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CONTENTS

3 New Year has Come and Gone and Left the Old Nonsense Still Enthroned
4 It's Time for the NDP to Speak Out on the Bank of Canada
5 John Crow Makes Amends
7 Rationality from a Maslowian View
8 Correspondence from France
9 Hedge Funds Ride the Crest of the Economy's Compulsion to Grow
10 History's Maps and Compass Cast Over the Bow into the Turbulent Sea
11 Washington's Cluelessness of What It was Getting into in Iraq has Hastened the Loss of Its Position of Lone Superpower
14 Our Deregulated and Globalised World is Producing an Excess of Liquidity
16 The Unending Confusion Brought On by Deregulation and Globalisation
17 In China Lessons Come Loud and Big
19 Putting the Pacific Ocean between Mother and Child
20 Jungles that Grow Best in Pitch-black Darkness

Untouchable Financial Structures Embedded in our Fiscal System

The New York Times (26/1, "U.S. Financial Sector Is Losing Its Edge, Report Says" by Jenny Anderson) informs us: "Adding to a chorus of concern that the United States is losing its edge as the leading financial center, Senator Charles E. Schumer and NY Mayor Michael R. Bloomberg will release a report today urging the country to improve its legal and regulatory environment.

"If not, the report warns, it could lose 4 to 7 per cent of the global financial services market over the next five years.

"'The last thing that New York and the country, for that matter, need is to wake up one morning and find we no longer are the financial capital of the world,' Senator Schumer, Democrat of New York said. 'This report shows that could happen not just for IPOs (initial public offerings), but for all financial services, all too easily and all too soon.'

"The committee's primary recommendations echo those of a similar report released in November, focusing on easing or eliminating provisions of the *Sarbanes-Oxley Act* for small and foreign companies – some steps that the Securities and Exchange Commission is currently undertaking – and curbing securities-related litigation. The latest report is one in a series commissioned in the public and private sectors voicing concern that the US is falling behind because of a burdensome legal and regulatory environment.

"The report adds some new dimensions to the debate, however, making recommendations to ease immigration restrictions facing skilled professionals from other countries, urging convergence on international accounting standards and recommending the adoption of Basel II on international accord on capital standards, without increasing capital requirements as some US regulators have suggested."

Is Crime Good for the GDP?

"Taking pre-emptive steps to address concerns about regulation and litigation might halt the country's loss of market share and add $15 billion to $35 billion in revenue in 2011 alone, the study said. It would

Continued on page 2

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Untouchable *continued from page 1*

also allow the creation of 30,000 to 60,000 jobs in the securities sector.

"Like all reports focused on American competitiveness, the latest report, entitled *Sustaining New York's and the US's Global Financial Services Leadership* and conducted by McKinsey, addresses the fact that the US now commands a significantly declining share of the global market for IPOs.

"But it also examines the broader financial services arena, including the fast-growing derivative and structured-product markets, the gigantic loan market as well as the traditional markets in stocks and bonds.

"The report shows foreign markets closing in on the US in size and in certain product offerings. For example, in 2005, American investment banking and sales and trading revenue totaled $109 billion ($69 billion in sales and trading and $46 billion in investment banking) compared with $98 billion in Europe and $37 billion in Asia.

"The US remains the largest financial market in the world, as measured by what is called 'financial stock' – equities, private debt, government debt and bank deposits – with $51 trillion in 2005, but the pace of growth was significantly slower than in other markets, especially the Asia-Pacific (excluding Japan and Britain)."

However, "emerging markets will naturally grow faster than the more developed US market. But administration officials for Mr. Blomberg and Mr. Schumer said the report aimed to address the factors particular to the US, namely litigation and regulation, which might deter business from coming here.

"Critics of easing regulatory standards and the ability to bring securities class-action lawsuits point out that litigation have been unusually high because of settlements related to the frauds that caused the collapse of Enron and WorldCom."

One might as well argue for letting up on blue-collar crime, because the profits from foreign visitors in such specialties also may contribute to the GDP by stays in Las Vegas and New York, apart from using our banking facilities for their deposits, not to say their rackets.

Since Globalization and Deregulation were brought in by those who wanted a free market, its proponents must also allow for outsourcing our financial services, including the incidental rackets that do not seem to bother them.

"Europe has a 56 per cent share of the $52 billion global revenue pool from derivatives and a 60% or greater share of revenue in interest rates, foreign exchange, equity and fund-linked derivatives. The US leads only in commodity derivatives.

"Short-term recommendations suggest improved guidance on Sabanes-Oxley implementation, including the ability for small companies within certain 'sophisticated' markets to opt out of some requirements as long as it is disclosed.

"The report suggests that the SEC use certain exemption powers to limit liability for foreign companies to securities-related damages and impose caps on auditors' damages. Like the Capital Markets Committee report in November, the latest study recommends that the SEC allow companies to mediate conflicts through arbitration rather than litigation.

"The pace of job creation in London far outstripped that of New York City, the report says. From 2002 to 2005, London's financial services work force grew by 4.3% to 318,000 while New York City's shrunk by 0.7%, or 2,000 to 328,000 jobs.

"London has been gaining an edge in attracting the largest hedge funds. In 2002, London was home to only 3 of the largest 50 hedge funds, compared with 12 today. New York had a decline: today 18 of the largest 50 hedge funds are based in New York compared with 28 in 2002. (Connecticut has gained two over that period, from 6 to 8.)"

In *The Globe and Mail* (2/01/07, "Sarbanes-Oxley: Window of truth in danger of slamming shut" by Barrie McKenna) sheds some calmer light on the campaign to tighten the morality of corporations listed on the stock market: "The drive to undo the post-Enron corporate reforms has officially begun. The US Justice Department is putting in place new guidelines to limit the power of prosecutors to play hardball in corporate corruption cases.

"Likewise the US Securities and Exchange Commission has proposed rule changes to the 2002 *Sarbanes-Oxley Act* that would lessen the auditing burden on smaller public companies to withdraw their US stock listings.

"The changes address some of what critics say was an excessive wave of corporate accounting scandals that began with Enron.

"But it's only the beginning. Corporate America has vowed to step up the fight to radically overhaul – even dismantle – Sarbanes-Oxley in 2007. In late November, a Wall Street-sponsored-committee issued a list of recommendations to roll back finan-

cial regulation. Among other things, the Committee on Capital Markets Regulation called for better protection from regulators and lawsuits for auditors, company executives and outside directors. The group also wants to restrict the ability of the SEC to make new rules, and limit its prosecutions.

"Early next year, the US Chamber of Commerce will issue a report expected to be sharply critical of the regulatory burden on public companies.

"And Treasury Secretary Henry Paulson, a former Goldman Sachs executive, will host a conference on financial market regulation."

All this – and much else listed by Barrie McKenna in the offing "…is designed to get the attention of the new Democratic-led Congress that takes over next month.... Sadly what the anti-Sarbanes-Oxley crowd overlooks is that Wall Street was badly in need of a cleanup. And Sarbanes-Oxley helped do the job.

"Last year, 1,250 companies, or 8% of all listed stocks, were forced to restate their earnings. To some, this is a costly burden on companies. To investors, it's a window of truth on corporate accounting that had begun to look more like alchemy than arithmetic.

"The law's new reporting rules, forcing companies to report stock options grants more quickly is widely credited for largely undercutting unfair benefits of back-dated options.

"What's wrong about a little accuracy in financial reporting? Nothing, it seems. US stocks have enjoyed a record-breaking run this year. So far this year IPOs have brought in nearly $40-billion (US), on par with last year's pace.

"One could draw the conclusion that Sarbanes-Oxley has been a resounding success, helping to restore confidence in a troubled market. There's little doubt that US reforms have sparked long-overdue crackdowns in other markets including Canada.

"At least, companies are spending their cash on producing more accurate books instead of outrageous options gifts and other perks."

And if our statesmen tire of straightening out the accountancy in corporate books, they could take a hard look at what passes for accountancy in our governments' ledgers. For example it was only in 1996 that the US government realized that the two main policy innovations to bail the banks out of their massive capital losses due to their repeal of the essence of the Rooseveltian *Bank Act* of 1933, were incompatible

Continued on page 6

New Year has Come and Gone and Left the Old Nonsense Still Enthroned

The major prize for bureaucratic blindness as the New Year came in, we owe the Governor of the Bank of Canada, David Dodge for his *Globe and Mail* interview with Heather Scoffield (27/12/06, "A warning for the services sector"). "Mr. Dodge was generally upbeat about 2006 and the year to come – despite the rapid slowdown that has hit Central Canada hard in recent months and is expected to persist into 2007.

"However, that doesn't mean that he takes for granted that inflation has been forever tamed by monetary policy. The Bank of Canada has devoted much effort in building up public confidence that inflation will remain low (a 2-per-cent target), and does not want to do anything that will jeopardize that 'social capital' as he calls it.

"'It is impossible to underestimate the value of that social capital,' Mr. Dodge said. 'It is part of trust, which is easily destroyed, and takes a long time to rebuild.'"

Not Only Burying History but Pinching Its Tombstone

There he is back at his old game of using the language to denote the exact opposite that it always had. Deregulation and Globalization have imposed a persistent deflation of the economy arising amongst much else from the constant outsourcing of our real production to countries with a fraction of our labour costs. Those who profit from this are the financial carpet-baggers who rummage about the wreckage of our producing economy while the living standards of our workers and their pensions take a beating. And now Mr. Dodge has even pinched the name that economists have for decades used to designate the new social infrastructures erected after World War II to assure our populations better social security, education, and health. Today you can hardly pick up a major newspaper in any part of the world without reading of the growing gap between the living standards of the financial elite and the masses of the population. So to handle that problem, with the New Year upon him, Mr. Dodge not only dodges, but buries the real issue in an unmarked grave and steals its tombstone. The *destruction* of that social infrastructure that was the major achievement of the two or three decades after WWII, he calls, "our social capital," while the real social capital is being reduced to bloody tatters.

In a period of growing population, and rapid urbanization throughout the world, as new technologies demand even far more educated consumers, let alone producers, prices move upward because more government services are called for and are paid for with higher taxation. Of course that taxation must show up as a deepening layer in price, but most economists choose to call it "inflation." It is lumped together with real "inflation," i.e., higher prices due to a shortfall of supply, and combatted with higher interest rates. That pushes up the cost of such additional government services and consequently of the private sector through even higher taxation.

There is such a thing as "real price inflation" when there is too much market demand to be satisfied by the market supply.

But prices can go up in a modern economy for reasons other than an excess of demand over supply. A deeper layer of taxation to pay for essential government-created infrastructures results in a "structural price rise" – to use a term that I coined almost a half-century ago.[1] The very air transports of globalization have brought previously unknown germs to the developed countries that require costly research and treatment. Our longer life spans require more public services, if nations are not to be beggared.

There is a heavy penalty inflicted on those who suppress history to deceive others. They themselves end up forgetting its lessons. If the Governor has really forgotten why prices and interest rates in the developed countries have settled down considerably since, 1995-6, let us refresh his memory.

The deregulation and globalization of the world's banks, begun seriously in the 1970s, led to massive losses of their capital. That crisis first came to a head in Mexico in 1994, where the banks had to be nationalized again, and the peso fell some 40% and the standard of living dropped as though an executioner's trap-door. From that experience Mexico has still not recovered. That crisis threatened to bring down the world financial system, to

the point where President Clinton without even Congress's approval, organized the largest standby fund up to that time – $51 billion – with the help of the International Monetary Fund and Canada.

To bail the first-world banks out of their capital losses, two main policies were resorted to under the leadership of the Bank for International Settlements (BIS) – a sort of central bankers' club to whose sessions elected politicians are not invited. Their *Risk-Based Bank Capital Requirements* sponsored by BIS declared the debt of developed countries risk-free, thus requiring no downpayment for banks to amass, This allowed Canadian banks to quadruple their holdings of government debt to $80 billion in round figures, while the government debt held by the central bank dropped considerably.

The Bank for International Settlements' Oversight

Note carefully that when the central bank holds federal government debt, the interest paid on it comes back almost entirely to it as dividends – for in 1938 a Liberal Government under Mackenzie King had bought out 12,000 private shareholders of the Bank of Canada, and our federal government became thereby the sole shareholder of the BoC. By 1988, when the *Risk-Based Bank Capital Requirements* were brought in, all that the banks needed to replace their lost capital was scissors to clip the coupons of the bonds that they could acquire for nothing down.

But since this constituted a massive shift of the national revenue to the banks, and hence of power, the process did not stop there. It moved on in 1991 to the revision of the *Bank Act* to phase out the statutory reserves that the banks had to put up on an non-interest-bearing basis with the Bank of Canada as a proportion of the deposits they received from the public. These statutory reserves had provided an alternative to the complete reliance on higher interest rates to "fight inflation." The proportion of the reserves to the deposits could be raised or lowered depending upon whether an overstimulated economy should be restrained, in which case the reserve rate could be raised, or a depressed economy had to be stimulated and, hence, bank credit was to be made more readily and cheaply available. The detail that such reserves earned no interest not only added to the leverage and hence the efficiency of this control, but hearkened back to the ancestral monarch's monopoly in coining and recoining precious metals ("seigniorage"). Higher interest rates, as the "sole tool for licking inflation," however hit everything that moves or stands still in the economy. Thus those affected most mercilessly were the unemployed who could hardly be contributing to inflation. The use of the statutory reserves allowed corrective policy to be focused on the targeted problem.

The *G&M* article emphasizes that "Mr. Dodge does not take for granted that inflation has been forever tamed by monetary policy. The Bank of Canada has devoted

It's Time for the NDP to Speak Out on the Bank of Canada

We need people in the legislatures and parliament who will promote use of the Bank of Canada to finance government debt. The previous Liberal government did not do this, and neither is the current government doing it. The Bloq has not shown interest in it, and it is too soon to know if Stéphane Dion is interested, although he should be if he hopes to achieve his goals respecting the environment in the face of pressures from big corporations. If the NDP would campaign for better use of the Bank of Canada (as well as abrogation of NAFTA and SPPA) and urge Dion to do likewise, maybe he would be able to resist the pressure.

Fear of what the "big corps" will do is real. Will they leave – with great loss of jobs? Perhaps, but with the Bank of Canada we can create many more good paying jobs in research, rebuilding the infrastructure, education and health services, assistance to small and medium size businesses (including farming) so that they can compete on an equal footing with the rest of the world, and more. The Bank provides the financial muscle to challenge the immense powers of the big corps and the banking system, to abrogate NAFTA and cancel the Security and Prosperity Partnership Agreement (SPPA, also known as NAFTA-plus) signed by Martin, Bush and Fox in May of 2005, and re-confirmed by Harper in 2006.

Canada is dependent on the NDP, as the only party with members in legislatures and parliament, to speak out on this issue. BUT it is not!

Transferring debt to the Bank of Canada is not a new idea! A resolution on monetary policy was proposed to the 1995 federal NDP convention which said, among other things, that deregulation and privatization of money creation is at the very root of Canada's national debt crises. To reduce the interest burden on public debt there must be a readjustment of the proportions of the money supply created by the Bank of Canada and the chartered banks.

BUT, the NDP did not talk about this, and Paul Martin reduced the deficit by slashing programs, down loading responsibilities to provinces without adequate funding and firing thousands of civil servants.

From 1995 to 1999, Canadian taxpayers paid $378-billions in interest on the debt of all levels of government – most of it unnecessary.

In 1999, Lorne Nystrom, NDP Finance Critic, produced a book of essays by several authors called "Just Making Change" in which it was stated, among other things, "We simply must have access to government created zero-cost money. There is no other way to find the resources necessary for health care, education, environmental protection and housing."

BUT, the NDP did not talk about this, and the government continued to use the cost of interest and the debt to justify the down loading and the under-funding of social and health programs, infrastructure, education and housing.

From 2000 to 2005, interest payments added another $409 billions to our collective tax bills – again, most of it unnecessary – and still the NDP does not talk about using the Bank of Canada to carry public debt, and the government continues to use the cost of interest and the debt to justify the down loading and the under-funding of social and health programs, infrastructure, education and housing.

Jack Layton, in his new book, *Speaking Out Louder*, talks about the "question that is frustrating," "the perception that people have that....they see (the NDP) as wanting to just tax and spend. They say they can't trust (the NDP) to keep spending under control." The NDP could dispel that perception if it promoted using the Bank of Canada to carry some of the public debt and applying the savings on interest to programs instead of raising taxes.

It's time the NDP started talking about this both for the good of the country and the good of the Party.

Richard Priestman

much effort in building up public confidence that inflation will remain low, and does not want to do anything that will jeopardize the 'social capital.'"

This passage shows either an ignorance or a lack of frankness of what it was that brought down the rate of interest in the United States and throughout much of the world beginning about 1995.

We have mentioned the two measures that were taken to restore the vast capital that banks had lost in the gambles that they were able to indulge in as a result of deregulation and globalization. That left higher interest rates the only tool for keeping prices flat. But what they overlooked was that these two measures were mutually incompatible. If you raised interest rates into the skies, as central banks did under Paul Volker in the US and John Crow in Canada, the huge new inventory of the banks in government debt acquired entirely on the cuff, would plummet in market price and bring the banks into trouble again. That in fact is what happened in Mexico where the peso plunged 40% and the banks – only recently privatized had to be nationalized once more, i.e., bailed out again, while financial power passed to a new group of stock-market magnates. The latter even came to market the government debt, and eventually to dominate the Mexican economy. The $51 billion standby fund organized on President' Clinton's initiative at least restrained the spread of the Mexican banking disaster.

Extra! Extra! The US Discovers Double-entry Bookkeeping

President Clinton's Secretary of the Treasury, Robert Rubin, grasped at once that high interest rates were incompatible with loading up the banks with unlimited amounts of 100% – leveraged government debt. He devised a simple way out of the dilemma.

The governments of just about every country in the world had been cooking their books by avoiding double-entry bookkeeping and treating capital investments just as though they did current spending. Roads, buildings, bridges, long-lasting equipment acquired by the government were written off in a single year, so that beginning with the following year they appeared on their books at a token $1, while the debt incurred to create or acquire these was carefully recorded as a liability. The result was to show a ficticious deficit that was used as a pretext for pushing up interest rates "to fight inflation" resulting from "the deficit."

Now accrual accountancy – also known as "capital budgetting" – that had been urged by government auditors for years, was actually introduced into the statistics of the Department of Commerce starting with January 1996, and the figures worked back to the year 1959. The private sector had used such serious accountancy since time imme-

John Crow Makes Amends

The Globe and Mail (17/11/06, "When Canada gave the economist a try – Mixed legacy for Friedman's ideas" by Heather Scoffield) carries an amazing confession.

"John Crow should have been Canada's leading disciple of Milton Friedman. As Canada's top central banker from 1987 to 1994 he clearly believed in the power of monetary policy to make or break a country's fortunes. And he hated inflation as much as the Nobel-prize-winning Mr. Friedman, who died yesterday at age 94.

"But even Mr. Crow found that real life can't always be forced perfectly into economic theory – not even the solid and high-profile theories developed by Mr. Friedman.

"'The Bank gave it a college try, it really did,' Mr. Crow said yesterday. 'It just doesn't work that way.'

"In a nutshell, Mr. Friedman thought that central banks should manipulate the country's money supply in order to push down inflation and foster a stable economic environment for businesses.

"Today, only the second part of this idea holds sway – the belief that central banks should keep inflation low and stable, and allow markets to fluctuate as freely as possible. But the first part of the idea, targeting the money supply, has not stood the test of time. Mr. Crow, like other economic thinkers, has concluded that Mr. Friedman was half right.

"The Bank of Canada's experimentation with implementing Mr. Friedman's ideas goes back several decades. Former bank governor Gordon Thiessen pointed out in a 2000 speech that Mr. Friedman was instrumental in Canada adopting a floating exchange rate in the 1950s.

"Mr. Friedman argued with Canadian central bankers back in 1948 that the country's fixed exchange rate was a losing proposition.

"By the 1960s, Mr. Friedman's theories about business cycles, inflation, the role of central banks and the value of the individual had taken off. His Chicago School of economic thought, as it is now known, took root.

"But it didn't really gain a foothold in Canadian economic policy until the late 1980s.

"Indeed, when then-prime minister Pierre Trudeau spoke about addressing Canada's inflation problems during the 1970s, he didn't even mention monetary policy, recalls economic historian David Laidler at the C.D. Howe Institute.

"By the 1980s, with inflation and interest rates soaring, Canada was more receptive. Central banker Gerald Bouey was looking for ways to stabilize prices, Mr. Crow recalls. He wanted an 'anchor' for monetary policy – a clear target that could be easily monitored and publicized.

"Mr. Friedman's theory – that a central bank can dampen inflation by limiting the supply of money in the economy – was appealing. The money supply, however, turned out to be far too dynamic for any central bank to contain. The Bank of Canada tied itself in knots trying to define and keep track of the ever-expanding supply of money, Mr. Crow said.

"In the end, the sophistication of financial markets outstripped the bank's efforts.

"Unlike in the 1960s and 1970s, the markets are now characterized by high-speed, global trading of complicated derivatives and debt instruments. Something as seemingly simple as the widespread use of credit cards has confounded attempts to measure the money supply.

"'It didn't work well, because M1 [a narrow definition of the amount of money in the economy] turned out to be unreliable,' Mr. Crow said.

"He did not, however, abandon Mr. Friedman's theories wholesale. The governor argued strongly, and controversially, that monetary policy should be directed at price stability. He would use interest rates, rather than money supply, to manage inflation expectations.

"'It turned out to be startling to people in Canada,' he recalls, referring back to a speech he made in 1988. 'It was something that struck people as being too monetarist.'

"Mr. Crow was widely vilified for the economic pain caused by his strict focus on keeping prices stable."■

morial – a corporation writing off its physical capital investments entirely in the year in which they were made would be in hot water with the tax authorities. The result was the recognition of something well beyond 1 trillion dollars of neglected federal assets.

However, since an open acknowledgement of how the new figures for assets was achieved would have clashed with the official dogma that government cannot invest, but only waste money, it appeared on the books under the heading of "Savings." Usually economists use the term "savings" to refer to *liquid financial assets*, while what was involved here was bricks and mortar and steel and concrete. However, a nudge to the bond rating agencies conveyed the true significance of the vastly improved government balance sheet. That brought down interest rates, and down they stayed. That assured Mr. Clinton of a second term, and the Western world a period of relatively low interest rates that produced an extended boom until the high-tech bust of 2000.

Canada, too, profited indirectly from the low interest rates resulting from the American adoption of serious accountancy, but its government continued writing off its physical capital investments until the Auditor-General put his foot down and refused to give unconditional approval to two annual statements unless accrual accountancy were brought in. What resulted was a ferocious wrangle between then Finance Minister Paul Martin and the Auditor-General that ended in a demeaning statement by the Auditor-General distorting what accrual accountancy was about. Yet accrual accountancy was brought in to support the lower interest rates that had already resulted from the US rectification of its bookkeeping. What still remains to be done is to accord the same treatment to our governments' vast investment in human capital – education, health, and social services. All that has been forgotten by Governor Dodge, and interest rates are on the rise internationally once again, with the Bank of England teeing off in the lead. (See page 17 for particulars about social capital.)

In another article (27/06, "Using sense in managing nation's dollars"), the same *Globe and Mail* reporter sings the following completely gratuitous paean to Governor Dodge: "This after all, is the intense man who... conquered the country's deficit, stared down inflation in the face of rising energy prices, and provoked serious debate on almost every economic topic known to Canadians."

If it were not to cry, it would be to laugh.

The Bank of Canada under Governor John Crow inflicted the longest and most punitive period of high interest rates, and in doing so was responsible for running up most of the current federal debt. However, in commenting on the death of Milton Friedman, the author of the notion that the price level is determined only by the amount of money in existence, John Crow has had the belated honesty and intellectual courage to declare his conclusion that the very notion a "zero inflation" brought on by high interest rates and scarce currency was mistaken. We quote below in full that significant declaration our current diligent Governor of the Bank of Canada, David Dodge, has overlooked.

This utter debasement of all standards of frankness and transparency in conducting our monetary policy calls for a Royal

Continued on page 18

Untouchable *continued from page 3*

with each other. (The story is told on page 4 of this issue of *ER*.)

To prevent the Mexican monetary collapse arising from the BIS's contradictory policies from spreading throughout the world Clinton's Secretary of the Treasury for the first time introduced serious accountancy into the government books.

Misleading Accountancy Cost Money

Clinton's introduction of accrual accountancy still ignored government investment in human capital. Nor is money spent to restore the environment included as investment. And when such restoration does not occur, and when public health deteriorates as a result, that should be treated not as fiscal prudence, but as fiscal irresponsibility and entered on the government books as a capital liability.

Yet as late as 1999 then Finance Minister Paul Martin was wrangling with the Auditor-General of the day against even treating physical capital as such in the government books, let alone human capital. By 2000 a demeaning compromise was reached: government investments in physical capital were recognized but the Auditor-General was forced to issue a statement that befuddled rather than clarified the issue.

And when we start down this path, there is no stopping. Rather than bemoan the taxes lost to New York or Toronto because hedge funds might go to London or Bermuda to play their games, and cost the government taxes and the nation jobs, why doesn't our government take a good look of the *Bank of Canada Act* that is still intact on our law books? In it are the detailed provisions for the central bank to lend the federal government an unlimited amount of funded debt, and up to 1/3 of its annual budgets in unfunded debt. Were it to make use of this power the interest paid on that federal debt would return to the federal government as dividends. For ever since 1938 when a liberal government bought out 12,000-odd shareholders of the Bank of Canada at a good profit some three years after the central bank had opened its doors, the federal government has been the lone shareholder of the Bank of Canada. In the mid-1970s more than 22% of the federal debt was held by the Bank of Canada on a virtual interest-free basis. Currently it is down to about 6%. We do not have to rely on speculators to practice their dubious arts while the government turns a blind eye on their misrepresentations to their shareholders to cover the government's bills.

The *Bank of Canada Act* in its Section 18 also provides for loans to the provinces, but the interest paid on those would end up largely going to the federal *not* the provincial government for the provinces are not shareholders of the central bank. But that would open a new basis for understanding between our federal and provincial governments. In return for observing federal standards or some other concessions, Ottawa could agree to negotiate the return of part the total amount of the interest paid by a particular province to the central bank. Municipalities, too, as corporations can receive loans from the Bank of Canada, but only if the debt is guaranteed by either the federal or provincial government.

When the banks were bailed out so that they might continue their gambles on an ever great scale, the federal government lost little time in downloading the programs it no longer had the funding to support since it was now paying the private banks screechingly high interest rates for much of its funding that it had formerly been receiving at a near-free rate. Subsection 14(2) clearly sets forth that the Minister of Finance of the Government, in the event of a policy disagreement with the Government may give him in writing the policy that he must follow within 30 days.

The present campaign to do away with Sarbanes-Oxley in the US must be answered with a counter-campaign for the use of our central banks for the purposes assigned them in the 1930s.

William Krehm

Rationality from a Maslowian View

Bounded Rationality and Satisficing

At the heart of neoclassical economics is the theory of rational choice or, in its more modern version, rational expectations, a refinement that incorporates the dynamic aspects of inter-temporal relationships. Inter-temporal aspects will arise when choices are made not only based on information about current conditions, but also on expectations to how the choices might affect agents' future maximization profiles. Without the presumption of rationally choosing agents, neoclassical economists would find it difficult to explain how its "hard core" assumption, that the price mechanism forces economic activities toward equilibrium situations, could work.

However, the assumption of rationality has been under attacks almost from its inception. First of all, rational choice was contravening results of other sciences dealing with human behavioural and cognitive aspects, as well as sciences dealing with wider aspects of human social relations such as sociology and cultural anthropology.

Secondly, during the 1920s, economists began to note that empirically observable market behaviour didn't appear to validate a blanket rationality assumption. For instance, Keynes pointed out that prices were what he called "sticky," that is, the use of contracts and menu pricing set by managers meant that prices were not responsive to demand from customers as individual acts, but were set as lagging responses to grouped and sequential market phenomena.

Around the 1950s the focus shifted towards broadening the scope of the rationality concept so that it would conform better to the empirically observed envelope. At the forefront of these efforts were the new concept of 'bounded rationality.' Its origin was the notion that decision-makers never are in a position to choose a best alternative since their outlook is clouded by cognitive deficiencies, imperfect information, and conflicting motivations within the organizational framework that a firm as a decision making body consists of.

Therefore, instead of optimal solutions they strive for satisfactory solutions that fulfill minimal goals of the firms (for instance, demands for owners profits) but also a host of other goals such as ad hoc interests of groups or individuals within the firm, or existing in the general community and political environment surrounding the firm. This type of decision processes have become known as 'satisficing.' The implication is that decisions within an organization often will contain many contradictory elements, since each decision maker first and foremost view their decisions in the light of how they solve his or her own set of problems. The only constraint is that decisions must be assured of leading to outcomes, including reaching official goals, in measures that won't threaten the decision maker's own position or hopes of advancement within the organization. However, considering satisficing as a main decision instrumental within organizations is at odds with the orderly decision processes envisaged by rational choice theory.

The Maslowian Hierarchy

Anthropologist have long cautioned – and been ignored by mainstream economics – that seen from the perspective of their science rationality is a culturally framed concept. This is what we can call the horizontal divergence of rationality. But rationality also contains a dimension of vertical divergence. One approach to elucidate this is viewing rationality in the light of the Maslowian hierarchy.

The American psychologist Abraham Maslow in a seminal article in 1943[1] put forth the theory that human acts are motivated by needs that "arrange themselves in hierarchies of pre-potency." While acts of course may be motivated by more than one need and the hierarchical orders overlap and even under certain circumstances can be reversed, nevertheless, it can clearly be observed that some needs are more basic than others and therefore, if unfulfilled, their fulfillment will take precedence over all other needs. Maslow's scheme for the basic hierarchical ordering is depicted in Figure 1.

If an individual exists in a state where some of the lower, more pre-potent needs are not fulfilled, their fulfillment will take preponderance over all other possible lines of activities that present themselves to the individual. Thus a starving man will not be disposed to listen to Verdi arias even if he is offered free tickets, but direct all of his energies towards obtaining food that can alleviate his hunger. He might be reduced to begging on the street, not caring about how this violates all the higher needs such as self-esteem, community participation, and even dramatically reducing his normal threshold for feelings of safety.

In the simple unsophisticated understanding of rationality (i.e., one that is non-economic) no one will however consider it irrational that a destitute and starving man abandons his higher needs, including loss of esteem, by begging on the street (unfortunately our current societies still accept that people are stripped of the higher need of community belonging by being reduced to such states). But if an individual with a normal income one day feels hungry, but discovers that he or she has forgotten to bring money along and thus is without wherewithal to pay for food, it will be considered extremely irrational if that person tries to solve the problem by sitting down on the street and begging for money. Thus, a person living under circumstances where the upper needs in the Maslowian hierarchy are the dominant motivators, an incidental short term lack of fulfillment of a base need will not compel that person to give up what he or she normally considers as rational acts. In other words, what a person considers as rational acts will to a large extent be defined by a rationality pertaining to the highest level of needs that under normal circumstances are the main focus of gratification at their current level in the hierarchy.

Corporate Marketing and Motivations

We thus see that rationality is not only determined by cultural contexts, as the anthropologists long have maintained, but also by the level of hierarchical needs that primarily motivates the individual. In modern societ-

Figure 1: The Maslowian Hierarchy

ies, there are, as mentioned, still groups living in poverty, thus even their physiological needs are not well fulfilled. It is also the case that in many poor urban neighbourhoods crime is rampant causing the security need to be poorly fulfilled. In other words considerable minorities in modern economically developed societies live under conditions where they are inordinately occupied by fulfilling the two lowest needs. But for most people in the developed economies these needs are well taken care of and are therefore not important as motivating forces.

The question, which becomes especially important when we turn to motivations and rationality related to economic activities, is to what extent the predominant focus of gratification and activity motivation can be influenced by external forces. In this respect the empirical evidence suggests that not only can they be influenced, but it is, in fact, a common phenomenon. From the impact the modern marketing industry has on the economic decisions people make, it logically follows that being able to influence peoples' decisions means being able to shift part of their motivational forces, as well as the needs they seek to gratify through their economic acts.

Seen from the view of the goals pursued by the corporate sector, it is in its best interest to keep people captured at the levels of belonging and esteem, since these are needs the gratification of which are most likely to be accompanied by high consumption levels. In conformity with that, even the most cursory analysis of the form and content of modern marketing techniques makes it obvious that these are indeed the levels at which the marketing techniques mostly direct their coded messages. Consequently, the majority of marketing messages can, when decoded, be seen as aiming at creating a connection (conscious or sub-conscious) between consuming the marketed products and a notion of attaining higher esteem.

Self-actualization and Rationality

Only when people have reached a stage of personal development where their focus mostly is directed towards gratifying the need for self-actualization will they be able to make truly rational decisions. The decisions of self-actualized people are independent and take all relevant aspects into consideration, which mean that they will not just look at gratification goals in money measurable terms – which the rational choice theory of standard economics advocates – but will also consider how the decision affects larger social questions and future developments.

Thus, for a self-actualized person, it is irrational to drive a Hummer as a means to solve urban transportation needs since a view that takes social and future consequences into consideration would find it unnecessarily resource depleting and polluting. Conversely, a person that is still mainly motivated by impulses gratifying the esteem

Correspondence from France

Dear Mr. Krehm:

I always read the publications of your organization before sending them on to the François Perroux Library at my university. But the December 2006 number brought me a great, agreeable surprise in your criticism of my little book on the dollar. After my initial treatment of the problem for a broader French public, I have in mind another work assessing proposed solutions of the problem. In this work I will take your criticism into account – my not having identified clearly enough what is and what is not real inflation. In any case, thank you for your message. And the best wishes for a happy 2007.

I have a couple of requests to make. The first is a bibliography (in addition to your book that you were kind enough to send me) dealing with factors that in your view could bring on a crisis arising from the situation of the US dollar; and with possible ways of forestalling such a development. The second is a proposal. It just happens that I am in charge of a project of the Harmattan [publishing house] called "The Economic Research of François Perroux." I am prepared to publish whatever work of fairly substantial size (300 to 350 pages) that you would wish to introduce to the Francophone public (which, however, could include passages in English text). I believe that you and I, had once begun such a discussion of this sort, but I cannot remember for what reason, we failed to pursue it.

Once again my best wishes for you and your associates,

Jean-Claude Delaunay

Dear Jean-Claude:

Your remarkable little book – that has far more positive content than many big, big books, and the renewal of our contact could not have come at a better time. I am at work on the second volume of *Meltdown* which is a summary of the past eight years of *Economic Reform*. In the course of working on this much useful material immensely relevant to our mounting problems today has come back to mind. I will in the course of this work compile as complete a bibliography relevant to your need as possible. Meanwhile, I will gladly send onto to you any of a half dozen books of my own that you may not have. Perroux and what I grasp as the essence of his teachings was handled in a special section of *Price In A Mixed Economy – Our record of Disaster*. It resulted from a 60-page article which had been published in *Revue Économique*, May 1970. That resulted in an offer from – I believe it was Levy Kallman, to write a book enlarging the subject for translation and publication by them. However, by the time it was completed almost a year later, the curtain had fallen on all non-self-equilibrating model-thinking, and I did not even get an acknowledgement from them. Hence to waste no further time I published it myself, and it got good reviews in the Cambridge university publication, Finland, the Netherlands and elsewhere. What impressed me once I became familiar with the French literature was the number of economists who were working their way towards a not dissimilar position that I had arrived at. It may be useful if you go to that May 1970 issue of the *Revue Économique* – which since of course has significantly disappeared. You will find mention of a most remarkable number of economists tunnelling in the same direction towards a conclusion that I had reached. Meanwhile from *Economic Reform* you will find the names of a perhaps a half dozen books of mine, which I will be glad to send to you if you do not have them.

At the time of the student demonstrations against the present economics curricula in Paris a few years ago, much expectation was aroused that this might be the beginning of a rebirth of economic thought. Unfortunately, the nub of the suppressed issues was ignored. What you and your publishing house are undertaking could be of significance not only for France but for the world.

I assume that you are unlikely to object to our carrying this long overdue resumption of our work together in the February issue of *Economic Reform*.

All best,

Bill Krehm

needs might consider driving a Hummer as a rational act since it, in response to the connection to gratification of the esteem needs the marketing images have created, enhances his or her sense of instantaneous fulfillment. What is noteworthy is that it is the rationality of the latter choice, and not the first one, that is in line with the views of neoclassical economics, since it is the choice that promotes growth in short term money measured aggregates.

Neoclassical economics also by and large denies the ability of the corporate marketing industry to influence consumers' economic decisions. However, this stance is not only illogical (it implies that the billions of dollars that firms spend on non-informative marketing is an irrational act as no utility is gained) but it also contravenes the facts. The reality is that the corporate influences wielded under asymmetric market conditions have created an over-concentration of focus on the esteem needs (and to a lesser degree on the belonging needs), that traps many people into constantly seeking gratification of these needs at the expense of a natural development into a higher focus on self-actualization. When such traps occur, pathological states can develop, requiring further overcompensation of one or more of the lower needs. Of course, in most cases the pathological states only exist in lesser degrees, but as an aggregated social situation the result has been that the entrapment has arrested social development toward rational solutions in a self-actualized context of social problems.

Adding to this state of affairs is the encroachment that the corporate commercialization of society has meant for areas of human endeavours that normally have been reserved for expressions of self-actualization. Most notably in this respect is the arts, which have been so thoroughly commercialized that motivations for participation in artistic activities are no longer primarily driven by gratification of self-actualizating needs, but rather as another avenue for gratifying esteem needs.

Since these trends are in full conformity with the rationality principle embraced by economics they have been given a stamp of approval by this science. But the fact remains that the rationality principle that economics espouses is not only bounded by factors such as the aforementioned problems of decision makers' cognitive deficiencies and the existence of conflicting motivations within firms, but also by the more basic fact that it is a partial rationality, valid only for decisions aimed at fulfilling needs congruent with the middle tier of needs in the Maslowian hierarchy.

Dix Sandbeck

1. "A Theory of Human Motivation," *Psychological Review*, 50, pp. 370-396 (1943) (available as an Internet resource). Later expanded in the popular book, *Motivation and Personality* (1954, 2nd ed. 1970).

Hedge Funds Ride the Crest of the Economy's Compulsion to Grow

The bank bailout in the late 1980s and early 1990s was both so brazen and so conspiratorial, that it implied a shift of political power to the financial sector. And in that change, the productive sector, the trade unions, farmers, and parliamentarians were the losers. At that very time it was no coincidence that Deregulation and Globalization took over the stage. Everybody else became bit players, put in their places by the "compulsion to grow." In this process, hedge funds, "big enough to know what they were doing," were believed by the authorities to have no need for supervision. That empowered the hedge funds to do a great deal to the disadvantage of others who were being deprived of previous influence.

The Great Depression of the 1930s and the Second World War, had been brought on by the collapse of the world banking system in 1929. And by the time of Franklin Roosevelt's inauguration in 1933, many hundreds of American banks had closed their doors. One of the first things the new president did was declare a bank moratorium. And shortly afterward he brought in a new *Bank Act* that severely restricted what banks could do. Ceilings were put on the interest rates they could pay or charge. They were prevented from investing in the other "financial pillars" – stock brokerages, and insurance and mortgage companies. For good enough reason. These had liquidity pools for the needs of their own businesses. Allow the banks to get their hands on these, and they would use them as money-base for applying the bank multiplier – the number of times a bank's credit creation could exceed the actual cash in its coffers. The 1933 banking legislation in the US came to serve as the model in most Western countries. It had two principal tools by which the central bank could keep the private banks from once again engaging in disastrous speculation. It could raise its benchmark interest rate for overnight interbank loans if it wished to cool an overheated economy; or lower it if the economy needed stimulation. But there was also the obligation for the banks to redeposit with the central bank a portion of the deposits they received from the public. On such "statutory reserves" the banks received no interest, to allow the central bank maximum leverage in controlling the banks' credit creation *without* changing interest rates.

Under Roosevelt, the economic recovery was weakly started, but the war and the reconstruction after it were far more bravely financed through the central bank itself. In countries such as Canada and after the war the UK where the central bank had been nationalized, the interest paid by the government to its central bank came back to it substantially in the form of dividends. But even in the US where the Fed's shareholders were private banks almost the same proportion returned to the central government by virtue of the ancestral monarch's monopoly in coining precious metals at a profit – the right of "seigniorage."

The Semi-underground Bunker for the Banks' Comeback

By 1951, the rigid regime on the which the banks had been placed for almost two decades had brought them into complete solvency. And they had come to lust after the good old days of their speculative freedom. But since governments had committed themselves to their armies in most parts of the world to creating a more just society, their comeback had to take place *outside* governments and to an extent *against* governments. For this they had need of a semi-underground bunker in which to plan and execute their strategy. Providentially, an institution already existed that answered this need – the Bank for International Settlements in Basel Switzerland. It had been set up in 1929 to handle the syndication of the World War I reparations of Germany to France and Belgium which was to be collected in German marks but had to be syndicated into a strong currency to be acceptable to these two former Allied powers. However, the Wall St. crash of October 1929, and the

Depression it ushered in made this impossible and BIS lingered on. When the Nazi troops marched into Prague in 1938, BIS immediately surrendered gold reserves that had been entrusted to it by the Czechoslovak government, For this and other services to Nazi Germany, that its critics claimed it had rendered, Resolution Five was adopted at the Allied Bretton Woods Conference in 1941 calling for the dissolution of BIS at the earliest possible moment. As a result it cultivated a very low profile. That low profile met the needs of the banks throughout the Western world for a semi-underground bunker where the banks' comeback could be planned and directed.

This took the form of deregulating the banks, and phasing out the statutory reserves that had used leverage of credit creation rather than manipulating the benchmark bank rate to keep the world economy on a level keel.

In 1988 it surpassed itself by organizing the bailout of banks throughout the non-Communist world from their huge speculative losses. One of the two main measures to permit them to fill the gaps in their capital was in its *Risk-Based Capital Requirements*, now referred to as Basel I. This, amongst much else, declared the debt of developed countries as "risk-free," thus requiring no additional capital for banks to acquire. The banks needed only scissors to clip the cou-

History's Maps and Compass Cast Over the Bow into the Turbulent Sea

US Secretary of State, Condoleezza Rice, always seemed to add at least a more cultured note to the White House of the day, headed as it is by a President who seems always to be wrestling with his mother tongue. It was therefore with something of a shock that we read in *The Wall Street Journal* (19/01, "Rice's Perplexing Use of History" by Neil King Jr.): "London – US Secretary of State Condoleezza Rice often calls herself a 'student of history.' And increasingly, she is using history both to explain and justify the Bush Administration's Middle East policy."

To be guided by history in assessing present economic policy, the point is to identify key cause-and-effect relationships that warrant an assessment of present policies in our day in terms of an earlier period. This would require if not an identification of such relationships then and now, at least include cultural and religious, economic and cultural affinities or hostilities between the states involved, and assessment of how the economic and military capacities of the two countries or alliances might be affected by these. The time factor before the military, diplomatic, and economic factors lead to a positive result, cannot not be detached and used as the only basis of the comparison. It is these other factors that decide whether the passage of time would prove an ally to the concerned party, or merely a greater span for disasters piling up and leading to an inevitable bloody retreat. However, none of this emerges from the Secretary of State's "scholarly" handling of history.

Let us return to the *WSJ*: "When Ms. Rice talks about the challenges the US faces across the Mideast she points somewhat surprisingly, to Europe after World War II and to the West's decades-long face-off against the Soviet Union, which happens to be her area of expertise. It is a penchant that has scholars scratching their heads.

"Citing the Cold War's denouement as context for today's bloodshed and tumult may seem far-fetched to some. But Ms. Rice uses the analogy both to beg for patience – the Cold War, after all, consumed decades – and to try to elucidate a diplomatic strategy that is increasingly assailed for its lack of assertiveness.

"While traveling this week through the Middle East and Europe, Ms. Rice engaged in several long historical tutorials with reporters in tow. Her point in reference to the Cold War, she said, isn't to argue that history repeats itself or that the analogy is exact."

"No One Seems to Have the Vaguest Notion of Modern Middle Eastern History"

"'The reason that I cite some of these other times, like Europe, is that it is so clear that the US and its allies came out victorious at the end of the Cold War,' she said in Kuwait. 'But if you look at what ultimately led to that, you would have thought that this was failing every single day between 1945-46 and probably 1987 or 1988.'

"She pushed a similar argument to reporters last month. The Middle East is 'moving toward something that I am certain will not have a full resolution and you will not be able to fully judge for decades,' she said. 'The administration's reservoir of historical analogies seems limited to the 1914-1991 period. And it's all about Europe,' said Adam Garfinkel, a former Rice speechwriter who edits the foreign policy journal, *The American Interest*. 'No one in a senior position in this administration seems to have the vaguest notion of modern Middle Eastern history.'

"When asked this week about what moments in Arab history inform her thinking, Ms. Rice said she had had read about 'the British experience' in Mesopotamia in the 1920s which led to the founding of Iraq and the withdrawal of British forces. 'I know a number of things that went right, and the things that went wrong,' she said.

"Ms. Rice cleaves to her Cold War history to try to drive home a bigger point about the diplomatic approach, which is seen by many as detached and lacking urgency. She tends to portray events, particularly the clash between what she calls 'moderation' and 'extremism' in the Middle East as driven by huge, almost inevitable forces that make diplomacy impractical or even irrelevant. Those who clamor for sitting down with Syria and Iran are out of touch with what Ms. Rice calls 'the underlying forces.' 'If you don't understand the strategic context in which you are actually negotiating. It is not deal-making.'

"Four years ago, the administration theorized that the US invasion would spawn a democratic Iraq, on good terms with Israel, that would break the regional mold and compel erstwhile enemies to end hostilities toward the Israelis. Now, Ms. Rice said it is the Iranian ascent wrought by the war that makes the Arab states more open to negotiations.

"To her thinking there has been a shift in underlying forces – as opposed to events the US may have influenced. Again, she points to a favorite historical analogy: the reunification of Germany. 'If you had tried to negotiate German unification for any period of time until 1990, you would not have been able to do it because the underlying circumstances were not there,' she said."

Clio, from a teacher, has become in this way, a homeless street-walker.

W.K.

pons on the government debt they were able to acquire under this new measure.

The other measure was the phasing out of the statutory reserves – a modest portion of the deposits made by the public with the banks that had to be redeposited with the central bank where it earned the banks no interest. These reserves had provided the central banks with an alternative to raising interest rates to cool an overheated economy. With their discontinuance in Canada, New Zealand, and in any country that receives financial aid from the International Fund – higher interest rates were left as the sole "blunt tool" to fight perceived inflation.

Washington's Cluelessness of What It was Getting into in Iraq has Hastened the Loss of Its Position of Lone Superpower

So great has the jolting surprise been of what they had gotten themselves into when they invaded Iraq that it has even affected George Bush's manner of pontificating on how he is going to bring a well-mannered democracy into whatever portion of the world oil and other goodies flow. *The Wall Street Journal* (09/01, "If Iraq Worsens, Allies See 'Nightmare' Case" by Neil King Jr. and Greg Jaffe) unfolds an amazing tale: "Washington – As President Bush prepares to unveil his latest Iraq strategy, Arab allies are worried what might happen if the plan fails: that worsening strife could engulf the entire region, sparking a wide war in the middle of the world's largest oil patch.

"The potential of a much larger regional conflict that pits Sunni Arabs against Shiite Arabs is increasingly on the minds of both Arab leaders and the US military planners. Some are calling such a possible outcome the 'nightmare scenario.' Even as Iraq is separating along sectarian lines, regional dynamics are shoving neighboring nations into two rival camps.

"On one side is a Shiite-led arc running from Iran into central Iraq, through Syria into Lebanon. On the other side is On the other side lie the American allies, Saudi Arabia, Jordan and Egypt, along with Persian Gulf states such as Qatar and the United Arab Emirates. These Sunni regimes are horrified at the emergence of an increasingly radicalized Shiite bloc, largely financed and inspired by Iran.

"In the middle of these is Iraq, increasingly less like a buffer than as a no-man's land that is bringing them into conflict. Arab officials fear that if the US withdraws from there, or diminishes its troops in a way that Iraq's weak military can't fill, the two sides will come into direct, bloody conflict."

But it was only after a decade of military intervention that Washington awoke to the existence of the deadly conflict that goes back to the generation after Mahommad, when the strife between Sunnis and Shiites arose over which branch of the Prophet's heirs would inherit his religious and military leadership.

What Washington Failed to Learn from Rome

What is amazing is the ignorant lack of concern about the rest of the world that was intensified by the role of the US as sole superpower after the collapse of the Soviet Empire. Yet the new role of the US required a greater sensitivity to the culture and preoccupations of other peoples. The only model that Washington might have looked to for guidance was Imperial Rome. For centuries Rome not only enjoyed a crushing military superiority over other powers, but used it sagely. That is why she was able to transmit a glorious heritage across even the Dark Ages. She was resurrected again and again, because of that wisdom – during the Renaissance, and in just about every reflowering of humanity that followed. And she knew how to retire with grace and in safety when the need arose. To this the walls she built to protect her various withdrawals bear witness. Rather than destroy other cultures, she absorbed much of the best they had to offer. No educated Roman was complete without having acquired some Greek, if possible during a period of study on the Greek island of Rhodes.

I do not wish to bring up uncouth instances of contrasting models of the mighty powers of modern times. But just let me refer to one eminent European politician famous in his day for his remark: "When I hear the word 'culture,' I reach for my pistol." Let nobody be too ready to dispose of the cultural preoccupations of other peoples.

That cultivated ignorance of the concerns of other nations prevented Washington from grasping – even if it had not already learned the lesson in Vietnam – that it was impossible to move into Iraq, take over the government and the oil-fields, period.

The costs of the endless, ever deeper Iraqi adventure, are already being felt on all continents. They have irreparably dented Washington's superpower status, and left it open to the competition of countries with a much greater population base, and even of powerful cultural traditions: China, India. And this process has been hastened by the humiliation of the US by a medium-sized Arab land, itself stricken with sectarian conflict.

There is no question that without Washington's hopeless Iraqi adventure, President Hugo Chavez – even with all his oil resources, would not enjoy the open approval for a new pattern of Latin American governments talking back to American corporations too aggressively gathering up Latin American resources, and compelling the renegotiating of deals that were a bit too one-sided. That is a far cry from the overthrow of the democratically elected President Jacobo Arbenz, in Guatemala after World War II, because he wanted to a build a highway to either ocean from the capital that would compete with the railway owned by the United Fruit Company. And he had moved to buy back at the evaluations they had declared for tax purposes the vast acreages of land that the corporation had acquired for a song from previous dictators and kept fallow.

There is not a Latin American country, from vast and mighty Brazil, through Mexico, the Argentine, Chile, Colombia, that has not its tales of resentment at the treatment received from the United States. Now that the mighty US has been caught in a trap in Iraq, accounts are being presented to a humbled United States.

And the presence of up and coming co-superpowers like China – no matter how dubious their own record of treating smaller nations – places a ceiling on what the US can allow itself. Interestingly, this aspect of the Iraq problem is almost wholly missing in the otherwise excellent commentary of the American press.

William Krehm

In countries with governments less servile than that of Canada, the reserves in one way or another were reduced to insignificance.

However, in Canada the government of Brian Mulroney, in 1982, actually tried putting the independence of the central bank from the government and "zero inflation" into the Constitution, but was voted down by his own caucus on the commons finance committee. In the UK such reserves were reduced to a fraction of one per cent, in the US they were shifted automatically to "non-reservable," i.e., interest-earning accounts at the close of business each day and back against when banks' doors opened again. Under these new provisions, government debt was moved massively from the central bank where the interest paid on it returned substantially to the governments as either dividends (where the central bank is nationalized) or as *seigniorage (*conceptually the continuation of the ancestral monarch's monopoly in coining precious metals). This of course left a screaming hole in the government budget, which was addressed by downloading social programs to junior government levels without adequate financing to support them. In the European Union, the central bank actually pays the banks' interest on their statutory reserves with it and calls it "banks' seigniorage." That is tantamount to crowning the banks financial monarchs.

The Monumental Slip-up of BIS

But for all its cunning, BIS had overlooked an important detail. Under its manager, Alexandre Lamfalussy, BIS moved on to ever more aggressive measures that merely reflect the increasing power accruing to the banks as a result of the drastic redistribution of the national income. In 1991 he took to task the most zealous central bank governors for bringing down interest rates to 1% or 2% instead of zero. But what he overlooked was that if interest rates go up enough preexisting bonds with lower coupons will shed market value and bring the banks into insolvency again. That indeed happened in Mexico at the end of 1994 when the banks had to be nationalized again, and a new stock market group took over even the banks' functions of marketing government debt – by TV auctions! If President Clinton had not stepped in at the last moment with a then-record standby fund ($51 billion without congressional approval but with the help of the IMF and Canada), it would have brought down the international monetary system. Clinton's resourceful Secretary of the Treasury, Robert Rubin, came up with a better solution.

For the first time, he smuggled accrual into government accountancy for almost the first time in any part of the world. Under accrual accountancy (also known as "capital budgeting") when the government acquires a capital asset it depreciates the value of the asset over its probable useful life, while amortizing the debt incurred in a similar way. But not wishing to even suggest that governments could make serious investments, such investments had been treated as current expenses. They were written off in a single year, and then carried at a token dollar. That, of course, created a deficit where no real deficit may have existed. And that bogus deficit – as a long line of Auditors-General and at least two royal commissions pointed out – "cooked the books" and created an argument against crucially needed social investments. This revision of the US government books – carried backward to 1959 – brought to light some $1.3 trillion dollars that had been disregarded. But instead of listing it as "investments" it was treated as "savings," which it was not. Savings in economic literature usually refer to cash or near-cash assets, and these rediscovered assets had for the most part the form of bricks and mortar, and steel. The were investments. Nor did this correction Include the vast government investment in human capital – education, health, and social services – Theodore Schultz of the University of Chicago had in the 1960s been awarded the Bank of Sweden's Nobel Prize for Economics, for proving on the basis of the rapid recovery of both Germany and Japan from their immense physical destruction suffered in World War II, had recognized as the most productive investment a nation could make.

The era of low interest rates ushered in by the bank bailout of the 1990s was particularly favourable to hedge funds. The "compulsion to grow" was up their alley, which was literally paved with government bonds, that banks of developed countries could acquire without down payment. For the Bank for International Settlements in 1988 had declared them "risk-free." And since hedge funds could after all do as well shorting corporations as acquiring them long, they were blessed with the capacity to acquire corporations by buying prosperous ones, as well reducing them to economic scrap and then picking them up on the cheap.

But where are our storied universities in all this? Adjusting to the high costs of operating, they have simply been silenced by the ability of the same hedge funds to endow them with what to them is pocket money leveraged by the banks to dizzy wealth and ever on a mission to earn still more. They have purged their economics faculties, retired those distinguished faculty members who refused to be hushed. So it is left, belatedly, to the very governments to try figuring out where all this is leading them. These are the governments who for at least two decades had argued that that they were not to be trusted to finance essential capital projects through their central banks at a nominal rate of interest. Only the banks that they had bailed out at a crushing cost to all levels of government apparently could do that.

The Undoing of the Supervision of Our Stock Markets

Such is the background of a *Bloomberg News* dispatch in the *International Herald Tribune* (10/01/07, "Scrutiny on Loans to hedge Funds" by Rich Miller and Jesse Westbrook).

"Washington – US and European regulators, turning a spotlight on Wall Street's most profitable businesses, are jointly investigating whether banks or and securities firms have set strict enough limits on loans to hedge funds.

"The US Securities and Exchange Commission, the Federal Reserve Bank of New York and the Financial Services Authority, which is the principal British market regulator, met last month with the biggest leaders in the hedge fund industry, seeking information on how they decide the amount of collateral required, an SEC commissioner, Annette Nazareth, said Friday in an interview in Washington. The Swiss and German authorities are also involved.

"'The purpose was to discuss margin practices,' Nazareth said. 'It was a fact-finding effort.'

"Any move to increase margins as a result of the investigation may affect the $8 billion a year in fees that securities firms collect for providing hedge funds with prime brokerage services like lending and clearing trades. Bear Stearns, a major prime broker, generates at least 30% of its profit catering to hedge funds according to estimates by Brad Hintz, an analyst at Sanford C. Bernstein in NY.

"Hedge funds, which use margin loans to add leverage and increase their trading bets, would have a harder time making money.

"'Any tightening will decrease the amount of business that the banks can do,' said Josh Galper, a managing principal of

Vodia Group, a consulting firm in NY. 'If the hedge funds' ability to borrow on margin is decreased, they're going to be unable to produce the same return for clients.'

"Officials want to know how much margin banks require hedge funds to provide up front to obtain loans and cover potential losses. They are hoping to avoid the kind of turmoil that engulfed financial markets when Long-Term Capital Management's losses put pressure on the Federal Reserve to organize a rescue in 1998.

"For hedge funds, private pools of capital that speculate on everything from interest rates to weather patterns, leverage can also multiply trading losses and put stress on the financial system.

"'We are doing work on credit-risk management with the SEC,' said David Cliffe, a spokesman for the Financial Services Authority.

"It's looking at the prime brokers in relation to the hedge funds.

"The Swiss Banking Commission has worked with the British, US and German authorities on the issue, said a spokesman, Tanja Kocher. The meetings included Goldman Sachs Group, Morgan Stanley Bear Stearns, Merrill Lynch, Lehman Brothers Holdings, JPMorgan Chase, Citigroup, UBS, Credit Suisse Group and Deutsche Bank, said a person helping to direct the examinations. All of the firms declined to comment.

"The person involved in directing the examinations who declined to be named, said the regulators were concerned that there had been a decline in lending standards because hedge funds were such lucrative customers. The agencies plan to meet in the next few weeks to decide what to do with the information, the person said.

"Hedge funds worldwide manage a combined $1.3 trillion, more than double the amount they controlled five years ago, according to Hedge Fund Research in Chicago. Returns last years averaged 13%, led by emerging-market funds, the best annual performance since 2003.

"It is common for prime brokers to relax margin requirements, because the bigger the loans, the more the banks make by charging interest and holding securities as collateral, said Galper, the managing principal at Vodia Group. He estimated Wall Street collected about $8 billion last year lending cash and securities to hedge funds.

"'That's a selling point of the banks, how much leverage they're willing to give,' Galper said.

Hedge funds are attracting more scrutiny after Amaranth Advisors' failed bets on natural gas forced the firm to liquidate positions as lenders demanded more collateral. The two main hedge funds of Amaranth, based in Greenwich, Connecticut, lost more than $6.5 billion, or 70% of their assets, in September, in part because its trades were leveraged.

"Nazareth, the SEC commissioner, said it was not clear what steps, if any, the regulators might take. The New York Fed's president, Timothy Geithner, described the question of margins as 'very complicated' in comments to a Nov. 29 meeting of the American Institute of Certified Public Accountants in New York."

The Temptations of Massive Gambling Leverage and Our Political Process

"Because hedge funds let managers participate substantially in the gains on money invested, they provide an incentive to increase returns with extra leverage. Federal officials have been troubled for months by the possibility that banks may be cutting margin requirements for hedge funds too far and in some cases demand no margin at all for potential losses on the over-the-counter derivatives.

"'It's very hard to figure out what's right,' Geithner said at the November meeting. 'It's maybe hard or harder to try to figure out whether you can bring about change that may be in the broader interest of all market participants.'"

It should be helpful if comparison is made with the refusal of central banks to finance the most urgent investments of government – environment – which would result in even the lower interest paid on such loans coming back to the central government as "seigniorage" – the modern equivalent of the ancestral sovereign's monopoly for coining precious metals that has been replaced by the banks credit creation as a wildly growing multiple of the cash in their vaults. This was on the grounds that governments are not to be trusted to make investments. Their purpose apparently is to bail out banks who overextend themselves to finance hedge funds in their gambles. The two must be compared and linked. Otherwise with minority governments and elections become a standing feature of our existence, hedge funds will use their bank-financed super-leverages to suborn democratic process.

William Krehm

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Our Deregulated and Globalised World is Producing an Excess of Liquidity

The ever mounting tsunami of financial speculation is creating the illusion of a thriving economy until you examine the living standards of our working population. Even as the financial sector is hyperactively employed, and profits seem ever climbing, the real earnings of factory and other workers have been static or declining, and the future of many of their pensions has become increasingly uncertain. The financial press is busily engaged in tracing the particulars of this "excess of liquidity" part of the way up to a dead end. Beyond that point the surrender of power from the producing economy to a thoroughly deregulated financial sector is forbidden territory and rarely investigated.

Let me quote from International *Herald Tribune* (08/0107, "Mergers thin out markets" by Michael Tsang and Daniel Hauck): "New York – Stock markets are shrinking as mergers and acquisitions take shares out of public hands faster than companies can add to them through equity sales. The value of US shares posted its biggest drop last year since 1984 and the European market narrowed for the first time, according to Citigroup. Last year, $3.68 trillion in takeovers, led by the $86 billion purchase of BellSouth by AT&T, outweighed initial public offerings in what was the biggest year for Public Offerings since at least 1999.

"Fewer shares available to buy means higher prices paid for them, for they are essential to pension and mutual funds. Especially with interest rates kept low ever since 1995, which is a semi-concealed story that plays a key part in the present muddled scene."

The Source of the Excess Money "Sloshing Around"

"The contraction [of publicly available stock shares] may continue in 2007 as deal-making accelerates. M&A, mergers and Acquisitions, will rise at least 10% in 2007 analysts at Deutsche Bank, JPMorgan Chase and Bank of America forecast. Private-equity investors alone have $1.6 trillion to spend, Morgan Stanley estimates.

"'Corporations and the private-equity crowd both appear to still be on a buying spree,' said Eric Bjorgen of Leuthold Weeden Capital Management in Minneapolis. 'Less supply implies higher prices. That's bullish.'"

Meanwhile the outsourcing of factory jobs to low-wage countries is shrinking the living standards and security of the working classes. Between the two, equally covered, by the heading Deregulation and Globalization, are the main causes of the ever-widening gap between the rewards of producers and of speculative finance.

"Last week, the S&P 500 fell 0.6% to 1,409.71.

"But buyout funds and companies may wind up paying too much as they view acquisitions. Jason Tennert, chief investment strategist at Stategas Research Partners, said that it might 'end badly' for stock investors this year.

"'Given the sheer amount of money that's been raised, it seems to me that there's a chance that this could be taken to an extreme," he said. 'Fads tend to take on a life of their own.'"

What has added immensely to the takeover rage was the doing away some three decades ago of the prohibition in President Franklin Roosevelt's *Bank Act* of 1933 that prevented Banks from acquiring interests in "the other financial pillars" – insurance, stock brokerage, and real estate mortgage institutions. The reason? Each of these had its own pool of liquidity essential for its own business. Allow the banks to get their hands on those reserves, and they would use them as money-base for the creation of a growing multiplier of interest-bearing credit, which the banks would *lend into creation*, thus replacing the loans that the government had taken from its central bank. The Canadian and British governments actually own their central banks, but the Federal Reserve System in the US is still the property of a group of private banks. But even there the net profits of the central bank go to the government (not as dividends as in the case of government-owned central banks), but by virtue of the right of "*seigniorage*" of the ancestral monarch – his monopoly of coining precious metals. The corresponding privilege of issuing credit paper and other token money or created by computer entry to many times the value of the cash in their vaults, has long since passed to the private banks. And the remittances of the net profits of the Fed to the government, after remitting a fixed dividend to the actual private banks that are its shareholders, continues for that reason.

The neglected point is that allowing the private banks to take over the non-banking "financial pillars," not only gave our banks a multilevel multiplier for their debt-money creation, but inside intelligence concerning the entire economy as never before. That invaluable information underlies much of their ability to organize, and promote Mergers and Takeovers – by far the most lucrative branch of deregulated banking today. The "excess of liquidity" which is a source of the ever-widening gap in living standards of the working class and the financial hierarchy is thus tightly linked to the removal of the controls imposed on banks in the US during the Great Depression that became pretty well standard throughout the world.

The Shrinking of a Rising Market

"Chief financial officers at Fortune 1,000 companies consider takeovers their top priorities, a survey of 100 executives by Morgan Stanley showed in September. A year earlier, M&A ranked seventh, while increasing the amount of cash on hand topped the list.

"The value of publicly traded US shares fell 2.2% during 2006 on a net basis, according to Citigroup, whose figures are based on constant stock prices and reflect only equity added to and removed from the market.

"The drop accelerated from 0.2% in 2005. Before then, the last time the market contracted was 1988, during Wall Street's first leveraged buyout binge.

"In Europe, the value of shares fell 1.2%. The British market shrank 4.1%, the third straight decrease and the biggest least as since 1983 when Citigroup began collecting data.

"The contractions last year occurred even as companies raised $242 billion in Initial Public Offerings (IPOs) globally, the most since Blomberg started compiling data in 1999.

"Repurchases [of stock] contributed to the declines. US buy-back announcements last year totalled $654.9 billion, 39% more than a record set in 2005, according to Biringyi Associates, a research and investment firm.

"Stock markets are likely to shrink again

because deals are inexpensive to finance and shares are undervalued., according to Darren Brooks and Robert Buckland, European equity strategists at Citigroup.

"In the US, yields on speculative bonds are close to 10-year lows. Yields on ten-year Treasury notes, at 4.65%, are lower than the 6.65% average in the 1990s. Corporate bond yields in Europe have been lower three times in the past when compared with earnings yields, or earnings per share divided by stock prices, according to Citigroup data.

"Rarely has it been as attractive as now for companies or private equity to use cheap financing," Citigroup strategists wrote in a report on December 28. They expect shares to get a lift from increased takeovers this year and forecast 15% returns in European stock markets.

"In Asia bank mergers in Taiwan will drive an increase in takeovers along with buyouts, said Angus Barmer, a corporate finance specialist for UBS.

"Potential stock gains are big enough that buyout firms may borrow more and buy larger companies. Nine of the ten largest US buyouts ever were announced in 2006, Blomberg data show.

"There is scope for more mega deals in Asia because there is a lot of money sloshing around."

"A lot of money sloshing around" is the leitmotiv of such analyses. But a lot of cheap credit to make profitable deals in an economy are profitable largely because of prevalent low interest rates in this deregulated economy. And it is to the little publicized origins of lower interest rates at a time when banks credit was being extended more rapidly than ever before that we must turn to foresee what may be ahead.

When BIS Laid an Ostrich Egg

For that we must disinter the roots of the near collapse of the international monetary system in 1995 resulting from the two quite incompatible major methods imposed by the Bank for International Settlements of Basel, a sort of central bankers club in no way dependent upon or appointed by governments. It was there that the campaign to deregulate and globalize the banks was conceived, releasing them from their severe confinement to banking that had been imposed on them after their collapse in the early 1930s.

Under the US *Bank Act* of 1933 that came to serve as a model in most developed countries, banks were strictly confined to banking and were not allowed to acquire an interest in the other "financial pillars" – stock brokerages, insurance institutions or mortgage companies. Ceilings were imposed on the rates of interest that banks could pay or charge. Statutory reserves were required of banks to deposit with their central bank as a percentage of the deposits they took in from the public, and on which the central bank paid them no interest.

On this severe diet the banks recovered, and by 1951 they were hankering for the fleshpots that had brought them to close their doors by the thousands during the early years of the Depression. Since the government had committed itself to their armies to bring in a more humane social system after the war, that comeback of the banks had to be effected *outside* government and to an extent *against* governments. The ideal semi-underground bunker for that purpose was provided by the Bank of International Settlements that was in the dog-house because of its surrender of gold reserves that the Czechoslovak government had entrusted to it in 1938, but that it surrendered to Hitler the moment his armies entered Prague.

As a result on the initiative of some governments in exile, at the Bretton Woods Conference in 1944, Resolution 5 was adopted for the dissolution of the BIS at the earliest possible moment. That led to the cultivation of a low profile by BIS, and that low profile recommended it perfectly as the semi-secret bunker for plotting the comeback of the banks to their full power of the 1920s and better. The deregulation that picked up real momentum in the 1970s, allowed them to take over the "other financial pillars" that the Rooseveltian *Bank Act* had barred to them. As a result of this deregulation the banks in the US had during the 1980s had lost most or all of their capital in their take over of the Savings and Loan mortgage institutions. In Canada the word got around that if the Canadian banks were to compete with the huge Japanese banks, they had to be released from all restrictions. What was omitted was the detail that many of those gigantic Japanese banks were no longer lending because they had lost their capital on the eurodollar market.

Here let us diverge to clarify the relationship between liquidity that is very much in economists' mouths today and the "purchasing power" that concerned Keynes and most of his contemporary colleagues. For them the key problem was getting the world out of the depression and keeping the economy near-fully employed. The overtones of "liquidity" imply to most ears that those social groups that miss it, are still in control of the economy, but suffer from the fact that they cannot convert their privileged positions into ready cash to enable them to "do deals." "Purchasing power" implies a more basic concern where what is involved is jobs to allow the mass of our citizens to pay their bills and bring up their families. The change from one key expression to the other points to a basic shift of power over the economy, from the producing to the speculative classes, indeed, a difference in the concept of what the economy might be about. Today the possibility of most people being able to earn a living is seen as a by-product of speculative deals that Wall Street and other financial markets are able to do to keep the economy purring.

A Shift of Power Reflected in Language

To bail out the banks two measures were brought in – both conceived and nurtured by BIS. One was the Risk Based Bank Capital Requirements. This declared the debt of the central governments of developed lands to be risk-free, and hence requiring no down payment for banks to acquire. Such debt – which was legal tender – served as monetary base for the creation of bank loans. And the banks in Canada quadrupled their holdings of federal government debt to a total of some $80 billion. Much of this money was shifted from the central bank where the interest paid on it found its way back to the government as dividends, since it had been nationalized by a Liberal government in 1938, when some 12,000 private shareholders of the Bank of Canada had been bought out by the government.

And in 1991, over a two-year period, the banks phased out the statutory reserves that the banks had had to deposit with the central bank from the deposits left with them by the public. These reserves were higher in the case of chequing and other short-term accounts and lower for term accounts. But all reserves could be increased if the economy was judged by the BoC to be overheated. When that happened the banks would have less leverage in creating bank credit on a given monetary base. Or the reserve requirement could be lowered if the economy was depressed and called for stimulation. With the phasing out of these reserves, the only policy tool left for the central bank to control the economy was interest rates. But interest rates happen to be the prime income of money-lenders,

that throughout human history have hardly needed their debt enthroned as the sole tool of government policy.

But there was another detail that completely eluded the BIS and the central banks of the world. If the banks are allowed to load up with 100% leveraged government debt, and the central banks raised interest rates to attain "zero inflation" – as the BIS through its manager Mr. A. Lamfalussy was calling for in 1991, those high rates will cause the steep loss of market value of the previous government debt held by the banks, and they will be in trouble again.

That in fact is what occurred – beginning in Mexico, where the banks had to be nationalized by the government once again, and the peso dropped a full 40%. Only an emergency standby loan organized by President Clinton with the help of the IMF and the Government of Canada prevented the

The Unending Confusion Brought On by Deregulation and Globalisation

Japan has traditionally prided itself on the sense of security that its corporations offered their labour force. Today that is a fading memory in this flattened-out globalized world.

The Wall Street Journal (16/01, "Japan's Profits Rise, but Wages Stagnate" by Yuka Hayashi) recounts: "Tokyo – Japan's economic expansion recently has been a one-sided affair: Corporations are booming, but consumers have not been invited to the party. Japanese corporate earnings are expected to rise this fiscal year for a fifth consecutive year. Stock and real estate prices are climbing – a contrast to the declines for a decade until the early 2000s. 'Help wanted' signs are everywhere, and the jobless rate fell to an eight-year low of 4% in November. The economy as a whole has been expanding for nearly five years.

"But one key element has failed to materialize: Growth in workers' wages. Even as many Japanese companies report record earnings, they aren't sharing the fruits with employees. In an effort to fend off competition from China and other Asian rivals, companies instead are using spare cash to beef up research and upgrade computer systems. They are also giving out fatter dividends and buying back shares in the hope of boosting share prices. They have held down pay raises and are replacing full-time positions with temporary and part-time jobs, which on average pay less than two-thirds the salaries of full-time posts."

There could be no clearer proof that Globalization and Deregulation in all languages translates into a growing gap between the rewards of those in the saddle and the mass of the population.

"After falling nearly continuously from 1997, Japanese workers' total cash earnings turned around 1% in the fiscal year ended March 2006. This fiscal year, however, they are falling again, down 1.1% from a year earlier in November, according to government data.

"'Consumers and households are simply not receiving the benefits of the recovery in the corporate sector,' said Yukio Noguchi, a finance professor at Waseda University in Tokyo. From Japanese companies' point of view, surviving in an increasingly competitive environment requires cutting costs by changing the labor structure."

That says it all. To help attain the highest return corporative returns, and grease financial speculation in company shares and options, the labour force must be kept severely rationed at all times. This is not the result of a dependence on immigrant workers as in some European countries. We are talking of native workers.

"So they are hiring lower-cost-labor: In the July-September quarter, the percentage of part-time or temporary employees hit a record 33.4%, compared with 21% a decade ago, according to government data. Meanwhile, though some of the biggest Japanese companies gave company-wide base-salary raises for the first time in five years last year, the amount was tiny – about $5 a month at Honda Motor Co. and Matsushita Electric Industrial Co.

"With wages not rising, consumers are not about to splurge.

"Annualized household consumption in the July-September quarter was down 3.8% from the previous quarter."

The Vulnerability of Japanese Manufacturers

"From the Japanese companies' point of view, surviving in an increasingly competitive environment requires cutting costs by changing labour structure. Japan is under pressure because its companies are heavily dependent on manufacturing. Chinese competitors are catching up more quickly in steel or auto making than in areas such as finance or biotechnology, in which the US and European companies have tended to excel.

"So they are hiring cheaper labour.

"Weak consumption has led to other consequences. Price rises have been very small, surprising many economists who thought Japan had escaped the grip of price declines. Just last summer, economists were predicting prices would start rising at a faster pace as the job market translated into higher wages and consumption. In November, the main consumer-price index rose just 0.2% from a year earlier, and recent declines in energy prices could push it down in coming months.

"'It is very possible that the CPI will turn negative starting in the April-June quarter,' said Taskehiro Sato, a Morgan Stanley economist.

"This is bad news for the Bank of Japan, eager to depart from super-low interest rates and 'normalize' monetary policy. After the BOJ raised its policy rate target to 0.25% from zero – for the first time in five years – many economists predicted another increase in 2006. That didn't happen. Now many think the BOJ will raise the target to 0.5% at its policy board meeting on Thursday.

"The low interest rates have had the effect of weakening the yen. Japanese investors have been shifting their savings into assets denominated in other currencies, which provide higher interest rates. This has weighed on the yen's value, which now stands 120 yen to the dollar, compared with about 100 yen two years ago.

"The weak yen, in turn, has boosted earnings for Japan's exporting companies, such as Toyota Motor Corp. The low yen makes these companies' products more competitive overseas, while the profits they earn overseas translate into more yen when repatriated into Japan."

The success of Toyota and other Japanese exporters is in part due to the ever more depressed condition of Japan's working class. That in fact has become – indeed always was – the basic rationale of Globalization and Deregulation.

W.K.

Mexican financial crisis from spreading further. However, it did contribute some echo effects in the Asian crisis and the Russian defaulting of its debt not too long after.

The upshot was clear. Robert Rubin, the US Secretary of Treasury, devised a way out of the impossible position that BIS had placed the world banking system. Up to then just about every government in the world had written off its capital investments wholly in the year when they were made, and hence beginning with the following year had carried the value of its roads, bridges, buildings, schools, whatever at a token dollar.

However, the debt incurred to create or acquire these was conscientiously amortized over the term of its financing. Obviously this created a deficit that was not really there, but presented the government to be in great debt and hence unable to provide many essential social and environmental programs. Now the US government introduced capital budgeting (also known as accrual accountancy) to replace this "cash accountancy." The assets reclaimed for the government books in this way, worked back to 1959, amounted to some $1.3 trillion dollars, appeared in the Department or Commerce figures beginning with January 1996 under the heading of "Savings."

The Never-mentioned Government Investment in Human Assets

This, however, they most certainly were not because "savings" usually refers to highly liquid assets, and we are dealing here with bricks, concrete and steel. However, the bond-rating agencies were well aware of such games and the real meaning behind them. Thus the revised government balance sheets brought down interest rates, assured Clinton a second term, and produced the Merger and Acquisition boom that is the subject of this article.

And up to now I have told only half the tale. In the 1960s, Theodore Schultz of the University of Chicago was awarded a Bank of Sweden Nobel Prize for Economics for his study of the recovery of both Japan and Germany to highly competitive positions after the physical destruction they suffered in WWII. Having taken part in the survey by American economists of those two countries right after the war, he had joined in predicting a long period before they could recover. Schultz concluded in fact the important factor was the highly educated, skilled, and disciplined workforce of these two countries that had come through the war with their human capital intact. And from that he deduced that investment in human capital was the most productive that a country could make – in education, and hence in health, the environment, social services.

If We had Advanced Further Along This Path

Suppose the adoption of capital budget brought into the US in 1995 and in Canada only in 2000 were in fact extended to human capital as well, and that it were accounted for according to the principles of double-entry bookkeeping and accrual accountancy. Would that not at least double the effect that our sources attribute to low interest rates? That we were able to track down to the adoption of accrual accountancy by the US in 1996. And instead of just trading environmental polluting rights, suppose any excess pollution were registered as a government deficiency as would unrepaired shortfalls in maintenance of not only the physical but our social infrastructures. Would it not follow that we would no longer be dependent on stock market gamblers to create the additional investment? The same amount of credit – handled through the central bank – could be used to deal with the deficits not only of our infrastructural deficits, but our environmental, and our human capital deficits. Society would be in far better shape for having narrowed rather than widened the gap between speculative financiers and the common productive workers instead of widening it, as has been the case.

We would then not be haunted by the fear that the relative if very one-sided boom will not last. We would make it last simply by attending to society's accountancy – through private corporations where private enterprise can better do the jobs in question, and through the use of the central bank for financing environmental and human capital investments. This lifts a dark curtain on a whole vital panorama of social strategies that have been neglected.

William Krehm

In China Lessons Come Loud and Big

One of the current lessons has to do with health care. From *The Wall Street Journal* (16/01, "In China, Preventive Medicine Pits Doctor Against System" by Andrew Browne) we have a shattering tale:

"Loudi, China – Dr. Hu Weimin has attracted a wide following amongst the poor in this city by providing free advice on how to avoid high blood pressure and dispensing cheap drugs to treat the condition, one of the biggest killers in that country. His efforts have won him national recognition, and he counsels thousands of patients through the Internet. But Dr. Hu's public health message has turned him into an outcast at his hospital. The bottom line: Dr. Hu is bad for business at the Loudi General Hospital. For making treatment widely affordable, his colleagues shun him, and administrators bar him from the wards. Dr. Hu says he has cost the hospital a small fortune in lost profits.

"Like hospitals all over China, Loudi Central earns the bulk of its income from sale of drugs and high-tech testing. Doctors who pull in the most revenue earn the biggest bonuses. That gives them an incentive to pad the bills. Academic studies show that 50% of all Chinese health-care spending is for drugs. In the US the figure stands at about 10%. 'Every prescription is a money-making opportunity,' says Dr. Hu.

"Dr. Hu's experiences show what makes it difficult to fix the broken-down health system. President Hu Jintao has made medical reform a priority. But incentives within China's pay-as-you-go system leads some hospitals to fight desperately needed changes. Dr. Hu, a rare whistle-blower, has been lauded in the state-owned national media for preaching basic preventive medicine, but Dr. Hu has been treated as a dissident in his hometown, beaten up by one of his bosses, and banished from the wards.

"China's socialist government once nursed the health of almost everybody. Then in the early 1980s it launched a privatization program. Private spending accounted for almost 64% of all health-care spending in China in 2004, compared with 55% in the US and 14% in Britain. Moreover, in China, almost all private spending is out-of-pocket. Private insurance coverage is negligible.

"Exorbitant health charges are putting health care beyond the reach of millions of people in a country where two-thirds of the 1.3 billion population has no health insurance and must pay cash up-front for treatment. If the patients can't come up with the money beforehand, there is simply no treatment. As simple as that.

"A Chinese health ministry study showed that 43% of hospitalized patients in 2003 discharged themselves against medical advice, two-thirds of them because they had run out of money.

"Just this week the chief spokesman of the health ministry was quoted by Xinhua calling for a hospital system that stresses public service instead of commercial profit. 'Hospital reform is the biggest problem we face,' he said. He won't comment directly on Dr. Hu's case, but expresses general sympathy with him.

"The system's failure has occurred just when strokes and heart attacks, cancer and vascular diseases have replaced contagious diseases and the leading causes of death in China. That is because of more sedentary habits and growing numbers of smokers, both linked to an increasingly urbanized and Westernized life-style.

"Resentment over health care is increasing. In November, some 2,000 people mobbed a hospital in south-west China after a boy died there. The boy died after he was rushed in by his grandfather after swallowing pesticides, according to the Hong Kong-based Information Center for Human Rights and Democracy. Doctors sent the old man away to fetch more cash, according to the report, but by the time he returned the boy – 3 or 4 years old – was dead. There are conflicting versions of the treatment the child received, but the protesters smashed hospital windows and equipment, and at least 10 people were injured.

"Dr. Hu is driven by personal tragedy. For several decades his father lived as an invalid following a heart attack. The hospital wouldn't free up a room for his venture, but grudgingly agreed to let him use a dank space outside the coal shed. There he set up a desk and hung a white sheet to hide the piles of dirty coal he'd shovelled to one side. His health messages to the crowds that thronged there were simple and cost-free – stop smoking, exercise more, avoid greasy foods, go easy on the salt.

"As more people picked up tips, Dr. Hu says attitudes in the hospital turned frosty as fellow physicians noticed their own patient numbers falling, and revenues decreased. Government data show that Hunan province is a hot-spot for hypertension, brought on by the region's spicy cuisine laden with salt and pork fat.

"Hospital officials declined repeated requests to respond to Dr. Hu's allegations.

"A bonus system for doctors is widespread in China, as documented in a study by researchers at China's Shandong Medical University and the Harvard School of Public Health. Dr. Hu describes how financial incentives work in Loudi Central, a sparkling new facility.

"Doctors who prescribe a CAT scan collect a personal bonus of 20 yuan ($2.50), he says. Inducements grow quickly with the sophistication of the treatment. The bonus for laser surgery is in US equivalent $63. For a heart pace-maker the reward is as much as $2,500. In addition, he says, the hospital pays departments collective bonuses based on the value of the drugs that doctors prescribe.

"The extra cash makes a huge difference to a hospital doctor in a provincial city like Loudi, who typically earn less than $200 a month in salary.

"Few countries let doctors profit so directly from their patients. China's system virtually forces the profit-making incentive upon hospitals that are still mostly owned by the government – yet are largely self-funded."

Doctors Depend on Prescription Profits to Eke Out Livelihood

"In an effort to make treatment affordable, health authorities set low wages for doctors and impose caps on hospital charges for basic care and common drugs, which are delivered below cost. To make up for this hospitals and clinics are permitted to charge a 15% to 20% markup on new drugs, advanced tests and technologies. An unintended consequence: hospitals have turned into giant pharmacies. Some 60% of their revenue comes from drug sales, according to official data.

"Doctors massively over-prescribe drugs to increase their salaries. One survey cited in a World Bank study last year showed that less than 1% of drug prescriptions at village clinics in poor areas of China were considered 'reasonable' by doctors who reviewed the records.

"Dr. Hu's battles with his hospital have upended the personal life of the gentle-mannered 43-old, who relaxes playing the violin and practising tai chi. Matters came to a head when he got into an argument with the deputy director of internal medicine, Chen Binhua, in 1999. According to local court records, there was some pushing and shoving and then Dr. Chen lashed out with a kick that caught Dr. Hu in the groin. The blow was serious enough to put Dr. Hu in the hospital – and, he says it rendered him impotent. As a result, Dr. Hu says his wife abandoned him. Dr. Chen, who retired, could not be reached.

"In 2003, the hospital director tried to remove him from medical practice altogether, and push him into a new job in the hospital union. Dr. Hu refused to go, but he was barred from working as an internist in the hospital wards, meaning that he could only do outpatient work. Finally in 2004, he resigned and with nothing more to lose took his story to the national media. Investigations detailing his persecutions begun appearing in state-run newspapers.

"Dr. Hu withdrew his resignation after two weeks. He says what changed his mind was a petition signed by 3,000 of his patients denouncing the hospital and begging him to stay.

"On one of his recent Sunday morning rounds, he dropped in on Wu Lianhua, 77 years old, in her windowless basement. A frail grandmother with wispy white hair, who gulps oxygen from a rusty cylinder by her bed, Ms. Wu says she ran through $6,300 in three months in another hospital. That exhausted the life savings of the retired textile worker and her husband. Dr. Hu says he immediately took her off a cocktail of expensive imported drugs that he says were working one against the other. A Chinese-made generic drug for hypertension plus another for anxiety gave her a full night's sleep for the first time in sic months. His monthly bill was $38.

"These days, Dr. Hu's clinic has moved inside the hospital. The sign above his door proclaims 'Prevention and Cure for Blood Vessels of Heart and Brain.' It's standing room only on weekday mornings. 'The most expensive medicine is not always the best,' he lectures the crowd. 'Find a drug that works for you.'

"Dr. Hu's relations with Loudi Central remains frosty. Even though he's now part of a national project collecting data on hypertension, his hospital will not let him into the wards." *W.K.*

New Year *continued from page 6*

Commission, of the sort that proceeded the setting up of the Bank of Canada as a private institution under a Conservative government in 1935. Banks should be confined to banking, and not allowed to roam the world in ever more hazardous financial plays, secure in the confidence that their gaming losses will continue – as in the Enron case – to be covered at the expense of the most vulnerable members of our society.

William Krehm

1. Krehm, William (May, 1970). *Revue Économique*, "La Stabilité des prix et le secteur publique." Paris.

Putting the Pacific Ocean between Mother and Child

The Globe and Mail ("Child care so costly immigrants sending babies back to China" by Marina Jimenez") recounts a touching tale, that victimizes all the citizens of this land, not only the Chinese immigrants.

"Sunny Wu had just immigrated to Canada from China when she discovered that she was pregnant. Overjoyed, Ms. Wu prepared for her baby's arrival, never imagining that within a year she would have to endure the agony and loneliness of being separated from her daughter.

"Ms. Wu, a Chinese teacher, and her husband, a computer programmer, were squeaking by on minimum-wage jobs and could not afford to pay $1,200 a month for daycare. Ms. Wu, 34, also knew that she would have to return to university if she didn't want to spend the rest of her life as an overeducated embittered immigrant, packaging groceries for $7 an hour. Though the separation was devastating, the couple could see no other way out. They sent their baby daughter to China to be raised by her grandmother, who was already caring for the toddler they had left behind."

"Not the Way My New Life was Supposed to Be"

"'I felt guilty. That wasn't how my new life was meant to be. I came to Canada for a better quality of life, not a worse one.'

"According to social service workers in Toronto's Chinese community, dozens, even hundreds of recent Chinese immigrants have sent their infants back to China to spend their early years with relatives. They are separated from their children due to financial constraints and unaffordable daycare in a country they came to, ironically, because they thought it would be a great place to raise children.

"Canadians are by now familiar with the heartache Filipino and Caribbean women endure when they leave behind their children to come to Canada as live-in nannies. They end up parenting their offspring via long-distance phone and video cameras. But the phenomenon of Chinese professionals immigrating here, and then sending their children back to China, is a new trend in what global experts call 'transnational parenting.'

"It raises troubling questions about how well the Canadian immigration model is working, and may help explain the recent decrease in immigration applications from China.

"'We discovered dozens of professional immigrants from mainland China were doing this because they all asked how to get passports for their babies,' said Florence Wong, a social worker with St. Stephens Community House in Toronto.

"In 2002, Ms. Wong conducted a study of Chinese immigrants in five prenatal programs. Seventy per cent of the women said they were planning to send their children back to China to be raised by relatives.

"Ms. Wong decided the problem was serious enough to produce a documentary profiling several Chinese newcomers who sent their children back home. She now screens the film to newcomers to attempt to persuade them to keep their families together.

"The Chinese women and their husbands interviewed by *The Globe and Mail* are all professionals in their 30s who came to Canada believing that they would find jobs in their fields that would pay well. However, instead of finding jobs as civil engineers or meteorologists, they were forced to accept minimum-wage jobs. With family incomes of $1000 a month, daycare often wasn't affordable; yet they also didn't qualify for subsidies.

"I have met so many immigrant women who want to send their babies back to China as soon as they are three months. 'I tell them not to do so,' said Faith Wu, an engineer who immigrated from Guangdong province in 2000. Chinese people are losing interest in coming to Canada because of this.

"As China's economy has surged in recent years, immigration applications to Canada have dropped dramatically. The number decreased to 19,000 in 2006 from a high of 40,000 in 2004, compared with 132,000 applications last year from India.

"Sunny Wu says she would do anything to recapture her early years with her children. When she and her husband immigrated to Toronto in 1999, they were planning to send for their elder daughter once they got settled. 'The immigration agency said Canada was the best place to live, an extrovert who speaks English flawlessly. However, when her second child was born in November, 2000, her husband was still searching for work. Her mother came from China and flew back with the baby when she turned 13 months. 'It was so difficult. I had breast-fed her, and we're very close.'

"Her older daughter came to live with them when she turned 2 and her husband finally had a job in his field, but her second child didn't rejoin the family until she was 4. At the airport she said, 'Where is my mommy. My mommy is a computer.' She was so used to talking to me by video camera.

"In China it is the cultural norm for grandparents to help raise children (though they are usually together in the same house). Sunny was raised by her grandmother and only reunited with her mother at the age of 11. She remains more bonded to her grandmother.

"Now that her two daughters, aged 6 and 8, have been reunited with their parents, Sunny Wu believes they are exhibiting signs of psychological damage from the separation. Her younger daughter always seeks out her grandmother, who lives with them, if she is hurt or upset. She is a less confident child than her first-born. During her first week in kindergarten, she wouldn't let us leave the room. It's as though she doesn't trust us as parents any more.

"Sunny Wu has now successfully trained as an accountant and has a good job. But the price seems too high.

"'The parent loses his or her status as an authority figure,' says Prof. Judith Bernhard, director of the Early Childhood Education master's program at Ryerson University."

Guilt of the Absentee Parent

"The children often feel resentful and may rebel by refusing to listen or accept their parent as a decision-makers. Prof. Bernhard recalls one child who refused to eat in front of her mother.

"For mothers, the most common emotion is guilt, and they sometime compensate by spoiling the child.

"An immigration selection model that recruits professionals who end up being forced to accept blue-collar jobs is a flawed one, she says. 'This story also points to the fact that Canada doesn't have subsidized daycare, while countries such as Sweden, Finland and even China do.'

"Last month, Ontario passed the country's first bill aimed at helping internationally trained professional work in their fields. The bill requires the province's regulated professions to ensure the licensing process is fair and transparent, and to assess the

credentials more quickly. A commissioner will look at eliminating barriers to entering professional association."

However, there are still bigger flaws in our set-up that flow directly for the wretched nature of our economic theory. If we recognized investment in human capital as the most valuable investment that a country can make, we would not be so improvident when professionally qualified people choose to emmigrate to Canada. And we would not risk imposing psychological burdens on the families that represent a liability for the country. Bad economic theory produces bad accountancy. Valuable social assets are treated as scrap because they require a minor additional public investment.

William Krehm

Jungles that Grow Best in Pitch-black Darkness

There is a powerful and two-way link between power and information. Power alerts those who possess it to what is cooking, since they themselves fill and stir most of the pots. But the potential of that information to increase already existing power is multiplied by turning out the lights. For that endows information with monopolist leverage.

On the point listen to *The Wall Street Journal* (9/01/07, "Shares Bought in the Dark" by Aaron Lucchetti):

"A Supreme Court jurist once wrote that sunlight is the best disinfectant. Wall Street, though, is finding it more profitable to work in the dark.

"In the past few years, large brokerage firms, trading boutiques and even stock exchanges have launched or announced plans to start almost 40 trading networks known as 'dark pools.' The are called that because they attempt to put buyers and sellers together anonymously without exposing their clients' orders first to the public, as happens on traditional stock markets like the New York Stock Exchange and NASDAQ stock market.

"The pools have proliferated as big institutional investors respond to the boom in electronic trading and seek alternatives to middlemen like floor traders. They have also become more popular as stock exchanges look to increase their fees, causing some traders to seek alternatives.

"The Securities and Exchange Commission and others, though, are voicing concerns about dark pools, which while only representing about 5% of stock-market activity, have tripled in volume since 2004, according to consulting firm TowerGroup. At a trading conference in September, SEC officials said they would increase scrutiny of dark pools, including a review of how they are used by sophisticated players like hedge funds and proprietary Wall Street trading desks.

"'Calling them "dark pools" is just calling for regulation,' said John A. McCarthy, a lawyer of a Chicago trading firm who at the time worked as an associate director at the SEC.

"Critics of dark pools say the rapid growth could lead to less competitive trading prices for small investors who buy and sell the old-fashioned way – on open markets such as the Big Board and NASDAQ. Brokers are generally obliged to offer their buyers the best available published price, something that will become harder as dark pools grow further, and the price is posted only after the price has been completed.

"Here's how the pools work: Trades are matched with other orders on a proprietary system that outsiders can't see. Within 90 seconds, the trades are required to be reported publicly. (Most are reported within a second or two.)

"Investors with big positions tend to favour dark pools because they don't have to expose their trading intentions to all market participants. Floor trading is more transparent, but players can still mask their intentions. For example, a trader can break up a large order and sell it in pieces, keeping the magnitude of the trade hidden from the public.

"Dan Mathisson, managing director of electronic trading at Credit Suisse Group, says if Wall Street didn't have dark pools, it would be like 'asking people to play poker with the cards face up.'"

Big Purchasers Wanting to Appear Small

That language is more proper to casinos which have to do with gambling rather than to investing. Besides, isn't the entire structure of official economic theory based on players so infinitesimally minute, that anything they do or don't do individually cannot affect prices or the market? Either the very substantial advantages of such an assumption must be abandoned, or the privileges of extraordinary size must be limited.

"In most dark-pool trades, the prices are usually slightly better than what is available in the general market. Dark pools typically charge higher fees than exchanges, but the customer often ends up by saving money when their better price is factored in.

"Dark pools started in the 1980s as firms like Investment Technology Group and Instinct Inc., designed networks to make trading easier for big investors.

"These players – primarily pension funds, mutual funds and some bigger hedge funds – wanted to buy and sell big blocks of stock without pushing prices around, which often happens when they make big purchases or sales in the open market.

"For years some Wall Street firms have crossed orders on their own systems, a practice known as internalization. That is now increasingly happening in dark pools. Many Wall Street heavyweights, including Goldman Sachs Group Inc., Credit Suisse Group and Morgan Stanley now operate dark pools, as do Nyfix Millenium ATS, Liquidnet Holdings Inc., and Pipeline Trading System, LLC.

"Still, regulators are looking into dark pools 'because they are not transparent,' says Robert Hegarty, managing director of Tower Group. The concerns are twofold: making sure investors get equal access to buy and sell at the best price, and linking the burgeoning number of dark trading platforms so that investors can be confident that they are getting a good price when they trade.

Now exchanges that are losing market share to these alternate trading venues have started moving towards their own version of dark pools, launching anonymous crossing sessions throughout the day. NYSE has only said that it will do such sessions only outside the 9:30 am to 4 pm trading day, but it is exploring expanding the sessions to regular hours.

"At NASDAQ, dark pools known as crossing auctions are offered at the beginning and end of trading, and more are being added throughout the day. In the electronic sessions, orders pile up anonymously and then are executed in a single piece in between the best advertised bid and offer. This system is appealing to investors who don't want their order displayed in the broader market."

W.K.