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Collapse of Bridge Uniting Investors and Investments

When a Minneapolis bridge collapsed with an abundant loss of lives, it was an astounding mishap in a country long noted for superb engineering. However, it was the result less of a flaw in engineering than in government accountancy that sees cuts in spending on maintaining infrastructures as "fiscal prudence." Nor was this the most shocking surprise to come out of the United States in recent days. Hardly less traumatic was the separation of investors from their securities for days on end when the pricing that provided the basis for accountancy needed in the trading of any securities by banks, brokerages, and other agencies suddenly disappeared. The rich manure fertilizing these fields to tropical splendor has been the complicated structures of asset and debt-based derivatives. So complicated had the system become, that it finally broke down for lack of a "fair" market price. To such a point that the very organizations that helped set up such arrangements in the first place found that the game could be reversed, to make even bigger profit by separating the owners of such securities from borrowing against them. The fiction of self-balancing markets, and "fair prices" had simply collapsed with the slightest kick from a few friendly banks. Some of the financial corporations who had lost out in a big buyout deal concluded that with prices driven into the skies, they could do even better simply by buying up the debt with which the victors loaded the companies they had acquired.

Let us turn to *The Wall Street Journal* for some details (15/08, "Valuations Turn Tricky" by Ian McDonald, Carrick Mollenkamp and David Reilly): "The seizing up of some debt markets because of the subprime-mortgage shakeup has left some investment funds wondering how to value their holdings.

"Last week, France's BNP Paribas, SA said it would stop the flow of money into and out of three of its investment funds because it couldn't 'fairly' value securities in the funds. That, the bank said, made it impossible to come up with a net asset value for the funds that would allow investors to get in and out. When the bank, for example, tried to sell about two millions of bonds backed by US mortgages, it couldn't find any buyers. 'Among the brokers they called, some were not even answering the phone,' said Alain Papiasse, head of BNP's asset-management and service division.

Are "Fair Prices" Compatible with Distressed Markets?

"Similarly frustrated with shaky market prices last month, French insurer AXA SA opened its wallet to cash out investors of two funds rather than sell securities at fire sale prices. The oft-repeated problem is that the funds and even some companies can't get a price for many debt securities and derivatives with direct or indirect links to loans made to homeowners with spotty credit histories. These are bundled into a package with higher grade debt, and then "swaths" of higher or lower risks are peddled at different prices to reflect the extent of their risk. That with more risk exposure is rewarded with a greater share of the ultimate profits, should such emerge. But it takes months if not years to disentangle the pieces of risk and of eventual hypothetical profits, to say nothing of the payment records of the mortgaged

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properties. Given that, they ask, how are they supposed to mark holdings to market when there is no market?"

And when there is no ascertainable market, that opens a new crap game with yesterday' losers in the buyouts suddenly become the immense profiteers in the sell-outs, still armed with the unused credit or cash mobilized for their unsuccessful buyout ready at hand to take advantage of even more lucrative bonanzas. And whereas so recently they were tweaking banks and funds to commit themselves to yet more cash for their buyouts sellouts, they are now prudently supplied with it for the sell-outs.

Thus immediately in the same issue of *The Wall Street Journal* article just cited there is another ("Hedge Funds Seek to Gain Again on Debt They have Arranged" by Henry Sender): "Private-equity firms and hedge funds helped create billions of dollars in debt during the leveraged buyout boom. Now some of these funds are eyeing and buying the very same debt at discounts as its value plunges.

"Typically to 'mark' or estimate the value of a holding, funds use market prices, quotes from broker-dealers, values tallied by third-party pricing services, or some internal combination of all four. Sometimes funds will block redemption of their securities in an effort to prevent having to sell into a market that they think is below reasonable values. But without a market, doing so can get tough, especially when markets take a dive.

"The methods may be pretty unpalatable for managers dealing with the turmoil now gripping markets. One answer is that everything has a price – if it is low enough. That is tough for many managers to swallow if they think the long-term value of a holding isn't impaired. Trading at such a price is also a difficult prospect if a manager wants to avoid selling into a distressed market. The key point with BNP, for example, was the use of the word 'fairly.'

"But if there are no buyers to be found, there may be even worse alternatives. 'Then the price is zero,' says Jack Cieselski, editor of *Analyst's Accounting Observer* newsletter. 'If there's no bid out there, there's a price. Take your pick.'

"Others are sympathetic to the managers' plight. 'You need securities to trade before you can price them,' says Michael Youngblood, portfolio manager and managed director of fixed income research at FBR Investment Management of Arlington, VA. The market for existing bonds lacks transparency and so isn't helping set prices. And 'with the primary market frozen, we have an ineffective reference for determining value,' he says.

"That logic is rarely cited when markets are soaring. Fund managers didn't explain that they were marking the value of their assets too high, Mr. Cieselski, the newsletter editor says.

"Yesterday in a Securities and Exchange Commission filing the fund said the market instability has made it difficult to obtain realistic values for the fund's securities and that it had hired a consultant to assist in the valuations. The fund said that many of the fund's securities may be difficult to sell at a fair price to pay for redemptions from the fund."

However, given the disparity between the powers of the fund managers and the average investing member who needs to get his equity out, the law of the jungle will often prevail.

Borrowed Money Fuels the Deal Boom

Borrowed money has been the fuel of the deal boom. Private equity firms loaded up the companies they purchased to help finance their purchase and pay their own fees. These loans provided by banks and others were then sold to hedge funds and other investors in a deal machine that chugged along energetically for years.

"But the recent credit-crunch has frightened off many buyers of these loans. That has left the banks that arranged the loans holding some of the debt while other debt issued earlier rapidly drops in value."

The abundance of money seeking investments was closely connected with the incompatibility of the two main factors planned by the Bank for International Settlements (BIS). BIS is a sort of semi-underground war-room that planned and guided the deregulation and globalization of the banking systems of the world to overcome their confinement to strict banking by the banking laws brought in under Roosevelt. They were not allowed to acquire interests in the "other financial pillars" – stock brokerages, insurance and mortgage companies. The reason: each of these had need for its own liquidity pools of cash and near-cash for its own businesses. Allow the banks access to these, and they will use them as cash base to which to apply the "banking multiplier" – the multiple of interest-bearing debt banks can lend out on the basis

of their cash and near-cash holdings. That by the new millennium had increased the proportion of bank-created money by the year 2000 into some 380 from the 9 to one that it amounted to after WWII. All this craved investment since it was created under a compulsion to grow.

BIS's Right Hand Knoweth Not What It's Left Hand Is Up To

There was yet another factor never mentioned in even the more conscientious business press – the incompatibility of the two main strategies of the BIS to repair the American banks' loss during the 1980s of most of their capital in taking over the Savings and Loans. The *Risk-based Bank Capital Requirements* drawn up by BIS (1988) declared the debt of the central governments of developed countries "risk-free" and thus requiring no down payment for the banks to acquire. As a result the Canadian banks increased their holdings of federal debt from $20 billion to $80 billion, all of it with no down payment. In 1991 the second measure was brought in to help our banks out of their past losses and head them towards greater conquests.

The statutory reserves – a proportion of the deposits taken in by the banks from the deposits had to be redeposited with the Bank of Canada, and on this the banks were paid no interest. The importance of these reserves was that they provided a second tool for the government to guide the economy by increasing the reserves and thus leaving less base for increased lending if the economy seemed overheated, and reducing the reserves if the economy needed stimulation. That was of crucial importance, for with interest rates the sole lever for raising or lowering the pace of the economy, economic power passed to the financial sector. For interest is the basic revenue of money lenders in general and banks in particular. When interest rates are raised they hit everything in the economy. Including particularly the unemployed who could not be contributing much to inflation.

The bottom seemed to have fallen out of the short-term credit markets right across the board. It was as though our banks by their taking over the other financial pillars made possible by the deregulation seriously begun in the 1970s had become not only short-term, collateralized lenders, but monopolist money-creators and lenders – not that they owned the whole field of activity, but because what they were doing, and the compulsions they operated under, put them at the top and in control of the heap. Globalization brought a great variety of economic services, but close conformity of compulsions and responses prevailed. Globalization is more prone to flatten the earth that to keep it well-rounded. Within the same issue of the *WSJ*, there are at least two other articles of the same phenomenon that we have been discussing in yet other areas.

Collapse of Short-term Collateralized Debt Markets

Thus "Credit Ripples Reach Cash Funds" by Shefali Anand and Ann Davis: "Turmoil in the credit markets is spreading to one of the most conservative kinds of investments, causing a small money-management firm to freeze its clients' assets. The move sent tremors through stocks as well as commodities, until now one of the few markets relatively

The Infinite Storeys of Deception in the Current Wall Street Crisis

About a century ago economists started identifying the economy with financial markets, and discovered that you didn't have to plod around with simple arithmetic as Adam Smith and even Karl Marx used to do. After all, Kepler and Newton, while staying on their earthly perches, were able to decipher the secrets of the heavens. You did not even need planes or elevators – a bit of arithmetic would help you get into heaven's secrets.

Any simple fraction consists of a numerator and a denominator. Our single whole numbers 1, 2, 3, etc., all assume a denominator of 1 – i.e., they count and multiply, they are "denominated" (hence the "denominator") in units of whatever measurement. If that denominator grows the value of the fraction shrinks – eventually to zero as the denominator achieves infinity. Or if the denominator shrinks to zero the value of the fraction moves to infinity. And it was by such devices that orbits of the planets around the sun observed by Kepler that helped Newton to identify the force of attraction between all from the shape of the planets' orbits around the sun plus the attraction from their fellow-planets.

The great goof of official economics is that it deduces that the economy is self-balancing not from studying the economy *with the help of* calculus or whatever, but *from* infinitesimal calculus itself. An exact parallel would be if a medical doctor examined not the patient, but confined himself to taking the pulse of the X-ray machine – while the patient was left in the waiting room to look after his fee. Incredible as that may seem, at the very time when through globalization and deregulation mega-corporations have been handling greater quantities of money in takeovers that involve commitments that have jumped from millions not so long ago into billions of dollars today. But all this is based on the use of infinitesimal calculus that requires a model that assumes that all the variables are of such tiny, tiny size that you can ignore all increase but the first degree of tininess.

Thus when Isaac Newton was faced with untangling the riddle of our solar system that Kepler had identified to be moving in closed orbits around the sun, he devised the calculus by assuming that when two quantities of the first degree of infinite tininess are multiplied. the result – developed by Newton in his youth in the binomial theory that we all learned in the first year high school: the square of a+ b or (a+b) x (a+b) multiplies to give you $a^2 + 2ab + b^2$.

Newton's daring was to shrink the growth and the size of the second variable which was the increase in the growth rate of the first so he could ignore the second degree of b which left the rate growth of the variable a 2b – but only if the b were small enough to ignore the second degree of b in the growth rate of b squared. Even so, Bishop Berkeley asked with aggressive piety why mathematicians could see numbers vanish but often refused to recognize that there was a holy spirit that might be invisible but even greater than the miracle assumed by Mr. Isaac Newton.

Our economists apparently see themselves in the guise of a such a holy spirit, since in a world where financial corporations span the globe, but are treated as so infinitesimally small that nothing they do or leave undone can interfere with the self-balancing act of the market.

William Krehm

Allen Good's cartoons will return.

untouched by recent worries.

"Yesterday Sentinel Management Group Inc. – citing 'panic conditions' in the market – prevented its clients from withdrawing money from their cash accounts. Sentinel manages money for hedge funds and commodities traders in what are mostly akin to money market accounts: short-term investment vehicles supposed to behave something like a bank account.

"Sentinel said to clients in a letter dated Monday that an inability to easily buy and sell securities in the credit markets was making it tough to price its holdings. 'We are concerned that we cannot meet redemption requests without selling securities at deep discounts to their fair value and therefore causing unnecessary losses to our clients,' the letter said. Sentinel did not respond to requests to comment.

"It is the latest sign that the bond market turmoil is hurting even investments considered among the most conservative places to temporarily park cash."

It is a self-defining conclusion that where there is no parking space for cash – the holiest of holies in an ever climbing all-embracing economy – there is no safe way of taking in the grand prix races.

W.K.

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Credit as Money

Some COMER affiliates in Kingston are preparing a brief educational video. One element is the following information recommended by Richard Priestman, about how banks create money.

Banks create money "merely by giving their promises to pay."

"What they do when they make loans is to accept promissory notes in exchange for credits to the borrowers' transaction accounts.… They do not pay out loans from the money they receive as deposits. If they did this, no additional money would be created."

Borrowers "spend" the credits by writing cheques.

Richard identified the source of the statements in quotation marks as the 1994 edition of the manual *Modern Money Mechanics* that has been published for many years by the Federal Reserve Bank of Chicago. It hardly rates as news, therefore, even though it is information that many people do not think about very often.

In the 1930s, however, it was the focus of many people who were trying to understand why they were suffering so much individual privation in the face of obvious material abundance. There was widespread agreement that an insufficiency of *money* was the primary source of the problem. Consumers didn't have enough money to buy the goods that were available, and entrepreneurs couldn't get loans for investment or even operations. Consequently, a lot of attention was paid to the nature and provision of money. The finger of blame was pointed at the banking system. That seems to have been the time when it began to dawn on popular understanding that most of the money supply is actually *credit*.

Populist monetary reformers were indignant over the discovery that banks could create money "out of nothing." They took pains to counter the view that banks *merely* lend out the money that depositors entrust to them. As the Federal Reserve manual affirms, that would not create any new money. The 1930s literature therefore emphasized the ability of banks to create money by granting loans in an amount several times that of their deposits. C.H. Douglas seems to have been a pioneer in spreading this understanding, as is reflected in his extensive testimony to the Banking and Commerce Committee of the Canadian Parliament in 1923. It is manifested strongly again, in a 1939 embodiment of the same committee when Graham Towers was the expert witness, as Governor of the Bank of Canada. (The occasion was consideration of the annual report of the newly nationalized Bank.) Several of the committee members were ardent money reformers and their questioning was designed to force out concessions about the "secrets of the temple" from the supreme high priest. Towers acknowledged that ninety-five percent of business volume is done with exchange of book-keeping entries in banks against which people write cheques, that bank loans create deposits, that the deposits so created are actual money, and that such creation of money is the essence of banking business, "just in the way that a steel plant makes steel."

Reformers in our own time are still fond of dipping back into that interrogation of Towers as a vindication of their ongoing mission, as if it had forced out the secrets of a mysterious cult. A perusal of the *Proceedings* leaves one with the unmistakable impression that a central banker in 1939 was not at all disturbed to make the revelation, however. So it was not news, even then. This is confirmed by an Australian pamphlet on money reform from the same period (see S.F. Allen in *The Reading List of an Economic Radical)*. It quotes the 14th edition of *Encyclopedia Britannica* as follows: "Banks create credit. It is a mistake to suppose that bank credit is created to any extent by the payment of money into the banks. A loan made by a bank is a clear addition to the amount of money in the community."

This reference to *Britannica* doesn't tell us how old this popular information was in 1939 without knowing when the 14th edition was published. Checking the history of the *Encyclopedia* confirms that the quotation could have been quite contemporary with the pamphlet, for the 14th edition was published in 1929 and was continuously revised after 1936. (The 15th edition was published only in the early 1970s and current versions are still called 15th edition.) In the early days of the twentieth century, every revision or supplementation of *Britannica* was published as a new edition.

Pushing back to the "classic" 11th edition of 1911 we get a hint of when the money creating power of banks became more widely understood. The article "Banks

and Banking" in Vol. 3 says this: "A bank collects capital from others. It could never prosper if it relied on its own alone. (The author cites David Ricardo, *Proposals for an Economical and Secure Currency*, on how it is done.) But it does not hoard. 'It only holds the funds with which it is entrusted till it can use them, and the use is found in the advances that it makes. Some of the deposits merely lie with the bank till the customer draws what he requires for his ordinary everyday wants. Some, the greater part by far, of the deposits enable the bank to make advances to men who employ the funds with which they are entrusted in reproductive industry, that is to say, in a manner which not only brings back a greater value than the amount originally lent to them, but assists the business development of the country by setting on foot and maintaining enterprises of a profitable description.'" (Experts on contemporary finance say that banks no longer fill this function to more than a minor degree.)

A significant change occurs with the 12th edition of *Britannica*. This one, published in 1922, simply supplemented the original 28 volumes of the 11th edition with the addition of three new ones. These are described as summarizing the state of the world before, during and after World War I. The article on banking in the 12th edition provides the data to show that deposits of British banks between 1913-4 and 1920-1 increased by 143%. The author considers why and how. He notes that some bankers said it was from money waiting for employment in trade (this reflecting the post-war trade slump of 1919-20).

But the author (Wm. F. Spalding, an official Examiner in Banking, Currency and Foreign Exchange) said that: "[T]he true causes during the war were to be found in the inflation arising out of the Government's war finance; while immediately after the war, bankers were certainly too free with their advances. Each advance had the effect of adding to the deposits of some or other bank in the country, since when a person raises a loan with a bank the amount is nearly always credited to his current account. Obviously, then, an increase in bank loans and advances is concomitant with an increase in bank deposits and…bankers were able to extend their loans in this manner because a large proportion of the inflated deposits of the war period still remained with them as additional cash…. Undoubtedly, the increase in deposits was largely due to the immense creation of Government credits, which eventually found their way into the pockets of producers, and wage-earners, and so on, to the banks."

This pattern of development in *Britannica* hints that the understanding of money as credit really began to take hold among even relatively sophisticated observers with the experience of major war finance in the early 20th century. That leaves a large gap to be explained, since the Bank of England is said to have been instituted more than two centuries earlier for purposes of war finance.

Keith Wilde

Was the Subprime Mortgage Mess Really Unforeseeable?

This little review has a simple topic. It seeks answer to the question: Was the current subprime mortgage crisis really as unforeseeable as is claimed?

There is broad agreement that the phenomenon of subprime mortgages would have occurred had there not been an unprecedented glut of liquidity – near-money with sea-legs, air-legs and actual wings seeking a haven – investment of just about any sort, so much of it was around. Our first step then is to get the official position on that phenomenon conceived and put into practice by the head of the Federal Reserve that still has more to do with the world's money supply than any other institution. So we will begin by quoting the *Monitor – Capital Flows,* 07/03/05, an issue entirely devoted to Causes and Consequences of the Buildup in Global Liquidity. This publication is put out by Financial Markets Center, PO Box 334, Philomont, VA, USA, 20301. It is a non-commercial institution devoted to monitoring the US Federal Reserve and the world financial conditions.

The quoted issue begins on page one by putting the problem we are concerned with into focus: "Testifying before the Senate Banking Committee on February 16, 2005, Chairman Alan Greenspan expressed surprise that long-term interest rates were lower at that moment than they had been when the central bank began a tightening campaign that more than doubled the short-term rates. Noting similar declines in long rates in Europe and other parts of the world, he said, 'for the moment, the broadly unanticipated behaviour of world bond markets remains a conundrum.'

"Viewed from a more disinterested perspective, however, this might be seen as a predictable outcome of the extraordinary buildup in global liquidity in recent years. During this period, an unprecedented increase in the availability of funding has spurred escalating amounts of leveraged speculation in the form of carry trades, where the effects of borrowing short-term at low rates is to drive down rates on the higher-yielding, long-term assets in which the funds are invested.

"Expanding liquidity is also reflected in two other characteristics of current market conditions that Greenspan mentioned: narrowed risk premiums and eased credit standards. In fact, what was surprising about the chairman's testimony was his silence on the subject of liquidity, which is, after all, what central banks create and curb in their quest for price stability.

"By contrast, the Managing Director and staff of the Bank for International Settlements argued in their 2004 *Annual Report* that a direct link exists between accommodative policies in the G-3 countries (the US, the euro area, and Japan) and mounting liquidity in global financial markets. The report points to quantitative measures such as the monetary base, broad money, and credit in the private sector – all of which have expanded rapidly over the last five years.

"Moreover, the BIS 2003 *Annual Report* specifically criticized the Fed for creating a situation in which a potential US downturn could be more severe due to the domestic debt build-up encouraged by monetary ease. Echoing other observers, the BIS noted the exceptional increase in household debt relative to disposable income in America and other advanced economies – and it warned that that such imbalances might damage these countries' financial systems. In addition, the central banker' organization suggested that stability was a factor in the debt buildup because policymakers failed to reckon with a shift in inflationary pressures from goods to assets markets.

"But BIS warns that it is not only the G-3 countries that confront these risks. Much of the rest of the world faces the possibility of spillover effects of the dominant status of the G-3 currencies. In addition, investors' aggressive search for yield has channelled a rising volume of capital to countries with higher

interest-rate differentials than the G-3, thus creating excess in these countries as well."

The International Investment Position

"When Wall Street crashed in October 1987, US residents still owned more assets abroad than foreigners owned here. But the increased borrowing to finance growing trade deficits had already taken a toll of America's once strong creditor position. By 1989, the US became a debtor nation and its foreign debt continued to mount throughout the 1990s. At the year-end 1996 the net debt reached a record $548 billion (with assets at market value). One year later it crossed the $1 trillion threshold – equivalent to 13% of gross domestic product. And by the end of 1998 it had risen to $1.5 trillion or 18% of GDP. At the end of 2003 it stood at $2.65 trillion. During 2003, new financial flows for US investment abroad ($283.4 billion and foreign investment here ($829.2 billion both rose from the previous year and the difference between inflows and outflows did not seem to grow as much as it had during the previous years, due to the effects of dollar depreciation. With the decline of the dollar giving a significant boost to the value of the US-owned foreign interests, America's net debtor position deepened by a comparatively modest $97.6 billion.

"More important, the ostensibly small change in the net investment situation and the decline in the external debt-GDP ratio both tended to understate growing US vulnerability to a loss of confidence by foreign investors.

"Private financial flows to and from the US increased in 2003 despite a weakened dollar – in part because easing by monetary authorities fuelled an expansion in global liquidity that encouraged borrowing and lending for carry trade [borrowing where money is cheaper and investing it where the return is considerably greater]. At the same time the depreciation of the dollar helped to further accelerate foreign official investment. During 2003, foreign central banks and government agents bought an additional $248.6 billion of US financial assets – nearly double the previous record in 1996 – thus accounting for 30.0 percent of net new foreign holdings. and 14.0% of total foreign holdings. In 2004, foreign holdings continued to rise as Asian economies purchased dollars to prevent the appreciation of their currencies and a resulting loss of export competitiveness."

W.K.

How We Confuse the Chinese Still Further

While they are still under a pretense of Communism and one of the most corrupt capitalist regimes, Wall Street is giving the Chinese a special course on how expensive mega-scams can be.

For years now the US has used all its charm and muscle to convince China to bring its huge merchandise trade into balance. However, following the Japanese post-war model that transformed its economy into a formidable export machine, the Chinese have resisted. To make matters worse, they have declined to push up the benchmark interest rate of their central bank, as the Americans have done by stripping all alternatives to the Fed fund interest rate – the statutory reserve, that required banks to redeposit with the central bank a portion of the deposits taken in from the public. Those reserves when they still existed throughout the west reduced its reliance on the central bank's benchmark interest rate to flatten out the price level. That not only helped the Chinese with their federal budget – for the statutory reserves earned no interest and thus provided considerable free financing for the central government, but avoided surrendering the economy to the financial sector – for interest is the primary income of money-lenders and its arm-breaking tool not only for collecting bad debts, but for creating basement bargains for aggressive financiers. Convincing China to rely more on manipulating interest rates is one of the goals of Washington policy, because that would strengthen the yuan's exchange value abroad, and thus shrink China's enormous export advantage.

As a compromise, China, ever eager to acquire US technology on whatever field except monetary policy, has followed the Japanese example – apparently once too often. Japan lost much of its winnings in keeping the yen low by plunging into US real estate at the worst possible time. The resulting losses put Japanese banking and interest rates in a deep freeze for almost a decade. Now, China has similarly dived headlong into Wall St.'s turbulent waters with disastrous effect.

The New York Times (3/08, "Feeling the Heat, Not Breathing Fire" by Keith Bradsher) reports: "The first purchase by the Chinese government new overseas investment fund, a $3-billion-dollar stake in the Blackstone Group has produced an unusual public backlash within China. Since Blackstone went public on June 22, the company's shares have fallen steeply, pushing down the value of the Chinese government's investment by more than $425 million in just six weeks. Chinese bloggers, and even some financial media here [Hong Kong] have not taken the hammering lying down. They are questioning Beijing's stock judgments – often in particular Chinese terms: 'O senior officials of the Chinese government, please do not be fooled by sweet-talking wolves dressed in human skin,' said one of seven scathing Internet postings compiled by an anonymous blogger on Sina.com, a Chinese website. 'The foreign reserves are the product of the sweat and blood of the Chinese people. Please invest them with more care.'"

"In a sign that the Chinese government may be more comfortable with the marketplace of ideas than with the stock market, the blogger's entry was visible on the Web site on Thursday afternoon, but had disappeared by Thursday night. Access to other entries of the same blogger were blocked, but milder criticisms of the Blackstone investment by others could still be found.

"'It is really alarming, the speed with which the Chinese government entered this investment,' read one signed 'Anonymous 386215' which remained on Sina.com Thursday night.

"Foreign investments are particularly tricky for the Chinese government because of the public's virulent nationalism born of centuries of foreign invasions and occupations like the British capture of Hong Kong in 1841 and the Japanese capture of Manchuria in 1931.

"And foreign investments could become more of an issue now. For decades, the Chinese central bank has followed the example of most central banks by investing the bulk of its [foreign] assets in Treasuries and other government bonds. But as China's foreign reserves have quintupled in five years to $1.33 trillion, the government has started chasing higher returns, It is learning the hard way that greater returns mean greater risk, and sometimes losses.

"Over the last several years, the People's Bank of China has led the way among central banks in buying American mortgage-backed

securities, accumulating an estimated $100 billion worth, according to people familiar with the central bank's trading. The People's Bank of China has reportedly chosen some of the most creditworthy tranches of these securities. But with the current malaise in the American housing market, even the value of some seemingly conservative mortgages is starting to erode. In May the central bank abruptly halted further purchases of American mortgage-backed securities, although it does not appear to be liquidating existing holdings, says one person who follows the central bank's trading practices, but insisted on anonymity.

"China's loss of appetite for mortgage-backed securities and its indigestion from the Blackstone deal, does not mean that China has lost interest in overseas investments. The China Development Bank, a state-owned institution, agreed last week to invest 2.2 billion euros ($3 billion) in Barclays, the British bank, and to invest another 7.6 billion euros if Barclays wins the ongoing bidding for ABN Amro.

"With China running a trade surplus that hit $26.91 billion in June, the central bank is issuing torrents of yuan and frantically buying dollars and other currencies to prevent the yuan from rising against the dollar. But the government's huge purchases of foreign currency have created another problem: what to do with the money?"

Enter the Sovereign Wealth Fund

"Beijing's latest solution is to begin creating a sovereign wealth fund: a government-owned investment company that will issue $200 billion worth of yuan-denominated bonds in China and use the proceeds to buy dollars for overseas acquisitions and other investments. Although the company has not been chartered yet, the Blackstone acquisition was made on its behalf by another government entity.

"The Chinese moved with unusual speed this spring in agreeing to acquire the Blackstone stake after just a month of negotiation. Jesse Wang, chairman of the government entity that made the purchase, said in a telephone interview on May 21 that the government wanted to invest before the initial public offering, partly to follow the practice of tycoons and large corporations that acquired large stakes at a discount before such offerings in China.

"However, as credit markets deteriorated in June, and as pressure grew in the US for higher taxes on private equity funds, Blackstone's leadership shrewdly pushed forward the date of the company's initial public offering, and priced it at $31, the top of the range. The stock rose on the day of the offering, but has slumped ever since.

"The Chinese government acquired its shares at a discount of just 4.5% to the initial public offering price. In exchange, the government agreed that its shares would have no votes and cannot be sold for at least four years. At the stock's low point, on July 26, the Chinese had paper losses of nearly $650 million. Blackstone shares closed higher Thursday, at $25.33.

"In another sign of the growing role of sovereign wealth funds like China's. Morgan Stanley announced on Thursday, that it had hired Dina Kos to the new position of director and head of central banks and sovereign wealth funds, in the company's investment division. Mr. Kos, who will be based in Hong Kong, had been the executive vice president for markets at the Federal Reserve Bank of New York. Chinese officials have called for other countries to accept government investments in their companies. But China's own record on this issue is murky.

"In a little-noticed move on July 18, the government of Hong Kong, a semi-autonomous Chinese territory, introduced a new banking policy. Any bank at least 29% controlled by a foreign government was banned from participating in the issuance of legal tender. HSBC, the Bank of China and Standard Chartered currently issue Hong Kong's currency under tight government regulation.

"The new Hong Kong rule came after Temasek, one of Singapore's sovereign wealth funds, bought 12% of Standard Chartered last year, and as Temasek and the China Development Bank were negotiating to take stakes in Barclays."

Obviously there is still some translation to be done both from and into Chinese.

W.K.

Following Tomorrow's Leaders

China and India have the attention of the world for their massive economic advances in acquiring Western technology. They are even taking over Western firms, and keeping their interest rates relatively low, while the central banks of Europe, the US, and Canada are relying on higher interest rates, to keep prices down and "cool" the economy. Instead of licking inflation, using interest rates as the only means of controlling their economies, prosperity has rewarded us with the subprime mortgages that threaten to cut the legs of our banks off at the knees.

The New York Times (03/08, "A Dragon Bowed: Feeling the Heat, Not Breathing Fire" by Keith Bradsher) gives us some of the very different Chinese figures: "With China running a trade surplus that hit $26.91 billion [US] for last June, the central bank is issuing torrents of yuan and frantically buying dollars and other currencies – to prevent the yuan from rising against the dollar [which would undermine its exports as our high dollar is doing with our trade]. But the huge purchases of foreign currency have created another problem: what to do with all the money?

"Beijing's latest solution is to begin creating a so-called sovereign wealth fund: a government-owned investment company that will issue $200 billion of yuan-denominated bonds and use the proceeds to buy dollars for overseas acquisitions and other investments."

The Indians, similarly active in recent months, have made acquisitions in iron and steel production that makes that country the largest steel producer in the world. Undoubtedly India's economic strategists have as model Japan's systematic way of working its way out of the defeat in WWII. Their first step for rebuilding their economy on a sounder basis was to base it on exports that would involve maximum inputs of engineering skills and minimal spending of their gross export revenue to pay for the raw materials needed to produce it. Another feature of the Japanese reconstruction plan was keeping its currency low, withstanding the pressure from Washington to let it find its own high level that would kill its exports and reward imports.

And in the Toronto *Globe and Mail* (01/08, "India follows China in tightening reserve ratio" by Rajesh Mahapatra) is a dispatch from New Delhi that gives us some crucial particulars on this strategy, now being used by the Indians as well as the Chinese: "India's central bank ordered lenders to hold a larger share of deposits in cash yesterday and took other measures to counter inflationary pressures arising from a surge in foreign money.

"The Reserve Bank of India increased the cash reserve ratio – the proportion of deposits that commercial banks must hold in cash from 6.5% to 10.7%, but kept the key interest rate unchanged.■

On the Morality of “Moral Hazard”

It is an intimidating subject, so from the wings we will push our old friend, *The Wall Street Journal* on stage to introduce the discussion which may determine whether we go broke in the next subprime sell-off of the stock market. In its issue of August 13, on the front-page of its “Money and Investing” section the *G&M* carried an article by E.S. Browning entitled “Fed Treads Moral Hazard” which begins: “Wall Street has a dream: that the Federal Reserve will rescue financial markets with a sharp cut in interest rates. Behind that dream lurks a problem, something financial people call moral hazard.

“Moral hazard is an old economic concept with its roots in the insurance business; If you protect someone too well against an unwanted outcome, that person may behave recklessly. Somebody who buys extensive liability insurance for his car may drive fast because he feels financially protected.

“These days, investors and economists use the term to refer to the market’s longing for Federal Reserve interest rate cuts. If investors believe that the Fed will rescue them from their excesses, people will take greater risks and ultimately suffer greater consequences. Some grumble that the Fed created problems this way in 1998, 1999, and 2003.

“If the Fed were to cut rates now, it certainly could help with the current market crisis. The cheaper money would reduce pressure by making it easier to buy beaten-down stocks, bonds and other securities world-wide. Wall Street is a powerful lobby in Washington, and its bleating for help can be hard to resist for politicians, whose campaigns often depend on contributions from Wall Street figures.”

There you have it poured out seemingly with nothing held back – even the dependence of our politicians on the bounty of Wall St. All? Well not quite, for the *WSJ* article’s recount of the facts is the merest peanuts, shelled and salted. The real moral hazard was when the banks and other high financial institutions were deregulated from the restrictions imposed in the Great Depression to prevent so devastating a moral hazard that it led to a decade of degrading depression and a world war that left millions burned or rotting. The initial concept of Moral Hazard was planned to prevent this from ever happening again but the premiums for excess of insurance that the high finance was provided with were paid beforehand by the common folk who would be run over by the abolition of just about all financial traffic rules.

Guarantees that the Great Depressions Would Not Recur

In the 1920s, the banks had pretty well come to control the economy – they financed dictators throughout Latin America, they set up electrical monopolies, they were up to their eyeballs in the stock market. The resulting stock market boom, they claimed, would make every last American a millionaire and would go on and on endlessly. Until suddenly, on an October day in 1929, the stock market collapsed, and brokers were jumping out of the upper storey windows of Wall Street skyscrapers, while the bread lines for the soup kitchens circled around entire blocks in Lower Manhattan. Little more than three years later when President Roosevelt was inaugurated for his first term, 38% of the thousands of banks in the US had shut their doors. One of the first things the new president did was to proclaim a banking moratorium. When he finally decided what was needed to prevent this catastrophe from ever happening again, it was a total outlawing of Moral Hazard. No pretending but the real McCoy. That would guarantee that the Great Depression that paralyzed the world for a decade and finally brought on the Second World War could never, ever happen again.

Lest you think that I am making this up let me get specific.

The banking legislation that the Roosevelt regime brought in confined the banks to banking. They were barred from acquiring participations in what was referred to as the “other financial pillars.” These consisted of stock brokerages, insurance and mortgage companies. For good enough reasons. Each of these other pillars keep their own pools of liquidity – cash or short-term bonds of the highest quality that can be readily converted into cash for the needs of their own business. Insurance companies must be able to pay claims, mortgage companies to finance real estate purchases, and stock market brokers are all over the map. Allow banks access to these cash and near cash reserves and they will use them as their legal tender base to which to apply the bank multiplier. If you can find any university economics text published up to 1991 in a second-hand bookstore buy it, and look up banking and the “bank multiplier,” and you will find an explanation of the very essence of banking. So long as a bank can honour its depositors’ cheques or other claims whenever they reach it, nobody asks how many time it has lent out the amount of legal money (“legal tender”) that it keeps in its own vaults or with the central bank – where it also earns the bank no interest, as did not the gold or silver coins that it kept when they were still legal tender before 1971. In 1946 the bank multiplier was around 9:1. Before the 1929 crash that ushered on the Great Depression of the 1930s, ruined the lives of hundreds of millions of people and eventually brought on the Second World War, banks were free to invest in just about anything they could get away with. The bank legislation brought in by President Roosevelt in the 1930s pretty well became the model throughout the non-communist world.

When Moral Hazard was Really Banished

That was the one occasion when Moral Hazard was really banished. But by 1951 almost two decades of controlled existence in an economy that was not only allowed but urged to operate on all cylinders to support first the war and then reconstruction, our banks had fully recovered and began longing for the grand days of financial swashbuckling. Step by step they were decontrolled and allowed the run of the financial world. Few boundaries were remained between industry and industry and country and country. The bank multiplier became a multi-storeyed affair, applied in turn to the cash reserves of all non-banking financial corporations taken over.

The Globe and Mail article that I quoted compared with the possibility of the central bank coming to the rescue of the financial sector by lowering the benchmark interest rate and making more credit available – the resulting “moral hazard” – with a motorist becoming careless of how fast he drove because he was over-insured. But the unique aspect of the present state of affairs is that the insurance is generous to the point of exceeding 100% of any possibility of damage, and the premiums for its purchase have been charged in advance to the victims of the arrangement. For that is what has happened

since the late 1980s on an ever bigger scale.

In the 1980s the banks were decontroled to allow them to enter the house mortgage field by acquiring the Savings and Loan companies that essentially were cooperative mortgage banks. By the late 1980s thousands of US were up to their eyeballs in not only financing house-building, but in developing lots in areas like the Arizona desert where house buyers rarely surfaced. The result soon became evident – Washington took over the banks that had lost their capital, paid off some $200 billion in debts, and then sold the banks back to private bankers. And to replace their lost capital the Bank for International Settlements – a sort of central bankers' club based in Switzerland, that invited no elected member of government to its sessions, issued its *Risk-Based Bank Capital Requirements* that declared the debt of the central governments of developed countries "risk-free" – and thus requiring no downpayment for banks to acquire. All the banks had to do was cash their dividends which were a clear profit on a zero-investment.

As a result, by the early 1990s in Canada, the banks quadrupled the debt they held. And in 1991, the *Bank Act* (not to be confused with the *Bank of Canada Act*) was amended with neither debate nor explanation to Parliament or in the media, doing away with the "statutory reserves" that banks had to redeposit as a proportion of the deposits left with them by the public. The importance of that move, completed between 1991 and 1993, is that it left the benchmark interest rate as the sole means of influencing the economy – "cooling" it when it was judged overheated by the central bank by raising the statutory reserves and thus leaving the banks with less monetary base to increase its loans, or stimulating it by decreasing the reserves. This provided an alternative or a supplement to the central bank using its benchmark interest rate for stimulating or restricting the economy. In effect it raised the interest rate to what the late French economist François Perroux has called the "dominant revenue," the revenue by the volume and return on which the prosperity and well-being of society as a whole is judged. In effect the government had become the accomplices of the banks in their takeover of political power.

Concretely, it meant that whereas in 1975 approximately 22% of the government debt had been held by the Bank of

From Collapsed Refinancing and Highway Bridges to Systems Theory

We are very critical of financing on the basis of structured risk, when the creators of these models close their eyes to the independent perils that lurk beneath their basic concept of value as an automatic balancing of supply and demand. Elsewhere in this issue I deal with the close parallel of the collapse of a highway bridge in Minneapolis and the collapse of the connection between the subprime lenders and the banks who normally bridge the financing of subprime mortgages from the financial companies that write them to the ultimate investor who buys them. The latter is served up an assortment of "swaths" of risk from the many loans supposedly to meet his needs – much like a customer buying a collection of jellybeans put together to suit his preferences in flavour and colour.

But the analogy still does not stop there. *The Wall Street Journal* (17/08, "Let's Rebuild America Together" by Harold Ford Jr. and Jim Hall) informs us: "The collapse of the I-35 bridge in Minneapolis is the most recent tragic development in a series of events highlighting the decrepit status of our nation's vital infrastructure…. Our road and highway network becomes increasingly congested with each passing year. Congestion costs Americans more than $1 billion annually in lost wages and added gasoline costs. This rapid growth further encumbers our already overburdened road, highway and bridge capacity, thereby jeopardizing public safety."

But the economic models and accountancy used by our governments report "growth" identified with an increasing Gross Domestic Product. Indeed, that is swollen by the actual collapse of the bridge and whatever other road accidents may be caused by such congestion. They will even push up interest rates to guarantee that so much success doesn't cause inflation. And the higher interest rates provide yet another seemingly sound reason for delaying looking after our maintenance of roads. But not only roads.

Economic Bliss Through Congestion

Let us return to the source quoted: "But these problems are not unique to ground transportation. Airline delays this summer have reached a record high in the 13 years since the FAA first began collecting these statistics. New York Kennedy and Washington Dulles are projected to see increases in passengers upwards of 505 by 2020, Runway air traffic control and navigation systems are already operating at capacity."

The article goes on, but our readers will get the pattern. From it emerges that when we note the increase in the world's population, and hail that as a sign of growth and progress, that is what we should classify as a bit of "subprime information." And if we base our insurance policies on such a misconception of social risk, we will end up with a misleading swath of these unsorted figures. If it were bees that we were counting for our statistics, we would most certainly distinguish between those who spent most of their time sipping the nectar from local blooms and retiring to their hives to produce their honey, and those vicious hornets that covered long distances stinging innocent people perhaps fatally en route.

Humans, however escape the distinction between those who run up ever greater mileages from those who used to spend most of their time with little beyond local traveling. Most immigrants who came to North America did not expect to set eyes on their native lands again. I remember in an emigrant ship in Naples harbour over a half century ago emigrants weeping because they did not expect to see again their native land and the relatives they had left behind.

What we are confronted with can only be handled by systems theory. All independent problems created by what passes for "economic growth," would be seen as subsystems that would have to be addressed by our statistics, our accountancy, so that we may develop policies to deal with them. Clearly the congestion at airports shows how population habits will have to fit within the transport system safely. For that is a higher system, but still a subsystem of the environment. The capacity, the technologies, and the economic subsystems are reconciled with the constraints of adjoining subsystems and of higher systems that must take priority, or we shall end up victims of failed subprime gambles in non-financial fields.

W.K.

Canada by 1993 that had sunk to 6% or so. At the same time interest rates were driven into the skies by the BIS.

In their haste to bail out the crumbling banks BIS overlooked an important detail. When you raise interest rates high enough, preexisting bonds paying lower than current rates plummet in market value. And because of that Mexico's banks were put into an impossible situation by the incompatibility of the two BIS measures for the bailout of the world's banks.

The Change in Central Bank Rules Was in Fact a Political Coup d'état

As a result the government of Mexico that had only privatized its nationalized banks a few years earlier, had to nationalize them again. Eventually, after their finances had been straightened out again 85% of them ended up under foreign ownership – and Mexico is a powerfully nationalist country. A new group of operators based on the stock market took over from the distressed bankers. Under NAFTA the Americans assumed control. A special bond issue, called *tesobonos,* had even been issued that gave the buyers the option of being paid out in US dollars when the bonds fell due even though they had been bought with pesos. Marketing government debt which came to be done in auctions held over the TV that they new financial group were based. Living standards fell by some 40%. Mexico's resulting plight threatened to bring down the international financial system, and led to President Clinton, without waiting for Congress's approval, to set up the largest standby fund to that date with the assistance of the IMF and Canada. The economic crisis that settled over Mexico led to the stepped-up migration of Mexican job-seekers – legal and illegal. That brought about the present building of the border fence to keep out NAFTA's Mexican Good Neighbours, whose labour is sorely needed in the US – but at super-bargain rates that only illegal status can assure.

But the long-term effects of the previous massive applications of Moral Hazard as the private bail-out privilege of the banking interest has ever further established banking as "dominant revenue." Much of the basis was laid in this way for the excess of liquidity that made possible, not to say inevitable, the subprime debt boom.

Once the consequences of the bizarre oversight of BIS became evident in overlooking the drastic effects of allowing the banks to load up with the debt of developed countries with no down payment, and at the same time pushing interest rates into the skies, the US Treasury realized that the days of ever high interest rates were over. It became clear that the banks would have to be able to accumulate the government debt of developed countries as a back-stop against their ever greater gambles, that had come to be recognized as the most dynamic aspect of banking.

RENEW TODAY!
(SEE PAGE 2)

It was the US Treasury as well, that devised the way of handling this. Up to 1995 – with the temporary exception of Denmark and Sweden – governments kept their books not in accordance with "accrual accountancy," also known as "capital budgeting," but by "cash accountancy." When a government built a road, a bridge, a building, or bought some heavy equipment that would last for decades, it carefully amortized the debt – more or less over the period that the capital assets would last. But on the other side of the ledger, instead of similarly depreciating the capital asset over its useful life, they would write it off when the financing of the asset was arranged, and as of year 2 carried its value at a token dollar to alert the auditors that the item had not been overlooked. Obviously the contrasted ways in which the debt incurred to acquire capital assets and the assets themselves were treated created a budgetary deficit that was not necessarily there. And that false deficit helped drive up interest rates. But interest rates – pushed up high enough – were grist to the mill of finance capital that had taken over as dominant revenue. What served it was that its booty by definition deemed good and beneficial to human kind.

The very conflict of inflation was an aspect of this Coronation of the financial sector as dominant revenue. The very concept of Zero Inflation was an expression of this. When anybody moves from a town of, say, 10,000 to New York City, he is not fool enough to expect his living costs to remain the same. How then could the cost of living remain flat when humanity makes a similar move? Too much Demand taken care of by available Supply will drive up prices, but the contrary is not necessarily true. There are structural reasons for prices going up. The world is becoming mega-urbanized, and that requires subways, and all the other services without which a large city cannot function. New technologies require not only far more educated producers, but more educated consumers. Without that, you would not have the rapidly expanding world economy. This in turn suffers from an inborn talent for falling on its face, and a reason for doing so. But so long as interest rates remain the dominant revenue, such analyses – which I carried out 50 years ago and had published in what was the leading economic review in France and of course has since disappeared.

A Regurgitation of Anti-accountancy

The Mexican crisis that soon contributed to the Korean crisis, the debt default in Russia and much else, convinced Washington that the day of high interest rates was over. But the dominant revenue position of interest did not allow that to be stated openly. The day had come when interest rates had to be brought down by the simple device that had been recommended in vain by long lists of government auditors, and in Canada by a couple of royal commissions. But beginning with January 1996 the figures of the government assets put out by the US Secretary of Commerce had been reworked to introduce the proper amortization of physical investments rather than written off in a single year. This in turn, carried back to 1959, turned up some $1.3 trillion of disregarded assets, and brought the federal budget into positive territory. But the government in circles that count had always held the government incapable of making investments. It was in the official folklore capable only of piddling away money, even when it did so to bail out the banks who were consider the wise and dependable investors. So the rediscovered capital assets that had been carried on the books for a token $1, were listed as "savings." Which they most certainly were not, since that term implies cash or near cash, and these rediscovered capital assets were in bricks and mortar, pavement, buildings, equipment.

A wink and a gesture to the bond-rating agencies who understood such procedure conveyed the message and interest rates came down. That gave Clinton his second term and brought on the extended high tech boom right until the bust of 1999.

And that, of course, was only part of the story. For to this day, government investment in human capital – education, and therefore, in health, and social services – were recognized in the 1960s due largely

to the work of Theodore Schultz. This was based on the false forecasts of hundreds of economists that Washington had sent to Germany and Japan to predict how long it would take before they could reconstruct their economies as the formidable competitors on world markets that they had been. Schultz, himself, had shared in formulating these false predictions and from them he drew the conclusion that he and the others had concentrated on the material destruction of the war and overlooked that the highly educated and disciplined work forces of the two lands had come out of the struggle with their work forces essentially intact. Add the detail that human capital, properly depreciated over several generations, since the children of educated, healthy parents, tend to be better educated and healthier than those of undereducated and unhealthy parents, and a case may be made that such investments are by far the most profitable investments a government can make.

The Need for Systems Theory

But the most general defect of current economic theory is that it underestimates the number of different factors that may contribute to a single problem in our highly pluralistic society. Don't be intimidated by the term "variable" that mathematicians use. As did your algebra teacher in the first year of high school, an independent variable is simply a factor that has its own requirements – like again the multiple different factors that may be involved in our planet warming. You cannot fit the planet-warming solution into any economic growth, or perhaps any growth agenda, because it has its own causes that solutions must address, and they must be considered quite independently of the economic growth agenda. Only systems theory can help us keep track of this – in an open-ended way. This organizes the identifiable independent variables into systems and subsystems. No system can be considered operational if the subsystems are not in functioning condition. As a gross simplification, we might take an automobile as a system. For the auto to be in functioning order all its subsystems – for example, the electrical, the electronic, the fuel, the mechanical, the transmission – must be in functioning state.

Now let us see how neglected subsystems can come up with some jarring surprises. When the US Department of Commerce introduced accrual accountancy instead of writing off the physical investment of government in order to bring down interest rates so that the banks stack of government debt bought with nothing down would not be devalued and bring the banks into bankruptcy, they gave no thought to the effects in other subsystems. Notably. ours is an aging population and the proportion of the population that will be entering their retirement years – the baby-boomers of the first post-war crop of births – will soon jump dramatically. But the bailing out of our banks by shifting free government debt from the central bank where it cost the government only a marginal amount of overhead, since it came back as dividends to the government – the one shareholder of our central bank since 1938. So the government was under pressure to cut other services so that it could pay interest rates to the banks.

The central government to balance its books passed on the problem to the provinces who did exactly that by downloading it to the municipalities without adequate funding to deal with it. And the lower interest rates, itself a good thing, meant that the private pension funds that many of the increasing cohorts of the retiring, would not suffice to take care of their retirement especially since industries like the auto-makers were slashing their retirement obligations with their unions. Those low interest rates, brought into being initially to avoid carelessly bankrupting the very banks to whom the government had surrendered much of its economic power, ended up hitting retirees and those who were about the retire.

Disentangling the Ignored Factors in Our Budgetting with Systems Theory

Several factors in that tangle of different factors contributed to the excess of cheap money that signed up for investment by the hedge funds and gave rise to the risk management schemes. That will give you an idea of the unsuspected consequences if you try formulating policy with a mind focused on helping the banks out of their previous losses and arranging policy to allow them to gamble bigger if not necessarily better.

A couple of decades ago several universities established economic courses in systems theory applied to economics. Those courses have long since been discontinued because they were lethal to the official theory of a decontrolled and globalized financial sector. There is an urgent need to retrain our economists in economic theory to enable them even to grasp the problems of a globalized world-embracing economy of a complexity that they have contributed to produce.

William Krehm

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Such Was the Enterprise of the New Masters

Money and Civilization, or a History of the Monetary Laws and Systems of Various States Since the Dark Ages, and their Influence Upon Civilization by Alexander Del Mar, published by Burt Franklin, 235 East 44th St., New York, NY. Originally published: 1867; Reprinted 1969.

There are many good reasons why this great work on monetary history, and practice, long forgotten, should have been reprinted 38 years ago, a century after its original publication.

Del Mar sets the social stage for the existence of a money economy (page 2): "After the fall of Roman liberty, the empire split into two, and afterwards into many fragments, each of which became a separate kingdom; these kingdoms subsequently became divided into numerous countships or dukedoms, and the latter into still more numerous realms. Every institution, composed of a plurality of men or things, fell apart in a similar way. The senate perished; the tablets of the law were obliterated the tribunals of justice disappeared; the books were either consigned to the flames or their lessons erased to make room for idle monkish legends; schools were destroyed; posts and inns were discontinued, banks colleges, guilds, and other corporations vanished ;life, fire. and marine insurance became disused; the census fell into oblivion; even the organization of armies ceased and counts and king decided their quarrels by single combat. Everything of a joint ownership, as a public road, an aqueduct, or a water-ditch – everything of a composite structure, from a sailing ship to a piece of paper – every art which depended upon the association of labour, from the representation of a drama down to the blowing of glass, was lost."

Rarely, if ever, did a single paragraph sum up such boundless and timeless destruction. And it all, Del Mar shows convincingly, flowed from social conjunctions that blocked money from performing its black magic. He goes on to lay out a scenario that has escaped his occasional contemporary popularizer: "The same course of disintegration attended the history of institutions, of ideas, of thoughts, the world, the commonwealth, the republic, the nation, the social state, the people, the public opinion, commerce, money, credit – all these were conceptions of the mind and societary regulations known to the Greeks and Romans in their widest sense."[1]

And a couple of pages further, he proceeds to some further startling but obligatory conclusions: "As money is a societary institution, and one of the widest extent and most general operation, it follows from the foregoing view of society during the Dark Ages that during that period money could have had no existence; and such was indeed the fact. Without tribunals of justice, without laws, without association of labour, without commerce, without even organized society, money is not only useless, it is almost inconceivable."

The Original Mental Roads, Canals and Bridges of Del Mar's Own Making

I would urge my reader to pause for a full appreciation of the original mental roads, canals and bridges of Del Mar's own making by which he tracks the utter breakdown and disappearance even from human memory of some of the greatest achievements of social cooperation in the Dark ages. And from that breakdown he reaches the conclusion supported by numismatic data that has come down to us – money itself disappeared and what remained of the precious metals handed from Roman times, went largely to adorn churches and convents – this replaced and excluded its original purpose. All of which will have perked up our ears to hear what he has to say about the social origins and the social purposes of money.

However, let me continue this remarkable passage: "By the fourth century of our era money had fallen to the position of ponderata when it was customary to assay and weigh each piece. Before the seventh century those events took place that led to the Renaissance, the weights themselves had been so frequently degraded that it was no longer possible to make a specific bargain for money. There was no law to define the weight of a pound or an ounce, and no power to enforce the law if one existed. Under these circumstances money became extinct. Nor was it the only institution that perished: all institutions had perished. There was no government except the sword; there was no law. Exchanges were made in kind, or for slaves or bags of corn which men could count to one another, but chiefly in kind, holding the thing to be sold in one hand, and the purchased commodity in another.

"In the dwindling Byzantine Empire, where civil law still prevailed and money yet lingered, the circulation consisted chiefly of bronze and silver coins, the few and oft-paraded gold bezants of the numismantists belong chiefly to a subsequent era. The bronze coins were from the wrecks of the old Roman monetary systems, and they passed as some approximation to the value of the copper metal they contained. In France, money, after becoming extinct, made its reappearance under the Merovingian dynasty, and towards the beginning of the seventh century the French system was adopted in England; but in both countries most payments, and in many parts of Europe all payments, between the fifth and seventh centuries, were made either with personal services, provisions, domestic animals, or slaves. In some countries this condition of affairs lasted until the twelfth or thirteenth century.

The Age of Dead or Living Money

"Henry in his *History of Britain* thus alluded to what in the Dark Ages was called living money. This consisted of slaves and cattle of all kinds, which had a value set upon them by law, at which they passed [as currency] for the payment of debts and the purchase of commodities of all kinds, and supplied the deficiencies of money so-called…. All kinds of mulcts imposed by the state, or penances by the Church, might have been paid in dead or living money, as was convenient, with this single exception, that the Church, to discourage slavery, refused to accept slaves in payment as money of penances. In Scotland and Wales it is much doubted that any coins were struck in the Saxon period. The price of a man was the same as that of a hawk or a greyhound.

"When after this condition of profound misery, European civilization began to revive, and money, among other institutions of the past, began to evolve itself anew out of the fading gloom of the Dark Ages, it seems to have been reinstated in the same

tentative manner that it fell. The order of falling was from numerata to moneta, from moneta to ponderata, and from ponderata – until the weights themselves were degraded and exchange was conducted by means of services and commodities – to barter. The order of revival was much the same. It began with the fixation of weights and money was weighed *ad scalam*, and assayed or tried by combustion. Following this came pieces or sums with the names of weights – to wit, pounds, shillings, and pennies, dennies, or denarii, which passed by tale."

Rather than a fixed amount of gold or silver, a fiction that montarists are so addicted to, the metal content of metal money, even in centuries when the pretence of it that existed, was an enduring fiction. That is one of

A Subprime Rescue for a Subprime Problem

After a full week of mounting panic on the stock markets of the world, the US Federal Reserve finally came to the rescue. But the only information how serious the emergency was was that what had arrived was not a nurse with a supply of band-aids but an ambulance with clanging alarm bells equipped for resuscitations and even emergency surgery.

The consequences on Canadian stock markets was immediate. The free fall of prices was broken and shot up to reverse the drop. There was public speculation whether some of our banks deeply into brokerage and all aspects of the market had not taken advantage of clients whose stocks were in free fall, to themselves pick up some sensational quick bargains. These were made possible by their sudden decision that the proceeds of sales would not be credited to their clients accounts for two days or more – during which the client – by previous practices would have continued under pressure to sell ever more securities on a market panicked by the sudden cancellation of previous arrangements between banks and clients. Meanwhile some banks were publicly accused of picking lucrative overnight bargains by such bank-forced sales.

Finally sorted out for the press, the US Federal Reserve on the 17th moved in to reverse the rout into a recuperation that was well summed up in the Business section of the *Toronto Star* (18/08, "Fed steps in to bolster economy" by Madhavi Acharya-Tom Yew). The Fed had two different ways of entering the stormy picture. It could change its funds rate at which US banks belonging to the system can make overnight loans to one other for borrowers to meet its reserve obligations with the Fed. That is the key federal funds rate for overnight loans between banks, by which the Fed shows its imperial pleasure, usually uttering a few ambiguous words on the occasion, over which the experts are left scratching their heads to decipher what the Fed might have in mind. That routine instrument the Fed did not use on this occasion, and the interest rate for such loans remained at 5.25% per annum. What was changed was its discount rate that was lowered from 6.25% to 5.75. That permitted the Fed to continue its time-honoured practice of speaking from both sides of its mouth. Since succour was arriving via the discount rate, which was actually cut, the interest paid for the rescue would be lowered. But since it was the discount rate rather than the federal funds rate that was tapped, the rescued were paying a half-point higher interest than would have been if rescue had the banks been allowed to lend one another the needed moneys under the unchanged fed funds rate. But such overnight loans bank-to-bank, not only had to be renewed daily, and a bank with available elbow-room had to be tracked down each time. It gave you a measure of the Fed's appraisal of the problem that it chose the discount rate, that involved money-creation by the fed, and once obtained was there for a whole month. The Fed, of course, can always create legal tender. That is not so in the case of the commercial banks.

And for readers that did not get the point, the *Toronto Star* ran an article on the same page by the same writer under a title "Investors warned to be ready for more volatility." In it you could read: "Trying to figure out what all the commotion is about? All week, you've been hearing about subprime this, and asset-backed that, and commercial paper whatever.

Subprime Homes that Can Blow Away

"Starting in 2001, with interest rates at historic lows, US lenders had something new to offer people who wanted a home but had a sketchy credit history and low income – the subprime mortgage. Subprime mortgages had a very low 'below prime' introductory rate. The most popular kind, known as a 2/28, offered a low teaser rate for the first two years, and then adjusted for the remaining 28 years to a rate often 3 percentage points higher than prime."

For those who wished to and could keep the house so financed, it was in fact a "superprime" rate that they had to pay.

"Those home loans don't just sit on the lenders' books. Instead, Wall Street investment banks come calling. They bundle loans into securities to be sold to investors around the world. Last year they processed some $480 billion US of such mortgages in this way, and then along with credit card debt and auto loans, they sold 'swaths' with various mixtures of recognized risk and higher grade debt. They made it attractive to banks, insurance companies, pension funds and mutual funds."

It seemed to spare the agent who put the deals together the "inefficient" work of interviewing borrower, examining his tax documents, proof of income, credit record. In the mortgage businesses, the popular name for such mortgages were "lie loans," since there was not even the effort to distinguish fact from fiction. This "product" went to "the commercial paper market." This $2 trillion market lets companies borrow money on a short-term basis quickly and efficiently when they need a safe place to park millions of dollars for a few weeks or months.

"This whole process helps spread the risk. but the final investors were so far removed from the original loans that it became hard for them to know the true value and risk of the selective mix of different grade securities that they bought." Until the bad news started coming in.

"US housing prices started to flatten and even fall in some places in 2005. Lenders became more strict and were reluctant to let subprime mortgagors refinance. The house prices started to drop in some parts of the country instead of continuing going up. At the last count 90 subprime mortgage lenders had been forced out of the business.

"Be prepared for more volatility, There will be more bumps as other financial institutions reveal that they have subprime mortgages tucked away in their portfolios."

They could become the financial equivalent of a lethal germ.

W.K.

the great conclusions of the Del Mar book.

"Laws prohibiting the export of the precious methods or coins made from them were common to all countries during the Dark and Medieval Ages, and these laws by creating an artificial and temporary superfluity of metal in a few of the strongest or richest of countries caused a corresponding scarcity in the others, and raised the purchasing power or value of these coins, until a change of the commercial current or a degradation of the coinage in the last-named countries lowered the value of their coins once more.

"Very little copper was produced during the Dark Ages, this metal requiring more metallurgical skill and greater division and cooperation of labour than were then attainable. Many silver mines were reopened by Charlemagne about the beginning of the 9th century. Gold was always to be obtained by washing the Tiber, the Po, the Rhine, the Rhone, the Garonne, and the numerous auriferous streams of Spain and Portugal.

"As to the right of coinage, it had fallen from the hands of the senate to the emperors, from the latter to the barbarian kings, and thence to innumerable feudal lords, both lay and ecclesiastic. As commerce developed and Europe revived, this right had been sold by the feudatories to the municipalities who had purchased their liberties from them. In most cases, however, it passed to the latter, and became vested in the crown as a royal prerogative.

"To persons who entertained the shallow belief that money coined from the precious metals conformed in value to the economical cost of the materials of which it was composed, it has ever been a favorite pursuit to deduce from the obscure annals of the feudal period some system of money founded on this imaginary principle, and to advocate the adoption of a system of money founded on this imaginary principle at the present time. But to say nothing of the folly of copying from the institutions of an ignorant age, it can safely be affirmed that no such system ever existed during that era, and that whenever tried in modern times, they almost immediately failed.

"Whilst the civilization of the Roman Empire was being slowly dissolved into its original elements, and its diminishing population seemed threatened with extinction, events were occurring in Asia destined to reverse this tendency and turn the decay of Europe into a condition of growth.

"In Arabia, near the coasts of the Red Sea the Romans had long mined for gold. Their method, the usual one, had been to reduce the natives to slavery, and force them into the exterminating labour of their own mines. In the days of Pliny, silver from Europe and gold from Arabia were shipped to India and China, to the aggregate value of one hundred million of sesterces, whatever that might have been."

The Miracle of the Bedouins

"These toilers in the desert, these victims to Roman cupidity and misgovernment, were not savages. They were essentially a trading people, probably descendants of those ancient Phoenicians whose venturesome barques had voyaged to distant India for spices, and perhaps rounded the mysterious Cape of Good Hope in quest of gold. The Bedouin had not become a vagrant by choice, but necessity, and when opportunity served, he showed himself capable not only of equalling the state of civilization to which Europe had now fallen, but of going far beyond it. To such a race, the slavery of the mines must have been as galling as it afterwards proved to the proud Mexicans whom Cortes subjected to a similar servitude. From the midst of this enslaved population, there arose in the seventh century a deliverer, who, armed with an 'inspired' work, and proclaiming himself the prophet of God, led his countrymen not only to overthrow the Roman Empire in Arabia, but also to effect the conquest not only of all the surrounding countries, and the establishment of a new empire.

"The flight from Mecca, or the Hegira, occurred in 622. In 633-9 the whole of Syria was subdued; in 637 Jerusalem was taken; in 638 Aleppo and Antioch fell; in 638-9 Egypt was conquered; in 637-51 Persia was overrun; between 647 and 709 every organized state of Africa westward, to Carthage, was reduced; in 692-8 Carthage was occupied; between 608 and 709 the remainder of Northern Africa, including Mauritania, to the Atlantic, was subdued, and in 711 the Arabians entered Spain. So within a century from the beginning of Mahomet's conquering career, their power was firmly established from India to the Western Ocean.

"During the Roman domination, the trade with the Orient had been conducted, at first by the Persian Gulf, and afterwards by the isthmus of Suez, through a canal that was cut some time during the reign of Trajan or Hadrian. With the decay of the empire, the canal was allowed to become filled with drifting sand, and what little remained of the oriental trade sought the precarious and expensive overland route via the Euxine and Caspian Seas and Tartary. The remnant of trade centered on Byzantium."

"Such was the enterprise of the new masters who had arisen to lead and instruct the world that in the same year in which they conquered Egypt they commenced the work of clearing the long-neglected Suez Canal. The work seems to have been completed within a comparatively brief time, for we hear soon afterwards of the reopening of the old Roman route to the Orient via Alexandria, Suez, Berenice, and Muscat. This being an all-sea route, offered immense advantages over any other.

"The Oriental trade was now centred at Alexandria, and at first was monopolized entirely by the Arabians. The inhabitants of Europe regarded with horror any traffic with heretics, it was confined entirely to exchanges with the Arabian dominions in Asia Minor and Africa. Towards the close of the seventh century, the Venetians so far conquered their aversion to the Mahommedans as to purchase Indian products in the markets of Alexandria, and these being carried to Venice, reopened to Europe the great channel of international commerce whose beneficial influences soon communicated themselves from profit to wealth and from wealth to social advancement.

"Everywhere throughout the Continent were now seen signs of an awakening. Isolated communities drew closer to one another, and merged into larger and stronger organizations; kingdoms appeared where formerly existed only a multitude of warring feuds and benefices; roads were built. canals were planned, and once more a promise of life instead of the shadow of death, was extended over the populations of Europe. The exports from the West consisted, for the most part, of woolens, linens, glass vessels, wine and the precious metals chiefly silver. There was none of that exchange of European silver for Indian gold which afterwards arose; the adoption by the far-seeing Arabians of an Oriental ratio of value between the two metals had prevented this. From India the exports were chiefly cottons, spices, silk, precious stones, sugar, ivory and tortoise shell."

W.K.

1. "The sphericity of the earth had been proved by Thales, 636 BC; Parmenides of Elis taught it in 503 BC; Eratosthenes computed the circumference of the earth at 252,000 stadia, and Hipparchus at 277,000 stadia; Strabo alludes to the sphericity as a well-known fact; and Pliny says: I do not suppose that the land is actually wanting nor the earth has not the form of a globe, but that on each side the uninhabitable parts have not yet been discovered."

New Swiss Giant

The supreme virtue attributed to management is not only the rapid growth of their corporations, but the acceleration of that growth, and of the acceleration of its acceleration. Clearly this must wrench social structures out of any recognizable relationship to what was necessary when life had more to do with continuity and wore a human face.

Not so long ago Canadians were still a semi-rustic lot, who cherished their background and origins more than running a race to become the biggest and strongest. If anything we were appreciated for the absence of such prickly traits. What contributed some permanence to both our physical and moral landscape were our institutions. Not only the Monarchy and all that, but our transcontinental railways that had been set up for a national purpose – to unify the British colonies that were exposed to a triumphant American Army that had triumphed in a civil war in which our British Motherland had chosen the side of continued slavery, largely because of the interests of its textile industry and its grumpy disapproval of any other country encroaching on its industrial pioneering. That made it inevitable that the CPR and then the CNR should have arisen endowed with a sense of permanence and institutional purpose beyond commercial profitability – which indeed still remained to be proved. The purpose of the railways was to make the survival and development of the country possible.

The countries that had once been the reason for many of the great capitalist corporations were necessarily limited in growth not only by the bounded nature of their countries, but by the vulnerability of the environment. However, if you substitute for the increase in the rate of growth derivative, and climb onto the rates of *increase* in growth rate, you will grasp the hopeless assignment into which humanity has allowed itself to be dragooned. It is the clash between institutions that arose at least in part to serve society, and another that answers instead to a compulsion to grow at an ever accelerating pace, that the nation and the country cannot begin to match, and hence are reduced to fodder in the resulting shuffle. Hence the basic destructiveness of Globalization and Deregulation. It is not angelic choirs that have been multiplying since Globalization and Deregulation was moved center-stage with its higher technology of destruction. Surely it is time that we paused in our futile preoccupations with climbing the accelerated growth ladder, and did some elementary reassessment of what has led us to outcomes so contrary to what we were led to expect.

We have two recent examples of mega-takeovers that join in confirming the common globalization trend – *The Wall Street Journal* and some of the other properties of its publisher Down Jones & Co. have over the years given clear public evidence of producing the highest objective goals in the excellence and omnipresence of its economic reporting throughout the world, and the tight Wall St. parochialism of its editorial and op-ed sections. But the excellence and considerable social sensitivity of its news reporting put it near the top of the pole even if much was more strikingly high-lighted by some of the more parochial stuff in its editorial columns. Nor was that reporting excellence mere bravado. To guide even those who impose their view of the world and its economies and politics, those in Washington must have some exposure to the deeper unconventional wisdom of what is afoot in the world. And the controlling family, the Bancrofts, took pride in that achievement and were reluctant to surrender that inherited responsibility to a press-baron from abroad uninhibited by any such moral concerns was not a total source of pride.

A Takeover Giant Based in Switzerland

Another takeover could hardly have provided better timing than the sudden domination of the massive takeover of aluminum and other commodities scene than the case of Glencore sudden appearing in the Alcan and other metal takeovers. *The Wall Street Journal* (31/07, "Aggressive Swiss Giant Rides Resources Boom" by Ann Davis) recounts: "Baar, Switzerland – When the fugitive commodities dealer Marc Rich sold his trading firm 13 years ago, it was best known for doing business with pariah nations. Since he left, the intensely private company – renamed Glencore International AG – has leveraged itself into an industrial colossus, with a stronger grip on ever more individual markets for the earth's riches than almost any other single company.

"Glencore is one of the world's largest suppliers of aluminum, nickel, zinc and lead. It is a major seller of oil, grains and sugar. Along with its affiliates Glencore says it ships more coal than any competitor.

"The takeover battle for Canada's aluminum leader, Alcan Inc., arose after Glencore combined assets of Russian companies to create a giant that knocked Alcoa Inc. off its perch as the largest producer. In a bruising fight over nickel, Glencore helped an affiliate win a lengthy multisided battle for Canada's Falconbridge Ltd.

"The story of Glencore's evolution from rogue trader to one of the most powerful private companies in the world was pieced together from interviews with people with intimate knowledge of the company and from documents such as bond prospectuses. The firm has long been willing to deal in virtually any commodity around the globe from cobalt in war-ravaged Congo to crude oil from Saddam Hussein's Iraq. Its long-standing knowledge and connections in isolated and unstable regimes often gives Glencore access to resources at good prices because it can tap opportunities that not everyone is going after. Glencore has said that its policy is to require its companies and employees comply with any economic sanctions in force in countries where they do business.

"Its revenue last year was $116.5 billion, besting by about 30% the largest private company in the US, Koch Industries Inc. A small number of people share these riches. The top 12 Glencore executives saw the value of their stakes in the employee-owned company soar an average of $87 million last year. And the top 67 people of Glencore reaped other pay and benefits averaging $8 million.

"As Glencore moves more into the corporate mainstream – floating billions of dollars worth of publicly traded debt – the company still struggles to convince some skeptics it's a different animal from the firm Mr. Rich founded and left long ago. Not helping is a 2005 report of a United Nations investigative committee saying Glencore paid millions of dollars of kickbacks earlier this decade to gain access to Saddam Hussein's petroleum under the oil-for-food program. Glencore told the UN that it didn't sanction any bribes.

"The evolution of the Swiss company owes much to its chief executive, Ivan Glasenberg, 50 years old, a skilled coal

trader and one-time South African walking champion. He operates from the home offices in Baar, in a low-tax Swiss canton."

A Versatile Metal Giant Addicted to Growth

"Glencore moves so much metal that at times it holds 50% to 90% of the nickel and aluminum scheduled for delivery in London Metal Exchange warehouses, according to traders who know who holds positions on the Exchange.

"There is no other company like Glencore that plays in so many fields. Glencore's history traces to 1974, when Mr. Rich founded a trading firm after a fractious departure from Philipp Brothers. In 1983 the US Justice Department charged Mr. Rich with tax evasion and with buying oil from Iran while it held US hostages. He fled to Switzerland, where his firm was based, It and its US unit pleaded guilty to some of the charges and agreed to a nearly $200 million settlement, but Mr. Rich remained a fugitive.

"In 1994 some of Mr. Rich's lieutenants bought him out for about $500 million and the firm took the name Glencore. They

Letter to the Editor of The Globe and Mail

Dear Sir:

I am the editor of the *Journal of the Committee on Monetary and Economic Reform* and am writing about the column of Neil Reynolds, "Political extremists hurt economic debate" in your issue of 08/08/07. In the second paragraph, the author states: "It [CAP] is Canada's right-wing nationalist party – which as it happens, makes it indistinguishable from Canada's left-wing nationalist party, the NDP, as together they mobilize for Montebello, Quebec."

There is nothing right-wing about CAP. The main point of its platform – the source of available funding for all necessary capital investments by all levels of government – is the use of the Bank of Canada. That was the purpose for which it was nationalized in 1938 after three years of functioning as a private institution with 12,000 shareholders. These were bought out at a handsome profit in depressed times when profits of any sort were scarce. And because of that, when the federal government borrows money from it for capital purposes, the interest it pays on the loans come back to it as dividends. I need not remind you that dividends are not "funny money" but a central capitalist institution.

That Act is still intact on our law books, but hasn't been made use of in any significant way since the mid-1970s. Nonetheless, subsection 14(2) sets forth clearly that in the event of a difference of opinion between the Finance Minister and the Governor of the Bank, the Governor need only give the Governor instructions on what policy must be applied within a period of 30 days.

There is nothing right-wing about CAP's position on the Bank of Canada. On the contrary, it made possible for Canada to finance its WWII to the extent of 16% – higher than either the US or the UK that still had private central banks at the time. After the war it made it possible for Canada to reduce the proportion of its federal debt to the Gross National Product from 150% to about 22%, while catching up with a near total lack of infrastructural maintenance – physical and human – during a decade of depression and six of war. It was in that period that Canada's health insurance and much else was brought in, the new generation was educated to a level undreamt of before the war, a vast and mostly penniless immigration was absorbed, new technologies were introduced. The country that had entered the war as a semi-rural land, came out of it a powerful industrial one.

Without our nationalized Bank of Canada, much of this would have been beyond out reach. The banks – both in Canada and the US – entered the Second World War very much in the doghouse. The Great Depression that had brought on a decade of depression and indeed the war itself had resulted from the Wall Street crash of October 1929. 38% of the US banks shut their doors by the time President Roosevelt was inaugurated. Roosevelt at once declared a bank moratorium and renewed it when it expired. Meanwhile a new *Banking Act* was passed that compelled the banks to stick to banking and forbade them to acquire interests in the other "financial pillars" – stock brokerages, insurance and mortgage companies. The reason? All these other non-banking financial corporations maintain pools of liquidity for the needs of their own business. Allow banks access to these, and they will use it as cash base for apply the banking multiplier. Which is just what brought us our subprime mortgage mess. I trust that it has not escaped your attention that on the very date that you carried Mr. Reynold's gem, that crisis that will be with us and was predicted by our party for some years, burst upon the world.

The title over Mr. Reynolds' column is "Political extremists hurt economic debate." That debate having to do with our giving up our currency – the ultimate manifestation of sovereignty has in fact been going on for some years. Long enough for the Howe Institute that supported the surrender of the loonie to have changed its position about three years ago, only to have lapsed in silence and hence is probably supporting it again.

This is a most unusual moment for our government to have come out for closer ties with the US, when it most unfortunately has garnered a most amount of unpopularity with its military adventures. We can only conclude that you identify a desire for a friendly independence vis-à-vis our southern neighbour as rightist. However, you skip the detail that for a half century Washington's favourite pastime was providing not only the money and instructions but at crucial moments the firing power for the overthrow of the democratically elected regime in Guatemala in the 1950s, followed by a repeat performance in at least a dozen other Latin American countries including Chile, the Dominican Republic, Brazil, the Argentine, Nicaragua. In the 1950s the US army opened a torture school in the Panama Canal Zone where military personnel from just about every Latin American country were instructed in the methods of torture. Interesting that this bit of history has not surfaced in all the discussion of the Arar case.

As for the scant vote that CAP has achieved in previous elections, that is the inevitable result when vital information on which the survival of our democratic system depends is in such short supply. CAP has no great political ambitions, just a very important democratic goal of conscience. CAP has long made clear that the moment another democratic party takes a position for using the *Bank of Canada Act* as its content requires and, indeed, prescribes, CAP will join it. But meanwhile CAP will keep the democratic banner high and waving.

Bill Krehm

raised the money by selling a 15% stake to a pension fund of Swiss pharmaceutical giant Roche Holding AG. President Clinton pardoned him on leaving office in 2001.

"At the time of the buyout, Mr. Glasenberg was among the trading firm's rising stars. He was able to find buyers for coal from his native South Africa when it was widely boycotted because of its apartheid racial policy. Glencore has a network of some 50 outposts in more than 40 countries, manned by field officers. Among their duties if to meet with commodity suppliers and consumers trying to gauge inventory levels and estimate local demand.

"When Mr. Glasenberg was running the coal division in the 1990s, he determined that the firm should buy coal mines. Depressed coal prices may mines easy to buy. Mr. Glasenberg became chief executive in 2002. That year, amid another beaten-down commodities market, Glencore folded its coal mines into a small producer of zinc and alloys that it partly owned. This company, Xstrata PLC, agreed to buy the coal assets for $2.5 billion and listed its shares on the London Stock Exchange.

"Xstrata is just the most visible of Glencore's public affiliates. Beginning in 1987 Glencore bought interests in several aluminum production plants, In 1996 it combined some of them into Century Aluminum Co. which is now North America's third largest producer. Glencore, which owns 29% of it, sells it raw materials and buys part of its aluminum output. Glencore also gets fees for its marketing efforts. At Xstrata, Glencore takes a cut of 3.5% to 5% of most sales of ferrochrome and vanadium, a metal used to strengthen steel. In nickel, Glencore shares profits when it gets Xstrata prices above a certain price level. The Glencore-Xstrata relationship has stirred concerns about their collective market clout, particularly in thinly traded markets where there aren't transparent futures exchanges. In 2004 one of Glencore's most far-reaching moves was in aluminum. It won an auction for Jamaican bauxite properties that mine and refine bauxite, a raw material for aluminum that were coveted by a company controlled by Russian oligarch Oleg Deripaska. Mr. Glasenberg offered to link up with them by contributing the Jamaican assets and some others to a joint enterprise. The result was the formation this year of the aluminum giant known as United Co. Rusal, of which Glencore owns 12%. After the deal closed, the former no. 1 aluminum producer, Alcoa, tried to keep up by acquiring Alcan, only to be outbid by the Anglo-Australian Rio Tinto.

"Glencore's relationship with the well-connected Mr. Peripaska may serve it well. One of his companies is poised to take control of a Russian oil producer from a businessman who fell out of favour with the Kremlin. Glencore has managed to keep its large stake in many of that Russian oil producer's assets, people familiar with the deal say."

And in that way the international corporative developments are leading over hill and dale into areas and hazards that it may not be in its interest to go.■

Climbing the Derivative Ladder

As the world grows ever more resistant to the policies imposed on it from a few command centers, the distinction between fact and fiction is rapidly disappearing. Policies are being shaped less by their feasibility in handling problems of society than by whether they serve the rate of expansion predetermined by the replacement with growth rates. These are "derivatives" of different degrees of the actual first-degree quantities on which bookkeeping is based. To come up with rates of growth, one must cast one's nets into the inscrutable depths of the future. Hence it is the growth rates, and the rate of the growth of growth rate of the actual production, and so on to infinity that come to rule economists' reasoning. These, of course, exist only in the future that must become every more malleable to keep the system functioning.

That widens the gap between reality and the fictitious world that is being reared to allow the empowered fictions with which a new world is being created. The origins of the current acrobatics with derivatives is clear. It came into fashion in price theory, hardly by accident shortly after the Paris Commune (1871) when the labour theory of value (used by Ricardo and Karl Marx) took the value of goods in a capitalist society to depend on the amount of average labour needed for a commodity's production. Or by the cost-of-production theory (John Stuart Mill). Both of these located the site of value creation in the workshop, the "Satanic Mills" of the raw industrial revolution.

That was all right in the days of Ricardo when most English workers were still illiterate. But mechanics' institutes soon arose to teach workers to read, and what had been over their heads could soon be read by more of them, and it could thus convey a potentially dangerous angle of vision. Hence, in the years after the bloody Paris Commune that was hailed by Marx from London as the precursor of proletarian revolution, created the need for a new observation post for economic theory. It was shifted from the workshop, to the counter where shoppers bought the merchandise. And with the Thinker's gaze directed the value of the goods were seen as determined entirely by the balance of supply and demand – if demand outstripped supply, prices rose; if supply outstripped demand, it sank. What, you may ask, would determine the level of the constant balance? The mathematical process of integration adds a constant number whenever performing the mathematical process for determining the new market price balancing supply and demand. That constant as is indicated by the name is not changed by the process of bargaining between suppliers and demanders. Significantly there was no curiosity about that constant of integration among any of the three different marginal utility theories of value that arose quite independently in three different countries at virtually the same time – Britain, France, and Austria.

But marginal utility value theory was baby stuff – it dealt only with the rate of growth or the first-degree derivatives, to distract attention from conditions in the workshops. Basically it expressed the political dominance of the industrial capitalist. But with the triumph of the financial sector of capitalism, the evaluation of worth of shares, bonds, corporations, and the world was done in terms not of ordinary commodity prices, but in terms the rates of interest with which the drover – essentially the deregulated bankers – whipped the productive herds that included the industrialists themselves into profitable obedience. Society thus ascended further steps on the derivative ladder.

This required the cleansing of our universities of everything that had been leaned in the Depression of the Thirties, including that the banks had to be prevented from taking over the other "financial pillars" – stock brokers and insurance and real estate. Unless this happens, capitalism cannot go on functioning.

William Krehm

Does Union Always Mean Closer Together and Never Further Apart?

The confrontation between the head of the European Central Bank President Jean-Claude Trichet and the new President Nicolas Sarkozy reminds us that international unions do not necessarily bring nations closer. We have much history to warn us on the point, but history is like a cute librarian who tends to keep the deeper truths safely on the bookshelves, and more than occasionally to manages her budget with a bit of whoring on the side.

We did of course have our warnings. After the American entry into the affairs of Europe to turn the tide of WWI, and Woodrow Wilson's evangelism of the League of Nations, Washington was notable for its absence from that body, and left the higher diplomacy to the almighty dollar with deplorable results.

John Maynard Keynes who seemed conceived and born to sum so much up in terms that reached beyond the purely economic: "People should move over frontiers with the greatest possible freedom but the goods we consume should as much as possible be homespun."

A Bundle of Varied Cultural Heritages

Not so many generations have elapsed since most of the world's inhabitants were tribal peoples, not only with their own languages and cultures, but with economies kept in negligible contact not by trade restrictions of primitive means of travel. And then when the masses began crossing oceans there arose migrating countries and countries that received immigrants and were even dependent upon immigration for the renewal of much of their labour force. And though much of what was learned by depending largely on immigrants has been forgotten, much of it does remain lodged in the perceptions and politics of Americans and Canadians in ways that Germans never learned. That is why the aging of the populations of countries like Germany and France – eventually of Russia where alcohol is proving a powerful substitute for the mere calendar in hollowing out the active population. In Germany, and Britain an aging population a tremendous dependence on Muslim immigrants for the hard physical unskilled work, and on the younger French generation for the skilled work and professions. In France, there is even a more dangerous contrast in the native work force between those who have been employed for longer periods and enjoy benefits in social security superior to those natives more recently born.

With social situations as sensitive as those resulting from these conditions, it should be apparent that a central bank of the European Union that removes the power of the individual members of the European Union to run up more than a 3% imbalance of their budget – even when capital spending is not always recognized as such, and gives priority to "keeping inflation in check," even when most of the members have been involved directly and indirectly in wars, is laden with perils. But let me quote from *The Wall Street Journal* (25/07, "Trichet is Put to the French Test" by Joellen Perry): "France's bid for influence over decisions of the European Central Bank has put President Jean-Claude Trichet in the hot seat as rarely before. Economists and central bankers say he is well equipped to defend the bank's independence. Nearly half way through his eight-year tenure running monetary policy for the €11.6 trillion euro zone, the 64-year-old Mr. Trichet has already proved that he has the political skills to battle Nicolas Sarkozy, France's barn-storming new president. He has also shown he is willing to tough out top-level criticism of his inflation-focused monetary policy for the ECB.

"A mining engineer and economist by training, Mr. Trichet has squelched public revelations of dissent on policy from within the ECB's governing-board since he took over the presidency in 2003. The board includes national bank chiefs from the 13 countries that share the euro, from slow-growing Italy to booming Ireland.

"Since Mr. Sarkozy's election in May, he has badgered the ECB and insisted the president should have more say over the bloc's exchange rate policy. Mr. Sarkozy – the leader of the euro zone's second largest economy, and riding the wave of an electoral mandate – has found little backing elsewhere in Europe, but his demands were well heard.

"Mr. Trichet also holds a lot of cards in his defense of the ECB's independence. His tight focus on inflation is supported by most of the euro-zone countries, including the bloc's biggest economy, Germany. And he is backed by hard-to-change treaties that give the ECB more independence than the US Federal Reserve.

"Mr. Trichet is already riding high on the back of the euro zone's economic recovery. Gross in domestic product this year is on track to rival 2006's 2.7% high. Inflation has been in the ECB's preferred range of just less than 2% for 10 months.

"As governor of the French central bank in the 1990s, Mr. Trichet faced down attacks by political leaders – including former President Jacques Chirac – on his anti-inflation policies. When the ECB raised interest rates in December 2005 from 2%, euro-zone politicians and international institutions including the International Monetary Fund, howled that the bank risked squelching the bloc's nascent recovery. 'We have been fully vindicated,' Mr. Trichet said last month.

"Neither a larger than life presence like former Fed chairman Alan Greenspan, nor a professorial economist who leads the debate like Ben Bernanke, Mr. Trichet has a reputation for guiding decisions through diplomacy.

"Sill, Mr. Trichet faces a formidable opponent and some genuine concerns. Mr. Sarkozy has shown he is determined to make his mark in Europe. After seeing his call for greater government influence on the ECB rebuffed by Mr. Trichet and Germany, Mr. Sarkozy may now try a different approach, pushing for Europe's governments and the ECB to take a tougher line on China's undervalued currency. His aides have said that he will ask other euro zone officials to join the push."

Will the Euro Outshine the US Dollar into the Next European Recession?

"Many economists expect the euro, which yesterday hit record heights above $1.38 to continue rising as the ECB increases interest rates and Euro-zone economy economic growth outpaces that of the US.

"Mr. Trichet signaled in June that ECB is likely to lift its key lending rate a further quarter point to 4.25% in September.

"Others say that the ECB should be more transparent. The Federal Reserve is accountable to Congress, while the Bank of England has its inflation target set by the

British government. Both publish the minutes of their meetings and the breakdown of votes on each interest-rate decision, helping markets understand the bankers' thinking. The ECB's mandate, by contrast, specifies that it should avoid all political influence, while the rate-setting decisions are taken by consensus and no minutes are published.

While Mr. Sarkozy is unlikely to dent the ECB's independence, some observers say he does, in fact, have a shot at giving politicians more say in euro-zone exchange rate policy because of the wording of the treaty that established the ECB's independence. "The treaty is ambiguous about who establishes the exchange rate," says Jacques Cailloux, euro-zone economist with the Royal Bank of Scotland in London.

"Using this loophole, Mr. Sarkozy is expected to try to get European politicians unified around a common currency policy and at a Group of Eight meeting of finance ministers in October, he could aim for a statement calling on China to let its currency appreciate. That is unlikely to sit well with Mr. Trichet, who has called himself, 'Mr. Euro.'"■

Rating the Rating Agencies

You cannot suppress a half century of critical economic thought and allow the financial sector of the economy to take over their gambles where they had left them in October 1929. Continue on that path and mankind will paying a penalty that will make the Depression of the 1930s and the war they led into look like child's play. You cannot wipe out the boundary separating responsible banking from unlimited financial gambles, where the talk is all of the self-balancing market but the reality is that the financial sector has acquired repeated access to the public treasury to cover its playing losses, and an increased supply of chips for the game to resume on a mounting scale. To this end accountancy and auditing have shrivelled to ghostly presences. The government is engaged in selling to private investors on a medium-term lease-back basis government capital assets that it will never be able to buy back again. Whenever any level of government or private developer improves the infrastructures in the area, it adds to the market value of such government properties. And government properties do tend to be located at nodal points of cities and the land. And of course, this ties in with the none-use of the wholly-government-owned Bank of Canada to finance at a nominal cost all federal and provincial government investments, and, with guarantees of either senior government level, of any municipality as well. All this raises some moral questions in professions that haven't the time of the day for morality when it stands in the way to extending privileged positions for their social group.

This is leading to the bandying about of some exceedingly hot potatoes in areas where trustworthiness is assessed for the sacred purpose of increasing the market value of the shares and credit of the very appraisers. And where is this baring of souls occurring? Well, you've guessed it: in *The Wall Street Journal* at the very time when the family of one of the principal founders were deeply engrossed in handling the $5 billion offer of Rupert Murdoch, the Australian mega-czar of the world commercial press.

On the front page of its Money and Investing Section, the article "Moody's Faces the Storm," the article carries no particular byline, thus giving it editorial weight: "Short sellers love to target companies heading into financial turmoil. Now some of those investors who bet on a stock's decline are targeting a company that is said to spot financial problems before they occur: Moody's Corp.

"But unlike some of the blow-ups in the recent past that the New York-based credit-ratings firm and its rivals caught too late, such as World-Com Inc. and Enron Corp., its profitability and cash flows remain strong. That makes it a tough stock to bet against."

That of course is an understatement, because even if it pointed to a potentially profitable gamble, you are left with a moral appraisal of what you and of course Moody's have been up to, in short the moral appraisal of the appraiser. And if too many business information distributors recommend too many dubious marketers as rewarding investments, we are left with a problem in what we may call "moral derivatives." Can misrepresentation of what firms are up to be misleading, and still lead to a profit? But let us go back to the *WSJ:* "Still, Moody's and other credit-rating firms are again taking heat for the meltdown in the subprime mortgage market – and that could put more pressure on Moody's stock price. 'I think they did a bad job, but they've weathered reputational storms before,' says Glenn Tongue managing partner of T2 Partners LLC, a hedge fund in New York that manages about $170 million. 'There might be a black eye on the franchise associated with subprime mortgage securitizations, but the business flow and probably the liability will be contained.'

"Bearish investors are betting that Moody's shares will tumble as the company's lucrative business in providing ratings for structured debt products, such as collateralized debt obligations, or CDOs, could dry up due to fears spreading from rising defaults in those mortgages extended to borrowers with poor credit histories. 'Together with some analysts and academics who believe the rating agencies played a key role in the subprime crisis by giving high ratings to thousands of bonds that fell quickly in value, some short sellers also are wagering that legislators and disgruntled investors will shake up the existing oligopoly structure and put an end to its fat margins and profits. It's a great model as long as you can get people to pay for it,' says James Chanos, President of Kynikos Associates, a New York hedge fund with about $3 billion in assets that specializes in short selling."

When Only Cynics Speak the Truth

Let us not pass over our encounter with him without a doffing of our hat in appreciation of the aptness of the name chosen for his firm. Here at last is a case of complete disclosure. Mr. Chanos, among the most vocal of Moody's critics, is known for having bet early against Enron. "If they have no predictive power over that which they are rating, then why bother?"

"Many of Moody's ratings for subprime debt represent 'shoddy goods' according to Joseph Mann, a professor of finance at Drexel University. In a paper co-written with Joshua Rosner, an independent research analyst, Prof. Mason argues that the ratings agencies – including Standard & Poor's Corp. and Fitch Ratings, as well as Moody's – are deeply involved with investment bank underwriters in structuring pools of assets, which places them in a more active role than simply publishing opinions on the creditworthiness of underlying assets.

"In past lawsuits that have involved cor-

porate debt ratings, judges have ruled that such rankings are opinions, like newspaper editorials, and are protected under the First Amendment. But, if lawyers can convince a judge that Moody's debt ratings shouldn't be treated as opinions, the company could be hurt by lawsuits.

"The argument against rating agencies appears to be gaining traction, at least in Ohio. The state's attorney-general, Marc Dann, is investigating the role of the credit rating firms.

"Moody' says it can't be held responsible for drops in market values of certain assets, 'Our ratings predict the probability of default. We do not offer views on market pricing,' says Linda Huber, chief financial officer at Moody's. 'People enter the market and trade these securities at their own risk.'

"To date, Moody's hasn't been sued in federal court on any of its subline credit ratings, which constituted around 6% of its revenue last year. And while structured finance ratings made up 43% of its total revenue last year, another 40% came from non-US revenue, where there is also strong growth.

"For most of the past decade, even when Moody's was under fire for the World.com and Enron debacles, its operating margins have held steady at about 53%, which is higher than Google Inc.'s margin. This is one reason that Berkshire Hathaway Inc., led by Warren Buffett, is Moody's largest investor.

Ms. Huber says the recent weakness in Moody's share price has created an opportunity for the company to repurchase its shares. During the first quarter Moody's bought back some $445 million of its shares."

In its feedings and regurgitations, the market is indeed a strange beast.

W.K.

Untying the Knots of Debt

Think not that once we have the knot of indebtedness disentangled and the subprime mortgagors evicted from their homes that all will be fixed. That is likely to depend mostly on who profits by the outcome.

You can sense a realization of this in what still remains of the better press. But then the better press, is facing a technological fight for survival of its own as has been the art of double-entry bookkeeping if there are enough digits involved.

Let us consult *The New York Times* (20/08, "Hedge Funds Are Squeezed by Investors Lenders" by Jenny Anderson): "As summer neared, investors in Sowood Capital Management, a $33 billion hedge fund, had little to complain about. The fund was up 16% over the previous 12 months. Blue-chip management was in place, and any risk was well-hedged with a comfortable cushion on financing, said the fund in a letter to its investors.

"But a rocky June turned into a calamitous July, and Sowood was on the brink of collapse. As the credit market tightened, Sowood had to sell stock to meet margin calls from skittish banks and add hundreds if millions of cash reserves. Sowood's manager, Jeffery Larson, sold the rest of the portfolio, seemingly overnight – at a fraction of its initial value, and embarked on what he would later describe as 'a deeply painful' process of returning the remaining money to investors and shutting the funds.

"As problems that began in subprime mortgages have expanded into the broader markets, hedge funds like Sowood have come face to face with the ghosts of previous crises: the one-two liquidity punch from banks and investors.

"On the one side, Wall Street banks and brokerage firms have stepped up their demand for more cash and collateral as they restrict the money they are willing to lend. Such pressure could not have come at a worse time. The prices of the debt instruments they hold continue to fall, if they trade at all. From small-cap stocks to potential targets for leveraged buyouts, have been pummeled. And accordingly banks and hedge funds are scrambling to reduce risk, selling what can be easily sold.

"For hedge funds, illiquidity is their Achilles heel. Pressure from banks to raise margin levels as well as pressure from investors could not have come at a worse time for hedge funds. The prices of the debt instruments they hold continue to fall, if they trade at all. Stocks widely held by hedge funds, from small cap-value stocks to potential targets for leveraged buyouts, have been pummelled. And with volatility in the market banks and hedge funds are scrambling to reduce risk and sell what can be sold.

"It's not that everyone is suddenly out of cash – they just don't want to lend it or invest it. With no ability to sell risky loans or slices of collateralized debt obligations, the funds started dumping stocks they owned and buying back stocks they had borrowed. As a result, 'high quality' stocks plummeted, stocks that managers bet would fall in price-soared because tied up with toes and elbows of other stocks as security for a common indebtedness, they were simply not available for dumping."

Risk management!! I would not trust those who designed the hedge fund strategies with walking my dog around the block – even on a leash. Or changing the analogy, it calls to mind a health program that produced a bumper crop of Siamese twins – joined at the head or the spine. Moreover, as security to banks there is little possibility of sawing one body free of the other.

But the story strings on from losses or gains scattered in quite unforeseen directions. "At United Capital Asset Management, John Devaney, a well-known manager said in early July that the fund had received an 'unusually high number of redemption requests,' including one from the largest investor that accounted for nearly a quarter of the firm's assets under management.

"Regulators have for years emphasized to banks, which they oversee, as well as to investment banks and hedge funds that they do not, the importance of managing 'liquidity risk,' i.e., the risk that hedge funds or banks wake up one day and cannot sell or borrow."

We need only gauge the enormity of the damage and eventual cost to all of society of this mega-goof of our governments and our financial communities of the deregulation of our banks since the mid 1960s, that has permitted them to structure virtual sky-scrapers of legal tender taken from the other "financial pillars" – stock markets, insurance and mortgages companies – that they had strictly not been able to acquire interests in. For precisely these risks would result from the banks being in a position to apply the bank multiplier to cash reserves needed by those other "financial pillars" for their own businesses.

The prospect is grave enough to call for a royal commission that will evaluate the use our sporting banks have made of the liberties and immunities, and bailouts previously bestowed on them.

W.K.