Beyond Capitalism: An extension of the Banking Act of 1933

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Columbia University, New York, N.Y.

[This paper was written in early 1988, but remains extremely relevant today. If anything all major trends outlined above have been exacerbated since then, as we shall discuss in the update below, with extremely worrisome implications.]

The doctrine of capitalism predicates that the chief duty of the board of directors of a company is to maximize the return on shareholders' equity, and that Society ought to be so structured as to facilitate this task as much as possible. It thus behooves Society to ensure total freedom of capital circulation and speedy access to credit markets for innovators, and to keep taxes and other onus as low as possible, in order not to deprive the innovators from their reward, thereby stimulating them into making further breakthroughs. A further claim is that the wealth so created will eventually trickle down from the entrepreneurs to the general public as the economy expands. Thus, it is argued, the capitalist model is also best able to maximize the welfare of the general public. The a priori advantage of this mode of production is indeed that it maximally spurs new discoveries and minimizes the time needed to parlay these advances into useful products, while accelerating growth in the process.

But the well-known, major drawbacks of this system cannot be ignored, nor as we shall demonstrate, even tolerated. These includes pollution, as industry cuts corners to compress costs, and worker exploitation and alienation, since the human factor is merely taken into account as a cost of labor parameter to be kept in check. In return, workers feel demeaned by a system that more and more puts them in competition with machines, resent the high-handed approach of management, and frequently complain of poor working conditions. The fruits are low personnel morale and productivity, minimum interest in the job, as well as little loyalty on the part of the worker towards a company that readily lays him or her off at the slightest hint of trouble.

As capitalist companies naturally strive to squeeze their labor costs, a massive immigration of the labor intensive sectors of the economy follows, bringing about higher unemployment or lower wages in the U.S. and pervasive trade deficits. Korean, Taiwanese and Chinese currencies are still pegged to the U.S. dollar instead of being allowed to float freely because too many American corporations' profits depend on cheap Korean, Taiwanese and Chinese labor for products they market in the U.S., and they would not want to be cut from this cheap labor pool should these currencies rise too fast. At first the American consumer does indeed benefit from cheap foreign crafting, but in the end high-paying jobs depletion in the U.S. leads to less disposable income, and a high trade deficit will bring about higher interest rates, chocking off consumption. Moreover, foreign production entails a slackening of domestic R & D as the company contracting out loses touch with progress in the manufacturing process, and therefore falls behind in the knowhow required to improve the product. That expertise is conversely very quickly acquired and improved upon by the foreign manufacturer who, in due time, is in a position to import improved goods of its own making into the U.S., driving the original American company out of the business altogether. This is the reason why, for example, even though American companies Ampex and RCA invented the VCR, not a single one is still being made in the U.S. today. No wonder the U.S. R&D civilian outlays stand at only 1.6 per cent of GNP, when they represent 2.4 per cent of GNP both in Japan and Germany, according to the National Science Foundation.

But a yet more critical conceptual problem requires our attention. All too often, board members are expert technicians or cronies co-opted by management, and very often hold very little company equity themselves. Boards therefore function more like an entrenched bureaucracy in cahoots with management, carefully safeguarding their perks, rather than as representatives of shareholders. And given the nature of the system, the interest of most shareholders of public companies tend to be short-term oriented, i.e. the shareholders want to maximize their immediate profits, whereas the company needs to take a long-term approach: it takes time and risk to develop new products and truly innovate, and success is never guaranteed. But the long-term approach frequently results in stock depreciation below book value because of stiff competition in saturated or fast maturing markets and business uncertainties, with the risk of infuriating shareholders and inviting a board reshuffling via a proxy fight, lawsuits against directors or unsolicited takeover or merger offers. Indeed the average listed company historically trades at 70 per cent of book value, and the trend is bound to intensify because of unrelenting, ever emerging new competition in world markets. Boards are very cognizant of these realities, and will tend to shy away from risk, in contradiction with the spirit of the system.

To placate shareholders, boards oftentimes will embark on non-productive stock buyback programs, or grant themselves golden parachutes, outrageous compensation packages or pass “poison pill” provisions for self-protection, which invite managerial complacency. Typically, boards will choose a goal that offers a good short-term payoff and leave the tough issues for the future, as exemplified by the behavior of the major U.S. banks in the 70s. Third World lending was known to be dangerous in the long haul, but the immediate payoff in terms of a fat spread was immediate. No bank could forfeit a few years of steady profits, even if the cost might be a decade of turmoil later on, as it turned out.

Another gimmick elected by too many boards is restructuring for its own sake. Some companies seek to diversify, often acquiring businesses only remotely connected to their own, in the belief that such pairings would lead to more steady earnings and share prices, since the unrelated divisions would be unlikely to hit a slump at the same time, or that greater size might deliver more competitive clout through economies of scale. This approach has proven, by and large, a resounding failure, for a posteriori obvious reasons: too different, un-blending, uncooperative corporate cultures, excessive personnel shuffles and layoffs depressing the work force and encouraging disloyalty, costly initial prejudices and misconceptions and turf fighting. At present, the trend seems to be the breaking up of large companies, on the premise that the redistributed assets of a broken up company will be used more intelligently by their new owners, spurring overall expansion. But it is far from clear whether the broken up companies were actually inefficiently managed, as opposed to merely at the bottom of a periodic business cycle, when they were preyed upon by speculators eager to profit from a natural recovery, or whether the possible benefit outweighs the growth lost by those corporations that would rather recapitalize and incur heavy debt in the process than be acquired, or the time and energy lost by entrenched boards and managements hedging against such attempts to safeguard their sinecure. Moreover, the acquiring companies themselves often end up excessively leveraged, if only to pay a large instantaneous dividend to the acquiring private equity shop, which could mean bankruptcy if the economy softens, as it surely will. Anti-takeover bills recently passed in most states, such as New York, New Jersey and most notably Delaware lend credence to these last remarks.

Another makeshift device for embattled managements is the Leverage Buy Out (LBO), in effect striking the shareholders before they strike you. The procedure involves buying the company with debt issues, often below investment grade, and repaying the debt with company assets. For the deal to be profitable, the company has to be implicitly worth far more than the tender offer would imply, and in most cases, only management knows the real potential value of the company's assets anyway), which amounts to robbing the shareholders blind of the wealth they were not made aware of in the first place. To quote John Dingell, a Michigan democrat who heads the House Energy and Commerce Committee in the House and author of a recent study of the LBO phenomenon released by the Congressional Research Service: "Rapid growth in Leveraged Buy Outs is of concern particularly when, in the process of going private, corporate managers – supposedly the trustees of the shareholders' assets- use those assets to enrich themselves". At any rate, the emerging company, overloaded with debt and or amputated, is all too often no longer a viable candidate for growth, and the whole economy loses out, even if a few benefit. Quoting again from the Dingell report: "For every anecdote describing the efficiency of a Leveraged Buy Out restructuring, there appears to be a case in which large scale layoffs have occurred and research and development budgets reduced under the weight of debt." Again, the viability of many LBOed companies would be very questionable in case of even a minor economic slowdown. This in turn would leave billions of dollars in uncollateralized junk bonds, and could trigger a serious financial crisis through a domino effect with unpredictable consequences.

Hence yet another inescapable consequence of the definition of capitalism is relative over-indebtedness. Debt is the engine of LBOs and protects against takeovers, debt leverages equity, and by definition the system privileges equity over debt. Debt interest payments are tax-deductible and need be in a capitalist framework, lest growth be stifled. The crucial contradiction at the heart of capitalism is not the absolute pauperization of the proletariat, but the fact that in a capitalist system, equity needs to be leveraged and therefore that debt has to be more advantageous than equity. Also, in periods of expansion, the run for profits forces companies to pile on debt, hoping to repay their loans through growth and public offerings of stocks in a booming equity market, while delivering more profits. Debt is now in excess of 50 per cent of corporate equity and was still rising as of October 18, 1987. This lethally couples with yet another sinister consequence of capitalism, namely a tendency towards excessive consumer indebtedness.

Consumer spending represented 65 per cent of GNP in 1985, up from 60 in 1980. New devices have be invented every day to push the consumer to buy. No accident if the savings rate is below 4.5 per cent, an historical low, and consumer debt over 20 per cent of net income, according to the Commerce Department, making debt repayment a real burden. However, at the slightest hint of an economic slowdown or less than optimistic news than forecast, the excessive debt is enough to transform a mild turnaround into a full-fledged recession. And mild regressions are truly of their own making: as debt expands widely relative to real income growth, the lending system becomes overloaded, which entails a rise in interest rates. At first, higher rates do not hinder borrowing. Assets prices keep on rising, which helps collateralize more debt, and rates will rise further. At some point, high enough rates typically end up making fixed income instruments (bonds, CDs) very attractive relative to other asset classes, and the stock and housing markets tumble, leaving a lot of debt uncollateralized. The ensuing scramble for liquidity sends rates higher yet, bringing down the bond market, creating still even more blatant debt overexposure, sharp contractions in investment and spending, and ultimately a severe recession, if not worse, and unemployment. This pattern is repeatedly borne out historically.

The 1920s witnessed roaring growth and whopping debt increases, until the collapse of 1929. After a huge hangover in the 30s, some Keynesian spending within the framework of the New deal and World War II's massive inflationary outlays reinvigorated the economy in the mid-40s, lifting the national debt to twice GNP level. Then the cycle resumed, with rapid growth in the 50s, accompanied again by an acceleration in overall debt, followed by a severe correction in 1962. A depression was averted by the 1962 Kennedy tax cut and the liberal money policy needed to pay for the Viet-Nam War. The outcome was, however, unavoidable: break down of the international money system in place since 1944 (Bretton-Woods) in 1971, stagflation in the 70s. By the early 80s, as state and corporate debt were at relative low after the diet of the 70s, New York City's brush with bankruptcy notwithstanding, we witnessed the resumption of the growth/debt cycle until October 19, 1987. We have yet to complete this last cycle, but the prognosis is bleak as LBO fever keeps raging on, and unabated excessive indebtedness continues in all sectors of the economy.

Let us note in passing that tax reductions in and by themselves do not have a long stimulating effect on the economy, and Kennedy's or Reagan's are no exceptions. The reason is that the government needs to borrow what it forgoes collecting, thereby raising interest rates and the value of the dollar. This in turn dissuades U.S. businesses from investing in the U.S., but makes the U.S. market an easier target for foreign competition, ultimately bringing about a fall in the value off the dollar, in 1971 as in 1987 after the Plaza Accord, and sharp tax hike follow, as they most certainly will after the '88 election. No wonder overall productivity increases in the Reagan years lagged behind the already paltry 1 per cent per annum increments of the 70s, and capital spending, in constant dollars and as a proportion to GNP, will only be catching up to the 1978 level in 1988, 10 years later, according to government figures!

Independently of the growth/recession cycle outlined above, the shortsightedness typical of the capitalist system sets us up for further major problems. For example, we are presently in the middle of an oil glut. World production hovers around 47 million barrels of oil a day, 5 million more than needed. The obvious consequence is that the spot price has fallen below 15 dollars a barrel, when the average cost of extracting oil in the U.S. is in excess of 18 dollars per barrel, bringing about a depression of sorts in the oil patch, while the U.S. currently imports about 40 per cent of the oil it consumes. As the glut drags on for awhile, American oil engineers (and rigs) will be decommissioned and will soon have to move on, get new jobs and forget about the oil patch. Already, oil drilling in the U.S. is down 70 per cent from the heyday of the early 80s. But we know that, sooner or later, OPEC, which controls 67 per cent of the world's oil proven resources will be in the driver's seat again. Industry, however, is so reluctant to do anything now that oil is so cheap and advantageous, since the time table of the impending crisis is unclear, and therefore profits are not guaranteed. Developing shale oil programs would be extremely expensive (Carter had earmarked 20 billion dollars for a modest project) and payoffs too far away. Fusion energy, THE absolute answer to our energy needs, is too elusive to sell to shareholders. When the crisis hits, with its retinue of stagflation, higher unemployment and the like, the oil pundits will be caught with their pants down, as they were in 1973, and as were most stock gurus in the likewise "predictable" October '87 crash.

Hence, the capitalist system cannot escape the growth/depression cycle, or the commodities whammy, and ultimately must rely on public authorities to supply the incentive and liquidity to get out of periodic tailspins through budget deficit, monetary expansion and other devices whose major impact translates into chronic inflation, which is, in fact, a hidden tax levied on the public to fix the mess brought about by the capitalist system in the first place. Concretely, there is privatization of the profits in the good times, and socialization of the losses in hard times. And recent history is no exception: on October 20th 1987, as the equity markets were teetering on the verge of collapse, the chairman of the Federal Reserve System, Alan Greenspan, stepped forward to insure that all financial institutions that needed liquidity would get it, no questions asked, even though they may otherwise be technically bankrupt as a result of the crash the day prior, thereby running the risk of rekindling inflation to bail the speculators out, and that is unfair. In the words of Robert E. Litan, Senior Fellow at the Brookings Institution as quoted by the New York Times, "In every major crisis since the depression, the Government has stepped in to rescue the System."

Hence it appears that capitalism cannot maximize the welfare of the general public by concentrating exclusively on the welfare of the entrepreneurs and its putative "trickle down" effect. Hence corporate leaders ought not to merely focus on the interest of their shareholders, but on that of the public at large as well. This could be the proper definition of Socialism, from the latin socius, societas, companion, society. Of course the interests of shareholders and Society at large will often clash, as we have seen. Moreover, the logical, recognized defender of public interest is by definition the government, and involving the government in the day to day management of corporations has proven tricky wherever attempted. What does Uncle Sam know about the car business, or the airline business, or for that matter any business? Surely the government's role should not be dominant, otherwise how do we protect civil liberties that could be threatened by its excessive powers? State intervention in the nitty-gritty of the economy has not been so successful where it has been tried, be it through nationalizations, state planning, paternalism, “dirigism” or what have you. State ineptitude, corruption, nepotism and cronyism have meddled with the management of corporations transformed into chips for political warfare. And socialism seems very much on the way out worldwide. Even glasnost and perestroika in Russia these days implicitly recognize the superiority of the capitalist system. So?

In order to make progress, we will draw inspiration from the only fireguard that the capitalist system has been able to come up with, once the great Depression was well under way. We are alluding to the Banking Act of 1933, and more specifically its Glass-Steagall provisions which separated commercial banking from investment and securities banking, and instituted regulatory capital requirements on the part of member banks of the Federal Reserve System. The idea was, in case of a major disruption, to avoid too many bank collapses that would result in grinding financial exchanges to a halt, in the process wiping out other corporations’ and individuals’ resources on deposit with the banks, and thereby bringing down the whole economy with it as was the case in 1929 and its aftermath. In effect, the intent was to limit, if at all possible, the consequences of a major crash to the securities market and prevent it from spilling over into the real economy. Similarly, the idea behind the notion of regulatory capital was to have permanent monitoring and regulating of the financial exchanges on a day to day basis by the Fed. Member banks hold a percentage of their deposits on reserve with the Federal Reserve Banking System in non-interest-bearing deposits, the percentage depending on the magnitude and type of loans outstanding, but generally fairly small. Regulating reserves, however, allows the Fed to progressively de-leverage the financial system should the need arise, i.e. let some air out of the system before the real trouble starts. If a bank’s loans exceed its funds, it is in a net borrowed reserve position. To meet its reserve requirements, a bank can borrow from banks in a free reserve position at the Federal Funds rate, or from the Federal Reserve itself at the discount window. In return for participation in the system, the outstanding deposits with the bank get FDIC protection, while the thrifts are protected by the FSLIC, which should avert a run to the cash window in case of a major panic.

But as the present thrift crisis illustrates, the protection was illusory. Thrift institutions, lending long term and borrowing short term were bound to be caught in an interest rate squeeze as Congress deregulated rates in 1980. Because of the FSLIC protection and the minuteness of the capital requirements constantly lowered by regulators as the crisis unraveled, thrifts were able to raise as much cash as they pleased, while engaging in very risky transactions in the faint hope of recouping their losses on their carry trades gone bust. These risky deals naturally went sour and the vicious circle fed on itself. William Proxmire, the chairman of the senate Banking Committee, recently stated that as much as 20 billion dollars in public money might be needed in 1989 to avert total disaster, but this would only be a beginning. Here again the speculators profited and the public will pay.

Likewise, FDIC protection made the banks careless in their search for profit from aggressive Third World lending. They knew that if anything happened, they would be rescued at the same public expense (The so-called “too big to fail” doctrine).

FSLIC/FDIC protection bears much of the blame for the thrift/banking crisis, since it encourages laxity on the part of depositors all too eager to chase and cash in on the highest interest rate available while getting Government protection, as well as on the banks’ and thrifts’ managers part. But the real problem lies with the financial regulators, who are basically outsiders to the companies they supposedly monitor, unable or unwilling to react fast enough and make often unpalatable choices. Real protection has to come from within and must bypass the political apparatus altogether, since timely action is key to success in the domain of risk assessment & control.

Moreover, the Glass-Steagall conception of financial markets was too narrow. The recent proliferation of unregulated financial institutions (the so-called non-bank banks) have rendered the Act obsolete. Unregulated commercial transactions, in effect direct bankingfroma cash rich company or investor to a cash poor one, amount to 360 billion dollars at present and growing fast. Fifty-five per cent of the consumers’ installment debt outstanding is now held by unregulated non-bank banks or thrifts, and a whole new zoo of financial instruments and derivatives exists outside the regulated sphere, be they municipal revenue bonds, mortgage-backed securities and collateralized mortgage obligations, junk bonds, insurance policies or securitization of consumers’ receivables, whose fate would determine the course of the economy in case of a major disruption/recession. It is already not unusual for a company to own both securities and banking facilities, such as American Express, which owns 60 per cent of Shearson Lehman and the 10 billion dollars in assets Boston State Deposit Trust Co. Glass-Steagall is indeed outdated, and its demise is in the cards. Recent Federal Reserve derogations, confirmed by the Supreme Court, have already exempted some banks or their subsidiaries from a useless Glass-Steagall. The key point is that, when companies of all ilk play banks and brokerages to each other, the buck does not stop anywhere any more. There is fundamentally no difference between financial activity and any other industrial form. The effect of a major junk bond default or that of a crash of the five major New York banks could well be the same on the economy, even though banks have as yet nothing to do with junk bonds! Again, the key factor is that it is uncollateralized debt that brings about catastrophic depressions, and the collateralizer of last resort will always have to be the Federal Reserve, hence the general public. This is the exact meaning of Mr. Greenspan’s action on the morning of October 20th 1987. In case of a major depression yet to follow in the wake of the stock market crash, the WHOLE economy will have to be collateralized by the fed at public expense, not just the banking system and securities industry.

The lesson is clear: capitalism breeds over indebtedness which leads to under collateralization and liquidity crisis and recession. FDIC protection is not good enough, since the public is after all the one called upon to bail the FDIC out. If the whole economy is to be insulated by the Fed from its as yet untamed periodic bouts of depression, the whole economy is somehow to be regulated globally by the Federal

Reserve, in such a way as to award the public some share in the spoils when times are good, since all citizens will have to shoulder the burden if a major recession hits.

The following scheme would satisfy the two requirements just enounced. The Federal Reserve would require every single corporation, S-corporation, partnership and single ownership companies within the jurisdiction of the United States to maintain at all times a regulatory portion of their capital on deposit with the Federal Reserve Banking System, in effect extending to all businesses the regulatory provisions of the Banking Act of 1933. To guarantee the constitutionality of the measure, companies could elect to opt out of the new system (just like banks that operate without a federal charter) but would be subject to prohibitively heavy taxation. The companies that would take part in the regulatory system would not need to part with any stock or disburse any cash: corporations would merely issue new shares that would be purchased by the Fed, and the proceeds of the purchase or the shares themselves would then be placed on deposit with the Fed with total sterilization, i.e. no change in monetary aggregates. Single ownership companies would transform themselves into partnership with the Fed and similarly increase their at-risk capital base. In the case of new and fledgling businesses, the Fed would contribute the appropriate part of the initial capital to be reserved and would become a full partner and stakeholder upon incorporation or signature of the partnership agreement. The net effect would then amount to ownership on the part of the Fed of a percentage of the economy.

Companies would of course be free to come up with the regulatory capital themselves by raising it in the open market, but that would not constitute an advantageous practice. As the fair market value of a given company is not a fixed entity, the regulatory requirements would be updated periodically. In case of an increase in value, the firm could elect to come up with t additional deposit required or enter into a total return repurchase agreement with the Fed, under the terms of which the Fed would sell back to the firm itself its stake in the firm at the old lower price and buy it back at the higher price that reflects the higher value. The Fed would then in effect cover the required additional capital deposit. No firm would then choose to escape partnership with the Fed under this plan, and the disposition is obviously intentional, to make sure the scheme passes constitutional muster. In the case of a decrease of the fair value of the company, the capital deposit in excess of the required percentage would be made available to the ailing enterprise, which would hopefully help turn the tide. If a recovery occurs and the capital value rises again, that money or part thereof (in effect a no interest loan) would then be re-deposited with the Fed at the next periodical update. If, however, receivership is the best alternative, the totality of regulatory capital would then be made available to the unsecured creditors.

In the aggregate therefore, the practices just outlined will therefore always engender a small expansion of the money supply. Money supply growth is a necessity in times of economic upturns, and smoothes out the rough edges when the economy hits the rocks, as Keynes advocated. No extra inflation needs follow. There would merely be one more tool in the panoply that the Fed uses to monitor the money supply, namely the discount rate, level of bank reserve requirement, or the sale and purchase of government securities. But it would be a highly precise tool, contrary to the others, for it would direct the added liquidity straight to where it is needed in the economy, namely the troubled entities, without burdening them further with extra interest expense. Money supply targets may need to be adjusted slightly downward on account of this new disposition. In case of a general economic emergency, the money or securities on reserve with the Fed would automatically serve as liquidity to bail the whole system out. Note that, as we have shown, the proponents of the capitalist model do expect the Fed to ultimately flood the economy with liquidity when the going gets rough, but, under the blueprint presently discussed, they would have to pay a price in terms of lost dividends and shared management in good times.

What should that regulatory percentage of total capital be? Sixty per cent of the fair value of the company, as determined by standard accounting rules and/or the stock market appears adequate. First, because it is often the ratio of equity dilution in cases of major crashes once the dust has settled, and also because the Fed's representative on the board must have the ability to prevent the economic agents from borrowing freely against the money on deposit, otherwise the protective purpose would be defeated and major inflation would follow. An exception might be made for the first five years of startups, to ensure maximum growth. The dividends collected by the Fed (roughly 60 billion dollars are expected yearly) would be surrendered to the government and used for public policy purposes, acting as the premium of the insurance policy against a crash received by Society.

A third and most important reason for a 60 per cent stake comes from the opportunity it would afford to empower the workers decisively. Depending on the number of employees in a given company, the Fed would in effect sell back up to two-thirds of the shares of the company it would own under the scheme back to its full time workers of some seniority (let us say two years) or trade unions at a steep discount. Technically this could be achieved by issuing so-called Primes and Scores securities, backed by the original share, and selling the Primes to the workers. The Primes would carry the dividend (if any) and the voting right of the share, plus the appreciation in the value of the share over time up to a certain pre-determined rate of return. Excess return would go to the Scores. Hence the global capital of our prototype company would be thus constituted: Forty per cent in private hands, twenty per cent in Federal Reserve coffers, and Forty per cent in the company's workers' hands. Private investors and the workers would then be truly equal, with the Fed acting as a referee, not a dominant player.

Before we go on exploring the advantages of such a system, let us consider an example. Duquesne Light Co. (symbol DQU) is an electric utility in Pennsylvania trading recently at around 15 on the New York Stock Exchange. There are 73 million shares outstanding, paying a yearly dividend of 1.20 dollars each. The company employs 4,600 people. Of course, utilities are traditionally paying high dividends, and are not very representative of U.S. industry on that account (the average dividend payout is around 3 per cent at present tally), but we will se how this difficulty can be sidestepped. In the case of DQU, the Fed would buy 109.5 million newly created shares and keep the proceeds on reserve in a non-interest bearing account (so that no money actually changes hands as we noted). The grand total is now 182.5 million shares paying 48 cents in yearly dividends. Seventy-three million Primes would be offered to the workers, amounting to 15,870 shares per worker, yielding 7,617.39 dollars per annum in dividends. The shares would be priced to yield the prime rate plus 625 basis points in the case of utilities, so that the equity cost, with February 1988 data, would be 50,782,60 dollars for the worker (3.20 dollars a share, as opposed to 15 on the open market). The equity would be paid for by a mortgage collateralized by the equity itself, whose duration would be up to the individual worker him/herself, and whose rate would be below market (100 basis point below the prime rate for instance). In the case of a 10 year fixed rate loan at 7.75 per cent, the yearly payment on the part of the worker would amount to 7,344.43 dollars. In the first ten years, the worker will net 272.96 dollars annually and the full 7,617.39 dollars a year thereafter assuming no dividend rate increases. Furthermore, he/she will have 50,782.60 dollars built in the equity of the shares which would be redeemable with the Fed at retirement at then prevailing value, while procuring 15,870 votes on the board until then.

Naturally, these sharply discounted shares could not be traded openly, and could only be sold back to the Fed ad lib, at current discounted value. There would be time restrictions and fees imposed on such transactions when in-the-money, since the purpose is not to encourage worker speculation but participation in company management and long-term savings. In no case would worker outlays be superior to the dividend received by more than 500 yearly. If the company pays no dividends, there would be a moratorium on loan repayment until the company in question does start paying out a dividend, when improved results warrant such an outlay, or at the Fed's and workers-owners' behest. The price and yield of the discounted shares would be fixed depending on the growth potential of the industry a particular company is involved in. The payoff would have to be higher in low growth sectors with poor capital improvement perspectives such as electric utilities, and could be lower (i.e. shares would be less severely discounted) in high tech, high growth areas of the economy.

In the case of small businesses, the Fed would paly no role in management, and would automatically reinvest its share of the profits (if any) in the business for maximum growth. The Fed's partial ownership would nonetheless entail automatic public auditing of every company on the land on an annual basis, which would sharply limit tax fraud, a first major advantage of the reform. Tax evasion is currently estimated at 100 billion dollars per annum, no small potatoes. It would also bring millions of small farmers back from the brink of bankruptcy, by in effect re-appraising the value of their land collateral. Another advantage would be the preservation of competition, freedom of enterprise and reward for success, which is the valuable engine of capitalism. Moreover, the reform is highly democratic and reversible: should the voters change their collective mind and go back to the pure capitalist model, the Fed would redeem the workers' shares (give them their money back), and return the regulatory funds on deposit to the companies. The money could then be used to repurchase the Fed's shares automatically, resulting in a total reversal, and no damage to the economy or cash outlays on anybody's part. Other advantages of the reform would include pollution control, since The Fed would represent the public on the polluters' boards and would see to it that the standards are strictly adhered to. Labor management relationships would be greatly improved, since in effect the Fed and workers together would control management. This should bring about greater worker participation and suggestions for R&D, a higher morale and greater productivity and therefore higher profits and dividends ceteris paribus. Smooth labor management relations and collective decision making are renowned to be at the core of the Japanese Miracle, and for good reasons.

Notice in passing that Japan does not qualify, under the strict definition, as a capitalist nation. Most leading Japanese corporations are owned by institutions with close links to the government, and the Ministry of International Trade and Industry (MITI), together with the Bank of Japan and the Finance Ministry, openly regulate, and at time initiates corporate strategies. Some companies might be ordered from above to sustain heavy losses for twenty straight years in a given market in order to finally capture it, which would be unthinkable for a U.S. company to undertake. In return, MITI apportions market shares among the Japanese players in times of crisis in order to avoid fratricidal rivalries, and arranges for docile capital and stock markets. The maximum benefit of "Japan, Inc." is regarded as essential, not that of individual companies and their shareholders, and the two are obviously not deemed a priori identical by MITI, contrary to what capitalist doctrine postulates.

Moreover, under our scheme, the conflict we noted between the short term interest of most shareholders versus the long term interest of the company that is so detrimental to the unfettered capitalist setup would be resolved, since both the Fed and the workers would be long term oriented. No takeover LBO or merger could be carried out without the workers' consent, which points to greater stability, peace of mind and democracy in boardrooms. The deleterious collusion between boards and managements alluded to previously would also disappear, owing to the emergence of a strong, equity-rich, pro-labor block. Debt levels would be more easily controlled with the Fed at the source of the indebtedness as a board member, rather than as an outside after-the-fact macroscopic monitor, with the only tools of short-term interest rates and the money supply size. It should also be easier to get industry to work together on alternative energy programs, and other projects that are vital to the Nation, but whose short term profitability is uncertain. The government would also save untold billions in weapons procurement programs, since it would now have the inside story on true weapons development costs. Currently, defense contractors' after-tax margins are more than double average industry figures, 25 per cent return compared to around 10 per cent for industry as a whole. These would be among the most striking advantages of the present proposal.

An important remark is now in order. Our proposal smacks of the "wage-earners' funds" idea put forward by Meiner and Palme in Sweden in the early 80s. The idea was to use part of a company's profit to buy shares of said company in the open market, so that in due time these shares could be represented on the board of the company by the workers who, in a second phase, would be left with total control. But there are crucial differences. The "wage-earners' fund" idea is dangerous because it could entice a company to shun growth and instead make itself barely profitable to avoid such progressive takeover. Moreover, buying the shares in the open market could drive their prices to unrealistic levels which would actually work out to the advantage of the bourgeois or the speculators, not the workers'. Lastly, the workers themselves would not personally have a say in management. Rather, some "Big Brother" fund substitutes for them, a situation akin to that of the many pension funds in the U.S., effectively owned by the workers and controlling 40 per cent of the equity outstanding, but acting very much like any other capitalist entity, independently of direct labor concern and consideration. This explains why the idea actually met with lukewarm approval among Swedish workers at the time and was actually shelved. Our blueprint calls for direct worker ownership, and would actually spur growth, not inhibit it.

Two difficulties remained to be addressed, however. First of all, how does one avoid a massive depreciation of the shares trading on the open market, if they are to represent only 40 per cent of the total capitalization? In the case of Duquesne Light for instance, we noticed that the dividend would be scaled down from a current 1.20 dollar a share to 48 cents after the reform. This seems to suggest that the free market value of DQU's shares should fall to 40 per cent of current value. With DQU currently trading at 15, one could expect its value to then fall 60 per cent to 6 dollars a share. However, one should note that Japanese stocks trade at an average 75 Price Earning ratio in part because about two-thirds of the shares, owned by institutions, never trade openly. If they did, the P.E. ratio would certainly be closer to 25, high by American standards but not outlandish. Such a reevaluation effect could also be expected under the proposed reform, since the newly created shares would not be directly marketable. The difficulty will be further obviated when we consider the last leg of our reform: the replacement of the Income Tax with a Federal Value Added Tax (VAT). The tax-free nature of the dividend and the increase productivity gains resulting in higher dividend payouts will ensure that the free market value of any corporation's shares will be almost unchanged from today's, because the after-tax payout per share will be unchanged, if not higher. Note that we use the price after tax dividend ratio to establish fair share prices. History shows that it is a better guide to stock valuation than the more popular price earnings ratio that fluctuates more widely, easily manipulated by accounting mumbo-jumbo and is therefore less reliable.

The second objection is of constitutional nature. How is our reform not tantamount to unlawful deprivation of private property? The answer hinges very much on the constitutionality of the Banking Act of 1933 itself. Banks' deposits with the Fed bear no interest, and to that extent, one might argue that the provision deprives the banks of the interest they could earn on that money in the open market, to the tune of roughly two billion dollars, a sizable portion of the banking industry's overall profits. If this is a constitutional deprivation, then the one herby proposed should also be, since under our scheme the capital portion on deposit with the Fed would certainly not be technically taken away, but merely put away for regulation purposes, even though that may entail some loss of return on equity to the present shareholders.

A last question emerges from our treatment. Why would a VAT, in effect a Federal sales tax, make more sense than the income tax? For one thing, the VAT dramatically encourages savings, since it taxes consumption only. And the U.S. is in desperate need to save. Debt at all levels of the economy has grown from 3.3 trillion dollars in 1977 to 7.1 trillion in 1984, while economic growth as measured by the index of leading economic indicators was only up 15 per cent. Clearly trouble looms ahead. With the sharp slowdown in births after 1964, the U.S. will have fewer workers in the XXIst century, anf farmore retirees than today (one retiree per three workers, as opposed to one in five today). Together with the Reagan debt legacy, a major reduction in the standard of living in the U.S. is in the offing, unless saving becomes a national priority. Another advantage is the ease with which the tax would be collected, and the sharp reduction in cheating possibilities it affords, which should translate into added revenues. The tax would vary depending on the item, and on the price of the item. For example a small car selling for 5,000 dollars today might carry only an extra 500 in VAT, whereas a luxury vehicle retailing for 70,000 might be hit with an extra 70,000. Common food staples would be hit least hard, if at all, while jewelry the hardest. VAT would also be collected at the border on imports, and would rise faster than the dollar depreciates, since it rises disproportionaly faster as the price of a given product increases in dollar terms, which would bring about lower trade deficits and more stable financial markets, without any recourse to tariffs. This would also help dissuade companies from using cheap offshore labor at the expense of American labor. The VAT sliding scale rates would be so skewed that the richest 5 per cent of the population would pay at least 50 per cent of their income in total taxes, given their spending habits. It would also help raise revenues (we surmise at least 40 billion dollars annually) which could be used to more than offset the effect of the VAT on the disadvantaged through more generous welfare outlays, a more realistic definition of poverty thresholds, the creation of family allowances (one third of all children are raised in poverty) and a National Health System (NHS). The money needed to finance these programs would also come from t eh Federal Reserve's dividends receipts and capital sales to the workers program (estimated at 75 billion per annum), as well as from added revenues due to sharply reduced cheating possibilities. This alone could come to 50 billion dollars per annum. Upon addition to these monies of another 25 billion dollars skimmed off the top of the Pentagon's budget through lower weapons' costs, the abandonment of gold plating and silly projects a la Star Wars, the government would have an extra 200 billion dollars (20 per cent of the present budget) to spend on judiciously chosen social projects. Revamping the education system should head the agenda. It represents an absolute necessity if the U.S. is to have any future as a technologically advanced nation. Repairing America's foundering infrastructure (a 3 trillion dollars undertaking), child care for working mothers and fathers and increased benefits for the disadvantaged should also have priority. There would obviously have to be currency control at the border, to make sure the rich do not go spend their untaxed earnings abroad in too great numbers. Currency control would also help in the fight against drug trafficking, making it easier to track down the flows of tainted money to and from the drug producing countries. The underworld organized crime economy is rumored to be worth about 150 billion in the U.S. alone, and currency control would help uncover it. For one thing, replacing the paper currency, unmodified since 1929, would help track the 95 billion dollars in paper money, out of a total of 150 billion that never officially circulate, lost as they are in the underworld.

These proposals mark but a first step in the long journey towards genuine socialism. Much remains in terms of de-biasing our Society against minorities, African Americans, Women and Hispanics, gays and Lesbians, concerns which the above proposal does not tackle directly. Dismantling the military-industrial complex and our presently imperialistic foreign policy, increased aid for underdeveloped nations the fight against AIDS and homelessness, all these tasks awaiting a truly just order would require more detailed attention. But we nonetheless believe that the above proposal could bring about the conditions necessary for the implementation and success of real socialism.

2006 UPDATE

As already asserted, the overall picture is much grimmer today than it was 18 years ago. Not only are we in the middle of a serious oil crisis, which, as expected, the myopic inclination of the capitalist system could not parry, but hedge funds, quasi unknown 18 years ago have joined non-bank banks in vastly extending the unregulated part of the financial system. Currently, 8,000 hedge funds manage a trillion dollars in investments, mostly likely leveraged at least 5 to one, although hard facts are hard to come by on that account, which would imply that hedge funds control at least 5 trillion worth of securities, commensurate with about 10% of all outstanding traded securities worldwide. And recent history offers a hint of what could happen in a hedge funds melt down: when Long term Capital management (LTCM) and other hedge funds blew up in 98 in the aftermath of the Russian crisis, the NY Fed under Gerald Corrigan engineered the disposition of the trillion dollars in assets (that's $1,000,000,000,000) that LTCM and its busted ilk had accumulated, implicitly guaranteeing, though not explicitly that all resulting losses would be socialized. Left to its own devices, it is doubtful that the market would have absorbed such a staggering amount of securities without some defaults (and appertained domino effect like in 1929) among market participants...And hedge funds are truly no help when it comes to better policing of corporate boards: they act as the short term investor par excellence, only interested in quick bust ups and repackaging for the immediate gratification of their partners who very often must report monthly results to their fickle investors who will desert them in droves at the slightest hint of disappointment…In an incestuous dance, traditional investment banks such as Goldman Sachs have joined forces with the private equity shops and hedges funds to prey on vulnerable companies around the globe on a scale much beyond that envisaged 18 years ago, loading their preys with debt in order to pay themselves outrageous structuring fees, and putting the global economy at risk in the process. Partly in response to the latter development, boardrooms democracy is more elusive than ever, with even a modest proposal for competitive director elections on the part of the SEC generating such an outcry on Wall Street that it resulted in the ouster of the chairman of the SEC himself, the widely respected William Donaldson…And beleaguered boards have dramatically scaled up their stock repurchase programs in order to shore themselves in, a wasteful use of corporate resource indeed…Total shares outstanding in the S&P 500 fell by about four billion in 2005, according to Standard & Poor's Compustat, as a result of stock repurchases and at a cost of $325 billion to them, up from $197 billion in 2004, billions that will therefore not be invested in R&D or productive uses… And Glass-Steagall, as predicted, has been rescinded, but has not been replaced by any strengthened regulation, Sarbanes-Oxley notwithstanding, and anti-trust enforcement has been stunted, as evidenced by the thriving Microsoft monopoly, or the recent approval of a Whirpool/Maytag merger that will dominate up to 75% of appliances the market…

All the while, egregious executive compensation is racing ahead, thanks to the rampant cronyism typical of the modern undemocratic board, to wit the astounding 1.6 billion dollars in incentive granted to its chairman, William Mc Guire, by the board of UnitedHealth Group, Inc. (which comes on the heels of 142.1 million in stock options exercised by the 5 highest paid executives at UnitedHealth in 2003 and 191.5 million in 2004), at a time when 46 million Americans go without any health insurance at all and, as the Commonwealth Fund is reporting, 41 per cent of non-elderly American adults with incomes between 20,000 and 40,000 dollars a year were without health insurance for all or part of 2005, up from 28% in 2001, or the $400 million retirement package ExxonMobil awarded its ex-CEO, Lee Raymond, as gasoline is galloping way past 3 dollars per gallon at the pump in most cities in the U.S.. According to Kevin Murphy, at the Marshall School of Business at USC, the total compensation of S&P500 CEOs measured in 1996 constant dollars has almost quadrupled between 1970 and 1996, and Forbes Magazine reported that the chief executives of America's 500 biggest companies (as measured by a composite ranking of sales, profits, assets and market value) received an aggregate 54% pay raise in 2004 from the year prior, accelerating the already alarming trend. In total, America’s 500 top executives earned a healthy $5.4 billion in 2005. Reward for a job well-done? Hank McKinnell, the chief executive of drug maker Pfizer made 79 million dollars over the last five years, while the stock fell 40%...Same story for AT&T, Verizon, Wyeth and countless others…

Meanwhile, thanks in part to globalization, the median worker’s pay check is not keeping up with inflation, even as measured by the very flawed CPI index. According to the New York Times, The average hourly wage for rank-and-file workers – who make up roughly 80 per cent of the work force – has fallen by 5 cents in the last four years, to $16.49, after inflation is taken into account, reversing some of the small Clinton gains. All in all, median purchasing power is pretty much where it was 30 years ago…In fact, and quoting Stephanie Salter at creditcardsmagazine.com, life's fixed costs (housing, child care, health insurance and taxes) have jumped to represent 75% of annual middle-class income, up from 53%, over the last 20 years, (while the S&P 500 index returned in excess of 800%), and about one-third of all U.S. households categorized as low-income or middle-income are racking up credit card debt to pay for basic living expenses. U.S. savings rates have actually recently turned globally negative for the first time since the Great Depression, a poor omen indeed, whereas World Bank data indicate that household savings in India are running at a 22% annual pace and 16% in China. Chinese Business savings, up from 11% in 1990 are closing in on the 20% mark…

Furthermore, as William Bonner and Addison Wiggin point out in their recent “Empire of debt: The Rise of an Epic Financial Crisis”, and as expected in our 1988 analysis, the Fed has responded to every single crisis in the last 18 years, be it the Mexican peso crisis of 1994, the Russian default of 1998, the stock market crash of 2000, or the tragic events of 9/11 by vastly expanding the money supply, igniting what is now turning into runaway inflation. As they point out, Alan Greenspan in his tenure created more money than all Fed chairmen in History put together. Since the founding of the Fed in 1913, the dollar has lost 96.82% percent of its initial value as measured against Gold. It took the Roman Empire almost 500 years to devalue the denarius by the same amount before falling to the barbarians...This liquidity and resulting low interest rates has been used by speculators to pump up real estate value (one in three real estate purchases over the last year was for "investment" read speculation purposes, 8 in 10 in some hot markets like Miami, according to real estate consultant Lewis Goodkin) to the point that, according to a report by Shawn Tully in Fortune Magazine, in California, only one household in seven can manage the payments on the median-priced house, now selling for $561,000. It takes an income of $134,000 to afford that home, which might be a modest three-bedroom ranch in a bland subdivision. Right now the ratio of home values to incomes in the bubble zones is about 40 percent above its historical average. Housing has vaulted to 34% of total households assets at the end of 2005, compared to 24% at the start of 2000 according to Moody's. In turn, rising housing prices have supported consumer spending, thanks to the cash out refinance mortgage market that allows consumers to borrow ever more against the ever rising value of their homes, courtesy of the Fed, taking out a total of $2 trillion in such refinancing, tax-free home equity loans, and sales profits over the past five years, compensating for stagnant incomes and making up most of the recent growth in recent U.S. economic activity. This growing consumer spending, coupled with the extension of outsourcing abroad of white collar work on top with the previous exportation of blue collar jobs to the lowest cost producer in turn has resulted in historically high profits for corporate America, currently running at an unsustainable 11.6% per cent of GDP according to the Commerce Department, the highest reading in 40 years, and up from 7% a mere 14 years ago, temporarily propping up the stock market, ahead of what could well be a repeat of the crash of 1987 or 2000…

As measured by the Financial Obligations Ratios (FORs) as calculated by the Fed, the proportion of disposal income allocated to finance charges and minimum principal payments on consumer debt has risen from 22.35% at end 1982 to 28.43% at end 2005 for renters, and from 13.80% to 16.77% for homeowners, in spite of a drop of more than 1,000 basis points in interest rates in the same period. Credit card debt alone amounts to 8,000 dollars per household on average. This entails that even a minimum rise in rates will result in an explosion in consumers' FORs as the interest portion of the payment increases, all the more so since over the past two years, 75 per cent of all mortgage loans issued were either interest-only or Adjustable Rates Mortgages (ARMs). In 2006, 22 percent of $8.7 trillion in outstanding mortgages will reset at higher rates, and the proportion will be higher in future years, because of the grace period in floating rate mortgages that calls for a fixed rate initially. As these grace periods terminate, more loan rates will rise and faster. Moreover, rising interest rates will trigger an unavoidable fall in the value of the over inflated real estate collateral for most consumer debt and other debt, thereby bringing about massive under collateralization of said obligations and subsequently default on a scale never seen, given the 25.3 trillion in total U.S. bonds outstanding, public and private, precisely along the mechanism described in the 1988 paper, and with the familiar socialization of losses after private gains solution.

Delinquency rates are already rising, up 14% since early 2005 to 2.5% of all outstanding prime loans according to Shawn Tully and a total of 323,102 properties nationwide entered some stage of foreclosure in the first quarter of 2006, a 72 percent year-over-year increase from the first quarter of 2005 and a 38 percent increase from the previous quarter, according to the RealtyTrac™ U.S. Foreclosure Market Report. Such a real estate-induced crash is exactly what happened in Japan starting 1990, and it took 15 years for the Japanese economy to de-leverage itself, at a cost of almost no growth in the period and a stock market value cut to a fifth of its 1989 peak at the nadir of the crisis. However, Japan all the while retained a strongly positive balance of payments and had no need of foreign borrowers, which greatly cushioned the blow. No such luxuries would be available in a U.S. meltdown…

The U.S. economy has been able to avoid the moment of reckoning longer than foreseen in 1988, thanks to a once in a century technological innovation, namely the coupling of the Personal Computer and the Internet, which has resulted in much greater productivity in the U.S. since 1995, running 3.3% per annum on average over the last 5 years and closer to 5% in manufacturing, almost comparable to the increase of productivity witnessed in the early XIXth century with the introduction of the steam engine, or the early XXth with electricity. Recently, corporate America has been able to shed a whole layer of middle management, whose only purpose was to pass information around the company, while improving production methods in most activities, just-in-time inventory management in particular. The fact that 30% of health care spending still goes to administration of claims clearly indicates that the trend has not exhausted itself and Dale Jorgenson at Harvard University foresees another 10 years at least of productivity gains. This productivity gain has had a non-negligible human cost, however: since the current recovery began in 2002, the economy has only generated 3 million new jobs as opposed to the eight million created in the prior recovery at the same stage, and manufacturing employment is down to the lowest level since 1951. And equally obvious and already alluded to, the Internet threatens white collar jobs in the U.S. directly. A radiologist in Mumbai can read an X-ray with the same competence and in same real time as one in Los Angeles, but at a fraction of the cost…Technology has accelerated the outsourcing of much of America's manufacturing base overseas to the lowest cost producers, keeping wages low in the U.S. as already noted, and with the added consequence that the current account deficit is now passing the 700 billion dollars a year mark. Imports now command their largest share of U.S. GDP in History, according to Douglas Irwin at Dartmouth College. Manufactured goods imports amounted to 1.7 trillion dollars in 2005. Coupled with the 400 billion annual federal budget deficit courtesy of the President's foolish militarism and ill-advised tax cuts (as quoted by "The Economist", even Bush's top economic adviser, Gregory Mankiw, estimated that decreasing taxes on labor generates enough growth to recoup only about 17 cents for each lost dollar; a tax cut on capital half) the nation is now looking to borrow about 8.5% of its GDP from foreigners, about 3 billion dollars a day every day as far as the eye can see…What happens then when, not if, foreign central banks have their fill of worthless U.S. Treasury paper? All in all, traditional economists see growth, currently running at 4.8% annualized, 3.5% productivity and 1.3% labor force growth, as the only redeeming factor in an otherwise extremely worrisome picture, given these excessive levels of debt, current account and budget deficits and corporate profits that characterizes the U.S. economy today…But a growth rate that depends so much on the tender mercies of foreign creditors is not sustainable in the medium term, and disaster will ensue once they are unable or unwilling to continue financing perennial, gaping U.S. deficits…

In a recent Wall Street Journal column, Martin Feldstein, the renowned Reagan adviser and Harvard Professor is well aware that consumer spending, 70% of economic activity, will peter out as the mortgage refinance boom comes to an end and housing values fall. Already, the total inventory of homes for sale, new and existing, stands at a 3.8 million units, 70 percent higher than in 1999, as reported by Shawn Tully at Fortune Magazine, an unmistakable harbinger of softening real estate prices. Feldstein therefore advocates a deliberate decline in the value of the dollar, in order for stimulated exports to take the place of falling consumer demand, thereby avoiding a serious downturn. His argument rests on the precedent of the 1985 Plaza Accord, which engineered what turned into a 38% decline in the value of the dollar between 1985 and 1988, increasing exports by more than 40% in the process. However, Feldstein misses a few crucial points: 20 years ago, it took the market a year and a half to realize that the fall in the dollar was deliberate and would likely continue, which triggered a massive reversal in the direction of interest rates, shooting up 300 basis points between February and October of 1987, mightily contributing to the stock market crash that month. And this makes eminent sense: if the market knows that the dollar is slated for the 40% devaluation Feldstein is calling for, it will exact compensation in terms of higher interest rates, as no rational economic agent will willfully surrender such a large chunk of his or her investment standing pat. The same phenomenon happened when Brazil devalued its currency in 1999: Brazilian overnight rates shot up as high as 40%, as frightened investors needed an incentive not to flee after being fleeced. Since Brazil needed the money, it had to pay the piper, and even today short term Brazilian rates still hover around 16%, crippling badly needed growth, as the memory of the devaluation lingers in investors' elephant-like memories, in spite of a spectacular recovery of the Real, the Brazilian currency, in the past two years. In 1985, the United Sates was still a net creditor nation by a large margin. Just ten years ago, Americans owned 2 trillion dollars worth of foreign assets more than foreigners owned in American assets. Today, foreigners own a net 3 trillion dollars in U.S. assets, a stunning 5 trillion dollars reversal in ten years, and a consequence of our trade and budget deficits. And let us not forget the borrowing that will be required to bail the Medicare Trust Fund out, currently scheduled to run try in 2018, or the Social Security Trust Fund, whose demise is expected in 2040… As we already underlined, the U.S. currently needs foreigners to buy more than one trillion dollars of its securities annually to stay afloat. The United States is absorbing about 80 percent of the net flow of international capital. They will not do so unless sufficiently satisfied that the purchasing power of their U.S. holdings is going to be maintained. The second the U.S. following Feldstein's advice takes steps to trash its currency, interest rates will shoot up and stay high for years to come, precipitating the very crisis in consumer spending and real estate collateral that he is trying to avoid in the first place. As the old saying on Wall Street goes, "No nation has ever grown rich by debasing its currency." Equally important, the Asian nations that currently peg their currencies to the dollar and generate huge trade surpluses with the U.S., such as China, will not agree to let their currencies float vis-à-vis the dollar without compensation either. Furthermore, China has accumulated 900 billion of U.S. securities in the last few years, and will jealously guard the purchasing power of its treasure trove. What Feldstein is asking the Chinese to do in effect is take their 900 billion and mark them down 40% to 540 billion as the Chinese Yuan is revalued upward by that amount, taking a nice 360 billion dollars loss Yuan equivalent in the chin, and watch its exports to the U.S. dwindle correspondingly, triggering recession and unrest at home, in a repeat of the consequences of the dreadful Smoot-Hawley tariffs of the 1930's… Not bloody likely without major and painful U.S. economic and geopolitical concessions to China, if at all.

The new Fed chairman, Ben S. Bernanke, proceeds from a different, innovative and indeed homeopathic approach. By trumpeting his decision not to keep raising short term rates, even in the face of growing inflation, he is taking the bet that real estate prices will keep going up at least as fast as inflation itself, preventing the fall in real estate prices that would certainly bring about the massive defaults in under collateralized consumer loans we have already discussed. The idea is somehow to let air out of the balloon slowly, allowing for the consumer to de-leverage over time and aim for a soft credit landing. Here is how it works: the fear of inflation arising out of the fed's potential laxity is poison to bond holders, and they already have responded to his initiative by driving the yield of the 10 year treasury up from 4.40% early this year to the current 5.15%. That in turn will slow consumer spending, probably bringing on at worst a minor recession, so he hopes, which will then bring inflationary forces to bay and in turn stabilize the bond market and presto, a soft landing, with real estate value essentially unscathed. The danger obviously is that the market herd, which has no respect for a greenhorn Bernanke is going to stampede, and the Fed will lose control of inflation, as happened in the late 70s and early 80s, and a repeat of the Paul Volcker 22% feds funds rate becomes necessary, with its appertaining retinue of misery and malaise, to quote Jimmy Carter…Déjà vu all over again, socialization of the pain, privatization of the profits (POP/SOP for short). Yogi Berra for Fed chairman!

Clearly, a different economic system is needed, as the last eighteen years more than confirmed the destructive patterns inherent to the capitalist system identified in the paper.

The corrective scheme in the paper itself is essentially an extension of the banking Act of 1933. In 1933, the Fed mistakenly thought banks created the crash by tightening liquidity, so they thought regulating banks would prevent another crash. Because the problem is actually systemic and banks are just as much the victims as the perpetrators of the liquidity shortage, the first idea would therefore be to extend the Act to all economic agents and not just the banks. Unfortunately the Act by its very nature is hard to understand by the public (it is after all the topic of a full semester course in most business schools at the post-MBA level very often), and the extension advocated in 1988, although warranted, smacks probably too much of communism…

It can be argued there are simpler ways to bring the same result about: the simplest one would be a transformation of the corporate income tax into an issue of new equity to the government (secondary offering or primary private offering in the case of non-public corporations), which in turn would be passed on to the workers at subsidized prices just as in the original paper. Corporate tax loopholes would need to be eliminated so that most corporations would indeed pay taxes (which is not the case today, far from it), S-corporations and partnerships status would have to be addressed and so on but the scheme would also address the most valid criticism of the corporate income tax: it puts US corporations at a disadvantage on the global scene, as other nations' corporate tax tend to be much lower than in the US (Ireland is 12.5% for instance, vs 35% federal tax in the US, to say nothing of state and local taxes). Moreover, income and corporate taxes are notoriously prone to non-compliance and are therefore inefficient: the I.R.S. estimated last February that it lost an enormous $290 billion dollars a year because of a “voluntary compliance rate” of only 83.7%... Paying the corporate tax in stock would certainly bring about a certain dilution of existing shareholders, but would do away with its adverse effect on the competitiveness of US companies. This might be a more fruitful way to explore, rather than focusing on the Banking Act extension....The drawback of this approach, it must be noted, is that it would take longer to implement than having recourse to the Banking Act. Shares would come in over time in lieu of taxes, and it may take a generation to get to the goal posts. The Banking Act route would change the landscape overnight, as it did for federally chartered banks in 1933...

Another important modification to the 1988 framework: instead of issuing Primes to workers and the state keeping the Scores (as per the definitions in the paper), we could be a lot more aggressive and actually issue the Scores to the workers, together with the dividend right and the voting right. This would result in greater leverage benefiting the worker, at lower cost to him or her, and would address the obvious criticism that the amount of stock issued to workers would never make enough of a difference to their net income to ever be of any significance to them. Case in point, United Airlines, where the pilots owned most of the stock in the ESOP, and because their base wages were so uncharacteristically high, the extra income from the stock was just too trivial to bother. Not so if Scores are issued instead.

Let us look at an example: take XYZ Corp., whose stock trades at 100 and pays 3% dividend. The state would issue 5 yr, 10 yr, 30 yr Prime certificates redeemable at 127.6 for the 5 yr and 432 for the 30 yr (5% per annum compounded return, in line with current Treasury yields) to itself, and a Score whose strike would be 127.6 for the 5 yr and carry dividend and voting right (which current stock options do not have). The price of the 5 yr Score, subsidized, would be 10 (True Black-Scholes price could be 20 or more, depending on volatility). Therefore, for $10, which could be borrowed at favorable rates from the government, the worker (or trade unions, which would also be eligible) would essentially own all the benefits of the original share trading at 100, with its $3 dividend (30% per annum return based on purchase price, before capital gains) and the voting right, except for the price move over the next five years from 100 to 127.6 which would go to the state, to compensate the state after 5 years, but also to create an incentive to perform on the part of the workers and alignment of interest between workers and capital, which is absolutely key in this view, unlike the traditional class struggle of yore. Workers will not have to borrow as much as they would need to in order to acquire the Primes, and therefore their leverage and overall return is greatly magnified, which should make for more enthusiastic participation in the program on their part.

Moreover, this feature also addresses the major criticism leveled at German style co-management (Mitbestimmung). Under German corporate law, a Supervisory Council (AufsichtsRat) names and oversees the managerial board (Vorstand), and a 1952 law (BetrVG 1952 , revised in 2004) provides that workers in companies with an established *betriebsrat* or works council (11 per cent of German companies in practice) have a third of the seats on said AufsichtsRat. But this disposition essentially allows the other two thirds representing the shareholders to elect the Vorstand at will. Not good. To remedy this flaw in the case of large companies, a 1976 law calls for parity between workers and shareholders on the AufsichtsRat, but its president (Vorsitzer) must be a shareholder and he can cast a tie-breaking vote. Moreover, management representatives on the Supervisory Council, although allied with shareholders, are considered representatives of the workers, further diluting the rank and file. Therefore, in practice, some workers do indeed get Vorstand representation, but it is at no expense and to no financial benefit to them, and because they are generally such a small minority of most managerial boards (Volkswagen being a notable exception) they do not value their board memberships much. It is just a gimmick, as argued long ago by **Deppe. F *et al*** (1973) in their "Kritik der Mitbestimmung". Or, as the proponents of Venezuelan *Cogestión* argue, it merely makes the workers complicit in their own exploitation. Same comment applies to French ESOPs (decree of 1946 and law of 1967) which call for two workers representatives on the board (somewhat more for state-controlled companies) and share in at most 5% of capital. Not so here: workers would ultimately control 40% of the shares on a leveraged basis meant to increase their return, free market interests another 40 and the state retain 20, as originally stated in the 1988 paper. Not only would workers be strong enough for blocking minority rights, but the permanent alliance of the state representative and the workers could essentially de facto "nationalize" the company, on a temporary basis at least, while maintaining a strong private sector involvement, unlike Venezuelan *Cogestión*, which essentially refers to shared management between the workers and the state, frequently after eminent domain expropriation of private sector interests. On that account, *Cogestión* is a variation on the tired theme of state capitalism that has failed around the world.

In our model, Primes and Scores would be re-issued every 5 (10, 30) years based on market prices in perpetuity, or issued once in such a way that, upon a sale by the worker-owner, the state would get the first 5% compounded from purchase until time of sale. For instance, the worker purchases the Score for $10 on the $100 stock as above. Let us hypothesize that the company does remarkably well and the stock traded at $150 2 years later and the worker decides to sell. The government would pocket the first $10.25 in appreciation on the stock, namely 5% appreciation compounded for two years, and the worker the next $39.75, plus $6 dollars in dividends ($3 each year for two years). If the worker instead sold at $200 after 7 years, the government would get $40.71 in appreciation, while s/he would pocket the extra $59.29 and $21 in dividends over seven years, assuming no increase in dividend payments in the meanwhile, unlikely for a company doing well…This actually translates into a 46.83% annual return on the $10 investment over the 7 years investment horizon, 4 times the S&P500 average over the last 20 years, and would be tax-free to the worker as well, while the stock merely doubled, which would yield a 12.70% annual return to a normal investor paying $100 for the stock initially, collecting $3 per annum dividend and selling it at $200 after 7 years. The Score, an enhanced stock option, greatly magnified the return to the worker as intended.

In such a modified scheme, the role of the Federal Reserve would be the monitoring of the short and long term liquidity requirements, not just short-term as is the case today. It is encouraging that both Greenspan and Bernanke were talking about this very same next step a couple years ago as an alternative to current policy. Interestingly enough, in such a world, it would actually be possible to rescind the Banking Act of 1933 altogether (at least the part pertaining specifically to Banking regulations)! Such a role obviously would arise out of the need to borrow the money that would have otherwise come in through the income tax, at least temporarily until the Primes are de facto redeemed and re-issued and pay the subsidy implied in the Scores selling price... Smoothing out the whole yield curve would become imperative in such a world, together with the imperative of essentially zero inflation, since inflation would no longer be needed to sustain capitalism in this world...Instead, through the mechanism of Scores repurchase, the Fed would essentially be increasing the money supply about 2% per annum, directly into the workers' pockets and not the speculators' as with the present system, which would be easily counterbalanced with standard monetary tools to prevent inflation.

There is a third intriguing possibility, which consists in the Fed itself purchasing stock on the open market, pretty much like it does short-term securities for its overnight ops...Said purchased stock would then be split in Primes and Scores and the Scores distributed to workers as above. This would have the advantage of being quicker than a generation to bear fruit, while avoiding the communist implications of the instantaneous Banking Act extension solution, but would be complicated by the fact that only large public companies would be covered, which do not represent a majority of the workers by a very long shot. The Hong Kong monetary authorities under Donald Tsang used this policy to great benefit during the Asian crisis in order to stabilize a choppy Hang Seng Index and actually turned a considerable profit doing so, but needless to say, such a use of the federal reserve would raise eyebrows and hackles in the US...Interestingly, Greenspan was talking about the idea way back when in the Clinton era when the possibility of the federal debt being entirely retired became a possibility (these days are long gone, thanks to Bush's profligacy): which instruments would the fed use for its daily operations, if there was no Treasury debt available any more? Agency debt (Fannie and Freddie) and corporate debt were seriously envisaged, but amazingly enough corporate stock as well, which the Republican Right squelched in very short order...The same idea actually came up recently, in the context of Social Security reform, where instead of having private pension plans managing Social Security money (a recipe for disaster) the Social Security Administrative Trust (SSAT) would be allowed to buy corporate stock as opposed to being restricted to Treasury bonds only, with appertaining paltry returns, under current law. That again was torpedoed by the Right, but the Fed's reaction to the idea, not as negative as could have been expected, and clearly a dovetailing strategy between Federal Reserve and SSAT could be of great interest and benefit, (The SSAT, and not necessarily the Fed, could be the depository of the 20% share the government would keep, with 40% in workers' hands and 40% general public as before) but further research in its technical details implementation is required, given the inflationary potential of the measure. To wit, the recent experience of the Central Bank of Zimbabwe, which faced with a $200 million U.S. dollars repayment to the International Monetary Fund, decided to simply print enough local currencies to buy the U.S. dollars on the local market, unleashing an inflation spiral currently running at a 900% annual clip and wreaking havoc in the local economy. If the Fed merely printed money to buy shares, the same deleterious consequences could readily ensue, although stock purchases could certainly replace, at least partially, the bonds purchases the Fed carries out on a daily basis, in its endeavor to stabilize the monetary aggregates at their prescribed target levels. One could certainly envisage the Fed a net buyer of stocks, while a net seller of bonds, the stock purchases being in effect "sterilized" through bonds sales in the Fed's every day operations…

At any rate, any of the three mechanisms described herein, the Extension of the Banking Act, payment of corporate taxes in stock or Federal purchases of stocks on the open market will rid society of the POP/SOP cycle typical of the capitalist system, its most significant weakness, and empower workers without doing away with the innovative edge that traditional economists argue is the redeeming factor in capitalism. Further research is clearly needed in the detailed consequences or the three different schemes, as stand alone or in combination, but it is permitted to hope that a new global framework could indeed emerge within a generation that bears little resemblance with the iniquities of the present arrangement.