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CONTENTS

3 How Wall St. Helped Ignite the Subprime Mortgage Binge
5 Some Fruits of Bank Deregulation in the US
6 A Statistic that has Grown Like Topsy
7 Edmonton Talk, March, 2007
11 The Greatest Central Bank Goof Ever
12 Could Social-minded Budgeting Prove Greatest of All Medical Advances?
13 Fed Changes Broken Record — Our Great Forgotten Economists
15 Satanomics
15 Our Mail Box
16 Maps Leading Where We Don't Want to Go
17 Language of Deceit on the Tongues of the Mighty
18 Is Man Both Chasing and Driven by His Technological Tail?
19 How NAIRU Became NEIRU When BIS Fell Asleep at the Switch

Governor Dodge Must Not be Allowed to Make Canada Look Ridiculous

Bank of Canada Governor David Dodge should not be allowed to go around making our central bank, himself and his country look ridiculous in his rant on Latin American affairs. On these he is even worse informed than on the Canadian economy. His motive may be to ingratiate himself with President Bush. Yet even that slow-learning President has learned to tread lightly when his defeats in the Near East have so obviously been taken by Latin Americans for a chance to speak their minds about the abuses they have for decades suffered at Washington's hands. It is incredible timing for Mr. Dodge to show servility to US policy at home and abroad.

As recorded by Heather Scoffield (*The Globe and Mail*, 30/03, "Dodge chides Latin America for policy missteps"), Mr. Dodge declared, "'Mismanaged monetary and fiscal policy across Latin America have hurt the poor, but the International Fund is in no position to help,' Bank of Canada Governor David Dodge said yesterday in a hard-hitting speech that also criticized China.

"His most disparaging remarks were aimed at Argentina. It failed to live up to its potential, and bad policy choices are largely to blame, Mr. Dodge told the Council of the Americas in New York. 'Argentine's policy path is pushing that country back into a high-inflation environment,' he warned."

We like that "back" which can only allude to the disastrous Argentine policy of a few years ago when it parted with its economic sovereignty by agreeing not to issue Argentine currency unless it were backed by the corresponding amount of US currency in the Argentine central bank. That meant that the Argentine government had surrendered the advantages of issuing its

Continued on page 2

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Rediculous *continued from page 1*

own currency – thus not only the freedom to raise or lower its value as befitted its own interests, but the near-free use of money created by its own central bank at a near-zero cost. As for the role of the International Monetary Fund, almost from its origin at Bretton Woods in 1944 it has been a puppet of American policy.

One of its conditions for providing loans to underdeveloped countries has been that their central banks abandon the statutory reserve system that provided the government with the tool of fractional money creation – i.e., the power to issue a multiple of the amount of reserves redeposited with their central bank of the money received by the commercial banks from the public. Not only did the government have the free use of that money for capital investments – but raising or lowering that multiple gave the central bank an alternative to changing the benchmark interest rate. The IMF policy has been to oblige each underdeveloped country to arrange a loan to do away with the statutory reserves. Using such reserves had been an alternative to using interest rates to "fight inflation."

In Mr. Dodge's mouth "inflation" is synonymous with higher price levels, although it should be clear that Third World countries in the process of rapid urbanization, making their population literate, building infrastructures require massive new public investment. They are thus acutely vulnerable to high interest rates. But then Mr. Dodge reflects the interests of finance capital at its most aggressive. He did make mention of "Mexico, Chile and to some extent Brazil" as "having made some progress in controlling inflation, but the rest of the continent needs substantial" work. "'And since the IMF is viewed with suspicion in Latin America, it is not the best organization for the job of fostering a more stable fiscal and monetary environment,' Mr. Dodge said."

What would seem at fault then in Mr. Dodge's mind are mere suspicions rather than the usury and murderous military coups supported by Washington over most of the post-Second World War period. In the case of Mexico, a variant of imposing US currency as was actively carried out in the Argentine, Panama and Ecuador, gave the purchasers of a special bond issue of *tesobonos* the option of having the principal returned in US dollars. That and the freedom of currency to cross frontiers at will, imposed by the North American Free Trade Agreement, caused the Mexican peso to lose 40% of its value, its banks to shut their doors, and to be renationalized and eventually 85% of them to be taken over again by foreign institutions. Mexico has still not recovered its modest living standards from that experience. It is at the origin of the surge of illegal immigration of farm labourers against which the US is engaged in building that friendly good neighborly fence.

Latin Americans may Uncover Canada's Constitutional Shame

It could well happen that if Mr. Dodge continues going about making such ignorant commentary about Latin American governments, that they will inform themselves to Mr. Dodge's and indeed all Canadians' embarrassment about certain aspects of the very institution that Mr. Dodge heads that have to be unique in all lands. That is the detail that in the *Bank of Canada Act*, particularly in subsection 14(2) that gives the Minister of Finance, in the event of disagreement between the Governor of the Bank of Canada on a policy of basic monetary policy may deliver in writing a statement of the policy to follow and the "Governor shall conform within thirty days."

Nonetheless, despite this and the fact that since 1938 when the Government of Canada bought out some 12,000 private shareholders at a good profit, the government of the country has been the sole shareholder of the Bank. That means that all the dividends payable by the Bank go to the federal government, and it thus enjoys virtual interest-free borrowing powers. Section 18(f) sets forth that the BoC may hold unfunded debt of the federal debt up to one third of its annual budget, and of provincial unfunded debt up to a quarter, and [debt of municipalities and other] corporations with the guarantee either of the federal or of any province. On funded debt there is no limit – the Act merely empowers the Bank to buy and sell government securities, which includes the ability to hold.

Despite such clear provisions, the Bank of Canada has replied to countless inquiries of municipalities, that the central bank is not able to finance essential capital projects like waterworks, schools, bridges and hospitals. Obviously that is taking liberties with the laws on the books in a way that might be worthy of one of the worst run Latin American republics, but hardly of a developed country like Canada. If Governor Dodge goes around making irresponsible remarks showing his lack of information about Latin

America, we run the risk of some enquiring Latin journalist or political leader learning about the discrepancy between the *Bank of Canada Act* still intact on our law books, and the pretences of the Bank of Canada to the claimed "independence" from the government itself that it is simply not there.

Should the inquisitive Latinos persist in their investigations this is what they would come up with. In 1982 when Canada was drawing up her constitution the government of Canada wanted to insert to clauses in that document: (1) that "zero inflation" be raised to a constitutional principle; (2) the Bank of Canada is independent of the Government of Canada. It should be noted that the 12,000 private shareholders of the Bank of Canada had been paid with a good profit – during a depression for their shares that they had held for just three years.

The ownership of the Bank of Canada is thus not subject to politicians' whims, but is a sacred right of property. As a result the very House of Commons caucus of the Progressive Conservative Party headed by Brian Mulroney turned down the proposed constitutional provisions. And since then no government has dared tamper with the *Bank of Canada Act*. That is why Latin American political leaders and central bankers, offended by Mr. Dodge's irresponsible remarks concerning their central bank policy might look into our central bank's violation of its basic law. If they did they would laugh at this fine democracy as just another banana republic sans the alluring fruit,

While there is still time, we must restrain and educate Governor Dodge. He is clearly lured by a desire to please Washington. But has it escaped him that Washington itself is starting to show a touch of grace in stepping down from its role as lone superpower? It is a bad case of missing the cue for our central Bank to continue its servility to the Fed under such circumstances.

William Krehm

Postscript

After the recent death of Milton Friedman, The Globe and Mail (17/11) carried a remarkable piece by Heather Scoffield quoting the previous Governor of the Bank of Canada, John Crow: "'The Bank gave it a college try, it really did,' Mr. Crow said yesterday. 'It just doesn't work that way. In a nutshell, Mr. Friedman thought the country's banks should manipulate the country's money supply to push down inflation and foster a stable economic environment for business.'"

How Wall St. Helped Ignite the Subprime Mortgage Binge

The Wall Street Journal (12/03, "At a Mortgage Lender, Rapid Rise, Faster Fall" by James R. Hagerty, Ruth Simon, Michael Corkery and Gregory Zuckerman) sums it up: "A look at New Century's swift rise and fall illuminates how Wall Street investment banks such as Morgan Stanley and hedge funds awash in cash helped fuel a binge in subprime lending that prolonged the housing boom. The lenders made themselves vulnerable by gunning for growth as the boom faded and relying heavily on outside mortgage brokers. The Wall Street banks readily gobbled up the loans, turning them into securities that global investors were avid to put in their portfolios.

"They fitted perfectly in the swaths of higher risk with correspondingly high nominal returns that the banks could quickly unload onto hedge funds and others intending to pass on to unsuspecting investors. Nobody at any point of the career of these mortgages assessed the risk of the borrower or had the slightest intention of monitoring the payments if they actually came in.

"With a work-hard, party-hard culture, New Century took its employees on a boozy cruise to the Bahamas and threw one bash in a train station in Barcelona, Spain, former employees say. Within a few years the company became one of the nation's top subprime lenders, jostling with older rivals like HSBC Holdings PLC and Countrywide Financial Corp.

"Last week New Century announced that it had stopped making loans because too many creditors had cut off funding. It is facing a federal criminal investigation of its accounting and trading in its stock before a negative announcement in February. The mortgage industry is undergoing one of the periodic purges of dubious practices and weak lenders. In the late 1980s, savings and loan institutions moved into risky lending, sometimes to recover losses after interest rates turned against them. Courts found that some executives looted dying S&Ls. A 1989 government bailout cost hundreds of billion dollars.

"The collapse of many S&Ls, once the dominant force in home mortgages, opened the way for specialist mortgage banking firms and commercial banks to take more of the business. Today Countrywide and Wells Fargo & Co. have a combined share of 30% of all home mortgages loans originated each year, but the rest of the market is splintered among more than 8,000 lenders. Regulation is a patchwork. Five federal agencies overlook the mortgage enders affiliated with banks, thrifts or credit unions, while New Century and others that don't take deposits are regulated by state agencies."

The Collapse of a Savings & Loan Creates Space for a New Breed of Mortgage Magician

"While companies like New Century are free to lend through branch offices, their main way of reaching customers has been via independent mortgage brokerage firms, generally tiny local outfits. Mortgage brokers find customers, advise them on which types of loans are suitable and collect fees for handling the initial processing. There are more than 50,000 mortgage brokerage firms, and they are involved in 60% of all home loans, up from 40% a decade ago, says Tom LaMalfa, managing director of Wholesale Access, a mortgage research firm in Columbia, MD. John Waite, a mortgage broker in Appleton, Wis., says he liked working with New Century because it was very easy. Until recently, he says, New Century rarely demanded reviews of the appraisals upon which loans are based.

"But by outsourcing much of its contacts with the consumers, New Century and other lenders lost some control over its screening of borrowers and the presenting of loan choices. Some industry leaders and consultants say this partly explains the surge of mortgage fraud. In a typical fraud lenders are duped into making loans based on inflated home appraisals or income data. Some schemes involve rings that take the money and run without ever making a loan payment. Normally people who borrow in good faith manage to make the first few payments.

"Lenders loosened standards considerably in the first half of this decade. Home prices were climbing so fast that borrowers who couldn't keep up the payments could almost always sell their homes at a profit or refinance into a loan with easier terms. That emboldened lenders to offer loans with little or no down payment. Sometimes they let borrowers skip burdensome paperwork such

as digging out tax forms to prove how much money they made.

"Subprime lenders took cues from Wall Street. Investment banks and hedge funds were ravenous for the riskiest types of loans, whose higher yields made them vital ingredients in investment parcels offered to investors globally. New subprime loans made in 2006 totalled about $605 billion, or about 20% of the total mortgage market, up from $129 billion, or 5% in 2001."

"Last year banks and brokerage firms pocketed $2.6 billion in fees from underwriting bonds that use mortgages as their collateral, nearly double 2001's figure. Wall Street banks extended billions of dollars of short-term credit, called warehouse lines, that allowed lenders to fund mortgage loans. New Century, whose loan originations jumped to $59.8 billion in 2006 from 46.3 billion five years before, proved an especially valuable client. It has spent about $38 million in fees just for stock and bond sales since 1998. The company is structured as a real estate investment trust and, under rules governing REITs, must pay out the vast majority of its earnings as dividends. That meant it needed to return frequently to Wall Street to raise money and keep its operations going.

"In short high finance in this deregulated globalized age joins deregulated banking at the hip with the sordid business of preying on helpless aged lost in the carnivorous modern mortgage refinancing jungle.

"Morgan Stanley has helped underwrite $9.8 billion of stock and bonds for New Century since 1998, pocketing about $17.4 million in fees, according to data-tracker Thomson Financial. Last week, Morgan Stanley helped New Century with an emergency loan even as other Wall Street banks said no. Morgan Stanley declined to comment.

"Wall Street firms such as Morgan Stanley and Bear Stearns also compete with subprime lenders by offering their own mortgage loans via brokers. On an online forum for mortgage brokers last week, Christopher Logan, an account executive for Morgan Stanley's recently acquired Saxon Mortgage subprime lending arm, said his company is still eager to lend as others bow out. 'With Morgan Stanley as our parent, we have the stability and strength – what it takes to survive in today's subprime!' Mr. Logan wrote.

"New Century's founders – Edward Gotschall, Brad Morrice, and Robert K. Cole – worked together in the early 1990s at a California mortgage lender and formed New Century in 1995 with about $3 million of venture capital. It went public in 1997, and survived a scare the next year when Russian loan defaults caused investors to flee risk business and some subprime lenders went out of business. U.S. Bancorp of Minneapolis helped out by acquiring $20 million in New Century preferred stock."

Its REIT Structure Made It Hard Putting Aside Earnings for a Rainy Day

"At the height of the housing boom in 2003 and 2004, New Century executives grumbled that the stock market was undervaluing their company. They and several other subprime lenders responded by turning their companies into REITs, hoping to attract investors interested in high dividends. The move didn't have much of an effect. Investors continued to worry that earnings and dividends in the mortgage industry couldn't be sustained at boom levels. The REIT structure also made it hard for New Century to put aside earnings for a rainy day.

"Despite disappointment over the share price former New Century employees say the company was a fun and rewarding place to work. Partying and heavy drinking were common on company outings, they say.

"Some analysts warned of trouble long before this month. An August 2005 report from Gradient Analytics Inc., a research firm in Scottsdale, Ariz., highlighted heavy selling of shares by the company's three founders as a sign that prospects for the company were clouding.

"New Century's implosion has big investors such as David Einhorn of Greenlgiht Capital Inc., a New York hedge fund that holds a 6.3% stake in the lender. Mr. Einhorn won a board seat a year ago, which he gave up last week without explanation. The value of Greenlight's stake in New Century has fallen to about $11 million from $160 million in mid-2006. Mr. Einhorn declined to comment.

"It isn't only investors who are smarting. In 2004, a mortgage broker at the Seattle firm Washington Loan Network Inc., offered to refinance Gertrude Robertson's mortgage into a New Century loan with lower monthly payments. The 89-year-old health aide agreed to take out a new $414,000 loan that carried a fixed rate for two years and then was set to adjust every six months.

"Last year, Mrs. Robertson found that she couldn't meet the payments, which had climbed to about $3,300 a month, leaving her without enough money to pay her other expenses. In October, she filed a lawsuit in King's County Superior Court against New Century and the mortgage broker. The complaint alleges that Mrs. Robertson's income was never sufficient to meet the expected payments and that the information in her application was falsified.

"Early this year, another mortgage broker, California Loan Co., arranged for Mrs. Robertson to refinance into a new mortgage with New Century that boosted her balance to $450,000 and cut her monthly payments slightly, to $3,139. 'New Century didn't know they had the earlier loan or even care,' said Melissa Huelsman, a lawyer representing Mrs. Robertson.

"'I just wanted to be able to eat and sleep in my house and have a roof over my head,' says Mrs. Robertson, who continues to work even though she will soon turn 90."

Elsewhere in the same issue of *The Wall Street Journal* Andy Laperrière ("Mortgage Meltdown") makes an important point: "Far from being limited to the subprime market, the data show that the risky loan features have become widespread. According to Credit Suisse, the number of no or low documentation loans – the so-called 'liar loans' – has increased to 49% last year from 18% of purchase loans in 2001. The investment bank also found that borrowers put up less than 5% down payment in 46% of all home purchases last year. Inside Mortgage Finance estimates that nontraditional mortgages – mostly interest only and payment ARMs that allow the borrower to defer paying back principal or even increase the loan balance each month – which hardly existed five years ago, grew to a third of all mortgages last year.

"Common sense suggests that the boom-time mania that led banks and investors in mortgage-backed securities to offer dangerous loans to individuals with poor credit histories also led them to offer the same kinds of risky loans (no income verification, no down payment, high payments as an income share, low teaser rates) to individuals with good credit scores.

"The Alt-A market – a middle-ground between subprime and prime has increased seven-fold since 2001 and accounted for 20% of home purchase loans last year. Fully 81% of Alt-A loans last year were no or low-documentation loans, according to First American Loan Performance. It should come as no surprise that delinquencies on

these unconventional loans have increased sharply. Investors were shaken last week by a Mortgage Bankers Association report which found that mortgage delinquencies his nearly 5% at the end of last year and that prime adjustable rate loans deteriorated at a faster rate than subprime ARMs. A recent UBS report finds the 2006 Alt-A loans 'on tracks to be one of the worst vintages ever.' This is no subprime niche problem."

"Foreclosure losses as a share of the economy will be small and most home owners have a comfortable amount of equity in their homes. But home prices – like all prices – are set at the margin. It was the marginal buyer, especially the subprime borrowers and speculator, who drove prices higher. The easing of lending terms increased the demand for homes and quickly translated into higher prices. It's not the size of the foreclosure losses as a share of the economy that matters. It is the effect of those losses on the availability of credit. When banks and investors in mortgage-backed securities start suffering losses, they inevitably pull back. This is so why so many subprime companies have gone bankrupt.

"What is more, the bank regulators are only now beginning to tighten lending standards, and will be under increasing pressure from Congress to do more. The concern that tighter lending standards could reduce access to financing is the reason a widely watched survey of house builders conducted by the National Association of Homebuilders dropped earlier this week.

"The report by Credit Suisse estimates mortgage originations could drop 21% during the next year or two because of the tighter credit standards. Coupled with high inventories of unsold homes and the additional supply likely from distressed sellers could produce an unprecedented nationwide decline in home prices."

W.K.

Some Fruits of Bank Deregulation in the US

The crisis resulting from the banks taking over the savings and loan mortgage companies echoed in the early nineties in a still bigger banking crisis. Accounting verging on the fraudulent was brought in by the US government to provide lucrative picking for vulture capitalists from the debris of the savings and loan institutions.[1]

In subsequent years the independence of the local central bank from its government and the end of reserves became a part of the obligatory menu imposed by the IMF for financial rescues in the Third World and emerging countries.

In Canada the combined Risk-Based Capital Requirements of BIS and the phasing out of the statutory reserves really launched the Topsy statistic into orbit.[2] (See page 6.) In 1980 it had stood at a mere 38.00. With the reduction of the reserves from 10% of deposits to less than an average of 4% by 1991, and a greater freedom in what banks could pay for funds on the money market and invest in, Topsy grew to 102.1, By 1996 it had almost tripled from there. Currently it stands at 404.7. But apart from COMER's modest newsletter, I know of no other place where it has rated a mention. Ignoring the grotesque growth of this statistic, however, is tantamount to acting out the amazing statement of Governor Thiessen of the Bank of Canada in December 1995 that the "multiplier" no longer exists.[3] Those who remember their elementary algebra classes will be aware that when the denominator of a fraction moves to zero, the fraction approaches infinity, rather than vanishes.

Topsy, moreover, is a shy statistic and understates the extent of its upward swoosh. The phasing out of the statutory reserves reduced the legal tender held by the banks in absolute terms from $5,259 million to $3,817 million or by $1,412 between July 1991 and July 1994. But since the total deposits held by the general public (Series B456) had meanwhile risen by 31%, the savings in legal tender held by the banks due to the phasing out of reserves amounted to $1.85 million. Were the multiplier was still recognized this could not have increased the money-creative powers of the banks by less than $55 billion, which even at 7% could not have been worth than $3.85 million per annum. In addition, the banks increased their holding of federal debt from $29,195 million to $84,833 by December 1995 or by over $55.6 billion. In short, the BIS risk-based capital requirement guidelines combined with the phasing out of reserves bestowed on our banks an annual entitlement of some $7.7 million p.a.

To provide room for the banks to increase their holdings of government bonds, the Bank of Canada trimmed its own inventory from, $9,751M in 1990 to $5,505M in June, 1996.

The largesse bestowed on the banks in this way was of the same order as the future cuts of federal grants to the provinces for social programs. This switch of program support from the neediest sections of our population to the banks might seem a reason for informing the public of what was afoot. But assuming any such thing would be to ignore the essential power-play identified by François Perroux in his "dominant revenue" concept. Indeed, it took a couple of years before even we at COMER grasped the diversion to cover the banks' bailout. An elaborate campaign had been mounted to put both "zero inflation" and the independence of the Bank of Canada from the government of Canada into the Constitution and the *Bank of Canada Act*. This was turned down by al three caucuses – including the government's own – of the House of Commons Finance Committee. That failed to rate a mention in the media, but its significance was powerful enough to persuade the government to leave the *Bank of Canada Act* alone. And there it stands in stark contradiction to the monetary and fiscal policies of both the Government and its central bank. The end of the statutory reserves was brought in by an amendment of the *Bank Act*. The Mulroney government and its Liberal followers took the message and didn't dare trifle further with the text of the *Bank of Canada Act*. It remains intact, a clash between the law and government practice that hangs a question mark over the democratic system of this land.

When I first mentioned this to the late John Hotson, he came up with an apt simile: "Like a well-executed Veronica in the bull-ring, where the sword is hidden from the victim in the folds of the cape."

It should be added that the legal tender still appearing in the denominator of our Topsy statistic is not available as collateral backing the deposits entrusted to our banks. Instead it is an amount of cash essential for conducting a banking operation – for filling clients' cash needs, and for meeting any net negative cheque clearance balance.

A further risk hidden from public view: Unless a bank has a 20% or higher holding of the issue of a given asset, its holdings are entered on its books at their historic rather

than at current market value. As we contemplate the table of the chartered banks' assets, little more than a 4% drop in the stock and bond markets could wipe out the banks' capital.

William Krehm

1. The tale is well told by Martin Mayer, *The Bankers – The Next Generation*, New York: Truman Talley Books, 1997. Another major accountancy scam of US banking – the handling of goodwill – is documented by the same source: "The logic of goodwill is that businessmen are rational, so when one company pays another more than its net asset value, the business must have tangible assets [to support this] – a franchise, a location, a brand name, a customer list – that will generate future income. Depreciating this goodwill over forty years legitimated fraud, since the average duration of a mortgage was 12 years. As the lower-rate mortgages were paid off, instead of writing off the goodwill acquired by purchasing them at a price below their face value, the S&L could take a profit and pay dividends to its owners – forgetting about its obligation to write off the surviving 70% of the goodwill still on its books."

2. COMER's continuation of the bank multiplier, undertaken to avoid a zero denominator caused by the level of the statutory reserves. A zero denominator would have given a value of infinity to the multiplier so we used the cash in the ATMs and tellers' tills as reserves.

3. This "Risk-Based Capital Provision" was obviously intended to replace the reserve that banks had to put up with their central banks in legal tender as a proportion of the deposits they received. However, even the US Federal Reserve and the German Bundesbank and the Bank of England declined to go along with the phasing out of reserves. Instead in the US they were reduced to insignificance. The German central bank continued requiring reserves to protect the banks' depositors but began paying the banks interest on such reserves. They are even referred to as "bank seigniorage." In the UK the reserves were reduced to .35 of one percent of deposits taken in by the banks. In the US the requirement is limited to banking hours; automatically they are shifted to unreservable accounts when the banks were closed. Either arrangement reveals the extent of the counter-revolution in world banking. They do protect the banks' depositors to some extent, though that burden implies an increased risk of the government through its central bank as "lender of the last resort" but deprives the government of all consideration – even the memory – of its former monopoly of money creation.

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A Statistic that has Grown Like Topsy

I am introducing you to a Canadian statistic that has grown like Topsy, but whose treatment by our central bank can only be described as topsy-turvy. When it started modestly on its career, it was accorded much attention. Books were devoted to its workings.

For example, in 1945 the Canadian Bankers' Association published *A Background of Banking Theory* by W.T.G. Hacket, economist of the Bank of Montreal that stated: "When the government borrows by selling the securities to the central bank there is made possible an expansion of chartered bank deposits equivalent to about a tenfold addition to the money supply" (p. 54). That ratio was known in economic literature as 'the multiplier.'"

The statutory reserve that the commercial banks had to put up with the central bank permitted them to create that multiple in new credit lent out at interest. The reserve put up by the banks with the BoC, however, earned them no interest.

Topsy got off to a slow start. For good enough reason. To get the banks out of the mess they had gambled themselves into in the 1920s, President Roosevelt had declared a bank moratorium as soon as he was inaugurated in 1933. 38% of the banks in the US had already gone belly-up. Severe restrictions were put on what banks could do with other people's money, or with the credit they themselves created. Ceilings were slapped on the interest rates they could pay or charge their customers. In these respects Canada and many other Western countries followed the American lead.

The Allied part of the Second World War was financed at about 2.5% interest, and as the conflict approached its conclusion the rate was actually lowered. And that is why our statistic got off to so slow a start. Even by 1971 it had not risen above 16.2. But beginning with the 1951 Fed-Treasury Accord of 1951 under President Truman the ceilings on interest rates were weakened, and the banks started a campaign to get back to the high jinks of the 1920s. In this the central banks proved their firm allies. The strategy towards this goal was largely directed from the Bank for International Settlements, a purely technical body, originally set up to handle the transfer problems connected with the World War I reparations from Germany. No member of a government was allowed to attend its sessions. That commended it as the semi-underground bunker from which to direct the banks' comeback drive.

The Birth of the Traders in Red Suspenders

You certainly have heard of the lads in red suspenders who throughout the world trade in government debt 24 hours a day. For several years the Bank of Canada laboured to bring a short-term government debt market into existence. It wasn't easy. At no small expense to the taxpayer, the Finance Ministry and the Bank of Canada brought bond traders into existence as master to dictate its pleasure to them.[1]

In 1967 for the first time Canadian banks were allowed to invest in government-guaranteed mortgages. In the same year the central bank was prevented from varying the amount of the reserves left with the central bank to control inflation. Accordingly, interest rates that had previously been frozen became "the one blunt tool to fight inflation." Today the only ceiling on interest rates is under the criminal code – 60% per annum. In 1980 secondary reserves, made up of interest-bearing reserves, that at the central bank's discretion had supplemented the primary reserves, were done away with.

If you plot the further deregulation of banking and interest rates against the difficulties that previous deregulation had got the banks into, you will find a perfect correlation. Invariably the banks were allowed to dictate the form of their bailout, and with few exceptions it took the form of the hair of the dog that bit them. And that guaranteed that they would be back with their begging bowls sooner rather than later. To fill those bowls social programs have been slashed.

To grasp the sociology of the process, we must reach for an invaluable tool developed by the late French economist François Perroux – the "dominant revenue." By its absolute volume and rate, the income of a particular group is seen as the index of well-being of society as a whole. In a particular historic perspective this may appear the case; with other social arrangements, however, another economic group might qualify

for this uniquely privileged role. Under feudalism, it was the landowners. In Britain after the Napoleonic wars and the abolition of the Corn Laws, the dominant revenue passed from the landowners to the industrial bourgeoisie. By the 1920s, the financial sector had taken over. When they overplayed their hand and helped bring on the Depression of the 1930s, manufacturers, with trade unions as junior partners, salvaged the situation. They came to determine the volume of investment and economic activity. The rentiers and the financial sector were relegated to the doghouse.

But beginning with the 1950s. Interest rates were gradually elevated to the one blunt tool for the enforcement of the free market. Few asked why a free market required for its enforcement the elimination of all rival tools, including those that had worked in the past.

By its very nature, the role of dominant revenue is a power position rather than an intellectual exercise. When challenged, it is defended by all means fair or foul, merely than just surrendered because of its catastrophic results. That is why there is so perfect a correlation between the failures of monetarism and the stepped-up dosages of it to which the world has been subjected.

A Critical Statistic — The Net Operating Income

The insolvency of monetarist policy can be measured by the levels to which real interest rates are driven. When these exceed the Net Operating Income of the economy, that is a declaration of failure, since it rules out a functioning economy; the Net Operating Income is what remains after operating expenses have been covered. From that residue, financing costs must be paid and a profit for the entrepreneur left. Importantly, that residue serves as a cushion of comfort for creditors as well. In its absence, interest rates will go up and the operation will become still more unsustainable.

Twice within a single decade this utter failure of the monetarist model was the occasion for it being driven to even more fanatical extremes.

The first of these was in 1980-81 – shortly after both the Federal Reserve in the US and the Bank of Canada announced their formal adoption of monetarism – the dogma that the price level can be controlled by restricting the money supply while supposedly allowing the interest-rate chips to fall where they may. But at the same time deregulation had introduced chequing interest-bearing accounts where previously cheques could be drawn only on non-interest-bearing accounts. It thus became impossible to say what the money supply – supposed to determine the price level that explained everything – might be. In the ensuing confusion bank rates were driven to just under 20% while prime rates charged the banks; customers nudged the mid-twenties.

Such rates led to Mexico's debt default and undermined the world financial system. They left their mark on government debt throughout the world. They brought on the savings and loan disaster in the US. Yet that disaster is still hailed as a triumph of Paul Volcker in breaking the back of inflation.

W.K.

1. The story is told by George S. Watts, the first archivist of the Bank of Canada, in *The Bank of Canada – Origins and Early History,* edited by Thomas R. Rymes, Carleton University Press, Ottawa, 1983: "By the end of the 1940s it had become apparent that with the return to peacetime conditions, that the postwar expansion was creating an environment in which efforts to foster a money market had prospects for genuine success, For several years, the Bank, in trading treasury bills had progressively widened the spread between its buying and selling levels to create an incentive for the chartered banks to look elsewhere for buyers.

"These efforts had met with little success and in the early 1953 a number of new steps ere taken. The principal objective was to broaden the market for treasury bills and other short-term paper by encouraging some of the larger investment houses to act as jobbers, that is to hold an inventory of short-term securities, ready to buy or sell. With this end in view, the regular auction of treasury bills was changed from a fortnightly to a weekly basis, a nine-month issue was offered in addition to the three-month issue and the amount outstanding was gradually increased over the next few months from $450 million to $650 million.

"Concurrently, the Bank of Canada undertook to provide investment dealers...with an alternative means of financing inventories of short-term Government securities through the institution of Purchase and Resale Agreements (PRA). Under these arrangements, the Bank would, if required, provide participating dealers with short-term accommodation by purchasing treasury bills and/or short-term Government bonds under an agreement to resell the securities at a pre-determined cost to the dealer."

In short, the Bank of Canada was competing with the private banks to fashion the clay god – the money market – before which it bows in reverence today.

Edmonton Talk, March, 2007

1929 threw up a steep divide in the thinking of the US and the world. Throughout the first 8 months of the year and well into October, the stock market soared on. Shoe shine boys gave their customers hot stock tips as they snapped their cloths to put a fitting high-gloss on the shoes of future billionaires. Business leaders were publishing articles in popular magazines explaining how nothing stood in the way of all Americans becoming tycoons. The odd future money reformer was putting himself on record in predicting that the stock market had reached a lofty plateau, without possible reason to fear a collapse.

And then suddenly, before anyone realized it, stockbrokers were jumping out of upper skyscraper windows, and below the penniless unemployed, three abreast, were circling entire Manhattan blocks en route to the soup kitchens.

From Flying Higher to Jumping Out of Control

When Franklin D. Roosevelt was inaugurated as president early in 1933, 38% of the nation's banks had already shut their doors, and one of the first things he did was to proclaim a bank moratorium. And when that original time set ran out, he renewed it.

In the years that followed business leaders like Henry Ford and Thomas Edison advocated "100% money" to replace the non-functioning banks. Banks were to be required to have the money in their vaults for every last dollar of credit they issued. Put in other words, they gave up on banking, since it is of the very essence of banking to lend out several times the amount of money held by the banks. But that assumed the ability of banks to honour the claims of depositors whenever they were presented. "Almost all" wasn't good enough. It was enough for a single bank to close its doors to impugn the safety of deposits in all other banks. No president would have declared a bank moratorium if there had been the slightest prospect of keeping them functioning.

But there was little understanding of what had happened to the so recently flourishing economy that so suddenly brought stock brokers to leaping to their deaths, and put would-be tycoons in the soup-kitchen lines. That gave rise to a period of open curiosity and enquiry in the highest political spheres.

A good résumé of that advice was incorporated into the *Bank Act* of 1933. It recognized two major policy tools for keeping the economy functioning with a minimum of instability. There was the *benchmark interest rate* that the central bank charged commercial banks for overnight accommodation, and influenced many of the other interest rates throughout the economy. And then there were the *statutory reserves* – a portion

of the deposits the banks received from the public – amounting from 4% to 12% depending on the advance notice needed for the withdrawal of the deposits. On such statutory reserves that had to be redeposited with the central bank the banks received no interest, for what created the stabilizing effects of these reserves was the difference in the increased net revenue that the banks could earn by applying the multiple of credit they could loan out when the statutory reserve was raised or lowered. If the central bank paid interest on these reserves that would decrease the effectiveness of the statutory reserves as an alternative to interest rates for influencing the pace of the economy. They had an advantage over the benchmark interest rate. High interest rates hit everything that moves or stands still in the economy. Clearly the unemployed could hardly be causing much inflation.

Then again the ability of the banks to create a multiple of credit on the basis of the cash reserves they took in from the public and were allowed to hold as credit base, was the modern equivalent of the monopoly of the ancestral monarch in coining and recoining precious metals. Two other key features of the Roosevelt *Bank Act* of 1933: ceilings were placed on the interest banks could pay for the money they borrowed or loaned out. And finally banks were not allowed to acquire interests in the other financial pillars – stock brokerages, insurance and mortgage companies. The logic here, too, was clear. Each of these other financial pillars maintained its own pool of cash or near-cash for the needs of its own business. Allow the banks to access these, and inevitably they would use them as money-base for the bank multiplier – the number of times they can lend out as much interest-bearing loans as the cash held by them in their coffers or at the central bank.

It was on this spartan regime that the banks regained their health above all in financing the purchase of victory bonds and other essential banking during the Second World War. The US banking legislation, moreover, came to serve as the model for banking legislation throughout the non-Communist world. In Canada where the Bank had been nationalized under a Liberal Government in 1938, greater use was made of the central bank in financing the war effort than in any other land. It rose to some 16% of the Gross National Product. The advantage of the arrangement was that the interest paid by the Canadian government on its loans from the Bank of Canada, found its way back to the government as dividends because of the nationalization of the Central Bank. The gimmick was not "funny money" but the good old only institution of dividends. That is what leads those people who hold shares in a particular bank to do their financing at that bank.

After the war, the amount of borrowing by the Canadian government from its central bank grew consistently until by the mid-1970s exceeded 22% of the GNP.

This was notably a period of a relative stability in the price level, despite the fact that the renewal of infrastructures – both physical and human – was catching up after 10 years of depression and six of war. A huge, mostly penniless immigration in the postwar years had been assimilated, an explosive growth in the younger generation had to be cared for, housed, and educated to levels undreamt of before the war. And while this was being done the public debt of the country dropped from as much as 160% of the GNP to a mere 22% in the mid-1970s.

Capital Budgeting Missing from Government Accountancy

Moreover, this remarkable achievement took place despite the fact that the government itself kept its books in a highly disorderly way, known as "cash accountancy." Were any corporation caught trying to use that, it would have landed its CEO in the dock. One of the things that the Crusaders brought back from Arab lands was double-entry bookkeeping that was soon applied to the ledgers of any corporation not only in reporting the debt incurred in acquiring an investment – say a building, a bridge a road, but the value of that capital asset. The latter value is only gradually depreciated over its useful life, more or less in stride with the amortization of the debt incurred for its acquisition. But our government – as practically every other one in the world – resisted its auditors, and in Canada the recommendation of two royal commissions that this practice be followed. It is known as capital budgeting or in accountancy circles as "accrual accountancy." Instead, whereas the debt incurred in acquiring such an asset was carefully amortized, the value of the asset itself was written off in a single year. In year 2 the government capital item appears on the books at a token $1 to alert the auditors that it was not just forgotten. In the light of recent developments in many countries, it has become evident that such government assets – real estate in particular – were being prepared for privatization to cope with a deficit that was not necessarily there.

This should remind us that accountancy is as much a feature of class warfare as let us say the barricades that the revolutionaries around 1848 used to throw up in explosive centres such as Paris. We will return to this subject but first we must introduce other major irregularities in the manner in which governments run their affairs.

By the 1950s the banks in the Western world, under the spartan US *Bank Act* of 1933 had recouped the capital lost in 1929, and with renewed health came a passion for the fleshpots that had brought them into the Great Depression. However, to win the world war, the Allied governments had committed themselves to their troops and the workers in their factories to a more humane economic system than that of the 1930s. This meant that the bankers of the world had to plan their strategies *outside* government, and to an extent *against* governments. For this they had need of a semi-underground war room. This turned out providentially at hand in The Bank for International Settlements. This was a sort of central banks' club based in Basel Switzerland. Originally it had been set up to handle the syndication of the German First World War reparations. This was paid by Germans in their weak currency, but had to be converted into a strong currency acceptable to France and Belgium. That project was suspended by the collapse of world banking in 1929, and BIS lingered on, providing one signal service to the Nazis fully documented, and accused by its critics of having served them in many other ways as well. When the German troops entered Prague in 1938, BIS almost fell over itself in surrendering the gold reserve left with it for safekeeping by the Czechoslovak government. That is why at the Bretton Woods Conference that planned the post war financial system in 1944, Resolution Five, moved by the Norwegian government-in-exile, was unanimously adopted. It called for the liquidation of BIS at the earliest possible moment.

With Resolution Five overhanging it, BIS cultivated a low profile – some of its offices in Basel were actually over a pastry shop. However, that low profile providentially answered the need for semi-underground war room from which the banks' comeback was to be planned. Elected members of government were not encouraged to attend its meetings. It was there that the grand bailout of the banks was planned and executed after they had lost much of their capital in the de-

regulations undertaken beginning in 1951, and at an accelerating pace after the 1960s – almost always on the initiative of BIS.

This constituted a dislocation of democracy in the Western world – allegedly devoted to making democracy prevail. Though the nicest words on the intent of world economic policies were spoken in parliaments, the actual plans originated from no vote of an officially constituted body. In actual fact it not only siphoned off to private financial institutions the financial reserves needed and that had even been even used for vital social and other capital programs. These were deregulated and globalized to allow them to engage in ever more speculative activities. This bankrupted the underdeveloped world, proclaimed high interest rates that inevitably squeezed the most defenceless groups like lemons. It reversed the policy of the first quarter of century after the end of World War II. To have this trend continue despite the ever, more disastrous effect, was possible only due to purging of our universities of even the knowledge of the immensely successful economic thought that that made possible the financing of the Second World war, the reconstruction of the economy and society itself after sixteen grinding years of depressions and war, and almost a century of social and economic progress. And while achieving all this, the proportion of government debt to the GNP had been reduced in Canada from some 160% in 1946 to some 22% in 1975.

The list of the great economists, whose very names have been forgotten can begin with John Maynard Keynes. His name is well enough known but his writings, so central in the brilliant financing of the Allies' Second World War, and the postwar reconstruction have not been taught in our universities nor recognized to have existed by our media for some years.

This in itself is a phenomenon without which the unofficial but unquestioned leadership of the world economy by the BIS would have been unthinkable. François Perroux, (1903-1987) developed the concept of the "dominant revenue" that alone can explain how an allegedly democratic Western world conforming to the commands of a highly secretive international body independent of any controls by elected parliaments, whose sessions are held in secret with no elected member of governments attending. BIS itself had been slated for dissolution in a unanimously passed resolution at the Bretton Woods Conference of the Allied governments in 1994 for services rendered to Hitler at least before that war. It has imposed upon the world the elevation of interest rates to the one "blunt tool" to attain "zero inflation" to attain a strictly flat price level. This goal of absolute zero "inflation" was announced by BIS manager of the day, Alexandre Lamfalussy, when in 1991 he declared that interest rates must be raised until the price level reached absolute zero, rather than the one or two percent where the best central bankers have been content to leave it. M. Lamfalussy issued this statement the "one blunt tool" of BIS policy had already brought on the massive loss of bank capital throughout the world. This had led to BIS – desperate to prevent the collapse of the whole world monetary system – proposing two major policies to bail out the world banks and assure its still more absolute domination of the world economy.

When Monetary Policy Serves High Finance Rather than the Nation

One of these was the *Risk-Based Bank Capital Requirements* that declared the debt of developed countries "risk-free" thus needing no down payment for banks to acquire. In this way they simply had to clip the interest coupons to reconstitute capital that had been lost in breaching the prohibitions by the Roosevelt *Bank Act* – especially those prohibiting banks taking over other "financial pillars." Then as now once more, the banks had taken over the mortgage companies and lost heavily in financing major real estate speculation. Then the statutory reserves were phased out in some countries and diminished to near-meaninglessness elsewhere. These had provided an alternative to high interest rates for reining in what was taken to be "inflation" – any case of a rising price level.

But what the BIS in the urgency of the bank collapse overlooked was that when you allow the banks to load up with government debt acquired at 100% leverage and then raise interest rates, that can only shrink the market value of pre-existing securities with lower interest rates. And that in fact is what came to pass. In 1994 the Mexican banks went bust since the North American Free Trade Agreement imposed by misrepresentation to both Canada and Mexico, had led to special bond issues that gave the holder the option of taking payment for it either in pesos or US dollars. Incredibly it threw in a currency option for the price of the bond while NAFTA left the frontier open to currency movement. As a result the Mexican peso dropped some 40% in market value and the Mexican banks that had only recently been privatized had to be nationalized again. Eventually the banks of Mexico (a proudly nationalist land if ever there was one) were sold to foreign banking interests while the stock market took over the marketing of Mexican debt in TV auctions. This led to a new stock market group assuming the financial leadership of the land.

Unemployment rose disastrously, and the Americans with some help from BIS, in bringing on deregulation and globalization, started the flocking of unemployed Mexican to the US. This in turn has led to the US immigration crisis and the building of "the wall" that has hardly enhanced President Bush's reputation throughout Latin America. It also threatened to bring down the international financial system. To bolster the international financial system the Clinton government, with the help of IMF and Canada, put together the largest standby fund up to that time – $51 billion US – without even waiting for Congress to come on board.

The US government was finally led to the conclusion that their two main ways of replacing lost bank capital – allowing them to load up with 100-leveraged government debt and raising interest rates to the skies – were incompatible. And to deal with that they resorted to introducing serious accountancy. François Perroux had defined the "dominant revenue" as the revenue whose volume and rate of growth is taken as a reliable index of the welfare of society as a whole. This may seem so, he adds, but only when viewed in the perspectives of the narrower interests of a given dominant class. However, should economic dominance pass to another social group, its revenue will come to dislodge this privileged "dominant revenue" from that role. Accountancy and price theory itself must, on the basis of our experience with the BIS, be seen as a weapon of class struggle, hardly the less than the barricades of Paris in 1848 or 1871.

The very concept of "inflation," mobilized as a main policy target cannot, by official economic theory, stand up under logical examination. It is true that, other things being equal, an excess of demand over available supply will lead to a higher price level, and that can justly be considered "inflation." But you cannot flip a proposition over like a pancake, and consider it still true. A man who holds a loaded pistol to his head and pulls the trigger falls dead. But from that you cannot deduce that when a man falls dead, that he has held a loaded pis-

tol to his head and pulled the trigger. Likewise the price level may have risen because the world and more specifically Canada has since the 1930s passed from a semi-agricultural country to a highly industrial, urbanized one. And an urbanized modern land requires a vastly more elaborate education even for consumers, let alone for producers. The pressures on the environment – of all sorts – multiply. These used to be classified as *externalities* which is a fancy way of saying thrown out the window. *On the contrary when any such essential measure paid for by the government out of taxation is not made, it must be entered into our accountancy as a capital debit and contribute to show the budget not balanced out of financial prudence, but in greater capital deficit.*

When Higher Prices Are Not Inflation

Were accrual accountancy not only brought in, but essential government measures paid for by taxation rather than on the market must be reckoned assets. If they are not looked after when necessary – whether environmental or health or educational – they must be treated as a capital *deficit*.

And when treated as a public investment and depreciated, that reduces its contribution to a higher price level. Any residual rise in the price level has nothing to do with "inflation." I have called it "structural price increase." Robert Eisner, one of our great forgotten economists (*Journal of Economic Literature*, December, 1988), analyzed the role of this effect in eroding the real value of this "structural price rise."

But that is still not all. In the 1960s Theodore Schultz of the University of Chicago was awarded the Bank of Sweden's Economic Prize for his revolutionary conclusion from his experience in studying the state of Germany and Japan right after their defeat in WWII. He had been one of hundreds of young American economists sent to the two countries after their defeat to forecast how long it would take for them to reappear as the formidable export competitors that they had been before the war.

Twenty years later Schultz concluded that his and the other economists' predictions had been so wide of the mark because they had concentrated on the physical destruction, but had overlooked that the highly educated, disciplined work force had come out of the struggle largely intact. From that he concluded that investment in human capital – education, and hence health and social services – is the most productive investment a government can make. Moreover, health and education, and hence social services, tend to be passed on to future generations – children of well-to-do, well-structured families, with adequate economic resources, tend to have children better educated and socialized. The depreciation period for investment in such human capital is thus far slower than that of physical investments.

Were our governments to restructure its accountancy to include human and physical investment by government for what it is – investment rather than a deficit – we would undoubtedly find that we can and should do timely repairs in our social and physical public capital without unbalancing the government budget. On the contrary, we should have access to interest-free loans for such essential public investments. And there should in the private sector be a decline in the rising costs of advertisement to whip up enough needless demand to keep the economy not only going up, but ever expanding. Much of the needless expansion that will no longer be necessary to keep the economy churning can be replaced with essential public services. Much of this will be contracted out for execution to the private sector, with a curtailment of investment directed to stimulating luxury desires of which society does not stand in need, nor can even afford.

Freed from its compulsion to ever expand the private sector would enjoy greater stability. Prices would be controlled against real inflation – that can really be traced to an excess of existing demand for which supply is not available, but not to repress a price ascent that is clearly due to greater public investment really needed. However, released from the burden of interest ever responding to any rise of the price index with no attempt even to distinguish whether it is due to too much demand for gold or diamond jewelry or the need for clean water for communities. And given the additional recognition of public investment in physical and human capital treated as such, it is likely that with the adequate use of our central banks as they were until the mid-sixties or so, inflation, except on rare occasions, would not be the serious concern that it has become.

We should start reintroducing to our universities the ideas of the many great economists whose very memory has been suppressed. COMER has been approached by a sympathizer who chooses to remain anonymous offering his aid to fund a modest program in a few universities that would be open to such a program. It would be a condition that writers such as Thorstein Veblen, Jan van Tinbergen, Robert Eisner, Abba Lerner, François Perroux, be presented to students who choose such a credit course, with lecturers both favourable to and critical of suppressed writers. The purposes will be not to sell their ideas but to bring their views to the knowledge of students.

But simultaneously there must be a history not only of the BIS its beginnings and the colossal goof of the two mutually main means it chose of bailing out the banks from their gambles.

Globalization has cut off what there was of democracy in economic policy at the knees. It has inserted a fourth level of government spanning countries beyond the reach of democratic institutions controlled by the electorate. Especially since the preeminence of the financial sector have local and provincial levels of government tended to be stripped of their power, overshadowed for even seriously discussing, let alone deciding, basic economic policy. It is at that new international level of which BIS is the earliest and most arrogant example, entirely beyond the ken or power of even national legislatures. It will require a Royal Commission devoted to the record of both the BIS and of its influence on our central bank policy to remedy the damage of this to our democratic system.

We need that perspective to save our society from disintegration.

Thus it was the BIS-sponsored *Risk-Based Bank Capital Requirements* in 1988, that declared the debt of developed countries "risk-free" and hence calling for banks of developed countries to be able to acquire such securities without advancing any money of their own.

As a result our Canadian banks quadrupled their holdings of Canadian government debt from $20 billion to $80 billion, while retrieving the down payment that it had previously outttttt for the lower figure put out for government debt held by it.

Again in it was BIS that hatched the phasing out of the statutory reserves in countries like Canada, Australia and New Zealand. In Canada this took place over a two year period and 1991-3 and thus left the benchmark interest rate as the sole policy tool against what was termed "inflation." Interest of course, is the basic revenue of money-lenders, and also the ultimate arm-breaking collection weapon that can create bargain basement-opportunities in stressed acquisitions.

William Krehm

The Greatest Central Bank Goof Ever

In organizing the world-wide bank bailout of the early 1990s, BIS overlooked a crucial detail.

When you allow the banks to load up with government debt 100%-leveraged, and then proceeded to raise interest rates to the skies "to lick inflation," you court disaster. For higher interest rates bring the market value of pre-existing bonds with lower coupons tumbling. And in his annual report for 1991, Alexandre Lamfalussy, head of BIS, announced that he would no longer be satisfied with 1% or 2% "inflation" that even the best central bankers have brought in, but would insist on a clear zero. As a result interest rates shot upward and threatened to collapse the world monetary system. That convinced the US Treasury that the day of sky-high interest rates was over. "Accrual accountancy" (aka "capital budgeting") had become indispensable. Carried back to 1959 the adjusted figures of the Department of Commerce retrieved some $1.3 trillions previously written off.

The change was called "savings," which it certainly was not. For rather than the cash and near-cash securities that "savings" usually implied, the rediscovered physical investments were in the form of roads, bridges, buildings, and highways. But a wink to the bond-rating agencies sufficed to convey the real situation. It brought down interest rates, gave President Clinton a second term, and Wall Street a boom that lasted until the high-tech bust of 2000.

The Savage Accountancy Games

However, there is far more involved in all this than can be conveyed by a wink and a nudge to the bond-rating agencies. Today the very system of accountancy is a subject for some very savage games being played between corporation and corporation, as between governments and corporations. That much you can gather even from a casual reading of our daily financial press. The great late French economist François Perroux summed this up probably better than any other economist, when he spoke of the "dominant revenue." This under a given social system – both by the volume and rate of its return is held to determine the welfare of society as a whole. That may be so only from the angle of vision of a particular social group in the saddle. If power shifts to another such group its revenue comes to occupy the dominant position. In this way after the Napoleonic Wars it was the land-owning class in Britain who behind high tariff walls protecting domestic food market profited mightily at the expense of the new industrialism that had to pay higher wages for its workers to keep body and soul together. At the time no more was offered by the industrialists and the economists who expressed their interest than that wages sufficient to allow their workers to renew their working force and to breed the next generation of labourers. That, to the satisfaction of David Ricardo and his clergyman friend, the economist Thomas Malthus, constituted the "iron law of wages" – anything more would merely lead to the workers having larger families because of their inability to practice abstinence. In that position of Ricardo Karl Marx was delighted to find confirmation of his very different view of the "iron law or wages" and the labour theory of value. To him and his followers it confirmed the need and possibility of a working-class revolution.

Today there is a new social vision implicit in the difficulties that corporations and government are experiencing in getting the accountancy of our society straight. For by now it should be clear that not only producers, but even consumers need a higher education to handle computer and countless other baffling technologies. By switching to what is nothing more than double-entry accountancy into our books – accrual accountancy – we can adopt a dominant revenue. That would help the peaceful coexistence of humanity in all its races and religions and cover the cost of conserving our environment. That would require that human capital as well as physical capital can that must be depreciated over its useful life. That was learned the hard way in the Second World War.

At its end Washington sent hundreds of young economists to Germany and Japan to forecast how long it would be before these two formidable industrial powers could emerge as competitors on the world market. One of these economists writing two decades later reflected on why their predictions – including his own at the time – had been so wide of the mark. He concluded that it was because they concentrated on the physical destruction and overlooked that their highly educated, disciplined work forces had come out of the conflict essentially intact. That netted for Theodore Schultz the Bank of Sweden Prize for economics and a brief celebrity. Today he is forgotten except by a few like COMER.

The Slow Depreciation of Human Capital

The investment in human capital survives more than the generation in which it is made. For the children of educated, healthy parents tend to be healthier and better educated. Properly accounted for, that would take care of the extra services necessary for our longer average life expectancies. If human capital assets were recognized in our official accountancy, our government's balance sheets would not only be in fair share but in surplus. This would permit catch-up not only for the neglected environmental conservation, but for generous assistance to the disease and poverty-ridden parts of the world such as Africa and parts of Asia. It would provide means and need for putting into effect the concepts of the social heritage of Major Douglas. The first step in that direction is to grasp the interdependence of Perroux's "dominant revenue" and the accountancy accepted by governments and society. This will allow, indeed invite, the lowering of the pressure in the social steam kettle that currently is designed to crush and destroy rather than to conserve and help flourish.

What we require towards that end is: (1) a knowledge of the work of the great economists whose work has been expunged from human memory. COMER hopes shortly to announce an initiative that it is planning in this sense. (2) A knowledge of our own history and how it could interface with other cultures. Certainly the sad experience of our American neighbours in Latin America, Europe and Asia should serve as a warning, and induce us to lend them much-needed help in reorienting their, and our, foreign policy before it is once again too late. Hectoring in Latin America, Vietnam, has led our government to the quagmire of the Near East. Our roaming bankers must be brought

RENEW TODAY!
(SEE PAGE 2)

home and confined to banking – if properly controlled, a socially highly useful art.

We must become aware of the perils of espousing a view on banking or whatever aspect of the economy, without considering what the conditions at the time have contributed to a particular formulation of the problem being considered. I have mentioned briefly the suddenness and violence with which the high hopes collapsed in October 1929. The banks of the nation had shut their doors. Figureheads not only amongst economists but amongst the great industrialists of the day, were prepared to throw in their hands. You can not shut 38% of a nation's banks and expect the other 62% go on functioning. The opposite of banking is 100% money – i.e., nothing is lent out by banks except what has been borrowed elsewhere by the bank – for the simple reason that it has forfeited public confidence. Only government guarantees could begin saving the banking institution.

Moreover, advocating 100% money does threaten one of the greatest assets that Canada has in our struggle to make the *Bank of Canada Act* which is still intact on our law books, though completely ignored by the government. In it we have a detailed description of the funded and unfunded debt that the central bank may lend to the federal and to the provincial governments, and with their guarantee to our woefully under-funded municipalities. The time has come to do something about it.

William Krehm

Could Social-minded Budgeting Prove Greatest of All Medical Advances?

We are indebted to Andre Picard (*The Globe and Mail,* 29/03/07, "Sanitation Clean Up as Top Medical Advance") for the following revealing medical view on government budgeting.

"What is the greatest medical advance of modern times?

"According to a poll conducted by the *British Medical Journal*, it is sanitation – the provision of clean water and waste disposal – that has provided the greatest benefit.

"The poll was a light-hearted exercise, designed as a reminder that the journal has been at the forefront of publishing medical research since 1840. Readers were asked to rank breakthroughs from its short list of 15.

"1. Sanitation – Its crucial importance was recognized in the late 1800s, as diseases began to be linked to dirty water.

"2. Antibiotics – Alexander Fleming discovered penicillin in 1928 by accident when he sloppily left a Petri dish of bacteria unwashed in his lab. He found a substance, later named penicillin, growing on it that killed the bugs.

"3. Anesthesia – In 1946, a Boston surgeon used ether during surgery, putting an end to much of the pain of operations.

"4. Vaccines – The first was Edward Jenner's smallpox vaccine, in 1796. Since then vaccines have helped prevent a wide variety of diseases including polio, measles and hepatitis.

"5. Discovery of DNA structure – Scientists James Watson and Francis Crick presented the structure of the deoxyribonucleic acid helix, the molecule responsible for carrying genetic information from one generation to the next, in 1953.

"6. Germ theory in the late 1800s – Louis Pasteur was the first to suggest that disease is caused by exposure to micro-organisms. Others furthered the theory, showing that specific diseases were caused by specific 'bugs' – viruses, bacteria, and other pathogens.

"7. Oral contraceptive pill – The Pill, which became widely available in the 1960s, was a medical and social phenomenon. For women who use it correctly, oral contraception can be up to 99 per cent effective at preventing pregnancy.

"8. Evidence-based medicine – As the name suggests. Evidence-based medicine involves making use of the current best evidence (such as research) combined with a doctor's clinical experience, to make decisions about patient care. The term was coined in the early 1990s and the concept has been evolving since.

"9. Medical imaging – The x-ray was accidentally discovered in 1895. Since then, the field expanded, giving us computed tomography (CT scans), magnetic resonance (PET scans), positron emission (PEI scans) magnetic resonance imaging (MRIs) and ultrasound.

"10. Computers – Computers are now a mainstay of modern practice. They allow ready access to information, including patient records, information, new medical studies, and clinical trials.

"11. Oral rehydration therapy – This involves giving fluids by mouth to replace losses by the body; It was first reported in 1964; now it is standard treatment for patients with cholera, acute diarrhea and other conditions.

"12. Risks of smoking – The first report of the connection between smoking and lung cancer was published in *BMJ* in 1950. Even so, tobacco use still kills an estimated 45,000 Canadians annually.

"13. Immunology – The history of immunology is traced to 1790, when Edward Jenner found that people could be immunized against smallpox. Numerous other immunological discoveries followed, leading to a greater understanding of such things as allergies and antibodies.

"14. Chloropromazine – Discovered in 1952 [Thorazine] was the first antipsychotic medication. Its development brought new understanding of the biological basis for mental illness, and some say it provided more humane treatment.

"15. Tissue culture – The practice of keeping alive and growing it in a culture medium for research or other purposes was 'discovered' in 1907; but it took until the 1950s for it to become an important tool for clinical investigation.

"The results, while not scientific, provide a good summary lesson in medical history. We get awfully excited about purported breakthroughs and cures that cater to over-medicalized societies.

"Yet our time, money and effort would be better spent implementing well-proven health measures to prevent disease and illness – beginning with wells, latrines vaccines – than in the search for ever greater profits from one-molecule variations of drugs of already of dubious value."

Put in another way, providing adequate pure water and waste disposal should have priority in budgeting, and the savings would – along with social criteria in public budgeting in general – be enough money made available from the economic as well as strictly medical results to spend for advancing scientific research on promising frontiers. That, however, requires a defence of social interests not only in our health but in all our health and sanitation budgeting, and in our monetary policy where the exploding maldistribution of wealth has its greatest roots.■

Fed Changes Broken Record — Our Great Forgotten Economists

The Wall Street Journal (26/02, "Low Jobless Rate No Longer Tops Fed's Worry List" by Greg Ip) informs us: "For decades, a simple rule has governed how the Federal Reserve views the nation's economy. When unemployment falls too low, inflation goes up, and vice versa.

"But Fed officials have rethought that notion. They believe it takes a far bigger change in unemployment to affect inflation today than it did 25 years ago. Now, when inflation fluctuates, they are more likely to blame temporary factors, such as changes in prices or rents, than a change in the jobless rates.

"One explanation for why inflation is influenced less by changes in unemployment is that the American has come to expect inflation to remain stable. When inflation moves up or down, it is less likely to get stuck at the new level because companies and workers don't factor the change into their expectations – or their behavior. Another explanation is that the Fed is better at adjusting interest rates in anticipation of swings in unemployment before those swings can affect inflation."

Let us interrupt to note that either of these explanations is what we might call "bureaucratically self-seeking": they attribute the lower grip of "inflation" to a successful job they have themselves accomplished.

However, in doing so they have shifted the argument from a discussion of objective causes of "inflation" to psychological ones – the reaction of the public to the past achievements of the Fed and its colleagues abroad in whipping the demon "inflation" that the public feels him to be cringing in a corner.

And that job that created this psychological reaction of the public was achieved by the Fed having for years driven its benchmark interest rate into the high teens which carried commercial long-term rates at times towards or well into the 20%+ range. And interest rates, be it never forgotten, do happen to be the primary revenue and the battering ram for creating liquidation bargains for banks and other money-lenders. By doing away with other ways of combatting real inflation – that could in fact be traced to more market demand than production could supply – the Fed elevated interest to the role that the late great and forgotten French economist François Perroux termed the "dominant revenue" – the revenue that by its rate and volume is taken to determine the welfare of society as a whole. Those whose revenue has been crowned "dominant" have no difficulty waiting for inflation to be licked in this way. It is the victims of the cure – the rest of society, especially the unemployed – who find it difficult.

Let us note that the revised explanation, as quoted by Greg Ip, shifts midstream from a discussion of objective factors like supply and demand to psychological ones – the sense of the Fed's achievements in the minds of an anonymous population.

The discussion thus takes flight from more or less hard statistics to what might or might not go on in the public's mind, and could well have been planted there by one-sided media reporting or the notoriously ambiguous language that the Fed and other central banks take pride in cultivating.

Introducting Another GFE

At this point we must introduce another Great Forgotten Economist (GFE), whose original training was actually as a physicist. Jan Tinbergen, who turned his back on the misapplied calculus economists had taken to use, and went back to test what they were up to by employing no more mathematics than the solution of linear simultaneous equations that we all learned in our freshman high school classes. He formulated what came to be known well over a half century ago as the Tinbergen Counting Test. It holds that if n independent variables can be detected in a linear equation ("linear" means that no variable occurs in these equations in a higher degree than the first – no squares, cubes, etc.), then it requires at least n linear equations to solve the problem. Or conversely. If you are to solve linear equations with n independent variables, you need n such equations to do so. This was recognized as the Tinbergen Counting Test and Tinbergen was feted for years. Today, along with dozens of other forgotten great economists who were too concerned about truth and the social need for it, than to concentrate on promoting their careers among the people enjoying the "dominant revenue," Tinbergen is plumb forgotten. Let us just note that the Tinbergen Test sticks to real facts as available in the best statistics. It does not leap from economic statistics to presumed psychological states of the mass mind. For that, given the tight control in the media and our universities today over what the public is allowed to think can have little objective validity.

Another major victim of this prevailing mixture of alleged psychology with objective economic statistics is our knowledge of history. For example there is another explanation for the reining in of high interest rates and the screechingly high unemployment that they caused: the decade of deep depression throughout the world that lasted 10 years and led to the Second World War was initiated by the stock market collapse of October 1929. By the time President Franklin Roosevelt was inaugurated for his first term in 1933, 38% of the banks in the country had closed their doors. A few months later Roosevelt brought in the *Bank Act* that became the model throughout much of the capitalist world. Its main points were to put ceilings over interest rates that banks could pay or charge, and to forbid them to acquire interests in the other "financial pillars" – stock brokerage, insurance, and mortgages. The reason? Each of these other financial pillars had their pools of liquid assets that they needed for their own businesses. Let the banks get their mitts on these and they would be used for speculative gambles, and put the entire economy into trouble. To keep this little note as practical as possible let us mention that today that the Roosevelt *Bank Act* has long since been trashed. Today the banks of the US and the rest of the world are up to their eyeballs in subprime mortgages that have spawned a speculative boom and involved the largest world banks.

On the spartan fare that the Roosevelt *Bank Act* had put them on, the banks became sound again, and started lusting after their high living of the 1920s. By the 1980s, the *Bank Act* had gradually been repealed. The banks, deregulated, had lost their capital once again – significantly, largely in real estate deals. Their bailout from these crippling losses was plotted in the Bank for International Settlements – an organization of central bankers, that does not welcome gov-

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ernment officials at its meetings. Two main measures were adopted. The BIS sponsored the Risk-Based Bank Capital Requirements that declared the debt of developed countries "risk-free," hence requiring no down payment for banks to acquire. This led to a massive shift of central government debt from the central banks – where the interest of central government debt went back substantially to the governments – to the private banks, where such interest stayed with them and helped fill the holes left by their speculative losses. And then the BIS resumed urging that central banks push up their benchmark rates high enough not just to bring down inflation to 1% or 2%, but to zero percent.

In their concern for bailing out the banks, the BIS had overlooked a detail – if you push up interest rates high enough, the market price of preexisting bonds with lower than market coupons will plummet. And that caused the collapse of the Mexican monetary system, the ruin and renationalization of its banks, and just missed bringing down the world monetary system. Only a record standby fund put together by President Clinton, the International Monetary Fund and Canada saved the situation. It had a significant more lasting effect. The US Treasury realized, if belatedly, that sky-high interest rates, were incompatible with allowing the private banks to load up with central bank debt that formerly had been held on a virtual interest-free basis at their central banks.

So starting with the US Department of Commerce statistics of January 1996, the US introduced proper double-entry accountancy for the first time. Up to then when Washington – like all world central governments – built a bridge, a building, a road, or made any other long-term investment, they wrote it off in the year of its acquisition, and beginning with Year Two carried it on its books at a token dollar. But the debt it incurred for its acquisition was carefully amortized over a period related to its useful life. Obviously, this created a deficit that was not necessarily there. But government deficits can be highly useful aids for putting through the program of the economic group – the "dominant revenue" of Great Forgotten Economist François Perroux. Now accrual accountancy (also known as "capital budgeting") was brought in. And though this was done under the misleading statistical heading of "Savings" a nudge of the elbow informed the Bond Rating Agencies what the item really represented. "Savings" usually in the mouths of economists refers to either cash reserves or very short-term securities of top order. This the recovered government assets are not – they are in the form of buildings, roads, buildings and equipment. This operation on the government books carried back to 1959 recovered well over a trillion dollars, and brought down interest rates.

It was thus a major Fed oversight rather than a triumphant record of achievement that accounts for the lower interest rates since then. The Canadian government held off introducing bringing in accrual accountancy until 2000 when the then Auditor General refused to give unconditional approval to two government balance sheets unless it were done. Here again it was finally achieved with a fair degree of misrepresentation – with the Auditor General obliged to issue a statement to the effect that since the new accountancy had brought no new funds into the Treasury it would not justify new federal programs. However, it was on the heels of a bailout of our banks that vital programs had been downloaded onto the provinces who passed them on to the municipalities without the funds to pay for them.

The Non-recognition of Our Government's Human Capital Investments

There remains only one more major inaccuracy in our government's bookkeeping. No government to our knowledge treats as capital assets the every growing investment in human capital – education, health, and social services, that the work of another Great Forgotten Economist Theodore Schultz was awarded to so-called Nobel Prize for Economics for having recognized, on the basis of his analysis of the rapid recovery of Japan and Germany from the immense physical destruction of World War II. It was, he proved, the fact that their human capital – their highly educated and disciplined population – had come out of the war essentially intact. From that he concluded the most productive investments a country can make is in human capital. Today – apart from a few stubborn people who seek and protect the lessons of our history and our GFEs – the name of Schultz is likewise forgotten.

Such is the real reason for the lower interest rates since the mid 1990s. Deprive us of our history and society is condemned to repeat its past mistakes – with an ever more lethal technology.

William Krehm

Satanomics

So, what's in a title? And where and when does His Satanic Majesty come in to take his bow?

Let's say it began with the ancient money-lenders, when they discovered that for each unit of gold and silver stored in their vaults, they could lend up to ten times the intrinsic value: this on the basis that they seldom had calls against their total exposure, and could be covered in contingencies by back-to-back guarantees within their own fraternity. They had thus stumbled upon the principles of fractional reserve banking, which, in one form or other, endures to this day.

They had also stumbled upon the Secret of Money, which in later centuries would make their banking successors both rich and powerful; so rich in fact that they would come to own much of the planet's corporate wealth between them, including radio, television, newspapers and most other means of mass propagation; so powerful that on occasions they could use these mediums of communication to silence all debate and criticism. Having thus established the means by which to confuse the masses and mind-control the Establishment, they would eventually become the Establishment, upon whose say-so and compliance all things depended.

A tacit bargain had been struck. Whilst the banking houses serviced the expansionist requirements of trade and industry, governments largely financed themselves through the issue of gold and silver coin. When in due course banknotes arrived, that too was a form of government-backed currency, deriving its value from the communal wealth and stability of the sovereign state in which it was contained. Anything else was credit money in some form or other, loaned out at interest by the bankers on the fractional reserve principle handed down to them by the mediaeval goldsmiths.

Still no satanomics! It remained a reasonably sane financial world.

Came the day when banking and entrepreneurial adventurers discovered the under-developed nations of the Third World, and promised they would lend them into prosperity by exploiting their natural resources of oil and minerals. Somehow it didn't work out as it had been intended. The carrot to the donkey in this case had been the promise of a doubling or trebling in the price of crude oil; the sting was in a commitment that the million dollar revenues accruing from such a bonanza would end up on long-term deposit in American banks.

It was the stage-setting for a long drawn out agony which would ultimately become known as the Third World Debt Crisis. The increased liquidity within the American banking system had created its own pool of investment capital, which rapidly became available for lending elsewhere, and found its own field of opportunity among the cash-hungry despots and dictators of the under-developed world, who lacked the claim to instant riches bestowed upon the oil sheikhs, but were nevertheless willing to mortgage their people's economic future in short-term prestige projects which ended in long-term debt.

Thus began that crisis of the under-developed nations whereby the bankers and their inter-linking corporations got the resources, while in some of the Earth's poorest regions a half-starved citizenry got the debt. It was a debt that would never be repaid, since in many cases the annual interest payments exceeded what could be extracted in revenue, and the capital sums just kept on rising.

It was then – or about then – that the banks and finance houses said to their governments, "We've lost a lot of revenue potential on this one, and we're just not going to get it back again by pussyfooting around with capital bases and fractional reserves. From now it's an age of *managed liabilities,* and the sky's the limit on our lending."

Satanomics? Was that it this time? Well, not quite! Read on a bit further.

Next stage! They deregulated the financial markets, and started lending more and more of that magical store of wealth which they had never possessed in the first place.

Our Mail Box

From André Marentette's Reply to Our Finance Minister

Reply to Finance Minister Flaherty's letter on alleged inflationary effect of the use of the Bank of Canada for municipal capital projects considering such use of the Bank of Canada would have an inflationary effect.

In response to Mr. Flaherty's letter about the danger of inflation by the government through our own bank creating money, let me quote from page 92 of Mr. Hixson's book, *What's the Difference between Bankers and Counterfeiters?:* "From year-end 1932 to year-end 1944, roughly Roosevelt's twelve years in office, the amount of GCM (government created money) in the USA was increased by amount unequaled before or since-an average of 2.11 percent of GDP each year. It may be remarked in passing that the relatively high rate of money-creation by government under Roosevelt was accompanied by a relatively low average annual rate of price inflation, 2.26% and a relatively high growth rate of GDP, 8.91%.

"On the other hand, the relatively low rate of money-creation by government between 1968 and 1992 was accompanied by a relatively high average annual rate of price inflation, 6.09%, and a relatively low growth rate of real GDP, 2.38%. Thus the belief that there is always and necessarily high correlation between the rate at which the government creates money and the rate at which price inflation occurs is totally *groundless.*"

Sincerely,

André Marentette

NASPPA

March 26, 2007

Right Honourable Stephen Harper
Prime Minister of Canada
Office of the Prime Minister
80 Wellington Street
Ottawa, ON K1A 0A2

Sir:

I am very much afraid that Canada is losing its independence and sovereignty through the on-going discussions by the representatives of Mexico, the United States and Canada under the North American Security and Prosperity Partnership Agreement (NASPPA). Will you stop these discussions until the members of parliament have fully disclosed the contents and meaning of NASPPA to all Canadians?

No doubt you are aware of the "Integrate This Teach-in" on NASPPA organized by the Council of Canadians which will take place this week-end in Ottawa. Will you attend and learn how ordinary Canadians feel about this Matter?

Richard Priestman

A strange mystique had been engendered in the public mind about the nature of money and its creators. They had been cast in the role of priests in a temple, practicing some occult science which was beyond the comprehension of ordinary men and women. Even the brightest of scholars, economists and politicians could not be persuaded to declare themselves openly, or try to understand.

Meanwhile that under-developed Third World was descending into trauma, hopelessness and misery. Millions were starving where they had never starved before, this because governments had stopped growing food for the people, and were cultivating lucrative cash crops which would sell in Western markets, and pay the bankers' interest.

Borrowing As If There Was No Tomorrow

On the other hand the global finance establishments of Europe and America were enjoying an era of previously unimagined prosperity. Almost everyone was borrowing as though there was no tomorrow. Giant corporations were emerging from the smoky atmospheres of the dealing rooms, and projecting their earnings in multiples for three, four, five, six years ahead. A new breed of auditor was pressed into service to monitor the new creative accounting practices of the computer age, and on Wall Street the Dow Jones index of share values went bounding into the stratosphere, fuelled by hedge funds and derivatives.

It would all go wrong of course. One of the iconic symbols of the high-flying corporate establishment suddenly fell to earth when it was revealed that multi-million dollar profits recorded on its latest balance sheet were actually bank borrowings which the new breed of creative accountants had introduced as earnings. There were ominous signs that a whole generation of American investors could lose their shirts, and be forced back to work out of leisured retirement. A newly elected President would shut his eyes to the financial chaos at home, and go looking for enemies abroad. Now everyone was in debt, and those who should have been bending their minds to an understanding of the Secret of Money were turning to bread and circuses.

Satanomics now, as being the sort of financial and economic system His Satanic Majesty might adopt for control of His Earthly Kingdom? Well as a matter of fact the jury are still out on that one.

James G. Stuart

Maps Leading Where We Don't Want to Go

If we are driving over unknown parts of the country and end up in the wrong places, the first thing we do is consult a road map to find where we may have made a wrong turn. We seek reliable information on how we got from where we knew where we were to where we did not want to be.

It would be logical to do something similar when we are shocked about the way in which society is headed. One of the key branches of information that for the record of how our government is running the land is its accountancy; and one of the most basic bits of accountancy is the distinction between current spending that serves us only during a single successive year. These must be treated as "current" spending, that are used up by the year end. Other expenditures are investments, that will continue serving us for several years, or even for generations.

Such expenditures must not be written off in a single year. If the government did that, it would not be informing but be reporting a deficit in its accounts that does not exist. If a private taxpayer followed this method, he would be sued by the government for having grossly understated his earnings and eluded due taxation.

But there are yet other effects of using what is known as "cash accountancy" – i.e., recording the amount of money that has been spent in the course of the year, while making no distinction between that, having been invested, rather than just spent, and given rise to capital assets that will only gradually lose their market value. That is known as "depreciation." And the gradual repayment of the debt incurred to acquire the capital asset is known as "amortization." The two do not necessarily coincide in their rates of growth. But they do have the general effect of balancing each other. Leave one out and record the other, and you distort both the costs of the infrastructure or the burden that it may represent. If you fail to make the infrastructure spending – whether maintenance of existing infrastructure or new infrastructure that is needed – you will exaggerate the "fiscal prudence" of the government – a favourite political trick.

The way to deal with that is to list any maintenance or replacement costs of necessary infrastructure that should be but are not made as a *capital deficit*. Sooner or later that will have to be made good with penalties both in human lives and monetary outlay. That subject is gently grazed in the next-to-last paragraph of Bob Herbert (*The New York Times*, 04/05, "Our Crumbling Foundation"): "Through the establishment of a national trust fund for example of a federal capital budget: a national trust fund is too remote and 'long-term' and a 'federal capital budget,' and find it very difficult to elbow their way into the nation's consciousness."

However, without a debit item to offset the false asset supposedly resulting from not having spent the necessary funds for essential infrastructure or its maintenance, you simply haven't applied double-entry accounting that the Crusaders are reputed to have brought back from the Near East. What you lack, in that case, is accountancy in any earnest sense of the word. What you have had inserted in its place is misinformation. And that is no accident. From times immemorial bookkeeping and taxation have been instruments of one economic group to take advantage of another.

Elsewhere in this issue we deal with François Perroux's notion of the "dominant revenue" that explains this class role of economic theory in general and in particular the choice of such reflecting the interests of the political group with economic and political power. However, it is in the class interests of the majority of humans, including those of conscience who are members of the more privileged classes, to consider the survival needs of the human race – something that cannot survive the ruin of our environment.

Our bookkeeping, our basic information about what spending that will be used up in the course of the year, will have broken down. Or resorting to the motoring analogy. Unable to distinguished between main highway and sideroad in our road map, we have become lost in a maze of badly presented and misleading information.

With this brief note under our belts let us now return to the column of Bob Herbert in *The New York Times*: "Fifty-nine years ago this week – on April 3, 1948 – President Truman signed the legislation establishing the Marshall Plan, which contributed so much to the rebuilding of postwar Europe.

Now, more than a half century later, the US can't even rebuild New Orleans.

"It doesn't seem able to rebuild much of anything, really. According to the American Society of Civil Engineers, the US infrastructure is in sad shape, and it would take more than a trillion-and-a-half dollars over a five-year period to bring it back to a reasonably adequate condition....

"But as we learned with New Orleans, there are consequences to neglecting the infrastructure. Just a little over a year ago, a dam in Hawaii gave way, unleashing a wave 70 feet high and 200 yards wide. It swept away virtually everything in its path, including cars, houses and trees. Several people drowned.

"On the day after Xmas in Portland, Ore., a sinkhole opened up like something from a science fiction movie and swallowed a 25-ton sewer-repair truck. Authorities blamed the sinkhole on the collapse of aging underground pipes.

"Blackouts, school buildings in advanced states of disrepair, decrepit highway and railroad bridges – the American infrastructure is growing increasingly old and obsolete. In addition to being an invitation to tragedy.

"Felix Rohatyn, the investment banker who helped save New York from bankruptcy in the 1970s, has been prominent among those trying to sound the infrastructure alarm. Along with former Senator Warren Rodman, he has been criticizing the government's unwillingness to invest adequately in transportation systems, water projects, dams, schools, the electrical grid, and so on.

"He recently told a House committee

Continued on page 20

Language of Deceit on the Tongues of the Mighty

The most flattering thing that can be said of our brand new Prime Minister Stephen Harper is that he has a way with words, neoconning them into quite the polar opposite of their accepted meaning. Even a right-inclining columnist like John Ibbitson of *The Globe and Mail* (11/10, "Clean-air pledge is just political smog") draws an unflattering conclusion: "Two months ago, Intergovernmental Affairs Minister Michael Chong said Canadians would be 'pleasantly surprised' by his government's autumn proposals to improve air quality. He may have been right about the adjective; but there's nothing to justify the adverb. Stephen Harper's announcement that his government will introduce a *Clean Air Act* next week was simply a political mirage.

"When the Conservatives declared earlier this year that Canada would fail to meet its Kyoto targets, they were simply speaking the truth. The Liberal government signed the protocol committing Canada to reducing carbon-dioxide emissions, then failed to live up to that undertaking.

"But the Tories had another calculation in mind: most Canadians were confused about global warming, which may or may not be linked to increased carbon-dioxide emissions, and which may or may not be reversible.

"But urban Canadians are very aware that smog is getting worse. The government's strategy was simple: Shift the from greenhouse gases to smog. Produce a program that toughens automobile emissions and reduces the pollution from coal-fired generating stations. Ignore environmental zealots such as those at the David Suzuki Foundation, but aim for at least a partial endorsement from the moderates in the environmental movement.

"Nice plan. Isn't working.

"To reduce urban smog, the Tories needed to achieve several goals all at once : to work with the Americans to establish continental targets for reducing harmful emissions from coal-fired generating plants. And they needed to toughen emission standards at home. But there was neither time nor sufficient political capital to achieve the first goal, while the second would decrease business competitiveness and require Draconian increases in the price of cars and fuel."

The PM's Sham Diversion

"And the electorate, when it isn't demanding cleaner air, is buying stupidly huge trucks while protesting against rising gas prices. The Liberals, to their sorrow, know all about this.

"Stephen Harper wants to be known as the prime minister who tackled smog. But nothing he has offered thus far suggests that, when it comes to fighting bad air, he is anything other than just another disappointment. However, his greatest misstep that concerns the environment, has to do with greenhouse-gas targets under the Kotyo Protocol.

In the same issue of the *G&M* ("PM plans 'intensity alternative' to Kyoto" by Bill Curry and Mark Hume) we read: "Mr. Harper said his government will introduce next week its *Clean Air Act*, legislation that will trigger at least a year of talks with industry and the provinces to set mandatory reduction targets for pollution and greenhouse gases. But in responding to questions in Vancouver, Mr. Harper uttered a phrase that had the opposition fuming. 'We will produce intensity-based targets over the short range and long term and they will cover a range of emissions, not just carbon dioxide, but nitrous oxide, sulphur oxide, sulphur dioxide, and it will be a comprehensive plan.' It marked the first time the Harper government has said its plan to address global warming would be 'intensity-based.' This means industries would have to reduce emissions per unit of production, such as per barrel of oil. Lowering emissions per unit, however, does not mean that Canada's total output of greenhouse gases will decline. If, for example, there is an expansion in the oil sands, total levels of emissions would increase even if per unit emissions decrease.

"Such an approach runs contrary to Canada's commitments under Kyoto, which calls for the country's total output of greenhouse gases to decline. Last month's report from federal Environmental Commissioner Johanne Gelinas warned that, left unchecked, greenhouse gas emissions from Alberta's oil sands could double between 2004 and 2015. But Mr. Harper said yesterday technology improvements will ultimately reduce total reductions over the long term. He cited a recent federal report that says emerging technologies – such as injecting carbon emissions back into the ground – could reduce emissions by 60% in 2050."

In short, the PM is evading the issue with a plethora of "mays" and "mights" decades ahead. From this there is a lesson to be learned. Once a political leader has done a masterful job in evading one important issue, he forfeits his conscientious use of language in dealing with other key issues that may arise. He acquires, as it were, a forked tongue that wraps itself around the very words of the issue and twists language to cover up rather than to clarify. Mr. Harper's "intensity-based" emission programs warns us of what lies ahead with Mr. Harper in office. *W.K.*

Is Man Both Chasing and Driven by His Technological Tail?

Like it or not, you are going to hear a lot about subprime loans in this next while. These loans were issued to borrowers who do not satisfy the old-fashioned criteria for *sound* borrowers. Instead, new software methods for dealing with masses of credit data on millions of people, including millions of applications for mortgage loans processed in no time flat. If the resulting loans are below par, that is handled with elegance, but it does not add up necessarily to a solution. The loans are bundled and syndicated to lenders who are prepared to take on higher risk because they are sold the bill of goods that they are in a position to handle incomplete data on the individual borrowers. They simply handle higher *tranches* of risk for a higher *tranche* of the eventual rewards of large masses of risk. *Tranche* is actually a French word that is used to designate a choice bit of meat that the butcher will cut for you.

But obviously to know what you are buying you would have to know something about the entire animal, its health, its origin. Leave out some key data like that in the interests of collecting your information quickly and painlessly and you could be in for major trouble.

Tranches of Trouble

The same goes for economic *tranches.* It has always been so. But the so-called science of economics consists most often of sitting on several chairs at the same time. It does want to understand the economy, but only from an angle that reflects the interests of the group in the saddle. The interests of the underdogs in any particular society are regarded only from that angle. This really does give rise to some serious omission of data, which may distort the prevailing view of where the economy is headed. Instead of rounding up all available data relevant to what is ahead for the given economy, there is a concentration on what concerns the interest of those that have a dominant position in the economy. Such matters as unemployment may be seen as beneficial to the interests of the employers who, however, do need buyers for the goods produced by their firms. If such buyers are no longer there, they themselves may go bankrupt. because of the very low wages.

The same goes for interest rates and many other such things.

A smart Dutch physicist turned economist, Jan van Tinbergen, well over a half century ago put all this into the language of first year high-school algebra in formulating Tinbergen's Counting Law. If you can ascertain that an economic problem has say n independent variables, it needs three independent linear (first-degree, not having squares or higher powers of the variables) equations to be solved. Anything less will be misleading.

That is because equations with fewer independent variables omit crucial independent factors at work.

There was a time when every economics student learned about Tinbergen and his Counting Rule. But not any more. You can get a PhD in economics without knowing how to spell Tinbergen. And yet his test is sorely missed.

At this point let's go to *The New York Times* (23/03, "The Subprime Loan Machine" by Linneley Browning): "Edward N. Jones, a former NASA engineer for the Apollo and Skylab missions, looked at low-income home-buyers, nearly a decade ago and saw an unexplored frontier.

"Through his private software company in Austin, Texas, Mr. Jones and his son Michael, designed a program that used the Internet to screen borrowers with weak credit histories in seconds. The software was among the first of its kind. By early 1999, his company Arc Systems, had its first big customer, First Franklin Financial, one of the biggest lenders to home buyers with weak, or subprime, credit.

"The old way of processing mortgages involved a loan officer or broker collecting reams of income statements and ordering credit histories, typically over several weeks. But by retrieving real-time credit reports online, then using algorithms to gauge the risks of default, Mr. Jones's software allowed subprime lenders like First Franklin to grow at warp speed.

"By 2005, at the height of the housing boom, First Franklin had increased the number of subprime loan applications it processed sevenfold to 50,000 each month. Mr. Jones's software has been used to produce $450 billion in subprime loans.

"The rise and fall of the subprime market has been told as a story of a flood of Wall Street money and the desire of Americans desperate to be part of a housing boom. But it was the little-noticed tool of automated underwriting software that made that boom possible. Automated underwriting software spawned an array of subprime mortgages, like those that required no down payment or interest-only payments. The software effectively brought what was a niche product only a decade ago into the mainstream.

"The software itself, of course, cannot be blamed for lowered lending standards or lax controls. But critics say that the push for speed influenced some lenders to take shortcuts, ignore warning signs or focus entirely on credit scores."

Economics — An Essay in Forgetfulness

Put in clearer and more generalized terms, when technical glibness and an excess of profits aching to be reinvested beckoned, investment planners simply dropped some of the essential variables that should have been recognized in determining what was a safe investment. But the whole course of official economic theory for well over a century has been an exercise in forgetfulness. That is why Jan Tinbergen formulated his test, that has since been deeply buried and put out of mind.

"During the housing boom, speed became something of an arms race, as software makers and subprime lenders boasted how fast they could process and generate a loan. New Century. Financial, second to HSBC in subprime lending last year and now on the brink of bankruptcy, promised mortgage brokers on its Web site that with its FastQual automated underwriting system, 'We'll give you answers in just 12 seconds.'

"Dozens of little-known software companies compete with Arc Systems. With small staffs, the companies typically sell their software to home lenders with vast networks of call centers employing hundreds of thousands of loan officers. Some big Wall Street bankers bought the software, then developed their own systems. A 2001 Fannie Mae survey found that automated underwriting reduced the average cost to lenders of closing a loan by $916. The software quickly weeds out the very riskiest of applicants and automatically approves the rest.

"Early forms of underwriting were first developed and used in the 1970s to process car loans and credit card applications. By the mid-1990s, software for home buyers

with good credit had gone mainstream at Fannie Mae and Freddie Mac, the large government-sponsored mortgage finance companies, and big traditional lenders. But none had been developed for subprime lending, then a niche market."

So those at the top of the heap, merely scrapped another of Tinbergen's essential variables and made another epic conquest.

"'Automated underwriting put the credit score on so high a pedestal that it obscured the other important things, like the income actually there,' said Professor Retsinas of Harvard. 'Before there was Automated Underwriting, down payments mattered a lot. Where we have crossed the line in recent years is to say, we don't need down payment.'"

The New York Times ends it story by quoting Mr. Jones, father of Automated Underwriting: "You know that old symbol of the snake eating its own tail? Well, we've always thought the industry was that. And that's kind of where we're right now."

In fact that is where the entire deregulated, globalized financial system is today.

William Krehm

How NAIRU Became NEIRU When BIS Fell Asleep at the Switch

For two decades the central banks across the planet tortured their nations with a stubborn attempt to hammer prices flat. The financial sector had taken over power, and when that happened it really didn't matter if the goal was overshot and if prices not only flattened but dropped to the point where firms went bankrupt and prices and employment actually deflated. For in that case – those who lived on capital gains took advantage of other folk's bankruptcies. There were always enough economists around with a nose for advancement who could come up with a theory that gave the process academic respectability. Under Paul Volcker as head of the Federal Reserve in the US and John Crow at the head of the Bank of the Canada, this was the period where the holy grail ever sought but never quite caught up with – was NAIRU – the Non-Accelerating Inflationary Rate of Unemployment.

The very name of the guiding theory decided its fate, adding hundreds of millions of unemployed across the globe. For it was taken as a given that whether the price level would move and in what direction depended on the degree of unemployment. All that was left open – as in the Crusade for the reconquest of the Holy Sepulcher – was the number and extent of the sacrifices. There was only one way for the model to go if the goal was to be achieved – unemployment had to be pushed higher.

As analysis it hardly made sense. However, the money-lending class lives by the volume and rate of interest paid on debt so for them it couldn't go wrong. Other classes lose all they have by its rise. But meanwhile it had even lost the pretense of being a serious analysis.

There were in those years no lack of well-constructed analyses that laid bare the fatal flaw of NAIRU, and central bank policy based on it.

The simplest of these was formulated by a Dutch academic who had been trained as a physicist, and thus had a familiarity with physical sciences and mathematics. And he made a point keeping the maths to the simplest terms, sharing as he must have the physicists' contempt for what passes as higher mathematics amongst economists. He used no intimidating calculus and kept to what all of us learned in our first year of high schools – the solution of linear (i.e., the variables appear only in their first degree. It came to be known as Tinbergen's Counting Test and stated that if you can identify n independent variables in your linear equations that cover a given economic problem you will need n independent variables to solve the equations. Any lesser number just won't do. Using it would omit some vital factor contributing to the problems you are trying to analyze.

NAIRU's Slip Started Showing — So Enter NEIRU

From time to time central banks took to amending their model. For example the central bank of the Euro Union as well as the national banks of the individual Euro Union have switched to a model called NEIRU. These stand for the Neutral Expected Inflation Rate of Unemployment. What is interesting here is that the model-builders who ran up most of the national government debts that exist in the world by following a single objective relationship, operating through a single cause – actual unemployment, shifted the argument to a psychic one – a subjective appreciation of the amount of inflation in store. But obviously that will depend on the press coverage in our tightly controlled media, the increasingly Delphic pronouncements of central banks and so forth. Most relevant to the van Tinbergen Counting Test. it simply hops over the fence of the crucial territory marked out by it – the argument becomes a psychological rather than an objective physical one.

So long as the official model stuck to physical factors, the Tinbergen Test could readily be applied to rule out NAIRU. For example, it was simply enough to find the jump in public services made necessary by the introduction of new public services related to the prodigious process of urbanization, the introduction of new technologies, the increased average life span and the medical technologies making that possible, defense against the degradation of the environment. Such a list would show that there are a plethora of statistical grounds that prove that not everything in our price structure depends on the amount of unemployment, there are countless essential infrastructural services paid for by government and hence with taxation. This highlights key physical factors that contribute to a growing layer of taxation in price that is not market-determined. Recognize such a non-market factor in our "inflation" and the use one term ("inflation") to designate a statistical phenomenon that has a variety of causes, many of them having nothing to do with the balance between supply and demand on the market.

Clearly, that will distort the picture. That is why some four or five decades ago, I decided to use these non-market-determined factors of higher costs and hence higher prices by a different name – my choice has been "structural price rise" as contrasted with market-determined price rise. Structural price rise lends itself to ready appraisal.

Translated into terms acceptable by the Tinbergen Counting Test, it means that those who shift from NAIRU to NEIRU are merely hopping over a defining fence, shifting the analysis from a test of one independent variable "inflation" to a number of independent variables but not confining

themselves to physical factors subject to ready statistical analysis. Of course, there is a high degree of simplification in the Tinbergen Test. For example non-market-determined physical linear equations can be broken up into innumerable other physical independent factors and T(a) designating one-variable (a) may be broken up further to a three-independent variable linear equation (T (b,c,d)) but all these remain in the physical domain having to do with money spent by the private or the public sectors. And in fact the influence of factor b on the other factors may be indirect as well as direct. For example, you can – as economists often do today remove power and food prices from the price index, and refer to the result as "core inflation." However, you can do that, but it will – while eliminating the change in the price of oil at the pump, or food at the market, leave untouched the indirect influence of any movement of fuel and food prices on the price structure for the factors that are included in core inflation. For we are all accustomed to eating from time to time and getting some power to keep warm in winter.

It should be mentioned that the quality of our accountancy will play a major part in our perception of the state of the government budget, which in turn will contribute to the perceived NAIRU or NEIRU or any future doodlings that our central banks choose to perform on that theme.

Forgetting the Double-entry Bookkeeping the Crusaders Brought Back from the Holy Land

Despite the efforts of a long line of Auditors General in Canada our government wrote off the entire cost of government physical investments not incorporated as crown corporations in the year in which they were paid for (aka "cash accountancy") whereas in the private sector such investments were shown on the books of private corporations and gradually depreciated over their approximate useful life. What resulted was that the debt incurred for the acquisition was careful amortized over the approximate useful life of the asset, whereas from year 2 the value of the acquired assets was carried at a token $1. This resulted in an increase of the apparent government deficit that was not necessarily there. This most certainly resulted in the government paying higher interest rates than would appear in either NAIRU or NEIRU, resulting from a breach in double-entry bookkeeping.

William Krehm

Maps *continued from page 17*

that Congress should begin a major effort to rebuild the American infrastructure 'before it is too late.'

"'Since the beginning of the republic,' he said, 'transportation, infrastructure and education have played a central role in advancing the American economy, whether it was the canals in upstate New York, or the railways that linked our heartland to our industrial centers; whether it was the opening of education to average Americans by land grant colleges and until the GI bill, making education basic to American life, or whether it was the American highway system that ultimately connected all regions of the nation.

"'This did not happen by chance, but was the result of major investments financed by the federal and state governments over the last century and a half.... We need to make similar investments now.'

"Politics and ideology are the main reasons that government has turned away from public investment for several years. Zealots marching under the banner of small government have been remarkably effective in thwarting efforts to raise taxes or borrow sufficient sums for the kind of investment that has always been essential for a dynamic economy. That this is counter-productive in a post-20th-century world should be as obvious as the rising sun. There is a reason why countries like China and India are racing like mad to develop their infrastructure and educational capacity.

"'A modern economy needs a modern platform, and that's the infrastructure,' Mr. Rohatyn said in an interview. 'It has been shown that the productivity of an economy is related to the quality of its infrastructure. For example, if you don't have enough schools to teach your kids, or your kids are taught in schools that have holes in the ceilings, that are dilapidated, they're not going to be as educated and as competitive in a world economy as they need be.'

"Mr. Rohatyn and Mr. Rudman are co-chairman of the Commission on Public Infrastructure at the Center for Strategic and International Studies. They believe that failing to move quickly to address the nation's infrastructure needs – through the establishment of a national trust fund, for example, or a federal capital budget. – could lead to long-term disaster."

And then comes the most critically significant passage in Bob Herbert's most significant column: "But words like trust fund and long-term and infrastructure find it difficult to elbow their way into the nation's consciousness. We may have to wait for another New Orleans before beginning to take this seriously."

Indeed, all the New Orleanses in the world won't do the job, unless we recognize what the growing obstacle has been to the realization of what was well on the way to being incorporated into the national and international consciousness in the post-War II generation.

For the most part Mr. Rohatyn and Mr. Rudman, though certainly deserving applause and gratitude for their efforts, merely graze the main source of infrastructural neglect. If we may return to our metaphor of the opening paragraph of the present piece, we might say that they concentrate on the regrettable state of the roads that makes it difficult arriving at the green acres because of the neglect of the road. But there no consideration of what may have led to this incredible misinformation, that has passed for accountancy.

For decades auditor generals of governments throughout the world advocated the adoption of "accrual accountancy" that accrues the depreciation (the loss of value) of a capital assets over its useful life. This, balancing the "amortization" of the debt incurred for the acquisition of the said asset likewise "accrued" the repayment of the debt incurred to acquire the asset. Occasionally, governments to encourage the acquisition of equipment by industries they considered specially important in the national interest, so that the excess of depreciation over amortization would provide a degree of tax protection, but the two more-or-less factors were essential for double-entry bookkeeping.

Attempts were made to bring accrual accountancy into the balance sheets of European governments. Sweden had been to the fore for a while until globalization took over. Keynes proposed it in his youth for Britain, but being essentially a brilliant social-minded opportunist, he was not prepared to waste his talents knocking his head against bolted doors.

It has in fact been brought into the government books of the United States in part as of the Department of Commerce figures on government "savings." The story is told elsewhere in this issue of *ER* (page 8).

The contribution of Messers Rohatyn and Rudman, outstanding men of conscience on the subject should be pondered.

W.K.