THE JOURNAL OF THE COMMITTEE ON MONETARY AND ECONOMIC REFORM

COMER

$3.95 Vol. 23, No. 10 • OCTOBER 2011

CONTENTS

Publications Mail Agreement No. 41796016

The High Cost of Burying Our History

We have a helpful example of this in *The Wall Street Journal* (06/06, "Ahead of the Tape" by Justin Lahart): "After a long hiatus, the Fed began raising rates in February of 1994. The increases that followed were steeper than most investors had expected and created more market havoc as well. By February of 1995, the fed had brought its federal funds target rate to 6% from 3% a year before and financial crisis had irrupted in Mexico and Orange County, Calif."

The argument here is simply "grin and bear what the Fed hands out," and don't try to understand it. But the actual facts that eventually cleared the way for the big boom that led to the big bust just don't fit into that bag. In fact policy was changed drastically but covertly, because the one that had been imposed decades earlier had collapsed the international monetary system. So frightening was the prospect, and so incompatible were the different policies rushed in to bail out the banks from their huge gambling losses, that those in charge did not even dare let the public know why they were changing their earlier certainties so completely and so abruptly.

It all goes back to the big crash of 1929, brought on largely because the banks had been allowed to expand into other financial sectors – real estate, the stock market, mortgage lending. Each of these "financial pillars" had its own pool of liquid capital essential for its own business. But these pools of liquidity exert a fatal attraction on bankers. If they could only get control of them, they could create many times their value in chequing account credits, and then move on to apply the same banking multiplier to the next liquidity pool, the banks would end up with a skyscraper conforming, if to anything, to an inverted pyramid. The market value of such a deregulated bank is embodied in the current price of the bank's stock. The trouble is that it is a deal with the devil. For at the first failure of the deregulated bank's stock to live up to this sustained growth rate already incorporated into the market price of its shares, the whole house of cards collapses. That was a major factor in the depression of the 1930s that brought on the Second World War.

That is why the Roosevelt banking legislation of 1935 confined the banks strictly to banking. However, by the end of the war, this severe regime had made the banks sound once more, with bankers feeling again the swelling libido to gamble with other people's money. And with unusually thorough planning they hit the comeback trail. Their goal was to recapture the economic preeminence they had lost with the bursting of the bubble of the late 1920s. For that they had to present a picture of the economy in danger of hyperinflation unless monopoly powers were vested in the banks – independence and power in monetary matters over the government itself.

Towards this end the universities and the press were purged of any dissenting views. It was summed up by Alexandre Lamfalussy. General manager of the Bank for International Settlements (BIS) in his annual report issued on May 23, 1991: "It has been argued that inflation in the range of 1-2% may be considered price stability for all practical purposes. Nonetheless the movement from an environment of low or moderate inflation to one of no inflation implies an important psychological shift. It has proved very difficult in recent decades to achieve merely low inflation and to move to actual price stability, even in those countries

Continued on page 2

COMER

FOUNDING EDITOR
John Hotson 1930–1996

PUBLISHER–EDITOR
William Krehm
(comerpub@rogers.com)

INFORMATION SECRETARY
Herb Wiseman (herbwise@cogeco.ca)

WEBMASTER
Tony Koch

Economic Reform (ER)
(ISSN 1187–080X) is published monthly by COMER Publications
27 Sherbourne Street North, Suite 1
Toronto, Ontario M4W 2T3 Canada
Tel: 416-924-3964, Fax: 416-466-5827
Email: comerpub@rogers.com
Website: www.comer.org

COMER Membership: Annual dues (includes *ER* on request plus 1 book or video of your choice): CDN$50

***Economic Reform* Subscription only:**
One year, 12 monthly issues, in Canada CDN$30, Foreign CDN$40

Send request and payment to:
COMER Publications
27 Sherbourne Street North, Suite 1
Toronto, ON M4W 2T3

***ER* Back Issues:** CDN/US$4, includes postage; additional copies same issue, $2; additional issue same order, $3. Send requests for back issues to Herb Wiseman, 69 Village Crescent, Peterborough ON K9J 0A9.

Postmaster, please send address corrections to:
COMER Publications
27 Sherbourne Street North, Suite 1
Toronto, Ontario M4W 2T3

PRINTING AND DISTRIBUTION
Watt Solutions Inc., London

Printed in Canada on recycled paper.

History *from page 1*

with the best price performance."

Yet technological revolutions, urbanization, mass migrations with all the infrastructures these called for, brought a mounting degree of public investment. But this resulted in a deepening layer of taxation that could only find its way into the price level. It had nothing to do with an excess of demand over supply, and hence ought not to be confused with the traditional definition of "inflation."

Moreover, our governments were at the same time treating their investments that would last for decades as current spending, rather than depreciating and amortizing them over their useful lives. When that is done even the unsuccessful effort to balance a budget is likely to raise more taxes than necessary – and thus push up prices higher. A series of Auditors General of the Canadian government had made the point, but COMER were pioneers in publicizing the issue, and relating it to the "inflation" problem.

Hyperinflation Swindle

Intent on its goal, the Bank for International Settlements warned that unless the slightest price rise were nipped in the bud it would bring on the sort of hyperinflation that ruined Germany in 1923. But that hyperinflation had resulted when Germany suspended its reparation payments from its loss of WWI, because it could not raise the strong currency that France insisted on receiving them in. As a result the French and Belgian armies occupied the industrial heartland of Germany, a national strike in response rallied the entire spectrum of Germans, virtual civil war broke out. To claim that any price climb, unless suppressed would lead to such hyperinflation is to imply that if interest rates had been pushed high enough – the BIS's formula for imposing "zero inflation" – there would retroactively have been no world war lost by Germany, no occupation of the Ruhr basin by the French, no general strike, no virtual civil war in Germany. Nevertheless this nonsense was repeated countless times in the world media. Professors and editors bit their tongues to keep their jobs. The morality of public officials became a sub-department of the bankers' drive to control the economy once again.

By 1951 the banking counter-revolution had been well enough prepared for its first coup to take place. In his memoirs President Harry Truman recounts his betrayal by his Treasury Secretary assigned the task of adjusting the peg of interest rates to the upward movement of prices brought on by the lifting of price controls at the very outbreak of the Korean War. Instead of adjusting the peg to prices, it was abolished altogether. That set the moral tone of the bank comeback over the following decades.

Under the legislation brought in under Roosevelt there were two tools for reining in "inflation." There were the "statutory reserves" that banks had to redeposit with the central bank as a small proportion of the deposits they received from the public. And there was the benchmark interest rate set by the central bank for overnight loans between commercial banks to enable them to meet emergencies. Few loans were made between banks at such overnight rates, and their relatively low level could only mislead the public about the largesse of the nation's money lenders. An increase in the statutory reserve, for its part, reduced the *volume* of loans that banks could make on a given cash base, rather than raising interest rates. However, between 1991 and 1993 in Canada the statutory reserve requirement was phased out completely. And though such provisions remained in force in the UK and the US, their use there was reduced to insignificance.

This left the central bank essentially with a "single blunt tool" for fighting inflation – raising interest rates. At the same time a vast campaign was initiated for declaring central banks independent of their governments – whatever their charters might say.

With few exceptions the governments that came out of the Second World War were oriented toward social-reform. The bankers' campaign had therefore to be based outside their governments, and often directed against them. There was thus need for a semi-underground bunker to direct the project. The vehicle for that was miraculously at hand in the Bank for International Settlements (BIS) in Basel, Switzerland. Originally set up as a purely technical body to handle the syndication of the German reparation payments arising from World War I, which Germany could pay only in its own currency but which had to be converted into a strong currency. That was the reason for BIS's founding. The Wall St. collapse of October 1929 made impossible this original purpose of BIS, but it lingered on to do some ill-considered services to Adolf Hitler. When his army marched into Prague, BIS practically tripped over itself in surrendering to him the treasure that the Prague government had stored with it. As a result at Bretton Woods in 1943, Resolution Five passed on the initiative of several governments-in-exile called for the liquidation of BIS at the earliest moment. This led to BIS cultivating a low profile – some of its offices in Basel were housed not in the standard fake Greek temple, but over a pastry shop. That low profile, however, commended it to the conspiring bankers for their underground bunker. Government officials other than central bankers are still not allowed at BIS's council meetings.

The second measure for the Big Bank Bailout was its Risk-Based Bank Capital Requirements Guidelines drawn up in 1988. It shifted the criteria for a bank's solvency from its *cash* to its *capital*. These are very different things. For the first principle of banking is to keep cash reserves to the lowest possible figure for meeting their obligations, since cash is to them "lazy money" earning no interest.

The purpose of the Risk-Based Capital Requirements that declared debt of the developed countries "risk-free" was to bail out the banks from their crippling speculative losses in gas and oil, North American real estate, and in euro dollar loans. The BIS-sponsored guidelines enabled the banks to acquire immense quantities of government debt without putting up any money of their own. To make that possible governments did less of their financing with their own central bank where its borrowing was virtually interest-free since the interest on the bonds held by the central bank came back to the federal governments. In Canada this took the form of dividends; since 1938 the Bank of Canada has had a single shareholder – the government. Now it paid through the nose by borrowing directly or indirectly through the private banking system. This latter was at rates pushed sky-high under pressure from BIS to "lick inflation."

However, in its rush to prevent a chain of bank bankruptcies, BIS had overlooked a detail – when interest rates are pushed up, the market-value of pre-existent bonds with lower coupons drop violently. This caused massive capital losses for the banks that were just bailed out by being allowed to acquire unlimited amounts of government bonds entirely on credit.

Through Jack Biddell, then a member of the COMER Board, we contacted Michael Mackenzie, former head of the Office for the Superintendence of Financial Institutions (OSFI) and warned of the time-bomb the combination of the BIS Risk-Based Capital Requirements and the phasing out of the statutory reserves, and his shocked reaction to Biddell was, "My God at the Basel meeting we overlooked the connection!"

This oversight becomes perfectly logical when you realize that the purpose of BIS was less the prudent management of banking than regaining the power position that bankers had lost in 1929. These are not only two different things, but two incompatible ones.

And in December 1994 the first of a resulting series of national banking disasters we were warning about began in Mexico. Investors fled the country. The prosperity of Mexico under the new Globalization and Deregulation and the North American Free Trade Treaty had depended largely on the influx of foreign money.

The Mexico Volcano Blows

When the smoke finally cleared, Mexico's endemic corruption had risen to historic records, informed capital, native and foreign, had fled the land, banks had been replaced by the new stock market moguls. Government borrowing took the form of auctioning on the stock market to reflect this. So severe was the shift of power, that it brought on the break up of the coalition of parties and the trade unions that had put an end of the long bloody history of civil wars and the not infrequent assassination of political leaders. Civil war broke out in the impoverished states of Chiapas and Guerrero, and candidates for the Presidency came to be assassinated again.

The Value Added Tax on consumers rose 50% from 10% to 15% interest. Gasoline prices rose by 35% and retail electricity rates by 20%. The peso dropped by 18% in March, 1995.

So serious was the outlook, that Washington feared that the entire international monetary system might be brought down. Without the backing of Congress President Clinton arranged for a standby fund in excess of $50 billion to be organized with the help of the International Monetary Fund and the Canadian government, that did not have to be drawn on. But even so the Mexican crisis echoed through much of Eastern Asia in 1998, and then in Russia. When the smoke finally settled 85% of Mexico's banking system had been taken over by foreign banks.

In the words of an American observer: "For the men and women in the street in Mexico, the experience of the meltdown was a tragedy. Incomes declined, unemployment rose, poverty increased, and lawlessness in large cities took on new intensity. Nothing will ever be quite the same for the Mexican people; distrust of what the government says, and speculation about what it is keeping secret, has now become part of the national character."[1]

Robert Rubin, Clinton's Secretary of the Treasury, an alumnus of Wall St. knowledgeable about capital movements, drew another even more important conclusion from these happenings. Grasping the incompatibility of high interest as a means of avoiding "inflation," with contemporary banking and the economy as a whole, he found a healthier way of alleviating the upward pressure on prices. He introduced the distinction between current and capital expenditures in the government accounts – something that had been recognized in the private sector for centuries. By depreciating government investment in physical infrastructures over the useful life of the asset and recognizing its depreciated book value as assets, and applying the adjustment to some earlier years, he was able to retrieve some 1.3 trillion dollars of ignored government assets on the government's books.

This was without extending the treatment to human investment such as education, health, and social services. In studying the unexpectedly rapidly recovery of Germany and Japan from the physical devastation of World War II, economists like Theodore Schultz of the University of Chicago even concluded that investment in human capital – i.e., education, health, and social services – was the most productive investment a government could make. But respecting Clinton's preoccupation with holding the political center, these increased assets were booked as "savings" in the statistics of the Department of Commerce beginning with January 1996. But they definitely were not savings – they had long been invested in bricks, mortar and equipment. Though this deprived the public from a knowledge of what was happening in their economy, it was enough with the usual wink and nod to convince the bond rating companies to improve the ratings on government debt, and bring down interest rates enough to give Clinton a second term and the nation the high-tech boom and bust that closed the millennium.

Such are the unmentioned and unmentionable factors behind the Delphic utterances of Chairman Greenspan. The reinstatement of the bankers as virtual rulers

Continued on page 6

As Scorn for Vote Grows, Protests Surge Around Globe

By Nicholas Kulish, The New York Times, September 27, 2011

Madrid – Hundreds of thousands of disillusioned Indians cheer a rural activist on a hunger strike. Israel reels before the largest street demonstrations in its history. Enraged young people in Spain and Greece take over public squares across their countries.

Their complaints range from corruption to lack of affordable housing and joblessness, common grievances the world over. But from South Asia to the heartland of Europe and now even to Wall Street, these protesters share something else: wariness, even contempt, toward traditional politicians and the democratic political process they preside over.

They are taking to the streets, in part, because they have little faith in the ballot box.

"Our parents are grateful because they're voting," said Marta Solanas, 27, referring to older Spaniards' decades spent under the Franco dictatorship. "We're the first generation to say that voting is worthless."

Economics have been one driving force, with growing income inequality, high unemployment and recession-driven cuts in social spending breeding widespread malaise. Alienation runs especially deep in Europe, with boycotts and strikes that, in London and Athens, erupted into violence.

But even in India and Israel, where growth remains robust, protesters say they so distrust their country's political class and its pandering to established interest groups that they feel only an assault on the system itself can bring about real change.

Young Israeli organizers repeatedly turned out gigantic crowds insisting that their political leaders, regardless of party, had been so thoroughly captured by security concerns, ultra-Orthodox groups and other special interests, that they could no longer respond to the country's middle class.

In the world's largest democracy, Anna Hazare, an activist, starved himself publicly for 12 days until the Indian Parliament capitulated to some of his central demands on a proposed anticorruption measure to hold public officials accountable. "We elect the people's representatives so they can solve our problems," said Sarita Singh, 25, among the thousands who gathered each day at Ramlila Maidan, where monsoon rains turned the grounds to mud but protesters waved Indian flags and sang patriotic songs.

"But that is not actually happening. Corruption is ruling our country."

Increasingly, citizens of all ages, but particularly the young, are rejecting conventional structures like parties and trade unions in favor of a less hierarchical, more participatory system modeled in many ways on the culture of the Web.

In that sense, the protest movements in democracies are not altogether unlike those that have rocked authoritarian governments this year, toppling longtime leaders in Tunisia, Egypt and Libya. Protesters have created their own political space online that is chilly, sometimes openly hostile, toward traditional institutions of the elite.

The critical mass of wiki and mapping tools, video and social networking sites, the communal news wire of Twitter and the ease of donations afforded by sites like PayPal makes coalitions of like-minded individuals instantly viable.

"You're looking at a generation of 20- and 30-year-olds who are used to self-organizing," said Yochai Benkler, a director of the Berkman Center for Internet and Society at Harvard University. "They believe life can be more participatory, more decentralized, less dependent on the traditional models of organization, either in the state or the big company. Those were the dominant ways of doing things in the industrial economy, and they aren't anymore."

Yonatan Levi, 26, called the tent cities that sprang up in Israel "a beautiful anarchy." There were leaderless discussion circles like Internet chat rooms, governed, he said, by "emoticon" hand gestures like crossed forearms to signal disagreement with the latest speaker, hands held up and wiggling in the air for agreement – the same hand signs used in public assemblies in Spain. There were free lessons and food, based on the Internet conviction that everything should be available without charge.

Someone had to step in, Mr. Levi said, because "the political system has abandoned its citizens."

The rising disillusionment comes 20 years after what was celebrated as democratic capitalism's final victory over communism and dictatorship.

In the wake of the Soviet Union's collapse in 1991, a consensus emerged that liberal economics combined with democratic institutions represented the only path forward. That consensus, championed by scholars like Francis Fukuyama in his book *The End of History and the Last Man*, has been shaken if not broken by a seemingly endless succession of crises – the Asian financial collapse of 1997, the Internet bubble that burst in 2000, the subprime crisis of 2007-8 and the continuing European and American debt crisis – and the seeming inability of policy makers to deal with them or cushion their people from the shocks.

Frustrated voters are not agitating for a dictator to take over. But they say they do not know where to turn at a time when political choices of the cold war era seem hollow. "Even when capitalism fell into its worst crisis since the 1920s there was no viable alternative vision," said the British left-wing author Owen Jones.

Protests in Britain exploded into lawlessness last month. Rampaging youths smashed store windows and set fires in London and beyond, using communication systems like BlackBerry Messenger to evade the police. They had savvy and technology, Mr. Jones said, but lacked a belief that the political system represented their interests. They also lacked hope.

"The young people who took part in the riots didn't feel they had a future to risk," he said.

In Spain, walloped by the developed world's highest official rate of unemployment, at 21 percent, many have lost the confidence that politicians of any party can find a solution. Their demands are vague, but their cry for help is plaintive and determined. Known as *indignados* or the outraged, they block traffic, occupy squares and gather for teach-ins.

Ms. Solanas, an unemployed online journalist, was part of the core group of protesters who in May occupied the Puerta del Sol, a public square in Madrid, the capital, touching off a nationwide protest. That night she and some friends started the Twitter account @acampadasol, or "Camp Sol," which now has nearly 70,000 followers.

While the Spanish and Israeli demonstrations were peaceful, critics have raised concerns over the urge to bypass representative institutions. In India, Mr. Hazare's crusade to "fast unto death" unless Parliament enacted his anticorruption law struck some supporters as self-sacrifice. Many opponents viewed his tactics as undemocratic blackmail.

Hundreds of thousands of people turned out last month in New Delhi to vent a visceral outrage at the state of Indian politics. One banner read, "If your blood is not boiling now, then your blood is not blood!" The campaign by Mr. Hazare, 74, was intended to force Parliament to consider his anticorruption legislation instead of a weaker alternative put forth by the government.

Parliament unanimously passed a resolution endorsing central pieces of his proposal, and lawmakers are expected to approve an anticorruption measure in the next session. Mr. Hazare's anticorruption campaign tapped a deep chord with the public precisely because he was not a politician. Many voters feel that Indian democracy, and in particular the major parties, the Congress Party and the Bharatiya Janata Party, have become unresponsive and captive to interest groups. For almost a year, India's news media and government auditors have exposed tawdry government scandals involving billions of dollars in graft.

Many of the protesters following the man in the white Gandhian cap known as a *topi* were young and middle class, fashionably dressed and carrying the newest smart phones. Ms. Singh was born in a village and is attending a university in New Delhi. Yet she is anxious about her future and wants to know why her parents go days without power. "We don't get electricity for 18 hours a day," she said. "This is corruption. Electricity is our basic need. Where is the money going?"

Responding to shifts in voter needs is supposed to be democracy's strength. These emerging movements, like many in the past, could end up being absorbed by traditional political parties, just as the Republican Party in the United States is seeking to benefit from the anti-establishment sentiment of Tea Party loyalists. Yet purists involved in many of the movements say they intend to avoid the old political channels.

The political left, which might seem the natural destination for the nascent movements now emerging around the globe, is compromised in the eyes of activists by the neoliberal centrism of Bill Clinton and Tony Blair. The old left remains wedded to trade unions even as they represent a smaller and smaller share of the work force. More recently, center-left participation in bailouts for financial institutions alienated former supporters who say the money should have gone to people instead of banks.

The entrenched political players of the post-cold-war old guard are struggling. In Japan, six prime ministers have stepped down in five years, as political paralysis deepens. The two major parties in Germany, the Christian Democrats and the Social Democrats, have seen tremendous declines in membership as the Greens have made major gains, while Chancellor Angela Merkel has watched her authority erode over unpopular bailouts.

In many European countries the disappointment is twofold: in heavily indebted federal governments pulling back from social spending and in a European Union viewed as distant and undemocratic. Europeans leaders have dictated harsh austerity measures in the name of stability for the euro, the region's common currency, rubber-stamped by captive and corrupt national politicians, protesters say.

"The biggest crisis is a crisis of legitimacy," Ms. Solanas said. "We don't think they are doing anything for us."

Unlike struggling Europe, Israel's economy is a story of unusual success. It has grown from a sluggish state-dominated system to a market-driven high-tech powerhouse. But with wealth has come inequality. The protest organizers say the same small class of people who profited from government privatizations also dominates the major political parties. The rest of the country has bowed out of politics.

Mr. Levi, born on Degania, Israel's first kibbutz, said the protests were not acts of anger but of reclamation, of a society hijacked by a class known in Hebrew as "hon veshilton," meaning a nexus of money and politics. The rise of market forces produced a sense of public disengagement, he said, a feeling that the job of a citizen was limited to occasional trips to the polling places to vote.

"The political system has abandoned its citizens," Mr. Levi said. "We have lost a sense of responsibility for one another."

❧ ❧ ❧

Editor: The answer to that should be clear enough, even though so unconscionably suppressed by those in power – recognize human capital not as a liability but as the most crucial investment that a government can make. This was undoubtedly the most important lesson drawn from World War II. Because it has been so unconscionably suppressed, we must repeat the circumstances under which it was learned.

No sooner had the armistice been signed with Japan and Germany, than Washington sent to these former great trading nations many hundreds of economists to study the damage to predict how long it would take for these great trading nations could take over that role again.

Some fifteen years later, one of these Theodore Schultz of the University of Chicago, published an essay in which he stated that he and his colleagues had been misled: "We concentrated on the physical destruction and ignored the fact that the human forces had come out the war essentially intact." And from that he went on – in a clear stroke of genius – to conclude that investment in human capital – rather that simple "spending," is the most crucial investment a society can make. For a few years his great conclusion was celebrated. and he was feted and decorated, but then suddenly forgotten, simply scratched of official society's memory and treated as a debt rather than an asset.

Governing Without Accountancy

But clearly nothing remotely related to serious accountancy has survived unless that distinction is made. Both Japan and Germany were able not only to rebuild but even profit in an important sense from that wartime destruction. Japan, in particular was able to change to the nature of its economy, formerly based on the export of textiles for which it had had to import even the fibers. Instead it shifted systematically to engineering, which would leave the country with a far higher net profit from her foreign trade. The end result reduced devastation from the first two atomic bombs exploded to proportions calling to mind the destruction when that lady's cow in Chicago kicked over the lamp and started the devastating fire that actually served to clear the scene for the rebuilding of Chicago into a modern metropolis.

Accidental fires served a not dissimilar purpose in most large cities both in the US and in Europe. It was no scant achievement to have reduced the havoc of two atom bombs to the proportions of the Chicago lady's cow's benign disaster when it kicked over her lamp. But it achieved the miraculous rebuilding of Japan's economy as a gem of economic planning that Soviet Russia couldn't begin to match. It served the Japanese brilliantly until they – like so many others – got entangled in US real estate investment.

And above all it holds an essential suppressed message for our world today.

W.K.

Europe Calls for Infusion of Capital for Banks

By Stephen Castle, The New York Times, October 6, 2011

Brussels – As European officials brace for the potential of a Greek debt default, Chancellor Angela Merkel of Germany said Wednesday that she would push for more capital to protect her nation's banks. And European banking regulators were trying to identify the region's most vulnerable financial institutions.

Mrs. Merkel's comments, after meetings with the European Commission here, came amid reports that customers were withdrawing savings from the French-Belgian financial institution Dexia, which is about to receive its second rescue in three years.

Shares of the bank, which is weighed down by its exposure to Greek debt, have plunged since Greece acknowledged over the weekend that it would miss the financial goals set as a condition for its receiving its next round of European bailout money.

The speed of that chain reaction has prompted the European Banking Authority to review the results of the bank stress tests conducted in July – this time to measure the effect of the even lower value of the bonds of Greece and some other governments held by banks in countries using the euro currency.

Dexia passed the July round of stress tests with some ease, indicating deep flaws in that exercise.

Although one official said stress test reviews take place regularly, this one may be the clearest indication yet that European policy makers are bracing for the financial fallout of the Greek debt debacle. The International Monetary Fund has also called for new infusions of capital for banks in the euro region.

And yet, while there is now widespread acknowledgment that euro zone banks need bigger capital reserves to gird against the potential repercussions of further write-downs of Greek debt – or a default by Athens – there is little consensus about how to proceed.

Germany, the euro zone's wealthiest member, seems politically inclined for each nation to protect its own banks. So is the affluent Netherlands. But France, the most dominant euro economy after Germany, is cautious about the whole exercise and is likely to lean toward an approach drawing upon the resources of the euro zone's bailout fund – an approach the IMF favors. "Germany is prepared to move to recapitalization," Mrs. Merkel said in Brussels, adding that other European countries should do the same with their banks. "We are under pressure of time," she said. "I think we need to take decisions quickly."

The European Commission played down suggestions Wednesday that a large-scale recapitalization plan was already taking shape. One official said the commission had been pushing for bank recapitalizations and was advocating a European approach, but added: "That's all. There is no big master plan."

If Europe did adopt a region-wide approach to recapitalizing the banks, the question is whether that money would come from the bailout fund agreed to in July, which must still be voted on by a handful of member nations. If adopted, as expected, that bailout fund – the European Financial Stability Facility – would gain an effective lending capacity of 440 billion euros ($595.4 billion).

That might be enough to provide the necessary capital cushion to the region's banks. But it would leave little cash to lend to any national governments that might require aid to protect themselves from a Greek contagion. Spain and Italy are seen most vulnerable on that count.

The IMF has estimated that Europe would need to pump as much as 200 billion euros ($270.6 billion) in fresh capital into its banks.

"There is a general consensus that this is urgent, and should be done in the next few weeks," said Antonio Borges, the IMF's European department head. "We would recommend that it move to a European approach."

On Wednesday, Mr. Borges also initially seemed to suggest that the IMF could invest "alongside" the euro zone's new bailout fund – along with a possible new task, buying Italian or Spanish bonds. But, in perhaps yet another indication of how politically volatile the issue remains, he later issued a statement saying that the IMF was not contemplating such moves.

France, worried that pumping too much of its taxpayers' money into a bank recapitalization could lead to a downgrade of its government debt rating – driving up the government's own borrowing costs – has called for a new look at whether Greece's private creditors should face higher write-downs on their Greek debt.

"Given what's happened over the last three months, we should perhaps look at the extent of the private sector involvement," the French finance minister, François Baroin, said on the French radio station RTL.

Mrs. Merkel also appeared to support that position, which was the subject of debate by euro zone finance ministers at a meeting Monday in Luxembourg.

But the more immediate concern appears to be what to do with big European banks deemed to have dangerously high exposure to the government debt of Greece and other potentially shaky euro zone members.

France's caution over recapitalization illustrates how each potential solution to the euro zone crisis tends to become entangled in member nations' domestic politics. A downgrade of France's debt rating would be damaging to the French president, Nicolas Sarkozy, ahead of presidential elections next year.

"The problem is that if you recapitalize the banks, then you have a problem with sovereign debt," said one European official not authorized to speak publicly. "That is Paris's big issue."

The subject is likely to come up on Sunday when Mr. Sarkozy is scheduled to meet with Mrs. Merkel. The issue of bank recapitalization also raises a question of strategy: whether governments should concentrate on shoring up European banks or spend resources instead on resolving the crisis in Greece.

Daniel Gros, director of the Center for European Policy Studies, said that the best solution would be to focus on recapitalizing the banks, using the currency's bailout fund. "There is no easy way out," he said. "You

---

History *from page 3*

of the world has gone far toward depriving society of even a language through which it can learn the lessons of its own recent history. In an epoch devoted to technological communication magic, economists and governments have lost the means of articulating an experience that is tightening like a noose around our necks.

W. Krehm

1. Weintraub, Sidney (2000). *Financial Decision-Making in Mexico. To Bet a Nation.* University of Pittsburgh Press, pp. 151 and 160.

need to have many things happening at the same time."

At the very least, the fate of Dexia should be settled soon. Belgium's prime minister, Yves Leterme, said that nationalization of Dexia's banking activities, including a large retail operation, was being considered.

Mr. Baroin, of France, said that the rescue was likely to be completed on Thursday and might involve Dexia's French municipal financing operations being merged with the French state bank Caisse des Dépôts and Banque Postale, the banking arm of France's post office.

Dexia "cannot continue in its present form, that is indisputable," Mr. Baroin said on RTL. "We are working on a solid, structured solution."

Belgium's central bank issued a statement Wednesday insisting that "the savings of customers of Dexia Banque Belgique are perfectly secure and there is no reason for clients to make withdrawals."

But the Belgian newspaper De Tijd reported that rival banks had received many deposits from customers withdrawing cash from Dexia.

A Dexia spokeswoman told Reuters: "We have had some customers taking money out, but it has been limited. We have faced many questions and we have been explaining the situation a lot."

❧ ❧ ❧

Editor: These ideas, quite independently, I had analyzed economically and mathematically and under the title of "social lien" assessed as the most valuable investment a government can make. This I sent to journals of economic theory throughout the world it was acquired and published in their journal, *Revue économique* in the issue of May, 1970, and reviewed not once, but twice most favourably in the *Economic Journal* of Cambridge University in Britain. All that sort of thing has been buried at present, without headstone, in our universities and publications and any rise in prices is treated as "inflationary" to be suppressed with higher interest rates. The upshot of all this is that the world as a whole is in the precisely the same bind as Greece itself – for the identical reason, i.e., the treatment as a deficit of human capital, the "most productive investment a government can make" and trying to suppress it by raising interest rates.

W.K.

Apple's Ive Draws Design Spotlight

By John Letzing and Andrew Morse, The Wall Street Journal, October 7, 2011

Without Steve Jobs, Apple Inc. investors and customers are asking a big question: Can it continue to turn out innovative products without its co-founder and design visionary?

The answer may lie with Jonathan Ive, an Apple executive little known outside the technology industry.

Mr. Ive is Apple's design chief. Since taking charge of the company's design team in 1996, Mr. Ive and his group have been responsible for coming up with the physical look and feel of products that have helped set Apple apart from competitors.

The demands on Mr. Ive likely will grow with the death of Mr. Jobs. Apple depends on just four product lines – computers, music players, smart phones and tablet computers – to drive the lion's share of the more than $100 billion in annual revenue the company is expected to take in this fiscal year. That means Apple relies on frequent product-cycle refreshes to generate the excitement for its devices.

To date, Mr. Ive's emphasis on elegant design has helped Apple products become consumer status symbols. The Ive-designed iPad – a simple slate of glass on an aluminum body – has defined the tablet-computer market. The latest generation of the iPad held 68% of global tablet shipments in the June quarter, outrunning rivals from Research in Motion Ltd. and others.

Backed by slick marketing, Mr. Ive's creations have powered a remarkable growth spurt that has made Apple the most highly valued technology company in the world.

The sleek iPhone has become Apple's single-biggest revenue driver, while the company's line of Macs is the fastest-growing segment of the personal-computer market. The spare iPod, which anchored Apple's renaissance with its debut in 2001, popularized digital music for the consumer market.

Mr. Ive's Apple role is so important that he reports directly to the chief executive. The reporting line underscores Apple's emphasis, burnished under Mr. Jobs, on design and aesthetics.

Apple declined to make Mr. Ive available to comment for this story. Mr. Ive didn't respond to an email requesting comment.

Mr. Ive was born in 1967 in London and studied design at Northumbria University. He worked at a UK design agency, Tangerine, that consulted for Apple in the early 1990s. In 1992, Mr. Ive joined Apple and quickly became head of its industrial design team.

Since joining, Mr. Ive has worked in the background while Mr. Jobs and other executives served as the company's public face. Mr. Ive's design team has spearheaded a revitalization of Apple's products, which were once gray or beige boxes. Among his most notable products: the candy-colored line of iMac computers and the glass-and-aluminum iPhone.

Analysts say Mr. Ive's attention to seemingly small details set Apple's apart from competitors. Charles Golvin, who tracks consumer technology for market watcher Forrester Research, says setting the keyboard on the Macbook deep on the machine's base to create a palm rest was one such decision.

Mr. Ive's designs are often compared to those of Dieter Rams, the German industrial designer who conjured products, such as calculators and radios, for Braun in the 1960s.

Those products, like Mr. Ive's at Apple, were known for their simplicity, elegance and ease of use.

"They share a design philosophy of 'don't overwork things, don't make it complicated,'" said IDC mobile-device and technology trends analyst William Stofega.

"Most people think design is about making things look pretty, but it's about much more than that," said Sophie Lovell, a Berlin-based writer on design, who said Mr. Ive's passion for design was abundant when they met last year when she interviewed him for a magazine article. "That's something that both Steve Jobs and Jonathan Ive have understood."

❧ ❧ ❧

Editor: However, it does not begin to touch the essence of our society's current dilemma – making things look pretty will not help regain control of our prepaid social capital, and without that we are flying with banded eyes and no social accountancy, headed for the next atomic war.

W.K.

In Cooling China, Loan Sharks Come Knocking

By David Barboza, The New York Times, October 13, 2011

Wenzhou, China – The 300 employees of Aomi Fluid Equipment here were delighted recently when the owner offered an all-expenses-paid, two-day trip to a mountain resort three hours away.

The owner, Sun Fucai – or Boss Sun, as he's known – was so insistent that his workers attend that he imposed a $30 fine on any employee who refused the getaway. Nearly everyone went.

Except Boss Sun.

When the employees returned from their holiday, they found that the factory had been stripped of its equipment and that Boss Sun had fled town. "It was entirely empty," Li Heying, a former Aomi worker, said of the factory. "It was like what happens in wartime."

The boss, as it turned out, was millions of dollars in debt to loan sharks – underground lenders of the sort that many private businesses in China routinely use because the government-run banks typically lend only to big state-run corporations.

As China's economy has begun to slow slightly, more and more entrepreneurs are finding themselves in Mr. Sun's straits – unable to meet debt payments on which interest rates often run as high as 70 percent in this nation's thriving unregulated, underground loan system. Such illegal lending amounts to about $630 billion a year, or the equivalent of about 10 percent of China's gross domestic product, according to estimates by the investment bank UBS.

In recent months, at least 90 business executives from this coastal city, a one-hour flight south of Shanghai, have disappeared because of mounting debts and impending bankruptcies, according to a local government report.

Whether out of fear of mafia-style loan enforcers – kidnappings and broken kneecaps are common tactics – or the family dishonor that is its own harsh penalty in China, some of the Wenzhou missing have gone into hiding or fled overseas.

And in the last few weeks, at least three have tried to commit suicide by jumping off high-rises in the city, according to the state-run news agency, Xinhua, which reported that two of them died and the other survived with a broken leg.

That tycoons in a city known for its savvy entrepreneurs are running scared has raised concerns that private business, a vibrant part of China's economy, may be losing steam – while exposing the high-risk, unregulated financial system on which so many of the nation's small and medium-size businesses have come to depend.

"There have always been people running away because they couldn't pay their debts," said Wang Yuecai, general manager at Wenzhou Yinfeng Investment & Guarantee, which guarantees state bank loans when small businesses are lucky enough to get them. "But recently, the situation here has gotten much worse."

Last week, Prime Minister Wen Jiabao and a delegation of top officials, including the head of the nation's central bank, visited Wenzhou, promising to get official banks to lend more to small companies and to crack down on underground lenders that charge high interest rates.

And on Wednesday, China's state council, or cabinet, announced a series of measures aimed at helping small businesses with tax breaks and new lines of credit.

Beijing no doubt worries that similar problems could surface in other parts of the country.

"This is not just happening in Wenzhou," said Chang Chun, who teaches at the Shanghai Advanced Institute of Finance. "Some companies borrow from the state banks and then lend into the underground market. Many are doing this type of arbitrage."

But caging the loan sharks could prove difficult, not only because the activity is so rampant but because the lending is in some ways a result of the government's own banking policies.

Here in Wenzhou, known for its pen makers, textile producers and big cigarette lighter factories, business owners complain that they are struggling with inflation and rising prices for raw materials. But they also point to a government-created credit squeeze. As elsewhere in China, most bank loans in Wenzhou go to big corporations or to finance projects backed by the government, making it increasingly difficult for smaller businesses to borrow money.

"This informal lending was aggravated by the credit tightening that made borrowing from the official banking system more difficult," said Wang Tao, a UBS economist based in Hong Kong.

Meanwhile, as is also the case throughout China, the government keeps interest rates on household bank savings accounts so low – currently only about half the 6 percent inflation rate – that people seek other ways to make their money grow.

Many households pool their money into underground lending syndicates, the source of the loans that have gotten borrowers like Boss Sun in over their heads. According to one local survey, more than 90 percent of Wenzhou's households have invested in such lending pools.

As long as China's economy was racing along at an 11 percent growth rate, small companies could hope for enough business to stay a step or two ahead of their underground creditors. But there was little room for error.

Now, businesses here and elsewhere in China are being caught short because the national economy has begun to moderate a bit, to a projected 9 percent rate by year's end, in response to government-imposed measures to fight inflation and let air out of the real estate bubble.

Ms. Wang, at UBS, said the slowing economy and weakening exports would hurt many small Chinese businesses. Already, according to a recent survey by the city's small-business council, one in five of Wenzhou's 360,000 small and medium-size businesses have recently stopped operating because of cash shortages.

At Aomi, former workers interviewed here this week said that Mr. Sun, like many other Wenzhou entrepreneurs, not only had borrowed from underground lenders but had dipped into his company's funds to lend to other private companies at exorbitant rates. That would have left him even more exposed if any of his borrowers' businesses collapsed.

"He was doing some financial business," said Ding Shouyu, a former Aomi executive who left the company shortly before its collapse. "But then everything fell apart."

Other workers said Aomi, a maker of valves, was doing relatively well, and was busy filling orders at the time Boss Sun fled. They said he owed them about $157,000 in wages, which the local government subsequently paid.

Earlier this week, after Prime Minister Wen's visit to the city, Mr. Sun and several other businessmen who recently fled Wenzhou struck a deal with the local government to return to the city.

City officials did not disclose details of the agreement with Mr. Sun, but the government released a statement saying it would aid Aomi and also ensure Mr. Sun's safety.

He will need it. A few days ago, newspapers in Wenzhou reported the arrest of seven people suspected of "collecting debts with violence."

Mr. Sun could not be reached at his office Wednesday or Thursday, and did not answer his mobile phone. But in an interview with Xinhua published Tuesday, Boss Sun said he had borrowed millions from banks and private lenders and the interest rates grew "higher and higher."

He also said his personal safety was in jeopardy.

"My capital chain broke completely," he said in the interview. "I was driven to foolishness by the debts and was forced to flee."

❧ ❧ ❧

Editor: There is only one conclusion to be drawn from this doleful tale: no matter what the political system might be – socialist, communist, or capitalist, if it ignores the crucial importance of human capital, it will run into stone fences or swamps. That was the most important lesson to come out of World War II.

It was formulated when on the surrender of Japan and Germany many hundreds of economists were sent to study the war damage to forecast how long it would be before those two great trading nations could become formidable traders again. Some fifteen years later, one of these economists, Theodore Schultz of the University of Chicago wrote an essay declaring how wide of the mark he and his colleagues had been.

And this he attributed to their having concentrated on the physical destruction and overlooked the importance of the human capital that had come out of the war practically intact. And then in a stroke of sheer genius he wrote an essay concluding that human capital is the most rewarding a government can make. For a few years Schultz was celebrated and decorated with a Nobel Peace prize. And then completely forgotten. But once you fail to recognize the critical importance of human capital, and you diminish the power of corporate and government bureaucracies of whatever political stripe.

Lost in the tangle of bureaucratic ambitions, was the prepaid crucial human investment. Yet without which it is impossible to run a high-tech, ever more urbanized society. In short what society has been deprived of is accountancy. It is flying, drunk blind, repeating the identical anti-accountancy on an ever more perilous scale. Even the teachings of countless sociologists emphasizing that with a change of regime, no leading personnel connected with the former regime must be allowed to continue in office, or they will undo the basic regime change undergone.

In the French Revolution the revolution assured itself of that with the guillotine, which of course, we are not proposing. However, allowing anybody of the failed regime to remain in a commanding position – which is Obama's folly – is bound to be fatal.

In a lengthy essay of mine that was acquired y the leading French journal of economic theory of the day, I identified the growing budget of expenditures of revolutionary governments that are not even marketed but financed directly by the government. This was reviewed by the leading French journal of the day and reviewed most favorably in the *Economic Journal* of Cambridge University, that was particularly taken with my references to investments made directly the government without being marketed as the "social lien."

Treating human capital as just an expense rather than the crucial capital asset, leaves the old regime in control. Let us assume a new subway line is to be built in one of the numerous cities that are exploding in size. If the capital resources of a well-educated population is seen, as a government prepaid asset rather than a liability, the government will be in a position to profit grandly from its advance knowledge of its own plans. This will allow it to pick up key sites close to the future subway stations before the news of the future subway is out. Leaving members of the old economic regime in key positions, makes that impossible.

Not recognizing the key importance of human capital, but treating it as just another expense that society cannot afford, leaves the government without serious accountancy. We are flying blind to disaster. There are international private corporations that grow wealthy by buying or leasing long term public-built bridges, roads and other facilities. A proper economic theory would keep the ownership of such facilities in the public domain.

William Krehm

How Did the Robot End Up With My Job?

By Thomas L. Friedman, The New York Times, October 2, 2011

I've done a lot of television book interviews lately, and I continue to be struck at what a difference there is in the technology in just a few years' time.

Here is a typical evening at a major cable TV network: arrive at Washington studio and be asked to sign in by a contract security guard. Be met by either a young employee who appears to still be in college or an older person who seems to have hung on with tenure. Have your nose powdered by that person. Have your microphone attached by that person. Be positioned in the studio chair by that person, and then look directly into a robotic camera being manipulated by someone in a control room in New York and speak to whoever the host is wherever he or she is. That's it: one employee, a robot and you.

Think of how many jobs – makeup artist, receptionist, camera person, producer-director – have been collapsed into one. I raise this point because there is no doubt that the main reason for our 9.1 percent unemployment rate is the steep drop in aggregate demand in the Great Recession. But it is not the only reason. "The Great Recession" is also coinciding with – and driving – "The Great Inflection."

In the last decade, we have gone from a connected world (thanks to the end of the cold war, globalization and the Internet) to a hyperconnected world (thanks to those same forces expanding even faster). And it matters. The connected world was a challenge to blue-collar workers in the industrialized West. They had to compete with a bigger pool of cheap labor. The hyperconnected world is now a challenge to white-collar workers. They have to compete with a bigger pool of cheap geniuses – some of whom are people and some are now robots, microchips and software-guided machines.

I wrote about the connected world in 2004, arguing that the world had gotten "flat." When I made that argument, though, Facebook barely existed – and Twitter, cloud computing, iPhones, LinkedIn, iPads, the "applications" industry and Skype had either not been invented or were in their infancy. Now they are exploding, taking us from connected to hyperconnected. It is a huge inflection point masked by the Great Recession.

It is also both a huge challenge and opportunity. It has never been harder to find a job and never been easier – for those prepared for this world – to invent a job or find a customer. Anyone with the spark of an idea can start a company overnight, using a credit card, while accessing brains, brawn and customers anywhere. It is why Pascal Lamy, chief of the World Trade Organization, argues that terms like "made in America" or "made in China" are phasing out. The proper term, says Lamy, is "made in the world." More products are designed everywhere, made everywhere and sold everywhere.

What is out and what is in anymore?

The term "outsourcing" is also out of date. There is no more "out" anymore. Firms can and will seek the best leaders and talent to achieve their goals anywhere in the world. Dov Seidman, is the CEO of LRN, a firm that helps businesses develop principled corporate cultures, and the author of *How: Why How We Do Anything Means Everything*. He describes the mind-set of many CEO's he works with: "I run a global company with a global mission and one set of shared values in pursuit of global objectives. My employees are all over the world – more than half outside the US – and more than half of my revenues and my plans for growth are out there, too. So you tell me: What is out and what is in anymore?"

Matt Barrie, is the founder of freelancer.com, which today lists 2.8 million freelancers offering every service you can imagine. "The whole world is connecting up now at an incredibly rapid pace," says Barrie, and many of these people are coming to freelancer.com to offer their talents. Barrie says he describes this rising global army of freelancers the way he describes his own team: "They all have PhD's. They are poor, hungry and driven: PHD."

Barrie offered me a few examples on his site right now: Someone is looking for a designer to design "a fully functioning dune buggy." Forty people are now bidding on the job at an average price of $268. Someone is looking for an architect to design "a car-washing cafe." Thirty-seven people are bidding on that job at an average price of $168. Someone is looking to produce "six formulations of chewing gum" suitable for the Australian market. Two people are bidding at an average price of $375. When Barrie needed a five-word speech to accept a Webby Award, he offered $1,000 for the best idea. He got 2,730 entries and accepted "The Tech Boom Is Back." Someone looking for "a rap song to help Chinese students learn English" has three bids averaging $157.

Indeed, there is no "in" or "out" anymore. In the hyperconnected world, there is only "good" "better" and "best," and managers and entrepreneurs everywhere now have greater access than ever to the better and best people, robots and software everywhere. Obviously, this makes it more vital than ever that we have schools elevating and inspiring more of our young people into that better and best category, because even good might not cut it anymore and average is definitely over.

❧ ❧ ❧

Editor: And yet it foretold that Japan's human capital not only allowed it to rebuild the country, but to do so along vastly more profitable – lines from a textile exporter that had to import the very fiber for its industries, it became, step by step, a great engineering nation, that made the most of its talented human capital.

For a few decades, as we have repeatedly explained elsewhere, Theodore Schultz and his great discovery were celebrated, and then completely forgotten. However, the great lesson he taught the world lives on in ever more crucial form.

Unless society stands guard over that human capital, it will merely become the dice of our speculative banks' future gambling. There were clear safeguards developed after WW II against this happening. One was the *Glass-Steagall Act* brought in under Roosevelt that forbade banks to acquire interests in non-banking financial institutions. For were they to do that, they would use the capital reserves for such firms – business to finance speculative banking – exactly what happened in the great bank busts in recent years.

Another were the statutory reserves that required the banks to deposit with the central bank money on which they earned no interest. This served as a damper for their gambles. And of course, in Canada, we have a nationally-owned central bank which allowed the government – and could still allow this – without the government paying more than a handling charge. Provisions are still on the books of the Bank of Canada to allow such advantages to be passed onto the provinces, and against the guarantee of the Federal government and to the municipalities, which would require the guarantee of either federal or provincial government.

There is also a series of important scholars, notably Douglass C. North, who have made the point that when a new economic class takes over, it must change political control as well. Otherwise, the old economic ruling class will sabotage the new economic regime. In the French Revolution, they cut off their heads, which we are not proposing.

But we must not allow representatives of the old order to run the proposed new one. For they will most surely sabotage. That is what Obama is doing.

W.K.

How Tough Are Times? Parents Cut Back Diapers

By Hannah Karp, The Wall Street Journal, October 4, 2011

The tight US economy has turned even essential goods into luxuries. Now consumer-goods companies are seeing something they thought would never come to pass: parents are buying fewer diapers.

Spending on children has traditionally held steady in times of recession, including the most recent one, with parents sacrificing other items rather than scrimping on their children's hygiene or happiness.

But as the economy continues to sputter, recent data show diaper sales are slowing and sales of diaper-rash ointment are rising.

The volume of diapers sold in the US slipped 1% in the four weeks ended Sept. 4 from a year earlier, extending a string of similar or steeper declines stretching back to August 2010, according to Consumer Edge Research, whose retail-sales tracking doesn't include Costco Wholesale Corp. or Wal-Mart Stores Inc. Dollar sales fell nearly 3%, indicating parents are both cutting back and trading down to cheaper private labels.

Dollar sales of diapers in the four weeks fell 4% at Huggies maker Kimberly-Clark Corp. Procter & Gamble, maker of Pampers and Luvs, saw dollar sales drop 2.5%. Even generics were down, with sales of private-label diapers slipping 0.5%.

The US birth rate has declined since 2007, and it isn't clear how much of the drop in diaper buying is due to penny pinching and how much results from fewer kids. Changing technology – more absorbent diapers, for example – also make comparisons difficult. Finally, the cohort being surveyed is always changing because parents buy diapers for a few years and then move on.

Still, Consumer Edge Research analyst Javier Escalante sees economic pressure behind the data. "This has never happened in this country before – this is a very rare circumstance," says Mr. Escalante, adding that the fact that people are having fewer babies is itself a strong indicator that the economy is influencing parental behavior. "That's a huge decision."

Meantime, sales of diaper-rash ointment have increased 8% over the past year, according to market-research firm SymphonyIRI. Analysts and pediatricians say the higher sales likely reflect either less frequent changes or a shift to lower quality diapers.

Most pediatric clinics don't keep statistics on benign conditions like diaper rash, but doctors in poorer areas say they see the long-stumbling economy starting to take a clear toll on children's health.

Anjali Rao, a pediatrician at Northwestern Memorial Physicians Group in Chicago, says she has seen a 5% to 10% spike in diaper-rash cases this year. Daniel Taylor, a pediatrician at St. Christopher's Hospital for Children in Philadelphia, says he and his colleagues have heard from a growing number of parents that they must choose between buying diapers and paying for food and heat.

"We're definitely seeing major effects of the economy: diapers are very expensive, and the longer you sit in a dirty diaper, the more likely the chances of an infection," Dr. Taylor says.

Diapering a child six times a day costs about $1,500 a year, according to diaper makers, so it isn't hard to see how it could become a burden on families dealing with chronic unemployment or struggling to cover rising costs.

P&G Vice Chairman Dimitri Panayotopoulos, a father of seven, noted at a conference earlier this year that the new "wetness indicator" on Pampers Swaddlers has saved his family unnecessary diaper changes because "you don't have to take the diaper off. You can just see the indicator, and you know if the baby is wet."

P&G says its research shows parents are also potty training children earlier to save cash as economic uncertainty deepens.

Eric Seidel, vice president of the Huggies brand, says lower birthrates account for most of the drop in sales, with fewer babies for three consecutive years affecting sales in every diaper size. But he also saw a decline – less than 1% – in the number of diapers used per baby last year. "That's one macro driver – we look at that as contraction," Mr. Seidel says. "But all of our data show that is not a big driver."

To appeal to the frugal consumer, companies are adjusting their products and marketing. To bring down the overall cost of diapers, P&G has increased the number of diapers in some brands' packaging, and it's offering more coupons via monthly newspaper inserts and direct mail, spokeswoman Jennifer Chelune says.

To encourage Pampers sales, P&G launched a rewards program that lets customers amass points they can spend on gifts.

Sandy Gill, a mother in Chicago, says she spoiled her children through hard times until her husband was laid off in May. Since then, she says, she has started combining Web coupons with store coupons, loading up on free samples at the doctor's office and writing "sob story" letters to her favorite baby-formula company to get discount vouchers. "Anything that's on sale, I'll buy," she says.

❧ ❧ ❧

Editor: I apologize for the lapse of my ballroom manners, but our governments' cheeky stupidity in imposing an identical reading of markets backwards and forwards ("inflation") makes it impossible to overlook in this the statesmanly equivalent to housewives' avoiding changing their babes' diapers to make ends meet.

W.K.

The Affliction of Comfort

By Frank Bruni, The New York Times, September 17, 2011

Just when you thought that absolutely nothing could make you feel warm and fuzzy about the American political system, I bring tidings from Italy. Here there are 945 active members of Parliament, in contrast with 535 members of the United States Congress, though Italy's population is less than a fifth of America's.

Italy has roughly twice as many members of Parliament per capita as Germany, and more per capita than France and Spain as well. The Italian Parliament is one larded body of government, fatter than a haunch of prosciutto.

You're figuring that with power scattered across so many lawmakers, each makes a pittance. Figure again – and get ready to fantasize about a new job as chairman of the Subcommittee to Oversee Trevi Fountain Coin Removal. (I made that assignment up, but in the context of Italian cronyism and waste, it's entirely plausible.)

Once you add the members of Parliament's salaries and an array of supplements – including travel allowances, even though lawmakers fly and take trains within the country free – all of them earn well above $100,000, while many make closer to $200,000. That's not to mention handsome pensions and subsidized health care, which reportedly covers thermal baths.

Such bloat spreads, like a Prada-shod Blob, from Rome. As Rachel Donadio reported in *The Times* last week, one Sicilian town of just 960 people has nine traffic officers on the payroll.

Italians outside of government – still, thankfully, a majority – are suitably outraged. They turned "La Casta" ("The Caste"), a 2007 exposé of government privilege, into a publishing sensation, with more than one million copies sold.

But when the Italian Parliament passed a $74 billion austerity package last week, government salaries didn't take a huge hit, and for the obvious reason: people on those salaries passed the package. They gave as much consideration to the preservation of their own comfort as to the broader interests of the country, which needs every euro it can muster for education, for infrastructure – for the future.

That underscores a central tension in these brutal, fearful economic times in much of Europe and America as well. Will the people who have already made it cling as tightly as ever, or perhaps more tightly than before, to their privilege and affluence, even if doing so lengthens the odds of outsiders' gaining traction? Or will they budge enough so that opportunity still exists, some sense of fairness is preserved and investments with long-term payoffs can be made?

That question has turned Europe into a battleground. Pensioners push back against decreased benefits while students scream that the largess their forebears long enjoyed – not to mention the debt these forebears racked up – has raised the cost of their own education and bequeathed them an economy leached of hope.

In America there aren't as many demonstrations, but it's otherwise not so very different. Without additional revenue or entitlement reform – and it would be best to have both – we can't spend as much money as we should on schools, roads and much else to stay globally competitive and position ourselves for optimal growth.

But there's potent resistance. Entrenched interests dig in further; sacred cows die hard. Last week's Republican debate demonstrated that Social Security remains a political grenade to be lobbed back and forth rather than a subject of serious, constructive discussion. And the latest round of Obama v. Boehner affirmed that any increase in taxes won't come easy, if at all.

Meantime, we keep slipping educationally, and the gap between rich and poor widens. Last week's joyous revelations? The College Board reported that for the high school class of 2011, the average SAT reading score was the lowest on record, while the Census Bureau reported that the percentage of Americans living below the poverty line last year, 15.1 percent, was the highest since 1993. These aren't the building blocks of a better tomorrow.

In Italy, the specter of present realities jeopardizing future possibilities looms especially large. The country's stubbornly low birth rate threatens to throw the balance of pensioners and tax-paying workers (or tax-evading ones, as is often the Italian case) wildly out of whack.

And Italy has its own education failures. Roberto d'Alimonte, an Italian political scientist from whom I've often sought insight, told me that only about 14 percent of Italians between the ages of 25 and 64 have college degrees or the equivalent. That puts Italy far behind France, the United States, South Korea and many other countries.

"It's one of the phenomena that explains continued support for the Berlusconi government," he said. "Low education."

In Italy there's also the problem of professionals – lawyers, pharmacists, notaries, journalists, government employees – who sometimes operate like members of exclusive orders, establishing systems and accumulating perks designed principally for self-protection. Many of the Italians I talked to mentioned and rued this.

"Older generations have closed ranks," said Maurizio Viroli, a political theorist whose 2010 book about Silvio Berlusconi's Italy, *La Libertà dei Servi* ("The Liberty of Servants"), will be published in English next month by Princeton University Press. Without enough new blood, he told me, "There's an impoverishment of leadership."

D'Alimonte said that in too many sectors of Italian life, "There's no meritocracy. And this dampens growth and the capacity to innovate. You don't get the best from people, and a society only thrives if you allow people to give the best of themselves."

He added that portions of northern Italy, with its vibrant manufacturing activity, were a robust exception to the doldrums of the rest of the country. But elsewhere, he said, the country was to some extent mired in competition-choking, incentive-depressing rules and entitlements.

And favors. You can't forget favors, which brings us back to government, a capacious trough of ready money on national, regional and municipal levels. One of the people currently supping at it is Nicole Minetti, 26, a former dental hygienist who will learn from a Milan court next month if she's to be tried for allegedly procuring prostitutes for Berlusconi.

Last year, thanks to his placing her on his party's ticket, she was elected to the legislature for the region of Lombardy. She reportedly makes more than $15,000 a month in that job, and doesn't have to worry the way she once did about plaque and gingivitis.

❧ ❧ ❧

Editor: Berlusconi's Italy may be an extreme instance of an ailment that afflicts much of the world not excluding Canada. And to help deal with it, we would make it compulsory for the government to compile – upon the request of a minority of three citizens – any legislation never repealed but simply ignored. *W.K.*

Eggheads and Blockheads

By Maureen Dowd, The New York Times, September 17, 2011

Washington – There are two American archetypes that were sometimes played against each other in old Westerns.

The egghead Eastern lawyer who lacks the skills or stomach for a gunfight is contrasted with the tough Western rancher and ace shot who has no patience for book learnin'.

The duality of America's creation story was vividly illustrated in *The Man Who Shot Liberty Valance*, the 1962 John Ford Western.

Jimmy Stewart is the young attorney who comes West to Shinbone and ends up as a US senator after gaining fame for killing the sadistic outlaw Liberty Valance, played by Lee Marvin. John Wayne is the rancher, a fast-draw Cyrano who hides behind a building and actually shoots Marvin because he knows Stewart is hopeless in a duel. He does it even though they're in love with the same waitress, who chooses the lawyer because he teaches her to read.

A lifetime later, on the verge of becoming a vice presidential candidate, Stewart confesses the truth to a Shinbone newspaperman, who refuses to print it. "When the legend becomes fact," the editor says, "print the legend."

At the cusp of the 2012 race, we have a classic cultural collision between a skinny Eastern egghead lawyer who's inept in Washington gunfights and a pistol-totin', lethal-injectin', square-shouldered cowboy who has no patience for book learnin'.

Rick Perry, from the West Texas town of Paint Creek, is no John Wayne, even though he has a ton of executions notched on his belt. But he wears a pair of cowboy boots with the legend "Liberty" stitched on one. (As in freedom, not Valance.) He plays up the effete-versus-mesquite stereotypes in his second-grade textbook of a manifesto, "Fed Up!"

Trashing Massachusetts, he writes: "They passed state-run health care, they have sanctioned gay marriage, and they elected Ted Kennedy, John Kerry, and Barney Frank repeatedly – even after actually knowing about them and what they believe! Texans, on the other hand, elect folks like me. You know the type, the kind of guy who goes jogging in the morning, packing a Ruger .380 with laser sights and loaded with hollow-point bullets, and shoots a coyote that is threatening his daughter's dog."

At a recent campaign event in South Carolina, Perry grinned, "I'm actually for gun control – use both hands."

Traveling to Lynchburg, VA, to speak to students at Liberty University (as in Falwell, not Valance), Perry made light of his bad grades at Texas A&M.

Studying to be a veterinarian, he stumbled on chemistry and made a D one semester and an F in another. "Four semesters of organic chemistry made a pilot out of me," said Perry, who went on to join the Air Force.

"His other D's," Richard Oppel wrote in The Times, "included courses in the principles of economics, Shakespeare, 'Feeds & Feeding,' veterinary anatomy and what appears to be a course called 'Meats.'"

He even got a C in gym.

Perry conceded that he "struggled" with college, and told the 13,000 young people in Lynchburg that in high school, he had graduated "in the top 10 of my graduating class – of 13."

It's enough to make you long for W.'s Gentleman's C's. At least he was a mediocre student at Yale. Even Newt Gingrich's pseudo-intellectualism is a relief at this point.

Our education system is going to hell. Average SAT scores are falling, and America is slipping down the list of nations for college completion. And Rick Perry stands up with a smirk to talk to students about how you can get C's, D's and F's and still run for president.

The Texas governor did help his former chief of staff who went to lobby for a pharmaceutical company that donated to Perry, so he at least knows the arithmetic of back scratching.

Perry told the students, "God uses broken people to reach a broken world." What does that even mean?

The Republicans are now the "How great is it to be stupid?" party. In perpetrating the idea that there's no intellectual requirement for the office of the presidency, the right wing of the party offers a Farrelly Brothers "Dumb and Dumber" primary in which evolution is avant-garde.

Having grown up with a crush on William F. Buckley Jr. for his sesquipedalian facility, it's hard for me to watch the right wing of the GOP revel in anti-intellectualism and anti-science cant.

Sarah Palin, who got outraged at a "gotcha" question about what newspapers and magazines she read, is the mother of stupid conservatism. Another "Don't Know Much About History" Tea Party heroine, Michele Bachmann, seems rather proud of not knowing anything, simply repeating nutty, inflammatory medical claims that somebody in the crowd tells her.

So we're choosing between the over-intellectualized professor and blockheads boasting about their vacuity?

The occupational hazard of democracy is know-nothing voters. It shouldn't be know-nothing candidates.

❧ ❧ ❧

Editor: It is most intriguing how Maureen Dowd broke up victimized humanity which is no longer allowed by speculative capital to use its total resources. She opens up with "There are two American archetypes, that were sometimes played against each other in old Westerns – the egghead Eastern lawyer who lacks the skills or stomach for a gun-fight is contrasted with the tough Western rancher and ace shot who has no patience for book learnin'.

In actual fact those two contrasted psychological types often occur in the same families and usually find ways of getting along with each another, to spare some sense of families' integrity of common parents or relatives. That however is no longer readily possible when speculative finance has cleaned out humanity's pantries so thoroughly. Hence what cannot be fitted into humanity's family budget, is in the process of being treated as the problem of an almost different species – a more active and resourceful group of students from poorer families with no rich resourceful relatives who guarantee high marks on their examinations, and is left on its own to become challenges that they must wrestle with unforeseen challenges. That leads to a problem-solver that is indispensable for a society so riddled with ever greater unsolved problems thrust on it by corporative greed today.

W.K.

Meltdown Volume 5 is now available. See the Bookstore on page 9 for details.

Buffett Builds His Tax-the-Rich Case

By Laura Saunders and Siobhan Hughes, The Wall Street Journal, October 13, 2011

According to a letter Mr. Buffett sent to a Republican congressman on Tuesday, the Berkshire Hathaway Inc. chairman and chief executive disclosed that he made almost $63 million last year, yet paid less than $7 million in federal income tax.

Mr. Buffett long has urged lawmakers to raise income-tax rates on the wealthiest, arguing that his secretary paid a higher effective rate than he did last year. President Obama embraced the concept, and went along with Senate Democrats' proposal for a 5.6% surtax on those making $1 million a year or more.

Prominent Republicans have challenged Mr. Buffett to release his income-tax return. Mr. Buffett stopped short of that, but provided key details in his letter to Republican Rep. Tim Huelskamp of Kansas.

Mr. Buffett's adjusted gross income was $62,855,038 in 2010, according to the letter, while his taxable income was $39,814,784. He said he paid $15,300 in payroll tax, and $6,923,494 in federal income tax. That made for an effective tax rate of 17.4%.

According to the Tax Policy Center, a nonpartisan group, the average tax rate for taxpayers in the middle quintile – those earning between $34,000 and $60,000 a year – is 12%, including payroll and income taxes. Those earning from $103,000 to $163,000 – the top 80% to 90% of earners – pay 18.2%. Those earning from $163,000 to $211,000 pay 19.8%, and those earning from $211,000 to $533,000 pay 20.4%.

Tax experts pored over the details of Mr. Buffett's letter hoping for a glimpse into his compensation and financial dealings. His salary has long been set at $100,000, with most of his income coming from other sources.

"Most of Mr. Buffett's income appears to be either long-term capital gain or qualifying dividend income," said Robert Gordon, president of Twenty-First Securities in New York, a tax strategy brokerage firm. The top rate on both forms of income is only 15%.

"Mr. Buffett isn't paid like most chief executive officers," added Lee Sheppard, an expert with Tax Notes, a nonprofit publication. They would have higher salaries and more ordinary income from exercising stock options.

Mr. Buffett didn't return phone calls seeking comment.

The biggest mystery is the nearly $23 million gap between Mr. Buffett's adjusted gross income and his taxable income. Without having his tax return it is impossible to know the reason for the gap for sure, tax experts say.

One possibility for the gap is that he made large charitable contributions, itemized deductions that are subtracted from adjusted gross income. Another possible element is interest expense. Mr. Buffett is known for not selling investments but rather borrowing money against them. To the extent that he has investment income, any interest paid on such loans would be deductible.

"I hope you succeed in getting the ultra rich – who, as a group, are paying less of their income to the federal government than their receptionists – to share in the sacrifice many millions of other Americans soon will be asked to do," Mr. Buffett wrote in the letter.

Republicans have been fighting a Democratic proposal to pay for President Obama's $447 billion jobs bill by imposing higher taxes on the wealthy. After Mr. Obama unveiled his plan to tax millionaires more, it became known as the "Buffett Rule," in a nod to Mr. Buffett's claims in an op-ed article that he paid taxes at a lower rate than people who worked for him.

The proposal for higher taxes on millionaires has angered Republicans, who complained that increasing such taxes would punish investment.

"The Buffett Rule…uses your anecdote to shape an entire nation's tax policy," Mr. Huelskamp wrote to Mr. Buffett in September. "Given the use of your name and your story as the guiding force for the President's policy prescription, it is my hope that the evidence to justify such a change in policy will soon be available for public review."

Mr. Buffett said that if Rep. Huelskamp could "get any of the ultra rich to release their returns simultaneously with mine, I will be willing to have a pre-release wager with anyone who wishes for any sum that they wish that the figures in my return will be exactly those used in my op-ed piece."

❧ ❧ ❧

Editor: To this, we can only add: It is far more serious than that. The greatest less to come out of World War II arose from an initiative of the US government when right after the armistice was signed with Japan and Germany, it sent many hundreds of economists the damage done to them to predict how long it would take those two great trading nations to resume such roles again.

Sixteen years later one of these economists, Theodore Schultz of the University of Chicago wrote an essay explaining how wrong they had been, and why: they had concentrated on the physical wartime destruction, and overlooked the crucial importance of the detail that the highly educated and gifted populations had come through conflict almost intact. And then from that in a stroke of sheer genius, deduced that investment in human capital is the most productive investment a government can make. Moreover, that comes prepaid. Moreover, the children of educated parents tend to be easier to educate, to be healthier, and, of course, those immense advantages come prepaid.

For a few years, Schultz was celebrated awarded a Nobel Peace prize – and then utterly purged from human memory. Still worse, the investment to renew and expand this key public investment is treated as debt.

I had picked my way to much the same conclusion. I had put together a long study of the growing ingredient of the national product that is not marketed, but directly arranged by the government. That, in fact was anticipated by the ancient Greek philosopher Plato from his study of the heavens where influence from one heavenly body can bounce off not one but several others at a variety of angles.

That study was published most approvingly by the leading French economical journal of the day as a forty-some page essay that explained an increasing portion of the crucial social product is not marketed at all, but produced directly financed by the various governments. That essay was carried in the leading French theoretical economic journal of the day, and reviewed most laudingly by the *Journal of Economic Theory* of Cambridge University in Britain that was particularly taken with the title "social lien." It was picked up approvingly by some eight other journals on economic theory, and then treated as debt. Today it has been forgotten.

That explains the fictitious debt that governments are using to tighten the control of our speculative mega-banks. The end result: our governments are running the world without anything that could be mistaken for serious accountancy, confusing prepaid capital for debt.

Unless that is rectified in good time, it could lead to the net atomic war to our final destruction.

W. Krehm

The Celebrated News Sources of a Unified World are Now being Blocked as a Technique of Espionage

The Wall Street Journal (8-9/01, "A Walled Wide Web for Nervous Autocrats" by Evgeny Morozov) reports: "At the end of 2010, the 'open-source' software movement whose activists tend to be fringe academics and ponytailed computer geeks, found an unusual ally: the Russian government. Vladimir Putin signed a 20-page executive order requiring al institutions in Russia to replace proprietary software, developed by companies like Microsoft and Adobe, with free open-source alternatives by 2015.

"The move will save billions of licensing fees, but Mr. Putin's motives are not strictly economic. In all likelihood, his real fear is that Russia's growing dependence on proprietary software, especially programs sold by foreign vendors, has immense implications for the country's national security. Free open-source software, by its nature, is unlikely to feature secret back doors that lead directly to Langley, VA.

"Nor is Russia alone in its distrust of commercial software from abroad. Just two weeks after Mr. Putin's executive order, Iran's minister of information technology, citing security concerns, announced plans for a national open-source operating system, China has also expressed a growing interest. When state-owned China Mobile recently joined the Linux Foundation, the non-profit entity behind the most famous open-source project, one of the company's executives announced – ominously to the ears of some – that the company 'was looking forward to contributing to Linus on a global scale.'

"Information technology has been rightly celebrated for flattening traditional boundaries and borders, but there can be no doubt that its future will be shaped decisively shaped by geopolitics. Over the past few years, policymakers around the world have had constant reminders of their growing dependence on – and vulnerability to – the new technology: the uncovering of the mysterious China-based GhostNet network, which spied on diplomatic missions around the globe; the purported crippling of Iran's nuclear capability by the Stuxnet virus; and, of course, the whole WikiLeaks affair. Governments are taking a closer look at who is providing their hardware, software and services – and they are increasingly deciding that it is dangerous not to develop independent national capabilities of their own.

"Open-source software can allay some of these security concerns. Though such systems are more democratic than closed ones, they are also easier to manipulate, especially for governments with vast resources at their command. But open-sources solutions can't deal with every perceived threat. As Google learned, the Chinese government continues to see Western search engines as a challenge to its carefully managed presentation of controversial subjects. Similarly, email can be read by the host government of the company offering the service, and the transmission of sensitive data can be intercepted via secret back doors and sent to WikiLeaks or its numerous local equivalents."

Internet Services as a Strategic Industry

"For these reasons, more governments are likely to start designing internet services as a strategic industry, with foreign firms precluded from competing in politically strategic niches. The Turkish government has emerged as the leading proponent of such 'information independence,' floating the idea of both a national search engine and a national email system. China and Iran have debated similar proposals.

"Judging by last year's standoff between the Blackberry maker Research in Motion and the governments of India, Saudi Arabia and the United Arab Emirates, questions of access also will play a growing role in shaping technology. If a government suspects that the US National Security Agency has arranged to be able to retrieve private emails sent with BlackBerrys secure encryption technology, it starts to wonder why it doesn't have similar streams of intelligence data from services like Gmail and Skype. At a minimum, more governments will demand that data servers base their operations in their own jurisdictions, inconveniencing global internet companies that have based their business plans on the assumption that they could run their Indian operations from Iowa.

"The real Internet trade wars will begin once Russian and Chinese technology giants, with their poorly veiled government connections and piles of cash, come looking for American and European acquisitions. How will officials in Washington and European react when China's Tencent 25 (with a market capitalization of $42 billion, almost twice that of Yahoo) makes a bid for AOL or Skype?

"Painful decisions will need to be made soon. The Russian company Digital Sky Technologies, owned by a Kremlin-friendly oligarch, has a nearly 10% stake in Facebook and 5% stakes in such hot Web properties as Zynga and Groupon. What will happen once Russian or Chinese firms seek to purchase a stake in companies like Google (a contractor to the National Geospatial Intelligence Agency) or Amazon (which caters to nearly 20 US government agencies through its Web hosting services? The unpleasant effects of this rising nationalism are already evident in the case of hardware exports. When Sprint Nextel began considering bids from China's Huawei and ZTE Technologies in 2010 for a projected $5 billion upgrade of its network, a group of American senators wrote to the company's chief executive expressing their concern that Huawei might be subject to 'significant influence by the Chinese military' and that communications in the US could be 'disrupted, interrupted, tampered with, or purposely misrouted.' Sprint Nestel turned down the bids. The European Union recently announced plans to create an authority similar to the US Committee on Foreign Investment to specifically vet approaches from China's technology giants.

"Even if they are spurned by the US and

Europe, China's tech giants are likely to resurface elsewhere. For several years China has been using its huge cash reserves to hand out loans – mostly to governments in Africa, but also to neighbors like Cambodia – with the condition that those governments only do business with China's telecom companies. With or without secret access to that data, the fact that China controls so much of the communications infrastructure in the developing world gives it political leverage.

"At the same time, Yota, a partly state-owned Russian telecom provider, has been trying to build a base in Latin America, launching its 4G service in Nicaragua and soon, in Peru. Other Russian companies are busy building (or buying up) the telecom infrastructure in the former Soviet republics, perhaps in a bid to do for the internet what Russia's gas giant Gazprom has done for energy: build up physical infrastructure and then use it as a tool of political leverage.

"What does all this mean for the future of America's technological industry? If China's expansion into Africa and Russia's into Latin America and the former Soviet Union are any indication, Silicon Valley's ability to expand globally will be severely limited, if only because Beijing and Moscow have no qualms about blending politics and business. The global triumph of American technology has been predicated on the implicit separation. between the business interests of Silicon Valley and the political interests of Washington.

"In the past, foreign governments have rushed to install the latest version of Microsoft Office or Google's Chrome browser

How the Weakness of Once Powerful Newspapers is being Ruthlessly Exploited

Elsewhere we have reported how the doom of humanity is being prepared by yoking seemingly thriving industries to pushing fictitious profits ever higher – even at the cost of bringing on the very doom of humanity's survival by such "cooked books" – the expression was used by an auditor-general of the Canadian federal government with a Finance Minister of his day, who was preoccupied by earning his future position as head of the federal government by such services to those who hold effective power these days.

For the great of print newspapers these past years there have been few real profits to be siphoned off, but ever growing losses to cover up. That has been achieved at an inestimable cost to society's survival by simply wiping out the great and ever more critical prepaid investment in human capital, that is simply treated as debt. When that is done we in fact have nothing that could be mistaken for serious accountancy in the dark.

The key importance of human capital was established as the most important lesson to have come out of World War II. On the surrender of Japan and Germany, Washington sent many hundreds of economists to those once great trading countries to study the extent of the wartime damage, and from it to predict how long it would take those defeated countries to become formidable traders again. Some sixteen years later, one of those, Theodore Schultz of the University of Chicago published an essay in which he explained how wide of the mark the forecasts of his colleagues – including his own – had been. This he attributed to the detail that they had concentrated on the physical destruction, but had attributed little importance to the detail that the highly gifted work-force had come out of the conflict virtually intact. And then in a sheer stroke of genius, he concluded that investment in human capital is the most productive investment a government can make. For a few years Schultz was celebrated, awarded a Nobel Peace Prize, and then completely forgotten.

However, Japan as well later, reunited Germany, provided adequate evidence of Schultz's great perception. Not only were the Japanese able to recover, but they were able to use the occasion to change the very nature of their economy. Before that war, their exports had been based largely on textiles, for which they were obliged to import the raw materials, leaving a minimal balance of their international trade within the country. Step by step, they shifted their rebuilt economy to heavy engineering, where the net profit remaining in their land would be far greater. Step by step, the Japanese made the change managing to reduce the damage created by two atomic bombs to the relative proportions of the Chicago lady's cow that kicked over the lamp that set the fire that cleared Chicago for its modern development. And indeed, most of the modern metropoles in the United States – and even in Europe, have come in the wake of great fires.

I had in my own researches reached quite independently a similar conclusion. Early, after the peace of WWII, I noted that an increasing amount of capital creation is taking place not on the market, but by direct government investment, and this I tagged as the "social lien" since it consists of a direct investment of government capital that does not take place on the market but by direct government investment. This I sent to leading journals on economic theory throughout the world. Almost by return mail it was purchased and published by the leading French publication on economic theory – *Revue économique*. It was reviewed not once but twice, most approvingly by the journal of Cambridge University in Britain, and I was invited to come over to explain my theory. Once I arrived in France I learned why. On the board of the *Revue* there sat not only The leading French sociologist of the day, but two statisticians who had tried relating the rise in the price level with the change in the supply-demand relationship with no success. Naturally they jumped on my explanation of the phenomenon. This led to invitations to explain my thesis in about eight universities in Europe and Japan, and led to an invitation by John Hotson of the University of Waterloo and the founding of COMER, that held its meetings for some years at the University of Waterloo. After a few years, however, all that was abruptly changed, and Hotson was given early retirement that led to his early death.

But most remarkable the entire subject has simply be erased from official memory. Today, *The New York Times*, excellent paper though it is, doesn't dare mention the "social lien" factor, but tags along with governments in these socially suicidal fictions, What had been recognized as prepaid social investments – the "most productive a government can make," suddenly disappears leaving only an unfilled statistical hole. Obviously that leaves society without any serious accountancy. We are flying blind with no serious accountancy. At the end of that sequence the prospect is for final desperate atomic war, for the atomic arms industry is being well-funded.

W. Krehm

because it was hard to imagine that Washington would tinker with technology to advance its strategic interests.

"But just a few weeks before Mr. Putin publicly endorsed open-source software, FBI Director Robert Mueller toured Silicon Valley's leading companies to ask their CEOs to build back doors into their software, making it easier for American law enforcement and intelligence gathering agencies to eavesdrop on online conversations. The possibility of such arrangements to force foreign governments to reconsider their dependence on American technology. Whatever the outcome of Washington's engagement with the Internet, Silicon Valley will be the one to bear the costs.

"For ordinary users, there is one silver lining. The embrace of open-source technology by governments may result in more intuitive software applications, written by a more diverse set of developers. The possible downside is that the era of globally oriented services like Skype may soon come to an end, as they are replaced by almost certainly less use-friendly domestic alternatives that would provide secret back-door access. As governments seek to assert control, companies will be providing fewer and fewer guarantees about both data security and access by third parties – such as governments.

"The irony in these developments is hard to miss. Information technology has been one of the leading drivers of globalization, and may now be in the process may become one of its major victims."

The globalized control of how the world reckons its balance sheet had come to be controlled largely by US influence when it ruled out the recognition of human capital investment which is not marketed and had been identified as the prepaid investment as the best investment a government can make. And that was eliminated by the determination of the US speculative banks and the government that they came to control, and imposed on the world as a whole. Now that same government is seen as imposing a powerful back-door official Washington propaganda, function that if accepted would prevent incipient countries to be fed Washington's interest rather than valid analysis of where the world economy might be headed. By its own doing, Washington is undermining its control of economic thinking in the rest of the world. That would give the Good Lord above the clouds to regain a say as to where the real interests of the rest of the world may lie.

W.K.

New Fare for Thrillers

From Economic Reform*, June 1994*

The collapse of the Evil Empire has deprived mystery writers of plausible settings for secretive characters prone to abrupt disappearance. But the industry can take heart: the derivative trading departments of some of our most venerable institutions are filling the gap.

In Chile, a 32-year-old whiz-kid in charge of derivative trading suddenly wasn't there, but he left behind undeclared losses for his employer – a nationally-owned mining trust. These amounted to 0.5% of the GNP. We have become accustomed to gauging our government debts as a proportion of the GNP, but doing so for speculative losses ushers in a new epoch.

In New York Joseph Jett, in charge of government-bond trading at Kidder, Peabody Group Inc., a General Electric Co. subsidiary, was suddenly fired when it turned out that he collected several million dollars in bonuses on his non-existing trading profits.

"Derivatives are side bets on things ranging from interest rates to currency values, caps, collars and floors, swaptions and captions, forward rate agreements and futures, straddles, strangles, butterflies and spreads."

In boardrooms an executive admitting that he did not understand the risks behind these seductive names would not only lose face, but possibly his bonus. As a result, the discussion at such gatherings has come to resemble cocktail chatter in a Woody Allen film.

On Mathematical Illiteracy

We hear a great deal about the deterioration of mathematical education in our schools. To that is attributed much of the malaise of the North American economy.

But that is not our most threatening brush with that unforgiving subject. Even more costly has been the mathematical illiteracy of the central banking community. Where our elementary schools are striking out is teaching students to handle specific numbers. That – without condescension – might be termed "grocery arithmetic."

Our central bankers, however, turn their backs on a more fundamental type of mathematics – one that mathematicians refer to as "abstract structure."

That in no ways deals with specific numbers. Instead it is concerned with relationships and, more basically, the symmetry and asymmetry of those relationships. Matrix theory, for example, x-rays the structure of the equations have to be satisfied simultaneously. Group theory enables mathematicians to detect common patterns of symmetry in operations in quite different fields and solve seemingly unrelated problems at a single crack.

Computers per se cannot replace the need for this sort of thinking – they themselves require the guidance of structural analysis. That is what software is about.

Our central bankers don't do much worrying about the software of economics. They have been staking the survival of our civilization on stabilizing prices through higher interest rates Let us compare a simplified version of symmetry analysis to check the odds in this gamble.

An open mind would have warned us that high interest rates taken to stabilize prices was bound to produce the wrong results. Our higher prices do not always indicate a market overheated with buyers confronted with empty store shelves, bidding up prices. On the contrary we take great pride in the fact that unlike the case in Russia our stores are well-stocked – so well in fact that many shopkeepers have been going broke. These days higher prices are more likely to result from higher taxes to pay the usurious rates on the soaring debt.

Another case of misplaced assumption of symmetry: it cannot be taken for granted that equations can be read backward as well as forward without further ado.

If a pistol is fired against a man's head, he will drop dead. But if a man falls dead, it is by no means proven that he has suicided. It could have been heart failure.

Yet that sort of nonsense is fed into econometric forecasts by the equilibrium model that identifies any price increase with an excess of market demand. When you start with software so wide of the mark, you can feed the most accurate statistics into your computer, and it will come up with the wrong forecasts. But at that point, instead of reexamining the model for basic flaws of structure, right-thinking economists simply proclaim the misfired prophecy an enigma.

"Trade-offs" implying reversible one-to-one relationships have become a staple of economic discourse. From the undeniable fact that, other things being equal, an increase of demand over supply will tend to push up prices, economists leap to the conclusion that every time prices go up, it is because of an excess of market demand.

Prices, however, can move up for any of many other reasons. For example, the very increase of interest-rates. In 1983 47% of sewage disposal costs in the Germany city of Aachen could be traced to interest payments, and for the Federal Republic as a whole (1979) 77% of public housing costs went to interest payments and for the Federal Republic as a whole (1979) 77% of public housing costs went to interest payments, Yet the German central bank, in its monetarist fervour, pushed its interest rates up to more than double the US figure to "fight inflation."

That still does not tell the whole story. To make sure that they will have their loans repaid, banks and other lenders usually ask for security. When the central bank squeezes up interest rates, the value of such security drops. The borrower is therefore to put up more collateral or his loan will be called in.

Nobody in business is unaware of these grim facts. Only our central banks shut their eyes to them. It is high time that we started a campaign again the mathematical illiteracy of our central bankers.

[Why the Greeks Themselves have Forgotten What Socrates and Plato Taught Them, as the World Takes a Short-cut to Atomic War

If you leave the choice of the necessary political tools, even if you dub them "social principles" to those with economic and political power, the resulting lack of serious accounting leads to deeper trouble. With the current world economy ever more dependent on international financial markets rather than on any abstract principles, no matter how unclear that may be to those who depend on their political or ideological connections to look after such daunting matters.

But with financial power increasingly dependent not only on world markets, but on the world distribution of market power, no strictly political or economic organization can withstand bending and breaking like a reed. All this threatens to lead to the desperate final gamble, atomic warfare. And that is not lacking funding, thank you!]

William Krehm

Hixson's Corner — The Mobile and the Immobile of the World

Transnational corporations champion free trade because they want to be at liberty to make those product components most likely to result in the nation with the fewer environmental protection laws; to make the components that are most labour intensive where there are the fewest occupational health and safety rules and labour is cheapest; make the sub-assemblies in another place and the final assemblies in yet another, and then juggle the accounting so that profits are shown to occur under the sovereignty where profits are least taxes.

This assures the next best thing to the business ideal of total escape from any sovereignty whatever.

Transnational corporations are thus able to arrange things to their benefit because of what economists call the "mobility of capital." That is to say, corporations can shift their money, investments, or production from to country with little impediment.

Unfortunately, for people who must make their living by working, there is no similar 'mobility of labour' and hence workers enjoy no comparable opportunity to take advantage of differences between national sovereignties. Wouldn't it be wonderful for workers if they could at one and the very same time, live in another country with the best environmental protection laws, live in another country with the best occupational health and safety laws, another country with the best health care and old-age pension system, and another country where there were no payroll taxes, sales taxes, or income taxes on workers? Of course, such "mobility of labour" is *physically impossible.*

Since it is impossible to provide a mobility of labour comparable to the existing mobility of capital, fairness demands that the mobility of capital of multinational corporations be severely restricted.

The mobility of capital works in two very different ways. In the first case, it involves the abandonment of a factory in Country A where unions are strong. Wages high, and fringe benefits large, and the erection of a factory in country B where there are no unions, wages are low, and fringes nonexistent – this followed by the shipping of the factory's products to country A.

This may be referred to as "flight of production capital" and results in a more or less direct confrontation between the agenda of labour and that of capital. The long-standing method of rendering in some measure ineffective the mobility of capital of this type is raising tariff barriers against products made in Country B. That is to say, the traditional method has involved the government of Country A placing limitations on free trade between itself and other countries.

The second class of mobility of capital involves the "flight of money capital." The confrontation in this case is less one between capital and labour than between capital and a government. Imagine that an administration enacts legislation protecting labour or the environment – legislation which capital for one reason or another finds repellent. Owing to the mobility of capital, holders of money are free to move it out of the country. Flight of capital in this case may result not in the erection of factories in foreign countries but in the purchase of "money market instruments" elsewhere in the world. The flight of money capital from a country depresses the international value of its currency and makes difficult or impossible the financing or refinancing of the country's debts. It is designed to so embarrass and to so pressure the government as to bring about the repeal of the legislation protecting labour or the environment not wanted by capital.

In earlier centuries labour and capital usually confronted each other directly in a given locality and the principal means of confrontation were essentially economic – the strike and the lock-out respectively. But strikes against factories that have been shut down and replaced by factories abroad are meaningless. Labour's traditional weapon has been rendered useless where the flight of production capital is involved. It is even more useless in cases of the flight of money capital. Confrontations between labour and capital now are essentially on the political rather the economic plane.

The purpose of FTA and NAFTA was to validate the effectiveness of the flight of production capital by making possible the unimpeded flow of goods from countries that do not protect labour and the environment to countries that do. The multinational corporations have won this round temporarily at least. But given that FTA and NAFTA could be reversed and a principal reason for the flight of production capital removed.

There would still be no impediments to the flight of money capital. This potent weapon of capital against governments that behave contrary to the wishes of the holders of money capital would remain unobstructed.

I believe the best way to think about these matters is that a national government, a national sovereignty has become very nearly the only instrumentality by which the attempts of the owners of capital to destroy "safety nets" and to pollute the environment can be confronted. There is practically no prospect of "international legislation" and certainly no international government that could enforce it.

William F. Hixson

Twin Comebacks

The signs are unmistakable. The rapacious right has overplayed its hand. Appetites for instantaneous megaprofits were presented as economic efficiency, and how could we have too much of a good thing? But the eighties have left a deepening chasm between the rich and the poor, and a hopelessly disjointed economy.

A year ago *The Economist* was accepting the monetarist dogma as gospel. But like Poland and Hungary electoral victories have gone to parties questioning the idolatry of the market imposed by the West. With little capital or private savings to acquire the privatized state industries, that evangel has left the ex-Communist lands awash in crime and scandals. The West itself is distraught with collapsing bond markets and a listing financial sector that it cannot begin to understand.

Reviewing some of these trends *The Economist* (11/6) devotes much of its issue to – of all things – "A Future for Socialism." "Socialism must continue to define itself less in terms of means (we will manage the economy and civilize the market) and more in terms of priorities (we will help society's losers)."

But for at least a decade society itself has been a loser, mugged by speculation gone berserk.

Statistics Canada has announced another comeback: the May Consumer Price Index – 0.2% *less* than a year ago – has brought back has brought back deflation for the first time in forty years. For many months now we had been warning that the country was already deep in deflation. Only the hopelessly flawed price statistics and government accountancy could obscure the point. Unrecognized public capital – whether bridges. Education, mental health or the environment – has been consumed and not replaced.

Last February the US Fed instituted the first of four increases in the "Fed rate" to "pre-empt" money lenders' fears of a resurgence of inflation. And where the Fed had hoisted its rates by a single percentage point between February and May, the BoC responded with increases almost twice as great. It was like a crack addict losing both self-control and his moral sense. The bigger the dosage, the more powerful the addiction and the need for a larger fix. And the less his concern about whom he victimizes to get it.

Futures

It was only last March that the Fed Governor Alan Greenspan told a congressional committee that money supply figures could no long taken as a reliable gauge of inflationary pressures, and that it was necessary for the Fed to take its cues from other statistics, including gold and commodity prices.

The present is a progress report on the results of this new dispensation.

The deregulation of our financial institutions begun a quarter of a century ago was supposed to assure the public "one-stop" shopping for all financial services. The reality? The banks have turned their backs on loans to business. Before finding financing these days, long-standing clients of banks with impeccable credit records can easily wear out a pair of shoes.

In chartering a bank the state delegates to it a franchise to create money – i.e., to lend out more than its own capital plus borrowings. "Every dollar of the depositors' money is not in storage on the premises. The art of banking is always to balance the risk of a run with the reward of a profit. The tantalizing factor is in the equation is that riskier borrowers pay higher rates" (James Grant, *Money of the Mind*).

Step by step, as the restraints on their activities have been peeled away, the banks have plunged into riskier investments. And whenever they have gotten into difficulties, the state has waded in to save them not only with money, but with further deregulation proposed by the bankers themselves. The idea was to recoup their previous losses, but the effect was to get them into deeper grief – the classical syndrome of inveterate gamblers. There are times when it seems that banks are in to everything except their proper business.

The theoretical underpinning of monetarism is the belief that if you control the money supply you can keep prices flat. But by now few people – not even Chairman Greenspan of the Fed – believe that it is possible to quantify or even define what the money supply might be.

Scarcely had Greenspan declared commodities a key to stabilizing the economy than they joined the bond and currency markets as one of the biggest crap games in town.

"'Since Alan Greenspan's testimony, there has been a huge and building interest in commodities,' said William Byers, director of futures re search for Bear Stearns & Co. 'Thus when grain markets are especially weather-sensitive, as they are now, bonds become directly sensitive to weather as well'" (*WSJ,* 30/5).

"For all of 1993, investment in futures jumped 56% to more than $50 billion, and much of that increase came from pension funds. The influx can be read in two ways. First, smart investors are hedging their bets against a resurgence of inflation. The second lesson, pension funds' growing appetite for futures may have been pushing the commodities markets to unnaturally high levels.

"In recent months hedge funds and commodity funds have been pouring money into grains, copper, cocoa and other commodity pits as never before. And that's raising concerns that, at least on a short-term basis, the commodity future markets no longer reflect the realities of supply and demand. Soybean future prices, for instance, rose the permissible daily limit May 23 on concerns about dry weather in the Midwest – and then plunged the next two days when rain fell throughout the Corn Belt. Silver, coffee, cocoa futures, though unaffected in a fundamental way by rain or the lack of it, followed grain prices up and down" (*WSJ,* 31/5). The article quotes a farmer: "The presence of funds can make the markets a dangerous place for farmers using futures contracts to hedge their business risks."

To cap it all, the *WSJ* (26/5) reported: growth in the mutual fund industry has been driven by distribution far more than by investment performance. Unless a fund company has a large distribution mechanism, it should merge with a bigger company before it is too late. The only way for a fund company to maintain market share these days is to spend more money on advertising and customer service, and to pay more money to brokers and others who will sell mutual funds.

And should you think we're kidding when we emphasize that the casino economy is elbowing the real economy off the map, there is the report in the *WSJ* (19/5) that the Kansas City Southern is trying to sell its flagship railroad unit to leave the company to focus on mutual-fund asset management.

Before long we will be left with an economy that is all flea and no dog.

W.K.

The Universe, Dark Energy and Us

By Robert P. Kirshner, The New York Times, October 6, 2011

Almost every scientific talk or seminar in astronomy today starts from the idea that we live in a universe in which a mysterious force known as dark energy makes up about 70 percent of the total cosmic amount of everything. A mysterious substance known as dark matter makes up about 25 percent. And ordinary matter – the stuff of the periodic table, including interesting assemblies of matter like galaxies, stars, planets and people – is a paltry 5 percent.

If this is right, the things we observe in the universe are not the important things. Think of it this way: when you look at a snow-covered mountain, what you see is the snow, but the snow is not the mountain. In the cosmic setting, the fate of the universe depends on a tug of war between dark matter, which is trying to slow down the expansion of the universe, and dark energy, which is trying to speed things up. We see the motion of galaxies as the space between them stretches out and the light from exploding stars to judge their distances, but they are just tracers of the underlying reality.

Some people are upset by the idea that we are made up of material – atoms – that is a minor part of the cosmic scheme. Personally, it makes me feel special.

This week, the Nobel Prize in Physics was awarded for the discovery, by two separate teams of astronomers, that the expansion of the universe is speeding up as a result of the force of dark energy. Saul Perlmutter of the Supernova Cosmology Project shared the prize with Brian P. Schmidt and Adam G. Riess of the High-Z Supernova team. Mr. Schmidt and Mr. Riess were graduate students of mine at Harvard, and I participated in this scientific adventure.

Both teams found, while they were taking measurements of distant exploding stars in 1997, that the expansion of the universe seemed to be speeding up, but at first neither team believed it. The energy needed to drive this acceleration seemed too crazy. It smelled of the notorious "cosmological constant," a kind of energy associated with empty space, which Einstein proposed in 1917 to guarantee a static universe and then later banished from polite company when the universe was observed to be not static, but expanding. "Away with the cosmological constant," Einstein said. As my mother said to me (more than once), "Do you think you are smarter than Einstein?"

Yet just a decade after the first inklings, this is the standard picture, secure enough for cautious Swedish academicians to select for this year's prize.

How did this happen? Not by persuasive argument, but by evidence. If the expansion of the universe is the result of a battle between dark energy speeding things up and dark matter slowing things down, then the history of cosmic expansion will have a record of which entity was winning at various points. Because light takes time to get to us, we can see into the past by observing distant objects. In the recent past (say, the last five billion years) we see acceleration. But if we could look far enough into the past, then the balance should tip – the dark matter should be denser when the universe was a smaller place, while the dark energy, if it resembles the cosmological constant, should hold steady. This would make the universe slow down. Mr. Riess led a group that carried out these observations with the Hubble Space Telescope. In 2004 and in 2007, his team showed that the change from deceleration to acceleration really happened: the predictions for a dark energy/dark matter universe match the observations.

Where do we go from here? We know we live in an accelerating universe that is about 13.7 billion years old, but we do not understand the nature of dark energy. What we really need is a better theoretical idea, but while we are waiting for inspiration, a prudent path is to devise more stringent tests to pin it down. After all, the "it" is 70 percent of the universe, discovered only a decade ago.

To help tackle the matter over the next decade, the scientific community has selected the James Webb Space Telescope, big telescopes on the ground like the Giant Magellan Telescope, the Large Synoptic Survey Telescope and a dedicated satellite – like the Wide-Field Infrared Survey Telescope or the Euclid telescope – to make dark energy measurements.

The case for investment in science often rests on the connection between technology and economic development, or national defense, or relief from suffering and disease. These are good arguments. Everybody wants to be rich and safe and immortal. But even in stringent times, it seems like a good idea to do some science to find out what the world is made of and how it works.

Robert P. Kirshner, a professor of astronomy at Harvard, is the author of The Extravagant Universe: Exploding Stars, Dark Energy and the Accelerating Cosmos.

❧ ❧ ❧

Editor: It tells us the extent of the trouble our world is in, that when our scientists have identified a mysterious "dark energy" that is by far the major force shaping the universe, that our governments should be disregarding what they must have learned in their first-year high-school – that you cannot turn around a simple proposition and consider it still valid. If I shoot myself in the head, I fall dead.

If I fall dead, it could have been not suicide, but due to countless other causes – heart failure, or murder. Run the world on the basis of such illiteracies, and you ignore the immense importance of human capital, that was officially recognized as the most important lesson learned from the Second World War, and you are guaranteeing major disasters ahead.

W.K.