

CHAPTER 9

THE FINANCIALIZATION OF GLOBAL CAPITALISM

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On the one hand, the risk management dilemmas unleashed by inflation, high interest rates, and uncertainties of borrowing worked to justify a legitimate role for electronic hedging tactics. On the other, these same volatilities gave electronic speculation what it needed to feed on and flourish beyond the wildest expectations. The consequence, two decades later, is a massive, revolutionized, and largely unregulated financial sector armed with the latest high-tech weaponry and pursuing profits on any battlefield, straining the stock and bond markets, plucking loot from any debacle, shooting the economic wounded, and outgunning the 'real economy' in its transactions by huge ratios. This leap in the importance of spectronic finance is hard to overestimate.

— Kevin Phillips

If Phillips' words seem extreme, he has sophisticated company. George Soros, one of the world's wealthiest speculators, also warns of *The Crisis of Global Capitalism*. Soros likens the financial forces in global capitalism to massive tectonic plates rubbing against each other, "often creating earthquakes, crushing minor currencies in the process." Soros also uses the metaphor of a giant wrecking ball swinging from country to country, knocking over the weaker ones. The *New York Times* described the enormous social damage in Indonesia in 1998 as similar to a drive-by shooting. This book calls it lethal financial imperialism.

What is the world's presumed economic leader, the United States, doing about this? Nothing. Congress held hearings on the 1997 Asian economic problems. Soros was invited to make his recommendations. Nothing is happening because those in government with the responsibility and the knowledge for reform have a higher loyalty to Wall Street. So many finance capitalists are making so many hundreds of billions of dollars from the monetary volatility in global capitalism that solutions to root causes are not pursued.

A powerful financial oligarchy is nothing new. What is new, however, is its capacity to damage global economic momentum severely, as it did to Mexico and South American countries in the 1980s, to Mexico in 1994, and to Asian nations in 1997. What is new is the sad picture of countries' successfully improving the lives of their people through economic freedom but then being set back by the imperfections in global finance. Positive economic momentum takes years to produce; reversal of this momentum can happen in weeks and always results in social chaos and violence.

These imperfections in international finance capitalism are now damaging the world's momentum towards economic common purpose. Coupled with the United States' aggressive geopolitics, they are tilting the world away from peace and plenty toward a continuation of folly and violence.

In the late 1990s, the world seemed to be moving toward a common ideology of economic freedom, powered by the growth, productivity, and unifying capabilities of the information age revolution. While communism and socialism had failed to produce a superior social contract, democracy and capitalism were improving lives wherever the combination was competently applied. Democratic capitalism seemed prepared to eliminate material and cultural scarcity. A world of peace and plenty seemed to be both an opportunity and an obligation for society.

Many Asian nations, including Malaysia, Thailand, South Korea, and Indonesia, were shining examples of the momentum of this common ideology. All had dramatically improved the lives of their people by adopting many of the principles of democratic capitalism. Faster economic growth had created jobs, but the Asians had also kept their economic fundamentals in reasonable shape: Inflation was under control; government deficits were modest; and the balance of trade was favorable. Indonesia, the world's fourth-largest nation in population, reduced the number of its 211 million people under the poverty line from 40% to 10% in a couple of decades. Was it an imperfect process? Was there "crony capitalism?" Of course, but the mission of improving lives was being accomplished.

By the end of 1997, however, all four of these Asian economies were in shambles. Currency had been devalued as much as 70%; wages were cut 40%; unemployment, prices, and interest rates were all rising; government deficits were growing bigger; virtually no new money was available for business; even lines of credit for operating successful businesses had been cut.

Quickly, the uplifting sense of common purpose had been replaced by confusion and dangerous social tensions. Government leaders who had been proud of their nations' successes were now disparaged at home and abroad. Those leaders who had espoused the common ideology of free markets now became angry critics of the immorality of currency speculation and the continued economic imperialism of the West.

When economic freedom is the norm, an economy can run itself, with little required of governments except civic order, a stable medium of commercial exchange, and capital prepared to invest in long-term growth. Instead, the world's economy has been damaged by great instabilities in the medium of exchange and impatient capital demanding quick returns.

The world's economic leader, the United States, is largely responsible both for causing and not correcting these situations. The U.S. government aided in the financialization of the global economy by coupling bank deregulation with abrogation of market disciplines, at the same time that it was helping to convince emerging economies that they should remove all cross-border capital controls—a good idea in theory, a bad one under the compromised circumstances.

To free the world economy to grow and improve all lives, governments, led by the United States, need to take action on the root-problems threatening global capitalism:

- Control speculation by taxation and limiting the amount that can be borrowed.
- Allow market disciplines to monitor the process by stopping subsidies, large-risk insurance, and bailouts.
- Standardize world banking to control the lending of "hot" or short-term money.
- Develop a new currency-stabilizing mechanism.

At the beginning of a new century the United States was unable to provide the necessary leadership, as there is now an enormously profitable industry dependent on the very volatility that must be eliminated. Government leaders were unwilling to chop down the money tree. The world's economy will be freed to improve all lives only if a new American political leader and/or an aroused citizenry demands the elimination of nondemocratic privileges and the reform of finance capitalism.

The U.S. government has always been ambivalent about how to combine democracy and capitalism, simultaneously providing the freedoms to improve lives, and, on the other hand, providing privileges to finance capitalists that slow growth, impede productivity, concentrate wealth, and hurt ordinary people.

The best example in history of the benefits of economic freedom has been the worst example of a government's allowing repetitive economic damage through its unwillingness to control leveraged speculation. This failure of leadership caused the panics of 1818, 1834, 1857, 1873, 1907, 1920, and 1929, the Great Depression, the savings and loan debacle, the bond massacre of 1994, and the failure of Long-Term Capital Management in 1998. The same failure of leadership infected evolving economies, resulting in the South American and Mexican crises of 1982, the Mexican crisis of 1994, the Asian crisis of 1997, and contributed to the Russian debacle in 1998.

The inherent contradiction in capitalism, according to Marx, is pressure on profit margins relieved by downward pressure on wages. In an economic downturn, both pressures are magnified until the system implodes in a proletarian revolution. Marx's contradiction was resolved in practice by greater growth, productivity, and broader wealth-distribution.

Behind the United States government's failing as the world's economic leader is the financial-speculative cycle that has caused every man-made economic disaster in history. It is the cause of the misunderstood business cycle. The inherent contradiction is not in capitalism; it is in government failure to manage currency and credit to benefit the general welfare. It is politicians' mistakes responding to the lobbying from finance capitalism for special privileges that cause the cycle.

On a global basis today, the inherent contradiction associated with the nexus of governments and finance capitalism has a volatility and power that has several times reversed economic momentum and caused civic disorder.

The phases of the finance-capitalism cycle are:

- Phase one: Accelerating economic growth. Good things are happening. Job opportunities are growing; the standard of living is going up; kids are healthier, happier, better educated. The government's mission, after providing basic order and certain benefits, is to free the economy, insure plenty of low-cost, nonvolatile, patient capital to grow on; and then get out of the way.
- Phase two: Finance capitalism becomes dominant. Accelerating economic growth attracts capital. Rising expectations encourage greedy people to seek larger and quicker returns. Capital is deflected from job growth to speculation in stocks, real estate, or other financial instruments devised to satisfy the speculative urge. These range from Dutch tulips to derivatives.
- Phase three: Climax and crash. An economic catastrophe is caused by leveraged speculation, particularly when much of the risk is government-insured. The system is driven by either greed or fear. When asset-inflation reaches the high point, fear takes over from greed, selling pressure takes over from buying pressure.
- Phase Four: Currency speculators attack. When the currency speculators see the weakening economic circumstances caused by the slippage into speculation, they sense the vulnerability of the economy and the currency. This phenomenon is new since the United States floated the dollar in 1971. Without any currency-stabilizing mechanism in the world's monetary system, and with the enormous capacity for the speculators to borrow, the system has been turned into an out-of-control casino. The government under attack usually goes to its national piggy-bank and tries to support its currency by buying. After wasting a lot of the nation's wealth that could have been used for social benefit, the country usually gives up and the speculators win. In mid-1997, the Thai government

gambled \$9 billion out of its \$39 billion reserves trying to protect the *baht* from falling, and lost.

- Phase Five. Flight of capital. Sensing a speculative attack on the currency, banks, corporations, the wealthy and well informed take their money out of the country. All of them now know that the central banks cannot support the currency value in a battle with the highly leveraged speculators. Unimpeded by capital controls, the giant sucking sound is money fleeing the country.

Even without an attack by the speculators, the flight of capital from this group can create a self-fulfilling prophecy of a dramatically falling currency value.

- Phase Six: Atonement. An extraordinary stage of the finance capitalism cycle is the pagan ceremony after the crash. The economic gods demand the sacrifice of millions of innocents on the altar of "fiscal integrity" to atone for the sins of the predatory few. The "cure," including higher taxes, deficit reduction, tightened bank reserves, and wage devaluation, slows growth, cuts wages, raises prices, puts people out of work, and lowers the standard of living. The government is locking the barn door after the horse is stolen. With values declining, bank reserves are increased, loans for good businesses dry up, and the economy slows. Why do bank reserves receive so much attention so late? Why were they not raised high enough in the first place to prevent speculative damage?

- Phase Seven: Loss of civic order. Reduced wages, unemployment, and higher prices inevitably cause violence and can destroy civic order. Societies need broad economic gains to sustain civic order. The destruction of people's economic lives and hopes brings forward traditional tensions and hatreds. Any fragile culture unified by improvement in the standard of living can quickly turn into riots, ethnic killings, and disruption of the political order. In Indonesia, the sequence of law and order, then economic freedom, then political freedom, had progressed from civic order through economic freedom, but after the economic damage, both economic freedom and basic civic order were lost. Violence, social confusion and devolution were the results.

- Phase Eight: Bottom-Fishers. In 1997, the currency speculators drove the Indonesian *rupiah* down 70% in six months, extraordinary in a country that had reasonably good economic fundamentals. Asset-deflation inevitably attracts the bottom-fishers looking for distress sales. In many cases, the same finance capitalists who caused the problem now find new ways to make money from the disaster. Manufacturers are attracted by even lower wages. Banks, investment banks, and companies buy up whole portfolios of multi-billion-dollar assets for a fraction of prior value.

Accelerating economic growth, financial capitalism's becoming dominant, climax and crash, atonement, and loss of civic order have been the historic phases of the speculative cycle. Phase Four, "Currency speculators attack" and Phase Eight, "Bottom-Fishers" are new phenomena during the last quarter-century, adding new, threatening dimensions. Governments such as the United States have not had the will and wisdom to prevent domestic economic damage from the speculative cycle for centuries. Now world organizations are much weaker and the threat of economic collapse much greater.

The historical conflicts in capitalism between those making money building and selling products and services, and those making money on money.

- Feudal Society. Until the Industrial Revolution in the nineteenth century, capital for commerce was provided by a few wealthy people. Labor was manual, provided mainly by slaves and serfs.
- Industrial Revolution (1800-1980) Productivity opportunities increased by several thousand times. Capital, held by a few, was still dominant. Adam Smith, and later Mill, described how to maximize surplus through involved workers' sharing in improved performance; however, most of industry remained feudal, for return on capital was adequate, even when workers were more wage-slaves than participants.
- Democratic capitalism (1900-). Visionary companies combined technology with involved workers motivated by performance bonuses and opportunities for ownership participation. The government's fiscal and monetary policies are still dominated by finance capitalism, even though the source of capital has changed dramatically: The

workers' savings and pension money have become the main source of capital.

- Ultra Capitalism (1980-). The domination of finance capitalism goes global and severely damages whole economies. A new form of mercantilism treats workers as a cost commodity. Capital becomes impatient, and the medium of exchange is very volatile. Wall Street and institutional investors demand short-term profits and corporations respond.

- Information-Age Revolution (1980-). The productivity potential is greater than the industrial revolution, being based on cognitive power, investment in human capital, not physical capital and manual labor. Companies compete successfully by encouraging all wage-earners to be involved and contributory. Democratic capitalism is now a competitive economic necessity. The source of capital is democratic and capitalism's rewards are shared democratically.

At the beginning of a new millennium, it is unclear whether society will benefit from the extraordinary opportunities of the information age revolution or whether the malign influences of ultra capitalism will destroy the economic momentum. This is the citizen's great responsibility: a choice for the next century of peace and plenty through worldwide economic common purpose or more folly and violence from a continued concentration of wealth and power.

The following is a chronological review of the events that represent the historical battle:

1000 B.C. and earlier: Barter is used as simple commercial exchange but is usually limited to two-party transactions.

1000-650 B.C.: Various items used as a media of exchange, including cattle, stones, and women; none is easy to handle or divisible.

650 B.C.: First coinage. Various denominations, based on precious-metal value. Basic system for next 2500 years.

Old Testament: "Unto a stranger thou mayest lend upon usury, but unto a brother thou shalt not."

New Testament: Jesus warned: "No man can serve two masters; for either he will hate the one and love the other, or else he will stand by the one and despise the other. You cannot serve God and mammon."

Rabbinical Literature: "The love of gold will not be free from sin, for he who pursues wealth is led astray by it."

299-400 A.D.: Roman emperors pay for war by debasing currency. Coin of the realm called in, melted, and reissued with lower precious-metal content. Over time, precious-metal content drops from 98% to less than 2%.

789 A.D.: When Charlemagne became Holy Roman Emperor, he forbade usury in his *Admonito Generalis*

800 A.D.: In the *Koran*, Islamic law encourages patient capital through equity investment but prohibits impatient capital through interest-bearing loans.

1200 A.D.: St. Anselm considered usury an offense against the fourth commandment, Thou Shalt Not Steal.

1215 A.D.: Cardinal Robert of Courçon, Canon of Noyon, gave the young University of Paris its first statutes in 1215. It adopted most of his *Summa* presented to the Council of Paris in 1213, emphasizing labor as the basic value and usury as the corruption of the commercial process. "The Council, presided over by the Pope and attended by all the bishops and princes, ordered each Christian, under pain of excommunication and censure, to work either spiritually or physically and to earn his bread by the sweat of his brow." Courçon concluded, "All usurers, all rebels, and all plunderers would disappear, we would be able to give alms and provide for the churches and everything would return to its original state."

1300 A.D. *Dante Alighieri (1265-1321):* In his allegorical poem, the *Divine Comedy*, Dante described the efforts of people to realize their potential in a world of peace and justice based on a commercial order. In Dante's scrutiny of the evils contaminating the commercial process, he recognized a natural law consonant with revealed truth, and he reserved some of the greatest tortures in hell for the financial predators who transgressed this law.

Dante speaks to Virgil:

"Go back a little further," I said, "to where
you spoke of usury as an offense
against God's goodness. How is that made clear?"

Virgil replies:

Recalling the Old Testament
near the beginning of *Genesis*, you will see

that in the will of Providence, man was meant
to labor and to prosper. But usurers,
by seeking their increase in other ways,
scorn Nature in herself and her followers."

1694: King William III establishes the first central bank, The Bank of England, providing privileges to finance capitalists in exchange for their help in funding the war with France.

1695: John Locke, physician, philosopher, and author of *Second Treatise of Government*, on the inalienable rights of man advises the new government on monetary matters. The governments kept the interest rate between 4% and 6%. Locke was concerned about advantages to speculators due to coin clipping. Lightweight coin was circulating at higher value than its metallic value. A provision for surrender of lightweight coin at high value enriched the fast-moving, well informed speculator to the detriment of the remote work-preoccupied farmer. Locke placed the conflict in capitalism in context:

This is evident, that the multiplying of Brokers hinders the Trade of any Country, by making the Circuit, which the Money goes, larger, and in that Circuit more stops, so that the Returns must necessarily be slower and scantier, to the prejudice of Trade: Besides that, they Eat up too great a share of the Gains of Trade, by that means Starving the Labourer, and impoverishing the Landholder.

1776: Adam Smith anticipates the conflict between the job-growth economy that benefits the many, and privileges for speculation that benefit the few, warning of the dangers to capitalism from the "prodigals and projectors," as he called them, who would make money high-cost and volatile, and deflect it from job growth. "A great part of the capital of the country would thus be kept out of the hands which were most likely to make a profitable and advantageous use of it, and thrown into those which were most likely to waste and destroy it."

1789: Alexander Hamilton, George Washington's Secretary of the Treasury, successfully lobbies for payment of war debts at par, and assumption of \$21,500,000 of state debts. An incidental effect was speculative profits for those who had anticipated this law and bought up revolutionary soldiers' scrip for 20 cents on the dollar. It was the first use of "insider information" in the new republic.

1790: Thomas Jefferson, the Secretary of State, battles with Hamilton over United States central bank. Jefferson thought banks were created "to enrich swindlers at the expense of the honest and industrious," while even Federalist John Adams could declare "Every dollar of a bank bill that is issued beyond the quantity of gold and silver in the vaults represents nothing and is therefore a cheat upon somebody."

1792-1845: Scotland's economy flourishes with free banking. There was no central bank, private banks could issue their own money, and virtually no bank regulation.

1805: President Jefferson opposes the National Bank and favored state banks to diffuse the power of financial capitalism. He exhorts his Secretary of the Treasury, Albert Gallatin: "It is the greatest duty we owe to the safety of our Constitution to bring this powerful enemy to a perfect subordination."

1806: The financial lobby builds a library of special privileges. At the state level, the mercantilists and financial capitalists successfully lobbied for a growing body of law for the privileged, resisting shorter work days and supporting imprisonment for union activity. The courts outlawed strikes in Philadelphia in 1806 and in New York in 1810.

1812: President Madison failed in his effort to control finance capitalism because he was forced to negotiate privileges for the bankers in exchange for their funding the War of 1812 when the country was nearly bankrupt. Subsequently, the postwar boom escalated into speculation, much of it on borrowed money. The Panic of 1818-19, the first speculative cycle in the United States, was the result. Madison described finance capitalism as parasitical.

1814: John Taylor, a Virginia planter and U.S. Senator, defends democracy against the financial oligarchy, describing the fiscal policy originated by Hamilton, as one that would produce "a peasantry, wretchedly poor and an aristocracy luxuriously rich and arrogantly proud." Taylor anticipated Marx's feeling that privileged capital would "in the case of mechanics, soon appropriate the whole of their labor to its use, beyond bare subsistence." Taylor warned about two threats to private property: "The first, by which the poor plunder the rich, is sudden and violent; the second, by which the rich plunder the poor, is slow and legal." Taylor concluded that the political process was biased because "we farmers and mechanics are political slaves because we are political fools."

1830s: Andrew Jackson, the first President not of the gentry, tried hard to democratize capitalism but lacked the tools. Jackson engaged in a fierce battle in the 1830s, with the head of the Bank of the United States, Nicholas Biddle. Jackson's veto of the National Bank Act passed by Congress came with a message: "The rich and powerful too often bend the acts of government to their selfish purposes, many of our rich men have not been content with equal protection and equal benefits, but have besought us to make them richer by Acts of Congress."

In Jackson's Farewell Address, he warned that the "great bone and sinew of this nation" was threatened by "gradual consuming corruption, which is spreading and carrying stock jobbing, land jobbing, and every species of speculation." Jackson pinpointed the democratic problem: Concentrated wealth also means concentrated political power because of the lobby money's going to politicians. In some cases, money corrupted politicians; in most, it moved the agenda away from the general welfare.

Jackson pointed out that although the people had the democratic majority, they had not the cohesion and organization to prevail: "The agriculture, the mechanical, and the laboring classes, from their habits and the nature of their pursuits ... are incapable of forming extensive combinations to act together. They have but little patronage to give to the press." In contrast, Jackson charged that, "exclusive

privileges enable corporations, wealthy individuals, and designing politicians to move together with undivided force ... to engross all power in the hands of a few.

Jackson won his battle by killing the Bank of the United States, but he lost the war when the banking structure that he had favored, state banks, discredited themselves through engaging in speculative lending practices that caused the economic disaster of 1837. Jackson was one of many reformers who recognized a corruption of democratic principles by finance capitalism but lacked the financial sophistication to design effective reforms, a continuing problem.

1860s-70s: After the Civil War, the domination by finance capitalism was great: Presidents Johnson and Grant were persuaded to control currency in a deliberate devaluation to restore the asset value of the wealthy to prewar levels. This caused unemployment, dropping wages, and rising prices. This technique, copied from the British, was a direct cause of the economic disaster of 1873. Ludwig Von Mises blamed economic calamities in England after the Napoleonic wars and the emergence of Marx on this same brutal practice.

1888: The Farmers Alliances organize to buy crops to store in cooperative warehouses in order to resell at advantageous prices. The alliance also tried to serve a purchasing function by buying supplies at wholesale with low-interest money. The bankers, however, refused to lend money, even with good collateral, to the farmers.

1890s: Labor, capital, and government oppose American imperialism. At the end of the nineteenth century, Samuel Gompers joined with Andrew Carnegie and others in an Anti-Imperialism League.

1896: Populist party defeated. The farmers, unable to borrow money from banks, had lobbied the government to lend money from the Treasury directly to farmers' cooperatives. This request for democratic capitalism was obscured by William Jennings Bryan's "Cross of Gold" platform, a political argument between gold and silver interests.

1873, 1884, 1893, 1907: Widespread money panics spawned the Federal Reserve Board in 1913. Each bank panic happened at the height of the crop season when large amounts of money were needed to finance crops to market. This seasonal need could not be met except by paying out limited reserves, causing the whole money supply to contract. When the surge of demand hit New York, J. P. Morgan and others could draw on reserves at higher rates, or they could form syndicates to pool resources to meet demand, or they could borrow gold from Europe to support more lending, but eventually they did not do any of this, which resulted in local farmers' banks not having liquidity to make loans.

This uncertainty caused people to take their money out of the banks, which in turn caused runs and panic. At root, the system did not have the flexibility to fund short-term working-capital needs of the most basic industry, agriculture. The farmers simply did not have democratic access to money.

1928-32: President Hoover committed three colossal mistakes in a single administration. He shrunk currency and raised taxes and tariffs. Although not the first President to do economic and social damage by following the advice of the financial oligarchy, Hoover was the first to cause damage that affected so much of the world's economy. His Republican predecessors had done little to control the leveraged speculation that caused the Crash of 1929. After the crash, Secretary of the Treasury Mellon followed the time-honored pagan ceremony of regaining "fiscal integrity" by hurting people. Mellon acted like an avenging angel, shrinking currency and instituting retroactive tax increases as high as 63%. These actions converted an overdue stock-market drop into the Great Depression. The protectionist act, Smoot-Hawley, then exported the Depression to much of the world.

The Crash of 1929 is an example of leverage, and the government's unwillingness to control speculation. In that crash, brokers' loans, that is, stock bought on borrowed money, went from \$1.5 billion in 1923 to \$6.0 billion in December, 1928. Anyone observing this pattern could have seen the train-wreck coming. New borrowings were collateralized by rising values; the sickness fed on itself for years.

Banks were borrowing from the government at 5%, and then lending at 12%. Corporations were pumping surplus cash into the stock market rather than into growth or dividends. After the crash, the margin calls fed the downward spiral. When values plummet, the borrower has to come up with money, which forces more selling, which continues the downward spiral.

After the damage in the 1930s, the government created SEC, the Securities and Exchange Commission, to prevent future calamities. SEC raised margin requirements to 50%, among other moves. By the end of the century, however, the leverage for speculation was over 100:1 in hedge funds, and the borrowings were in trillions of dollars. Government responsibility for controlling currency and credit for the general welfare is now spread among SEC, the Federal Reserve Board, the Treasury Department, the Commodities Exchange Commission, and Congressional banking committees. In 1999, the Chairman of the Federal Reserve warned of "excessive exuberance" in the stock market and tried to control it with increases in the interest rate that slow the whole economy. Broker's loans in 2000 are at record levels; why did the government not raise the margin requirements?

1932-44: President Franklin Delano Roosevelt in 1936 bragged that he had neutralized the privileged financial oligarchy during his first administration and planned to complete his mastery of them in the second. Roosevelt by then had been seduced by the collectivists and then needed the finance capitalists to fund World War II. FDR saved the country and instituted benefits, such as Social Security, but his legacy was also centrally administered programs that were high-cost and that failed at much of their mission, and,

on the other hand, no real reform of finance capitalism. FDR reluctantly instituted bank deposit insurance of \$5,000 to stop panics but warned that the practice was an abrogation of market discipline and could cause economic catastrophes. He was right. By the 1980s the deposit insurance was raised to \$100,000 without limit on how many bank locations. The savings-and-loan catastrophe was the result.

1920-33: Early failures of the Federal Reserve Board. The Federal Reserve was intended to solve the repetitive liquidity problems, but it failed its test in the 1920 recession. In the 1930s the FED made a major error that converted an overdue stock market spasm into the Great Depression by reducing currency in circulation 30% in two years, the wrong move at the wrong time.

The economic catastrophe known as the Great Depression was not caused, as the collectivists love to describe it, by inherent contradictions in capitalism. It was caused by lack of government control of speculation during the 1920s, followed by *ad hoc* mistakes of politicians. The unlearned lesson was that fiscal and monetary policy need to be long-term and protected from capricious acts of politicians.

1936: John Maynard Keynes, viewing the catastrophic economic damage done by the stock market crash of 1929, put speculation and the motivations of Wall Street into perspective:

Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of *laissez-faire* capitalism—which is not surprising, if I am right in thinking that the best

brains of Wall Street have been in fact directed towards a different object.

Despite Keynes' advice, by the end of the century daily speculation on the global electronic casino dwarfs commercial transactions by many times.

1963-68: President Lyndon Johnson initiated actions that eventually caused enormous worldwide economic damage. His "Guns and Butter" programs, that is, the expansion of the Vietnam War and his "Great Society", were funded by deficit spending that caused extreme inflation, in turn driving interest rates as high as 20% to combat inflation. This high-cost money was the direct cause of the Mexican and South American economic distress in the 1980s, as they could not even service debt, that is, pay the interest on their loans that floated up with the interest rate increases.

These actions were also the direct cause of the savings and loan debacle, as the S & Ls were in the impossible position of borrowing high-cost, short-term money to invest in low-return, long-term mortgages. Congress tried to fix the problem with deregulation, but that caused worse problems. Later Congress tried to rectify the damages caused by bad deregulation and went so far in the other direction that financially sound thrifts were forced out of business. Later these thrifts successfully sued the government. Each of these mistakes of politicians was paid for by the taxpayer.

Johnson's legacy included an administration so ignorant of history and other cultures that they did not realize that World War II was the end of Western imperialism in Asia and that the Vietnamese-French battle should have been the last spasm. This history is relevant, because at the end of the century the United States was still following policies of aggressive geopolitics with Russia and China that ignore the lessons of history. Xenophobes and the military-industrial complex intimidate the politicians to ignore the opportunities of economic common purpose throughout the world in the information age, instead, they act in ways that can doom the world to repeat its violent history.

1971: President Nixon opened up the world's electronic monetary casino.

Despite the bipolar tension between the United States and Russia, the world after World War II was making economic progress. The relationship between freedom and improving lives was becoming clear. Interest rates and inflation were low and the dollar was stable. It was a great time for long-term investments. Hundreds of millions of people around the world were improving their lives. Then, Democrat Johnson, with his "Guns and Butter" programs, followed by Republican Nixon, initiated actions that would seriously affect the stability of global capitalism. Joel Kurtzman summarized the watershed event:

For nearly thirty years the Bretton Woods system provided an environment of stability. The world economy grew by about 7-1/2 percent a year during its heyday in the 1950s. Oil and commodity prices were stable for more than twenty years. Interest rates were usually between 3 percent and 4.5 percent, inflation was practically nil, mortgages and other loans were at low fixed rates, and the dollar's value was set by law. It was the perfect environment for investing in long-term productivity-enhancing technology and for adding capacity. And with productivity growing but other costs more or less fixed, wages could increase without harming a company's bottom line. With decades of stability under the Bretton Woods system, billions of people around the world climbed out of abject poverty and into the middle class. The new neural network of money made its debut rather abruptly on Sunday, August 15, 1971, although most people did not recognize its appearance for at least a decade. It came into being more out of expedience than careful planning, when Richard M. Nixon, then President, was saddled with a forecast of a recession occurring just months before the Presidential election of November, 1972. Nixon was also faced with a trade balance that had suddenly climbed to a negative \$4 billion, an inflation rate of nearly 5 percent, an unemployment figure of

just under 5 percent, and billions of dollars in expenditures to support the war in Vietnam—very alarming circumstances for the time. Nixon's critics—and they were legion among both Republicans and Democrats—charged that he was mismanaging the economy, and they demanded action.

Action is what they got. To fix the 'sick' economy, Dr. Nixon, as he was called in a subsequent headline in *The New York Times*, tried shock-therapy. In a televised speech Nixon—upper lip wet with sweat, voice resonant—announced that he had signed a Presidential order freezing wages and prices for 90 days. He said he would try to persuade Congress to make it illegal for unions to strike during that time, that he had imposed a 10-percent surtax on imported automobiles and other products, and that he would propose a cut in income taxes to Congress. He also said, to quote the day's vernacular, that he had closed the "gold window."

The last item, closing the gold window, although buried in a long laundry list of essentially useless economic policy changes, represented the biggest challenge to the world economy since the Great Depression; it meant the value of the dollar was no longer linked to the amount of gold in Fort Knox.

It was a change of monumental proportions that not only redefined money but created the opportunity, to dramatically speed up the rate at which transactions between companies and countries took place. It created enormous arbitrage possibilities and set the stage for the invention of a myriad of new financial products. It also initiated the process of decoupling the "money" economy from the "real" economy.

As a result, two-plus decades later, the money economy, where transactions take place purely for financial or speculative gain, and the real economy, where the world's raw materials, goods, and services are produced and traded, are badly out of balance. That is Nixon's economic legacy.

The world was launched into uncharted territory by Nixon when he opened the electronic monetary casino. Nixon, a Republican, took action in areas of the economy that were contradictions to free market principles. The effort to control prices and wages by government did not work, of course, but the real damage was done by the abandonment of the world's currency-stabilizing mechanism without an alternative. The premise that market forces would discipline the system was not valid, because market forces were compromised by deposit insurance, bank subsidies, and bailouts on the "too big to fail" theory.

A less visible effect of Nixon's actions was the beginning of ultra capitalism, where high-cost money changed industry to short-term goals, as described by Kurtzman:

With interest rates in the 1970s double what they were in the 1960s and going as high as 21 percent, companies were forced to think in shorter and shorter time-frames or risk watching their stock prices collapse. For the first time, it was no longer important how a company made money, only that it was able to do so. Selling off portions of a company, borrowing money in the capital markets and then paying it out to stockholders as dividends, even using profits not for new investment but to purchase a company's own shares of stock, all became common practices used by companies to keep their stock prices high.

The era of long-term investing ended sometime in the 1970s, and we are still recovering. Switching in and out of risk groups—under the guidance of the equations—became the newest investment fashion. The company mattered less than its stock. What that meant, from the perspective of the big picture, was that ability to trade rapidly grew in importance.

1974: ERISA provides an opportunity to democratize capitalism, but most of the money went to the stock market. The Employees Retirement Insurance Security Act was passed to protect pensions. A worker's money would be there on retirement because it was "funded", that is, cash was taken out of companies and given to trustees to invest to be later paid on retirement.

Before ERISA, companies assumed that most of the pension money would be funded out of future earnings, consequently the cash was being used within the business. In effect, ERISA took no-cost growth capital out of companies and invested it primarily in the stock market. Creative financial engineering to direct this workers' money to democratize capitalism was not done. For example, basic pensions could have been insured, money directly invested in companies with a preferred stock paying a 6% dividend annually, plus the opportunity for stock appreciation during the employee's career.

Propelled by adding \$100 billion a year of private and public pension money to the demand side, the stock market in the 1980s began to increase at a double-digit rate. Improving corporate earnings were also a factor. The double-digit returns attracted an additional flow of funds, causing the self-fulfilling prophecy of rising stock prices. The 401-K government tax feature that allowed savings from pre-tax dollars, and the demographics of the baby-boomers, increased the demand further. The combination of pension and 401-K money created an enormous buy-demand making the rising prices inevitable. The rationale was: "We have to put the money somewhere."

During the last quarter of the twentieth century, ownership of public companies in America shifted to the institutional investors, with the wage-earners the prime source of

capital. Money managers' performance was measured quarterly and annually. It was logical, therefore, that their interest in companies would be based on short-term quarterly and annual results. The companies assisted in the short-term conversion, for they were anxious to appear prudent in investing large amounts of pension money. Money-managers who underperformed their competitors in the short-term, hence, were regularly dumped (Chapter 13).

1975: Democratic capitalism and ultra capitalism, two opposing forces, battle over the future of capitalism—and of the world.

By the end of the century it was apparent that the American economy had set records for length and height. As most regard capitalism as a generic system, what was not apparent was the struggle between forms of capitalism. Ultra capitalism was concerned only with short-term earnings and treated the worker as a cost commodity. Mergers and acquisitions were a wonderful way for bankers, lawyers, and executives to make enormous amounts of money. Benefiting from accounting rules, mergers were themselves a way to improve short-term earnings. In this climate, CEOs were measured by Wall Street by their enthusiasm for large and quick downsizing.

Information-age industries, excited by the stock market enthusiasm for IPOs (Initial Public Offerings), were equally interested in stock price and stock options but still depended on the involvement and contributions of their people. The cognitive power demands of information-age industries made democratic capitalism a competitive necessity.

Along with the new information-age companies were the best of the traditional companies built on the loyalty of wage-earners and customers. Some of these companies were forced to downsize because of global competition, or as a result of efficiencies from information-age technology. They did it, however, with attention, retraining, and generous severance, always with a view to retaining the spirit of cooperation and trust.

Wall Street and most of the financial press celebrated the ultra capitalism image, where putting the stockholder first means putting the wage-earner last and ignoring the interests of other stakeholders, which became a pejorative expression.

After the crash of communism, the world was moving towards a common ideology of free markets, with many of the leading companies in global capitalism building momentum on the fundamentals of democratic capitalism: employee participation, profit-sharing, ownership, job security, and workers who were independent thinkers, educated, and involved.

At the same time, the relationship between government and finance capitalism in the world's most successful economy was growing stronger. Wall Street became transactional and speculative. Compensation for investment-banking partners became routine in the \$10 to \$50 million bracket annually. Many corporate executives were seduced by the big bucks into ultra capitalism, choosing short-term profits, downsizing, and deals while

matching the multimillion dollar compensation of Wall Street. The new influence of ultra capitalism was described by Kevin Phillips:

Back in the early 1970s, before the global economy was hooked up to supercomputers and changed to the megabyte standard, the financial sector was subordinate to Congress and the White House, and the total of financial trades conducted by American firms or on American exchanges over an entire year was a dollar amount less than the gross national product. By the 1990s, however, through a twenty-four-hour-a-day cascade of electronic hedging and speculating, the financial sector had swollen to an annual volume of trading thirty or forty times greater than the dollar turnover of the 'real economy,' although the latter was where ordinary Americans still earned their livelihoods.

Deal-makers thrived in this environment. Smart financial people figured out how to make enormous amounts of money with OPM (Other People's Money). A company would become targeted for takeover as the company's assets could then be effectively leveraged to finance the takeover, that is, used as collateral for the borrowed money. The institutional investors lined up their votes, without polling their constituency, for the deal always meant a big win on their investment and a higher ranking on their national ranking.

Most of the deal-makers had an accountant's love of cost-cutting. The complexities of building for the long term were of less interest to deal-makers who discovered that one-dimensional management was all that was required. Shortly after takeover, the word would go out to cut people; "downsize" became the expression. This is easy to do and will always improve results in the short-term, particularly when tax laws allow the downsizers to pull in expenses from future years, making increasing profits in following years almost a certainty.

Earlier Phillips had made a contribution to understanding the financialization phenomenon with his book *Boiling Point*. He traced the history, since the sixteenth century, of first Spain, the Netherlands, and then Great Britain as robust, growing economies that were progressively infected and diminished by "financialization." In each case the government policies resulted in penalizing the middle class for the benefit of the wealthy, similar to the recent American experience. Phillips applied his historical view to the American situation:

This national transformation was no accident. Economic circumstances had begun souring for Americans in the 1970s, and in the 1980s the United States electorate had embraced new leaders who unleashed the third of America's Republican-led capitalist booms in which income and wealth were realigned upward. Some of these same economic forces worked to the detriment of ordinary Americans by encouraging speculation, shifting tax burdens, and redistributing income.

During the financialization phase over the centuries in various countries, the poor and the middle class were hurt, manufacturing declined, financial services grew, and capital became more concentrated. In the simplest terms, the excitement and satisfaction of building and selling things slipped into only the excitement of making money on money.

John D. Rockefeller was castigated for excessive capitalism, but he brought kerosene to the ordinary person at an extraordinarily low cost. Almost everyone was then provided with the opportunity to read and study after dark—a watershed event for working people. Academia, the media, and politicians, however, tend to lump all kinds of capitalism without any discrimination in relative social benefit.

At the turn of the century, the U.S. economy is so good that Phillips' concerns seem outdated. The question remains, however, whether the terminal effects of capitalism will overwhelm the growth and productivity opportunities of the information age revolution.

1980s: LDCs fail, demonstrating the need for an international monetary policy that is long-term, integrated and protected from politicians.

The failure of the less developed countries, as they were known at the time, provided most of the lessons that, if learned, would have prevented future economic damage. In the 1970s, South American countries and Mexico were excited by great growth potential at the same time that New York banks were awash in petrodollars from Arab countries. South America's growth was financed with short-term money, impatient capital, and—worse—was on a floating interest rate. Greedy bankers chased profitable loans, and ignored fundamental banking principles such as not making long-term investments with short-term money.

Because of rising inflation caused by the deficit funding of Johnson's "Guns and Butter" programs, Paul Volcker was forced in the late 1970s to conduct a scorched earth attack on inflation with interest rates rising as high as 20%! An unintended consequence of this high interest rate was the bankrupting of several of the LDCs. After the economic damage to the LDCs, the pagan ceremony was repeated. Bankers and governments cause problems in the banking system and then fix them by hurting the people with lost jobs, lower wages, higher prices, and curtailed government assistance.

The textbook on the modern version of the speculative cycle was written in the 1980s in the LDCs' experience, but if it was read, it was ignored. A tragedy, considering the millions hurt later all over the world.

1980s: The government subsidizes the large United States banks back to health; several large New York banks were broke because of the LDC problem. All kinds of tricks were used to prevent the full damage to banking profits from becoming visible. A typical subterfuge was to loan more money to a LDC so that the interest could be paid. If interest was not paid, the loan was designated "non-performing," and rules required that the loan be written off, that is, a reduction in the bank's profits.

During the same time, many big banks had hyperventilated on bad real estate loans. Underlying these speculative, bad-banking actions, the banks' basic business, commercial loans, had been declining. Competition from the finance arms of big corporations was taking this business away. Instead of staying on the sidelines and watching free-market forces in action, the United States government decided to save the commercial banks.

The deregulation that followed made speculators out of bankers, but most bankers had not been trained for speculating; if they had wanted a higher-risk career they would have become investment bankers. A well run conservative bank like Bankers Trust became a not-very-good currency trader, and it ended up being sued by Proctor & Gamble. The biggest bank, Citicorp, was near bankruptcy several times from bad loans and speculation under the same leadership; and it was bailed out each time. The combination of deregulation with the abrogation of market-disciplines pushed the bankers toward financialization of the economy, that is, an economy in which making money on money becomes the dominant mission.

The government intervened, suspending the effects of competition and ignoring the mistakes of banks, by feeding the banks a spread between the cost to borrow 3% or less, and the return on Treasury Bonds, 6% or more. The spread was so large that bankers only whispered about it. Some called it the "Greenspan spread." This weaning process brought banks back to health at the taxpayers' expense and further desensitized the bankers to the negative effects of imprudent loans.

1980: Leveraged Speculation: Bunker and Herbert Hunt, Texas oil barons, try to corner the silver market on borrowed money.

One of the more bizarre episodes in the history of speculative capitalism's domination of the system was the effort by the Hunt brothers of Texas to corner the silver market, presumably as the ultimate hedge against inflation.

Silver was selling for \$6 an ounce in early 1979; by November, it was \$18.77, then \$52.50 in January, 1980. This movement exposed the plan by the Hunts and some Saudi Arabian associates to corner the market. The Hunts had been accumulating silver since 1973. The subtitle of Steven Solomon's book, *How Unelected Central Bankers are Governing the Changed World Economy* describes how these secretive, unelected men try to manage the world's money. Solomon's title might more appropriately read *How the Central Bankers are Losing Control to Politicians' Mistakes and Speculators' Growing Power*.

Solomon reported that the Hunts ended up "controlling some two-thirds of all silver in the United States." In doing so, they borrowed nearly \$1.8 billion from banks and brokerage firms at rates as low as 5% to buy silver-future contracts on margin. The collateral for the loans was the loftily priced silver assets themselves. In February and March, 1980, Hunt borrowings accounted for an astonishing nine percent of all new United States' bank credit.

This type of demand on the lending agencies tends to deflect capital and raise the cost of money for the real economy. The saga of the Hunt Brothers provides an extraordinary example of Adam Smith's warning that the "prodigals and projectors," if uncontrolled, would divert funds from "sober" people and use them for purposes that subtract from the nation's wealth.

Record high interest rates in 1980 helped get the Hunts in deep trouble and their potential default threatened to topple their main broker, Bache Halsey Stuart Shields, and possibly the giant bank, First National of Chicago. Chairman Paul Volcker of the Federal Reserve was faced with the usual "Hobson's choice:" From the discipline of free-market forces, the speculators and those who lent money to them should have been punished quickly and severely. But, lacking government control, the amount borrowed to speculate was so huge that potential failure triggered a concern over total financial security.

The "too big to fail" law was applied in this case when Volcker had the government come to the rescue. Silver prices had plunged to \$10.40 an ounce by the end of March, 1980. Volcker worked over the weekend to help bail out the Hunts with various creditors, including, according to Solomon, "giving his blessing as godfather to a thirteen-bank consortium for a new \$1.1 billion, ten-year loan to enable the Hunts to repay their short-term debt."

This type of speculative capitalism overwhelms the slower, plodding efforts of unrepresented democratic capitalism. The lobbying power of financial capitalism is enormous; in fact, it is the largest single lobbying group. Efforts to discipline speculative capitalism are always met with warnings not to "upset the markets," as if they were a vengeful spiritual force. Maybe they are.

The Hunts were hurt, but their \$2 billion in losses probably did not affect their lifestyle. Some Congressional people, however, accused Volcker of bailing out the Hunts. Financial capitalism was pleased that its lobbying had prevailed, for the government had protected the system rather than allowing free-market disciplines to work. This event further sensitized the banking system to the idea that if the potential failure is big enough, then it carries a *de facto* taxpayer guarantee. It is the worst of both worlds, far from Adam Smith's free banking, where if people took stupid risks and banks made stupid loans, the punishment was quick, severe, local, and visible.

Solomon summarized this escapade that:

touched a raw nerve in the bosom of democratic capitalism that politicians were only too glad to deflect onto central bankers. It was hard to explain to the democratic body politic why rescuing big financial institutions, because of their unique ability to spread contagion, served the public good while the government failed to intervene to save ordinary businesses employing thousands. In the United States this tension always threatened to reawaken the barely dormant, passionate political divisions that fought

over money since the founding of the republic."

Solomon's observation is accurate, but he does not go far enough. For two hundred years, the argument has been over a fair slice of the distribution pie. Now, speculative capitalism has become so powerful that it can damage the growth of whole countries in the global economy, upsetting their fragile political structures.

1980-88: President Ronald Reagan.

President Ronald Reagan and Secretary of the Treasury Don Regan, former head of Merrill-Lynch, initiated the deregulation that got banks into trading (speculation) and promoted the idea of free capital's roaming the world to fund economic growth. Reagan also proudly described the deregulation of the savings-and-loan industry as the most important financial legislation in fifty years. Reagan did not realize that he was initiating an economic catastrophe.

A Congressional staffer and industry lobbyist added the fine print to the law that escalated deposit insurance to \$100,000 without a limit on the number of locations speculators might use. It was not President Reagan's habit to study details. The Secretary of the Treasury was pleased to anticipate enormous, profitable shift of capital from savings accounts to certificates of deposit that would benefit Wall Street.

Reagan was determined to "get the government off peoples' backs." He was convinced that "the government was the problem, not the solution." He then proceeded, like Presidents before and after him, with badly designed programs that failed in their mission, gave deregulation a bad name, and further confused people on the proper function of government. The source of the confusion is applying *laissez-faire* to the banking function. It could only be applied in free banking, which is not likely, otherwise the control of currency and credit is a prime government obligation.

The government's mistakes and the resulting economic damage support the argument that monetary and fiscal matters should be Constitutionally protected, that is, safe from *ad hoc* action by politicians trying to win the next election. They should be part of an integrated long-range plan designed by bipartisan experts, not by Congressional staffers and industry lobbyists. The S & L scandal should be a required case study for all citizens. The mistakes were large and went on for three decades. The several hundred billion dollars wasted could have been used to educate and train youths who have been deprived of the opportunities implicit in the democratic promise.

1987: Marty Lipton, a famous New York attorney, places mergers, acquisitions, LBOs and takeovers in context.

Part of the conventional wisdom in ultra capitalism is that takeovers are provoked by entrenched, poorly performing management. That may be true occasionally, but the true motivation initiating takeovers is money. Deals are extremely lucrative to all involved—

bankers, lawyers, accountants, CEOs of takeover companies, and CEOs of those taken over. Deals follow the logic: "If it can be financed, it should be done."

From the earliest days of the takeover craze in the 1970s, Marty Lipton was one of the most famous mergers and acquisitions lawyers. Marty made money from the process by collecting \$20 million fees, but then criticized the system, not as an efficient reallocation of resources, but rather as merely a new way to make lots of money without regard to the social impact.

Lipton wondered how the job sector might have been improved if the \$139 billion that financed mergers and acquisitions in 1985 had been invested in new products, new markets, and automation. Lipton believed that the laws gave special privileges to the takeover artists. To level the field, he proposed elimination of tax deductions on dividends, elimination of tax deductibility on junk bonds, no two-tier bids, all financing in place before announcement of a takeover, no voting rights for short-term equity, a legal limit of 10% of junk bonds as a percent of S & L assets, and a graduated capital-gains tax on securities held for less than five years, starting with 60% on gains made in less than a year. All of his proposals bounced off the wall built up for years by financial capitalism's lobbying.

In 1987, Lipton published his thoughts from an earlier lecture. From his profound experience in many deals, Lipton could separate the superficialities from the realities. These were his major points:

- Takeovers are driven by speculative financial considerations, not intrinsic business reasons.
- Some managements may be deficient, but, as a group, they pursue socially beneficial objectives such as expanding the enterprise, improving productivity, and cultivating planning, research, and development.
- Financial corporatism has none of these objectives.
- Institutional investors, such as pension funds, dominate the market. Their managers are graded and compensated on annual performance.
- Tax and accounting rules favor the takeover. Interest is tax deductible, dividends are not. Acquisition costs, including premiums, can be capitalized and amortized over many years.

1991: President George Bush and Secretary of the Treasury Jim Baker helped cause the later Asian crisis with the Plaza Agreement in New York in 1991. They were fiddling with the relationship of the dollar and the *yen* because of the enormous trade imbalance

between the U.S. and Japan. A stronger *yen* and a weaker dollar would slow down Japanese exports and help the United States.

The communique issued from that meeting said that a 10-12% downward adjustment of the dollar was "manageable," or around 215 yen to the dollar. By the summer of 1992, the *yen* was under 80.

This wild ride of the *yen* demonstrated why politicians should not intrude on free market forces. The mature economies, the G-7 nations, should certainly try to provide the world with a stable currency. This is their unfulfilled responsibility. The drop of the *yen* demonstrated the fundamental instability of the system. Countries with their currency pegged to the dollar, such as Thailand, were ignored in the process, despite the large dislocations that were caused.

The Japanese took their interest rate to less than 3% to fund the productivity improvements necessary to protect their export sales from the strong yen. Later, they took the interest rate to almost zero. The unintended consequence of this low-cost Japanese money was the overfunding of Asian economies, resulting in too much money put into poor investments. With this kind of capricious action of politicians destabilizing the world's economy, and with this level of volatility, no currency system, fixed, pegged, or floating, can work well.

Johnson had initiated the inflation with his "Guns and Butter" programs. Nixon had cut the world's currencies loose without a stabilizing mechanism for the first time in commercial history. Reagan deregulated financial services at the same time the market disciplines that deregulation requires were suspended. Bush tried to fix the export/import imbalance and further destabilized currencies while contributing to the funding of overcapacity.

1991: Pope John Paul II was explicit in *Centesimus Annus* about future world developments being dependent on stable currency and control of speculation. Almost a decade later the world is still not listening and great economic and social damage has been done.

Economic activity, especially the activity of a market economy, cannot be conducted in an institutional, juridical or political vacuum. On the contrary, it presupposes sure guarantees of individual freedom and private property, as well as a stable currency and efficient public services. Hence the principle task of the State is to guarantee this security, so that those who work and produce can enjoy the fruits of their labours and thus feel encouraged to work efficiently and honestly. The absence of stability, together with the corruption of public officials and the spread of improper sources of growing rich and of easy profits deriving from illegal or purely speculative activities, constitutes one of the chief obstacles to development and to the economic order.

The Pope specifically warned about the "dominance of capital", a paradox in the new world where wage earners are the prime source of capital.

In this sense, it is right to speak of a struggle against an economic system, if the latter is understood as a method of upholding the absolute predominance of capital, the possession of the means of production and of the land, in contrast to the free and personal nature of human work. In the struggle against such a system, what is being proposed as an alternative is not the socialist system, which in fact turns out to be State capitalism, but rather *a society of free work, of enterprise and of participation*. Such a society is not directed against the market, but demands that the market be appropriately controlled by the forces of

society and by the State, so as to guarantee that the basic needs of the whole of society are satisfied.

1992: President Clinton and Secretary of the Treasury Rubin exported the domination of financial capitalism worldwide, pulling down cross-border capital controls and opening new markets for American financial services. Clinton and Rubin sensed the promising world movement to free markets, and, with the encouragement of the Wall Street lobby, pushed for open markets for financial services and elimination of all cross-border capital controls—all wonderful concepts, in fact, part of the route to a world of peace and plenty.

Unfortunately, the devil is in the details; they did not address the stabilization of world currency and the standardization of banking protocols that would have kept the lending of hot money in proportion to long-term, patient capital. Neither did they address the growing borrowing leverage that was making the speculators more powerful than the central bankers. Nor did they address the abrogation of market disciplines that had muted the sense of risk in lending money. Also ignored were the wage levels in emerging economies so low that there was no spendable income necessary for reciprocal purchases that make free trade work.

1990s: The invisible hand or the wrong claw: Adam Smith's invisible hand, that extrapolated the energies of the butcher and the baker into broad social benefit, a growing economy that produced jobs, has become the wrong claw with a mission to make money on money, with consequent adverse social effects.

The "prodigals and projectors" have a new toy called "derivatives:" puts, calls, options, futures of all types. A derivative is a financial instrument by which a speculator bets on the future value of another underlying financial instrument. Carol Loomis described them as "alligators lurking in the swamp." The alligators are multiplying: \$1.6 trillion in 1987, \$7.4 trillion in 1991, \$16 trillion in 1994, and over \$100 trillion in 2000. These numbers can be compared to the entire U.S. GDP of about \$7 trillion. Derivatives have given the

speculators new ways to bet, new ways to leverage those bets, and new ways to avoid banking regulations.

Joel Kurtzman describes this new phenomenon:

Conceptually, these abstract products are often outgrowths of real products that have been traded on the futures markets for years. But when they go electronic, they do it with a twist. Rather than trading a contract today for a bushel of wheat to be delivered next year, these new products are usually contracts to take delivery on a financial product. Instead of buying wheat on the futures market, the new products that are traded are contracts to buy stocks, specific ones or all the stocks on the entire stock market, in some cases, and even such esoteric items as foreign currencies and future interest rates. Future contracts on interest rates did not exist in 1971. They did not really get into the market until the late 1970s when Citicorp invented them in Tokyo. Today, there are outstanding contracts for \$3 trillion worth of them, a little more than half of the gross national product of the United States.

Though complex, these products can be traded with lightning speed. There are immense profit (and loss) opportunities inherent in the market for products like options because they are intensely volatile. As a consequence, the market for tradable options has grown from essentially zero in 1973—the year the Chicago Board Options Exchange opened for the first time—to a market where more than \$170 billion changes hands each day. One hundred and seventy billion is enough money to purchase about 1.7 million average homes.

Kurtzman is restating Keynes' point, made in the mid-1930s, when trading volume at this level was not considered, that speculation as a bubble on commerce is not a big problem, but when commerce is a bubble on speculation, watch out!

This is not a suggestion to abandon free-market principles; it is recognition that free-market disciplines have already been abandoned. Money is supposed to be a simple medium of exchange, but it is now subject to governments' use of it for political purposes, and speculators', with enormous amounts of borrowed money, using it to make money.

The free choices that bring the buy-and-sell system into equilibrium would work in totally free banking, but cannot work in a monetary system where governments intrude, creating volatility, the speculators are allowed the privilege of borrowing most of the money to benefit from the volatility, and market disciplines that penalize imprudent action have been suspended.

1990s: The Federal Reserve Board, representative of Wall Street, not the people.

This observation is a contrarian view at a time when the long-time Chairman of the Federal Reserve is almost deified by most, crediting him for continued economic

success. He has been successful in the sense that he has not made mistakes and did eventually recognize the radical impact of the information age.

His exclusive function now is to prevent inflation, but his subsidiary function is "not to upset the markets." For example, his focus on inflation has appropriately moved from worrying about factory-worker wages to asset inflation in the stock market. His tool is raising interest rates, hurting home-building. Why not mute asset inflation by limiting borrowing for speculation? Because it would be unpopular with Wall Street.

The structural arrangement between the government and the Federal Reserve Board has been based on the perceived tension between government's urge to exercise control over money, and the capitalist's not trusting them to do it. Central banks, including the Federal Reserve, were created to bridge this tension between government and finance capitalism.

Steven Solomon analyzed this relationship of democracy and finance capitalism:

Central banks arbitrated an unspoken marriage of convenience between two disparate regimes that constituted democratic capitalism, the democratic nation-state polity and market capitalist economy, to make the rules of the game by which society's wealth was produced and managed. Since the sixteenth century, these two overlapping, though at times opposing, forms of social organization evolved together through uneasy and shifting *modus vivendi*.

The logic of capital was to maximize profit, regardless of national borders, political rights, social equity, or environmental consequences, and to seek to preserve the value of the capital it accumulated. The primary purpose of the democratic liberal state, by contrast, was to ensure liberty, equity, defense, and economic welfare for its citizenry. The disparate logics of capital and the democratic state converged on one crucial common goal—economic prosperity—and its prerequisite, a stable and friendly political economic environment for capitalist enterprise. Each of the main models of democratic capitalism—Anglo-American *laissez-faire*, European liberal social welfare, Japanese neomercantilist, "relationship" capitalism—provided this with varying divisions of responsibility and power between the market and governmental realms.

One of the main fulcrums of prosperity that had to be managed was the special role of money and finance. Governments naturally preferred to exercise the state monopoly over money freely itself. But private capitalists did not trust them and possessed a veto—abstention from

lending. Central banks evolved as a medium of compromise from this historical tension, especially from the mid-nineteenth century, when the paper money and credit revolution had assisted "financial capitalism" to dominate the heights of the market economy.

Solomon explains the background and the partial domination by finance capitalism. The perceived tension between the profit motive and democracy need not exist when, in democratic capitalism, profits are maximized and broadly distributed by wage-earner participation. In a democratic capitalist environment, trust, cooperation, participation, and broad wealth distribution maximize profits while supporting and reaffirming democracy.

The central bankers including the Fed, are notable for what they do not do, that is, provide representation for democratic capitalism or the will of the majority in the deliberations. This incestuous relationship between the politicians and the finance capitalists produces ugly results. Milton Friedman, paraphrasing the nostrum that war is too serious to be left to the military, says "money is much too serious a matter to be left to the central bankers."

The concept of the Federal Reserve Board as a bridge between capitalism and government has always been incorrect. The Fed is a bridge between *finance* capitalism and the government. The Fed's original dual obligation to pursue full employment and protect against inflation, has been simplified to inflation-fighting only and support of finance capitalism. This Fed mission ignores the dramatic changes in finance capitalism in the past quarter-century with the threat posed to the global economy. The Fed Chairman is Wall Street's Washington representative.

Anything that Wall Street does not like, the Fed Chairman opposes, such as FASB's (Financial Accounting Standards Board) recommendations on charging earnings for stock options, or banks' marking the value of derivatives to market (see LTCM later in chapter). In the FASB recommendation, the stock options given to an executive would be disciplined by a reduction in profit, now they are "freebies." Presently, banks are not required to show losses on derivatives as a reduction in balance-sheet value or a reduction of profits.

Through deregulation and failure to control leveraged speculation, the government has added to the power of finance capitalism to control other people's capital and to concentrate wealth for its own benefit. Do not, however, expect the Federal Reserve Board to initiate reforms to distribute wealth more broadly or to stabilize the international monetary system.

1994: The Bond Massacre—a worldwide margin call: In the 1980s, traders in government bonds became more important as the deficit grew and something as prosaic as government bonds became a speculative commodity. The politicians make political moves to pressure the Fed on interest rates or take action trying to affect the value of the

currency, all economic nationalism. The bond traders then use increased volatility to turn these instruments over every few weeks instead of every few years.

The speculators love this rapid turnover and uncertainty. They make commissions on the increased turnover, but they can make enormous amounts of money by guessing right, not on fundamentals, but by guessing what the bond traders perceive the Fed will do with interest rates. For example, if the Fed moves rates up, the bond market can either respond positively to a movement against inflation, or it can respond negatively, assuming that the Fed is concerned about more inflation. The speculator guesses which one, and then bond derivatives are bet like casino chips.

Interest rates controlled by the Fed kept coming down in the early 1990s for the political reason of helping the economy. Then the Fed began to raise interest rates to "fight inflation." This government-induced volatility first provoked many to refinance homes and then later stopped them from refinancing homes. What on the surface looks like a straightforward transaction, borrowing money to buy a home, thereby becomes another casino chip called "mortgage-backed securities."

When the refinancing of mortgages slowed to a crawl, reflecting both saturation and Fed action, the mortgage-backed securities took a dive. Overleveraged companies, such as Askin Capital, using exotic techniques, went broke. Then following the formula of Wall Street, "Sell what you can, not what you should," \$20 billion in 10-year T-bills were sold in March and April of 1994 to offset the new risk in mortgage-backed securities.

Nervous traders on margin try to average out the maturities on their holdings, that is, the mix of 5, 10, 20 and 30 year bonds. They cannot sell enough ten-year mortgage-backed securities, so they do the next best thing, and sell ten-year government bonds. Now, all of a sudden, there is selling pressure on ten-year government bonds. "What's happening? Where did this come from? How do I get out? At what loss? The phone's ringing, they want me to cover my margin. Maybe this is a free-fall, I'd better dump." Sophisticated investors such as George Soros diversified their government bonds in many countries, but still took a beating in this massacre.

The *Wall Street Journal*, May 20, 1994 describes this as "Push the balloon in one place, it pops out somewhere else:"

The average life of mortgage-backed securities was stretching out like silly putty. They suddenly became longer-term bonds which, by nature, are riskier because they are more sensitive to changes in interest rates. To compensate for this, the universal response on Wall Street was to lighten up on other long-term securities, primarily by selling 10-year Treasury notes.

The signals in a finance-capitalism cycle are always clear, but as the numbers get bigger, the greed grows stronger, and the margin requirements become smaller. In the great bond

market massacre of 1994, bondholders worldwide suffered more than \$1 *trillion* in losses. Al Ehrbar described this speculative adventure on margin:

Consider this somewhat simplified example. An institution puts up \$100,000 in cash to buy \$10 million of treasury bonds yielding 6.2% and—here's the leverage—borrowing the other \$9.9 million at a rate of 3.5%. It collects \$620,000 in interest on the bonds, pays \$346,500 in interest on the loan and winds up netting \$273,500 a year on its \$100,000 investment, unless long-term rates head up, that is. When that happens, the institution gets a margin call to put up another \$100,000 for each drop in bond prices, and it can quickly become a net loser, even if the carry remains rich.

Ehrbar makes the signals clear by showing that net borrowing, secured by Treasuries, by primary government dealers has increased from under \$50 billion in 1990 to almost \$200 billion in 1994. The crash was again caused by too much money on loan for speculation. The media, as usual, searched for some explanation other than leveraged speculation, including the Federal Reserve's rate increase or even a political assassination in Mexico. The real logic never changes: When margin calls are made and the money is not there, values plummet. Gilbert deBottom, Chairman of Global Asset Management, commented, "You had a snowballing liquidation completely out of proportion to the economic fundamentals; both the United States and Europe had been overexploited by investors on margin."

The bond massacre of 1994 resulted in visible casualties. Hedge-fund managers lost heavily, life-insurance companies lost \$50 billion, insurance companies lost \$20-25 billion. Rep. Henry B. Gonzalez (D., Texas), Chair of the House Banking Committee, held hearings in April, 1994, on the dangers posed by hedge funds using large credit lines for speculative purposes. Gonzalez maintained that hedge funds now need extra scrutiny because of their ability to disrupt markets. The bond market has been described as a zero-sum game; some gain, some lose. It is not as easy for the media to export a bond crash to the general economy as they do with a stock market crash. Despite Gonzalez's comments, the record shows the unwillingness of government to prevent speculation until a catastrophe has happened, at which time it passes *ad hoc* laws, slowly.

1994: A Mexican economic crisis, not much different from the earlier one in 1981 or the Asian one to come in 1997. Its root causes were:

- No international disciplines to control the amount of short-term loans. This "hot money" stimulates economic growth beyond prudent levels. In every case when there is an oversupply of money, the result is increasingly risky projects and speculation. When the economy weakens because of the effect of imprudent loans and speculation, the currency sharks are attracted. The lenders of hot money, corporations, and the well informed wealthy, sensing the attack, then flee the currency, creating a self-fulfilling prophecy: the currency goes into free-fall. Cross-border capital controls

previously prevented hot money from precipitous flight out of the country, but they were taken down in most countries on the urging of the U.S.

- United States bankers are motivated by short-term earnings and stock price. The bankers make profitable but risky loans, knowing that they are protected by the government from a bad-loan calamity, expecting the government to bail them out, as it has done many times in the past. This abrogation of free-market disciplines makes a mockery out of the expression "free movement of capital."
- The G-7 nations have not agreed on a new stabilizing mechanism for international currency since the dollar was floated in 1971. Commerce hates instability; speculators live off of it. Business plans for growth based on the expectation of a certain value for currency and a certain cost of money. This predictability was provided for many centuries by the gold standard, when bank and government paper was backed by gold; or in the twentieth century by the willingness of first Great Britain and then the United States to convert currency into gold.
- In 1994 New York banks were buying Mexican bonds dominated in dollars, called *tesobonos*. For the loaner it was a hedge against changes in the value of the *peso*. For the Mexican borrower it was available money without a currency risk premium. When the Mexican economy crashed in 1994 for all the usual reasons outlined earlier, the United States government "bailed out" the Mexicans with \$50 billion of taxpayers' money. Actually it was the imprudent lenders of money, *tesobonos*, mainly New York bankers, who were bailed out.

The Mexican economy was severely damaged. Wages dropped, prices went up, social tensions were exacerbated. Five years later, the bankers described the Mexican bailout as a win, but the standard of living had not yet returned to the 1994 level. Social unrest included the Indian uprisings in Chiapas and students occupying and shutting down a University in Mexico City. Few of the protestors knew anything about controlling hot money.

1994: Judy Shelton warned about the lack of any monetary stabilizing mechanism for a world moving toward free markets:

At a time when the transition to a post-communist world holds out the prospect for an international marketplace of free trade and entrepreneurial initiative, offering new levels of economic prosperity for a growing number of participants, the lack of an orderly global currency system threatens to destroy the vision. The international monetary system currently in existence is no system at all ... global currency arrangements

have deteriorated into a high-stakes poker game where the exchange rates are determined on the basis of the latest bluff between government officials and speculators.

Keynes' warning in 1936 came after leveraged speculation almost destroyed the world's model of a democratic economy. Shelton's more contemporary warning is, hopefully, in time to prevent leveraged speculation and instabilities from upsetting whole economies, and moving the world away from the universal benefits of free markets.

Shelton was an economist at the Hoover Institute when she captured the world's dichotomy, the greatest opportunity in human history for a world of peace and plenty threatened by the inability of governments to agree on and put in place an international monetary system. A system that can support this extraordinary opportunity with a medium of exchange that is *stable* and investment capital that is *patient*. Not a finance capitalism that makes money on money, speculating in the world's electronic casino unconnected with the real economic world, or makes money on short-term loans not dependent on the success of the investment.

1997: Thailand, Malaysia, Indonesia and South Korea were all improving their people's lives through economic freedom. In most years, their economic growth was in double-digits. Then, culminating in 1997, these Asian countries were caught in the government-speculative-finance-capitalism cycle described earlier in the chapter. The rush of short-term money from international bankers overheated their economies, resulting in speculation and the funding of questionable projects. The consequential economic weakness might have been corrected by a modest tightening and a slower growth rate. Because of financialization of the global economy, however, economic progress was set back a decade or more. The unifying force of a rising standard of living was displaced by unemployment, falling wages, higher prices, and social unrest, sometimes violence.

After the predictable bailouts, the American banks made out very well. They had been booking big profits on loans for years, and following a crisis, they either pulled their money out or rolled over their loans, that is, they made newly negotiated loans with higher interest rates. They are rewarded, in effect, for having made bad loans. When the IMF talks about bailing out the Asians, they are not talking about the people; rather, they are talking about the European, Japanese, and American money lenders.

Opposite to the positive notion of economic common purpose is the view that the twenty-first century will be one of violence from a coupling of new economic power with residual animosities among Islamic and Asian nations against the West. Unfortunately, this view seems to be supported by the tragic events in Asia that exhibited the vulnerability to lethal financial imperialism of nations trying to improve the lives of their people. In a matter of months, these nations went from improving most lives through economic growth to a clash of cultures, negative growth, and a breakdown of civil order.

This clash of cultures was highlighted in September, 1997, by a battle of words between Malaysian Prime Minister Mahathir Mohammed and global speculator George Soros—a

Muslim Prime Minister declaring the immorality of currency speculation versus an American-Hungarian Jew, the world's wealthiest speculator. Soros had already written extensively about the instabilities in global finance capitalism that can lead to economic damage; consequently, his response to the Prime Minister was limited to a personal attack.

The media, a presumed strength of an open society, unfortunately are part of the problem and do not inform citizens on economic scandals such as Asia in 1997. The reason is that most reporters are educated in the humanities and are economically illiterate. It is easier to report on the macho excitement of ultra capitalism because downsizing is an easy concept to assimilate. It was even easier for the media to convert the economic complexities of what happened in Indonesia to a political event where the media are comfortable and, in fact, help define the agenda.

Indonesia was following the proper sequence: First, civic order; next economic opportunity, helped by a better education; and then, in a generation or more, full political freedom. With the help of the media, political freedom has now been given greater priority than economic freedom, and this will result in continued social chaos.

The front page of *The New York Times* on January 18, 1998, proclaimed: "Crisis Pushing Asian Capitalism to United States-Style Free Markets." The article was a prediction that Asian countries would become more short-term-profit oriented, "more ruthless about laying off workers." The effect of the crisis would be an emphasis on cost-cutting, not growth. Workers would be dumped as the route to greater profits, and any sense of social contract would be dumped with them.

Economists are well known for not agreeing on anything. This is true in regard to currency techniques, as there is endless debate about the merits of fixed, floating, and pegged systems. One reason that economists have difficulty agreeing is that frequently their rational theories are overwhelmed by irrational politicians. The out-of-control international monetary system results in a volatility that prevents any one of the three choices from functioning properly.

The IMF is an international body, but it functions as the arm of American policy. Being bankers, their damage control follows the time-honored pattern of victimizing the poor and the middle class to fix problems in the banking system that were caused by the bankers.

The IMF's demands are all antigrowth: higher interest rates, fewer business loans, less government spending. Other parts of the American model being adopted in Asia are more useful: greater disclosure, better governance, elimination of crony capitalism; improved debt-equity ratios, audits by independent accountants, and more outside Directors on Boards. None of this, however, addresses the root-problems. The better disclosure advice is ironic, however, because finance capitalism, with help from the Chairman of the Federal Reserve, has successfully resisted better disclosure on derivatives in the United States.

A country can adopt a floating exchange rate, in which case, the monetary policy is set by the central bank, and the rate theoretically adjusts based on free-market forces. If politicians massage the relationship of the dollar and yen to try to minimize the trade imbalance, this is not a free-market force, and it can cause volatility in another currency. In the free-float country, there can be no theoretical contradiction between exchange rate and monetary policy, for the exchange is supposed to be on automatic pilot, protected from politicians.

In a pegged-rate system, the central bank tries to control both exchange value and monetary policy. Thailand, the first Asian country to fall, was on a pegged-rate system with 25 *baht* to the dollar. A pegged-rate system assumes a reasonably stable currency to which they are pegged, with reasonable relationships with other major currencies, not a relationship in which the dollar could go from 240 *yen* to 80 *yen*.

Companies in Thailand borrowed in dollars and *yen* even though the returns would be in *baht* and other local currencies. This seemed safe as long as Thailand maintained its currency peg of 25 *baht* to the dollar.

But if it devalued to 50 *baht* (which had seemed inconceivable but eventually happened) borrowers were devastated.

The Japanese had taken their interest rates to low levels to fund the capital investment for productivity that was needed to compensate for the strong *yen* forced on them in the Plaza Agreement. Japan became a source of extraordinarily low-cost money.

This began the "carry trade," which was initially highly profitable but ultimately catastrophic. It took many forms, but typically financial institutions would borrow *yen* at 2-percent interest rates, convert the proceeds into Thai *baht*, and reap the differential: *baht* interest rates were about 10 percent.

The world's economic growth depends on a stable monetary system. It could tolerate 10-15% variations, but not the currency of two of the biggest economies' shifting in a few months in ratios of 5:1. Interest rates are similarly volatile. Interest rates can go up to 50% or 100% when a country is forced to defend its currency.

The apologists for finance capitalism argue that speculators' attacking a country's currency is a useful discipline. It is a scandal that the mature economies, led by the United States, have let the international monetary system get so out of control. The final insult to the people victimized in the countries attacked is to describe the extraordinarily leveraged speculators as providing a "discipline."

1998: The \$3.6 billion bailout of Long-Term Capital Management in 1998 gave new meaning to leveraged speculation and took the financialization of capitalism into dangerous new territory. LTCM was a spin-off from Solomon Brothers after the 1991

scandal in which the later head of LTCM, John Meriwether's senior people admitted falsifying bids for Treasury securities. Meriwether's boss, John Gutfriend, took several months to inform the Fed. Warren Buffet, Solomon's largest shareholder, took over. The bond trader was fired, and, later, Meriwether and Gutfriend left.

This was not the first time that Meriwether and Gutfriend had been publicly linked. Michael Lewis described how John Gutfriend, the head of Solomon Brothers and designated on the cover of *Business Week* as "King of Wall Street," walked over to John Meriwether's desk one afternoon in 1986 and said, "One hand, one million dollars, no tears."

John Meriwether was a member of the Board of Solomon Brothers and why not, he made the firm hundreds of millions of dollars trading bonds. Meriwether was also "king of the game," the Liar's Poker champion of Solomon Brothers trading floor.

Gutfriend "played the game" most afternoons with Meriwether and the six young bond-arbitrage traders who worked for Meriwether and was usually skinned alive. Some traders said John Gutfriend was heavily outmatched.

Lewis concluded this tale with Meriwether's raising the ante to \$10 million and outbluffing Gutfriend. It is a world with which few people are familiar.

Meriwether set up LTCM in 1993 with, at one time, 25 PhDs, including two Nobel-Prize winners in economics, on the payroll. The customers were wealthy and financially sophisticated, like the CEO of Merrill-Lynch. Why not? LTCM made 43% for its investors in 1995 and 41% in 1996. That is after cutting principals like Meriwether in for 20% of the profits.

John Meriwether seemed to have a magic touch. What he really had was nerve-wracking leverage. With returns like that, no wonder the Chairman of Merrill-Lynch and dozens of others at the firm invested in Long-Term Capital. But, adjusted for the risks, how good really were those returns? It's the old story: financial genius is a short memory in a rising market.

LTCM's business was to bet on market-neutral changes of interest rates on different-maturity government bonds. They were making enormously leveraged bets that rates would converge, in which case they made money whether bond prices went up or down, that is, the bets were market-neutral.

Without leverage the bet is hardly worthwhile: You would make \$5,000 on a \$1-million trade when the discrepancy is eliminated.

But introduce the Archimedes principle and the picture changes. Suppose that you were able to buy \$1-million worth of Treasuries on \$10,000 in

margin. Now that \$5,000 profit is not just 5% on your money — it is 50% on your money.

Meriwether bet the wrong way. Instead of converging, the yields on the Treasuries spread further.

With many of the trades suddenly under water, the banks made margin calls — just as your broker would if you owned stocks on margin and those stocks dropped in value. The \$4.8 billion in capital dwindled very fast; it was down to \$1.5 billion when the Fed stepped in. Soon it was just \$600 million.

Again, instead of taking action to inoculate society against the disease, the government stepped in to nurse the source of the infection.

On October 1, 1998 the Chairman of the Federal Reserve, Alan Greenspan, and the head of the New York Fed, William McDonough, appeared before the House Banking Committee to defend their role in saving LTCM. The committee chair, Jim Leach, (R., Iowa), questioned whether the Fed action precluded an offer to purchase LTCM from Warren Buffet and Goldman Sachs, which would have resulted in tossing out all the principals of LTCM. The Fed bailout left them in place— bloodied, bruised, but still able to take their 20% profit percentage and still with 10% ownership.

LTCM is a useful case-study in four areas:

- LTCM took leveraged speculation to new levels.
- LTCM showed that regulated banks in their lending practices do not protect against unregulated hedge funds.
- LTCM illustrated why better disclosure of derivatives by banks is needed.
- In LTCM the government extended the "too-big-to-fail" principle, in effect to private investors.

Citizens of the United States cannot count on the Federal Reserve Board for protection. The Fed is the bridge between finance capitalism and the government, not between job-growth capitalism and the government. These matters need sustained citizen attention assisted by the media. National elections should include these subjects as part of the agenda that will shape the twenty-first century.

LTCM was an unregulated hedge fund headquartered in the Cayman Islands. The Chairman of the Federal Reserve Board admitted to the House Banking Committee that the Fed was powerless to control hedge funds, saying but that "the best we can do is what we do today: regulate them indirectly through the regulation of the source of their funds." The source of funds, New York banks and investment banks, however, did not know what LTCM was doing with the money, nor did the various banks know how much was borrowed from other sources.

In 1990, there were about 600 hedge-funds in the United States with estimated assets of \$38 billion. By 1998, there were 3,300 hedge funds with assets of \$375 billion, an example of the skyrocketing financialization of the economy. *Forbes* estimated that Wall Street firms, on which the Fed was counting to monitor the hedge funds, grossed over \$2 billion a year on hedge fund business "and bring a good part to the bottom line." This does not count the revenue that hedge funds were generating for other parts of the firm.

Business Week is usually sympathetic to finance capitalism but it warned:

Who's watching the hedge funds? The lessons are clear. More disclosure is an absolute necessity in this age of leverage and global capital. Hedge funds are no exception. Someone must also be watching. The banks, certainly, must take an active role in monitoring their loans, as well as the kind of derivative transactions they support. But LTCM's wild ride shows that banks have a difficult time monitoring themselves, much less others. Federal regulators, as a consequence, must accept the fact that the public holds them responsible for the nation's financial stability.

If a small businessman has an inventory of material for which he or she paid \$100,000 that can now be sold for only \$75,000, he or she is obligated to "write down" the inventory to \$75,000 and reduce earnings by \$25,000. The same simple accounting principle should apply to derivatives, but bankers interested in the price of their stock and the value of options do not like this idea.

If you asked a financial expert why the Fed opposed better disclosure on derivatives, the answer would be so complex that most people would get a headache listening. The real answer is close to the simple accounting described, used to value inventory based on market value, then reflecting changes by adjusting profits. The defense is that cash is transferred based on cost-to-market comparisons, but it is not visible.

In LTCM the mockery of using the expression "free markets" while insuring and subsidizing risk was extended to private investors. Investors in LTCM used every possible artifice to avoid paying taxes. These were investors using esoteric models to make huge amounts of money on minuscule changes in interest rates. These were PhDs who built a model that did not consider a whole government's defaulting on bonds, as Russia did in 1998.

The Fed's argument before Congress that no private funds were used in the bailout is specious. What if the banks lost money in the bailout? The taxpayer would, one way or the other, make up the losses.

Ron Chernow, author of *The House of Morgan*, 1989, and *Titan*, about John D. Rockefeller, 1998, observed:

What's striking this time is that commercial and investment banks, prodded by the Fed, are extending a safety net to a hedge fund—an unregulated firm supposedly rich enough and sophisticated enough not to require government regulation. In that way, the massive bailout indirectly extended the too-big-to-fail doctrine to institutions that are neither chartered banks nor regulated broker-dealers—a very disturbing precedent.

Representative Bruce Oruto (D., Minnesota), a member of the House Banking Committee, put a finger on the problem, pointing out the gap between free-market theory and practice:

We have a lot of speeches about free enterprise and the marketplace but a lot of folks don't like to practice it. The problem we have as representing our constituencies is that there seems to be two rules, a double standard: one for Main Street and another for Wall Street.

It was a nice speech and probably played well in progressive Minnesota, but the Congressman did not acknowledge Congress's own responsibility to turn a deaf ear to the lobby-power of finance capitalism, and to commission a long-range integrated plan to control currency and credit for the general welfare.

1998: The Russian Debacle. The results of "One of the greatest peacetime economic and social disasters in history" are as follows: Russia's GDP in 1998 was half what it was in 1989; life expectancy in Russia was falling, the only industrial country with such a trend. Some 70 percent of Russians now live below or just above the poverty line; capital investment in Russia is only 10% of what it was ten years ago; the Kremlin's own studies identified hundreds of billions of dollars lost to the Russian people through corruption. Once Russia was a world superpower, as the U.S.S.R. Russia's national budget is now \$2.9 billion, less than New York City's. Rudy Giuliani has more money to spend than Vladimir Putin.

The worst foreign policy disaster in history may turn out to be the United States' blowing the opportunity to help a willing Russia move toward economic freedom. Most of the advice to the Russians was provided by finance capitalists whose motivation was making

money on money, not building an economy, and U.S. economists who knew little about management of change.

Fareed Zakaria pointed out a unique way to recognize capital flight:

In all, more than \$200 billion has leaked out of Russia, most of it to Switzerland. The Palace Hotel in St. Moritz is a reliable indication of the national origins of surplus cash. In the 1970s it translated its menus into Arabic; in the 1980s it was Japanese; today it has them printed in Russian.

Successful governance follows the sequence: Civil order, economic freedom and then political freedom. The Russian tyrannical structure was torn down without a replacement. One of the key structures was of course the monetary system and the experts were consistent. They recommended eliminating all cross-border controls of cash. The financial services industry was thus encouraged to pump money in as it can be quickly pulled out. In Russia it was corrupt Russians taking capital out. The capital flight was estimated to be between \$150 billion and \$200 billion. *The Nation's* editorial does not equivocate:

It's probably wrong to think of it as capital flight, think of it rather as a chronic hemorrhaging of Russia's natural resources. That could hardly have happened without the knowledge and complicity of Western governments, central banks and finance houses.

At the turn of the century, Russia was fighting an ugly civil war in Chechnya, using war as a last resort to unify its restless, if not revolutionary, people. Boris Yeltsin resigned only after ominously raising his voice to remind the United States that Russia was still a formidable nuclear power.

The United States had failed to help Russia understand how to couple democracy and capitalism; it has succeeded in antagonizing the Russian military by pushing NATO up to the Russian border. Instead of Russia's and China's joining in unifying the world through economic common purpose, United States' actions were pushing Russia and China together: An imposing combination, the second largest inventory of nuclear bombs and the world's most populous country, whose GDP will exceed that of the United States during the twenty-first century. Who designed this foreign policy? And for what purpose?

The Chinese understand management of change better than Russia's American advisors. They are moving deliberately on the path of civic order, economic freedom, and political freedom. Their economic program was hurt by the wage devaluation in Asian nations caused by the United States' lethal finance capitalism. The Chinese have a similar need to protect their vital export sales but at the end of the century they had not responded to the Asian competition for export sales by devaluing the *yuan*.

Fareed Zakaria, who wrote about identifying national origin of surplus cash in the Palace Hotel in St. Moritz, added that one does not see any Chinese there, because China has a

non-convertible currency which prevents the capital flight that drained Russia. Free-floating capital, with no border controls, is a nice theory. It should become the norm some years in the future, some time after all nations have their structures in place to support economic freedom, and when the international community has standardized banking, stabilized currencies, deleveraged speculation, and put free-market disciplines in place.

1998: The world's most famous speculator, George Soros, warns the world with his book: *The Crisis of Global Capitalism, Open Society Endangered*.

The speculator side of George Soros became famous in 1992 when he bet on the German mark and shorted the British pound. The British government used a good part of its national piggy-bank trying to defend the pound, but was forced to give up. "Mr. Soros closed out his bet, netting his funds \$1 billion, plus another \$1 billion on related investments."

The same George Soros is also famous for recycling billions to help Eastern European countries, including his homeland, Hungary, become "open" societies. *Time* magazine reported on Soros' \$1/2 billion megagifts trying to help Russia move to an open society. "Soros who has amassed a \$5 billion personal fortune trading currencies and given \$1.5 billion to humanitarian projects worldwide, so far has only vague ideas about who gets the Russia money."

Soros has made billions from the volatility in international currencies *and* spends billions and lots of energy trying to help society. Soros, from his profound understanding, has warned the world about the dangers from the instabilities in world finance capitalism, starting with an article in the *Atlantic Monthly* in 1997, and repeated with another article and a book in 1998. Some ridiculed him as a hypocrite, some for his writing style.

Soros' dedication to an open society has been long-term and sincere. His efforts to help countries move from tyranny to freedom span the globe. His record proves that he understands the system. He should be listened to:

- An open government is the opposite to totalitarian government but can also be threatened by lack of government in selected areas and lack of social cohesion.
- Without supervision, the international financial system will not follow the supply/demand equation and return to equilibrium.
- Global capitalism as now practiced results in uneven distribution of benefits.
- The burden of taxation has shifted from capital to citizens.

- Unemployment, and other social dislocations caused by the movement to economic freedom, "increases the demands on the state to provide social insurance while reducing its ability to do so."
- Every financial crisis is preceded by an _____? expansion of credit.
- The financial risk to banks from derivatives is supposed to be eliminated by cash transfers on any difference between cost and market. In the Russian collapse, Soros observes, "Banks remained on the hook to their own clients. No way was found to offset the obligations of one bank against those of another. Many hedge funds and other speculative accounts sustained large enough losses that they had to be liquidated."
- Society needs a common ideology to sustain itself. Global capitalism reduces everything to commodities, a buy-sell equation. "The development of a global society has lagged behind the growth of a global economy. Unless the gap is closed, the global capitalist system will not survive."
- "There is no international regulatory authority for financial markets, and there is not enough international cooperation for the taxation of capital."
- Since 1971 when the dollar was floated, the single international currency in the form of convertible dollars backed by gold has been replaced with three major currencies—the dollar, the *euro* and the *yen*. They are "rubbing against each other like tectonic plates, often creating earthquakes, crashing minor currencies in the process."
- The belief in unsupervised financial markets or "market fundamentalism is today a greater threat to open society than any totalitarian ideology."
- The United States has an identity crisis: The only superpower or the moral and economic leader of the free world?
- Participatory democracy, economic freedom, regulation of financial markets, and international law are all necessary for peace and plenty.
- "The deficiencies of the political process have become much more acute since the economy has become truly global."
- "The institutions of representative democracy have become endangered, and civil virtue, once lost, is difficult to recapture."
- "In a transactional market, as distinct from a market built on relationships, morality can become an encumbrance."

- Stability cannot be done by market participants alone; preserving stability must become an objective of public policy.
- Soros told Congress on September 15, 1998, that financial markets were behaving like a wrecking ball swinging from country to country, knocking over the weaker currencies.
- Soros reminded Congress that Indonesia had dramatically improved the lives of its people but lost all of this, and more, in a few months after getting hit by the wrecking ball.
- "Both money and credit are intimately connected with issues of national sovereignty and national advantage and nations are disinclined to give up their sovereignty."

Soros' solutions all depend on moral and economic leadership by the United States. No new world order is needed, because enough international structures, are available, if the United States will only lead. Economic policy will continue to favor financial services over the general welfare as long as there is no democratic lobbying power to counteract the lobbying power of finance capitalism and as long as policy is determined by government officials whose priority is not to "upset the markets."

1999: European countries forego nationalism with a common currency for monetary stability and stronger economic growth.

A test of countries' ability to harmonize economic fundamentals was the 1999 introduction of a common currency in Europe, the *euro*. Each participant had to have its economic fundamentals within a proper range to qualify. For example, each had to control government spending in order to have its deficit under a specific percentage of its Gross Domestic Product (GDP), that is, the country's total economic output. Similar measurements apply to inflation, unemployment, and the relationship of exports and imports.

This large undertaking was predicated on the willingness of countries to forego economic nationalism, such as a currency devaluation to help export sales. It was also predicated on curtailing actions of politicians such as building a large deficit. The European plan is intended to expedite commerce and take away the volatility that the speculators live on. By eliminating this impediment, all expect to gain in an accelerating economy.

1999: Wall Street and Washington defeat efforts to regulate derivatives:

Disturbed by the collapse of LTCM, Brooksley Bonn, the Chair of the Commodities Futures Trading Commission, (CFTC) recommended that Congress study new regulation.

On November 9, 1999, the President's "working group on financial markets" issued its report recommending to Congress that it bar the CFTC from regulating derivatives. The committee included the Chairman of the Federal Reserve, the heads of the Treasury Department and the Securities and Exchange Commission, and the new head of CFTC. Ms. Bonn had resigned.

This event illustrated the confusion of government with so many agencies responsible for different aspects of the monetary system and markets. More importantly, it shows again the unwillingness to control leveraged speculation. Derivatives are defended as a way for companies to hedge their businesses against changes in interest rates and currency. This defense is limited, as it does not address the root causes of the volatility; take away the volatility and there is no reason for expensive hedging. Nor does this defense address the fact that the use of derivatives for speculation dwarfs its use as a business hedge.

Representative John Dingell (D., Michigan), the ranking Democrat on the House Commerce Committee, commented:

After six months of study, the working group has basically concluded that we should get rid of almost all regulation of these products and let

the good times roll. Proposals for the creation of totally unregulated institutional markets are dangerous follies."

Democrats frequently issue such warnings after another triumph of the Wall Street lobby. But there is never serious effort at comprehensive reform. The dominance by finance capitalism gets stronger.

Power-sharing by the left and right of the political spectrum threatens the democratic experiment. The left continues to build a wasteful collectivist government, while the right continues its support of the privileges that concentrate wealth. Each side loudly proclaims the sins of their opposite, but the play goes on, and nothing happens. Reform will happen only when public demand is applied to the corruptions on both sides of the political spectrum, simultaneously.

1999: The century's final act of domination by finance capitalism—elimination of restrictions on finance capitalism merging different services.

The Glass-Steagall Act, passed in 1933, separated banking, investment banking, and insurance. A new bill signed in late 1999 by President Clinton rescinded this law. Most of the debate in Congress had been about privacy in banking and priority lending to low- and-middle-income areas. There was little or no discussion of adding billions of dollars of potential obligations onto the taxpayers to bail out the enormous financial services corporations that this bill will encourage.

Bankers are not disciplined in their actions by free-market forces. In the United States, they are insured from loss, subsidized after failure, and bailed out after total failure. The new banking law will add substantially to the "too big to fail" rule; now it will be "the *really* too big to fail."

Confidence in the lobbying power of finance capitalism was so great that a merger of enormous size of insurance and banking companies into Citigroup was already a *fait accompli*. The bank has been receiving taxpayer subsidy for over twenty years.

Just to add a final touch of cynicism, the Secretary of the Treasury, Robert Rubin, who retired just weeks before this important new legislation was passed, was announced as the new third member of the Citigroup senior management. Rubin's move provoked a letter from a coalition including the Center for Community Change, The Association of Community Organizations for Reform Now, The Greenlining Institute, The New York Public Interest Research Group, and Ralph Nader. The letter to the Office for Government Ethics objected to Rubin's move as "turnstile behavior with an undeniable appearance of impropriety."

It is not anticipated that anything will change. The coalition fired its pop-gun at Congress; the Wall Street lobby is nuclear-armed.

January 4, 2000: "Growing Number of Companies Choose Not to Offer Dividends."

The profit motive in capitalism and the distribution of surplus are two distinct matters. In democratic capitalism the priorities for distribution of surplus are reinvestment in the business for greater growth and distribution to the shareholders in dividends. With profit sharing and opportunities for worker ownership, dividends are particularly important as a source of additional spendable income or an opportunity to reinvest for more ownership. Such a distribution would have the greatest multiplier effect on the economy and if the concept were exported to all economies, it could add spendable income on which free trade depends.

Wall Street and some CEOs have a different view. The priorities for distribution of surplus are stock buy-backs and mergers and acquisitions. Both tend to raise the price of the stock by the specific action and by the steady reduction in the supply of stock's helping to sustain the bull market.

Proponents of big dividends, however, do not have a good argument because stock buy-backs are more tax-efficient than dividends. Dividends are taxed twice, once to the corporation, once to the recipient. Why this is so? Wall Street doesn't like dividends and those who understand their potential economic and social benefit are few with small voices.

The *New York Times* article referred to reported dividend yield, that is, dividends divided by stock price, dropping from almost 6% in 1980 to 1% in 1999. There has been a great

drop, but this calculation is distorted, as it is based on the year-end bull market stock prices, not acquisition cost.

Dividends of about 6% could be used to encourage the spread of profit-sharing stock ownership plans. These plans would be further encouraged by eliminating the double taxation and capital gains taxes for low and middle-income participants. In time, dividends could be a significant part of rectifying the traditional maldistribution of wealth.

The *New York Times* accurately describes the motivation of corporate executives:

Corporate officials are far more likely than in the past to have a large part of their wealth in stock options. Stock options become more valuable as the stock price rises, but do not benefit from dividend payments.

The distinction between profit maximization and distribution of surplus receives little attention but it should. Profit maximization is primarily the responsibility of managers but the distribution of surplus of public companies should be determined by a broader constituency. Institutional investors (Chapter 13) represent a broad constituency but now favor the short term gains.

Summary and Suggestions

The foregoing are examples of how the "prodigals and projectors" are able to control the world's financial system for their benefit because governments are unwilling to tax and curtail leveraged speculation, to standardize banking practices, or punish the banks which do not control loans to hedge funds, to stabilize currency, or to allow market disciplines to monitor the process.

It was bad banking to make unsecured bank loans to LTCM in 1998, and it was also bad banking to recycle petrodollars into South America and Mexico in the 1980s with short-term, hot money, on floating-rate interest. Companies should not be allowed to fund long-term growth with short-term money, particularly with no idea of how high the cost of this money may go. Despite the lesson of the 1980s, the same mistake was repeated in Mexico in 1994, and in Asia in 1997.

Governments cannot engage in economic nationalism such as massaging the relationship of the dollar and *yen*, or introducing major changes in interest rates, without destabilizing the international monetary system. Whether a country uses a pegged, fixed, or floating rate, it assumes limited volatility.

Governments are unwilling to design a new currency-stabilizing mechanism, thus leaving financial predators in control of the world's electronic casino. Throughout history, the financial capitalists have negotiated privileges that allowed them to take an unfair slice of a growing economy. At no time in history, until now, has global finance capitalism reversed the momentum of such fragile political structures that the social damage can go

on for decades. It is a scandal that the mature economies have let the international monetary system get out of control and do this damage. The presumed leader, the United States, has in many cases led in the wrong way and even resisted reform.

At the end of the twentieth century, there seemed to be an opportunity for the world to attain peace and plenty through economic common purpose. The predatory forces inherent in the warrior state and imperialism were weakening through lack of economic logic, while the improvement in lives from economic freedom was being demonstrated around the world. This momentum was being accelerated by the natural energy of capitalism, the invisible hand's needing nothing more than reasonable freedom and a money supply that is low-cost, ample, nonvolatile, and patient.

Unfortunately, the country pivotal to the world's momentum toward economic common purpose, the United States, had serious structural flaws in its domestic monetary policy that were helping to reverse the world's momentum. The structural flaws go back to the beginning of the republic, when the mandate to control currency and credit for the general welfare was not supported with sufficient specificity to insulate monetary policy from the actions of politicians and the lobby-power of the financial oligarchy.

For more than two hundred years, these flaws had been impediments, but not severe enough to stop for long the economic momentum produced from coupling democracy and capitalism. The flaws did allow a privileged few to take a disproportionate slice of the pie and regularly resulted in recessions. Until the Crash of 1929, the economic damage did not threaten the global economy, but each time the numbers were getting bigger, and the mistakes of politicians were becoming more frequent and egregious.

During the final quarter of the twentieth century, the mistakes and the numbers had grown exponentially. In a shrinking world of interdependent economies, the damage had become global. The country that should have been providing moral and economic leadership was instead allowing its economy to be financialized. The United States seemed to be following the terminal cycle of earlier world powers with imperial overstretch and domination of the economy by finance capitalism.

Job-producing growth needs low-cost, patient capital. Leveraged speculation always gives the appearance of higher returns and pulls long-term money away from job production. It then drives up the cost of money, hurting growth. It pushes the hurdle rate up so that some job-producing projects never get started. Finally, it fosters an environment of such volatility that long-range planning becomes confused and frequently does not happen. It then funds the cycle, overtrading in artificial assets, driving the price up to the inevitable climax and crash.

Congress is Constitutionally responsible for the control of currency and credit. It could do its job with tax laws that encourage growth, such as no dividend or capital-gains taxes for long-term holdings by participants in profit-sharing and stock-purchase plans; by imposing high capital-gains taxes, starting at 60% under six months, and progressive up to ten years, to dampen speculation; by transaction taxes, imposing high margin

requirements to dampen speculation; and by requiring higher bank reserves for escalating trading devices. All together, these could eliminate the wild ride of uncontrolled speculation that inevitably result in damage to millions of innocents, without eliminating the limited service that speculation provides, that is, allowing business to hedge currency values and interest rates.

Because of the present success of the United States' economy, powered by the information-age revolution, and partly the result of mature companies cashing in future growth, the key representatives of finance capitalism, in government the Chairman of the Federal Reserve, and the Secretary of the Treasury, are almost deified, their pictures being published on the cover of *Time* magazine. If their mission is to promote finance capitalism, they are doing a good job. If their mission is to make the structural changes necessary to provide low-cost, ample, nonvolatile, patient capital for the world economy to grow on, they are failing.

Robert Rubin, Secretary of the Treasury, shied away from solutions to the volatility that would have involved harmonizing United States' fundamentals with those of other countries; he feared losing control over such political levers as interest rates. Xenophobic nationalists were ready to pounce at any evidence that the country's sovereignty might be compromised. Although President Clinton had proclaimed the obligation to reform fiscal and monetary policy in the international economy, Rubin, before his retirement in 1999, did not pursue them abroad:

Although Rubin echoed some of the President's rhetoric, calling for a new financial architecture, he dismissed out of hand Tony Blair's call for a powerful global central bank, he scorned German suggestions for coordinating leading currencies, and he squelched talk about capital and currency controls. His reforms looked a lot more like patching the plumbing than like new architecture. In Cologne, Rubin squired through a reform program that reflected Wall Street's caution: Instead of a new Bretton Woods, there was a new fund for the IMF to provide help for countries prior to a crisis, and instead of capital controls or taxes on short-term speculation, there were calls for more disclosure and banking guidelines so that investors could police themselves. The debt forgiveness for the poorest nations demanded by Jubilee 2000 became partial debt relief, to be meted out only after three years of painful adherence to IMF conditions. Enforceable labor rights were reduced to a new ILO (International Labor Organization) declaration against the worst forms of child labor.

President Clinton pushed for the WTO (World Trade Organization) meeting in Seattle in November, 1999. Clinton, accompanied by five Cabinet secretaries also appeared at the World Economic Forum in Davos, Switzerland, on January 30, 2000, to repeat his message:

We have got to reaffirm unambiguously that open markets and rules-based trade are the best engine we know to lift living standards, reduce

environmental destruction and build shared prosperity.

The President was correct and summarized it well, but his cry for a new "international financial architecture" went unheeded by his key officials.

Global capitalism is spreading wealth to hundreds of millions at the same time that it is concentrating wealth for a few in record amounts. At a time when economic freedom was improving lives and unifying people, it is particularly tragic that the excesses of a few are so visible that they are stimulating a populist revolution against global capitalism.

Many of the participants at the Davos meeting have been rewarding themselves with many millions of dollars in personal compensation. Most of them at Davos have little recognition that their compensation feeding-frenzy has a relationship to the violent protestors a few miles away's attacking a McDonald's restaurant. These demonstrators would have stormed the meeting rooms, but they were held back by police.

About two months earlier, there were roughly 1,000 NGOs (Non Government Organizations) at the WTO meeting in Seattle. Their disturbances virtually shut down the meetings. There were probably 1,000 different agendas represented with the only unifying force a distrust of the WTO, and global capitalism.

Successful free trade, spreading a sense of economic common purpose, is the only alternative to continuing world violence. This makes reform of lethal finance imperialism and broad wealth distribution urgent. The violence in Seattle and Davos should be a wake-up call for real reform or it can remain unfocused protest. Instead of reform based on the synergistic coupling of democracy and capitalism, the reform can degenerate into anarchy, that always makes the situation worse and obscures true reform.

Notably, however, one of the NGOs at Seattle, a French group, showed an understanding of the problems by promoting a "Tobin tax." This is a tax on international speculation proposed by Professor Tobin, an economics Nobel-Prize winner from Yale over twenty-five years ago. It is a win-win idea. A tax on the \$1.6 trillion traded daily on the world's electronic monetary casino, over 90% of which is speculation, would dampen speculation and provide hundreds of billions to help economies get going, and to address cross-border environmental problems.

In the United States, the democratic process should be provoking reform, but it is gridlocked. Neither the executive nor legislative branches is likely to give up the prerogatives to mismanage the monetary and fiscal policies. Most of the popular media are economically illiterate and not equipped to educate citizens about these monetary and fiscal policies.

Think tanks on the right and the left were full of brilliant people making intelligent suggestions for specific legislation, but they were not likely to make the broad structural proposals needed to democratize the monetary system. Most of the liberal Democrats do not study the monetary problems thoroughly. Paradoxically, these advocates of the

"mixed economy", where government controls the excesses of capitalism, fail to realize that most of the excesses are caused by fiscal and monetary policies that the government does control domestically, and in which it could take a leadership role, internationally. The problem is government mistakes. The problem is the wrong perception on the part of liberal reformers: *Laissez-faire* in the Adam Smith original was never intended to include finance capitalism. Finance capitalism adopted *laissez-faire* as its own, when no one was looking, and then compromised the concept by successfully lobbying for the abrogation of market disciplines.

The think tanks on the right have a better understanding of the problem, and some have had even applauded free banking. Most, however, were held hostage to finance capitalism as the prime source of their funding and spend their energy describing the pathologies of collectivism.

This, then, was the situation at the end of the twentieth century. As long as this gridlock persists, the corruptions will continue; worse, after the economic damage that follows, the left will be consistent and use economic decline as a wedge for concentrating more central power. The reality that fewer government mistakes, policies directed to broader wealth distribution, and low-cost, ample, nonvolatile, patient capital are all that is needed will be lost in the confusion. The reform agenda awaits the demand of an educated, aroused citizenry:

- Tax speculation with a Tobin tax.
- Deleverage speculation.
- Standardize international banking to control overlending of hot money.
- Reinstate market disciplines by modifying insurance, and eliminating subsidies and bailouts.
- Develop a new currency-stabilizing mechanism.
- Give priority in foreign policy to promulgation of economic common purpose through democratic capitalism.
- Recognize the new world realities and change American foreign policy from trying to be the only superpower engaging in reciprocal atrocities to a collaboration as strong team player in the United Nations.
- Align fiscal and monetary policies for broad wealth distribution.
- Redesign the government structure with information-age technology and participatory democracy.