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Those in Charge of Dragging our Economy Out of the Gutter at Tether's End

The New York Times (10/09, "Taking Hard New Look at a Greenspan Legacy" by Peter S. Goodman) opens with a sweeping 2004 quote from Alan Greenspan, former Chairman of the Federal Reserve setting up his "legacy": "Not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but the financial system as a whole has become more resilient."

Then Mr. Goodman presents the result of his own researches: "George Soros, the prominent financier, avoids using the financial contracts known as derivatives, 'because we don't really understand how they work.' Felix G. Rohatyn, the investment banker who saved New York from financial catastrophe in the 1970s, described derivatives as potential 'hydrogen bombs.'

"And Warren E. Buffett presciently observed three years ago that derivatives 'were financial weapons carrying dangers that, while now latent, are potentially lethal.

"One prominent financial figure, however, has long thought otherwise. And his views held the greatest sway in debates about the regulation and use of derivatives – exotic contracts that were used in "swaps" with special insurers to protect investors from losses, thereby stimulating riskier practices that contributed to the financial crisis. For more than a decade, Alan Greenspan has fiercely objected whenever derivatives have come under scrutiny in Congress or on Wall Street.

"'What we have found over the years in the marketplace is that derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn't be taking it and transferring it to those willing to and capable of doing so,' Mr. Greenspan told the Senate Banking Committee in 2003. 'We think it would be a mistake to more deeply regulate the contracts,' he added.

"Today, with the world caught in an economic tempest that Mr. Greenspan recently described as 'the type of wrenching financial crisis that comes along only once in a century,' his faith in derivatives remains unshaken.

"'The problem is not that the contracts failed,' he says. 'Rather, the people using them got greedy. A lack of integrity spawned the crisis,' he argued in a speech a week ago at Georgetown University, intimating that those peddling derivatives were not as reliable as 'the pharmacist who fills the prescription ordered by our physician.

"But others hold a starkly different view of how global markets unwinded, and Mr. Greenspan's role in setting up this grief.

"'Clearly, derivatives are a center-piece of the crisis, and he was the leading proponent of the deregulation of derivatives,' said Frank Portnoy, a law professor at the University of San Diego and an expert on financial regulation.

"The derivatives market is a whopping $531 trillion, up from $106 trillion in 2002 from a relative pittance just two decades ago. Theoretically intended to limit risk and ward off financial problems, the contracts instead have stoked uncertainty and actually spread risk amid doubts about how companies value them….

"Over the years, Mr. Greenspan helped enable an ambitious American experiment

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FOUNDING EDITOR
John Hotson 1930–1996
PUBLISHER–EDITOR
William Krehm
(comerpub@rogers.com)
CONTRIBUTORS Vol. 20, No. 11
David Gracey, William Krehm, Richard Priestman
CARTOONIST
Allen Good
INFORMATION SECRETARY
Herb Wiseman (herbwise@cogeco.ca)
WEBMASTER
John Riddell

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in letting market forces run free. Now the nation is confronting the consequences."

To take such an approach is to befuddle the post mortem that our society has need of.

Underlying the derivatives we should be discussing is infinitesimal calculus developed in the 17th century independently by Isaac Newton in England and Wilhelm Gottfried Leibnitz in Germany. The mathematical essence involved is the shrinkage of scale to such a degree that the second degree of magnitude of the variable – its acceleration – its velocity being the first degree – can be disregarded.[1] That is why the technique is called *infinitesimal calculus*. Violate that basic concept, and the validity of the great discovery of Newton and Leibnitz vanishes…. Specifically what we should be discussing is not the *linguistic* essence of the word "derivative," but the mathematical essence of *infinitesimal calculus.*

The Mathematical Sense of "Derivative"

Returning to *The Times* effort: "For example, some of the contracts protect debt holders against losses on mortgage securities. (Their name comes from the fact that their value 'derives' from underlying assets like stocks, bonds and commodities.) Many individuals own a common derivative: the insurance contract on their homes.)"

It is true that the word "derive" in English does means something that emerges from something else; however, the infinitesimal calculus that we are concerned with exclusively deals with the rate of growth of algebraic expressions as the powers of the variables decrease a step at a time – constants becoming zero (because they do not change at all), first-degree terms (velocity) becoming constants, powers with the squares of variables become term of the first degree and this process is pursued over the infinite number of terms of the series. We are not dealing with the Webster dictionary use of the term "derivative," but with the infinitesimal derivatives of Newton. To miss that distinction is to befuddle the key mathematical problem of our day – the illiterate pursuit of continual explosive growth that confronts us wherever we turn.

"Throughout the 1980s, some argued that derivatives had become so vast, intertwined and inscrutable that they required federal oversight to protect the financial system. In meetings with federal officials, and celebrated appearances on Capitol Hill,' Mr. Greenspan banked on the good will of Wall Street to self-regulate as he fended off restrictions.

"Ever since housing began to collapse, Mr. Greenspan's record has been up for revision. Economists from across the ideological spectrum have criticized his decision to let the nation's real estate market continue to boom with cheap credit, courtesy of low interest rates, rather than snuffing out price increases with higher rates. Others have criticized Mr. Greenspan for not disciplining institutions that lent indiscriminately.

"But Mr. Greenspan's reputation may ultimately rest on a more deeply embedded and much less scrutinized phenomenon: the spectacular boom and calamitous bust in derivatives trading.

"A professed libertarian, he counted among his formative influences the novelist Ayn Rand, who portrayed collective power as an evil force set against the enlightened self-interest of individuals. In return he showed a resolute faith that those participating in financial markets would act responsibly.

"Time and again, Mr. Greenspan – revered figure affectionately nick-named the Oracle – proclaimed that risks could be handled by the markets themselves.

"Arthur Levitt, Jr., a former chairman of the Securities and Exchange Commission, says Mr. Greenspan opposes regulating derivatives because of a fundamental disdain for government.

"Still, over a long stretch some did pose questions. In 1992, Edward J. Markey, a Democrat from Massachusetts who led the House subcommittee on telecommunications and finance, asked what was then the General Accounting Office to study derivatives risk. Two years later, the office released its report, identifying 'significant gaps and weaknesses' in the regulatory oversight of derivatives.

"In 1997, the Commodity Futures Trading Commission, a federal agency that regulates options and futures trading, began exploring derivatives regulation. The Commission, then led by a lawyer, Brooksley E. Born, invited comments on how best to oversee certain derivatives.

"Ms. Born was concerned that unfettered, opaque trading could 'threaten our regulated markets or, indeed, our economy without any federal agency knowing about it,' she said in Congressional testimony. She called for greater disclosure of trades and reserves to cushion against losses.

"Ms. Born's views incited fierce opposition from Mr. Greenspan and Robert E. Rubin, the Treasury secretary then. Treasury lawyers concluded that discussing new rules threatened the derivatives market. Mr. Greenspan warned that too many rules would damage Wall Street, prompting traders to take their business overseas.

"Greenspan essentially told Brooksley that she didn't know what she was doing and that she would cause a financial crisis,' said Michael Greenberger, who was a senior director at the commission.

"Brooksley was this woman who was not playing tennis and not having lunch with these guys."

Like Our Decontrolled Economy Derivatives Strive to Infinity

The exponential expression has appropriate constant coordinates so that each subsequent term equals in form the one to the left of the preceding one but a single step higher. Accordingly, the value of the total expression goes growing at an ever-accelerating pace right into infinity. That is why the atomic bomb dropped on Hiroshima blew up the city in no time flat.[1] That, too, is why the same scenario – at a relatively slower pace, of course, has taken over our economy.

The fact that we can make use of such an expression for infinite growth in no way proves that such growth exists in the economy. In fact it can't, and the tortures that the world economic system is currently undergoing is proof that for environmental, and social and simple arithmetical reasons it cannot. But all that is lost on a public intimidated by the group with political power whose material interests are advanced by the fraudulent confusion of a purely mathematical abstraction with the world of reality.

What economists overlook is that mathematics – while endlessly resourceful in *analyzing* the realities they are applied to have themselves no empirical content. To pretend they do is to stand problems on their head. To discover gravity, Newton needed the empirical observations and preliminary analyses of astronomers such as Tycho Brahe and Kepler.

Today economics stand in need of appropriate mathematics which indeed had been developed, but have been suppressed. Among these we must include the work of a brilliant French economist, with whom I worked very closely, the late François Perroux, who formulated the concept of the "dominant revenue." This is the revenue of a particular class or economic group whose income is taken as a proper indication of the well-being of society as a whole. Under feudalism it was that of the large landowners. Then with the resumption of mining in Europe and trade becoming possible again, it came to be shared by merchants and bankers, and ushered in the consolidation of monarchies and an aristocracy of large landowners dependent on high tariffs on food stuffs, then the proto-manufacturers depending on the division of labour rather than on human muscles, and then during the industrial revolution brought on by Watt's steam engine, industrialists who were free traders so long as they enjoyed a world monopoly in harnessing energy for manufacture. At that time – the days of Ricardo – the gospel they preached was free trade, until rivals appeared on the continent. Then in short enough order followed the bankers. and then speculative banking, which preached globalization and deregulation that finally led to its current perpetual crisis. With the passage of power from one such group to another, the view of the world and the notion of what is more civilized changed radically. For the supremacy of these successive groups involved the view of the world and life itself.

And, of course, the alleged universal truths of economic theory were by no means unaffected by these shifting appraisals.

Thus when Ricardo wrote in the early 18 hundreds the working class was largely illiterate, and accordingly the labour theory of value that conceived of the value of a commodity in terms of the average labour that went into its production could carry no dangerous message to what was largely an illiterate working class. But before long mechanics institutes sprang up sponsored by philanthropists and began to teach more and more workers to read and write, and that made any labour theory of value seditious. It was like parents, having put their small children to bed, were free to discuss the intimate scandals of friends without fear of the kids hearing. The situation by the 1850s was more like the kids having awakened and the labour theory of value became seditious in a continent where barricades of class warfare had been thrown up. A need arose for a radical change in economic theory that would shift the determination of the value of a product from the factory floor to the consumer where value and its origins were reconceived as the amount of pleasure the ultimate consumer enjoyed in acquiring it. No accident that the idea for the new value theory was conceived almost simultaneously in Britain, Austria and France – in France in the very year of the Paris Commune.

The longer I live, the more convinced I am that even our greatest thinkers are deeply influenced by the technologies surrounding them. Karl Marx grew up in the railway-building age and that is reflected in his social thinking that sees society moving from stage to stage in a predetermined pattern to arrive at the grand terminal to which all passengers descend happy and content.

Our age combines the destructive potential of the atomic bomb with the scattered fragmentary information of internet blogs – anticipated by the late Marshall MacLuhan's brilliant summation of what had just begun happening: "The medium is the message."

And our culture and technology tap their toes to exponential expansion beyond anything that our environment can sustain. The constant conquests fed by the rhythm of derivatives that underlay the globalization and deregulation have brought us the into our present economic near-collapse.

However, it required a great deal more than derivatives to undermine our economic thinking to bring on the present all-enveloping crisis.

The Swindle of the Inflation Definition

There is, to begin with, that any rise in price levels is "inflationary." It stems from the illiterate view that has taken over in economics courses as a condition of professorial tenure: the proposition that a market demand larger than the available supply will have the inflationary effect of driving up the price level can be turned around to read that any rise in the price level indicates that that an excess of demand over supply exists. But logical propositions cannot simply be turned around and remain valid. Example: if you put a loaded pistol to your head and pull the trigger, you fall dead. But that proposition cannot be turned around: "A man falls dead, hence he must have shot himself in the head." There are countless other reasons for a man falling dead. From heart failure, to cite a single one.

Likewise a rise in the price level may be due not to an insufficient supply, but to the fact that more and better health, schooling, and other public services may have become necessary and that the governments providing them may have raised taxes substantially to provide them. That will result in a deeper layer of taxation in prices to provide unmarketed public services This I identified in a

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Global Bank Bailout Perpetuates World Financial Woes

UK Prime Minister Brown appears to have a more thorough solution to banking difficulties that had eluded the US Treasury and the Fed. And there is certainly no question that he went much farther towards bailing out troubled banks with government money. But there is this about stopping bold leaps to the half-way point. While stopping them at the half way point in mid-air, requires a winged hero, planning to complete them and landing with one foot on firm ground would be wiser. That the British Prime minister has not yet planned to do.

The congratulation to Prime Minister Brown for his bold thinking about taking the government injection of capital to the half-way point – was indicated by Carl Mortishhead of *The Times of London* (16/10): "Britain's partial nationalization of the biggest banks is causing consternation at the European Commission.

"On Monday, the commission approved the UK government's financial package for the banks, as a £37 billion ($75.9 billion) bailout under which the Treasury will buy preferred and ordinary shares in three big institutions. It is still unclear how much the state will own of these banks, but it could be almost 60 percent of Royal Bank of Scotland that also owns NatWest and ABN AMRO, the Dutch bank. More than 40% of Lloyds TSB, HBOS, another big lender, could also be in the state's grasp.

"The latter mega-bank in its enlarged form will control about a third of Britain's home loans market. If we add to that RBS and the other two banks, Northern Rock and Bradford & Bingley that are already languishing in the Treasury, the state has virtually nationalized the banking sector.

"In Brussels [capital of the European Union] there is unease and enthusiasm. The commission, as usual, has found itself sidelined as heads of government grabbed policy tools with no more than cursory consultation with the Eurocrats. The commission said it was approving Britain's aid package because it was 'limited in time and scope.'

"In terms of scope, it would have been hard to fashion a more far-reaching bailout, and as for time, the Treasury is keeping mum. No one knows how long the nationalized banks will remain under state jurisdiction. In theory, the government would like to see them return to the private sector as quickly as possible – the taxpayer wants his money back. The banks, too, don't want the government on their backs, not least because the preferred shares that form the bulk of the capital injection carry a 12% coupon. For the banks it's a hugely expensive prop to their balance sheets that they would like to repay as quickly as possible…."

Banks Hobbled by Preferred Shares

"If that is to happen, these parastatal banks need to recover quickly to do lots of profitable lending. But that could prove difficult, hobbled as they are with the burden of the preferred shares, which forbid any dividends to ordinary shareholders until the taxpayer has been fully repaid. Barclays has ruled itself out of this rescue package, hoping that the equity markets will help it to raise its Tier 1 capital rations to the new stringent requirement of 9%.

"Meanwhile, in mainland Europe, the leading banks were running shy of their own government bailout schemes. Credit Agricole and BNP Paribas said non merci to the French government's proposed €4 billion ($6.398 billion) rescue fund and the German Banks are less than eager to take up the offer of expensive state support.

"It is easy to understand why they would rather go it alone. Hamstrung rescued banks with government shareholders breathing down their necks will be unlikely beneficiaries of corporate opportunities. There will still be casualties over the coming years in the European financial sector but these will be isolated cases, niche players who will look for big shoulders to lean on. To whom will they turn for safety? They cannot look to Britain's part-nationalized firms, which will be barred from acquiring further market share due to their state support.

"Over the next few years there will be a massive restructuring of the global banking system as the borrowing in exotic structures is unwound and off-balance-sheet vehicles closed."

All this has guaranteed that the world will not be running out of banking headaches.

And yet there is a simple way of dealing with the banking crises. We are thus caught, we might say, in mid-air with no safe landing in sight – except one tried and rooted in our own history, unfortunately buried and forgotten.

The United States, Canada, and eventually the world softened the bite of the Great Depression fairly early – in 1933 – financed WWII and the first two decades of the reconstruction in the peace, by adopting the banking reforms introduced under Franklin Roosevelt. These forbade banks to acquire interests in the "other financial pillars" – at the time stock brokerage, insurance, and mortgage corporations. The reason? All such firms carry cash and near-cash reserves for the needs of their own firms. Allow banks access to these, and they will use those reserve as money-base for applying the "bank multiplier" which allowed them to lend out as much as ten times the cash in their vaults. It was only when these wise restrictions were removed beginning in the 1950s and speeding up as they went along, mixing up bank money with real legal tender, and building what might be called many-floored skyscrapers with one-way elevators that can only run upward, never down, that the banks got into ever greater difficulties.

That is one thing we might well have learned from history, had it not been systematically suppressed – where it relates to the conversion of our banks to the media of speculative finance. That was embodied in the *Glass-Steagall* legislation adopted in 1933. It was weakened after the war bit by bit into practical non-existence and formally repealed in 1999.

It could and should be brought back. And a further hardly less vital bit of legislation must be introduced as well. The accession of our banks to power over governments and society, was planned and coordinated by the Bank for International Settlements, a sort of central bankers' club based in Basel, Switzerland. To its sessions elected members of government are not invited. When the American banks lost heavily in the 1980s by being allowed to take over the Savings and Loans (S&Ls – essentially mortgage trusts). they lost a peck of money and passed those losses on to the US taxpayers. The BIS brought in two measures to their rescue. The government debt of developed countries was declared risk-free, therefore requiring no down-payment for banks to acquire and a few years later the BIS raised interest rates wildly – into the high-teen percent range and even beyond – to bring what it chose to call "inflation" to zero.

In actual fact prices may rise not only because of a shortage of supply to satisfy existing demand. That is a definition of "real inflation." Prices, however, can go up as well for quite different reasons – because the government has invested more capital in physical and human infrastructure. Paid for through taxation, such investments result in an ever deeper layer of taxation in price. However, this has not been recognized as such and is lumped together under the heading of "inflation."

In 1993, at the behest of the BIS, interest rates were raised into the mid-teens range and beyond to reduce prices to absolute flatness, at a time when the treasuries of many governments had been allowed to load up with government bought entirely on credit. Incredibly what was not foreseen: those high interest rates would deflate the market value of the banks' 100%-leveraged bond hoards. That almost created an international financial collapse.

That impressed the US government that the time had come to put an end to the high-interest regime. To deal with that problem in stealth, the Clinton government decided that high interest rates as means to a flat price level must be ruled out. And to remedy that, they introduced a more honest if not completely forthright accountancy.

Why Clinton Brought Serious Accountancy into Government Books

Up to that point, when a government built a bridge, a building, or made other capital physical investments, it would write off the debt incurred for the investment over the probable period of usefulness of the investment. That is known as *amortizing* the debt. But the value of the actual asset acquired was written off completely in the year the investment was made. That, of course, throws open all doors and windows to a land of fiction showing deficits where they do not really exist. In Canada many economists and several royal commissions decades ago urged that proper double-entry accountancy be introduced into the government's books. When the failure to do so almost precipitated an international crisis in 1996 the US government actually adopted accrual accountancy, but mislabeled it "Savings," which it was not, since that implies cash or assets readily convertible into cash. It was almost as though the government was ashamed of committing a good deed in the light of day. By carrying the correction back to 1959, it actually retrieved well over one trillion dollars in the net value of its physical assets that had been kept off its books.

Investment in human capital, however, has been left untouched to this day. Spending for it is still treated as a current expense. There is still an immense amount of unacknowledged capital assets totally paid for by the government that has been kept off its books.

One of the positive outcomes of WWII is the proof that it provided that investment in human capital is the most productive investment that a government can make. This was arrived at by Theodore Schultz, one of the hundreds of young economists that Washington had sent to Germany and Japan after World War II to forecast how long it would be before those great defeated powers could emerge again as formidable competitors in world trade. Twenty years later Schultz published a paper on how mistaken in their conclusions he and his colleagues had been. And the reason, he concluded, was their having concentrated on the physical destruction of the war, and attributed little importance to the fact that the well-educated, trained and disciplined

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paper carried by the *Revue Économique* of Paris in its May 1970 issue. It those dim distant days it was reviewed favourably in the Economic Journal of Cambridge University and in other university publications. I referred to this non-inflationary but structural rise of the price level as "the social lien."

Obviously raising interest rates to suppress this non-inflationary price rise makes no sense, but it does increase the profits of money-lenders and empowered speculators.

William Krehm

1. The exponential expression has been designed so that the whole infinite algebraic expression stays the same but simply moves one step to the left with each increase in the order of the acceleration.

Here are the first couple of terms of the infinite series that are the mathematics of infinite growth: $1 + (x+dy)^2 = 1 + x^2 + 2xdy + (dy)^2$. The 4th term being of the second order of smallness equals approximately zero, since the terms are infinitesimally small and the difference between the two or the first derivative is $dy = {}^1/_2x$. In calculating the first derivative – the growth rate of the entire expression – we take its first derivative, and the first term, being the constant 1 disappears.

Not to worry since the first derivative of the second term x) becomes 1 so that total effect is for the whole expression to move one space to the left, while at the right end – it being an infinite expression – a new term not given in the previous paragraph appears to replace it. It is built around the "factorial" expression that consists of the following: 1 x 2 is factorial 2; 1 x 2 x 3 is factorial 3, etc., to infinity.

The use of the factorial in the denominator of each successive term gives the derivatives of the exponential curve preserved the exact form of the immediately previous derivative of the expression: the factorial expression is placed in the denominator of the coordinate of the various terms of the derivative so that it will exactly cancel out the coordinate of the higher derivative as they move to a higher order has produced in the numerator of each term.

work force of these two great countries had come through the conflict basically intact.

For that Schultz was awarded the Bank of Sweden Nobel Prize for Economics, briefly celebrated, and then carefully forgotten. Nevertheless his discovery today could serve quite miraculously to get our banks and governments out of the blind alley in which they are stuck. Doing that would bring the current mounting crisis to a glorious resolution. Anything less will be preparing the world for still more disastrous consequences of the same cooked government books a few years further down the line.

And for good measure, governments must shift all their investment business to their own central banks.

In this way instead of heading into a major depression, they would emerge with a vast program for rehumanizing governments and serious accountancy long overdue. The alternative can lead us nowhere except to ever mounting disasters.

William Krehm

Britain More Alert than Washington to the Depths of the Crisis

The greatest sell-off of the world's stock markets since the 1929, for its depth and spread, found the British Government embarked on what was definitely more than the palliative that Washington had been dabbling with for the occasion.

Let us consult *The New York Times* (9/10, "British Government Takes Different Route to Rescue the Nation's Banks" by Landon Thomas Jr. and Julia Werdigier): "London – In a bold move to restore confidence, Britain announced an unprecedented £50 billion government lifeline for the nation's banks Wednesday that it hailed as a quicker solution to the credit crisis than a $700 billion American plan to buy impaired mortgage assets from troubled financial institutions.

"Britain offered banks like Royal Bank of Scotland, Barclays and HSBC Holdings up to £50 billion or $88 billion, to shore up their capital in exchange for preferred shares. It will also provide a guarantee of about $438 billion to help banks finance debt. The Bank of England will double the amount it lends banks under its special liquidity plan to $350 billion.

"Prime Minister Gordon Brown, whose political legacy presented the British strategy as a means to address the heart of the crisis. 'This is not the American plan,' he said Wednesday. 'Our plan is to buy shares in the banks themselves and therefore we will have a stake in the banks. We are not simply giving money.'

"In a further jab at the American approach, shaped by Treasury Secretary Henry M. Paulson Jr., Mr. Brown added that the time for buying devalued related assets had passed. Indeed, although Mr. Paulson would restore the financial industry by purging weak holdings from bank balance sheets, many analysts believe he will need to consider recapitalization of American banks.

"The British package, stitched together in 48 hours, was intended to restore trust among banks after the effects of the credit crisis wiped billions of pounds from their market values. It aims to encourage banks to start lending to each other and to consumers and companies, to prevent a further lockdown of Britain's already strained economy.

"Britain's decision to effectively nationalize any bank that accepts public funds rolls back more than 20 years of accepted political thought. That view held that financial institutions, charged with the responsibility of protecting a nation's savings, can do so with minimum supervision and aid from the government.

"But a spate of high-profile bank failures and a sense that the rapidly spreading credit squeeze could result in a global stock market crash have given momentum to the idea that the government must rein in excesses of its misguided financial institutions by becoming their largest shareholders.

"The announcement coincided with an emergency interest rate cut by the Federal Reserve, the European Central Bank, the Bank of England, and three other central banks that was intended to ease pressures.

"But most banks, while welcoming the government intervention, stopped short of saying they would use the offer to exchange preferred shares for capital. Many may be reluctant to tap the program except as a last resort to steer clear of government intervention."

British Banks' Reluctance to Trade Preferred Shares for Capital

"HSBC, for example, said it 'had no current plans to utilize the UK recapitalization initiative.

"Mr. Brown said banks that accept taxpayer money to bolster the capital they set aside for emergencies would have to be satisfied with executive compensation, dividend payments and lending activities. He said there would be string attached and conditions to be met by the banks, as the government expects taxpayers to be 'rewarded for the support we provide.'

"Mr. Brown's salvo could serve as a model across Europe, as well as in emerging economies where the idea of the state's taking supervisory stakes in strategic businesses is accepted. Already, governments in France and Italy have said they would consider buying stakes in their banks if doing so would improve their financial conditions.

"European leaders are still clashing over common measures to be adopted to ease the financial crisis. Many, including Chancellor Angela Merkel of Germany, are opposed to paying into a joint European fund to rescue banks.

"Laying blame for the mortgage crisis at America's doorstep, Mr. Brown argued that aside from providing banks with a desperately needed source of funds, the British plan would serve as a force for discipline and supervision.

"Since 1997, Mr. Brown has been a powerful voice behind the Labour Party's embrace of an American-style economic philosophy light on regulation. The laissez-faire approach encouraged the country's banks to expand internationally and chase returns in areas far afield of their core mission of attracting depositors. The City of London boomed and the Bank of England became independent and Labour's old, statist tendencies were abandoned.

"For a nation that has veered so far from the heavy regulatory mind-set that dominated its political agenda of the 1970s, the moves on Wednesday to nationalize rejects some of the worst excesses of capitalism built up in recent years.

"'This reminds you of a fundamental truth: there is no such thing as a free market,' said Sunder Katwala, the general secretary of the Fabian Society, an organization in Britain that long has held the view that the government should have a supervisory if not interventionist role in the economy."

W.K.

Accountancy Can Help Us Over the Paradoxes of Debt and Possession — Let's Use It

A front page article in *The New York Times* (31/10, "Economy Shrinks With Consumers leading the Way" by Peter S. Goodman) wages a doleful tale: "Less than a week before Americans go to the polls to select a president, the government reported on Thursday that the economy contracted from July through September. In a stark indication of widening national distress, consumer spending dipped for the first time in 17 years.

"Economists said the drop in economic activity – with the gross domestic product shrinking at a 0.3 percent annual rate – presages bad news in the months ahead. The impacts of a now global financial crisis are continuing to squeeze companies and impede investment, causing more layoffs and austerity, while prompting Congress to consider a fresh round of spending aimed at stimulating commerce….

"With the economy the dominant issue in the presidential election, the latest batch of dismal data offered no comfort to the Republican nominee, Senator John McCain of Arizona, who has been running behind the Democratic nominee, Senator Barack Obama off Illinois, in polls. On Thursday, Mr. Obama seized on the latest evidence of the backsliding economy to warn that Mr. McCain would deliver more of the same.

"'Our falling GDP is a direct result of eight years of the trickle-down, Wall-Street first, Main-Street-last policies that have driven our economy into a ditch,' Mr. Obama said while campaigning in Florida….

"'Obama's ideologically driven plans to redistribute higher taxes on families, small businesses and investors,' Mr. McCain's chief economic adviser, Douglas J. Holz-Eaking, said in a statement distributed to reporters.

"Economic downturns have proved unkind to the incumbent party in elections. Many analysts argue that the recession of 1990 and 1991 cost President George H.W. Bush a chance at re-election in 1992. President Jimmy Carter, a Democrat, lost his 1980 re-election bid to Ronald Reagan after a particularly nasty recession earlier in the year. In 1960, in the midst of a recession, John F. Kennedy defeated Richard M. Nixon, who had been vice-president in the Eisenhower administration.

"Not since 1900. when William McKinley, a Republican, won re-election, has the incumbent party retained the White House in the midst of a recession or within a few months of one."

Unless economists really know what and why recessions come when they do, and how to avoid them, our democratic institutions are to a large degree bluff – they really are not there as they claim to be when they must prove themselves.

"Whoever captures the White House seems certain to inherit a starkly challenging economic picture. The economy began slipping in the last three months of 2007, dipping at a 0.2 percent annual rate. Then it grew modestly for six months, aided by tax rebate checks, but has since succumbed anew to slow down."

The Slaughter of Credit

"Consumer spending, which makes up more than 70% of American economic activity, dipped at a 3.1% annual rate between July and September after growing at a 1.2% annual rate in the previous three months.

"That was the largest three-month drop since the second quarter of 1980, a contraction that was in some sense artificial: the Carter administration, seeking to suffocate inflation, imposed limits on bank borrowing. Putting that episode aside, this year's drop represents the sharpest decline in consumer spending since the end of 1974. Economists saw in the data a testament to the degree to which many households are so strapped that the very culture of American consumption has been altered.

"After years of pulling winnings from soaring stock markets, borrowing against the appreciating value of homes and leaning on abundant credit cards, Americans are finding those arteries of finance sharply constricted.

"The economy has shed 760,000 jobs since the beginning of the year, with layoffs accelerating in recent months. Many companies have cut hours of workers on the payroll, further diminishing paychecks. Housing prices have continued to plunge, removing home loans as a channel for finance. Banks still reckoning with disastrous investments in real estate have cut credit even to people with relatively decent histories.

"This month, consumer confidence, a broadly watched gauge of American sentiment in use since 1967, plunged to its lowest point on record, attesting to the new psychology of worry and scrimping that now holds sway. Tucked into the data released Thursday was a worrying sign of a new potentially pernicious phase of the downturn. Investment by businesses for things like machinery, trucks, computers and software slipped by 1 percent in the third quarter. That dip could swiftly accelerate, as companies recognize diminishing business opportunities and forgo purchases.

"In the last recession, in 2001, this type of outlay, capital spending, slipped at a 14-percent annual rate in the worst quarter. As orders dry up, layoffs accelerate, further reducing business in a downward spiral. This is the thinking behind forecasts that now broadly assume the unemployment rate could jump from the current 6.1 percent to beyond 8% by the middle of next year, a level last seen a quarter-century ago. This is the image that has many analysts assuming that the next six months will bring more pronounced contraction, as the downturn deepens into the most painful recession since the early 1980s, and perhaps even the 1970s, when the oil shocks assailed the nation.

"Most economists think a continued slowdown in exports is inevitable as much of the globe follows the US into disarray. The financial crisis born in the US has spread to Asia, Europe, Latin America and the Middle East. Many countries that have been major buyers of American-made goods are now suffering.

"Another continued source of economic growth is government spending, which expanded at a 5.8% annual pace in the third quarter. Military spending surged at an 18.1% annual rate, and federal spending over all jumped at a 13.8% annual clip.

"There's a message in that, 'said Mr. Bernstein, the Economic Policy Institute economist, who has urged Congress to create another package of government spending measures to stimulate the economy. "The one part of the GDP we can reliably count on in these times is government."

That like all the "analyses" hemmed in by the sharply staked preconceptions of a class-ridden society, those figures reveal only what they want you to know. Then why does it happen that the subheadings of the GDP arising from government spending break up into 18.1% for military spending while over all federal spending – i.e., jumped at a 13.8% annual clip. Could this not indicate a preference for military spending to keep the economy and the expansions that make for armament races and wars? And what is the nature of the accountancy by which the government records its spending, in whose interest is it made, and how is it recorded?

Let us begin with what we have learned from our own history. For in the 1920s the banks had gambled where and as they wished until the world economy collapsed around their ears as ours is in the process of doing today.

We have in our very government's own partial amendments that resulted from the belated adoption of accrual accountancy (also known as "capital budgeting") a wide distinction that was only recently under duress partly introduced between the way our government treats its purchases of floor wax and the education of its engineers. Elsewhere in this issue of *ER* we discuss the matter and we will not repeat ourselves in detail. They used what was known as "cash accountancy" that carefully recorded and brooded over the amount spent to build or buy a building and "amortized" that cash spent over the approximate expected life of the asset it paid for, but treated the physical asset that money paid for just as it would the wax for its floors. It *depreciated* that value in a single year leaving a token one dollar on its books to assure the auditors that it had not escaped their memories, but that they had in fact carefully cooked its books on the matter.

That sort of "cash accountancy" had been criticized by a series of Royal commissions and the governments' own auditors-general for decades to not avail. Were a private company or individual to use it in reporting his tax returns, he would be severely punished by the government for cooking its books. Even after the world went off the gold standard and central government debt became the only legal tender left in existence, the system went right on. And during federal election campaigns questions from voters to the heads of government were invariably asked on national radio and TV systems, "When are you going to pay off the national debt?" with the answer delivered with a solemn statesmanly face: we will reduce it by 25% in five or ten years, whatever, with no hint that by reducing the supply of legal tender, the economy would be deflated. The democratic electorate was a donkey to be mounted rather than taken into the government's confidence, no matter how it voted.

Now it just happens – not unlike 1929 – that our history, and the work of a whole series of great economists, once appraised at their real worth, had provided the answer – ready-made to a simple solution for the problems that increasingly plague this.

But then in the 1980s the *Glass-Steagall* legislation brought in under President F. D. Roosevelt to revive a banking system that was in the process of being closed out. This legislation forbade banks to acquire interests in the "other financial pillars," to wit, stock brokerages, insurance or real estate mortgages. The reason? Each of these other "pillars" kept cash reserves for the needs of their own businesses. Allow the banks access to these, and they would inevitably apply the banks' multiplier to them as legal tender base, and lend out – at the time – up to ten times the actual cash on the basis of these reserves. Hence it would no longer be available for the purpose for which it had been kept.

However, with the passing of the years and the healing of the banks under the severe discipline imposed on them under Roosevelt, they hankered after the imperial sway that they had enjoyed in the 1920s.

So one by one the Rooseveltian reforms were done away with, and the banks took over the other financial pillars. As inspiration and model the economists who devised the system have in fact developed the supposedly economic equivalent of the exponential curve that produced the atomic bomb. "Exponential" refers to the power of the infinite algebraic series that expresses this: the powers of the coordinates – described elsewhere in this issue – are such that every power of the series raises the value of the series to equal that of its increase. It leaves compound interest behind as a mere stick-in-the-mud pace of interest growth. That is what has been powering the one-way ever-accelerating elevator that our economy has become.

But God in His heavens is not unmerciful. For the very mess of our governments and the economics faculties in our universities has unwittingly provided us with a ready-made solution.

Inevitably, having busied themselves suppressing everything of key importance that economists have come up with in the past, governments have overlooked the ready-made solutions out of the seemingly hopeless tangle they have made of our monetary and credit system.

Reversing What Would Be a Just and Workable Solution

While the governments of the world are missing a legitimate solution of the current world financial crisis, some of them are busy along the exact opposite lines – that will give the choice of avoiding write-downs of assets that have declined in value at their original purchase price. We quote from *The Wall Street Journal* (20/10, "EU Banks Get Leeway On Making Write-Downs" by Sara Schaefer Munoz): "London – European banks could soon find it much easier to avoid write-downs thanks to changes in accounting rules being pushed through by European policy-makers.

"In moves that analysts say could boost earnings but make it harder to discern the financial health of banks, the European Union and international accounting standard-setters are loosening so-called mark-to-market accounting rules, which require banks to value investments at the price they would get if they sold them immediately.

"The new accounting rules are 'one of the many weapons being deployed to fix the banking crisis, Belgian Finance Minister Didier Reynders said in an interview.

"Analysts say it is difficult to estimate how much banks could reclassify among their hundreds of billions of dollars in loans and other investments. Yet not having to value some assets at the current market price 'could have a material impact on earnings, said Morgan Stanley analyst Michael Helsby.

"Bankers have complained that mark-to-market rules are making their finances look worse than they are by forcing them to value their assets at market prices when markets are not working. But loosening the rules could allow them to hide serious problems.

"EU officials say that by month's end, the International Accounting Standards Board changes could be broadened to include complex derivatives, a type of investment on which banks have already suffered tens of billions of dollars in write-down."

In short, more of the dodging of serious accountancy that brought on the current crisis.

William Krehm

Elsewhere in this issue (page 14) I tell the tale of how the Bank for International Settlements having become the semi-underground war-room where the comeback of international bankdom to its past deregulated glories is plotted, it was at the center of the planning of the bailout of the banks from their vast losses when they were allowed to take over the Savings and Loan (S&Ls) in the US during the 1980s. Elsewhere (page 4) in this issue tell in detail how they brought in two bailout schemes that were irreconcilable. On the one hand they declared the debt of developed countries "risk-free" and therefore allowed the banks to accumulate such bonds with no money down. A few years later BIS urged central banks to raise interest rates to the skies to bring what it considered "inflation." This included any rise in interest rates including what is inevitable given the rapid urbanization, and longer life span, and need for a more highly educated work force and better care of the natural environment, as inflation to be repressed – of all things! – with higher interest rates. But they overlooked what every central banker should know – when interest rates go up previously issued government debt with coupons set at far lower levels years back lose value. And that is what happened to the apparent surprise of our assembly of central bankers. Elsewhere I recount how it almost brought down the international monetary system. But first a standby fund of the US, IMF and Canada of $51 billion was set up and did not have to be used, but for a more durable solution the US government introduced accrual accountancy, but only to cover the physical investments of the government. And this, lest some actual relationships shine through, started turning up in the Department off Commerce figures under the heading of "Savings," which they were not, since century-old roads, buildings and bridges, though very valuable are not readily convertible into cash as "savings" usually implies. Too many schemes of privileged groups rest on lack of clear facts to have them endangered. This set the precedent, however, for governments to get out of their otherwise hopeless mess today. The need only extend to government investments in human skills, and health, and well-being which includes environmental protection, to produce enough capital assets to back up the moneys needed to bail out banks that merit being saved, and the homes of mortgagors who are able to carry a reasonably adjusted mortgage.

But the key to it all is to bring to the government the unacknowledged vast investment in human capital that – as we recount elsewhere in this issue. It was recognized in the 1960s as the most valuable investment a government can make – the work of Theodore Schultz, who was much honored for it in the 1960s but since forgotten and his great work buried. It is the key to opening a way out of the blind alley into which deregulated finance has gotten us. Let us use it without delay.

William Krehm

Debt Folly

"Debt is the disease... and you don't cure it by freeing up banks to issue more of the stuff to consumers who can't afford what they already owe" (*The Globe and Mail*, September 27).

Truer words were never spoken. At $2.58 trillion, US consumer debt is staggering. Canadians aren't much better off, with consumer debt now exceeding 130% of per capita disposable income. The US national debt is approaching $10 trillion and will rise by over a trillion in the coming year. US consumers now spend 14% of their income on debt service. If interest on the national debt – paid through taxes – is included, the figure approaches 25%.

Such debt levels are unsustainable, hence the current financial meltdown in the US. We in Canada are not immune, despite the media cheerleading about our secure banking sector. Our banks have had to be bailed out before and they probably will again.

There is outrage, as there should be. There is anger at the financial executives who extracted millions from companies which are now bankrupt. There is anger at the president and legislators who took millions from Wall Street to deregulate the financial sector. It has become apparent that, despite all the rhetoric about free markets, what we actually have is capitalism on the way up (at least for the rich) and socialism on the way down. Hopefully this anger will result in some badly needed reforms.

But the basic problem will remain, because there is no public understanding and no political will to solve it. The real problem is that the US economy – and ours – run on debt and, unless we make fundamental changes in our monetary system, they will continue to do so. Almost all of our money supply is debt, i.e., money borrowed at interest. Only a tiny fraction – less than 5% of our money supply is debt-free legal tender issued by the government. If the credit system is impaired by bad loans, loss of capital, or loss of confidence, the money supply sinks and the economy shrinks.

As the credit becomes harder to get, consumers and businesses retrench or go bankrupt, spending falls, and jobs are lost. This is our current predicament.

Notice that in the US nothing is being done for the overextended consumer or mortgage holder. Wall Street is totally opposed to such action. Instead, hundreds of billions of dollars has already been committed to various financial firms. The $700 billion "rescue" package passed by Congress will buy up much of the toxic paper held by the financial sector.

The financial experts tell us repeatedly that this bailout is essential. Without it confidence would be lost, credit would dry up, and a financial meltdown would ensue. They are right. We are totally dependent on the credit system to supply us with money. Unless confidence is restored people will not borrow enough and banks will not lend enough. If the bailout works, we will experience a painful recession, but the money will start to flow again and the economy will recover.

But the price of recovery, and we cannot escape this, will be more debt. Since we deregulated the financial sector, allowing for an explosion of credit, it has become apparent that, for the economy to grow, indebtedness must grow even faster. The chief, indeed the only, beneficiary has been the financial sector, which lobbied for deregulation in the first place. The financial sector has got bigger and fatter, but there are no concomitant gains for the "real" economy. We can restore "confidence" and get the credit engine working again, but it is certain that debt will increase and that this debacle will recur in a decade.

Instead of a bandaid (some bandaid!) we must change the monetary system. The financial markets must be tightly regulated – as they were for several decades after the Great Depression. A Tobin tax to reduce speculation would be highly desirable. But most important, we must reduce our dependence on credit. A much greater percentage of our money supply must be debt and interest-free. It can be done.

David Gracey

Saving the Unholy Bank Mess with Simple Accountancy

The Governor of the Bank of England, Melvyn King, recently cited the worst bank crisis since World War I, as reason for cutting interest rates. That, however, would cause the price index to move upward. And in the vocabulary of those who run our economy, that is "inflation" – the worst thing that can happen. The main cited purpose of banks for the last half-century is to keep prices flat.

In the real world, the price level can, indeed, move upward because there is too much demand and not enough supply to satisfy it. That is real "inflation." But that does not mean that that prices may not have moved upward for quite other reasons. Nobody who moves from a town of 20,000 to New York City is foolish enough to believe that his living costs will stay the same. How then can it stay the same when a growing portion of the world's population has been making just such a move? The number of cities of 5 million has increased on all inhabited continents.

And then there is the detail that the higher technologies that have taken over call for far more education than used to be norm. A century ago anybody who learned to read and write was deemed educated. Today you need some university education to hold you own against your computer. One could go on indefinitely enlarging the list of such upward movements of the price level having nothing to do with an excess of demand over supply. Many of such non-inflationary types of price rise simply reflect the fact that our economy requires more public services that only the government can supply and are covered by taxation. The resulting taxation I have called "structural price rise." And the deepening layer of taxation imposed to pay for them, I have turned "the social lien."

There used to be two quite distinct ways of dealing with these very different kinds price level increases. The government can make no distinction and respond to any rising of the price index by raising interest rates. That will bring down prices only by beating down the economy into a recession, and if persisted in, a depression. This method hits everything that moves and reduces prices by increasing unemployment.

That is particularly appealing to those whose basic income is interest rates or who live by speculation on the price level.

But there was another policy weapon that had been developed in the great banking reform brought in at the very depth of the Great Depression by President F. D. Roosevelt in 1933, when things had become so bad that 9,000 American banks had shut their doors by the time the new President was inaugurated. After a full month during which all banks were shut down, and after consulting every economist who had something to suggest, Roosevelt brought in the *Glass-Steagall* law that amongst much else forbade banks to take over the other "financial pillars" – i.e., brokerage houses, insurance, and mortgage companies. The reason: each of these institutions keeps its own cash or short-term interest-bearing securities easily convertible into non-interest-bearing legal tender, to meet the needs of their own business.

Allow the banks to take over such non-banking businesses, and they will use those reserves as the basis for applying what used to be known as the "banking multiplier" – the number of times these bank reserves can serve as the basis for bank-loan creation. If permitted, not only can the bank multiplier become a many-storeyed skyscraper, but the risk and hence the interest rates multiplied until from the initial 1:10 as it existed in 1949, attained the level of 380:1 that it did by 1998. This amounted in fact to a growing skyscraper with the elevator running only upward at an ever greater speed and, of course, at greater risk. At a certain point there is only the military option left for the economy going on functioning.

Farewell Glass-Steagall

By that time the *Glass-Steagall* legislation brought in to prevent this, had not only been weakened and ignored, but actually repealed.

Such change in the guiding legislation implied a shift of political power into the hands of the banks. Under Roosevelt the manipulation of the central bank benchmark interest rate was not the only tool for encouraging or restraining business activity as the need came to be perceived. There was also the statutory reserves requiring private banks that took in deposits from the public to leave a modest portion of that deposit with the central bank that earned the depositing bank no interest. If the economy became over-heated – rather than depending entirely on raising the benchmark interest rate – that hit everything that moved or stood still – the central bank could increase the statutory reserves if it judged that the economy needed cooling, or lowering it if they wanted to perk up economic activity. The advantage of this alternative tool was that it reduced the dependence on high interest rates to control movements of the price level.

The end of the statutory reserves left interest rates the sole remaining arm for guiding the economy. But interest rates are the primary income of money lenders; and a mobile interest rate is the powerful arm of speculative capital. Along with Globalization and Deregulation carried out in the 1980s, this in effect delivered the world economy as a private casino to world financial capital.

This leaves little but the military option as a desperate way out of a seemingly hopeless situation. It certainly has been a major factor in Washington's incredible involvement in Iraq and above all Afghanistan.

Today the direct involvement of central governments in prime debt is to rescue major banks. What is imperiled is the soundness of many countries' legal tender.

And yet, instead of pushing stubbornly along these paths to doom, there is a simple, safe solution involving the double-entry accountancy that is a legal requirement for the private citizen or corporation. What is more, such double-entry bookkeeping was adopted to get the central banks out of a hopeless dilemma in 1996 in the US and in 2002 in Canada. To extend it to human capital would be as simple as baking with a cookie-cutter. Instead of the government or central bank taking over part of a growing deficit from banks involved in questionable securities, our governments could credit the banks with its vast and totally unrecognized investment in human capital.

Almost a half-a-century ago Theodore Schultz reached an important conclusion. At the end of the Second World War he had been one of the hundreds of economists that Washington sent to Japan and Germany to predict how long it would take for these powers would take to become formidable competitors on world markets again. And some twenty years later – in the mid-1960s. Schultz wrote a paper in which he noted how wide of the mark he and his colleagues had been in their prediction. And the reason, he concluded, is that they had concentrated on physical destruction, and overlooked that their highly educated and disciplined work force had survived largely intact. From that he concluded that human capital was the most productive investment can make.

That in fact may well be the greatest lesson learned from World War II. For a few years Schultz was highly honored, and soon almost totally forgotten.

Redoing the accountancy of our central governments would not only strengthen the bank balances with top-rank assets – the government's own credit – but recognize the resources unrecognized but more definitely at the disposal of developed countries to revive the economy even while providing highly useful projects in health, education, environmental upgrading.

There is nothing subgrade about these resources that cry out to be used. We will be happy to provide further documentation of this immense resource that comes pre-tailored for the purpose to exactly what the society needs.

William Krehm

A Rapprochement in Lack of Frankness of the Capitalist and Former Communist Worlds

A complete breakdown of an economic system, becomes impossible to hide with lies. The facts become as barefaced as the face of a full moon on a cloudless night.

And we experienced something very much like that on the 13th of October where after months of announcement of progress in reactivizing the banking system in North America and Europe, the stock markets in Canada and a bit across the non-communist world. After putting finishing touches on what might have been accompanied by the blare of trumpets, so much did sheer ceremony outweigh substance in the announcement that the banking crisis was over, the 13th dawned to reveal the reality: zilch.

That gave Mr. Putin a chance to gloat over would appear to be a final proof of the Russian model or whatever you might choose to call it. In *The New York Times* report (10/13, "Stock Slump Imperils Putin's Effort to Pump Up Russian Wealth, and His Legacy" by Clifford Levy), it is only in the final brief paragraph that we read: "Only at the end of the segment did the anchor mention in passing that the Russian market was not even open, without saying why."

But as we read this we found that similarly without advance announcement, the Toronto Stock Exchange was also non-functioning. The whole may be taken as proof of the principle: if you channel enough greed and corruption into whatever holistic plan for grabbing the bulk of society's product, you will end up with not dissimilar end results. You might start out with non-democratic Communism or with non-democratic Capitalism with power and all its trappings – no matter what the colour of the uniforms, the end results will be basically non-dissimilar.

Under a Moscow dateline the *Times* dwells on this uninspiring parallel in the financial management of the two competing systems: "The stock market here has swooned so often in recent weeks that regulators have repeatedly shut it down, as if Russia which aspires to be a financial powerhouse, has become just another bumbling backwater. The oligarchs, those Kremlin-connected magnates who once dazzled the world with their riches, are reeling. And Vladimir V. Putin is facing a threat to his legacy of bringing growth, stability and a renewed swagger to this nation.

"The global financial crisis has not spared Russia, wiping out roughly a trillion dollars in wealth and forcing the government to adopt a broad rescue plan to shore up banks. At stake is the country's robust economy over much of the last decade, which has been the first time given many Russians a taste of the comforts enjoyed in the West.

"For now, the damage has been largely limited to the Russian elite. While Russia's stock market plummeted by about two-thirds in May, more than those in the United States and Western Europe, it had a very narrow base of investors. It was dominated by foreign and Russian investment funds, which sprinted for the exits when things started turning bad."

Focussing on the Other Fellow's Stock Market Pains

"The Kremlin has also sought to contain the fallout from the crisis by having the main Russian television networks play down or even ignore the stock market collapse here. The network news programs have instead focused on financial troubles in the US and Europe.

"Still, the Russian stock market declines seem to be signaling investors' pessimism over the future of the economy and the government's steward of it. Even as Russia has experienced strong growth in recent years, driven by oil and gas revenue, it has not achieved gains in diversifying its economy. Nor has it had success in modernizing decrepit railways, power grids and housing.

"Russia's invasion of Georgia, the perception that the Kremlin has meddled in the affairs of large companies and pervasive corruption have deepened investor concern. These issues may help explain why Russia's stock market has declined more than those of other emerging economies like Brazil's.

"'The market drop has revealed one of the basic flaws in the Russian economy,' said Christopher Weafer, chief strategist at UralSib Bank in Moscow. 'Over the last eight years, they have gotten $1.3 trillion in oil and gas revenues, but the money has not been able to bring up the country's infrastructure. The bureaucracy and red tape and corruption are all lagging. This is a big problem for the market.'

"Moreover, while the average Russians have so far been insulated from the anxiety of Americans who have watched their anxiety plans shrivel, they should be feeling the pain soon. Major Russian companies – including Gazprom, the gas monopoly, and others controlled by the government – have lost large chunks of value, which could force them to cut employment and spending.

"Another danger is the drop in the price of gas, oil, metals and other natural resources, which form the base of the Russian economy. If the financial crisis causes a sustained recession in the West, depressing demand for these commodities, government and industry should suffer a sharp decline in revenue.

"The price of oil closed at $78 a barrel on Friday, only slightly above the level that the Kremlin factored to maintain its current spending. If prices go much lower, the federal budget will run a deficit, officials say.

"Russia's terms of trade are now moving against it. It will take some time, But it certainly will be felt.

"It has already been felt by Russia's oligarchs, the Kremlin's allies who control large portions of the economy. One of Russia's richest men, the metals tycoon Oleg V. Derepaska, said to be worth more than $20 billion before the crisis, has absorbed such steep losses that his associates have been obliged to give assurances that he is not sinking under debt.

"The Kremlin has announced several plans to support the economy using its reserves, and last week, Mr. Putin, the former president and current prime minister tried to project an image of calm, if not nonchalance. A judo expert, he released an instructional judo DVD in which he stars, and he was later shown on Russian television receiving a tiger cub for 56th birthday.

"He is also seemed to take satisfaction in the economic distress in the US: 'That confidence in the US as leader in the free world and the free market, the trust in Wall Street as the center of this confidence, has been undermined for good, I think,' he told members of Parliament from the Communist Party.

"Mr. Putin and his protégé, President Dmitri A. Medvedev, remain popular, in part because the stock market plunge has not yet touched most of the population. In 1998, when the government defaulted on its debt and devalued the ruble during the last major crisis here, things were far different, a many Russians lost their life savings.

"The Kremlin's popularity has also risen because of Russia's victory in the conflict in Georgia in August.

"The Russian population had gotten used to the fact that life was getting better, perhaps not as quickly as Russians thought they deserved, but getting better.

"All that was the foundation for a very positive attitude towards the Kremlin,' said Boris Makarenko of the Center for Political Technologies, a non-partisan consulting group in Moscow.

"Even so the Kremlin seems to be trying to forestall a public backlash by curbing news of the Russian stock market on the television networks.

"One morning last week regulators, worried about another plunge, closed the market. On the main television news at noon, the anchor described 'a new drop in world stock markets,' discussing declines in Japan and Europe that he called a reaction to losses the day before in New York.

"Only at the end of the segment did the anchor mention in passing that the Russian market was not even speaking without saying why."

William Krehm

Politicians Avoid Issue Costing Hundreds of Billions of Dollars

Taxes go up. Services go down. Pot holes get bigger.

Infrastructure deteriorates. Long term planning is postponed.

Not one of the parties in parliament has been willing to talk about the issue which has cost Canadian tax payers hundreds of billions of dollars. There was a lot of noise when the $100 million sponsorship scandal took place, but the mother of all scandals – which cost 600 times as much as the sponsorship scandal and continues year after year – has received nary a mention. This scandal is the failure of our politicians to support use of the Bank of Canada to finance government debt and the capital costs of public infrastructure. It costs our governments at all levels over $60 billion every year. Journalists don't write about it and politicians don't talk about it, yet it is one of the main reasons why we don't have enough money to pay for health, education, infrastructure and all the other things we think of as necessary for our society, why municipalities are almost swamped with downloads and why property taxes are rising.

If a public capital acquisition (e.g., subway, sewers, water system, etc.) costing $100 million were amortized over 20 years at 6 percent (which is what a private lender, bank or developer might charge) the cost would be about $8.5 million per year. If the facility has a life span of 50 years the payments, using the Bank of Canada, could be amortized over 50 years and would amount to $2 million a year plus the cost of administering the loan – less than 1/2 of 1 percent. In this example, financing public infrastructure with our public bank would reduce annual payments by about 70 percent.

The Bank of Canada was nationalized by Prime Minister Mackenzie King in 1938. It helped to finance WWII and all the enormous development after the war until the mid 1970s. It did all this without creating inflation, (inflation rate: 1950, 2.8; 1971: 2.9). One of the tools used to control inflation was the "statutory reserve" which was rescinded by Brian Mulroney and would have to be reinstated. Policy changed as the western world got caught up in the extreme free-market ideology promoted during the 1960s. Privatization became the vogue, including privatization of our money supply, as government reduced its borrowing from the Bank of Canada and increased its borrowing from the private sector. Federal debt increased by 3,000%, from $18 billion in 1974 to $588 billion in 1997, with huge increases in debt financing. To cope with these costs the federal government reduced transfer payments and downloaded programs and services to the provinces which in turn downloaded them to the municipalities. Municipalities have had no alternative except to raise taxes or cut services or both.

The usual excuse given by government for not using the Bank as it has been and could be used is that it would cause inflation – in spite of the record to the contrary. Other possible reasons (not mentioned by government):

- Chartered banks, wealthy financiers and some pension funds would howl at the loss of easy guaranteed income from lending to the government;
- The free-market ideology mentioned above;
- Central banks, coordinated by the BIS (Bank for International Settlements) support current policies;
- The fear that if Canada's monetary policy should veer substantially from the free-market ideology, world financial interests would come down hard on Canada, business would be hurt, jobs would be lost.

Referring to the Bank of Canada Act

The fear of repercussions is like a straight jacket limiting the actions of politicians. To get out of the free-market straight jacket requires politicians who recognize both the problem presented by the way the Bank is currently used and the strength which would come from using the Bank as it could and should be used. Canada has immense natural resources and a well-educated work force. Through its Bank it could finance infrastructure renewal, education, health services, housing and other community needs. The spin-offs from such activity would stimulate the private sector and create many well-paid jobs. The Canadian Labour Congress should support this use of the Bank because of the great benefit to Canadian workers.

The authority and power for doing all this comes from the *Bank of Canada Act*.

Section 18(c) of the *Bank of Canada Act* states that the Bank may buy and sell securities issued or guaranteed by Canada or any province. This means that municipal securities could be bought by the Bank if they were guaranteed.

Section 17(2) states that the capital (of the Bank) shall be held by the Minister (of Finance) on behalf of Her Majesty in right of Canada. This means that the Bank is wholly owned by Canada which receives as dividend the net income earned from interest or otherwise. It also means that interest paid by the Government of Canada to the Bank is returned to it as dividend less the cost of administration (very minimal). Interest which might be paid to the Bank by a province or municipality also becomes part of the government's income. By agreement, this interest could and should be returned to the province or municipality less the cost of administration.

Section 14 states that the Minister and the Governor (of the Bank) shall consult regularly on monetary policy. If a difference of opinion should emerge between the Minister and the Governor concerning monetary policy, the Minister may give to the Governor a written directive and the Bank shall comply with that directive. This means that the Bank is not independent.

There are no international laws preventing the Bank from being used to finance public debt or infrastructure, but international agreements can have the same effect as law if we do not challenge them. Examples of such agreements are those arrived at by the governors of the central banks of the western nations during their meetings organized by the Bank for International Settlements.

So, what to do? Vote only for candidates who agree to support use of the Bank of Canada to finance public debt and public infrastructure – even if their parties have not included this in their platforms.

Richard Priestman
Kingston Chapter, COMER

The Credit Crisis — No Way to Run the World

It was not always that our great Canadian papers felt free to express too critical a way in which our southern neighbors ran this planet. But yet there are now more leading articles like that in *The Globe and Mail* (10/04, "The End of the American Order" by Kevin Carmichael, Ottawa) that convince us that we are seeing the end of an epoch: "The debilitating credit crisis has knocked the US from its perch as the supreme economic power. The climb back up will be steep.

"Before US Treasury Secretary Henry Paulson was pressed into becoming the fire chief of the financial crisis, he had a good thing going as an economic missionary.

"Basking in what he liked to call 'the strongest global economy of his business lifetime,' Mr. Paulson, who joined George W. Bush's administration in June, 2006 embraced with zeal an aspect of his new job with roots in Cold War diplomacy.

"In his two years as Treasury Secretary before financial markets came totally unhinged this summer, Mr. Paulson conducted more official business in China than he did in New York. He had visited as many cities in Latin America than he did cities in the USA. He rolled through Calcutta, New Delhi and Mumbai in three days in October, 2007; two weeks later, he spent five days in Africa.

"The places changed, but the message stayed the same: American-style banking, unencumbered by regulation and open to US financial institutions, is the surest way to produce wealth.

"'An open, competitive and liberalized financial market can effectively allocate scarce resources in as manner that promotes stability and prosperity far better than government intervention,' Mr. Paulson told an audience in Shanghai in March 1907.

"Mr. Paulson's brand of capitalism is not promoting much stability these days, and prosperity isn't a word that jumps to mind as policy-makers from Canada to Japan to France scramble to avert a global economic recession. The Made in America financial crisis has seriously undermined the US standing as undisputed leader of the international economy, posing the first serious threat to US hegemony since the height of the Soviet Union.

"After decades of strong-arming governments in Asia, Latin America and Eastern Europe to keep the state out of the economy, the US government in September put $285 billion (US) to nationalize mortgage giants Fannie Mae and Freddie Mac and insurer American International Group Inc.

"That's nothing compared with the $700 billion Mr. Paulson got from Congress to purge the financial system of the bad debt at the root of the credit crisis. With governments saving failing banks in Europe, stock markets plunging in China and exports slowing in Brazil, the world is in no mood to take economic lessons from the US Government.

"'There is a real element of anger and frustration around the planet that this is a US originated problem with global repercussions,' John Manley, a finance and foreign affairs minister under former prime minister Jean Chrétien, said in an interview. 'The world will be looking for a lack of hubris from the United States as a result of this. America has dominated global economic affairs virtually unopposed since the collapse of the Berlin Wall, an era marked by the acceleration of global free trade agreements, the confirmation of the dollar as the world's de facto currency, and the rise of Wall Street as the world's financial centre.'

"The US and Britain dictated the Bretton Woods agreement in 1944, establishing the International Monetary Fund and the World Bank. The US became the largest shareholder in the global institutions, which built their headquarters side by side in Washington. Unsurprisingly, the American vision of private ownership and unfettered markets dominated the prescriptions those agencies imposed on weaker economies in return for financial aid. That culminated in the Washington Consensus, a term coined in the 80s to encompass policies such as privatization, lower taxes and deregulation.

"These days countries cannot distance themselves fast enough from the way of Washington economic management,

"'The world is on the edge of the abyss because of an irresponsible system,' French Prime Minister Francois Fillon said on the eve of a gathering of European Union leaders to discuss the financial turmoil.

"German Finance Minister Peer Steinbruek predicted end of the US's status as the superpower of the world financial system.

"French President Nicolas Sarkozy, current President of the European Union, wants to host a summit of the world's major economies next month to consider global rues for financial markets. Germany's Mr. Steinbruek, whose push for stricter oversight of hedge funds and private equity funds last year was blocked by Mr. Paulson, will be a ready ally.

"There's an element of *schadenfreude* in the world's criticism of the US government's role in the financial meltdown.

"After all, nobody likes a bully, which is essentially the approach American officials have taken in international negotiations for decades. 'If the US can save its banks faster than the Europeans can theirs, Mr. Paulson will restore some of his department's reputation abroad,' said Daniel Drezner, a political science professor at Medford, Mass.-based Tufts University and a former Treasury Department economist.

"But gone are the days when a US Treasury secretary will automatically be seen as the smartest guy in the room. 'It's tough to tell the other countries you should privatize and liberalize when you are going the other way.' Mr. Drezner said, 'The Washington Concensus is dead.'"

W.K.

Never Too Late to Abandon What Hasn't Worked

It is never too late to start drawing upon the forgotten and unused investment in human capital that was once proved the most productive investment governments can make.

The New York Times (21/10, "Fed Chairman Endorses New Round of Stimulus" by Edmund L. Andrews) wrote: "The Fed chairman refused to be drawn into a debate about the size or the components of a stimulus plan, though he cautioned that infrastructure projects often took too long to start to be useful as stimulus measures."

However, it is not necessary to have calculated the total cost from the date that it appeared on the government books. A partial calculation will do to get started. We can draw on that unused capital resource in instalments, utilize that for back-up to provide the sure financial resources for the Treasury and/or the Bank of Canada to provide an understated backing to save what banks merit saving, and as far and fair as can be to the house-owners who can offer serious prospects of repaying the government when the economy and the housing market improve. That will leave plenty of time to improve the accuracy of the first underestimate of the government's currently ignored investment in human capital. And by the government underwriting infrastructure projects at once backed by the first instalments in the recognition of such security, the economy will improve and allow more people in need of housing to be provided with the employment that will permit them to undertake mortgages.

And how about those unfortunates who cannot qualify for a mortgage, especially as unemployment is mounting? Against the unused government human capital investment assets that have up to now not even been recognized as such, CMHC (Central Mortgage and Housing) (a federal government institution) shall borrow from our central bank money to finance rental housing with particularly good schools for immigrants and native children of very limited means. Let us learn to consider expenditures of that nature as amongst the most rewarding investments a government can make.

We and our political leaders must reeducate ourselves in the buried lessons of the great economists, whose teachings – learned at great cost in the Second World War – were once celebrated and then suppressed by those who cleared the path for the takeover of our economy by the bone-crushing system of high finance that has now collapsed, beyond repair. Precisely as we and others have long predicted.

The recognition of physical investment by the government took place in the US in 1996 in the US, when the US government – having bailed out their banks from their losses incurred when they had been allowed to take over Savings and Loans mortgage trusts – and lost heavily in the process. To cover their capital losses, banks were allowed to accumulate whatever government bonds they wished with no down payment. But the same Bank for International Settlements that planned the return of the banks to their free gambling of the 1920s, raised interest rates as high as 20%. In their haste to do so, they overlooked that this would drastically bring down the market value of the completely leveraged bonds that had already been issued with far lower coupons.

To deal with the shattering crisis that ensued, Washington, the IMF and Canada put together a $51 billion standby fund to deal with any market run. That having been dealt with, the Clinton government reached out for a more durable solution. Up to then the physical investments of the state had been entered on its books in a way that would have gotten any businessman in trouble with the law. The debt incurred for the acquisition or creation of the given asset was carefully amortized over a period approaching its useful existence. But the value of the capital built or bought, was wholly written off in the year of its completion. This so-called "cash accountancy" left a huge deficit on the books of the government that simply was not there. But those government deficits were vastly useful to those with political power. The illusion of a deficit kept wages down and pushed interest rates higher. And, of course, it favoured large investors given to scooping up sensational bargains in acquiring government assets for a song. They could multiply the book value of the value – $1 – by 10 or 100,000, and still walk away with the combined dignity of philanthropists and big winners.

The *Times* reports, "Mr. Bernanke cautioned that any program should be designed, to the extent possible, to limit longer-term to limit longer-term effects on the federal government's structural deficit." Wise words, since the debt of the federal government since 1971 when the US abandoned the gold standard and on this carried the rest of the world with it. What is at risk if our deregulated non-banking financial pillars are deregulated, in pursuing the overwhelming urge to expand, utilizing the cash reserves they have been allowed to take over, not for their own businesses for which they were set aside, but as the money base for applying the banking multiplier. Since the reserves of the "non-banking pillars" are not supposed to serve as legal tender, it is likely to become a source of interest-bearing near-money with ingredients of dubious subprime debt.

The unrecognized government investment in human capital is the capital our government must use to get out of the present banking mess. It will continue growing in value not because of speculative over-expansion, but because of improvements in human skills knowledge, and hence in health and social welfare. In such investment we must take care of the environment, for we live on its bosom.

It is incredible that our governments should have this unique resource all around them, which is as though designed to get the world out of its present break-down of its overblown gambles, and yet there has been no recognition that in the development of human resources we have a ready and powerful solution left unused in our moment of gravest need.

W.K.

FROM *ECONOMIC REFORM*, NOVEMBER 2003

Our Visit to the Cambridge Conference

The theme of the two years of Economic Reform *covered in the third volume of* Meltdown *is the headlong Wall Street encounter of the mathematics of the atomic bomb translated into big business format. It was only some five years later that the equivalent of Hiroshima became apparent in our business world, and our governments have not even come close to finding their way out of that major catastrophe. To do so would require that they dig up the teaching of some of our greatest economists, who they have so assiduously buried. It is the purpose of* Meltdown *and COMER to lend them a helping hand in this ever more urgent task.*

In response to more than a single great need, conferences on Heterodox Economics are becoming a world-wide phenomenon. To the point in fact where their heterodoxy has begun developing a disquieting orthodoxy of its own. Universities on all continents are feeling the pinch of budgetary downsizing, and transforming the current disrepute of economics into a source of income is a brilliant if delicate operation. Franchises by their very nature exclude as much as they include.

And what university the world over has a vaster franchise than Cambridge that nurtured Newton and Keynes? Newton's glory remains safe, and by the sheer force of personality Keynes goes on dazzling as during his lifetime. It is a grandiose doghouse to which he has been committed today by those who hold our economy in a throttling grip. The policies that won both the war and a good stretch of the peace are today decried by all major parties on both sides of the great waters. At the Cambridge Conference the way to Keynes's office was clearly marked, but less evident were the rebellious stands that made Keynes: his recognition of the need for government investment not only to keep capitalism churning, but in the process of doing so producing a more just and durable society. And there was his ability – rare enough in the eye-gouging profession of economics – of scrapping previous certainties and admitting his debt to those whom he had dismissed as "unscientific" just a few years before: Marx, Gesell, Major Douglas.

Unfortunately, pressure from academic peers led Keynes to do his most basic thinking in a private manner, much as a gentleman does his ablutions. In the words of G.L.S. Shackle, "Keynes spared his readers, even in the deliberately provocative *General Theory* of 1936, the ultimate force of his conclusion uttered in speech, 'Equilibrium is blither.'"

On reading the proofs of *The General Theory*, Roy Harrod, his future biographer, had offered this advice: "[Your] effectiveness is diminished if you try to eradicate every deep-rooted habit of thought unnecessarily. I am not thinking of the aged and fossilized, but of the younger generation. It is doing a great violation to their fundamental ground-work of thought, if you tell them that two independent demand and supply variables won't jointly determine price and quantity. Tell them that we don't know the supply function. Tell them that the *ceteribus paribus* clause is inadmissible and that we can discover more important relationships governing price and quantity in this case which render the s. and d. analysis nugatory. But don't impugn the analysis itself."

Despite such advice, there are in *The General Theory* the two most significant and least-quoted passages of his entire output. One we referred to above.[1] "The great puzzle of Effective Demand vanished from economic literature. You will not find it mentioned once in the whole of the works of Marshall, Edgeworth, and Professor Pigou. It could only live on furtively in the worlds of Karl Marx, Silvio Gesell or Major Douglas."

On page viii of the introduction there is a passage that must have been the fruit of much anguished rethinking, but no Keynesian seems to have read: "I sympathize, therefore, with the pre-classical doctrine that *everything is produced by labour*.… It is preferable to regard labour, including, of course, the personal service of the entrepreneur and his assistants, as the sole factor of production, operating in a given environment of technique, natural resources, capital equipment, and effective demand."

There is the nugget that would not only equip economics for dealing with the problems of deflation, which were foremost when it was written, but to the new ones of today. Ours has become a two-tiered world economy that brutally deflates the markets for real production to make space for the unbridled speculations of high finance. It diverts our attention from the root production for human needs to remote derivatives of them, i.e., the growth rates of the profits wrung out of their deflation. Incorporated into share prices, these commit our security markets to exponential growth. Since by definition these are as unsustainable as the atomic bomb, inevitably they crash.

That ignored observation at the very gateway to *The General Theory* might have warned us against the fate that has befallen our world. Instead the "pure and perfect market" where supply and demand dance around equilibrium points has taken over. Everything else – all aspects of public investment in material and human capital have been declared "externalities," not depreciated over their useful life but treated as current spending. This leaves no depreciated asset to balance against the debt incurred for their creation.

Keynes Continues Bemusing the World for Lesser Reasons

The phenomenon of Keynes bestrode the world; his wisdom played a key role in mobilizing the Western world against the Nazis. Yet his fate is surely one of the most paradoxical in recent human history. His teachings were completely wiped out of official and even academic memories, but the man himself has continued bemusing the world, as though it were troubled by the injustice it had done to both Keynes and to itself. Biographies continue appearing, but the obsession is with the personality both in his Bloomsbury and Cambridge contexts, rather than his theories. Of the first volume of Sidelsky's three-volume effort in the field, Keynes's brother remarked – "Sidelsky took his entire first book to let us know that my brother was a bugger." His economic views, however, Sidelsky took little pain to understand.

That format of reverence was in evidence at the Cambridge Conference. The essence of his mature theory as transmitted in the above quotes did not show up at the sessions I managed to attend. Instead a far greater bias against mathematics as such turned up than against illiterally misused mathematics. One academic, whom I leave charitably unnamed, even referred to chemistry as a science "free of mathematics" that might be a possible model for economics. That disposes of molecular weights, isotopes, and indeed Mendeleieff's table.

Few who read papers or discussed those of others disrupted the conventional view of the economy as a market surrounded by "externalities." These included activities like the household economy, the public sector, the environment, investment in human capital, social security, that are not driven by the search for maximized profits. All the greater surprise then, that Victoria Chick should have read a paper on systems theory, a subject that is quite the exact inverse of "externalities." For it brings these areas of the economy out from the cold and ceases treating them as mere food chain for the market. Recognized as essential for the system as a whole, they assume the status of subsystems. Of course, they must really be indispensable for the proper functioning of the entire socio-economic system. That requires a discipline for monitoring their reserve resources.

Entropy as in Niagara Falls

In the natural sciences such reserve resources are known as "negentropy," and if they are drained by another subsystem, "entropy" ensues. In the physical world, energy is always present in matter, but it can be harnessed only where a difference of potential – negentropy – exists. In the natural sciences too, there is a precise mathematical equivalence between the different forms of negentropy – chemical, thermal, electromagnetic, nuclear. Between the negentropies of the different social-economic subsystems, that is not the case. There the notion of negentropy is essentially a metaphor, but a very essential one. Although the "fuels" or "food chains" of the various subsystems are very different, they do have some common factors. One of these is funding, that almost invariably comes from the government. Another such common need is an economic theory that sees everything indispensable to society as subsystems rather than externalities, that concentrates on the doughnut rather than on the hole.

That is what caused conventional economists to shun the very idea of systems theory that had become familiar among engineers and scientists. The compliment was returned by the systems theory people. Except for a brief period in the early 1970s when Jay W. Forrester and his colleague Meadows did a study on the subject for the Club of Rome, economists have been notable for their absence at conferences of the systems people. The attempt of Howard T. Odum and Elisabeth C. Odum, "to equate the flow of money with that of energy in an equal-value loop" as "the way human beings recognized that the flows are of equal value" is an echo of the equilibrium model of economics. It is unlikely that the total energy consumption in Shakespeare's London was as great as that of a modern urban slum, and yet legacy that it left to human survival today is proof that no such equivalence exists.

The title of Victoria Chick's paper was "The Future is Open" and from that resulted a discussion of whether the future as seen through the lense of systems theory is open or closed. At the same time, from the floor came the statement, "Keynesianism has failed." I don't know whether the person who expressed that view was from Cam-

Dubai Is at the Opposite Pole of Excessive Bank Debt Financing

At the farthermost extreme from Iceland in the uttermost dependence on foreign bank dependence stands Dubai. In the same issue of *The Wall Street Journal* (10/10, "Dubai's Heavy Debt Load Stirs Concern" by Chip Cumming) tells a tale of devil-daring that, unlike Iceland, has no herring swarms to turn to for refuge.

"The global credit crisis is forcing a new look at this Mideast boomtown's mounting international debt and its ability to fund its ambitious growth strategy.

"Dubai, one of seven emirates that make up the United Arab Emirates, has been spending heavily on roads, a subway system and other infrastructure projects to keep up with the city-state's explosive growth. The government, though state-owned and state-controlled real estate developers has embarked on a series of ambitious property projects aimed at turning Dubai into a tourism and business destination.

"Emaar Properties PJSC, partly government-owned, is building the world's tallest skyscraper. On Sunday, Nakheel, a government-backed developer, unveiled plans for a 3,281-foot-high tower here. Nakheel is already building a palm-tree-shaped archipelago of man-made islands packed with luxury villas and hotels.

"Dubai doesn't have big reserves of hydrocarbons. Instead, it has been bankrolling much of its building boom through international debt markets. With those all but shut down these days, analysts are warning of a slowdown if global markets don't free up soon. 'Given the magnitude of the projects that Dubai is taking on, it will certainly need to borrow internationally,' said Philipp Lotter, a Dubai-based analyst at Moody's Investors Service.

"A Dubai finance official declined to comment, and the government didn't respond about its debt management.

"Dubai is among the most heavily indebted governments in the wealthy Persian Gulf. Standard & Poor's estimated at the end of last year that the Dubai government debt represented 41.8% of its gross domestic product, compared with 22% in Bahram and 2.9% in Abu Dhabi.

"Dubai hasn't obtained a government-debt rating. A rating might reassure debt investors somewhat that the government assets and revenue are sufficient to back that borrowing.

"In today's debt markets, the uncertainty means higher costs for big and prudent borrowers. The cost of insuring $10 million of Dubai debt for five years has risen to $247,500 a year, up more than five-fold from the start of the year, according to CMA Datavision, a price-discovery service.

"CMA, which calculates a cumulative probability of defaulting for sovereign borrowers, estimates the likelihood over the next five years is just shy of 20%. That's up from 4.3% at the beginning of the year.

"Still, many analysts and economists say chances of the government getting into real trouble remain low.

"There are other headwinds buffeting Dubai, further clouding the ability of the government and its corporate entities to raise cash. Banks have significantly tightened lending, and local lending costs have soared. Dubai's red-hot real-estate market shows signs of cooling. Property prices haven't fallen yet, but Dubai's stock markets have fallen recently, wiping out billions of dollars of wealth among retail investors.

"While autonomous in many ways, the emirates that make up the UAE are tied into a federal system. Abu Dhabi's hereditary ruler is the UAE's president, Dubai's ruler is the federation's prime minister."

Whatever the financial structures of debt may be, debt as such becomes the target of distrust, fear and loathing. It is part of the penalty that at least a half century of ruthless disregard of accountancy or even of laws.

W.K.

bridge or not, but no one from Cambridge rose to dispute it.

I attempted to find an answer by combining the two questions. Keynes had died in 1946, before the price effects of his policies could possibly emerge and hence could not have been addressed by him. Price controls were still in effect. And in 1951, a serious event took place in Washington. At this point Dr. Chick almost in unison with me gave that a name – the Treasury-Fed Accord: behind President Truman's back proclaimed the independence of the Federal Reserve from the government, and gravely disturbed monetary creation. And in the 1960s immense public investments had to be made not only to catch up with the backlog of ten years of depression and six of war, but to introduce any number of new technologies. This caused a great need for additional public investment as we moved into a mixed economy.

Thus the economic system is continually changing adding and altering subsystems, to benign or malignant effect.

Dr. Chick was good enough to recommend attention to my "efforts to recruit economists" to some of the points I raised in my paper. I was delighted to have possibly contributed to a deeper appreciation of Keynes in Cambridge. For elsewhere in the conference I had heard more of the flatulences of Lord Kaldor than of Keynes's deeper doubts about conventional economics.

William Krehm

1. The General Theory, page 32.

Applying Systems Theory to Agriculture

The New York Times Magazine (12/10, "Farmer in Chief – What the next president can and should do to remake the way we grow and eat our food" by Michael Pullan) applies systems theory – without mentioning the name – to society's mounting problems with its food supply.

To illustrate the purpose of the discipline, I will begin with a simpler application that COMER has devoted decades to – the very different factors that may be driving up a society's price level. Few economists distinguish one from another, although that is extremely important: (1) to distinguish the different causes that can lead to higher prices. Thus while it is true that if there is too much demand for available supply – other things being equal – prices will go up.

(2) But that does *not* mean that the proposition can be turned around. Prices may be due to a variety of other causes. For example, there may have been a greater layer of taxation to pay for public services not paid for in the market but by taxation.

(3) Nobody leaving a town of 10 or 20 thousand to move to New York City is foolish enough to expect his living costs to remain the same. Why then expect it when society is making just such a move? The needs of cities are much greater than those of small towns – subways, universities, centres of development of high technologies.

(4) Technology requires a more elaborate work-force. That involves public expenditures that should be considered public investments and hence, too, so must spending on health, social services. What is lacking is accountancy recognizing such expenditures, which economist Theodore Schultz in the 1960s was celebrated for having identified as the most profitable investment a government can make. I have told the tale in the article beginning on page 4.

These circuits cross and tangle. They cannot be flipped around and stay valid, or be replaced with the notion of a market that is supposed to keep the price level flat or "uninflated." Non-inflation should be used not as a synonym of "flat-priced" but a price climb tilted only enough to express the result of an excess of demand over available supply. The rest of our price rise is the result of quite other factors. Of these a particular group requires our particular attention.

Thirty years ago systems theory was taken up by many economists. It was the subject of special conferences by Economic Associations. But it ran counter to the campaign of the banking sector to acquire a monopolist command of the world economy. As a result systems theory is no longer mentioned by officially approved economists.

The Pullan essay is a quite brilliant application of its principles. I will merely condense his arguments.

Addressed to Mr. President-Elect, renamed "Farmer-in-Chief" for the occasion, Pullan writes: "It may surprise you to learn that among the issues that will occupy much of your time in the coming years is one you barely mentioned during the campaign: food. High food prices have not presented a serious political peril, at least since the Nixon regime. But with a surprising suddenness the era of cheap and abundant food appears to be drawing to a close. Like so many other leaders through history, you will find yourself confronting the fact – so easy to overlook these past few years – that the health of a nation's food is a key issue of security.

"Complicating matters is the fact that the price and abundance of food are not our only problems. If they were, you could follow Nixon's example, appoint a latter-day Earl Butz as your secretary of agriculture and instruct him to boost production. But there are reasons to doubt that the old approach would work this time around."

Here is where other equally critical systems enter the picture, its cause-and-effect lines become entangled with the simple "increase of food production at the lowest cost" system. There will be an army of other factors of menaces and possible solutions that will turn up. It is Pullan's task to disentangle them and study how they can be kept assisting rather than undermining one another, if possible. The jumble and tangle of independent and even clashing factors is greater than that between a flat price level and the accommodative needs of ever greater public investment in physical and human capital.

Returning to Pullan: "You will need not simply to address food prices, but to make the reform of the entire food system one of the highest priorities of your administration. Unless you do, you will not be able to make significant progress on the health-care crisis, energy independence, or climate change. Unlike food, these are issues you did campaign on – but as you try to address them you will quickly discover that the way we currently grow, process and eat food in America goes to the heart of all three problems and will have to change in the hope to solve them. Let me explain."

That is the purest system theory – the causal lines entangle and negate one another. Policies can be judged not in isolation one at a time, but with an eye to harmful entanglements amongst them.

"After cars, the food system uses more fossil fuel than any other sector of the economy – 19%. And while the experts disagree about the exact amount, the way we feed ourselves contributes more greenhouse gases to the atmosphere than anything else we do

– as much as 37% according to one study. Whenever farmers clear the land for crops and till the soil, large quantities of carbon are released into the air. But the 20th century industrialization of agriculture has increased the amount of greenhouse gases emitted by the food system by an order of magnitude, chemical fertilizers (made from natural gas), pesticides (made from petroleum), modern food processing and packaging and transportation together transformed a system that in 1940 produced 2.3 calories of food energy for every calorie of fossil-fuel energy it used into one that now takes 10 calories of fossil-fuel energy to produce a single calorie of modern super-market food. Put another way, when we eat from the industrial food system, we are eating oil and spewing greenhouse gases. This state of affairs appears all the more absurd when you recall that every calorie we eat is ultimately the product of photosynthesis – a process based on making food energy from sunshine. There is hope and possibility in that simple fact.

"In addition to the problems of climate change and America's oil addiction, you have spoken at length on the campaign trail of the health-care crisis. Spending on health care has risen from 5% of national income in 1960 to 16% today, putting a significant drag on the economy. There are several reasons health care has gotten so expensive, but one of the biggest, and perhaps most tractable, is the cost to the system of preventable chronic diseases. Four of the top 10 killers in America are chronic diseases linked to diet: heart disease, stroke, type 2 diabetes and cancer. It is no coincidence that in the years national spending on health care went from 5% to 16% of national income, spending on food has fallen by a comparable amount – from 18% to 10%. While the surfeit of cheap calories that the US food system has produced since the late 1970s may have taken food prices off the political agenda, this has come at a steep cost to public health. You cannot reform the health care cost to public health, much less expand coverage, without confronting the public health catastrophe that is the modern diet.

"The impact of the American food system on the rest world will have implications for your foreign trade policies as well. In the past several months more than 30 nations have experienced food riots. Should high grain prices persist and shortages develop, you can expect to see the pendulum swing away from free trade, at least in food. Nations that opened their markets to the global flood of cheap grain persist and shortages develop, you can expect to see the pendulum shift away from free trade, at least in food. Nations that opened their markets to the global flood of cheap grain (under pressure from previous administrations as well as the World Bank and the IMF) lost so many farmers that they now find their ability to feed their own population hinges on decisions made in Washington and on Wall Street.

"Rich or poor, countries struggling with soaring food prices are being forcibly reminded that food is a national-security issue. When a nation loses the ability to substantially feed itself, it is not only at the mercy of global commodity markets, but of other governments as well. At stake is not only the availability of food, but its safety. As the recent scandals in China has shown, we have little control over imported food.

"There are many moving parts to the new food agenda I am urging you to adopt, but the core idea could not be simpler*: we need to wean the American food system off its heavy 20th century diet of fossil fuel and put it on a diet of sunshine.* That requires putting the food system back on sunlight by changing how things work at every link in the food chain in the farm field, in the way food is processed, and even in the American kitchen and at the American dinner table. Yet the sun still shines down on our land every day and photosynthesis can still work its wonders wherever it does.

"It must be recognized that the current food system – characterized by mono-cultures of corn and soy in the field and cheap calories of fat, sugar and feedlot meat on the table – is not simply the product of the free market. Rather it is the product of a specific set of government policies that sponsored a shift from solar and human energy on the farm to fossil-fuel energy.

"When you fly over Iowa from October to April, you will notice that the land below is completely bare – black. What you see is the agricultural landscape created by cheap oil. In years past, except in the dead of winter, you would have seen those fields a checkerboard of different greens, pastures and hayfields for animals, cover crops, perhaps a block of fruit trees. Before the application of oil and natural gas to agriculture, farmers relied on crop diversity (and photosynthesis) both the replenish their soil and to combat pests, as well as to feed themselves and their neighbours. Cheap energy, however, enabled the creation of mono-cultures, and mono-cultures vastly increased both the productivity of the American farmer and the American land. Today the typical corn-belt farmer is single-handedly feeding 140 people.

"After World War II the government encouraged the conversion of the munitions industry to fertilizer – ammonium nitrate being the main ingredient both bombs and chemical fertilizer – and the conversion of nerve-gas research to pesticides. The government also began subsiding commodity crops, paying farmers by the bushel for all the corn, soybeans, wheat and rice they could produce.

"Subsidized mono-cultures of grain led directly to mono-cultures of animals, since factory farms could buy grain for less than it cost farmers to grow it. So America's meat and dairy industries migrated from farm to feedlot, driving down the price of animal protein to the point where and American can enjoy eating animal protein, on average, 190 pounds of meat a year.

"But if taking the animals off the farm made a sort of sense, it made no ecological sense whatsoever. Their waste, formerly regarded as a precious source of fertility on the farm, became a pollutant – factory farms are now one of the greatest sources of pollution.

"What was once a regional food economy, is now national and increasingly global in scope. Cheap energy – for trucking food as well as pumping water – is the reason New York City now gets rather more from distant sources than from the "Garden State" next door, as it did before the advent of state highways More recently, cheap energy has underwritten a globalized world economy in which it makes sense to catch salmon in Alaska, ship it to China to be filleted and then ship the fillets back to California. Or Denmark and the United States can trade sugar cookies across the Atlantic. About that particular swap the economist Herman Daly once quipped, 'Exchanging recipes would be ore efficient.'"

It was actually John Maynard Keynes who made the observation about the cookies exchanged between Denmark and Britain, and Keynes died some sixty years ago. But our cookies today are more likely to come from China.

Beyond the facts relating to agriculture, we must try to do all our thinking in this broad way of encompassing all major factors that in the real world have an important bearing on the issue being considered. That is what systems theory about. Without it humanity is lost in trying to find its way with the help of a favored issue or two.

William Krehm

The Strains of Nations Changing from Guests to Hosts

It would seem anything but easy for nations moving from guests to hosts of people of other countries. Italy, one of the great migrating nations right from Roman times is witness to that basic fact. It was from Italy that the United States and Europe and the Americas received much of the heritage of the Ancient world, in the builders, scientists musicians as the epicenter of economic development moved north and West, to say nothing of the entire Latin heritage which in significant part originated in Greece, that was likewise familiar with the burdensome aspects of both the emigrating and immigrating role.

Certainly an important factor in the difficulties of these two contrasting roles is related to how well the receiving nation lives with itself.

The New York Times (13/10, "Italy's Attacks on Migrants Fuel Debate on Racism" by Rachel Donadio) reports: "Milan – The metal shutters are closed at Shining Bar, a coffee shop near the central train station here. On the facade, someone has written 'proud to be black' and spray-painted 'Abba Lives' in red.

"Abba was the nickname of Abdul William Guibre, who was born in Burkina Faso, raised in Italy and beaten to death last month by the bar's father-and-son proprietors, Fausto and Daniele Cristofoli. The two suspected Mr. Guibre, 19, of stealing money and set upon him with a metal rod, the authorities said, believing he had taken a package of cookies. During the altercation, the attackers shouted 'dirty black,' lawyers of both sides said.

"The attack on Mr. Guibre was the most severe in a recent spate of violence against immigrants across Italy. The attacks are fueling a national conversation about racism and tolerance about racism and tolerance in a country that has only recently transformed itself from a nation of emigrants into a prime destination for immigrants."

"Though Italy had provided more than its share of the greater explorers, its disunified political state prevented it from founding a great overseas empire, that would have made possible an emigration of its excess population – from saints to sinners, scientists and artists to laborers and scoundrels from having to emigrate to non-Italian lands of alien cultures.

"The attacks are fueling a national conversation about racism and tolerance in a country that has only transformed itself from a nation of emigrants into a prime destination for immigrants.

"In recent weeks, as Ghanaian man, Emmanuel Bonsu Foster, 22, was injured in Parma in a scuffle with the police, a Chinese man, Tone Hongsheng, 36, was beaten by a group of boys in a rough neighborhood in Rome, and a Somah woman, Amina Sheikh Said, 51, said she was strip-searched and interrogated for hours at Ciampino Airport in Rome. Last months, six African immigrants were gunned down in Castel Volturno, a stronghold of the Neapolitan Mafia.

"In a meeting with Pope Benedict XVI at the Quirinal Palace in Rome this month, President Giorgio Napolitano called for church and state to work together 'to overcome racism.' He cited a recent speech in which the pope pointed to 'worrisome new signs of social tensions.'"

Italy's "Racism Emergency"

"Last week, Parliament debated whether Italy was facing what newspaper headlines referred to as a 'racism emergency.' The interior minister, Roberto Maroni, of the separatist Northern League, said that the attacks were isolated and that the alarm was overstated.

"Many on the left disagreed. 'You can't say all Italians are racist, but it would also be dangerous to underestimate what's happening,' said Jean-Leonard Touadi, a black member of Parliament.

"Mr. Touadi is originally from Brazzaville in the Congo Republic. Formerly Rome's deputy mayor for security, he was elected in April with Italy of Values, a party supporting judicial reform. 'Faced with social and economic crisis, it's easy to push rage and frustration on to the foreigner,' he said, adding that the government should work to create opportunities for everyone. 'It shouldn't make this a war between poor Italians and poor immigrants.'

"Indeed, Italy's deep tradition of Roman Catholic tolerance is hitting up against economic uncertainty. And sometimes, church is pushing up against state.

"Last week, Msgr. Agostino Marchetto, a high-ranking Vatican official, spoke out against 'discrimination, xenophia, and racism' towards immigrants. Monsignor Marchetto, the secretary of the Pontifical Council for Pastoral Care of Migrants and Itinerant People, said that refugees were often treated 'without consideration of the reasons that forced them to flee.'

"'This has led,' he said, to measures that had caused 'erosion of humanitarian standards.'

"Also last week, the Northern League called for greater controls on immigrants as part of a security bill pending in Parliament, including the deportation of legal immigrants if they accumulated a certain number of points on their criminal records. That prompted a front-page political cartoon in *Corriere della Sera*, Italy's leading newspaper, in which an official asks a black man for his residence permit. The man points to the bandage on his head and says 'seven points'; in Italian 'punti' means both points and stitches.

"The Northern League is a crucial member of Prime Minister Silvio Berlusconi's right-center coalition. In the campaign for elections in April, it ran on a program of fiscal federalism and security concerns, which often resonated as anti-immigrant rhetoric.

"There are paradoxes. The North, with the most integration and the most jobs, also registers the highest levels of anti-immigrant sentiment. and the strongest support for the Northern League.

"Immigration is definitely on the rise. The number of legal resident foreigners in Italy rose 17% last year to 3.4 million, or 6% of the population, according to recent data from the Italian National Institute of Statistics, the government research agency.

"Italy is becoming a multiethnic society, said Mr. Touadi, the member of Parliament. We shouldn't hide our heads and deny it, but realize that it is a trend worth taking seriously, because we don't have an alternative."

W.K.

RENEW TODAY!
(SEE PAGE 2)

World's Richest Land is Skimping on Its Medical Prescriptions

Some statistics are cold and remote from our own personal experiences. Others translate into intimate tragedy.

No difficulty where this recent report in *The New York Times* belongs (22/10, "In Sour Economy Some Scale Back on Medications by Stephanie Saul): "For the first time in at least a decade, the nation's consumers are trying to get by on fewer prescription drugs.

"As people throughout the country respond to financial and economic bad times by juggling the cost of necessities like groceries and housing, drugs are sometimes having to wait.

"'People are having to choose between gas, meals and medication,' said Dr. James King, chairman of the American Academy of Family Physicians, a national professional group. He also runs his own family practice in rural Seimer, Tenn.

"'I've seen patients today who said they stopped taking their Lipitor, their cholesterol lowering medicine, because they can't afford it,' Dr. King said. 'I have patients who stopped taking their osteoporosis medication.'"

Significant Decline

"On Tuesday, the drug giant Pfizer, which makes Lipitor, the world's top-selling prescription medicine, said United States sales of that drug were down 13 percent in the third quarter of this year.

"Through August of this year, the number of all prescriptions dispensed in the US was lower than in the first eight months of last year, according to a recent analysis of data from IMS Health, a research firm that tracks prescriptions.

"Although other forces are also in play, like safety concerns over some previously popular drugs and some prescription medications to over-the-counter sales, many doctors and other experts say consumer belt tightening is a big factor in the consumer belt-tightening.

"The trend, if it continues, could have potentially profound implications. If enough people try to save money by forgoing drugs, controllable conditions could escalate into major medical problems. That could eventually raise the nation's total health care bill and lower the nation's standards of living.

"Martin Schwarzenberger, a 56-old accounting manager for the Boys and Girls Clubs of Greater Kansas City, is stretching out his prescriptions. Mr. Schwarzenberger, who has type 1 diabetes, is not cutting his insulin, but has started scrimping on a variety of other medications he takes, including Lipitor.

"'Don't tell my wife, but if I have 30 days worth of pills, I'll usually stretch those out to 35 or 40 days,' he said. 'You're trying to keep a house over your head and use your money to pay your bills.'

"Although the overall decline in prescriptions in the IMS Health data was less than 1%, it was the first downturn after a decade of steady increase in prescriptions, as new drugs have came in on the market and the population aged.

"From 1907 to 2007 the number of prescriptions filled had increased 72% to 3.8 billion last year. In the same period the average number of prescriptions filled by each person in this country increased from 8.9 a year in 1997 to 12.6 in 2007.

"Dr. Timothy Anderson, a Sanford C. Bernstein & Co. pharmaceutical analyst who analyzed the IMS data and first reported the prescription downturn last week, said the declining volume was 'most likely tied to a worsening economic environment.'

"In some cases the cutbacks might not hurt, according to Gerard F. Anderson, a health policy expert at John Hopkins Bloomberg School of Public Health. 'A lot of people think there's probably over-prescribing in the US,' Mr. Andersen said.

"But for other patients, he said, 'the prescription drug is a life-saver, and they really can't afford to stop it.'

"Dr. Thomas J. Welda, a family physician in Hershey, PA, said one of his patients ended up in the hospital because he was unable to afford insulin.

"Not everyone simply stops taking their drugs.

"'They'll split pills, take their pills every other day, do a lot of things without conferring with their doctors,' said Jack Hoadley, a health policy analyst at Georgetown University.

"'We've had focus groups with various populations,' Mr. Hoadley said. 'They'll look at four at four or five preparations and say, 'This is the one I can do without.' They're not going to stop their pain medication because they'd feel bad if they don't take that. They'll stop their statin for cholesterol because they don't feel any different whether they take that or not.

"Overall spending in the US for prescription drugs is still the highest in the world, an estimated $286.5 billion last year. But the number makes up only about 10% of this country's total health expenditures of $2.26 trillion.

"Pharmaceutical companies have long been among those arguing that drugs are a cost-effective way to stave off other, higher medical costs.

"The recent prescription cut-backs come even as the drug industry was already heading towards the 'generic cliff,' as it is known – an approaching period when a number of blockbuster drugs are scheduled to lose patent protection. That will be 2011 for Lipitor.

Generics Not the Obvious Answer

"Already, a migration to generic drugs means that 60% of prescriptions over all are filled by off-brand versions of drugs. But with money tight even cheaper generic drugs may not always be affordable drugs.

"Diane M. Commy, the director of market insights for IMS Health, said the drop in prescriptions might also be partly related to the higher out-of-pocket drug co-payments that insurers are asking consumers to pay.

"Some consumers are making decisions based on the fact that they are bearing more of the cost of medicines that they have in the past."

Notable, too, is the fact throughout this highly informative article, at no time is the problem approached from the point of view of Theodore Schultz developed in the 1960s that we have proposed holds elsewhere in this issue yet it holds the solution to the overwhelming credit crisis that is sweeping the world: the conclusion reach on the basis of the rapid economic reappearance of Japan and Germany as world exporters: that human capital is the most important investment that a country can make.

Once recognized as the formative essence of national policy, it has since been buried. Were that re-examined again, the logic conclusion would be for governments to pay full prescription costs, after checking, of course, as should take place in all investments, that the prices for such mass purchases were fair.

W.K.