanizing high-tech economy, was denied even a hearing. What should have been met in the open and refuted – were that possible under light and logic – was ignored.

The growing need for costly physical and human infrastructures to run such a society requires a rapid growth of essential public services that only the government can provide. These are paid for by taxation, not by sales. Since they are not marketed, they have no price and therefore are ignored by a theory that identifies value with the price of the last transaction on the market. This is the deepest root of the classification of all non-marketed services as "externalities." Equally obvious, since all unmarketed government services are financed through the growing layer of taxation in price, flattening out price caters to those who oppose as an extravagance government spending for anything other than police, defence, jails, and hangmen.

This fits handily with the resistance to accrual accountancy that declares capital expenditures of government an "externality." For by writing off the cost of public investments in a single year, while noting the liabilities incurred to acquire them, the deficit and the debt can be puffed up to intimidate.

Putting Together the Jig-Saw Puzzle of Deceit

That also set the stage for the fire sale of government investments carried on the books at a token dollar. You could sell a public asset at one tenth of its value and use the proceeds "prudently" to reduce the deficit and the debt.

But what could the government do about such things? For we aren't we told that the Bank of Canada is "independent" of the government? Yet article 17(2) of the *Bank of Canada Act* reads: "The capital [of the Bank] shall be divided into one hundred thousand shares of the par value of fifty dollars each, which shall be issued to the Minister to be held by the Minister on behalf of Her Majesty in right of Canada."

There is in addition a highly relevant detail. The Bank was founded in 1934 by the ultra-conservative government of R.B. Bennett. The shares were sold to some 12,000 private stockholders. In 1935 the Liberals under Mackenzie King scored a sweeping victory on a program that included the privatization of the Bank. And in 1938 the shareholders were bought out by the government at a handsome profit – especially for those depression years.

It turned out an excellent investment for the government, essentially because article 18(c) that authorized the bank "to buy and sell securities issued or guaranteed by Canada or any province." These are immense powers, essentially the rights that go with ownership under capitalism. They could be made use of in two ways.

1. Securities of the federal government held by the BOC. Almost the entire interest paid on such debt (over 95%) would find its way back to the federal government as dividends.

2. Guaranteed by the Federal government and/or the province, loans could be made to municipalities. That, however, would not result in the return of the interest paid to the municipalities, since they are not shareholders of the Bank of Canada. Nor are the provinces. But such arrangements would open a new dimension of cooperation rather than confrontation between the different government levels.

In return for the municipalities agreeing to observe federal standards in the investments financed by such loans, part of the dividends corresponding to the interest paid to the bank of Canada could be refunded to the provinces or the municipalities. In this way the lower levels of government could be helped out of their present straits. The brutal downloading onto first the provinces and then onto the municipalities of social obligations without adequate funding would be repaired. That would do more to improve the relations of the different levels of government than a baker's dozen constitutional conferences.

But for all this, accountancy that distinguishes between public investment and current spending is an essential link. But that will require a proactive democracy that seeks out rather than buries essential information.

William Krehm

Onward to a Subprime Federal Reserve

If you had to put in a few words the great Rooseveltian revolution that brought us out of the Depression of the 1930s, it would be this: private banks were confined to commercial business and were not able to acquire interests in the other financial pillars – brokerages, insurance or mortgage companies. Why? Just look around you and see the mess that Wall Street is in with the subprime mortgages, that has spread like the Great Pox that has put the banks themselves in the category of subprime banking. Nor is it stopping there. Political power since the 1970s has shifted decisively to the financial sector to serve Wall Street better. Because of that clutch on power what we are now witnessing is the conversion of our central banks into subprime central banks. At that point there will remain only a final fling – military adventures as a way out – subprime peace will be the final option left. And at that point, even with President George W. Bush retired, Bushism and its weakness for preventive wars will have triumphed.

It is in a note of disbelief that *The Wall Street Journal* itself (11/04, "How Lehman Tapped the Fed's Spigot" by Serena Ng and Suzanne Craig) brings us up to date: "Financial Engineering helped get Wall Street into its current credit-market problems. Now, Wall Street's Lehman Brothers Holdings Inc. is using a little engineering – and some help from the US Federal Reserve – to bolster its finances."

Peddling Investment Vehicles Backed by Dubious Loans

"In recent weeks, Lehman moved $2.8 billion in loans, including some risky leveraged buyout debt that has been difficult to sell, into a newly created investment vehicle it named 'Freedom,' which in turn issued debt securities backed by the loans. About $2.26 billion of the securities received investment-grade credit ratings from Moody's Investment Service and Standard & Poor's. Lehman then pledged some of the securities as collateral for a low-interest, short-term cash loan from the Federal Reserve, according to people familiar with the matter."

The reader will note that in the process of this engineering, the miracle of rehabilitating Moody's and Standard and Poor's has already taken place.

"The result for Lehman: by repackaging unsold debt and turning to the Fed's new borrowing facility, it was able to turn loans that had been mostly shunned by investors for months into cash it could use to finance its business.

"Fed officials had worried in the early stages of the debt crisis that banks would be worried about the stigma of borrowing directly from the central bank. But use of the Fed borrowing facility has been robust.

"The Lehman deal shows how some of the issues brought to light by the credit crunch – such as the market's dependence on credit-rating firms and Wall Street's affection for complex investment structures – are still very much part of market activity."

That can only mean that that the Fed itself has gone subprime. We are not alone in such a conclusion. Thus the same *WSJ* goes on to quote Ed Grebeck, CEO of Tempus Advisors, a debt strategy firm: "The loss of confidence in structured finance ratings is at the heart of the current market crisis,' said Mr. Grebeck. For investment banks to go back to the ratings firms and say, 'Here's a new structure for you to rate investment grade – that's shocking to me.'"

We couldn't have said it better.

"A spokesman for the Federal Reserve Bank of New York said it doesn't comment on the collateral it takes on loans."

Wall Street in short has swallowed and digested the Federal Reserve.

"Last month, after a liquidity crisis nearly caused the collapse of Bear Stearns Cos., the Fed introduced a new lending facility for investment banks that would give them more ways to borrow against their holdings. Called the Primary Dealer Credit Facility, it accepts a range of securities as collateral for cash loans that can be rolled over daily. Among other things, the securities pledged must have market prices and 'investment grade' credit ratings.

"As of the end of February, Lehman held $17.8 billion in leveraged loans. These are typically issued to companies that have below-investment grade, or junk credit ratings and were commonly used to finance

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the Northeast because too many borrowers fell behind on their bills. Losses on the banks' loans ballooned. In January, to conserve cash as it wrote off more bad loans, Sovereign eliminated dividend payments. On Tuesday, the bank is expected to announce a 40% drop in first-quarter earnings.

"Similar troubles are echoing through small and midsize banks across the US. In a bid to expand during the recent boom, many set up operations in unfavourable markets or started pitching new products. Others, aiming to stave off encroachments by huge US financial institutions, boosted their lending by offering easy terms or lower rates. Now the slowing economy is exposing bad timing and blunders.

"Big US banks have received the lion's share of attention since the crisis began, due to their exposure to housing-related woes. Some analysts and investors are betting that these larger banks have gone a long way towards cleaning up their books. On Friday, stocks soared when Citigroup Inc. posted a first quarter loss of $5.1 billion, one day after Merrill Lynch & Co. announced its own first-quarter loss of nearly $2 billion.

"But there's a growing sense that there's another shoe to drop: losses at smaller banks. Regional and local institutions mostly dodged the initial wave of trouble because many weren't exposed to the complex mortgage-backed securities that slammed the behemoths. As housing prices continue to erode and the economy weakens, they're taking their lumps now, too.

"Regulators are bracing for a surge in bank failures, especially among smaller lenders that often lack the diversification to absorb steep losses in one area. These banks are also less appealing to the sovereign wealth funds and other big investors that have poured billions into larger banks.

"Though delinquencies and losses have risen in many types of loans, both remain below peak levels. About 1.4% of loans were between 30 and 90 days delinquent at the end of last year. That is the highest level since 1992, but still below 1990 and 1991 when more than 2% were delinquent according to FDIC (Federal Deposit Insurance Corporation)."

We are experiencing the fruits of unlimited sped-up growth, entrusting measurement of growth by complicated derivative games, where the players also fill in as goalies until….

We have reached that point and there is literally no way of assessing it other than running for cover – those who can.

W. Krehm

leveraged buyouts. The market prices of such loans have dropped significantly from levels nine months ago.

"Unlike commercial banks which can use loans as collateral for borrowing from a different Fed borrowing facility called the discount window, securities dealers and investment banks can pledge only securities, not individual loans.

"Lehman's Freedom vehicle is commonly called a collateralized loan obligation, or CLO, on Wall Street. CLOs are securities backed by a pool of loans. Freedom bundled together more than 60 of Lehman's loans and divided the risk by issuing two groups of securities which Lehman kept.

"One group of securities, valued at $565 million, wasn't rated and was structured to bear the first 20% of losses among the $2.83 billion in loans in the pool. The other group, comprising $2.26 billion in securities was assigned an 'A' rating by credit rating services because the debt pool would need to lose more than 20% before these securities suffered losses.

"Was it brilliant? One person familiar with the matter said the vehicle was named Freedom because it was designed to give Lehman freedom to tap as much cash as possible if needed. The size of the borrowing from the Fed wasn't known, but the person said it wasn't 'material' and was meant to as a test of what the Fed would accept."

"A number of Wall Street executives said they may follow suit. One senior finance executive at a rival of Lehman's said his main reservation with Lehman's move was that it might lead to criticism that Wall Street is taking its junk to the Fed for cash. Still, unlike many troubled mortgage securities, there is a discernible market for leveraged loans. 'It's a very creative way for investment banks to get liquidity from assets that they don't want to sell at fire-sale prices,' said Todd Kesselman, manager-director of Precision Capital.

"Since the summer when many parts of the credit market seized up, banks and Wall Street firms have been stuck holding hundreds of billions of dollars of loans, bonds, and complex securities backed by mortgages and other assets. The banks created the debt with the intention of selling it to investors for handsome fees.

"When many investors backed away from riskier debt last year, banks were forced to keep the loans. Liquidity in the market dried up as a result.

"To encourage firms to trade more freely with each other, the Fed has taken a series of unprecedented steps to boost liquidity in the markets, including the direct lending to securities dealers. So far, the Fed's measures have helped alleviate some of the strains in the credit markets."

But it has shot to hell the credibility of the debt of the government to the Fed as the sole legal tender of the land and the seigniorage rights of the government in spending that legal tender into existence. That provided an alternative to borrowing it from private banks at interest rates high enough to produce a price level as flat as the medieval world took the earth to be.

William Krehm

Architectural Evidence of Long Laid Plans for Sub-Priming Our Banking

The Globe and Mail (26/04, "A piece of drywall away from being part of the branch" by Tara Perkins) reports: "Customers who pull up in front of the new Royal Bank of Canada branch in Oakville, Ont., might not notice anything unusual. Through the front doors there's a set of automatic bank machines. Windows and doors divide them.

"What's unusual here, even revolutionary, is that that those two glass walls separating that bank branch from the coveted world of insurance sales represent one of the greatest growth opportunities left for the big banks in this country.

"Canada's *Bank Act* outlaws the promotion of most types of insurance to bank branches, a law that is unique in the developed world. The insurance ban is one of the few remaining restrictions banks continue to face in financial services, which is increasingly moving towards one-stop shopping.

"If a customer walks into the banking side of the RBC location in Oakville and asks where they can buy some car insurance, the employee is likely to squirm. Responding with 'we sell insurance,' or next door 'or just pointing at the insurance office is likely to break the law. They're instructed to hand over a generic brochure about insurance that does not promote the RBC.

"Within the next five years, the industry is hoping to demolish the laws that ban banks from selling most insurance products, including life, health, home and auto insurance in a branch."

The important thing to note here that the issue of the insurance is getting into financing and taking over entire insurance companies including those that insured the bogus quality of subprime mortgages and mortgagors. The really important issue the banks won in the series of deregulations that began in the sixties and continued in the seventies, eighties and nineties, when they acquired access to the cash reserves of the insurance companies.

That was far more important than the ability to sell insurance in a bank branch or not. The first issue which was won by keeping all relevant information from the public has to do with increasing the financing of banks for future adventures in real estate, stock markets in Canada and across the world. Once the banks won those key rounds they increased their gambling capital inordinately. Much of that new capital they lost in a series of gambles of which Enron is a shining example. The losses of the Canadian government in taxes in the out-of-court settlement of the CIBC in the off-balance sheet settlement amounted to about a billion dollar in taxes that would otherwise have been due to the Canadian government. Notably, an out-court-settlement to settle a class action was recognized was covered by the Canadian taxpayers without complaint.

At the time, too, there was a tremendous campaign lauding the conveniences of a single location arising from having Canada's banks take over the forbidden non-banking financial pillars. However before we knew it, when the banks won their battle, that one place for the consumer turned out to be before ATM machines in the bitter winter cold, as banks staffs were cut to the bone to absorb the massive losses in the US Savings and Loans.

It is notable that in the article we are citing the discussion is confined to the consumer area of insurance. The access to the insurance reserves, however, was by far of greater importance to our banks than insurance as a field of investment. The banks at the time won complete access to the cash reserve of insurance companies.

William Krehm