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Hedge Funds are Johnny-on-the Job when a Firm is to be Sold or Bought

The brazen money-making repertory of hedge funds is not exhausted by buy-outs. When it comes to managing a firm they sell they can extract funds that nobody would suspect to be there and indeed often are simply not.

Again we will piggy-back on *The Wall Street Journal's* reporting (25/07, "In Today's Buyouts, Payday for Firms is Never Far Away" by Greg Ip and Henny Sender): "When a trio of private investment firms acquired Burger King Corp. in late 2002, the chain was unprofitable. But immediately it started paying off its investors.

"At the time of the acquisition, Burger King paid its new owners – Texas Pacific Group, the private equity arm of Goldman Sachs Group Inc. and Bain Capital – $22.4 million of unspecified 'professional fees.' Burger King also started paying the group quarterly fees for monitoring its business, serving on the board, and other services. The total reached $29 million by this year.

"In February, after three years of restructuring efforts under the new owners, Burger King announced plans to sell shares in an initial public offering. Three months before the sale, Burger King paid the owners a $367 million dividend. The company justified it in part by saying it had produced cash 'in excess' of its needs – and then borrowed to make the rich payment. Burger King also paid the owners a $30 million fee to terminate their management agreement.

"According to company filings, the three investors collected a total of $448 million in dividends and fees from Burger King – ap-

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An Oracle Speaks in Riddles Out of Either Side of its Mouth

The American economy and with it that of the world is fast approaching a tipping point. The US Federal Reserve, that has raised its benchmark interest rate one quarter of a percentage point every three months seventeen successive times, is currently undecided whether to go on doing so to make some very imperfect price statistics lie flat. For the skies are filled with omens of more military adventures which may appear to some as the only practical alternative to a serious recession.

In last month's *ER* ("Sewing Together the Chopped Off Limbs of the Free Market Model," I summed up the quandary of the new Governor of the Federal Reserve: "Speaking at an international bankers' conference in Washington, Mr. Bernanke warned that inflation in recent months has been running 'at or above the upper end of the range that many economists, including myself, would consider consistent with price stability.' He said Fed policy makers would remain 'vigilant to ensure that recent inflation readings don't become the norm.'

"What hit me between the eyes, is that the closest approximation to the financial Czar of the most powerful nation in the world should have decided that what to his mind is 'inflation' can be depressed to flatness with 'the one blunt tool' at his disposal – interest rates high enough 'to do the job.'"

If Greenspan and Bernanke had Run the Fed During WW II

"Let us transfer this mindset to, the fifth year of World War II. By 1944, the war's outcome was clear enough for the Bretton Woods Conference to plan the post-war financial regime. That had been possible because there had been no reliance on a 'single blunt tool,' that not accidentally happens to be the basic revenue of the banks. Interest rates at the time were minimal *and pegged.* Prices had been under control since the beginning of hostilities. As were the availability and export of domestic and foreign currencies. As a result peace was in sight after five years of warfare. The same can hardly be said of the present Middle Eastern situation after a decade of warfare. Bretton Woods led to at least three decades of healthy reconstruction and transformation of society along the lines of social justice."

Then comes the great question: Why is no one in official circles asking why the world should be depending on "one blunt tool" to fight and lick inflation rather than follow policies that worked brilliantly during that period?

And why has the work of scores of brilliant economists who developed the economic theories and policies that made this possible been expunged from our university curricula as though they at no time had existed? Of these I will mention only a single one – Jan Tinbergen – a laureated economist who originally obtained his doctorate in physics. His "Counting Rule" applied to economics a basic rule of algebra that students learn in their first year of high school – to solve a problem in which n independent variables can be identified, you need n independent equations – i.e., n policy operators. None less will do.

This, of course, elementary mathematics on which higher mathematics are based. By ignoring this the policy of our central banks today has a serious ingredient of charlatanry. It has been imposed and maintained because interest is the basic revenue of the financial sector and the battering ram that serves it to dominate the productive economy.

Nor does the concept of "core inflation" that excludes fuel and food and several other items make the slightest sense. For two reasons: (1) Nobody and no industrial process can do without fuel; (2) precisely because of that after you eliminate from your core index the sources of energy and food, their costs will still show up in part indirectly in wages and in the production costs of all the remaining items in your index. In short you have the same evasive twaddle in the choice and treatment of price statistics, as you have in the Fed's explanation of what it is up to. And that leaves out the grotesque distortions due to the treatment of physical investment in the public sector until very recently as a current expense, and the continued handling of all investment in human capital – education, health and social services-as current spending.

In the article in our last issue on Mr. Bernanke's utterances, we noted that there was no mention of the effect on the price level of the wars in Afghanistan and Iraq,

not to say of the efforts against terrorism on all continents.

That is why, I thought that all this military effort was at least being alluded to if not fully recognized or even openly mentioned in Mr. Bernanke's more recent pronouncement (*The Wall Street Journal,* 20/07). It did not speak openly about the growing range of the Mid-Eastern war, but he did tell the Senate (*The Wall Street Journal,* 20/7, "Bernanke Expects Slowing Economy to Tame Inflation" by Greg Ip and Mark Whitehouse): "The recent rise in inflation is of concern. Possible increases in (energy) and other commodity prices remain a risk to the inflation outlook." That could be charitably interpreted as an allusion to the ongoing warfare in which the US and much of the world is being engaged, gently understated to suit the Fed's panacea. But how the "one blunt tool" syndrome affects the Fed's perception of what is happening in the world appears in the rest of the *WSJ* quote: "But Fed policy makers 'project that growth should moderate to its long-term potential rate this year and next.'" One can scarcely believe that these words were uttered during the Israel-Hezbollah military interchange, and the increased prominence of Iran in the Shiite Muslim world.

The article continues, "Part of Mr. Bernanke's task was to blunt the accusation of sending inconsistent messages since taking the post on Feb. 1. In April, he raised the possibility of a pause in interest-rate increases just as inflation began to rise. The following month, he talked tough on inflation as signs of economic weakness began to gather.

"Yesterday, he appeared to seek a better balance by acknowledging that inflation was too high but laying out a forecast of slowing growth and stable energy prices under which inflation would fall back to a more comfortable level. In a significant break from Fed commentary of the past few years, he gave no signal about how the Fed would move interest rates to achieve that forecast, forcing markets to decide for themselves...."

Risk Insurance against Misinterpreting Bernanke's Mystic Prose

"Markets read Mr. Bernanke's testimony as a signal that the Fed is less likely to raise its short-term interest rate target to 5.5% at its next meeting from 5.25%. The release of the inflation data at 8:30 a.m. Eastern time, had prompted futures markets to raise the odds of a rate increase from 65% on Tuesday to 90%. But shortly after Mr. Bernanke's remarks were reported, the odds returned to 65% and stocks began to climb."

In short risk insurance can be taken out against misinterpreting Mr. Bernanke's prose, which can be considered a continuation in the torture of the language with ambiguity so regally pursued by his predecessor. And our banks, I am sure, will lose no time in "managing" the desired slices of risk in interpreting what the Fed might mean to clients for a reasonable fee.

Meanwhile, "June's energy price drop is likely to be reversed. Oil Prices have risen again as Middle East tensions fuel worries about supply. Last week, the price of a barrel of crude reached $77 a barrel, though it since has subsided. Besides pushing up inflation, high energy prices can slow growth, making consumers feel poorer and thus less willing to spend."

But all such ramblings get us further and further away from the grim fact that fighting a chain of wars against armies and terrorists is an increasingly costly undertaking beset with unknown surprises. Countering its threats and uncertainties with the deliberately ambiguous application of the single "one blunt tool" of interest rates is suicidal madness. *W.K.*

Running the Economy on Debt Growth is Making Society a Clawing Jungle

The compulsion to grow is certainly no exercise in higher morality. To begin with, who is to do the growing and at the expense of whom? Most of the problems that underlie the increasing violence in the world – of humans against the environment, of one nation and culture against another, and of classes within countries, can be traced back to this agenda. That formula applied in a limited setting with restricted resources can only be pursued at the expense of other groups, classes or nations, by taking over part of its territory, polluting the environment, blocking its trade, undercutting its prices, denying it credit except at usurious rates. Clearly feeding their own impoverished could hardly be a formula for obligatory growth.

As usual the reporting columns of *The Wall Street Journal* (27/06, "Blizzard of Deals Heralds New Era of Megamergers" by Dennis K. Berman and Jason Singer) are helpful:

"A new era of megamergers is under way. In less than 100 hours starting last Friday, $110 billion of acquisition deals were sealed world-wide in sectors ranging from natural gas, to copper, to mouth wash to steel, linking investors and industrialists from India, to Canada, to Luxemburg, to the US.

"The deals – which included the marriages of Arcelor SA to Mittal Steel Co., Phelps Dodge Corp. to both Inco Ltd. and Falconbridge Ltd., and Johnson & Johnson to the consumer brands division of Pfizer Inc. – provided striking evidence that 2006 is on pace to be the most active merger year in history, as measured in absolute dollars. The figure top $3.5 trillion by year end, based on Thomson Financial figures."

The Curse of Perpetual Growth as a Survival Need

"As was the case during the merger frenzies of the 1980s and the 1990s, the latest boom is being fueled by cheap credit, changes in technology and global competition."

That is a fair summary but it leaves out the main point. The increasing gap between country and country and between the top executives and the working staff of our large corporations did not come into being with a heavenly injunction "You shall grow ever faster, to justify the future growth of profits and salaries that have already been incorporated into your share prices and the derivatives of growth." It doesn't matter what economic theories the professors in our economics departments dream up about trickle down, the basic fact is that corporations must grow, not as an option but as a survival need. For by its very nature the modern corporation and those who head the corporative packs are hunters lavishly paid in advance for rounding up and bringing in the kill. The only alternative in that game and in the setting the gamesters have created, has become financing consumer credit at home and abroad. But that is another game, that combines poorly with the ever higher interest rates, that has become the key means of distinguishing the hunters from the hunted. And growing consumer

debt to create artificial market growth for consumer goods, like the allegedly risk-free bonds that the banks were allowed to load up with, combines badly with ever higher interest rates. For credit card and consumer debt, already stretched to the breaking point, becomes bad debt that jeopardizes the ability of the economy to qualify as a hunter rather than one of the hunted – an object for takeover at ruinously low prices because of its debt load, barely serviced or already defaulted on.

Hence it become mandatory to collect some of the bad debt, real or imagined, or perish.

What banks or financial corporations do not tackle themselves is the tough collection jobs. Like Capone, they, too, have their arm-breakers. Where there is a demand there will always be a supply. And the demand is certainly there for bringing in as high a percentage of the debts gone bad as possible. No matter by what means.

New specialties amongst debt collectors have arisen to look after this need. *The New York Times* (5/07, "An Outcry Rises as Debt Collectors Play Rough") tells a sordid tale: "The rise in American consumer debt has been accompanied by a sharp increase in complaints about aggressive and sometime unscrupulous tactics by debt collection agencies, a phenomenon that has government regulators increasingly concerned.

"In February the Federal Trade Commission, which enforces the federal law that governs debt collection practices, reported that it received 66,627 complaints against third party debt collectors last year – more than against any other industry, and nearly six times the number in 2000.

"The agencies often buy the debt from more established companies for pennies on the dollar and seek to collect even if the debt has been paid or never was valid to begin with. Sometimes consumers pay because they are worn out by threats from companies and fear damage to their credit rating."

Collecting Debts that Never Were

"One New York City victim, Judith Guillet, complained and filed a police report in 2003 after receiving a Chase credit card bill for $2,300, including five charges from Amoco gasoline stations in the Bronx. She has never owned a car or had a driver's license.

"The bank agreed that the charges were not valid, but the debt case hung on because the bank had turned it over to a collection agency. Last November, that agency obtained a court order to freeze Ms. Guillet's bank account even though it could not demonstrate that the debt was valid.

"'I feel helpless,' said Ms. Guillet, 57, retired as a nurse on full disability. 'I couldn't pay my rent, buy food, or pay my electricity bills.'

"Officials in New York City, which has some of the most stringent consumer protection laws in the country, said the number of local complaints about debt collectors more than doubled in three years – to 900 in the 2006 fiscal year which ended on Friday, from 774 in 2005, 309 in 5004, and 422 in 2003.

"The City's Department of Consumer Affairs recently subpoenaed records from eight companies with the most complaints and is considering whether to propose tougher regulations. And last month, New York's attorney general, Eliot Spitzer, sued a national debt collection company, accusing it of trying in thousands of cases to collect on debts that could not be verified.

"The Federal Trade Commission enforces the *Fair Debt Collection Practices Act*, the 1977 law that prohibits abusive, deceptive, and unfair tactics by collection agencies. Last July, the commission won $10.2 million – its biggest judgment for illegal collective practices – in a case against National Check Control of Syracuse, NJ. The company, now out of business, overstated the amounts consumers owed and threatened them with arrest and prosecution.

"In its most recent annual report on the act, the commission identified tactics that have become particularly common: misrepresenting the nature, the size and status of a debt; making constant harassing and abusive phone calls at all hours; contacting the debtor's relatives, employers and neighbors; failing to investigate claims by consumers that a debt was paid, expired or fraudulent; and threatening to sue or seek prosecution. (Such threats are illegal unless the collector has both the legal basis and the intent to take such action.)

"In addition to filing complaints with regulators, a growing number of consumers are suing over debt collection abuses, according to the National Association of Consumer Advocates.

"Stephanie M. Clarke, 36, and her husband sued the Triad Financial Corporation of Huntington Beach, Calif., in August 2004 and Verizon Wireless in Federal District Court in Santa Ana, Calif., in August 2004. After they fell behind on their car payments, the suit alleged, Triad hired a collector who threatened them with arrest, posed as a Verizon Wireless employee, changed the password on their cell phone account and obtained their cell phone records. The collector called dozens of the couple's relatives, friends and business associates, posing as a law enforcement officer and telling them there was an arrest warrant for the Clarks.

"In June, 2005, before the case was to go to trial, the companies settled with the Clarks for an undisclosed sum. (Both companies said they could not disclose the settlement because of a confidentiality agreement.)

"Eric M. Berman, a lawyer in Babylon, NY, and an officer of the National Association of Retail Collection Attorneys, whose members represent creditors, said complaints filed with the government were not always legitimate. For example, he said some debtors complain when debt collectors will not accept partial payments on the same installment terms that the original lender provided.

"'People need much more education about credit accounts and what they're getting into,' Mr. Berman said. 'In addition, there is a small minority who are scammers – people who will run up credit with no intent of paying and then try to negotiate their way out of it.'

"While consumer advocates say that abusive collection practices have a disproportionate effect on poor people with limited English, the rise in complaints seem to span the social and economic spectrum.

"Mary H. Monroe, 71, a retiree in Williamsburg, Brooklyn, received repeated calls last year from Diversified Collection Services, part of the Performant Financial Corporation of Livermore, Calif., insisting that she owed more than $5,000 in tuition and fees at a beauty school that she had never attended. 'I thought they had to be kidding,' she said.

"She said the calls continued, despite her protests that the collectors had the wrong person. 'I finally got a lawyer to write to them, and they haven't bothered me since,' she said."

Running the world on the accelerating growth of debt, not only guarantees bigger and better busts, but turns society into a clawing jungle. *W.K.*

RENEW TODAY!
(SEE PAGE 2)

As Though a Lobe of the Brain had been Excised

China is not only a country but a culture of great promise. However, it is not without equally great challenges. Its transition from the position of punching bag of the great colonial powers to its present economic might is portentous. But its current rapid development has the contradictory aspects of trying to keep ahead of its notorious social inequalities and at the same time contributing to them.

And, since the essence of what is currently in vogue in the West is 'bigger is better,' China's vast population base is both a problem the like of which the West has never had to face; and yet potentially a powerfully strategic advantage if the rapidly expanding economy should end up in open conflict with the US.

Historically, China has been the land of passively endured exploitation broken at roughly half-century intervals by widespread rebellions often triggered by Western ideas grotesquely adapted to local needs. The Tai Ping movement of the mid-1800s combined primitive Communist ideas that came down from ancient Chinese traditions with teachings of Protestant missionaries for well over a decade as it set up local governments headed by Hong Xiuquan, "God's younger Chinese Son." Moving ahead of the central Chinese armies reinforced by various European troops, it spread its doctrine. A half-century later, the movement of Sun Yat Sen mimicked European nationalism and, of course, above all the Communism of Mao Ze Dung was a deeply Chinese distortion of Marxism. As is the grotesquely capitalist Communism of today. All have this general pattern.

If the West were one tenth as well acquainted with this historical background of China, as Chinese scholars are with that of the West, we might at least be spared much inane advice directed to China.

Thus in *The Wall Street Journal* (19/07, "Chinese Economy Surges by 11.3%" by Andrew Browne) we read: "The root of China's imbalances is the money flowing in from export earnings. June's trade surplus, a record of $14.5 billion, sent the total for the first half to $61.45 billion – $54% bigger than in the year-earlier period. By year end, China will likely have foreign-exchange reserves of $1 trillion, the largest stash in the world.

"As dollars flood into China, they are bought by the central bank for yuan, a process that keeps the value of its currency stable but floods local banks with cash. Big lenders such as Bank of China and Industrial & Commercial Bank of China keep lending those funds – the loans are the source of most their profits."

The Experts Miss the Essence of Banking

Here we come upon the first powerful understatement. The commercial banks lend out – as a result of the present process – far more than the $1 trillion dollars that has been translated into yuan. What they loan out is the *multiple* of the credit they create on that *increase* in their money base. That is the essence of banking which has been omitted in the accounts of what is happening to control such inflationary expansion *without relying exclusively on higher interest rates.* For high interest rates hit the small trader the worker, the farmer, the unemployed hardest.

That is why in the depth of the Depression of the 1930s the Roosevelt government in the US in its *Bank Act* established ceilings that banks could pay for the money they borrowed or charge their borrowers. Instead it provided not "one blunt tool" – the central bank raising its benchmark interest rate to fight rising prices. It provided the alternative of reducing the leverage of the multiple of credit that banks could lend out on a given amount of cash that they held in their coffers.

Though that alternative to higher interest rates is not even mentioned, the Chinese as we reported in our last issue (quoting *The New York Times,* 17/06): "Hong Kong – China's central bank tightened monetary policy on Friday night for the second time in six weeks. Faced with the soaring growth in bank lending, the People's Bank of China announced that it would require most banks to hold 8% of their loan assets as reserves in the central bank, up from 7.5%. This means that banks will have a bit less money available to lend out for new houses, office buildings, factories and other projects, which could have the effect of slowing economic growth slightly."

So unusual is it even to read of such measures for combatting an overheated economy – past or present – that even the best reporters, presumably out of ignorance, don't grasp the major effect of statutory reserves in combatting excessive demand. The reserves they require the banks to deposit is not bank credit but legal tender, familiarly known as "cash" or "the money base" for bank credit creation. As far back as 1946 when banks had to stick to banking, the multiple of credit the bank could create to the money base they held was 11:1. But since then banks have been deregulated so that they have taken over stock brokerages, insurance companies, and mortgage companies, all of which have their own pools of cash that the banks have access to and can use as money base for bank credit creation. When last tracked – in the year 2000, the multiple of bank assets to the cash in their vaults had risen to over 400 to 1, and since then the deregulation of banks has proceeded further. We estimate that it is more likely to be 1000 to 1. If you consider the increasing presence of hedge funds and their trading of abstract risk with incredible leverage (see other articles in this issue) even that figure will be understated – particularly if you include the losses sustained by the banks in their highly leveraged gambles. The banks' losses in these are almost invariably made good by our governments plus a bonus of further deregulation.

Even the rare reporter who deigns mention the use by the Chinese central bank of the statutory reserves as an alternative or a supplement to raising interest rates fails to grasp the immense significance of the Chinese having remembered a less harmful way of reining in inflation that the West has made a point of forgetting.

This is the latest instance of China's secular sensitivity to other cultures and its genius in borrowing from them much of the symbolism, and some of the ideas, to serve its purposes.

When you compare that with the flat-footed insistence of Washington that China adopt high interest rates as the "one blunt tool" to bring down its growing balance of payments, you are left wondering, how much of this is due to simple doctrinaire insensitivity, and how much is deliberately to do on China the equivalent of what Washington inflicted on Russia after the collapse of the Soviet regime. After WW II there had been an attempt to impose balanced budgets on the Japanese government, but, with the timely help from the outbreak of the Korean war, the Japanese as an oc-

cupied land tactfully resisted those pressures of the conqueror. Unleash a climbing yuan and soaring interest rates on China, and the chances are that you would rip its social fabric apart even more drastically than happened in Russia.

In some basic respects those in power in the West have slammed shut their minds to much of the great achievements of our past. Some of these the Chinese authorities have salvaged and are beginning to make use of in a way that will give China an immense advantage in its competition with its Western rivals. Unless of course, the West awakens to the use of statutory reserves as an alternative to higher interest rates to keep the world economy on a level keel.

William Krehm

The Sweet Headaches of Too Much Cash

After years of boom, successful large corporations are left with a problem. They find themselves sitting uneasily on mountains of cash. What to do with it? Reinvest it in their own business? The very plethora of profits taken rings a warning: it may be a reminder that the cycle is well advanced and money today can be lost more readily than made. For towards the end of the boom costs are palpably up, and markets tend to be oversupplied. Keep the funds in cash, and your shareholders are likely to wonder why they are paying you in so many digits for sitting on a huge pile of cash.

Invest them in other corporations' shares or your corporation's own, and you risk at this late stage of the cycle overpaying, and seeing your purchases go down in value. Besides you become a target for a hostile takeover by other corporations that covet your cash pile. Pay some of it out as dividends, you spoil your shareholders, who will grumble when the dividends may have to be lowered as these reserves are used up. Or if it should inspire you to use it for a takeover of another corporation, you risk losing by over-paying.

"The record of most takeovers are notably mediocre or worse." *The Wall Street Journal* (21/07, "Capital Pains Companies' Growing Cash Hoards" by Ian McDonald) remarks: "S&P's Mr. Silverblatt believes that steep cash balances and pressure to seek growth opportunities could already bolster the already-rising wave of mergers and acquisitions. And corporate takeovers have a spotty track record in creating value for shareholders of acquiring firms." Particularly towards the end of a boom. Most takeovers towards the end of the cycle tend to be lucrative mostly or even only to the Merger and Acquisition Departments of the large banks who coin their inside knowledge of other peoples' affairs.

"The piles of cash and repurchased shares at these companies have hit record levels and continue to grow along with corporate earnings, creating challenges for the executives who must decide how to allocate all that capital.

"While some investors carp about managers hoarding cash rather than building their businesses, data show that companies have in fact been reinvesting in themselves. Some are acquiring other companies, although such deals are often smaller in scope than the takeovers executed in the go-go late 1990s, as executives don't want to undertake expensive deals that could hamper investor returns for years to come."

The Problems of Appraising Corporate Performance

"The cash figures are also becoming so large that they are skewing some of the yardsticks used to gauge corporate performance. For example, with more companies having bigger portions of their bottom line accounted for by interest income, it becomes harder for Main Street investors to gauge how well some corporate managers are running core operations.

"At the 174 companies in the Standard & Poor's Industrials Index with complete treasury-share disclosure, cash and the companies' holdings in their own stock topped $790 billion in the first quarter, or nearly 20% of their total market value, according to research that S&P will release today.

"That particular S&P Index excludes sectors that will always carry a lot of cash such as financial firms and utilities. The figure includes shares repurchased by the companies and held in their treasury accounts that can be used as currency either to buy another company or to fund employee compensation plans, among other uses.

"Those 174 S&P Industrials had more than $295 billion in cash in the first quarter. That equals more than 7% of the com-

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panies' combined stock market value, the highest level in nearly two decades.

"For some of the biggest and best known names, including Exxon-Mobil Corp., Coca-Cola Co. and Merck & Co., cash and the first-quarter market value of the companies' investments in their own shares added up to more than one quarter of their total market value in the period, according to the S&P, a unit of McGraw Hill Cos.

"Despite ample cash piles many companies are being careful in how they invest. Thanks to high profits driven mainly by soaring oil prices, Exxon had more than $36 billion in cash at the end of the first quarter. Earlier this year Chairman and CEO Rex Tillerson said the company plans to minimize its cash position by investing $20 billion a year from 2006 through to 2010. He also said the company was willing to be methodical, repurchasing shares and paying dividends, rather than rushing into lower-return projects.

"Microsoft said that it had more than $34 billion in cash and short-term investments on June 10. The company also announced plans to buy up to $20 billion of its own shares and plans to invest up to another $20 billion on repurchases over the next five years.

"As a group, S&P 500-stock index companies hit 16 consecutive quarters of double-digit earnings growth through the first quarter, and a lot of that money fell to the bottom line as companies continued to cut costs and otherwise improve their profitability. Companies have also been paying off their bonds and refinancing their remaining debts. Share repurchases, or 'buybacks' are in uncharted territory, too. What companies choose to do with all that repurchased stock – retire it or put it toward acquiring other companies – could have an important follow-up effect."

The Options of Too Much Corporate Cash

"Companies have three options for what to do with their cash piles. They can keep the money in the bank. Or they can turn it into shares. Or they can return it to shareholders as dividends. Finally, they can seek growth by investing the cash in their own business or buying another company.

"S&P's Mr. Silverblatt believes that steep cash balances and pressure to seek growth opportunities could bolster the already rising wave of mergers and acquisitions."

But is that good news for investors? Corporate takeovers have a spotty track record of creating value for the shareholders of acquiring firms.

As the Time-Warner merger with AOL proved, most of the sexiest mergers these days turn out to have been based, more than on anything else, on a mismatch of two contrasting systems of accountancy – of a corporation of the Old Economy (loaded with real assets that the market insists of valuing by its likely future expansion rate – which is low precisely because its real assets are immense and ratio of growth prospects are modest) compared with the high growth typical of the New Economy. In the latter earnings are low or non-existent, real assets sparse, but perceived growth prospects, depending on the modest current asset base can appear enormous.

That, as turned out in the Time-Warner AOL nuptials, can prove disastrous for the Old Economy partner to the merger and lucrative to the shareholders of the New Economy hopefuls.

All these autumnal trials of a boom already long in the tooth are in evidence in the review of *The Wall Street Journal*: "Many Americans need to look for ways to curb their spending. Big US corporations have the opposite problem.

"In February 2005, then Federal Reserve Chairman Alan Greenspan told Congress that companies' spending was lagging behind the pace of growth of their profits. Early this week, Fed Governor Kevin M. Warsh cited data indicating that cash is beginning to decline and that corporate borrowing is starting to pick up."

However, "companies are spreading their money around rather than making big-ticket, headline-grabbing purchases. Early this week, for example, International Business Machines Corp. reported cash and marketable securities, not including treasury shares, of about $10 billion as of June 30 – down 27% from the end of 2005. IBM paid cash, the result of buying 39 companies in the past three years, many of them relatively small software companies, says spokesman John Bukovinsky. The company plans to put $6 billion into Indian operations in the next three years. IBM has also significantly cut its share count through repurchases, and consistently raised its dividends in recent years."

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Hedge Funds *continued from page 1*

proximately what they initially invested. All that took place before the May stock sale, which valued their remaining stakes at $1.8 billion – more than triple their original investment.

"These are the new rules of the private-equity game, part of a gnawing wave of private money reshaping global financial markets. In many of their deals, the private equity firms have turned the buyout game on its head. In the late 1980s it was a high-risk, high-reward business that sometimes took years to pay off. Nowadays, buyouts can generate income for the firms almost immediately, long before a significant turnaround in the company has occurred. And since acquired companies frequently borrow money to pay off the new owners, many are left saddled with debt.

"Since 2003, companies have borrowed $60 billion primarily to pay dividends to private equity owners, according to Standard & Poor's Corp. that compares with $10 billion during the previous six years.

"The new power players are private financiers – hedge funds, buyout firms, and venture capital firms – that often operate with limited scrutiny from the public and regulators.

"Collectively, hedge funds, which invest in all types of assets: venture-capital firms, which invest in early-stage companies, and buyout firms, which generally buy mature businesses, managed some $1.5 trillion world-wide in 2005. That compares with $54 trillion managed by pension, insurance and mutual funds, according to International Financial Services, London, and industry group.

"But the comparison understates the large and growing influence of private money. Hedge funds have become the biggest source of trading volume and commissions for the brokerage industry, sometimes accounting for half the daily volume at the New York and London stock exchanges, according to traders.

"Proponents say hedge funds give markets flexibility and encourage risk-taking, key underpinnings to a dynamic economy. Venture capital funds have nurtured many smaller companies, and private-equity firms have made the rough choices to turn around a host of troubled companies.

"The new quick-profit buyout game is fueled by low interest rates and willing credit markets. They let private equity firms use their investors' capital, and fees mean the new owners' interests are no longer aligned with those of the company. The company can do poorly while the private equity firms do well."

William Krehm

The Age of the Market

We live in the age of the Market, written with capital M. It not only shuffles money and values around, it apparently also has a mind of its own. The endless parade of financial analysts on the TV networks money news, feed us not only with the Market's latest twist and turns, but also with its "views" on all sort of events that might influence its next move. "The Market won't like it" might be a comment to some political announcement. Or, "the energy sector was calm, showing that the Market doesn't seem overly concerned", which might refer to a flare up in the Middle East.

However, in the cool, air-conditioned rooms where zappy dressed traders watch the Market's latest movements in the numbers flickering across their screens, such events have little to do with more bombs falling or real people dying; but with what influence such events might have on oil prices, currency rates, et cetera. In short, all that which ultimately determine the value of the positions they hold in the Market.

Therefore, valuations and investment positions are all that matters when the analysts lead us into the secrets of the Market's inner working. More mundane questions that might baffle ordinary people are left out. For instance, why do stock prices of firms go up when they lay-off workers? And, why does a report, stating that real wage growth are slower than expected, trigger a stock market rally when nobody seem to mind that top executives walk away with tons of money.[1] But these are not questions that one will get answered by listening to the analysts. The point to be aware of is that in modern financial markets the focus is always on whether or not events create more 'investor value'.

The Problem of Externalities

That we are in the age of the Market is underscored by recent statistics showing that more than half of the population is invested in it. Apparently, we are well on the way to become a society of investors, a trend warmly supported by, for instance, President Bush, who showed his support by sharply cutting taxes on capital gains incomes.

This added to a paramount feature of the new economy, that it radically has rearranged incomes and wealth distribution. This is partly due to the profits reaped from market investments, but also because of skyrocketing executive pay. Modern executives have through stock options been firmly harnessed to business strategies that create "investor value", while this form of payment at the same time ensures that the executives will not be distracted by cost enhancing attempts to, for instance, create better conditions for their employees, or higher social values of their products.

However, a cloud on the firmament of the new economy is that it is not well suited to solve the problems of externalities. In the jargon of modern economists, externalities are unintended consequences of economic acts, impacting people not directly a party to them. While externalities in principle can be both beneficial and harmful, the debate within economics has focused on the harmful ones. The conundrum is that when private agents deal in a market, the market has no mechanism for redirecting the cost of removing the harmful externalities back to them.

It is clear that the modern economies have developed some serious problems caused by a number of harmful externalities that are by-products of the industrial system and prevalent transportation modes driven by fossil fuels. As they have been largely unattended to ever since industrialism moved into high gear by the mid-1850s, the accumulative effect of some of these negative externalities, such as air pollution and global greenhouse effect, now pose a major threat to our civilization.

Science has clearly documented the greenhouse effect and also that a resultant global warming are showing up in the climate data for the last hundred years.[2] Consequently, an increasing number of people are beginning to worry about these problems. This is indicated by recent opinion polls that also indicate a growing wish that governments do more about the environmental problems.

However, if concerned citizens want to privately do their own part in diminishing the problems of the externalities they face a difficult situation in the current socio-economic climate. First of all, low energy products that compete with the standard energy hogging ones come at a substantial price premium, if they can be found at all.

Secondly, going a step further and radically organize one's life-style along less energy-dependent patterns face an even more serious up-hill battle, in particular if one is dependent on a wage paying job in a city. Housing being built in these are not implementing available technologies that radically could diminish the needed energy inputs. Therefore, to reach higher energy efficiencies, costly retro-fitting would be necessary. The culprit is cost considerations by developers who, as good economic men, only think in terms of profit maximization. In this they are aided by lax standards and unimaginative city planners, who continue to develop the ever expanding suburbs on the presumption that every household will have two cars at their disposal for job commuting and shopping.

The Myth of Market Efficiency

An economy with the financial markets at its heart create institutional networks well suited to convey individual and private economic interests. Conversely, it is not be well suited to deal with community or public economic aspects, including combating harmful externalities.

The gains reaped in financial markets demand that new money constantly are feed into them. This can either be money created by banks by collateralizing rising asset values, or monetization of previously illiquid assets. Markets will also expand when the outcomes of economic growth largely befall high income households. As these have high propensities to save, a comparatively large part of their extra incomes will return to the markets as new money.

Investors in modern financial markets mostly focus on capital gains incomes, accruing from buying and selling within comparatively short time frames. This creates a pull through the whole of the economy that is driven by short term speculation. In this state of affairs, combatting externalities is viewed as profit-eroding costs that have to be avoided whenever possible.

Defendants of unfettered markets argue that the reason we don't have more energy efficient products is that the demand is simply not there. The big corporations at the center of the supply side of the economy constantly engage in expensive R&D. The result of this is the endless flood of new products we see in the markets. If demand for environmentally friendly products existed, the corporations surely could also come up with that.

But in reality most of the corporations R&D are not engaged in developing truly innovative products, but on developing in-

cremental new features of existing products, and oftentimes merely trying to package old products in new designs.

While it runs against the established myths, the reality is that financial markets view truly innovative companies as high risk and therefore unattractive as investment opportunities. Today's private investors and fund managers are increasingly unfamiliar with the actual business conditions that underlay market valuations, but rely more and more on computer generated investment models. This means that there is a tendency to heavily discount unpredictable business situations and strategies. Thus, if a firm fires workers to cut costs it's a well-known move and, accordingly, the markets will applaud by raising the value of the firm's stocks. In contrast to this, if, say, a major car maker announces investing substantial amounts in developing a viable electric car, the market will view it as the firm is trying to shoot itself in the foot in the short term, and consequently will send its stocks plummeting, even though the strategy might be sound over the long term.

A Structural Problem

For economic theory, the existence of externalities has been a long standing problem. For some time, the suggestion was in vogue that litigation would be able to re-impose the costs of externalities upon their originators. But upon closer scrutiny, a stumbling block was that this notion, in line with other neoclassical theories, would

Does Congress not Read The Wall Street Journal?

How otherwise would we go on to read in *The Wall Street Journal* (28/07, "Congress May Let Hedge Funds Manage More Pension Money" by Deborah Solomon): "Washington – a little-noticed provision in the pension bill now moving through Congress would allow hedge funds to manage significantly more pension-fund money than they can now.

"The change is the latest sign of the growing influence of the loosely regulated investment pools in all corners of the financial system – even as hedge funds resist proposals to tighten government oversight or supervision.

"The hedge fund industry which sits on assets of about $1.2 trillion, already manages billions of dollars of employer- and government-sponsored pension plans. But most hedge funds limit to 25% of their assets the amount of pension-fund money they'll take.

"The reason: Going above that ceiling generally requires a hedge fund to become a fiduciary – that is, a party with specific legal obligations towards workers and retirees – under the *Employee Retirement Security Act*, or Erisa, the federal law that sets the standards for most private pension plans. That triggers broader scrutiny and limits the flexibility and fees of hedge-fund managers."

It is clear from our preceding notes that the plan of pension funds is to bend the economy and corporations to their profit and pleasure and not to submit to supervision of what they may be up to.

"Hedge funds, largely deregulated pools of investor money, have surged in popularity and numbers in recent years as investors have pursued. They employ a wide range of complex trading strategies, including taking long and short positions on a stock and investing in credit derivatives and commodities."

When Too Many Smart People Get Too Smart

Conceptually sloughing off the risk by selling a put derivative is fine on paper, but if too many smart folk do the same thing the correspondent parties will go broke and so will the balancing strategy. All that happened in 1997 when a large hedge fund – the Long-Term Capital Hedge Fund, managed by two economists who had been awarded the so-called Nobel Prize for Economics for their cunning derivative strategies to duck risk, narrowly escaped triggering a world-wide financial collapse. It was avoided by Washington stepping in for the rescue.

"Originally aimed only at wealthy and sophisticated investors, they increasingly have drawn money from institutions like pension funds. Pension fund assets invested directly in hedge funds grew more than fourfold between January 1997 and January 2005 to $71 billion from $13 billion, according to Hennessee Group LLC, a hedge fund advisory firm.

"The provision likely to emerge in the pension bill – provided it survives a particularly contentious House-Senate conference – would alter the existing law so that hedge funds wouldn't have to count assets of public employees or foreign pension plans toward the 25% ceiling, according to congressional aides and hedge-fund lobbyists. That would allow funds to accept unlimited amounts from public or foreign funds, even if they continue to limit the amount they accept from private-employer pension funds to 25% of total assets." In short the government is stuck with the ultimate costs of cleaning up the misadventures of the hedge funds as they have in the past. That would be another link in the long chain of deregulation and the shift of control of our economy to the most gamble-prone operators whose aggressive strategies are based on the certainty that the government will clean up any ensuing mess.

"The perverse situation is that the really good hedge funds get taken up with pension investments and can't take on any more, and that forces pension funds to go to investment advisers that they didn't really want," said Lisa McGreevey, chief operating officer of the Managed Funds Association, a hedge-fund trade group that has been pushing the change.

"Besides that group, the Securities Industry Association, a major Wall Street lobby, supports the measure. The Treasury Department's top domestic financial official, Randal Quaries, told the Senate Banking Committee this week that Treasury backs it too.

"But the change is opposed by a coalition of unions and the association of state securities' regulators, which says it could risk workers' pensions. Hedge funds aren't subject to the same disclosure or other regulatory requirements as other pension-fund investments, such as stock and bonds of publicly traded companies or mutual funds. They also tend to be more risky and volatile – though sometimes they are also more profitable.

"The AFL-CIO is among those that have urged Congress to stick with existing law. 'There's a lot of public money in hedge funds and there would be a lot more if the rules are changed,' said Damon Silvers, AFL-CIO general counsel. 'You can put huge amounts of money in (hedge funds) and there is no regulatory scheme attached. That's very bad for our members.'"❧

depend on unrealistic perfect conditions in order to work. In particular, it would require that all effected parties possessed full information about the problems, something not likely to exist when the externalities are wide ranging, nor when the originators are large, secretive corporations. Therefore, it has quietly been taken of the table again by most economists, except for the most die-hard market fundamentalists.

Giving up the notion that litigation can solve the problems of harmful externalities, means that standard economics have returned to a state where it has no good answer to the externalities problem. Logically, a harmful externality will to some degree impact the utility arising from the economic activity that it is a result of. Furthermore, it can be argued that all economic activities to some extent create externalities; for instance, each extra car will add its own bit to the externality of road congestion, et cetera. Another point is that the use of finite, non-renewable resources has an externality-like character and therefore from the view of social values should be discounted by their long-term future values and not their present or near-term values as financial markets do.

Therefore, even when market exchanges are viewed as optimal seen from the point of view of the money incomes they create, their value from the point of view of social economics will be less, both by the disutility that economic activities create, but not assign a cost to, and by the difference between the present and future value of finite resources.

In other words, the social value of economic activities will always be less than their values in monetized exchanges – the latter being the sole basis for the financial markets' valuations. With the pivotal importance financial markets play in modern societies this create a serious impediment to establishing effective strategies to combat the looming environmental crises and preserve resources. This impediment can only be removed by structural reforms of the economic system. As a primary agenda such reforms must eliminate the current ability of investors to, through the mechanisms of the financial markets, put their private interests before important general social goals.

Dix Sandbeck

1. For an example of this, see Chris Isidore, *CNN Money*, Apr 7, 2006: "Average wages are up 3.4% over the last 12 months, just below the 3.6% rise in retail prices…suggesting that hourly workers are not keeping up with inflation. Still, the more modest gain in wages was seen as a positive for financial markets."

2. Reuters' article of July 23, 2006: "Does heat wave prove climate change?" include references to the recent scientific debate.

What We can Learn from China

Let us assume that our government and the academic community – that part of it that has not been given early retirement for asking impolite questions – have forgotten what was suppressed in the text books but is still in the *Bank of Canada Act*. For in this land of paradox ignoring some the provisions of our laws seems more acceptable than allowing economic texts used in our universities to go uncensored. And thus it came to pass that our banking system reverted to what brought on the 1929 Wall Street crash and a decade of depression and a devastating world war. That system is in fact working no better today than it did up to a day before the crash. In Canada our dollar gets stronger than our export industries can bear and much of our economy is depressed while our stock markets boom one week and then almost bust the next. However, the remedy for all this – that we had already learned the hard way – has escaped us again. It is no longer to be found in our textbooks and the central bank pretends that is it s in no longer the law of the land, though a few troublemakers like COMER are given to citing chapter of verse of the *Bank of Canada Act* to prove that it is still there, though majestically ignored. It is as though some malign foreign secret service – terrorists in the art of making memories and archives disappear – had been at work.

And recently the plot has thickened, we suddenly see that "Communist" China' is successfully coping with a problem that Canada seems helpless to solve: Keeping its currency from flying so high that it disadvantages our industries more than all the concessions that were to have supposedly gained from the globalization and deregulation of world trade.

Communist China is actually keeping its currency low and its export industries prospering, *without* ceding to the pressure of Washington. To that end it is making use of monetary techniques developed and successfully applied in the West that allowed a country to use its full productive potential *without* having its price level and the exchange value of its currency rise inordinately to damage it exports and its employment. Rather than depend upon "one blunt tool" – higher interest rates – to strengthen its currency and keep its price level flat as most countries of the West are doing today, the Chinese are reducing the volume of loans their banks can make by siphoning off to their central bank part of the deposits their banks take in from the public that provide most of the "money base." It is to this money base that the banks apply their "multiplier" to determine the volume of loans they can make.

You might leap to the conclusion that this is another case of the Chinese violating copyright laws, and stealing an important Western invention without paying royalties. But you would be mistaken. They could have found the details of this shrewd technique in the garbage bins of the West. Today. However, without its use, it is a moot point whether the Allies could have won WWII, for Hitler had snatched the idea from the writings of the Brit, John Maynard Keynes, and financed the German rearmament with it, and also the pioneering highway systems that were to allow him to move troops from front to front.

The Western Allies, more ploddingly, also used it to financing their WW II at about 2%, and then reconstructed their economies after sixteen years of depression and war to undreamt-of standards, assimilated a vast penniless immigration, caught up with the "hollow years" of low birth rates, and meanwhile reduced the proportion of their national debt to their Gross National Produce from 160% at the end of the war to around 25% in the mid 1970s (Canadian figures).

Counter-Espionage in Chinese Restaurants?

Surely the loss of this key monetary technique upon which Western security and prosperity depended would be considered a high-security concern. Surely it must be prompting the FBI and the CIA and their Canadian side-kicks to track down possible suspects, concentrating, of course, in noting citizens who make a practice of dining in Chinese restaurants rather than a Mcdonald's. That would be the logical story line. Fortunately, too, biometric details of the suspects could be gathered from the soup spoons as they are brought back to the kitchens of the most popular Chinese eateries.

But let's look at the hard public evidence, instead. *The Globe and Mail* (25/7) informs us: "China's President Hu Jintao is calling for steps to rein in future growth in fixed as-

sets investment growth that officials warn is exacerbating economic imbalances." When we reported the first attempt of the Chinese government along these radically 'new' lines, we observed that the American reporters didn't know what the Chinese were talking about, though it was as American as Yankee Doodle.

Now our correspondents are familiarizing themselves with that forgotten Western technique. The consoling thought is that the Chinese may indirectly be responsible for helping the West rediscover the great innovations of the Roosevelt *Bank Act* of 1935. Unless this happens, it will be another vast advantage of the Chinese in their rivalry that is clearly shaping with the US.

"China's need is to keep the economy growing fast enough to help reduce poverty while reining in a boom in construction and bank lending that it fears could spin out of control, setting off inflation and financial problems."

The US has for years tried convincing China to raise their interest rates. That would strengthen the Chinese yuan and thus make their exports less ruinously competitive with the products of the US at home and on the world market. To quote from the *G&M* piece, "Investors hope to profit from price increases and an anticipated rise in the yuan, which would push up the value of mainland assets in foreign currency terms." In short it would put finance capital even more securely in the drivers' seats.

The dilemma that China is facing in its own way is precisely what Canada needs to cope with – the devastating effects of too strong a currency and the determination of the Bank of Canada to use what it cherishes as "its one blunt tool" to deal with the contrasting economies of its various provinces. This is hardly a time for our new PM to take dictation from Washington.

William Krehm

A Lot of Soul Searching is Needed to Stop the Slaughter in Lebanon and Israel

Thomas L. Friedman's column in *The New York Times* (5/07, "The Age of Interruption") helps create an appropriate mood for this:

"Lima, Peru – The best part of this job is being able to step outside your routine and occasionally look at the world through a completely different lens. The Peruvian Amazon rain forest is such a lens, and looking at the world through this dense jungle has given me new perspectives on two issues – Middle East violence and the spread of the Internet.

"What is so striking about the rain forest, when viewed up close, is what an incredibly violent place it is – with trees, plants and vines all struggling with each other for sunlight, and animals, insects and birds doing the same for food. I was always impressed at how our Peruvian Indian guide would identify a certain bird or wild pig or possum or parrot and immediately add who its predators were. In the rain forest, everyone and everything is part of a matched pair of predator and prey.

"Yes, there is nothing like the violence of a rain forest, but it is a violence with an identifiable purpose: plants and animals demarcating and protecting territory for the survival of their species.

"I have to say that the violence unfolding between Israelis and Palestinians today is utterly without purpose. Israel has evacuated Gaza, and what does Hamas do? It doesn't put all its energy into building a nest for its young there – a decent state and society, with jobs. Instead it launches hundreds of rockets into Israel.

"The Palestinians could have a state on the West Bank, Gaza and East Jerusalem tomorrow, if they and the Arab League clearly recognized Israel, normalized relations and renounced violence. Anyone who says otherwise doesn't know Israel today. But those driving Palestinian politics seem determined to destroy Israel in its territory – even if it means destroying themselves in their own territory. Species that behave that way in the rain forest become extinct.

"As for the Internet in the rain forest, my point is this: There is none. Yes, I had to go to the Tambopata Research Centre, deep in the Peruvian Amazon, to find it, but I can report that there is still a place with no Internet or cell phone service. The fact that people could use their cell phones from atop the sacred Incan ruin of Machu Picchu, in the Andes, reminds one that there are fewer and fewer such places every day."

The Continuous Partial Attention of our Times

"As a wired junkie myself, I have to say there was something cleansing about spending four days totally disconnected. It was the best antidote to the disease of our age, what the former Microsoft executive Linda Stone aptly labeled 'continuous partial attention.'

"Continuous partial attention is when you are on the Internet or cell phone or Blackberry while also watching TV, typing on your computer and answering a question from your kid. That is, you are multitasking your way through the day, continuously devoting only partial attention to each act and person you encounter.

"It is the malady of modernity. We have gone from the Iron Age to the Information Age to the Age of Interruption. Who can think or write under such conditions? One wonders whether the Age of Interruption will lead to a decline in civilization – as ideas and attention spans shrink and we all get diagnosed with some version of Attention Deficit Disorder.

"What struck me about our Peruvian forest guide, Gilbert, was that he carried no devices and did not suffer from continuous partial attention. Just the opposite. He heard every chirp, whistle, howl or crackle in the rain forest and would stop us in our tracks and immediately identify what bird, insect, or animal it was. He also had incredible vision and never missed a spider's web, or a butterfly, or a toucan, or a column of marching termites.

"I wonder if there's a lesson there."

No question that there is. But it is not the entire lesson of our needs to grasp the tragedy of the Middle East.

For much of the rest of the answer, fortunately, we can turn to a book review in *The Wall Street Journal* (19/07, "The Tribal Way of War" by Robert D. Kaplan, a review of the book *Insurgents, Terrorists, and Militias* by Richard H. Schultz Jr. and Andrew J. Dew, Columbia University Press).

The authors raise some very sensitive neglected issues, essentially in a professional military perspective. However, within such confines we cannot possibly exhaust their implications. Still, they leave us with an improved focus on the problems involved that ultimately lie beyond the military sphere.

They write, "While the US spends billions of dollars on sophisticated defense

systems, the dime-a-dozen kidnapper and suicide bomber have emerged as the most strategic weapon of war. While we tie ourselves in legal knots over war's acceptable parameters, international law has increasingly less bearing on those with whom we fight. And while our commanders declare "force protection" as their highest priority, enemy commanders declare the need for more martyrs. It seems that the more advanced we become, the more at a disadvantage we are in the 21st-century battlefield.

"Richard H. Schultz Jr. and Andrea J. Drew, both of Tuft's Fletcher School, have produced a wise and cogent briefing book about who our enemies are and how to anticipate their field tactics. The problem is that the Pentagon, the product of a rational, science-based Western culture – relies on objective quantification for its analysis. But what happens, the authors ask, if there is nothing to quantify? What happens if the enemy is merely an organic part of the landscape, revealing its features only at the moment of attack? Well, then all we can do is study these 'idiosyncratic' human landscapes and use anthropology to improve our intelligence assessments.

"Forget Karl von Clausewitz's dictum that war is the last resort and circumscribed by the methodical actions and requirements of a state and its army. Forget Hugo Grotius's notion that war should be circumscribed by a law of nations. As the authors remind us, paraphrasing the anthropologist Harry Turney-High: 'Tribal and clan chieftains did not employ war as a cold-blooded and calculated policy instrument. Rather, it was fought for a host of social-psychological purposes and desires, which included... honor, glory, vengeance, and vendetta.' With such motives, torture and beheadings become part of the normal ritual of war.

"Because the authors take tribes seriously, they don't stereotype them. The whole point of the book is that because each tribal culture is unique, each will fight in its own way; it is a matter of knowing what a culture is truly capable of once it feels itself threatened.

"The Somali way of war – so startling to US Army Rangers in Mogadishu in 1993 – emerged from Somalia's late-19th-century Dervish movement, on which the country's top warlord, Mohammed Farah Aldid, based his strategy. What the West viewed as fanaticism was merely the Somali proclivity for judging a man's character by his religious conviction and his physical ability to fight without limits. In the Somali world view, our aversion to killing women and children was a weakness that could be exploited by using non-combatants as human shields. Clearly, the task of anticipating the enemy's tactics requires thinking that goes beyond Western moral categories."

Understanding the Tribal War Ethos of Your Enemy

"There is no better example of how traditional warrior cultures hold fast in the face of globalization than Chechnya, where cowardice is among the worst of transgressions and a dagger the most prized material item. There is in Chechnya, too, the Sufi proclivity for ascetism and mysticism; the former providing the mental discipline for overcoming physical hardships, and the latter for sustaining morale. Furthermore, the Chechens' decentralized, clan-based structure – and their tradition of raiding – help determine their guerrilla style, which has resulted in lethal hit-and-run tactics by small units on large, conventional Russian forces in the 'urban canyons' of Grozny.

"It's all in the local history. As one Afghan elder said in the early 1800s: 'We are content with discord, we are content with alarms, we are content with blood. But 'we will never be content with a master.' And so, in the late 1900s, an Afghan commander explained why the Soviet Union lost a war: His men intended to fight to the last man, while the Russians didn't.

"As for Iraq, the authors write, the traditional Iraq way of war, and how Iraq fits into the larger global jihad, could have been deduced by the US planners' for the sake of a better military outcome. Saddam expanded his military machine by tribalizing it. Rather than eliminate Sunni clan networks, he incorporated them into his bureaucratic control system. Thus if his army ever disintegrated, the results would be a congeries of Bedouin-like raiding parties with a tight social network, reprimitized for the urban jungle.

"Our progressive global culture – with its emphasize on convenience and instant gratification – finds it difficult to cope with such warriors, for whom war is a first resort rather than a last one. And what if a warrior takes command of a large and modernizing nation-state, as Iran's Mahmoud Alumadinejad has done? We are accustomed to adversarial states with rational goals, like China. In the long run, China may constitute a greater threat to American world leadership than Iran. Yet China is a traditional and, therefore legitimate power. We will have a serious military competition with the Chinese, but only through miscalculation would we ever fight them. Yet the darkest cloud on the 21st-century horizon is big states whose leaders may simply like to fight. Their reasons are tied up with price, vengeance and martial religiosity.

"The authors quote Sun Tzu, the fourth-century BC Chinese theorist of war: 'Know your enemy.' This book is a good place to start."

We have no quarrel with that conclusion, but before the researchers proceed further they will have to consult both some forgotten books on our own history and take a good look at themselves in the mirror.

The Tribal War Ethos of Bush's Globalization

From the history books they will learn of the long line of eminent conquerors. And notably they included Alexander the Great who had the good sense to withdraw from Afghanistan in good time. And before we turn too lyrical about the rationality of our military doctrine, we must enquire into our ever greater dependence on nuclear power not only to crush our trade rivals, but to muck up what we can reach of God's universe. Then we must examine the rationality and the sustainability of an economic system that has contributed to messing up our relations with the Muslim world:

1. It must grow ever faster in order not to collapse, because the growth rate is extrapolated into the remotest future and then incorporated into today's market prices of corporation stock and options. The globalization and deregulation that constitute the "Washington Consensus" can only appear to the Third World and in particular to the Muslim World as a diabolic plan of aggression.

2. The goal of Globalization and Deregulation has shifted complete economic and political power to our financial sector. This happened with the phasing out or reduction to insignificance of the statutory reserves that until the 1970s had provided an alternative to raising the benchmark central bank interest rate for cooling an overheated economy. But Islam from its beginnings had condemned even interest, let along usury, as a mortal sin: if persisted in it, it is punished by an eternity of hell-fire. Imagine what that must look like to all the sundry Muslim tribes of all branches. It is incredibly revealing of the lack of sensitivity not only to other cultures, but to our own background, and to our own aggressive vulnerabilities.

Starting with the latter, both the Old Testament and the Catholic Church severely banned or limited the devastations of interest. Venice rose to be the paramount trading power of Europe when Islam dominated the Mediterranean, by designing trading partnerships that allowed passive partners to share in profits only if they shared in the risk involved with the active Venetian entrepreneurs. I have still to come across a mention of similar adjustments in our laws and practices to make Islamic interests feel some respect for their faith.

But above all the world economy must be freed from the compulsion to go on expanding to justify the future expansion already incorporated in today's share prices. An immense literature that made it possible for the Western world to finally emerge from the Depression of the 1930s, finance its WW II at 2% and less, catch up with the neglect of 16 years of Depression and War, and assimilate a vast destitute emigration from Europe after the war, introduce a whole series of new technologies, undergo rapid urbanization, while reducing the burden of the national debt at the same time. Today even the knowledge of this has been suppressed though much of it remains in our law books.

To attain a more peaceful relationship with the rest of the world – not only Islam – we must lift the suppression of our own history. With proper programs presented in terms acceptable to Islam, and of course guarantees of recognition and peaceful coexistence with Israel, there is no reason why peace cannot be restored and maintained. It is no secret that part of Hezbollah's influence in Lebanon was achieved by its social services to the Palestinian refugees. Some promising cooperation between Israelis and Palestinians had been achieved, and could certainly be feasible on an expanded scale with the help and participation of the UN and other international bodies. After all there is a rich positive history of Muslim and Judeo collaboration in the glories of Muslim Spain. Jews like Maimonides were a bridge between Islam and the Christians, and the translators into the Christian vernacular of the Greek literature that the conquerors had brought from North Africa in Arabic translation. There were long stretches of pan-Semitic collaboration before the age of George W. And immense progress had already been made by Israel returning to Muslim nations lands conquered from them during the Yom Kippur war.

William Krehm

The New Rules of a Double Game

Recent events in the Israeli-Lebanese relationship, has led to a greater explosion of violence than understanding. In *The New York Times Magazine* (30/07, "Mideast Explosions, the Threat of Elected Islamists" by Noah Feldman), we are given some deeper analysis of the abrupt change in the political landscape of the Middle East.[1]

"In the past, Israel was the only democracy in the region, and its enemies, whether autocratic states or free-floating terrorist groups, were not accountable to a voting public. This time, however, things are different. With the Iraq war the United States introduced a bold new policy of democratization by destabilization. That policy encouraged elections in Lebanon and Palestine, opening the door to entities like Hezbollah and Hamas that are experimenting with a potent cocktail of electoral politics, radical Islamist ideology and violence.

"The most important new feature is the strange hybrid character shared by Hamas and Hezbollah: both are simultaneously militias and democratically elected political parties participating in government. In the case of Hamas, which won the Palestinian elections in January, the political wing may not be able to control the military wing, yet the party maintains a basic unity of purpose. Hezbollah, for its part, does not hold a majority in the Lebanese Parliament, but its elected leaders participate in the Lebanese government, whose democratic credentials have been cited by the Bush administration as a sign of progress.

"The dual political and military structures of Hamas and Hezbollah are not unique. The model of Islamist organizations that combine electoral politics with paramilitary tactics is fast becoming the calling card of the new wave of Arab democratization.

"For one thing, the boundary between the state and non-state violence has essentially been erased. Has the Palestinian government demanded an exchange of prisoners with Israel, or has the Hamas militia? Israel has been acting as though it were at war with Lebanon – its targets have included a Lebanese Air Force base and Beirut's international airport – but Hezbollah began the hostilities, not the Lebanese government. More important still, the fact that Hamas and Hezbollah owe much of their present standing to elections calls into question the viability of Middle Eastern Democracy as a peaceful practice. In choosing these, Islamists, Palestinians and Lebanese Shiites were in effect endorsing not only their political aims but also their commitment to violence, which was never hidden during their campaigns. It was possible that once in power, the politicians at the helm of Hamas and Hezbollah would distance themselves from violence or at least refrain from initiating it. We now know that the leaders have rejected that path.

"How will the constituencies that support Hamas and Hezbollah (H&H) react over time, to kidnappings and rocket attacks calculated, it would seem, to provoke Israeli reprisals? The elected Islamists are gambling that popular anger at Israel, apparent in the streets of Gaza and southern Lebanon in the first weeks of battle, will translate into redoubled enthusiasm for Islamist intransigence and rejectionism. This has sometimes worked for H&H in the past. Both groups came to power in part because they were perceived as the only actors willing to fight Israel head on.

"For its part, Israel is gambling that the right strategy is to make the people who elected Hamas and a government that includes Hezbollah pay for their representatives' recklessness. That is why Israel has targeted not only Hezbollah leaders and strongholds but has also bombed infrastructure that sustains daily life for everybody in Lebanon. From Israel's standpoint, this is no longer a fight with nonstate terrorists who are holding their fellow citizens hostage to their tactics. It is, rather, war between Israel and countries pursuing violent policies endorsed (or at least accepted) by their electorates.

"Israel withdrew from southern Lebanon in 2000 and from Gaza last year on the theory that disengagement would lead to fewer attacks on it, not more. Right-wing Israelis argued that withdrawal rewarded Islamist violence and that rockets would soon be fired into Israel from the very areas being vacated. Now those critics claim to be vindicated.

"The reply of the centrist Israeli government – elected on the promise that it would unilaterally withdraw from the Left Bank too – is to insist that in the long run H&H can be deterred like Israel's other Arab enemies. The route to deterrence, claims the government, is to degrade the capabilities of H&H and in the process inflict on Gaza and

Lebanon defeat in war – the same approach that eventually led the major Arab powers to stop attacking Israel a generation ago.

"The catch for Israel is that, taken too far, the strategy of making all Palestinians and all Lebanese pay for the actions of H&H may backfire. Destroying the prosperity that had begun returning to Lebanon is likely to generate fresh hatred of Israel, and Palestinians under the gun have tended to become more radicalized, not less."

Blaming Others for Troubles Caused by Your Government

"Democracy means that you cannot blame someone else for troubles caused by your own government. That is a comparatively new lesson in the region, and whether it is learned or not will determine the prospects for democracy itself. But dodging missiles and running from tanks is not the ideal circumstance for rational reflection on the nature of self-rule."

There are yet other circumstances of the Lebanese crisis that would seem to impugn the Israeli position, without, in the longer run, favouring the Arab nations. TV coverage, weary of the Iraqi and Afghan blind alley has turned avidly to footage on the incredible human suffering inflicted on the Lebanese population by the shells of the Israelis. However, the conflict began with Hezbollah with artillery moving around sheltered from one civilian institution to another. Tunnels for the purpose had been prepared long in advance. A seeming advantage for Hezbollah in the arrangement is that the inevitable casualties of civilian Arabs and their children could be used for propaganda for the cause, to the point that even Americans are inclined to forget that the artillery bombardment was begun by the Arab terrorists. Contributing to these propaganda successes is that they have offered the US media the means of shoving the Iraqi war grown stale with repeated disappointment into the thickening shadows.

Forgotten, too, is that since their great success of the Yom Kippur war that began so unpromisingly in 1973, Israel not only under leftist governments but under rightist ones looked to its defence by attempting to cultivate relatively good relations with its Arab neighbours. This included making important territorial concessions to some of these neighbours, returning lands conquered at cannon mouth. The return of The Sinai peninsula was no small example of that, as was the restitution of almost all the

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The Insider

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I was chief economist at the World Bank from 1996 until last November, during the gravest economic crisis in a half century. I saw how the IMF in tandem with the US Treasury Department responded. I was appalled.

The global economic crisis began in Thailand on July 2, 1997. The countries of East Asia were coming off a miraculous three decades: incomes had soared, health had improved, poverty had fallen dramatically. Not only was literacy now universal, but on international science and math tests, many of these countries outperformed the US. Some had not suffered a single year of recession in 30 years.

But the seeds of calamity had already been planted. In the early 1990s, East Asian countries had liberalized their financial and capital markets – not because they needed to attract more funds (saving rates were already up 30% or more) but because of international pressure, including some from the US Treasury Department. These changes provoked a flood of short-term capital. In Thailand, this short-term capital helped fuel an unsustainable real-estate boom. Just as suddenly as capital flowed in, it flowed out. And, when everybody tries to pull their money out at the same time, it causes a big problem.

The last set of financial crises had occurred in Latin America in the 1980s, when bloated public deficits and loose monetary policies had led to runaway inflation. There, the IMF had correctly imposed fiscal austerity (balanced budgets) and tighter monetary policies, demanding that governments pursue those policies as a condition for receiving aid. So, in 1997 the IMF imposed the same demand on Thailand. As the crisis spread to other East Asian nations – and even as evidence of the policy's failure mounted – the IMF barely blinked, delivering the same medicine to each ailing nation that showed up on its doorstep.

I thought this was a mistake. For one thing, unlike the Latin American nations, the East Asian countries were already running budgetary surpluses. In Thailand the government was running such large surpluses that it was actually starving the economy of much-needed investment in education and infrastructures, both essential to economic growth. And the East Asian nations already had tight monetary policies as well: inflation was low and falling. The problem was not imprudent government as in Latin America; the problem was an imprudent private sector – all those bankers and borrowers, for instance, who'd gambled on the real estate bubble.

Under such circumstances, I feared, austerity measures would plunge the East Asian economies into recession or even depression. High interest rates might devastate East Asian firms, causing more bankruptcies and defaults. So I began lobbying to change the policy. I talked to Stanley Fischer, a distinguished former Massachusetts Institute of Technology economics professor and former chief economist of the World Bank, who had become the IMF's first deputy managing director. I met with fellow economists at the World Bank who might have contacts or influence within the IMF, encouraging them to do everything they could to move the IMF bureaucracy.

Convincing people at the World Bank proved easy; changing minds at the IMF was virtually impossible. When I talked to people at the IMF Asian, they would at first resist. Then they would retreat to another response: if only I understood the pressure coming from the IMF board of executive directors – the body appointed by finance ministers from the advanced industrial countries that approves all IMF loans. With everything going on behind closed doors, it was impossible to know who was the real obstacle to change.

Of course, everybody at the IMF assured me that if their policies really turned out to be overly contractionary, then they would reverse them. This sent shudders down my spine. It takes 12 to 18 months before a change in monetary policy (raising or lowering interest rates) shows its full effects.

How the IMF "Negotiates"

Officially, of course, the IMF doesn't "impose" anything. It "negotiates" the con-

ditions for receiving aid. But all the power in the negotiations is on one side – the IMF's – and the fund rarely allows sufficient time for broad consensus-building or even widespread consultations with either parliaments or civil society. Sometimes the IMF dispenses with the pretence of openness altogether and negotiates secret covenants.

When the IMF agrees to assist a country, it dispatches a "mission" of economists. These economists are likely to have more firsthand knowledge of its five-star hotels than of the villages that dot its countryside. They work hard, poring over numbers deep into the night. But their task is impossible. In a period of days, at most weeks, they are charged with developing a coherent program sensitive to the needs of the country. Needless to say, a little numbers-crunching rarely provides adequate insight into the development strategy of an entire nation. Even worse, the number-crunching is not always that good. Country teams have been known to compose draft reports before visiting. I heard stories of one unfortunate incident when team members copied large parts of the text for one country's report and transferred them wholesale to another's. They might have got away with it, except the "search and replace" function on the word processor didn't work properly, leaving the original country's name in a few places. Oops.

IMF experts believe they are brighter, more educated and less politically motivated than the economists of the countries they visit. In fact, the economic leaders from these countries are in many cases brighter or better-educated than the IMF staff, which consists of third-rank students from first-rank universities.

My frustrations mounted. (One might have thought that since the World Bank was contributing billions of dollars to the rescue packages, its voice would be heard. But it was ignored almost as resolutely as the people in the affected countries.) The IMF claimed that all it was asking of the East Asian countries was that they balance their budgets at a time of recession.

Hadn't the Clinton administration just fought a major battle with Congress to stave off a balanced budget amendment in this country? And wasn't the administration's key argument that, in the face of recession, a little deficit spending might be necessary? Quite frankly, a student who turned in the IMF's answer to the test question would have gotten an F.

As the crisis spread to Indonesia, I became even more concerned. New research at the World Bank showed that recession in such an ethnically divided country could spark all kinds of social and political turmoil. So in late 1997, at a meeting of finance ministers and central-bank governors at Kuala Lumur, I issued a carefully prepared statement vetted by the World Bank. I suggested that that the excessively contradictory monetary and fiscal program could lead to political and social turmoil in Indonesia. The Fund's managing director, Michel Camdessus, said there what he'd said in public: that East Asia simply had to grit it out, as Mexico had.

But that was an absurd analogy. Mexico hadn't recovered because the IMF had forced it to strengthen its weak financial system, which remained weak for years after the crisis. It recovered because of a surge of exports to the US which took off thanks to the US economic boom, and because of NAFTA. By contrast, Indonesia's main trading partner was Japan – which was then, and still remains, mired in the doldrums. Furthermore, Indonesia was far more politically and socially explosive than Mexico, with a much deeper history of ethnic strife. And renewed strife would produce massive capital flight (made easy by relaxed currency flow restrictions encouraged by the IMF). But none of these arguments mattered. The IMF pressed ahead, demanding reductions in government spending. And so subsidies for basic necessities like food and fuel were eliminated at the very time when contractionary policies made those subsidies more desperately needed than ever.

By January 1998, things had gotten so bad that the World Bank's vice president for East Asia, Jean Michel Severino, invoked the r-word (recession) and the d-word (depression) in describing the economic calamity in Asia. Lawrence Summers, then deputy treasury secretary, railed against Severino for making things seem worse than they were. But what other ways were there to describe what was happening? Output in some of the affected countries fell 16% or more. Half the businesses in Indonesia were in virtual bankruptcy, and, as a result, the country could not even take advantage of the export opportunities the lower exchange rates provided. Unemployment soared, as much as tenfold, and real wages plummeted – in countries with basically no safety nets. Not only was the IMF not restoring economic confidence in East Asia, it was undermining the region's social fabric. And then, in the spring and summer of 1998, the crisis spread beyond East Asia to the most explosive country of all – Russia.

The Architects of Russia's Calamity

The calamity in Russia shared key characteristics with the crash in East Asia – not least among them the role that the IMF and US Treasury policies played in abetting it. But in Russia, the abetting began much earlier. Following the fall of the Berlin Wall, two schools of thought had emerged concerning Russia's transition to a market economy. One of these, to which I belonged, consisted of a mélange of experts on the region, Nobel Prize winners like Kenneth Arrow and others. This group emphasized the importance of the institutional infrastructure of a market economy – from legal structures that enforce contracts to legislatory structures that make a financial system work. Arrow and I had both been part of a National Academy of Sciences group that had a decade earlier discussed with the Chinese their transition strategy. We emphasized the importance of fostering competition – rather than just privatizing state-owned industries – and favoured a more gradual transition to a market economy (although we agreed that occasional strong measures might be needed to combat hyperinflation).

The second group consisted largely of macroeconomists, whose faith in the market was unmatched by an appreciation of the subtleties of its underpinnings – that is of the conditions required for it to work effectively. These communists typically had little knowledge of the history or details of the Russian economy and didn't believe that they needed any.

Unfortunately for Russia, the latter school won the debate in the Treasury Department and in the IMF.

We all know what happened next. In the December 1993 elections, Russian voters dealt the reformers a huge setback, from which they have yet really to recover. Strobe Talbott, then in charge of the non-economic aspects of Russian policy, admitted that Russia had experienced "too much shock and too little therapy." And all that shock hadn't moved Russia toward a real market economy. The rapid privatization urged upon Moscow by the IMF and the Treasury Department had allowed a small group of oligarchs to gain control of state assets. By paying insufficient attention to the institutional infrastructure that would allow a market economy to flourish – and by easing the flow of capital in and out of Russia – the IMF and Treasury had laid the

groundwork for the oligarchs' plundering. While the government lacked the money to pay pensioners, the oligarchs were sending money obtained by stripping assets and selling the country's precious natural resources into Cypriot and Swiss bank accounts.

The US was implicated in these awful developments, In mid-1998, Summers, soon to be named Robert Rubin's successor as secretary of the treasury, actually made a public display of appearing with Anatoly Chubais, the chief architect of Russia's privatization. No wonder anti-Americanism spread like wildfire.

Output plummeted by half. While only 2% of the population had lived in poverty at the end of the dismal Soviet period, "reform" saw poverty rates soar to almost 50%, with more than half of Russia's children living below the poverty line.

Today Russia remains in desperate shape. High oil-prices and the long-resisted ruble devaluation have helped to regain some footing. But living standards remain far below where they were at the start of the transition. The nation is beset by enormous inequality, and most Russians, embittered by the experience, have lost confidence in the free market.

The East Asian Mess

East Asia is better off, though it still struggles, too. Close to 40% of Thailand's loans are still not performing. Indonesia remains mired in recession. Unemployment rates remain far higher than before the crisis, even in East Asia's best performing country, Korea. IMF boosters suggest that the recession's end is a testament to the effectiveness of the agency's policies. Nonsense. Every recession eventually ends. All the IMF did was make East Asia's recession deeper, longer and harder. Indeed, Thailand, which followed the IMF prescriptions the most closely, has performed worse than Malaysia and South Korea, which followed more independent courses.

I have often been asked how smart – even brilliant – people could have created such bad policies. One reason was that these smart people were not using smart economics. Time and again, I was dismayed how out-of-date – and how out-of-tune with reality – the models employed by Washington economists were. For example, microeconomic phenomena such as bankruptcy and the fear of default were at the center of the East Asian crisis. But the macroeconomic models used to analyze these crises were not

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On Politicians Who Commit Themselves to Retiring the Government Debt

When you suddenly feel the smell of smoke in a large building, it is often wise to take a look at what might be going on remote from the living room – in the cellar. That thought occurred to me on reading an item in *The Globe and Mail* (25/07, "PM has little spending room, economist says," by Steven Chase):

"Stephen Harper's Conservative government is barely able to afford its election promise to chop the GST by a second percentage point within five years, a senior Canadian economist says.

"Toronto-Dominion Bank chief economist Don Drummond said Ottawa's fiscal outlook is tighter than it has been in nearly a decade, after two successive budgets that doled out tens of billions of dollars in spending hikes and tax cuts.

"Mr. Drummond said the federal government will be hard pressed to offer significant new cash to the premiers, who want more federal funds to fix what they say is a 'fiscal imbalance' between Ottawa and the provinces. Mr. Drummond warned that the federal government, which has already cut the Goods and Services Tax to 6% from 7%, cannot afford more than $1 billion in additional annual spending without jeopardizing Ottawa's capacity for a second percentage-point cut in the GST by the 2010-2011 fiscal year.

"Ottawa is in little danger of slipping into deficit. Mr. Drummong projected it will reap surpluses of $25.9 billion over 5 years.

"But there is not enough spare cash in any one of those years to fund the full annual cost of a GST cut, because another Tory election pledge means that 60% of that $25.9 billion will be used to pay off the national debt at a rate of $3 billion a year."

That gives us our first hint at where in the back room or the basement we must look to locate the source of the trouble. Since the talk is of a lack of "spare cash," let us reach into our wallets and take out a sample of this allegedly imminently scarce substance and examine why if it is so important, it should be so scarce. It doesn't matter what the denomination might be – a five dollar, ten, twenty or a $100 bill. What you will find is not what used to be there before the early 1970s: the Government of Canada "promises to pay 20 dollars" or the "Bank of Canada promises to pay $20 dollars in gold," but today that has been replaced with Canada – Twenty dollars. The money is no longer a promise to pay on demand, but *is* the cash itself – it *is* the money in which government debt is paid – that is why it is called "legal tender." It can be tendered in payment of any private debt. And if the creditor doesn't accept it, he can lump it. His debt is void. The creditor cannot sue in court for any other payment.

Not can we leave the matter there. We must go on to ask what the Conservatives meant when they promised to pay off $3 billion dollars a year of Canada's debt? Clearly it means recalling debt that we have just described either in the form of bills or just computer entries, based on nothing more than the central government's credit. If you pay that off you would be left without money in the hand. If you pay part of it off, money becomes scarcer, making it more difficult and dearer for businesses to finance their projects, and thus increasing unemployment. It becomes more difficult for the government to finance essential infrastructure and services. Long before you finished retiring the total federal debt, the country would be torn apart, starving in tatters.

An important secondary lesson can be learned en route to the really big one – wherever a demagogic politician detects public ignorance on this matter, even if he knows or should know better, he is likely to climb aboard that band wagon. For example Bill Clinton joined the chorus, because his entire strategy after his first defeat while running for reelection as governor of Arkansas was "never to lose the political center." The political center is the legendary beast that comes up with the money to finance TV time during political campaigns. But obviously we can hardly keep society in one functioning piece if we yield to such temptation. In our Canadian garden not only Stephen Harper, but Paul Martin went along with reducing the debt by a quarter or a half when ever asked for his position in the matter. Of course, he knew better. As must Stephen Harper. You cannot have democracy with that sort of contempt for the

intelligence of your fellow citizens.

Franklin D. Roosevelt honestly believed in such rot during his first campaign for the presidency. But once in the presidency, he came to realize the need for ever more government investment in capital projects to restore the economy when the private sector had become paralyzed with fear and corruption. And such government projects could only be financed by government debt, which came to replace the gold that was theoretically still the money standard.

And another indication of Roosevelt's greatness was that anybody with a view on how the economy might be gotten to function again had no difficulty in getting the ear of the White House.

If that existed today, the politicians would long since have learned that paying down the debt can serve as a most useful tool when the economy is fully functioning and there is too much demand – i.e., too much money supply – to avoid real "inflation." Then the government should shelve economic programs that can be postponed until the economy has moved to the other part of the cycle when there is not enough demand to keep willing workers and available materials and plant busy. Cutting the baby in two even when it is done neatly down the middle and the unfavoured half thrown a way is not a helpful formula for infant care. But that is what the old political parties are offering us, while the NDP and the other lesser groups in Parliament just avoid the issue like the plague.

Roosevelt's Bank Act and the Ungrateful Bankers it Saved

Roosevelt's *Bank Act* of 1935, provided not only for raising or lowering the benchmark interest rate of the Federal Reserve to keep the economy on an even keel, but offered an alternative less harmless means of doing so. Interest is, of course, the prime revenue of money-lenders and banks and if reduced to "the one blunt tool" for fighting inflation, can readily put economic and hence political power in the hands of speculative finance. Since that in fact had been the major factor in the Crash of 1929 that brought on the Great Depression, Roosevelt was very alert to this. He therefore provided an alternative policy to avoid leaving absolute economic power with the financial sector. Accordingly, the commercial banks were required to redeposit a modest portion of the deposits they received from the public as statutory reserves with the Federal Reserve. Because one of the purposes of these reserves was to increase or decrease the leverage of the lending the banks could do on a given cash base, it was important to have those reserves non-interest bearing. Otherwise the device would forfeit its effectiveness. Instead of constituting the denominator of the ratio of new interest-bearing "near-money" that the banks could create on a given money-base, the denominator of the crucial ratio would also earn the banks money and the critical ratio would lose part of its significance. For that was to decrease purchasing power during a boom and increase it during a recession. Similarly the gold and silver reserves that the banks had kept as reserves to guarantee their both their solvency and their liquidity earned no interest whether held by the banks to guarantee their loans or later entrusted to a central bank for the same purpose.

But those statutory reserves served still another purpose. Cost-free to the central bank it provided it with more elbow-room for the central bank to make loans to the government within the restrictions in force. In this way they helped overcome the concern of bank economists that the government would run out of money. They should concentrate such concerns on the use that the our deregulated banks have made of the many billions of money that were shifted from social programs to bail out the banks from the losses sustained in gambles incompatible with banking. The extent of that appeared in the evidence before the US courts, that disclosed the part that three of our five largest Canadian banks played not only in financing but in the CIBC designing side shows to the main Enron scandal that ended up in an out-of-court settlement of these banks as high as 2.4 billion US dollars in the case of CIBC.

It had been a key provision of the *Bank Act* adopted under President Roosevelt in 1935 that banks would not be permitted to acquire interests in the other financial pillars – the stock market, insurance and real estate mortgages. Such features of that Act pretty well became the model throughout the non-Communist world. There are abundant indications that the Canadian banks may soon be in need of another bailout. And bank economists – as those of the government and those of Academe – would be well-advised to disinter the suppressed details of the bailout of the early 1990s. There is no way in which our society could be subjected to a repetition of the bleeding that its most vulnerable members underwent in the late 1980s and early 1990s and survive.

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typically rooted in microfoundations, so they took no account of bankruptcy.

If the IMF and Treasury had invited greater scrutiny, their folly might have become clearer much earlier. The Treasury Department is so arrogant about its economic analyses and prescriptions that it often keeps tight – much too tight – control over what even the president sees.

To what extent did the IMF and the Treasury Department push policies that actually contributed to the increased economic volatility? Treasury pushed liberalization of Korea in 1993 over the opposition of the Council of Economic Advisers. Treasury won the internal White House battle, but Korea and the world paid a high price. Did America – and the IMF – push policies because we – or they – believed they would help East Asia or because we believed they would benefit financial institutions in the US and the advanced industrial world?

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left bank and Gaza; to governments some of whose members still refuse to recognize Israel's right to exist.

The physical dimensions of Israel are puny. Any military engagement in its defence will have to be fought outside its borders. That has determined the Israeli defence doctrine – the army is a citizens army with every man and woman undergoing military training and liable for service in defence of the country. The other part of picture is that Syria as a client of the former Soviet Union has a Soviet-trained army that accordingly relies inordinately on its Russian-produced artillery. That, too, enjoins an Israeli defence doctrine of dealing with any aggressor long before he crosses its borders.

War is war, and the firebombing of Dresden by the Allies and the atom bombs dropped on Hiroshima and Nagasaki all occurred needlessly when the war had essentially been won. I am not aware that the Allies compiled statistics of innocent women and children amongst the victims. The evil is war that should not be advocated or indulged in Once engaged in, the goal is victory. Those who have made a specialty of suicide bombers are given to seeking their targets in innocent civilian crowds to maximize the horror rather than confining themselves to military parade grounds.

The Editor

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A Tollgate Economy

You may have heard that "there's no free lunch." *Tanstaafl*. That was the word when economists began to address the environmental issue as it gained popular momentum in the late sixties-early seventies. According to the economic theory prevalent since the turn of the 20th century, payments to factors of production exhaust the total product. The important corollary is that all incomes are earned. Some early developers of this theory went so far as to assert that everyone receives in compensation the value of what they contribute to society – in a "free market" economy. That is, the income of an individual consists of payments for the value of productive factors he or she has "supplied" to the collective enterprise – the national income. The inevitable inference was that if people wished to reduce resource depredations and biosphere destruction they would have to pay for it out of their earned contribution to the national income.

But what if the highest incomes aren't really earned, and that their recipients are among the worst offenders in raping the earth? Maybe a few members of society are getting not only free lunch but also lavish dinners out of collective wealth and the labor of the majority. Authoritative and widely reported studies show that over the past five years income and wealth in the US have become more concentrated than at any time in its history.[1] Commentators regularly point out the contrast with the mid-century US economy that was more equalitarian as a consequence of political action and regulation. Jared Bernstein has observed that "Economics, once an elegant and sensible set of ideas and principles devoted to shaping outcomes for the betterment of society, has been reduced to a restrictive set of ideologically inspired rules devoted to an explanation of why we cannot take the necessary steps to meet the challenges we face." (*Tanstaafl*) The multi-million dollar compensation packages received by chief executives of failing corporations puts a severe strain on the credulity of these payments as the "value of productive services provided."

The Bernstein comment is a reminder that economics evolved as arguments for the advantages and value of removing restrictions to trade. Studies in medieval and early modern economic history point out that commerce was inhibited for centuries by payments demanded for the movement of merchandise through roads, rivers and ports by persons or groups who could dominate strategic locations where they operated tollgates. Merchants and financiers opposed them of course, and princes eventually found that fewer such impediments increased their own revenues as the realm prospered. Thus, as governments gained more power over regions, regulations became more systematically designed to foster collective productivity and well-being by minimizing unproductive constraints and tolls on commerce. The deliberate focus on principles for increasing the commonwealth evolved into *political economy*. This focus explains why the first professors of political economy in Britain were appointed to faculties of the *moral sciences*. For questions of *what ought to be done* call for an application of *practical* reason in Aristotle's terminology, as contrasted to speculative (*what is*) and productive (*how to do*) uses of the mind.

The Concept of Economic Rent

The "no free lunch" stance of current doctrine is contradicted by economists who have been studying *unearned incomes* from early days of the specialty. (The extortion of tolls is a fitting metaphor.) In the economics literature, payments that individuals or companies are able to extort due to strategic advantage (or unique personal attributes) have been labeled *rent*. David Ricardo focused on the payments to aristocratic landlords from persons who labored on the land to make it productive, but in venerable English usage rent was a payment exacted from those who had insufficient will or ability to resist. These *rentier* incomes have been a focus for analysis of disparities in the sharing of collective wealth.

Michael Hudson is an analyst and historian of finance and of economic thought. He has explored the evolution of opportunities to extract rents, from pre-industrial Britain to our own times. It is a story of social change in response to technological developments. In a recent speech he showed how banks and other financial institutions have replaced landlords as the primary tollgate operators. As prelude to that, he gave some hints of the immense magnitude reached by the "tolls" in the 21st century. Most of what follows is direct quotation from the text of his speech.[2]

"Suppose someone at the end of World War II had been informed of the remarkable technological breakthroughs that have occurred over the past 60 years – the advances in medicine and pharmaceuticals, genetics, air and even space travel, communications, computers and information processing, atomic power, and a better ecological understanding of how our planet works. The expectation might reasonably have been for a leisure economy in which citizens could devote themselves to better educational and cultural pursuits. That was what futurists promised as they looked at the great potential of technological progress. Why haven't these rosy pictures materialized? Why are employees working longer than ever before, with many couples holding three jobs between them? How can GNP be rising at about 4% a year in America while real wages have been drifting downward since 1979? Where are the fruits of productivity going?

"Henry George asked the same question in the 19th century: Why there still was so much poverty in the face of the Industrial Revolution's remarkable explosion of productive power. His answer was that rent – and rising land prices – was diverting the economic surplus away from capital formation and consumption, exploiting both capital and labor. But the problem does not stem only from land-rent. The most notable examples of prices and incomes without corresponding (necessary) costs of production are finance and insurance, whose interest, commission and policy charges are set independently of costs. And much of what passes for industrial profits actually consists of monopoly rent and "intellectual property rights." These rents are highest in areas where productivity and technological breakthroughs since World War II have been largest and were expected to bring society the greatest benefits.

Tollgate Operators are Creative

"Instead of showing up as increases to the general level of incomes, however, the benefits show up in accumulations of wealth where tollgate power is exercised by monopolies in areas such as fuels and minerals, the broadcasting spectrum and intellectual property rights. Technology has become a property right, permitting its owners to charge economic rent. The pharmaceuticals industry has been among the greatest abusers. The DNA code and even long-known Chinese herbal cures are being patented into "intellectual property." And no companies are more notorious than the HMOs

– "health management organizations" that have interjected themselves as a skimming operation [i.e., a tollgate] between patient and doctor. Broadcasting companies have privatized the electromagnetic spectrum rights originally and "naturally" in the public domain. Meanwhile, the phone and cable companies are trying to create tollgates for the Internet, much as Microsoft has become the major rent collector for information processors. The stock market's major "industrial" growth areas turn out to be examples of economic rent, although their "super-profits" are reported as profits and dividends ostensibly produced by capital. These rents create prices "empty" of actual cost-value. They are a margin over necessary production costs, siphoning off income otherwise available for spending on goods and services.

"Notwithstanding these other manifestations of tollgate power, most wealth today is still based on rent from real property (shown, e.g., in the Forbes list of the world's wealthiest people). The Federal Reserve's "Balance Sheet of the US Economy" (quarterly) shows that real estate remains the economy's largest asset, and further analysis makes it clear that land accounts for most of the gains in real estate valuation. Stock-market speculation today is largely a rent-seeking activity as companies are raided for their land or other property income. Earlier this year, corporate raiders wanted McDonald's to mortgage the land value of its restaurants and pay out the loan proceeds as dividends. This raid illustrates how today's real estate bubble[3] itself is largely a financial phenomenon. The upshot is that the mortgage banker ends up with most of the net ground-rent. Since World War II, interest charges have absorbed the increase in real estate rent as a proportion of US national income, just as interest is absorbing a rising share of industrial cash flow and consumer income.

"It is mainly rentier income that distinguishes the wealthy from the working classes. A study for the Congressional Budget Office recently showed sharply increased concentration of those incomes in recent years, largely as a result of lowered tax rates on capital income and capital gains. "In 2003, the top 1% of the population received 57.5% of all capital income." This was the highest proportion since the CBO began collecting data in 1979 – which also happened to be the year in which real wage levels peaked. At that time the top 1% of the population received "only" 37.8% of capital income…. The study concludes that "extending lower tax rates on capital gains and dividend income would exacerbate the long-term trend toward growing income inequality."[4] It illustrates the result of regressive tax policies replacing the progressive taxes that existed prior to the 1970s.

Thank you for your support!

Finance as Parasitic Tollgate

"The bulk of this *rentier* income is not being spent on expanding the means of production or raising living standards. Instead, it is channeled back into the property and stock market to buy more rent-yielding real estate or ownership rights – legal rights and claims for payment from such productive capacity as already exists. This inflates prices for these assets, making property and financial speculation more attractive than new capital formation. The economy shrinks....

"The financial industry and its creative instruments have contributed to this process. For example, absentee owners buy property rights on credit, pledging the rental income to pay the mortgage interest, in accordance with the motto "Rent is for paying interest." Equilibrium is reached when the winning bidder for a property pledges to pay all the free rental income (after costs) to carry the mortgage. The banker gets the rental cash flow, while the titular owner is willing to settle for the chance to get a capital gain. Thus the real estate game is an exercise in borrowing money to ride the wave of asset-price inflation (in which individual homeowners participate). These capital gains from asset-price inflation were called an "unearned increment" by John Stuart Mill.

"Other rent-extracting enterprises, including pharmaceutical and broadcasting companies with special monopoly, patent or intellectual property rights, have been 'colonized' in like fashion by the financial industry. It is the expectation of asset-price gains that motivates corporate raiders and other empire builders to issue high-interest 'junk' bonds, pledging corporate earnings to cover the interest charges. (Thus, *rentier* income 'is for paying interest.') Whether the *rentier* income is due to land price inflation or to other tollgate powers, therefore, it winds up in the form of interest payments. Tax systems encourage this debt pyramiding because they permit interest to be deducted as a "cost of production." The effect of buying property on credit is thus to exempt *rentier* income from taxation.

"Taxes on rental income and land-price 'capital' gains are declining as the growing political power of *rentiers* enables them to shift the tax burden onto labor and industry. Classical economists and Progressive Era reformers had the contrary objective. Their ideal was an economy in which public revenues are collected from *rentier* incomes as user fees for land sites, subsoil mineral resources, transportation and communications infrastructure and other parts of the public domain that were natural monopolies – not from taxes on wages, profits or sales. Progressive policies included taxation of economic rents, anti-monopoly regulation, and a credit system that would *finance* industrial capital formation rather than exploit it as a parasite. Incomes would be earned by productive work and enterprise to generate wages and profits, not by tollgates. Prices would reflect the necessary costs of producing goods and services, free of economic rents. The harder one worked, the richer one could become.

To achieve and maintain reforms such as these requires political clout. Why are they not high on political agendas these days? Much of the explanation, says Dr. Hudson, is that the financial and real estate interests have promoted a self-serving economic ideology and body of theory. A summary of his most interesting exposition of that theme will have to wait until next time.

Keith Wilde

1. Teresa Tritch for the *NYT* editorial board, July 19, 2006, "The Rise of the Super-Rich." The same is doubtless happening in Canada, for the same reasons, but the information is less available here.
2. "Real Estate, Technology and the *Rentier* Economy: Pricing in excess of Value, producing Income without Work" at the conference on *Economics of Abundance* at King's College, London, 3 July 2006.
3. See the feature article in *Harper's* magazine of May, 2006, by Hudson: "The New Road to Serfdom: An illustrated guide to the coming real estate collapse."
4. The statistics, based on C.B.O., *Historical Effective Federal Tax Rates: 1979 to 2003* (December 2005), are summarized in Isaac Shapiro and Joel Friedman, "New Unnoticed CBO Data Show Capital Income has Become Much More Concentrated at the Top," Center on Budget and Policy Priorities, January 29, 2006. The CBO study defines "capital income" as "interest, dividends, rents, and capital gains."

Editorial Note: Our readers may note how closely Dr. Hudson is mining the same promising vein of thought as J.W. Smith is doing in his generalization of Henry George's way of thinking. The latter was covered by ER *in its May/06 issue.*

A Bad Grade for NAFTA'S Environmental Record

If I were in a highly responsible position in the government of the US – or even that of Canada – there is one special nightmare that would disturb my slumbers. If all the millions of innocent Canadians and Americans who cross our frontier have to accept the cost and humiliation of carrying biometric identification to ensure that they have no part in a world-wide plot to blow up or poison their compatriots, should not a similar effort be made to identify and bring to justice those in government who are overlooking poisoning of the air we breathe? By shutting their eyes they are contributing to the tsunamis and the hurricanes that are causing so much damage to life and limb. A whole generation of children is growing up impaired in various ways all in the interests of greater profits.

Yet those in power point a finger at every Muslim immigrant, or even native-born of no matter what racial stock or religion. The evidence supporting such charges is neatly condensed for those who should be officially concerned about it. It appears in a shrewd bit of reporting by Martin Mittelstaedt, *The Globe and Mail's* environmental reporter (*G&M*, 27/07, "Pollution data smell foul in NAFTA report"): "NAFTA's environmental agency is supposed to be a watchdog that alerts North Americans to pollution threats, but it often't have much of a bark, let alone a bite.

"Consider one of its latest finding, an enigmatic discovery about pollution released from the 126 cement plants in Canada and the United States.

"In a report issued today, the Commission for Environmental Cooperation (CEC) says that US cement plants foul the environment with tons of tonnes of noxious pollutants such as corrosive hydrochloric acid and birth-defect-causing toluene. "There is no room left for the doubt that President Bush still finds in the relationship between planet-warming and the increased industrial output of the so-called greenhouse gases.

"Paradoxically, even though the Canadian plants are larger, US plants, on the average produce 13 times more dangerous chemicals.

"The CEC says it can't explain why one of the continent's dirtiest industries pours out pollutants in the US, but claims low levels in Canada. It doesn't know whether the information it analyzed, compiled by the Canadian and US governments from what the cement companies report is trustworthy.

"'In most cases, it was beyond the scope of this report to investigate how the data were developed or their accuracy. These facts should be kept in mind when attempting to draw conclusions about the differences in environmental performance of the facilities in the different countries,' the CEC says.

"Those familiar with the workings of the Montreal-based organization say it is being hobbled by government meddling and shrinking budgets. 'The CEC was supposed to be the environmental watchdog of North America and it has been turned into a house pet by government restrictions and budget cuts,' contends Stewart Elgie, a University of Ottawa professor and environmental law specialist."

An Agency Planned to be Non-functioning

"Even executive director William Kennedy concedes the organization is having its troubles, which he attributes to the reason the CEC was created.

"Although it isn't a household name, the commission originated in the early 1990s during the stormy debate whether a North American free-trade zone was a good idea. There were fears that a trade bloc including Mexico could lead to a so-called race to the bottom for environmental laws, with Canada and the US gutting rules to compete with a developing country.

"To allay these worries, then-president Bill Clinton pushed through a side agreement added to the North American free-trade agreement that would create a pollution watchdog.

"But Mr. Kennedy says that governments never really wanted an environmental agency and created one only because it was 'the price to pay' to blunt public opposition to the trade deal.

"In a frank admission sent in an e-mail to *The Globe and Mail*, Mr. Kennedy, whose term expires at the end of next month, says the three countries 'have never really embraced the CEC nor realized its potential.'

"Besides the head-scratching cement findings, the report being released today details how US and Canadian cement companies created about three million tonnes of pollutants in 2003. Data on Mexican companies won't be available until next year.

"The worst fears about free trade from the early 1990s haven't been realized, according to figures in the report. Pollution at US manufacturing companies declined by 21% between 1995 and 2003, and in Canada by 10%.

"Despite these improvements, controversy has been growing over whether the CEC has enough independence to blow the whistle on pollution by calling NAFTA government to account. As in the case of all of its reports, the CEC allows the NAFTA governments to pore over the findings and try to alter them before they are released. This is an unusual practice for an agency that is supposed to alert the public to pollution threats. Prof. Elgie says the governments have 'raised an ever-increasing stream of objections and complaints' about CBC reports and try to 'sanitize' them.

"The agency's budget, shared equally by the three countries, is also becoming a sore point. The amount has been frozen at $9 million (US) a year since its inception more than a decade ago.

"When the CEC was set up, environmentalists thought it would need $30 to 70 million a year. Now the agency is axing work to cope with the money squeeze. For instance, even though the trade bloc is the world's biggest emitter of greenhouse gases, the agency doesn't work on climate change.

"Critics say the Bush administration blocks such efforts, although Mr. Kennedy denies this.

"The most contentious work the CEC has done was a report issued in 2004 on the risks to Mexico of genetically modified corn, a touchy subject in the US, a big corn exporter, and in Mexico where wild relative of the staple food risk being genetically contaminated.

"The report, written by some of the world's leading agricultural scientists, recommended a cautious approach to the export of the modified corn, but this advice was denounced by the US as 'fundamentally flawed and unscientific.' The US has been pushing its exports of genetically modified foodstuffs, often getting into trade fights with Europe over the subject.

"After being assailed over its corn report, CEC's next topic of investigation is guaranteed to offend no one. It's on energy-efficient buildings."❧