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For a just and sustainable society

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Notice: The ERA(SA) end-of-year meeting and barbecue will be held once again at Largs Bay on Monday 2 January 2012 (a national holiday) starting at 2pm. The venue is The Cottage, 25 Everard Street (off Lady Gowrie Drive). Look for the ERA banner.

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ECONOMIC REFORM AUSTRALIA (ERA)

ERA is a non-party-political organization, formed in 1993 as a union of the Economics Review Association and other economic reform groups. Its long-term goal is to achieve a socially, environ-mentally and financially sustainable economic system. ERA's commitment to economic sovereignty seeks to return control of the economic and financial system to the people. This requires full public scrutiny and accountability for all economic processes and a recognition that economic systems must serve the people for the global good.

Membership of ERA is open to all who agree with its objectives and overall philosophy, and may be effected by forwarding A$20.00 per annum (A$15 concession, A$30 joint membership for partners) to the Treasurer (address below), together with address, telephone and fax numbers, and email address. It would be appreciated if new members would calculate the part of the year remaining and remit the appropriate pro-rata amount, with the option of paying for the following year as well (make cheques out to E.R.A.) All members are entitled to receive the regular ERA publication *The ERA review*, and are entitled to vote at ERA meetings and participate in organized activities.

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NSW Division Inc

We are committed to maintaining our links and meet twice a year.
Details: Frances or Bruce Milne Ph (02) 9810 7812

SA Division Inc

Meetings are held on the last Saturday of each month at the SA Conservation Centre, 157 Franklin Street, Adelaide, SA 5000 (Level 1). Meetings begin at 2pm. Details: John Hermann Ph (08) 8264 4282

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Items suitable for publication may be sent to any member of the editorial committee. Please contact Victoria Powell if you wish to receive the ERA Review electronically as an email attachment, instead of as a posted copy

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Please renew your ERA membership for 2012

It has been our practice within the Nov-Dec issue to invite members to consider renewing their ERA membership for the following calendar year. Renewing your membership this side of the festive and holiday season will ensure that you don't forget to do so in the new year, thereby avoiding the need for a reminder letter at a later stage.

Subsidies, Good or Evil?

Doris Phelps

I suppose that most regular readers of the ERA Review are agreed that the present situation, in which privately owned banks are allowed to profit from the creation of the nation's money supply, is undesirable. It is fairly obvious that the Government, through a government-owned bank, should have this duty. If this were to come about, no doubt there would be many lively discussions as to the best ways to benefit the nation by the use of this government-created money. An argument always used to oppose the creation and distribution of money by governments is that it would lead to galloping inflation. Of course it could, if money were created in ridiculous amounts and distributed unwisely, but it need not be so. One way in which it could have exactly the opposite effect would be by using it for consumer subsidies.

Over the years, because of overproduction brought about in European countries by subsidy payments, "subsidy" has become a dirty word. But those were subsidies paid to producers, without enough thought given to how much demand there was for the goods the farmers were thereby encouraged to produce. A subsidy designed to benefit consumers need not lead to overproduction.

Between I963 and I988 there was in Australia a subsidy known to farmers as the 'super subsidy'. Fertiliser manufacturers were paid a subsidy, not on any amount of superphosphate they cared to produce, but on what Australian Farmers were willing to buy. "A producer of these fertilisers was not entitled to the subsidy unless a number of conditions were met, including that the goods were sold by the producer for use in Australia and the full benefit passed on to the purchaser" (Hon Warren Truss MP, former minister for Agriculture).

In other words, the subsidy was used to keep the consumer price down to a certain level. It worked well, enabling the manufacturer to sell more of his product, and the farmer to buy fertiliser at a price he could afford. Both parties were winners. Because it was not necessarily paid on goods produced, but only on those purchased, it did not lead to overproduction.

This kind of subsidy, in the way it affects consumers, and in the way it could be administered, has sometimes been described as a sales tax in reverse. There is no reason why a government with the ability to create its own debt-free money, could not apply similar subsidies to many of the necessities of life, thus putting an end to the ever-climbing price spiral.

[Doris Phelps is a frequent contributor and a member of ERA(SA)]

How the RBA outsources its role to foreign private bankers
Ann Pettifor

The tectonic plates of Australia's economy are shifting, as the mining boom generates the kind of ebullience common to all booms.

But cracks are appearing that could quickly overwhelm the gains made by the boom. These expose the Reserve Bank of Australia's flawed management of Australia's financial system.

It is worth reminding ourselves that the RBA's role (according to the 1959 Reserve Bank Act) is "to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia to the maintenance of full employment and the economic prosperity and welfare of the people..."

We need to bear that in mind in light of the RBA's recent policy stance. First the policy to set the highest official interest rate in the developed world. Second, the policy that permits the Australian dollar to rise to unsustainable levels. Third, the policy that allows Australia's banks to go abroad to raise funding in international capital markets.

The RBA *should* fulfil its mandate by providing Australia's banks with finance - just as the US Fed and the Bank of England do. The process is a virtually costless way of injecting finance into the system, at very low rates of interest. However the RBA has chosen not to.

The cost of borrowing in foreign markets has risen recently because of the crisis in the eurozone. Australian banks' credit costs in international money markets have increased by more than 1.00 per cent in less than three months.[1] In addition these banks face exchange rate risks - risks that could be avoided if the RBA was fulfilling its role.

But these are not the only risks posed by this policy. Foreign bankers lend to Australian banks by borrowing from their own central banks at rates of 1 per cent or less. When they collect the prize of lending at 4.5 per cent, they do so by raiding the coffers of the RBA for hard currency. In other words, foreign private bankers are leaning on their taxpayer-backed central banks to make a quick and lucrative buck at the expense of Australians. The RBA turns a blind eye to this form of daylight robbery.

It gets worse. By borrowing in global capital markets, banks attract funds into Australia - $100 billion this year. These, added to inward investment flows into mining sectors, force up the exchange rate, the cost of Australian labour, products and services. Indeed there is a direct causal line between a very high rate of interest; banks borrowing abroad, the rise in the dollar, and the collapse of Bluescope Steel.

The ability of central banks to create cheap, but carefully regulated finance is intended to encourage and support sound private and public investment to guarantee the prosperity and welfare of Australians. The RBA has outsourced this role to foreign private banks.

Some might say that the big four Australian banks are very profitable indeed; that they survived the tsunami of the GFC and that there is little to worry about.

Except that one small 'crack' has appeared in the system. International market players have taken out insurance against Australia's big four banks defaulting on their foreign loans Credit Default Swaps (or CDSs). CDs's are 'premiums' taken out by speculators that do not own the underlying asset insured. (Something forbidden by regulators on normal insurance, because if we were allowed to take out insurance on *another's* asset e.g. property the incentive to burn it down would be very great. But hey, this is the global financial system where anything goes.)

The 'premium' on the likelihood of the four Australian banks' defaulting has climbed by 50 per cent over August indicating that speculators are losing confidence in these banks.

The noise around the mining boom means that this 'crack' appearing in the Australian economy is not audible to most. Nevertheless it poses a grave threat to Australians: one that the RBA would be wise to address before the onset of Credit Crunch 2.0.

1. Satjayit Das, author of *Traders, Guns and Money* in *The Big Picture: From Green to Red - is Credit Crunch 2.0 imminent?*

[Source: *http://www.abc.net.au/unleashed/2911672.html* Ann Pettifor is a British Economist who co-founded the Global Jubilee 2000 Campaign]

Banking for California's Future
Ellen Brown

Wall Street's not cutting it: California's legislature voted to do a feasibility study on establishing a state-owned bank.

Photo by Steve Rhodes

AB 750, California's bill to study the feasibility of establishing a state-owned bank that would receive deposits of state funds, has passed both houses of the legislature and is now on the desk of Governor Jerry Brown awaiting his signature. It could be the governors chance to restore the state to its former glory. As noted in *TIME* Magazine:

> [I]n the 1950s and 60s, California was a liberal showcase. Governors Earl Warren and Pat Brown responded to the population growth of the post-war boom with a massive program of public infrastructure - the nation's finest public college system, the freeway system and the state aqueduct that carries water from well-watered north to parched south.

But that was before Proposition 13, a California constitutional amendment enacted by voter initiative in 1978. Prop 13 limited real property taxes to one percent of the full cash value of the property and required a two-thirds majority in both legislative houses for future increases of any state tax rates.

Prop 13 radically reduced the tax base, and as economist Michael Hudson observes, it is too late to raise property taxes now. The tax savings simply drove property prices up, getting capitalized into additional debt service to the banks. Today, he says, so much urban property is sinking into negative equity territory that a rise in property taxes will lead to even more foreclosures and abandonments, and hence even lower fiscal returns.

Meanwhile, the state is struggling to meet its budget with a vastly shrunken tax base. What it needs is a new source of revenue, something that wont squeeze consumers, homeowners, or local business.

The BND is not a business competitor of the local banks but partners with them, helping with capital and liquidity requirements.

A state-owned bank can provide that opportunity. North Dakota, the one state that currently has its own bank, is the only state to be in continuous budget surplus since the banking crisis began. North Dakotas balance sheet is so strong that it recently reduced individual income taxes and property taxes by a combined $400 million and is debating further cuts. It also has the lowest unemployment rate, lowest foreclosure rate and lowest credit card default rate in the country, and it hasnt had a bank failure in at least the last decade.

Revenues from the Bank of North Dakota (BND) have been a major boost to the state budget. The bank has contributed over $300 million in revenues over the last decade to state coffers, a substantial sum for a state with a population less than one-tenth the size of Los Angeles County. North Dakota is an oil state, but according to a study by the Center for State Innovation, from 2007 to 2009 the BND added nearly as much money to the states' general fund as oil and gas tax revenues did. Over a 15-year period, according to other data, the BND has contributed more to the state budget than oil taxes have.

North Dakota is a conservative red state, not the sort you would expect to be engaging in government enterprise. But the conservative justification for a state-owned bank is that it preserves state sovereignty, allowing the state to be independent of Wall Street and the Feds. The BND is not a business competitor of the local banks but partners with them, helping with capital and liquidity requirements. It participates in loans, provides guarantees, and acts as a sort of mini-Fed for the state.

According to the annual BND report for 2010:

> Financially, 2010 was our strongest year ever. Profits increased by nearly $4 million to $61.9 million during our seventh consecutive year of record profits. . . . We ended the year with the highest capital level in our history at just over $325 million. The Bank returned a healthy 19 percent ROE, which represents the states return on its investment.

A 19 percent return on equity beats the 170 billion dollars LOST by CalPERS and CalSTRS, Californias two public pension funds, by the time the stock market hit bottom in March 2009. The BND was making record profits all through that period.

The BND augments state revenues in other ways besides just returning its profits to the general fund. It helps build the tax base by providing the funding needed by local businesses, and by financing the infrastructure that attracts them. Among other resources, it has a loan program called Flex PACE that allows a local community to provide assistance to borrowers in areas of jobs retention, technology creation, retail, small business, and essential community services.

North Dakota: Banking on the Locals

The BND also furnishes a credit line to the state itself, one that is effectively interest-free, since the state owns the bank. Credit lines are extended in times of emergency or whenever state departments or municipalities face unforeseen circumstances, such as the recent flooding in the state. Having a credit line to the states own bank allows state and local governments to avoid extortionate interest rates from Wall Street and pressure to privatize and reduce services in order to avoid downgrades from rating agencies.

Timothy Canova is Professor of International Economic Law at Chapman University School of Law in Orange, California. In a June 2011 paper called

The Public Option: The Case for Parallel Public Banking Institutions, he compared North Dakotas comfortable financial situation to California's:

> . . . California is the largest state economy in the nation, yet without a state-owned bank, is unable to steer hundreds of billions of dollars in state revenues into productive investment within the state. Instead, California deposits its many billions in tax revenues in large private banks which often lend the funds out-of-state, invest them in speculative trading strategies (including derivative bets against the states own bonds), and do not remit any of their earnings back to the state treasury. Meanwhile, California suffers from constrained private credit conditions, high unemployment levels well above the national average, and the stagnation of state and local tax receipts.

California was once the nation's leader in technology, industry, public education and entertainment. Under Governor Pat Brown, tuition at UC campuses was free, making higher education available to all. Today tuition costs $13,000 a year, and the state has an unemployment rate around 12%.

California, like North Dakota, is resource-rich. A state-owned bank will allow it to capitalize on its resources to full advantage by providing the credit needed to realize its potential. As the bank was described by Assembly Member Ben Hueso of San Diego, who authored AB 750, "It's not the fad of the moment, a pair of tight fitting jeans; it's a pair of construction boots."

Ellen Brown wrote this article for *YES! Magazine*, a national, non-profit media organization that fuses powerful ideas with practical actions. Ellen is an attorney, president of the Public Banking Institute, and the author of eleven books, including *Web of Debt: The Shocking Truth About Our Money System and How We Can Break Free.* Her websites are WebofDebt.com and PublicBankingInstitute.org

Economic Growth and Population
Bruce Dinham

There is a popular belief that economic growth is essential for our prosperity and because population growth is seen as a driver of economic growth, a corresponding belief in a need for population growth. So what is economic growth, what is the economy and how does it grow?

What we call the economy is an artificial, man-made system for trading goods and services using tokens and symbols called money as indicators of comparative value.

Values represented by money are arbitrary, set by fiat and the market, the latter influenced by mob psychology and the so-called “invisible hand” of greed and self-interest, euphemistically referred to as supply and demand. The system has positive feedbacks in the form of interest, especially compound interest, and fractional reserve banking, creating money as debt out of nothing so is inherently unstable and subject to continuing inflation and recurrent booms and busts.

A measure of the economy is taken as an aggregate, with some adjustments to avoid double counting and to allow for inflation, of money spent over a particular period. This is expressed as a number called Gross Domestic Product or GDP. An increase in GDP is called economic growth and usually celebrated as an achievement, regardless of the cause or effect of the increased spending.

Economics has no morality, in that it makes no distinction between good and bad or between essential and inessential. While GDP includes essential food, clothing, housing, education, health services (including aged care) and law and order, a large part of it is inessentials, such as professional sport, advertising, car racing, fireworks displays, festivals and pageants, luxury and sports vehicles, fashion clothing, speculative finance, gourmet foods, alcohol and tobacco, horse racing, gambling, tourism and other indulgences and extravagances. GDP is as much a measure of inessentials or waste as it is of needed products and could just as well stand for Gross Domestic Profligacy.

The waste in inessentials is not all we need to consider. The inescapable end effects of almost everything we buy or do are increased pollution, greater environmental degradation and more rapid depletion of finite resources, especially oil. Because they are not monetised or accounted in money terms, end effects (or in economists’ jargon, externalities) are ignored and not included in GDP. Nevertheless they are real and significant. The more of us there are and the more we spend and consume the worse they become. Together with waste in inessentials, end effects are part of economic growth.

The reality of economic growth, when all parts are considered, is that far from being beneficial it is an insidious cancer, with widespread and damaging symptoms. Water shortages, greenhouse emissions, climate change, land erosion, river and dry-land salinity, over-fishing, deforestation, species loss, urban sprawl and traffic congestion are some of them. It is often said that economic growth creates employment, however an alternative viewpoint is that economic growth is a consequence of employment, rather than a cause.

We argue about carbon trading (an attempt to monetise some pollution), build expensive energy intensive desalination plants, fritter around mandating half-flush toilets and banning incandescent light globes, subsidising hybrid cars and solar panels and sticking efficiency labels on appliances but this is only dealing with the effects, not the causes. The primary cause is fairly obvious -- there are too many of us, and we are wastefully spending and consuming more than we need (and calling it economic growth).

We live in a world of finite resources. No matter how cleverly and efficiently we use those resources, the more of us there are the faster those resources will be used, the smaller will be each share, the less there will be for the future and the worse off we and our children will become.

The supposed benefits of population and economic growth are a delusion. Instead of a mindless pursuit of growth with increasingly disastrous boom and bust cycles and destructive environmental effects, a government concerned for the future and not hostage to various self-interested growth lobbies (business and industry will always want growth because it means bigger and easier profits) would stop encouraging growth and be planning and acting for an orderly transition to a stable no-growth economy.

With a stable population and economy there would be no need to keep building new houses and expensive infrastructure, meeting continually increasing demands for services and endlessly digging holes in the ground for minerals.

In regard to immigration policy, it is often said there is a skills shortage. This depends upon how one looks at it. From a different perspective a skills shortage may be viewed as a surplus – a surplus of profit-seeking companies eager to rip out our mineral resources and sell them to foreigners as fast as possible. After they have taken all they want, they find a gullible government elsewhere and move on, leaving us to deal with the holes in the ground and the mess left behind. In effect our country is being used as a quarry and turned into a big rubbish dump - an ugly downside of economic growth.

[Bruce Dinham is a member of ERA(SA)]

Do credit unions and building societies create credit money?

John Hermann

This short article summarises my recent thoughts on this issue. The essential difference between banks and credit unions/building societies (CUBS) is that the former are commercial firms listed on the stock exchange whose profits derived from retail members provide dividends to shareholders, while the latter are cooperatives with a mutual agenda (meaning that in theory the profits and losses are shared by retail members in proportion to the business each transacts).

Around 10 years ago, at an ERA meeting in Adelaide, we enjoyed a presentation from guest speakers representing a well-known credit union. At that meeting it came as a revelation to me to discover that credit unions are obliged to maintain deposits in the Reserve Bank of Australia (RBA) equal to a substantial fraction of their deposits. The speakers complained to the meeting that this placed credit unions at a competitive disadvantage to Australian commercial banks who (since the start of the 1990s) have been subjected to no such statutory requirement . I also discovered that the changes to banking practices which occurred during the 1990s resulted in credit unions and building societies being placed on an equal footing with banks in regard to prudential supervision. All of whom are now obliged to report to APRA (the Australian Prudential Regulatory Authority) on a regular basis.

These facts prompted me to have a look at the Australian Banking Act and its amendments. In that Act, it is clearly stated that commercial banks, credit unions and building societies will be treated separately from all other financial institutions. They are collectively designated as Authorised Deposit-taking Institutions (ADIs). Moreover every ADI has the right to describe itself as a "banking institution" and to describe its business as "banking". This is very interesting, since the primary business of banking is to take deposits and advance loans. And lending by banks to their retail customers always involves the creation of new bank credit money.

The acid test would seem to be whether a financial institution is to be regarded as a true depository, meaning that its "deposits" are counted as forming part of the national money supply (the latter being money accessible to and used by the public and business community). Partly with this in mind, I recently directed a letter to the RBA, asking why - in their monetary aggregates - the deposits of ADIs are included in the aggregate M3 (the broader measure of the money supply which includes time deposits) but not within the aggregate M1 (transaction money). Specifically my letter contained the following: "I can see no logical reason why M1 should exclude the current deposits of non-bank ADIs. Indeed to do so would seem to give a false statistic for the amount of transaction money available to the public and the business community." Here is the response obtained from Chris Stewart, Senior Manager, Domestic Markets (whose team is directly responsible for constructing the monetary and credit aggregates):

> ... non-bank ADI deposits are not included in M1 as we can't distinguish between current and non-current CUBS deposits. Consequently, we have a choice between over- and under-estimating M1. Liaison with the CUBS sector suggests that many of their deposits are reasonably large, with these funds not held in current accounts, consequently, the choice has been to include their deposits within M3 but not within M1. This is consistent with the International Monetary Funds statistics compilation guides, which relies on national discretion within some broad guidelines to determine the exact composition of each countries monetary statistics.
>
> While we collect 10 different breakdowns of deposits at CUBS, we do not collect the current versus non-current breakdown for two reasons. First, we have to trade-off the burden it would impose on these firms versus our desire to get more detailed statistics. In particular, while the CUBS sector makes up about 5 per cent of deposit-taking institutions deposits, this is spread quite widely across a large number of institutions and the compilation of these statistics can be quite expensive. Indeed, the smallest CUBS have about $50 million to $60 million in assets. In contrast, the smallest Australian-owned bank is eighty times larger, having about $4 billion of assets (the Australian regional banks have assets of about $40 billion to $70 billion). Consequently,

> while the banks report close to 500 items on their balance sheets each month (and about 3,000 across all the statistical forms), each credit union or building society reports about 230 items on its balance sheet.

What is clear from this response is that the omission of CUBS deposits from M1 is simply a matter of convenience, based on the undue cost of collecting the statistics, the small impact of the omission on the measure of transaction money, and uncertainty anyway about what constitutes a meaningful measure of transaction money. However the convenient shunting of CUBS deposits into M3 cannot disguise the fact that these deposits are qualitatively no different from commercial bank deposits.

'Front Running' Against Humanity in the Oil Markets
Stephen Zarlenga

"Front running" is an insiders' term for an often illegal, always immoral practice in commodity and other markets. Here's what happens:

A broker holding a client's order to buy at a certain price instead buys for himself just in "front" of it. The client's order isn't filled, and the broker has an unfair advantage over other traders because he controls the client's order, which will buy the position back from him and protect his trade from a loss.

The client loses the opportunity to gain, where his order is never filled if the market moves away from his order point. If some participants can trade with little or no risk, over time everyone else is hurt.

Because Exchange members' margin requirements are usually about one percent or less, the front-running brokers have a possibility of quick, great gain with almost no risk of loss.

Why Is This Important to Public Policy?

"Front running" is one way to view what criminal Enron executives did to California. They had the client's non-cancellable, inelastic "orders" to buy electricity, and they grabbed the available supply in front of that, restricted the delivery process and extorted higher prices, blaming price rises on "market forces."

Enron was bad enough, and Sarbanes-Oxley was passed to hold corporate officers criminally liable -- a good law, as judged by the corporate types screaming for its repeal. But it didn't go far enough, as judged by the present (2007 to 2011), bold attack against humanity in the oil markets.

The manipulation of energy markets has widened from cheating California to a deadly attack on all humanity. That's what allowing speculation in oil futures is doing today. These markets aren't providing "price discovery", as apologists claim. They've driven oil prices to destructive levels and done immense damage.

We witnessed the devastating effects on airlines, trucking, food delivery and production, families trying to keep up with living costs, and restaurants and hotels Americans can no longer afford. Add your own examples. It's the speculation that does it. Exxon couldn't have grabbed its record-setting, $11.7-billion, second-quarter profits in 2008 if its costs of obtaining oil were rising.

And so I put aside an outline for this piece when it appeared that Congress would do its job to rescue *the world economy* from this pernicious vandalism, by limiting speculation in oil futures to a few contracts per account, by enacting the Stop Excessive Energy Speculation Act of 2008. *That's all it would take to stop the nonsense!*

You see, there's no reason to allow wealthy speculators to position themselves between the world's limited oil supplies and those who have to use that oil to keep the world economy functioning. Such speculation leads directly to hardship, starvation, death and warfare. "Congress will finally fulfil its responsibility", I thought, but the bill failed in the Senate with 50 for, 43 against and seven not voting (including Senator Obama!). Sixty votes were needed to enforce closure.

Why Didn't Congress Act?

How could the Senate refuse to act? Are they some kind of demons? No, but something almost as bad; we're confronted with a bad idea that many people believe in: the sanctity of markets!

The vote exposes a bad methodology, an ideology based on false axioms, a false view of markets that's been strongly promoted and not questioned. With its negative effects not understood, markets are given a sacred character:

- **Omnipotence:** Don't try to legislate against the market; market forces will crush your laws.
- **Omniscience:** Don't try to instruct market behavior; it has inputs from millions of participants and knows more than your regulators ever could!
- **Benevolence:** Do the right things and the market will reward you; misbehave and you will be punished!

Omnipotence, omniscience and benevolence are attributes of a *god*, and Senators don't often fight with God!

What's sorely missing from these beliefs and assumptions is *evidence!* Where's the *evidence* that removing regulation from the airline industry had good effects? Where's the *evidence* that removing FCC restrictions on media ownership had good effects? Where's the *evidence* that removing government regulation from any industry has had good effects?

Of course, it's worse than that. It goes beyond a lack of evidence because holding those beliefs requires *ignoring* loads of evidence: ignoring the damage done to the airline passengers by deregulation, the damage done to society by media concentration, continuing damage done to America's middle class, etc.

How can proponents of unregulated markets justify ignoring the facts? It's crazy, but it's also a necessary part of their false methodology, which loves theory but avoids experience -- the facts. That's only so long as their paymasters benefit! One of their leading "lights", economist Ludwig von Mises, carries it to extreme levels, actually claiming that facts cannot disprove his theories! So we are confronted here with momentous errors of judgment and methodology.

Though these men are in the U.S. Congress, they are thinking like scared children. But such errors belong in children's sand boxes, not our nation's halls of power.

This battle over methodology is an old fight. We've see it since our nation's beginnings. Ben Franklin's 1729 essay "The Nature and Necessity of a Paper Currency" gave the correct methodology when he summarized the ideas used to help Pennsylvania set up its paper money system in 1723, rescuing her from a prolonged usury crisis. Franklin told the world, "EXPERIENCE, (more prevalent than all the Logic in the World) has fully convinced us all, that [paper money] has been, and is now of the greatest Advantage to the Country".

Fortunately section 737 of the Dodd-Frank Act of 2010 required the Commodity Futures Trading Commission to begin enforcing position limits on the market by Jan. 17, 2011. But the CFTC has yet to obey the law and start enforcing position limit rules months after the deadline! Maybe the congressmen who want to allow speculation to continue harming our nation hold a mistaken belief in the *utility* of unbridled selfishness and greed.

The great senator Bernie Sanders is leading the fight against the oil speculators to put in position limits. Senator Sanders introduced the End Excessive Oil Speculation Now Act of 2011 in June to stop oil speculators from harming our nation. Monetary reforms along the lines of the American Monetary Act would act to limit speculators' access to bank funding, to maintain margin positions.

[*Stephen Zarlenga is co-founder and Director of the American Monetary Institute and author of "The Lost Science of Money". The piece edited by Jules Brouillet, a researcher for the American Monetary Institute. Source: The Huffington Post <http://www.huffingtonpost.com/stephen-zarlenga/front-running-against-hum_b_937179.html*]

How economic theory came to ignore the role of debt

Michael Hudson

Starting from David Ricardo in 1817, the historian of economic thought searches in vain through the theorizing of financial-sector spokesmen for an acknowledgement of how debt charges (1) add a non-production cost to prices, (2) deflate markets of purchasing power that otherwise would be spent on goods and services, (3) discourage capital investment and employment to supply these markets, and hence (4) put downward pressure on wages.

What needs to be explained is why government, academia, industry and labour have not taken the lead in analyzing these problems. Why have the corrosive dynamics of debt been all but ignored?

I suppose one would not expect the tobacco industry to promote studies of the unhealthy consequences of smoking, any more than the oil and automobile industries would encourage research into environmental pollution or the linkage between carbon dioxide emissions and global warming. So it should come as little surprise that the adverse effects of debt are sidestepped by advocates of the idea that financial institutions rather than government planners should manage society's development. Claiming that good public planning and effective regulation of markets is impossible, monetarists have been silent with regard to how financial interests shape the economy to favor debt proliferation.

The problem is that governments throughout the world leave monetary policy to the Central Bank and Treasury, whose administrators are drawn from the ranks of bankers and money managers. Backed by the IMF with its doctrinaire Chicago School advocacy of financial austerity, these planners oppose full-employment policies and rising living standards as being inflationary. The fear is that rising wages will increase prices, reducing the volume of labour and output that a given flow of debt service is able to command.

Inasmuch as monetary and credit policy is made by the central bank rather than by the Dept. of Labor, governments chose to squeeze out more debt service rather than to promote employment and direct investment. The public domain is sold off to pay bondholders, even as governments cut taxes that cause budget deficits financed by running up yet more debt. Most of this new debt is bought by the financial sector (including global institutions) with money from the tax cuts they receive from governments ever more beholden to them. As finance, real estate and other interest-paying sectors are un-taxed, the fiscal burden is shifted onto labour.

The more economically powerful the FIRE sector (Finance, Insurance and Real Estate) becomes, the more it is able to translate this power into political influence. The most direct way has been for its members and industry lobbies to become major campaign contributors, especially in the United States, which dominates the IMF and World Bank to set the rules of globalization and debt proliferation in today's world. Influence over the government bureaucracies provides a mantel of prestige in the world's leading business schools, which are endowed largely by FIRE-sector institutions, as are the most influential policy think tanks. This academic lobbying steers students, corporate managers and policy makers to see the world from a financial vantage point.

Finance and banking courses are taught from the perspective of how to obtain interest and asset-price gains through credit creation or by using other peoples' money, not how an economy may best steer savings and credit to achieve the best long-term development. Existing rules and practices are taken for granted as "givens" rather than asking whether economies benefit or suffer as a whole from a rising proportion of income being paid to carry the debt overhead (including mortgage debt for housing being bid up by the supply of such credit). It is not debated, for instance, whether it really is desirable to finance Social Security by holding back wages as forced savings, as opposed to the government monetizing its social-spending deficits by free credit creation.

The finance and real estate sectors have taken the lead in funding policy institutes to advocate tax laws and other public policies that benefit themselves. After an introductory rhetorical flourish about how these policies are in the public interest, most such policy studies turn to the theme of how to channel the economy's resources into the hands of their own constituencies.

One would think that the perspective from which debt and credit creation are viewed would be determined not merely by the topic itself but whether one is a creditor or a debtor, an investor, government bureaucrat or economic planner writing from the vantage point of labour or industry. But despite the variety of interest groups affected by debt and financial structures, one point of view has emerged almost uniquely, as if it were objective technocratic expertise rather than the financial sector's own self-interested spin. Increasingly, the discussion of finance and debt has been limited to monetarists with an anti-government axe to grind and vested interests to defend and indeed, promote with regard to financial deregulation.

This monetarist perspective has become more pronounced as industrial firms have been turned into essentially financial entities since the 1980s. Their objective is less and less to produce goods and services, except as a way to generate revenue that can be pledged as interest to obtain more credit from bankers and bond investors. These borrowings can be used to take over companies ("mergers and acquisitions"), or to defend against such raids by loading themselves down with debt (taking "poison pills"). Other firms indulge in "wealth creation" simply by buying back their own shares on the stock exchange rather than undertaking new direct investment, research or development. (IBM has spent about $10 billion annually in recent years to support its stock price in this way.) As these kinds of financial manoeuvring take precedence over industrial engineering, the idea of "wealth creation" has come to refer to raising the price of stocks and bonds that represent claims *on* wealth ("indirect investment") rather than investment in capital spending, research and development to increase production.

Labour for its part no longer voices an independent perspective on such issues. Early reformers shared the impression that money and finance simply mirror economic activity rather than acting as an independent and autonomous force. Even Marx believed that the financial system was evolving in a way that reflected the needs of industrial capital formation.

Today's popular press writes as if production and business conditions take the lead, not finance. It is as if stock and bond prices, and interest rates, reflect the economy rather than influencing it. There is no hint that financial interests may intrude into the "real" economy in ways that are systematically antithetical to nationwide prosperity. Yet it is well known that central bank officials claim that full employment and new investment may be inflationary and hence bad for the stock and bond markets. This policy is why governments raise interest rates to dampen the rise in employment and wages. This holds back the advance of living standards and markets for consumer goods, reducing new investment and putting downward pressure on wages and commodity prices. As tax revenue falls, government debt increases. Businesses and consumers also are driven more deeply into debt.

The antagonism between finance and labour is globalized as workers in debtor countries are paid in currencies whose exchange rate is chronically depressed. Debt service paid to global creditors and capital flight lead more local currency to be converted into creditor-nation currency. The terms of trade shift against debtor countries, throwing their labour into competition with that in the creditor nations.

If today's economy were the first in history to be distorted by such strains, economists would have some excuse for not being prepared to analyze how the debt burden increases the cost of doing business and diverts income to pay interest to creditors. What is remarkable is how much more clearly the dynamics of debt were recognized some centuries ago, before financial special-interest lobbying gained momentum. Already in Adam Smith's day it had become a common perception that public debts had to be funded by tax levies that increased labour's living costs, impairing the economy's competitive position by raising the price of doing business. The logical inference was that private-sector debt had a similar effect.

How national debts were seen to impair economic competitiveness prior to Ricardo

An important predecessor of Adam Smith, the merchant Mathew Decker, emigrated from Holland to settle in London in 1702. In the preface to his influential *Essay on the Causes of the Decline of the Foreign Trade*, published in 1744, he attributed the fall in Britain's international competitiveness to the taxes levied to carry the interest charges on its public debt. These taxes threatened to price its exports out of world markets by imposing a "prodigious artificial Value . . . upon our Goods to the hindrance of their Sale abroad." Taxes on food and other essentials pushed up the subsistence wage level that employers were obliged to pay, and hence the prices they had to charge as compared to those of less debt-ridden nations.

The tax problem thus was essentially a debt problem, which in turn reflected royal military ambitions. Eight centuries of warfare with France had pushed Britain deeply into debt. Interest on the government's bonds was paid by levying excise taxes that increased prices. The cost of doing business was raised further by the high prices charged by the trading monopolies such as the East India Company (of which Decker himself had been a director) that the government created and sold to private investors for payment in its own bonds.

Adam Smith's views

Smith's protest against government profligacy and taxation was essentially an argument against war debts. He saw that new wars could be financed only by running further into debt, as populations were unwilling to support them when they had to pay taxes to defray their costs directly on a pay-as-you-go basis and thus felt the full economic burden immediately. The landed gentry, whose members formed the cavalry and officer corps, supported wars out of patriotism but opposed the proliferation of public debts whose interest charges were defrayed by taxes that fell ultimately on their own property. When the barons had opposed royal taxation in medieval times, rulers avoided the tax constraint by borrowing from Italian bankers and other lenders.

By the 18th century, governments had turned to more anonymous Dutch and domestic investors. This created a vested interest of bondholders. And it was only natural for them to portray their lending in as patriotic and economically productive a light as they could, claiming to provide capital to the nation. However, Smith wrote (V, iii; Cannan ed. pp. 460ff.): "The opinion that the national debt is an additional capital is altogether erroneous." Debt was just the opposite of an engine of development. A nation's real wealth lay in its productive powers, not its money or the build-up of financial securities. These were only the shadowy image of real wealth. In fact, Smith explained, the policy of funding wars by bond issues diverted money that taxpayers could use more productively for direct investment. Taxes to pay debt service were "defrayed by the annual destruction of some capital which had before existed in the country; by the perversion of some portion of the annual produce which had before been destined for the maintenance of productive labour, towards that of unproductive labour."

How Ricardo's value and trade theory ignored the impact of debt and interest charges

The debt discussion peaked at a time before most modern readers imagine that economic theory began. It was the bond-broker Ricardo that ended the discussion rather than moving it forward. His labour theory value focused only on the direct costs of production, measured in labor time. Credit and interest charges did not enter into his model. Workers earned the subsistence wage, and capital was valued in terms of the labour needed to produce it. The land was provided freely by nature, and its natural fertility (and hence, economic rent) was not a cost of production. As for the taxes to which Ricardo referred in his 1817 *Principles of Political Economic and Taxation*, they were the tariffs levied on agricultural products, not taxes levied to pay bondholders. Yet as the economic historian Leland Jenks has observed (1927:14ff.), Britain's government paid out some three-fourths of its tax revenue as dividends to bondholders in the typical year 1783. "Nine million pounds were paid to *rentiers* when the entire annual turnover of British foreign trade did not exceed thirty-five millions."

How Keynes discussed saving and investment without citing the role played by debt deflation

Keynes distinguished himself in the 1920s by defining the limits that existed to debt-servicing capacity,4 above all with regard to the Inter-Ally debts and German reparations stemming from World War I. By 1931 he was pointing out that "the burden of monetary indebtedness in the world is already so heavy that any material addition would render it intolerable. . . . In my own country it is the national debt raised for the purposes of the war which bulks largest. In Germany it is the weight of reparation payments fixed in terms of money. . . . In the United States the main problem would be, I suppose, the mortgages of the farmer and loans on real estate generally." He criticized deflationary monetary proposals as threatening to derange the financial superstructure of "national debts, war debts, obligations between the creditor and debtor nations, farm mortgages [and] real estate mortgages," throwing the banking system into jeopardy and causing "widespread bankruptcy, default, and repudiation of bonds."

But by 1936, Keynes was concerned mainly with the shortfall in consumption resulting from people's propensity to save. Pointing out that new investment and hiring would not occur without stronger markets, his *General Theory of Employment, Interest and Money* described the solution to lie in getting people to spend more. The countercyclical government hiring that he advocated would lead to budget deficits, which would have to be financed by debt. Yet Keynesian macroeconomics ignored the role of debt and its carrying charges. This was its major loose end, and the blind spot that has led to the most confusion.

How debt and interest rates are autonomous from the "real" economy

Keynes was not the first economist pointing to savings as not being an unalloyed benefit. Marx had described how the "new aristocracy of finance, a new sort of parasites in the shape of promoters, speculators and merely nominal directors . . . demands . . . precisely that others shall save for him" (*Capital* III:519f.). The saving in this case take the form of debt repayment with interest, much as British money lenders advertise that buying a home helps buyers save by building up equity via their mortgage payments each month. The liquid savings of course accrue to the lenders, not the debtors. But it was mainly fringe groups that warned of the collision course between the debt overhead and the "real" economy's production and consumption trends.

The reality is that credit has no cost of production beyond a modest administrative overhead. Interest rates have no determinate foundation in the "real" economy's production and consumption functions, although they intrude into that system's circular flow. Such charges therefore cannot be assigned to labor or other “real” costs of production, but the administered prices for interest and underwriting fees are akin to economic rent, out of which the financial sector’s bloated salaries and bonuses are paid.

Ignoring the role of debt leaves it free to devastate the economic system. Beaudelaire famously remarked that the devil would defeat humanity at the point where he was able to convince it that he did not really exist. Financial interests have promoted the idea that money and credit are merely a veil, passively reflecting economic life as “counters” rather than actively steering and planning economies. The study of debt and its effects have all but disappeared from the curriculum. In an academic version of Gresham’s Law, the financial sector’s approach to the debt problem has driven other perspectives out of the intellectual marketplace. Policy-makers take the financial and banking system for granted rather than discussing what kind of a system best would serve society’s long-term development and best cope with debts that grow too large to be paid without fatally polarizing economies between creditors and debtors.

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< http://www.paecon.net/PAEReview/issue57/Hudson57.pdf >

A Suggested Theme for the Occupation of Wall Street

William K. Black

The systemically dangerous institutions (SDIs) are inaccurately called "too big to fail" banks. The administration calls them "systemically important," and acts as if they deserve a gold star. The ugly truth, however, is what Wall Street and each administration screams when the SDIs get in trouble. They warn us that if a single SDI fails it will cause a global financial crisis. There are roughly 20 U.S. SDIs and about the same number abroad. That means that we roll the dice 40 times a day to see which SDI will blow up next and drag the world economy into crisis. Economists agree that the SDIs are so large that they are grotesquely inefficient. In "good times," therefore, they harm our economy. It is insane not to shrink the SDIs to the point that they no longer hold the global economy hostage. The ability -- and willingness -- of the CEOs that control SDIs to hold our economy hostage makes the SDIs too big to regulate and prosecute. It also allows them to extort, dominate, and degrade our democracies. The SDIs pose a clear and present danger to the U.S. and the world.

It takes a global effort against the SDIs because they constantly put nations in competition with each other in order to generate a "race to the bottom." We are always being warned that if the U.S. adopts even minimal regulation of its SDIs they will flee to the City of London or be unable to compete with Germany's "universal" banks. The result of the race to the bottom, however, as Ireland, Iceland, the UK, and U.S. all experienced is that we create intensely criminogenic environment that creates epidemics of "control fraud." Control fraud -- frauds led by CEOs who use seemingly legitimate entities as "weapons" to defraud -- cause greater financial losses than all other forms of property crime -- combined. Because of the political power of the SDIs and the destruction of effective regulation these fraudulent SDIs now commit endemic fraud with impunity.

Effective financial regulation is essential if markets are to work. Regulators have to serve as the "cops on the beat" to keep the fraudsters from gaining a competitive advantage over honest firms. George Akerlof, the economist who identified and labeled this perverse ("Gresham's") dynamic was awarded the Nobel Prize in 2001 for his insight about how control fraud makes market forces perverse.

> “[D]ishonest dealings tend to drive honest dealings out of the market. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence.” George Akerlof (1970).

One of the most perceptive observers of humanity recognized this same dynamic two centuries before Akerlof.

> "The Lilliputians look upon fraud as a greater crime than theft. For, they allege, care and vigilance, with a very common understanding, can protect a man’s goods from thieves, but honesty hath no fence against superior cunning. . . where fraud is permitted or connived at, or hath no law to punish it, the honest dealer is always undone, and the knave gets the advantage." Swift, J. Gulliver’s Travels

We are the allies of honest banks and bankers. We are their essential allies, for only effective regulation permits them to exist and prosper. Think of what would happen to banks if we took the regular cops off the beat and stopped prosecuting bank robbers. That's what happens when we take the regulatory cops off the beat. The only difference is that it is the controlling officers who loot the bank in the absence of the regulatory cops on the beat. It is the anti-regulators who are the enemy of honest banks and bankers.

Top criminologists, effective financial regulators, and Nobel Laureates in economics have confirmed that epidemics of control fraud, such as the FBI warned of in September 2004, can cause financial bubbles to hyper-inflate and drive catastrophic financial crises. Indeed, the FBI predicted in September 2004 that the developing "epidemic" of mortgage fraud would cause a financial "crisis" if it were not stopped. It grew massively after 2004. The fraudulent SDIs (who were far broader than Fannie and Freddie, indeed, they only began to dominate the secondary market in sales of fraudulent loans after 2005) ignored the FBI and industry fraud warnings for the most obvious of reasons -- they were leaders the frauds. The ongoing U.S. crisis was driven overwhelmingly by fraudulent "liar's" loans. Studies have shown that the incidence of fraud in liar's loans is 90% (MBA/MARI 2006) and that by 2006 roughly one-third of all mortgage loans were liar's loans (Credit Suisse 2007). Rajdeep Sengupta, an economist at the Federal Reserve Bank of St. Louis, reported in 2010 in an article entitled “Alt-A: The Forgotten Segment of the Mortgage Market” that:

> "[B]etween 2003 and 2006 … subprime and Alt-A [loans grew] 94 and 340 percent, respectively. The higher levels of originations after 2003 were largely sustained by the growth of the nonprime (both the subprime and Alt-A) segment of the mortgage market."

Sengupta's data greatly understate the role of “Alt-A” loans (the euphemism for “liar’s loans”) for they ignore the fact that by 2006 half of the loans called “subprime” were also liar’s loans (Credit Suisse: 2007). It was the massive growth in fraudulent liar’s loans that hyper-inflated and greatly extended the life of the bubble, producing the Great Recession. The growth of fraudulent loans rapidly increased, rather than decreased, after government and industry anti-fraud specialists warned that liar's loans were endemically fraudulent. No one in the government ever told a bank that it had to make or purchase a "liar's" loan. No honest mortgage lender would make liar's loans because doing so must cause severe losses. Criminologists, economists aware of the relevant criminological and economics literature on control fraud, and a host of investigations have confirmed the endemic nature of control fraud in the ongoing U.S. crisis.

But the banking elites that led these frauds have been able to do so with impunity from prosecution. Take on federal agency, the Office of Thrift Supervision (OTS). During the S&L debacle, the OTS made well over 10,000 criminal referrals and made the removal of control frauds from the industry and their prosecution its top two priorities. The agency's support and the provision of 1000 FBI agents to investigate the cases led to the felony conviction of over 1,000 S&L frauds. The bulk of those convictions came from the "Top 100" list that OTS and the FBI created to prioritize the investigation of the worst failed S&Ls. In the ongoing crisis -- which caused losses 40 times larger than the S&L debacle, the OTS made zero criminal referrals, the FBI (as recently as FY 2007) assigned only 120 agents nationally to respond to the well over one million cases of mortgage fraud that occurred annually, and the OTS' non-effort produced no convictions of any S&L control frauds. OTS' sister agencies, the Fed and the OCC, have the same record of not even attempting to identify and prosecute the frauds. The FDIC was better, but still only a shadow of what it was in fighting fraud in the early 1990s. If control frauds can operate with impunity from criminal prosecutions, then the perverse Gresham's dynamic is maximized and market forces will increasingly drive honest banks and firms from the marketplace.

The Financial Crisis Inquiry Commission reported on the results of the Great Recession that was driven by this fraud epidemic:

> "As this report goes to print, there are more than 26 million Americans who are out of work, cannot find full-time work, or have given up looking for work. About four million families have lost their homes to foreclosure and another four and a half million have slipped into the foreclosure process or are seriously behind on their mortgage payments. Nearly $11 trillion in household wealth has vanished, with retirement accounts and life savings swept away. Businesses, large and small, have felt the sting of a deep recession."

It is the fraudulent SDIs that are the massive job killers and wealth destroyers. It is the Great Recession that the fraudulent SDIs produced that caused most of the growth in the federal deficits and made the fiscal crises in our states and localities acute. The senior officers that led the control frauds are the opposite of the "productive class." No one, without the aid of an army, has ever destroyed more wealth and dreams than the control frauds. It is essential to hold them accountable, to help their victims recover, and to end their ongoing frauds and corruption that have crippled our economy, our democracy, and our nation.

Source: <http://neweconomicperspectives.blogspot.com>
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Peter Lock's (abridged) Marketplace

Alan Ecob (ERA/NSW)

What an excellent article! It presents what, from the perspective of humankind, is *our fundamental problem*. It is written in language that any may understand. The problem, of course, is that posed by our now-global financial system. With the possible exception of a few outposts such as Iceland and Cuba, the system effectively determines the policies and practices of national governments, and limits what may be reported in the media. The article's only needed qualification is to the implication that Henry George's 'Remedy' may 'do the job' for us today. The global situation has now gone far beyond what it was in the USA of the late 1800s. My brief argument for this is:

1).Economic Rent, properly defined, is 'something for nothing', the 'price of monopoly', the accountant's 'super-profit', gained by private interests at the expense of what, in a democratic market economy, should become public revenue.

2).In the late 1800s, in the circumstances of the USA, to have appropriated the economic rent attributable to unimproved land and natural resources, and intelligently applied it towards the elimination of other taxes, together with other government action to minimise the emergence of monopoly and undue economic concentration, would have been magnificent policy. But from 1914 on, World Wars changed the game.

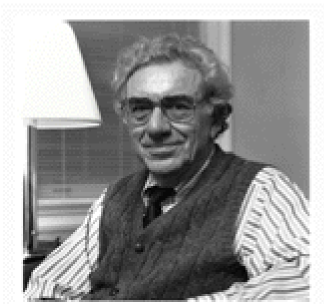
3).Today, in the major developed economies, the flow of economic rent that *in the shorter term* could be related to unimproved land etc. is only a 'drop in the bucket' compared with what is being secured from the legion of other sources of economic advantage that are being exploited.

4).Yet, the position as it may become by say 2025, as the availability of key resources such as oil and fresh water declines, as food becomes more scarce, as environmental impacts become more severe, and repayment of our unrepayable global debt becomes seen to be the boulder of Sisyphus being endlessly pushed uphill by world consumers, is indeed an interesting and open question.

Hyman Minsky on Financial Instability

Steve Keen

The current turmoil on the Stock Market - and especially the sudden collapse of many once high-flyers - has taken a lot of people by surprise. One person who, were he alive today, wouldn't be the least bit surprised, is Hyman Minsky, who predicted that events like this would be a regular feature of a deregulated financial system. He developed what he called "The Financial Instability Hypothesis", and anyone who wants to understand today's events needs to know about it. The following is an extract from an article by Minsky in Challenge in 1977 - well before even the 1987 Stock Market Crash - that provides a nutshell-sized precis of his theory.



The natural starting place for analyzing the relation between debt and income is to take an economy with a cyclical past that is now doing well. The inherited debt reflects the history of the economy, which includes a period in the not too distant past in which the economy did not do well. Acceptable liability structures are based upon some margin of safety so that expected cash flows, even, in periods when the economy is not doing well, will cover contractual debt payments.

As the period over which the economy does well lengthens, two things become evident in board rooms. Existing debts are easily validated and units that were heavily in debt prospered; it paid to lever. After the event, it becomes apparent that the margins of safety built into debt structures were too great, As a result, over a period in which the economy does well, views about acceptable debt structure change.

In the deal-making that goes on between banks, investment bankers, and businessmen, the acceptable amount of debt to use in financing various types of activity and positions increases. This increase in the weight of debt financing raises the market price of capital-assets and increases investment. As this continues the economy is transformed into a boom economy.

Stable growth is inconsistent with the manner in which investment is determined in an economy in which debt-financed ownership of capital-assets exists and in which the extent to which such debt-financing can be carried is determined by the market. It follows that the fundamental instability of a capitalist economy is upward. The tendency to transform doing well into a speculative investmcnt boom is the basic instability in a capitalist economy.

Innovations in financial practices are a feature of our economy, especially when things go well. New institutions, such as Real Estate Investment Trusts (REITs), and new instrunient, such as negotiable Certificates of Deposit, are developed; old instruments, such as commercial paper, increase in volume and find new uses. But each new instrument and expanded use of old instruments increases the amount of financing that is available and that can be used for financing activity and taking positions in inherited assets.

Increased availability of finance bids up the prices of assets relative to the prices of current output and this leads to increases in investment. The quantity of relevant money, in an economy in which money conforms to Keynes' definition, is endogenously determined, The money of standard theory - be it the reserve base, demand deposits and currency, or a concept that includes time and savings deposits - does not catch the monetary phenomena that are relevant to the behavior of our economy.

In our economy it is useful to distinguish between hedge and speculative finance. Hedge finance takes place when the cash flows from operations are expected to be large enough to meet the payment commitments on debts. Speculative finance takes place when the cash flows from operations are not expected to be large enough to meet payment commitments, even though the present value of expected cash receipts is greater than the present value of payment commitments. Speculating units expect to fulfill obligations by raising funds by new debts.

By this definition a "bank" with demand and short-term deposits normally engages in speculative finance. The RET, airlines, and New York City engaged in speculative finance in 1970-73. Their difficulties in 1974-75 were due to a reversal in present values (the present value of debt commitments exceeding the present value of expected receipts), due to both increases in interest rates and a shortfall of realized over previously anticipated cash flows.

During a period of successful functioning of the economy, private debts and speculative financial practices are validated. However, whereas units that engage in hedge finance depend only upon the normal functioning of factor and product markets, units which engage in speculative finance also depend upon the normal functioning of financial markets. In particular, speculative units must continuously refinance their positions. Higher interest rates will raise their costs of money even as the returns on assets may not increase.

Whereas a money supply rule may be a valid guide to policy in a regime dominated by hedge finance, such a rule loses its validity as the proportion of speculative finance increases. The Federal Reserve must pay more attention to credit market conditions whenever the importance of speculative financing increases, for the continued workability of units that engage in speculative finance depends upon interest rates remaining within rather narrow bounds.

Units that engage in speculative finance are vulnerable on "three fronts.' First, they must meet the market as they refinance debt. A rise in interest rates can cause their cash payment commitments relative to cash receipts to rise.

Second, as their assets are of longer term than their liabilities, a rise in both long- and short-term interest rates will lead to a greater fall in the market value of their assets than of their liabilities. The market value of assets can become smaller than the value of their debts. The third front of vulnerability is that the views as to acceptable liability structures are subjective, and a shortfall of cash receipts relative to cash payment commitments anywhere in the economy can lead to quick and wide revaluations of desired and acceptable financial structures.

Whereas experimentation with extending debt structures can go on for years and is a process of gradual testing of the limits of the market, the revaluation of acceptable debt structures, when anything goes wrong, can be quite sudden and quick.

In addition to hedge and speculative finance we can distinguish Ponzi finance—a situation in which cash payments commitments on debt are met by increasing the amount of debt outstanding. High and rising interest rates can force hedge financing units into speculative financing and force speculative financing units into Ponzi financing.

Ponzi financing units cannot carry on too long. Feedbacks from revealed financial weakness of some units affects the willingness of bankers and businessmen to debt finance a wide variety of organizations. Unless offset by government spending, the decline in investment that follows from a reluctance to finance leads to a decline in profits and in the ability to sustain debt. Quite suddenly a panic can develop as pressure to lower debt ratios increases. What we have in the financial instability hypothesis is a theory of how a capitalist economy endogenously generates a financial structure which is susceptible to financial crises and how the normal functioning of financial markets in the resulting boom economy will trigger a financial crisis.

Excerpts from "The Financial Instability Hypothesis: An Interpretation of Keynes and an Alternative to "Standard" Theory, Challenge, March-April 1977, pp. 20-27. For copyright reasons, I can't forward the entire article, but anyone who wants a copy who doesn't have Web access to Challenge is welcome to send me an email requesting it.

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Historic Kucinich bill to reform U.S. monetary system
William Hummel

[Extracted from a posting in the UnderstandingMoney email network]

On September 21, 2011, U.S. Representative Dennis Kucinich introduced a Bill in Congress to reform the U.S. monetary system. The details can be seen at <http://kucinich.house.gov/UploadedFiles/NEED_Act_FINAL_112th.pdf>

The following are some of the highlights of the proposed Act:

1. An end to fractional reserve banking and the Federal Reserve.
2. A Monetary Authority created under the Secretary of Treasury, with quasi independence.
3. No borrowing by the government. All money spent into circulation.
4. "The Monetary Authority shall pursue a monetary policy based on the governing principle that the supply of money in circulation should not become inflationary nor deflationary in and of itself, but will be sufficient to allow goods and services to move freely in trade in a balanced manner."
5. All deposits in depository institutions treated as transaction money and earn no interest. Lending involves transfer of actual deposits, with a maximum interest rate of 8%.

Media release from Dennis Kucinich:

Kucinich Proposes Landmark Jobs Plan Bill To Put 7 Million Americans Back to Work, Rebuild Infrastructure

WASHINGTON - September 21 - As the nation struggles to deal with long-term unemployment at rates not seen in generations and as infrastructure crumbles across the nation, Congressman Kucinich (D-OH) today introduced a dramatic new proposal to address our structural economic problems directly by creating over 7 million jobs.

The National Emergency Employment Defense (NEED) Act of 2011 would allow the federal government to directly fund badly-needed infrastructure repairs and fund education systems nationwide by spending money into circulation without increasing the national debt or causing inflation.

“Today, nearly 25 million Americans are either unemployed or cannot find a job on which they can live and support their families. FDR’s response to such circumstances was the New Deal. Today, we need similarly bold solutions,” said Kucinich. “We need a solution that will revive our economy in a sustainable way that will put millions of American back to work.”

“There should be work for those who are able to work. Government must become the employer of last resort. The private sector is not providing the jobs. When the private sector fails to provide the jobs, the government has a moral responsibility and a practical responsibility to step forward to put the country back to work.

"The ability to coin money is an inherent power under Article I, Section 8 of the United States Constitution. The NEED Act would control inflation because it will enable the government to invest in America by creating infrastructure, which is real wealth. Inflation is caused when new money is created without the creation of new wealth," explained Kucinich.

The proposal would also establish fiscal integrity, reassert Congressional sovereignty and regain control of monetary policy from private banks.

More Bathtubs
James Kwak

Recently I criticized David Brooks for not understanding the difference between stocks and flows (that is, between your paycheck and your bank balance). (Paul Krugman instead criticized the Tax Foundation, the source for Brooks's error - I wonder why?)

It turns out that a lot of people make this kind of mistake. Difficulty understanding stocks and flows may be a fundamental cognitive error such as anchoring or availability bias. One experiment by Cronin, Gonzalez, & Sterman <http://www.sciencedirect.com/science/article/pii/S0749597808000447> it was shown that more than half of a group of students at MIT Sloan - one of the top business schools in the U.S. - could not figure out, from a chart of entrances to and exits from a department store, when the most and fewest people were in the store. These errors turn out to be robust to different framing stories, different ways of presenting the data, and even when getting the questions wrong meant you had to stay in the room for an hour.

The underlying issue seems what they call the correlation heuristic: people think that the behavior of a stock (the amount of water in the tub) should be similar to the behavior of its inputs (the rate at which water pours from the faucet). This is especially a problem when it comes to understanding climate change. In another experiment <http://jsterman.scripts.mit.edu/docs/Sterman-2007-UnderstandingPublicComplacency.pdf> most people thought that stabilizing emissions was sufficient to stabilize the level of carbon dioxide in the atmosphere; if you think about it, though, you should realize that if you want the level to be stable, inflows have to equal outflows (and right now inflows are about double outflows).

This fallacy may be one thing that leads people to adopt a wait-and-see approach to climate change. On a correlation heuristic-influenced view, we should wait until bad things start happening in year X and then reduce emissions (because reducing emissions will reduce the level of greenhouse gases in the atmosphere). But if we want to stabilize greenhouse gas concentrations at the year X level, we would have to immediately reduce emissions to the rate at which they are absorbed by plants and oceans—which right now would require a 50 percent reduction in emissions. (And this leaves aside the fact that climate change itself lags behind greenhouse gas concentrations, so keeping concentrations stable will not prevent climate change from continuing.)

The national debt situation is complicated (and helped) by the fact that (according to most people) what matters is debt as a percentage of GDP, not in nominal terms. So spending is the inflow, but there are two outflows: tax revenues and economic growth. (Or, to put it another way, the bathtub is constantly getting bigger.)

Still, I don't think this gets David Brooks off the hook. Thinking that the impact of a tax increase on the national debt will equal one year's incremental tax revenues goes well beyond the correlation heuristic. That's more like thinking that a salary increase and a bonus are the same thing, or confusing the speed and the range of a car.

Source: Baseline Scenario <http://baselinescenario.com/2011/10/18/more-bathtubs>

The Hope and Anger of Raj Patel

Jane Gleeson-White

Raj Patel - author of *The Value of Nothing* and *Stuffed & Starved* - was in Sydney for the 2010 writers' festival. In an electrifying conversation with Ross Gittens, Patel blasted free market ideology, extolled 'commons' and confessed he's a big disappointment to his family. Here are seven things Patel said.

1. Becoming an activist

Raj Patel has an Indian name, sounds English and lives in America. His mother was born in Kenya, his father in Fiji and Patel grew up in London helping out in the family convenience store. 'My father thought I was a bum until I was thirty. Then I got my PhD and now I'm a Dr bum. I'm a big disappointment to my family because I didn't become an accountant, I didn't become a lawyer. I became an activist'.

When Patel was five his family visited India. One rainy day Patel heard knocking on their taxi door: 'There was this little girl in a monotone asking for money, saying please can we have some money'. He began to scream at his parents. 'I was wondering why she was on the outside and we were on the inside. Why she was wet and we were dry. Why she needed money and why we had it'. That moment set Patel on his path to activism.

2. The Global Financial Crisis

The problems of the GFC are far deeper than we realise - and prompted Patel to write *The Value of Nothing*. He was especially enraged by the lack of response to Alan Greenspan's admission in Congress that his free-market ideology was flawed. For Patel it was like the Pope saying there is no God or the Dalai Lama saying 'violence does solve everything'.

Greenspan's ideology has governed the USA and most of the capitalist world for the past forty years - and it's wrong. But we still cling to the myth of self-regulating markets. And when they fail, instead of serious analysis, we make up stories (more regulation, Bernie Madoff was craven, Wall Street is greedy). Yes, we need more regulation. Yes, there was greed - who knew? - on Wall Street. But ‘there‘s something deeper going on’ and that’s what *The Value of Nothing* is about.

3. Commodities are fictions and we invented the market

Drawing on Karl Polanyi's book *The Great Transformation: The Political and Economic Origins of Our Time*, Patel says our commodity-based market economy is not natural, but was created in 19th-century England. The ‘great transformation is the process by which things became commodities'.

‘There’s a lot of political work and sometimes also a lot of violence that goes into making us believe that we can buy and sell stuff'. Right now we’re seeing the construction by our governments of a new commodity - carbon. ‘Can we buy and sell the right to pollute the environment?'

‘But the original commodities had a much darker history, especially land and human labour'. ‘Today we think nothing of selling our labour for a salary. We think nothing of being able to buy and sell land. But it’s not natural'.

Capitalism emerged through the often violent enclosure of commons. Shared land was turned into private property which could be bought and sold. The people kicked off the land were sent to the city ‘to buy and sell their labour as part of the urban proletariat'. Polanyi shows us that ‘the market needed to be created by society itself. The market and society are the same thing'.

4. There’s no freedom in free markets

There is nothing inherently wrong with markets: they decentralise decision-making and exchange happens peer to peer. But modern capitalism is ‘the anti-market’. It involves such concentrations of power 'that everything that’s good about markets' is destroyed, including freedom. The free market is not about liberty, it’s about money: if you don’t have money you’ll starve and be denied freedom. 'That seems to me to be a very bad way of distributing resources'.

5. We’re made for our economy like we’re made for our food

Supermarkets are ‘the most manipulated environments on earth’. They are ‘engineering us into becoming consumers. We believe that our food is made for us - but in every way that matters, we are being made for our food'.

The comparable idea in *The Value of Nothing* is that ‘we are being made for our economy. We're being transformed into the sorts of people who are unable to make real and effective change through political action. We’re taught how to be consumers, so if we want to change something we go to the right shop and buy the right product. But when it comes to deeper political transformation we’re not equipped to be able to make the change. We’re told that the overriding concern is precisely the one about efficiency. And everything else be damned'. To be a citizen ‘is to re-own the idea that in fact there are different ways in which we can allocate resources other than by the grinding calculus of neoclassical efficiency'.

"Economics is the science of confusing stocks with flows" [attributed to Michal Kalecki]

6. Commons

Neoclassical (free market) economics says we're selfish, greedy, rational, calculating. Yes, our genes may be selfish - but we are not. We are primates, capable of altruism and cooperation. Research into forest communities by Nobel Prize winning Elinor Ostrom has shown that if governments and corporations are removed and the communities are given enough forest space, not only do they achieve higher welfare levels but they sequester more carbon. The communities managed the forest better than governments and corporations, who developed the forest 'by chopping it down'.

'We are not forest communities. We live in urban areas. But we can start to recreate some of these commons - and one of the most exciting ways we can do this relates to food'. To feed 9 billion people in 2050 we'll need urban agriculture and farming techniques not hostage to fossil fuel and cheap water. This will take political work. 'And the dark side here is that I fear that in many ways we've been disempowered by consumer capitalism not to have the imagination to think that we can do stuff'. 'But I think activism around food in particular is something that offers hope'.

7. There's plenty to get angry about

- 'Women in Australia earn 70% of what men do for the same work'.
- 'The biggest subsidy to modern capitalism comes from raising children, building communities, caring for the elderly, work often denoted as women's work'.
- 'In 1995 the UN found that unpaid women's work was equivalent to 50% of the world's total output'.
- '300,000 people die every year because of climate change. In Australia it seems to me that climate change is a very real environmental issue'.
- 'BHP Billiton has announced that you should get rid of this government rather than it suffer a small tax on its already marginal 13-14% tax rate. If corporations are inciting you to overthrow your government so they can pay less tax, then there's plenty to get angry about'.

Source: <http://overland.org.au/2010/06/hope-and-anger-raj-patel-on-free-markets-commons-and-being-an-activist-bum>

Frederick Soddy's contribution to Economic Thought

[extracts from his book *Wealth, Virtual Wealth and Debt*, and from a Wikipedia entry]

In four books written from 1921 to 1934, British scientist and Nobel laureate Frederick Soddy pursued a campaign for a radical restructuring of global monetary relationships, offering a perspective on economics rooted in the laws of thermodynamics. His proposals - to abandon the gold standard, let international exchange rates float, use federal surpluses and deficits as macroeconomic policy tools that could counter cyclical trends, and establish bureaus of economic statistics (including a consumer price index) in order to facilitate this effort - are now conventional practice. However his critique of fractional-reserve banking is still regarded by many conventional economists as too radical. Soddy wrote that financial debts grow exponentially at compound interest but the real economy was based on exhaustible stocks of fossil fuels. Energy obtained from the fossil fuels could not be used again. This criticism of economic growth is echoed by his intellectual heirs in the now emergent field of ecological economics.

Extracts from Soddy's *Wealth, Virtual Wealth and Debt*

The definition of wealth has always been the touchstone of clear thinking in economic matters, and after centuries of effort that definition still eludes most people. Aristotle tried to clarify the issues by defining wealth as all things whose value can be measured in money. The Roman jurists, in their practical fashion, followed suit in defining wealth as what can he bought and sold with money. Their coin money had a real positive tangible existence and also had a quantitative intrinsic value as precious metals.

As generally understood today, debt-money is merely a claim to wealth, and to define wealth as that which can be claimed by claims to wealth, or can be measured by the numerical legal claims to wealth called money, is merely like defining a fluid as that which can be measured by an empty vessel, capable of holding the fluid and called a fluid measurer. It adds nothing to our understanding of space and time if length is defined as that which can be measured with a length-measurer called a ruler and time as that which can be measured by a time-measurer called a clock.

Most economists, past and present, identify real physical positive wealth with tangible earthly assets. For them, Wealth is what is measured with a wealth-measurer called money. Their numerous difficulties and apparent inconsistencies regarding the real nature of wealth were, and still are, simply solved by ignoring them entirely and to base their understanding, as the Roman jurists of old did, upon the principle of exchangeability as the sole criterion. That alone is wealth which can be exchanged for money.

The whole idea of balancing one thing against another in order to measure its quantity involves equating the quantity measured against an equal and quasi-opposite or other quantity. Wealth is the positive quantity to be measured whilst debt-money as the claim to wealth is a negative quantity of wealth owed to but not owned by the legal owner of the debt-money. The ability to measure the exchange-value of wealth by money was deemed the one and only thing necessary to confirm economics as a quantitative science fit to rank with the great mathematical and physical group of exact sciences. Instead unfortunately, it has reduced most academic economics to the chaos and utter futility everywhere apparent today. Society is now dominated and administered not by and for those who create real wealth and health, but by and for those who create want and unreal debt.