PROSPERITY

OPTIMAL GOVERNANCE

Banking, Capital Markets, Global Trade, Exchange Rate

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Dedicated to:

HUMANITY

PREFACE

What should be the goal of a society? It has to reflect individual desires: high incomes and low costs of all needs. The needs include food, education, healthcare, clothing, home, safety and security.

How should a society assess the fulfillment of individual desires? The current norm is the *per capita income*, deflated by the rate of inflation in the price of a standard basket of goods. But no standard basket can fulfill every individual need. The current norm cannot tell if incomes are sufficient to pay for diverse needs of various households.

If the income of a household is sufficient to cover the cost of its needs, this will be reflected in its net income or saving. Households feel *prosperous* only if they have net savings after paying for their needs from incomes over time. Net savings can fluctuate due to incomes and needs varying from year to year. Negative saving or borrowing in a year does not make a household poor if its accumulated savings are significant. The accumulated savings thus signify *prosperity* or *richness* of a household.

The accumulated savings are held in assets like home equity, stocks, bonds and bank deposits. The value of net assets is *net worth*, which is the value of assets minus liabilities. Growth in net worth is thus the only valid measure of prosperity of a household. The inflation-adjusted real income tells little about prosperity of a household.

The *social prosperity* of a democratic nation should be gauged by the per capita net worth growth of an absolute majority of households in the middle. The bottommost net worth is zero for an absolute destitute. But the topmost net worth is almost boundless. The per capita net worth of either the topmost or the bottommost absolute majority of households of a nation is thus a misleading indicator of national prosperity. The middle absolute majority representing two thirds or three fourths is important in a democracy because it can amend laws and constitution to beget its prosperity.

The long run national stability will depend on periodically measuring and broadcasting the per capita net worth growth for the absolute majority of households. Growing net worth makes households feel secure and happy. Falling net worth makes them vulnerable to unforeseen economic calamities like illnesses and injuries. Children growing in such households may simmer in anger and turn violent. Violence adversely affects social prosperity. It is important to monitor any *latent* anger due to declining household net worth. Latent social discontentment can be inferred by a negative or declining per capita net worth of the middle absolute majority of households.

Happiness or sadness of a society depends on growth in household net worth. Yet, economists have touted inflation adjusted growth in national income or *gross domestic product* as an indicator of social prosperity. Rims of data on national income and GDP growth are documented and broadcasted by public service institutions like national bureaus of labor statistics and central banks and global bodies like the World Bank and the International Monetary Fund. These data hide the truth on any declining prosperity. It is dangerous to harp on national income or GDP growth as a barometer of prosperity. It is not. Declining net worth can make households seethe under the veneer of national income or GDP growth. It can result in unexpected violence.

The national income growth is not a true indicator of social prosperity because it hides vital information about the incomes transferred from one group of households to another. Consider an example of a nation of 100 households, each earning an income of $100000, with a national annual income of $10 million in some year. Suppose that in the next year, one household makes a life-saving drug which is badly needed by the other 99 families. If the drug-maker collects $50000 from selling the drug to each of the 99 families, he earns an extra $4950000 of income. The drug-maker earns a regular income of $100000 plus $4950000 from drug sales, i.e., a total of $5.05 million. But the remaining households witness a decimated total income of $4.95 million. The total national income stays at $10 million, showing per capita income stability. The government may trumpet about drug discovery and national income stability. But 99 households have become poorer. These households may have even contributed to the discovery of the drug by working as researchers and scientists in the capitalist venture of the drug maker. The absolute majority may have supported "their" government to protect drug patents. The drug maker may control the media to broadcast the importance of governmental protection of patents to induce inventions for social prosperity. He may financially support political campaigns of legislators to protect drug patents by spreading myths that economic prosperity and social stability are possible by such protection. But underneath such propaganda lurks a devastatingly poor society.

The majority of households in a democratic society will eventually discover if they have been deprived due to self-serving shenanigans of mega capitalists and crony political patrons.[†] Youths from some deprived households can turn to violence and terrorism, even if the majority seeks peaceful policy reforms. Violence and terrorism will keep groups within such societies at loggerheads until cataclysms like the Great Depression erupt. In the wake of such depressing events, the majority of households

[†]Myopic mega capitalists and crony political sponsors permeate in most, if not all, political parties in every democratic nation. Non-democratic nations have their own mega myopic elements ruling the roost. This script is not politically motivated. But the treatise here will be incomplete without mentioning crony political sponsors of mega capitalists who bedevil human society.

will organize themselves to take over reigns of government. Once in power, they may adopt draconian policies to restore the wangled wealth back to public domain. Draconian policies are socially sub-optimal, even for mega capitalists and crony politicians. Safeguarding against recurrence of serious events like the Great Depression is in everybody's interest. Nations should strive for adopting preemptive optimal strategies for long run prosperity without degrading the environment.

Suppressing the truth about economic prosperity can eventually make a society volatile. Volatile social situations can produce events beyond the control of mega capitalists and their political patrons. The current economic growth statistics suppress the truth about any deprivation of the absolute majority. They camouflage any anger simmering within such households. Brewing anger may erupt without forewarning in the form of revolution within a society. Suppressed anger can be inferred only by the true measure of social prosperity: per capita household net worth of the absolute majority.

An absolute majority of households (voters) can rule a democratic society. Such a majority can change policies. It is crucial for them to know whether they are prospering through growth in their per capita net worth. The national income or GDP growth is meaningless for them. Democracy is a farce without common knowledge of the true measure of social prosperity.

Public institutions designated to enhance social prosperity are not performing their duties by sticking to national income or GDP growth as the barometer of prosperity. Collecting data on net worth of all households is not hard at all. Households are now required to furnish data on their assets and liabilities if tax authorities ask, even under existing laws. A new law can be enacted to mandate that government agencies collect net worth data from all households periodically.

A question arises about why households in democracies are not forcing their legislatures to enact such laws to measure and broadcast the true norms of social prosperity. There has been no mass campaign anywhere yet. Maybe households in advanced democratic societies are extremely occupied in enhancing their net worth. They may be unaware of the importance of common knowledge of the absolute majority's net worth for long run social stability. Knowledge and awareness are even more acute problems in less advanced democracies.

Democratic societies should be aware of the importance of measuring and broadcasting the true measure of social prosperity - the per capita net worth growth for the absolute majority of households. Such awareness will eventually force democratic governments to periodically measure and broadcast net worth of all households. This is the only way for a society to learn if policies should be reformed to beget optimal prosperity through democratic capitalism.

Propagating the *truth* about real social prosperity is the only way to protect the virtues of democratic capitalism from the vices of mega capitalism. Without a common knowledge of the truth, democratic capitalism can be derailed and rejected by masses. Only capitalism can induce the most talented and skilled individuals to produce their best, which is necessary for human development. Communism stifles talented and skilled individuals due to decreed equal pay for all. Most nations have, therefore, abandoned communism and embraced capitalism for advancement of their societies. But unbridled capitalism leads to autarchy in which a few mega capitalists and their political sponsors hijack the democracy. Only propagation of the *truth* can save a society from mega autarkists. Any deliberate design to suppress data on net worth of households must be foiled to protect democratic capitalism for advancement of humans.

The argument is not about what is right or wrong. It is about measuring and disseminating information on the true social prosperity. This is crucial to achieve prosperity under democratic capitalism. Dissemination of the truth is necessary for long run stability of democratic capitalistic societies in an environmentally conducive planet earth, which is necessary to produce the best from human endeavor.

Social wealth and prosperity are stored in assets owned individually and publicly. Values of such assets are determined by markets. Capital markets involve bonds, stocks and other financial securities. Commercial banks and investment banks channel individual savings for acquisition of financial and real assets and merchandise. Intriguing wealth transfer schemes prevalent in banking, financial, and exchange rate markets are addressed in the chapters that follow. Optimal public policies emerge for governance, banking, capital markets, global trade, and exchange rate. Optimality is predicated on enhancing prosperity of at least the absolute majority. Such policies are crucial to strengthen the virtues of democratic capitalism. They can be construed as the preemptive strategies needed to arrest any potential derailment of prosperity due to social and banking instability.

Specific optimal policies include the following:

- Safe banking to remove panics and regulation.
- Banning short-selling of financial securities.
- Cutting household debt of the absolute majority.
- Reducing the nominal interest rate close to zero.
- Banning patent rights.
- Instituting a form of global democracy.

Contemporary economic arguments lead to optimal policy proposals. Some proposals have already been adopted by the U.S. Congress and the Chinese government authority. But a lot remains to be done to save the virtues of democratic capitalism from the shenanigans of mega capitalists and their political sponsors.

I am beholden to my deceased father, Sadasiva Acharya, for his inspiration to search for the latent truth and to seek justice without fear. This inspiration has led me in this journey for uncovering latent truth under the veneer of mega capitalism. The path to justice presented here is *equitable democratic capitalism*.

Sankarshan Acharya

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1 SYSTEM OF GOVERNANCE

How should humans be governed? What is the wisdom gained from history? These questions need to be addressed before discussing wealth, prosperity and development.

The core human desire is to control others by aggrandizing wealth and knowledge. A wealthy feeling dawns only after crossing a threshold of richness. But such threshold levels are not uniform across all societies. It depends on information about the wealth of others in the neighborhood or beyond, depending on the vista of an individual. Human perspectives depend on flow of information within a nation and across national boundaries. For instance, people may feel wealthy only after crossing the 95^{th} percentile rank in a society. But after crossing the 95^{th} percentile, they may know more about the top five percent. Their new information may likely stretch their vista to pine for crossing the 95^{th} percentile in the top five percent, which is the 99.75^{th} percentile rank for the whole society. The human desire to become wealthy is thus unending.

Cultivating human dreams to become wealthy can make a society pursue for baser instincts like killing others through war. Knowledge and wisdom enhanced through research can redirect human energies from baser pursuits.

The propensity to acquire wealth and power is common to humans and animals. Wild mammals like gorillas live in jungle habitats. Gorilla leaders risk their lives to defend their habitats against aggression from other jungle gorilla leaders. A gorilla leader's incentive to fight comes from the lust to control followers in his habitat and to conquer other habitats. Wealth of a gorilla leader in a jungle habitat simply comprises foodstuff and labors of other animals under his control.

1.1 LEADERS AND SOCIETY

Human habitats take the form of organized communities, kingdoms or countries. Human leaders assume roles similar to their jungle counterparts, motivated by instincts to acquire wealth and power for their habitats. Superior intelligence and technology have led humans to create defense systems. Human leaders control such systems and motivate others to sacrifice lives to make their national habitats wealthy and powerful. Individuals willing to sacrifice their lives for national security are appointed as soldiers. The leader or commanders-in-chief of a nation is responsible to imbibe nationalistic spirits in soldiers to make them defend their nation against attacks by other nations.

The baser lust for wealth and power ultimately remains common to humans and animals. Superior intelligence has led humans to devise more sophisticated means than animals can to expand spheres of influence for aggrandizement. But the baser human lust has remained similar to instincts of jungle animals. By deploying fifty-thousand nuclear warheads to intimidate and kill each other, human leaders have not become wiser than animals by any stretch of imagination.

Incipient human habitats consisted of only homogeneous individuals. In a comparatively virgin Afghanistan, for example, a habitat was used to be and still is a fiefdom. Each fiefdom comprises a few villages with people communicating in the same dialect and owing their allegiance to a tribal leader with a small army of soldiers willing to die in order to defend their fiefdom.

In the ancient times, human habitats were small in size but numerous. For example, India had many kingdoms with subjects that paid taxes to the kings and were conscripted as soldiers to defend their territories or conquest new places. The Europeans lived in the past and continue to live now in relatively small territories marked by common languages.

In the very early days of their existence, humans within a habitat formed a narrow perception of homogeneity of the inhabitants. For example, people having common beliefs or skin color or dialect of communication or habits could remain within a habitat.

1.2 KNOWLEDGE AND POWER

The principal difference between humans and animals is the cerebral ability of the former to think and analyze facts. The human analytical ability has led to discoveries of many truths about natural phenomena. This has resulted in a reservoir of human knowledge called science: a collection of discoveries including the methods of such discoveries. This human knowledge reservoir is dynamically expanding as new discoveries are made.

In course of time, science has helped humans in one habitat to believe that they have inherent similarities with others living in a different habitat. Such knowledge has profoundly altered human perceptions about one another across habitats. It has brought different habitats together under a bigger banner called a country or a kingdom with a common leader called king, president or prime minister.

While human leaders pursued to expand wealth and power by bringing more and more habitats under their control, they have also devoted their resources to advance human knowledge. The ability to seek and acquire knowledge has made humans very different from animals. In the course of human history, the depth and breadth of their knowledge has made one group of humans more powerful and wealthy than other groups.

Humans were confined to their own countries due to immigration restrictions and inadequate transportation facilities. The available knowledge within a country then defined the level of its advancement. For example, the knowledge on agriculture had once made India one of the most advanced human habitats in the pre-industrial era, contributing to an estimated 17-21% of global output. India missed the industrial revolution. It now contributes about 1.7% to global output. It has been left far behind industrially developed societies, which tend to restrict new technologies to their boundaries. Table 1.1 compares the three most populous countries. The numbers in percent are their shares of the world GDP, trade, exports and imports. The GDP-PPP is based on purchase power parity. China is catching up the U.S. Populations of India and China may be currently contributing to their economic weakness.

Table 1.1
Rising Competitors of the U.S.
(Data are from World Bank)

2004	USA		CHINA		INDIA	
GDP	$11667b	28.5%	$1649b	4.0%	$691b	1.7%
GDP-PPP	$11628b	20.8%	$7123b	12.7%	$3362b	6.0%
Population	294m	4.6%	1297m	20.4%	1080m	17.0%
Merchandize Exports	$819b	9.0%	$593b	6.5%	$73b	0.8%
Merchandise Imports	$1526b	16.1%	$561b	5.9%	$95b	1.0%
Services Exports	$319b	15.2%	$60b	2.8%	$32b	1.5%
Services Imports	$259b	12.4%	$70b	3.3%	$38b	$1.8%

1.3 IMMIGRATION AND PROSPERITY

Humans inherently relish personal independence and self-advancement. This is despite willingness of many to promote warfare to secure their countries. Expansion of human knowledge and skills has resulted in new means of transportation over land, air and sea. This has made curious Europeans to explore new territories like America and India. In the very incipient stages of exploration, humans fought their way through new territories or were welcomed as visitors. Subsequently, refined systems like passports and visas were instituted to make humans cross national boarders.

Many individuals look for greener pastures and reach countries which offer greater freedom for acquisition of wealth and knowledge. Others may be unable to leave their nation. National spirit may induce some to not leave their country. Many may not like to emigrate if they are already satisfied with their knowledge and wealth within their nation. For many, the desire for knowledge and prosperity may be so acute that they seek emigration to greener pastures.

An individual will accept an opportunity to emigrate only if his enhanced prosperity due to emigration is greater than the utility of staying in own country. This truth has led leaders of some nations to enhance wealth and power of their territories by luring talents from other lands to immigrate. Immigration dilutes homogeneity of the populace within a country. But immigrants with greater talents than the available pool can enrich a country. The optimal policy on immigration is dictated by a trade off between a homogeneous population and enhancement of wealth and power through foreign talents. Most nations have debated and others continue to analyze such tradeoffs. But the American leaders have welcomed talented immigrants to enhance wealth and power of their nation. They have succeeded by adopting a coherent system of governance to guarantee the highest degree of individual freedom and material success. This sagacious policy has sustained the inflow of human brains and financial capitals to the U.S.

The American leaders have established a self-improving system of institutions. The objective is to develop and enforce fair rules to foster liberty and offer incentives to individuals seeking to advance knowledge and prosperity. Immigrants continue to flock to USA, winning about 32 per cent of all the Nobel prizes in physics, 31 per cent each in medicine and economics, and 20 per cent in chemistry. The American Association for the Advancement of Science has recently said, "The best and brightest come here because there has been a tremendous research establishment built up in this country." A wave of foreign scientists from Europe came from Nazi Germany or from occupied lands. Einstein and Enrico Fermi fled to the U.S. after the rise of Nazism and anti-Semitism. Immigrants who became Nobel laureates as American citizens or for their work in USA have come from several countries, including Switzerland, Mexico, South Korea, Austria, Germany, Hungary, Poland Canada, India, China, Britain and Australia. The number of foreign-born Nobel Prize winners is all the more striking since, as the National Research Council says, the foreign-born population in the US was just eight percent in 1990. About 23 percent of those earning science and engineering doctorates in the U.S. are born overseas.

1.4 MARKET SYSTEM TO REWARD CREATIVITY

The U.S. government does not generally assume a direct role in doling out incentives to citizens in order to encourage them to create human knowledge. It has rather fostered a market mechanism that rewards individuals to generate valuable knowledge to enhance prosperity. For example, markets raise the values of scientists and laboratories involved in discoveries of life-saving drugs as soon as new useful discoveries are made.

Rewards may include pecuniary salary raises and bonuses or non-pecuniary promotions to leadership positions.

The U.S. is now the only peerless superpower on earth. It is due to wisdom of its visionary leaders to realize the following:

- Protecting individual liberty attracts talented immigrants.
- Efficient, self-correcting markets can reward talents.
- Continual reforms are vital to retain human talents.

Despite human talents, a country like India has remained poor. It is due to a system of governance, which stifles creativity and promotes emigration of some of its most productive citizens.

1.5 DEBT DRIVEN PROSPERITY

The U.S. has witnessed phenomenal growth in its annual gross domestic product (GDP) of about $12 trillion. Yet, households have piled up $11 trillion in debt. This is in addition to the federal government debt of $8 trillion. About $1.7 trillion of this debt is owed to the developing world. The rest is the credit granted by mega capitalists. The U.S. is also facing massive trade imbalance with imports exceeding exports by $700 billion annually.

Economic liberty is thus being held hostage to massive debt. The U.S. wealth disparity is portentous:

❖ Annual addition of 3000 households with $20 plus million in net assets.

❖ Ninety-percent of households have no net-savings.

❖ Many have negative net assets, despite bubbly home equity values.

Figure 1.1
U.S. National Debt (1940-2004)

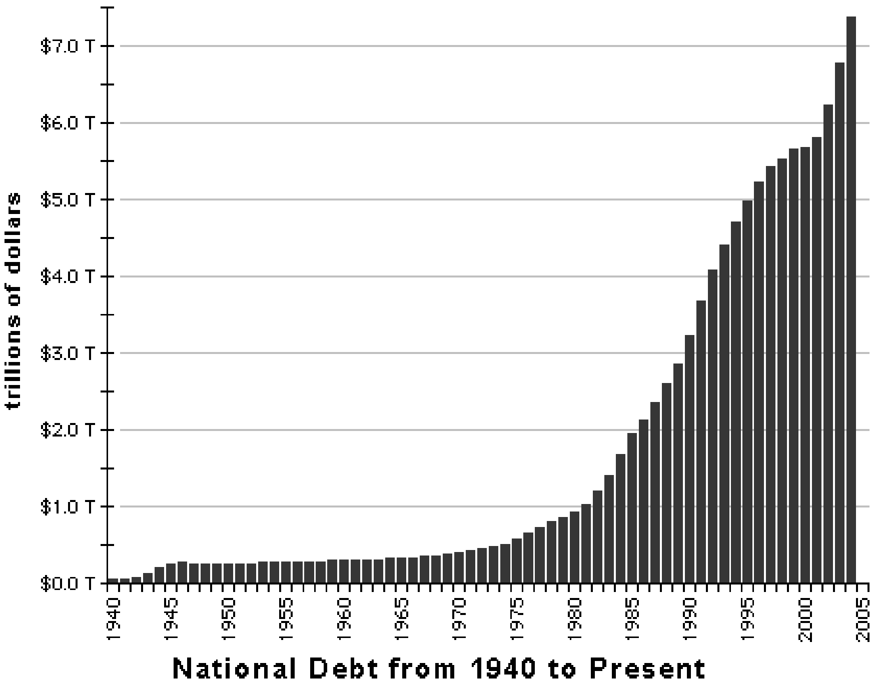


Figure 1.1 captures the dramatic rise in the U.S. national debt. Even the inflation-adjusted national debt, presented in Figure 1.2, is rising steeply. These figures do not still include the astronomical sums borrowed by households and corporations.

Figure 1.3 shows aggregate national saving. It is based on the U.S. national income account. The national saving is the private saving in the economy less the government budget deficit. It is also equal to the domestic investment less any borrowing from abroad. The borrowing from abroad is equal to the national current account deficit. All domestic investments are financed by national savings and funds borrowed abroad. The net U.S. national saving is 14% of the GDP. This figure is not alarming by any means. But what it suppresses may be disconcerting. It does not show whether the absolute majority is saving at all.

Figure 1.2
U.S. National Debt Adjusted for Inflation (1940-2004)

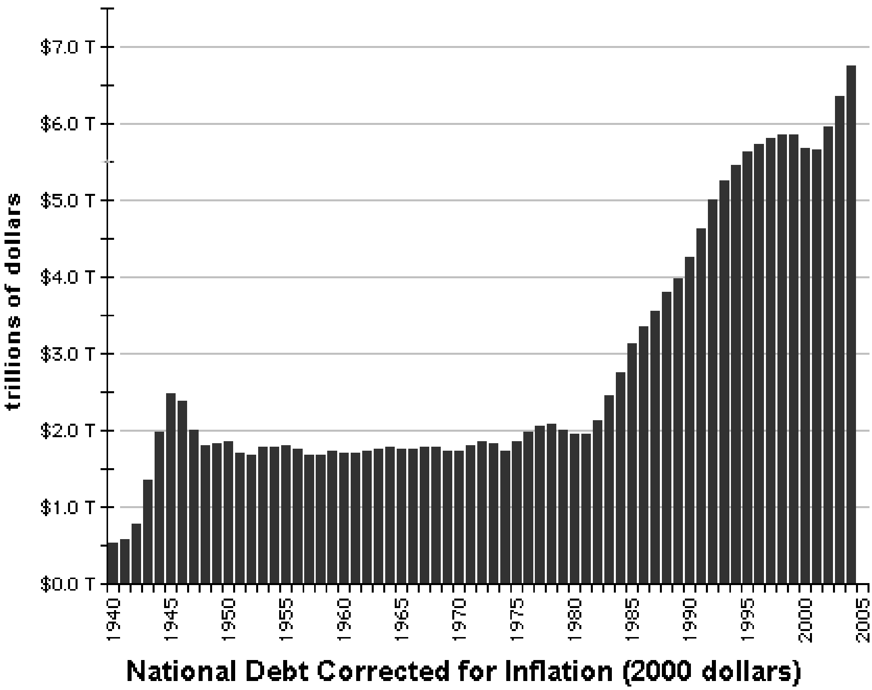
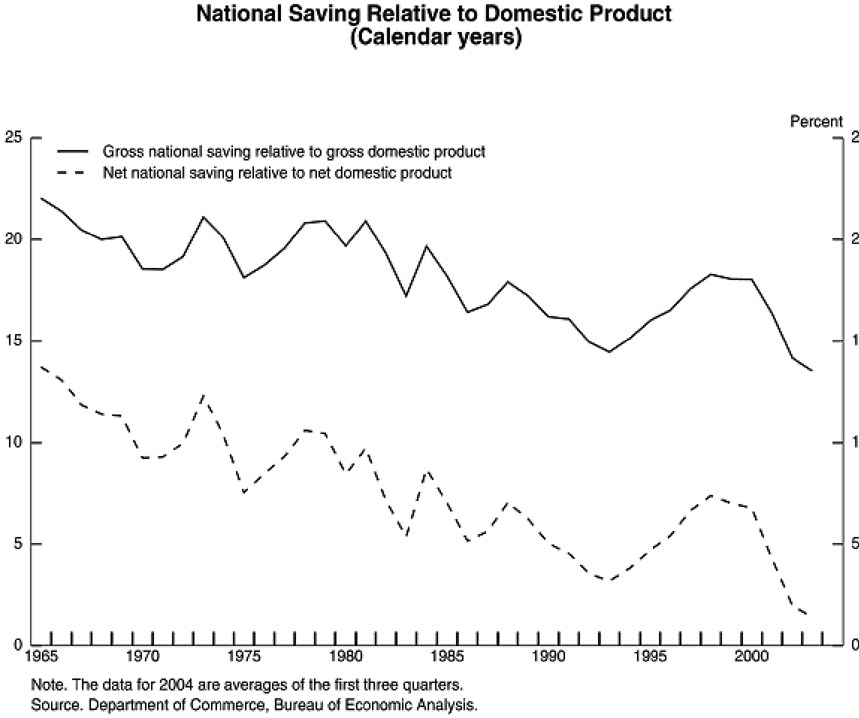


Figure 1.3



A wider wealth disparity can result in banking instability, frustration, violence, and social tension. China and India are now witnessing unprecedented animosity between haves and have-nots. While China suppresses social tension by brute force, India leaves it to chaos. USA follows rules of law to make it the largest per capita jailing nation in the world. Social disenchantment is negatively related to national GDP growth. Jailing is perhaps optimal to maintain national GDP growth. But this growth does not necessarily enhance prosperity of the absolute majority. During 1990's the U.S. economy grew astoundingly. The U.S.

economy has not shrunk even during 2000-2004. But the absolute majority's household wealth has perhaps plummeted badly. This may have contributed to increases in American jail populations. The issue of banking instability is discoursed later.

Table 1.2
Growth in U.S. Debt in Billions of Dollars
(Source: Federal Reserve Board)

YEAR	HOUSEHOLD	DOMESTIC NON-FINANCIAL (1)	DOMESTIC FINANCIAL (2)	TOTAL (1)+(2)
1972	560	1714	163	1877
2000	7009	18101	8237	26338
2001	7630	19216	9128	28344
2002	8365	20537	9963	30500
2003	9232	22237	10978	33035
2004	10276	24170	11794	35964
2005	10515	24773	11935	36708

Tables 1.2, 1.3, and 1.4 are based on *Flow of Funds Accounts of the United States,* published by the Board of Governors (BOG) of the Federal Reserve System, Washington DC 20551. The BOG does not collect data on all households. Data for this sector, according to BOG, "are largely residuals and are derived from

data for other sectors. " Households include consumers. Data on consumer credits, according to BOG, "are estimated directly." The figures for 2005 are annualized representation of the first quarter 2005 estimates.

Table 1.3
Growth in GDP and Income in Billions of Dollars
(Source Federal Reserve Board)

	2000	2001	2002	2003	2004	2005
National Income	8795	8980	9226	9680	10340	10887
Private Consumption of Fixed Capital	991	1076	1093	1136	1178	1168
Government of Fixed Capital	197	206	211	218	229	240
Net U.S. Income Receipts from Rest of the World	39	44	27	55	44	33
Gross Domestic Product	9897	10128	10487	11004	11735	12192

Table 1.2 shows phenomenal growth in total U.S. debt from $1877 billion in 1972 to $36708 billion in 2005. It is 9.01% per year, compounded annually. This rate has slowed to 6.63% between 2000 2005. This is nearly 60 higher than the growth of 4.17% in GDP and 4.27% in income during the same period, based on figures in Table 1.3. During 2000-2005, the total debt grew by $10370 billion. The average annual growth in debt during this period is $2074 billion. The GDP grew by $2295 billion and the GNP by $2092 billion during the same period. The average annual growth in debt has been roughly equal to the GDP or income growth. Other studies show that the income of the vast majority of households on salaries and wages has not been rising. The growth in national income occurs only for a tiny fringe. This fringe has been storing its increased income almost entirely as new lending to indebted households and governments (federal, state and local).

The U.S. now has 37 million people below poverty level and 45.8 million with no health insurance. The productivity of U.S. workers rose 75% since early 1970's. But their real wages have remained stagnant. The extra hours of their work from home and as consultants are not factored in calculation of productivity. The absolute majority is toiling harder for the same income over three decades. Costs of its existence have escalated.

The phenomenal GDP growth due to productivity of the absolute majority has basically accrued to a small fringe of mega capitalists. Many households have lost all their savings. Others count their prosperity based on bubbled up home prices. They fear that their incomes may be lost to outsourcing of jobs to other countries. Few million jobs have been wiped out during the last few years. Medical costs are soaring. The oil and energy prices are rising uncontrollably. Trade deficits are at record levels and rising. The government is on imperial missions to control other societies. Uncertainties abound. These developments may someday scare the vast majority of Americans to rise and agitate.

Table 1.4
U.S. Borrowing and Lending in Billions of dollars
(Source Federal Reserve Board)

BORROWERS	2000	2001	2002	2003	2004	2005
Household	599	773	807	690	951	1078
Business	533	386	162	304	389	518
Government	-304	-14	371	477	395	744
LENDERS						
Domestic	643	790	923	917	996	1505
Foreign	185	355	417	554	716	835
Borrowing = Lending	**828**	**1145**	**1340**	**1471**	**1735**	**2340**

Business executives eliminate jobs of subordinates to rehire the fired as consultants for significantly lower wages. They usurp the savings as bonus, raises and perquisites. This enhances their wealth at a cost to the absolute majority. The absolute majority has forfeited significant parts of its income due to the power of mega capitalism. Wages have been less than optimal. The part of the forfeited wages is gone as usurious profits to mega capitalists. Mega capitalists' self-enrichment strategies include the following:

- Cut employee wages by presenting credible threats about outsourcing jobs.

- Amplify public fear of insecurity through media that runs at the behest of mega capitalists.

- Keep the absolute majority disorganized and uninformed about the truth on their decaying prosperity.

- Spread myth about the national GDP growth, measured by a system originally instituted by mega capitalists.

Due to these factors, a significant portion of the optimal value of labor of the absolute majority has gone to mega capitalists in the form of usurious profit. The accumulated usurious profit or the saving of mega capitalists is stored as credits to households and government. The absolute majority also owes a part of the government debt. It is thus bonded, perpetually. The perpetual stream of interest income on savings of mega capitalists is indeed equivalent to the forfeited part of optimal income of the absolute majority.

Mega capitalism has outsmarted the absolute majority, including the government regulators. Mega capitalists' insatiable avarice for wealth and power has rendered *regulation* virtually impotent.

Mega defense contractors had once crafted a virtual Soviet ghost to make the government borrow trillions of dollars during 1980's to sell their exorbitantly priced defense gizmos. The U.S. has effectively mortgaged its future revenues for debt owed to mega capitalists. Mega capitalism is thriving on public's fear of insecurity in the wake of the recent terrorist attacks.

Government officials and endowed politicians willy-nilly support mega capitalism. Global terrorism has now offered mega capitalism new opportunities to create deeper economic bondage of the absolute majority to usurp more public wealth by furtively amplifying pervasive fear.

The greatest enemy of prosperity of the absolute majority in any nation is surreptitious mega capitalism. It is designed to usurp public wealth though tacit collusion with the government. It is through economic bondage of the public. It is forfeiture of a significant part of optimal wage and salary of the absolute majority. Mega capitalism may vary from country to country and over time. But it has one ulterior objective. It is domination of the absolute majority through economic, if not physical, bondage.

1.6 OPTIMAL GOVERNANCE FOR PROSPERITY

The indebted absolute majority will eventually discover the truth that its borrowing is almost equal to the mega capitalists' surplus which stems from sub-optimal wages. Mega capitalism will then unravel, as the usuriously generated credits pile up. The indebted majority will then form its own government to collect optimally higher taxes from mega capitalists and to *demonetize* debt. Demonetizing is a way to force mega lenders to accept default by decree. It will make them recover less than the sum they have lent. For example, Microsoft has amassed about US$50 billion of net profit during the last two decades of its existence. This accumulated profit has been invested mostly in government insured banks and U.S. Treasury securities. Demonetizing debt by fifty percent will result in Microsoft accepting only half of its lending to the U.S. Treasury. It is a government engineered default. In fact, a smart company like Microsoft might have anticipated such a potential outcome before paying off a large portion of its U.S. Treasury holdings as dividends.

For lenders, cutting rates of interest on household debt, preemptively, is better than engineered default. Catastrophes like the Great Depression can be averted if sub-optimal wages are redeemed to the indebted households as interest rate cuts on their debts.

The above argument is not about fairness. It is optimal for the indebted absolute majority with democratic power. It will avert a potentially looming threat to democratic capitalism. Even mega capitalists face danger to their prosperity. The current process of accumulation of usurious profits through sub-optimal wages to the absolute majority cannot be sustained. If the real estate bubble bursts, unprecedented defaults on household debt will follow. The mega capitalists will then need banks and courts to confiscate defaulting household assets to recoup unpaid debts. But they cannot succeed if the indebted majority unites to change the rules of governance and banking. Most likely the indebted majority will follow this course. It is, therefore, optimal for the society and even for the mega capitalists to cut interest rates on household credit, preemptively. This policy will avert deadweight losses to all.

2 SYSTEM OF COMMERCE

Free market capitalism is based on self-interested entrepreneurs, who are engaged in profitable economic enterprises. Self-interest is the motivating force of a capitalistic economy. Self-interest is driven by the motive to generate profits based on expectations. The expectation of an entrepreneur is to earn a higher return after meeting all expenses in a venture than the opportunity costs of his capital. The *opportunity cost* is the best rate of return that a capitalist can earn from alternative investment opportunities. This is the minimum he expects to earn from an investment venture. For example, an entrepreneur wishing to start a new steel plant could alternatively employ his capital in a portfolio of stocks of existing steel plants or simply invest his funds in a commercial bank. The best expected rate of return from all such alternative investments is the opportunity cost of capital for starting a new steel plant. The expected net rate of return from investment in a new steel plant must exceed this opportunity cost of capital. The entrepreneur will decide to invest in a new steel plant only if he expects to earn more than his opportunity cost of capital.

Only if entrepreneurs expect to earn their opportunity costs of capital will they deploy capital in enterprises to create employment. Any capital investment venture that is not expected to generate a rate of return equal to at least the opportunity cost will not be undertaken. Since social prosperity is enhanced by new employment, governments acting in public interest offer capitalists various incentives to induce investments in economic ventures.

2.1 CENTRAL BANK AND BUSINESS PROFITABILITY

Observe that an entrepreneur can also borrow funds from a bank by paying a sufficiently higher interest rate than that the cost of funds deposited in the bank. The *cost of funds* is a rate of interest paid on bank deposits. The difference between the rate at which a bank lends and the rate it pays on deposits is the *spread.* Spread earned by a bank goes towards the cost of operation and profits of the bank. Banks accept deposits from individuals with net savings. Every individual in an economy may have residual funds after consumption of a part of his income. These residual funds can be invested in a business or deposited in a bank.

In addition to accepting deposits from net savers, banks can also borrow from the *central bank* or reserve bank of an economy. The government of a society or nation owns its central bank. There is one central bank in each nation. The government raises taxes from individuals of society. Some of these taxes are used to fund the central bank. Individuals of a society thus collectively fund their central bank. The central bank can set a rule that commercial banks in the economy maintain certain portion of their funds as *reserves* that cannot be lent. The borrowing and lending between commercial banks and the central bank is done at the same rate of interest called the *central bank rate.* Usually, commercial banks offer this rate of interest or a slightly lower rate on deposits of net savers. Commercial banks thus borrow from net savers and from the central bank at the lowest possible rate in the economy. The effective rate at which commercial borrow is their *cost of funds.* Commercial banks lend to entrepreneurs and other borrowers at higher *lending rates* than cost of funds. Lending rates are pegged to the *prime lending rate* of an economy.

For simplicity, assume that all commercial banks in an economy have one prime lending rate and call this rate the *cost of borrowed capital* to focus on how capitalism leads to economic growth and creation of virtual prosperity.

The observed or published central bank rates and prime lending rates are nominal. The nominal central bank rate, simply called the *nominal rate* of the economy, is equal to the *rate of inflation* plus the *real interest rate*. The *nominal prime lending rate* of an economy is equal to the nominal rate plus the spread earned by commercial banks. The *real rate* of interest is generally equal to zero in long run equilibrium of a well managed economy.

Inflation is measured as the rate of appreciation in the prices of a representative basket goods and services used in a nation. Inflation rate is specific to a nation because prices are expressed in terms of the currencies of the nation. The bureau of statistics of a nation periodically measures any appreciation in the price of a basket of goods and services, most commonly used by consumers. This price appreciation is the economy's inflation rate.

If the nominal rate is equal to the inflation rate, the real interest rate of the economy is zero. If the total value of all economic activities in a nation increases at a rate greater than the inflation rate, the national economy is said to have grown in real terms.

Marginally unprofitable businesses can become profitable if their effective costs of capital can be lowered. Similarly, marginally profitable businesses can be unprofitable if their effective costs of capital can be raised. The effective cost of capital of a business is equal to the spread plus the nominal rate set by the central bank of an economy. The spread in a competitive banking industry does not fluctuate much. But the nominal rate of an economy can be changed by the central bank. By lowering the nominal rate, a central bank can make marginal businesses profitable. Similarly, by raising the nominal rate, a central bank can make marginal businesses unprofitable.

Suppose that the real interest rate of an economy is zero. This will happen when the interest rate on deposits of net savers at commercial banks and the nominal rate (central bank rate) are both equal to the inflation rate. Commercial banks will still charge borrowers a spread or premium over cost of funds. The spread comprises two parts: (i) risk premium to cover unforeseen losses due to the risk of borrowers and (ii) a rate to cover the regular cost of commercial bank operation. The second part of spread depends on the efficiency of operation of banks and the level of competition in the banking industry. In a competitive banking industry, as in USA, the second part of spread can be assumed to be constant, about 2.75-3.00% in equilibrium. In competitive equilibrium, less efficient banks either perish or are acquired by the more efficient ones. Commercial banks generally set their prime lending rates equal to the nominal rate plus the second part of the spread. They offer loans at this rate to their prime customers. In a competitive banking industry the prime lending rate of most banks is the same. Commercial banks lend a risky borrower at a rate of interest equal to the prime lending rate plus a risk premium consistent with its risk level. Lenders conduct research to set premiums corresponding to risks.

2.2 CAPITAL AND ECONOMIC GROWTH

Owners of capital are called capitalists. Capitals can grow only when capitalists earn greater residual rates of return on investments in new businesses than their opportunity costs of capital. Residual rates of returns are calculated from profits after all expenses including wages, raw materials, actual depreciation in plant and machinery, marketing and selling of products, interests on debts and income taxes. If capitalists do not expect to earn higher residual rates of returns than their opportunity costs of capital, they will not invest in new real ventures. Then new jobs cannot be created. Creation of jobs is thus crucially linked to economic environments that support earnings of higher residual rates of returns than opportunity costs of capitals. Employment cannot grow without capital growth.

Generally an entrepreneur must invest enough of his own capital (called *equity*) in order to borrow the rest (called *debt*) needed to finance his business. Commercial bank lenders often impose *debt covenants* that stipulate maintenance of a minimum equity-to-debt ratio in a business enterprise. Commercial bank lenders monitor *equity-to-debt* ratios of their business borrowers. Lower *equity-to-debt ratios* signify greater risks to lenders. Lending risk stems from the probability of non-repayment of the amount borrowed. Banks often stipulate within the covenants to increase their rates of interest on outstanding loans, should equity-to-debt ratios of borrowers decline in time.

Banks in practice set lending rates equal to economy's prime rate plus risk premiums appropriate for risks of borrowers. If an entrepreneur borrows some funds to operate his business, the *effective opportunity cost of capital* is a blend of the cost of borrowed capital (interest paid to lenders) and the cost of equity capital (foregone interest on own capital). To be profitable, a business must earn its effective opportunity cost of capital.

If all capitalistic entrepreneurs generate higher rates of return on their businesses than their effective opportunity costs of capital, the economy's total quantum of capital will increase at a rate greater than the nominal rate. If no entrepreneur has some investment opportunity to generate a rate of return larger than his opportunity cost of capital, then the capital level of economy will stand still, i.e., not grow.

An Example of capital growth: Suppose that at the beginning of year 2003 in an economy, the total net savings deposited in commercial banks is \$50 and some entrepreneurs have another \$50 as their accumulated profits. The entrepreneurs could either deposit their accumulated profits in banks or invest in businesses. Assume that the commercial bank prime lending rate is 4% per year, the real rate of interest is zero, the central bank rate or nominal rate of the economy is 1.25%, and the rate of interest on bank deposits equals the nominal rate of 1.25% per year, yielding a spread of 2.75% towards bank operation.

Entrepreneurs can use $50 of their own equity and borrow $50 from banks to invest in businesses. If entrepreneurs simply deposit their money in banks and choose not to invest in businesses, they will earn 1.25% per year. In this case, the total funds in the savings will grow to $101.25 by the end of a year, because the rate of interest on the total deposit of $100 is equal to the nominal rate of 1.25%. Since the real rate is assumed to be zero, the rate of inflation is 1.25%, which means that wages and product prices grow at this rate. That is, the sum of values of all products and services will rise at a nominal rate of 1.25% per year in the year 2003. This nominal rate of growth of the economy amounts to a real rate of growth of zero in this example. The real rate of growth refers to the total value of all products and services at the end of 2003, measured by their prices at the beginning of year 2003. In this case with no lending, commercial banks will not be able to earn their spread towards their operation and so will have to close down. The central bank will be the sole bank in operation accepting all net savers' deposits at a rate of interest of 1.25%. This assumes that the central bank can be sustained at a negligible cost for its operation.

In this example, the economy will grow if the entrepreneurs can run businesses with a total investment of $100 ($50 in equity plus $50 in debt) and with an expected rate of return greater than the effective cost of capital. If $50 is borrowed at 4% and the opportunity cost of $50 of equity is 1.25%, the effective cost of debt and equity capital is 2.625%. The opportunity cost of equity is 1.25% because this is the rate the entrepreneurs can receive by depositing their equity funds in bank. Suppose that the businesses in which $100 is invested are expected to generate a higher rate than 2.625%, say 7% per year. Then, the expected value of businesses rises to $107 at the end of

2003 from $100 at the beginning of the year. The entrepreneurs will pay banks an interest of $2 at 4% interest rate plus the borrowed sum of $50, i.e., a total of $52 and retain the difference between $107 and $52, i.e., $55. If the entrepreneurs had simply deposited their accumulated profits of $50 at the beginning of 2003, they would have made $50.625 at the bank deposit rate of 1.25%. The risk of their business is thus rewarding when the expected rate of return is sufficiently high, by an amount equal to $55 minus $50.625. In the presence of such profitable businesses that enhance the entrepreneurs' capital, the total capital stock of the economy grows. It makes the economy grow at a higher nominal rate than the rate of inflation of 1.25%. Profitable businesses have thus increased the value of the economy by $5.75, which is the difference between $107 made through businesses and $101.25 possible without the business opportunities.

What is the size of economy at the end of 2003 in the above example? It depends on the size of economy at the beginning of 2003. Suppose that the economy's size is $200 at the end of 2002. This means that the total value of all products and services produced in 2002 is $200. Suppose that the on-going productions continue in 2003. This means that without new profitable business opportunities described above for 2003, the economy will grow at 1.25% from $200 to $202.50. This is because the prices of products and services from on-going businesses will rise due to inflation by 1.25% in 2003. With profitable business opportunities described above, the economy will rise to $202.50 + $5.75 = $208.25. Thus, a positive value of new products equal to $5.75 from new business opportunities makes the economy grow from $200 to $208.25, which is a nominal rate of growth of 4.125%.

The real rate of growth is measured from $202.50, which is a value to which the economy will have grown in the absence of the profitable business opportunities. The real growth rate of the economy is thus (208.25 - 202.50)/202.50 = 2.84%. Thus, the economy will always grow as long as new businesses generate values at a rate greater than the nominal rate of interest of the economy. Observe that while new businesses can expect to add net positive values as illustrated above, there is no guarantee that the realized value from the businesses will remain positive by the end of the year. Realized business losses can make the economy recede, i.e., fall below 202.50.

Economic (GDP) growth or recession thus depends on the increase or decrease in the values of products and services from businesses during the measurement period. The amount of capital of an economy also depends on how businesses are valued. A real positive growth of an economy means that the total available capital has increased as in the above example.

2.3 CONSUMER MOOD AND ECONOMIC GROWTH

By the laws of physics, the total mass on earth cannot be altered barring a meteoric collision. Then how is new capital created? The idea of capital is derived from prices of products and services. Markets set prices by arbitration following supply and demand for products and services. Arbitration makes capital illusory or virtual.

Entrepreneurs selling newly innovated products at high enough prices, relative to existing prices and wages, generate surplus profits which translate into increased values of their invested capitals. The amount of capital or wealth of an individual is the value of his assets less liabilities.

Prices of various products are relative to each other, though they are expressed in terms of the currency of an economy. The price of a product is expressed as a number of units of the currency. For example, if a skirt sells for $10 and a blouse sells for $20, the relative price of a blouse is two skirts.

Proposition 2.1: *Wealth or capital is virtually created from consumer* *mood and demand.*

Argument 2.1: Consider a simple *island economy* with an entrepreneur producing garments, skirts and blouses, for a sole consumer, a moody princess. Assume that the princess has a limited reserve of gold used as currency: one gram of gold, denoted 1g, is a unit of currency in the island. Prices expressed in grams of gold have been set by market forces, i.e., through an interaction between the entrepreneur and the princess: 10g per skirt and 20g per blouse. Limited reserves restrict the princes to purchase 10 pairs of garments for 300g per year. The current gross domestic product (GDP) of the economy is 300g. Assume that garments last for a year and are worthless at the end of the year.

Suppose that the consumer princess gets bored with garments at some point in time. After noticing consumer boredom, the entrepreneur creates a new exciting product - a durable laced hat - to meet the demand of the princess. To determine a price for this new product, the princess accords a value relative to prices of existing products.

Suppose that the hat is accorded a price of 50g while the prices of skirts and blouses remain unchanged. Assume that the entrepreneur has to forfeit production of a pair of garments to make a hat. The entrepreneur takes the same amount of time and effort to produce either a hat or a pair of garments. The producer thus forfeits 30g of income due production of one less pair of garments to make a hat to sell for 50g. The producer's opportunity cost for producing a hat is 30g. Since the price of the hat is 50g, the producer generates a profit of 20g per hat. This is possible due to the excitement of the moody consumer princess about a new product like a laced hat.

Suppose that the princess demands just one hat in the year of hat. Her willingness to pay 50g for a hat means that she prefers to own the hat by giving up 50g from hear wealth reserve. This amounts to her desire of owning a hat instead of, say, one skirt valued at 10g and two blouses valued at 40g. Simply put, the princess-consumer exchanges a part of her existing wealth worth 50g for an exciting new hat that she values at 50g. She is happier now than she used to be before the introduction of the hat in the island.

Suppose that the princess buys 9 pairs of garments for 270g and one hat for 50g by paying a total of 320g from her gold reserves in the year of hat. She buys all that is produced in the year. Her limited wealth (gold reserves) has been shrinking over time at a rate of 300g per year before the introduction of the hat. But purchasing the durable laced hat, per se, does not change the market value of her wealth in the year: she loses 50g to get a durable hat valued at 50g.

Suppose the consumer and the producer, respectively, have C grams and P grams of gold reserves at the beginning of the year of hat. Then the consumer will have C-320g of gold reserves at the end of this year plus a durable hat worth 50g, i.e., a total of wealth of C-270g. If she does not buy the hat and buys only 9 pairs of garments, her wealth would be C-270g of gold. Buying the hat will make her wealth comprise gold reserves C-320g and a hat valued at 50g.

The hat production will raise the entrepreneur's wealth to P+320g of gold. Without the hat the entrepreneur will produce 10 garments for 300g and have a total accumulated wealth of P+300g at the end of the year. The hat increases the entrepreneur's wealth by an extra 20g: he receives 50g for the hat that costs him 30g to produce.

Total wealth of the island economy at the beginning of the year of hat is C+P. At the end of the year of hat, the wealth of this economy rises to (C-270g) + (P+320g) = P+C+50g. The hat worth 50g is durable, adding to wealth of the economy. The princess reduces her consumption of perishable garments by one pair, which amounts to an extra saving of 30g. The producer generates a new product for profit 20g. The wealth or capital of the economy therefore grows by 50g.

Table 2.1
Income Growth due to New Products

		BEFORE NEW PRODUCT	AFTER NEW PRODUCT
Endowment of	Consumer	C	C-270g
	Producer	P	P+320g
Production = Consumption	Garments	300g	270g
	Laced Hat	0	50g
National Income		300g	320g
Income Growth			6.67%

If the princess does not reduce her consumption of perishable garments, then the wealth will grow by 20g due to the extra value coming from profits of the hat. This extra value is created due to the consumer's sentiment to accord a value of 50g for a product that costs 30g to make. This is the virtual nature of capital growth.

Introduction of the hat makes the size of the economy grow by 20g, from 300g to 320g per year. This growth adds to the capital stock in the economy. The newly created capital is due to the moody consumer who values the new hat higher than the opportunity cost. In this example, the new product makes the producer better off. It makes the consumer happier and wealthier. It also makes the economy grow due to free markets and trade. But the creation of new capital value is illusory. How?

Suppose that the mood of the consumer turns sour making her to pay at most 30g for the new hat, despite the entrepreneur's expected price of 50g. Then, the entrepreneur will be unable to make profit as long as the cost of production remains 30g, dampening any growth in the economy and capital stock. If, however, the entrepreneur can relocate his manufacturing plant to a cheaper location outside the island, where the cost of producing the hat is 20g, he can make a profit of 10g by selling the hat to the moody consumer at 30g.

In a subsequent time period, however, the princess' mood may further deteriorate due to some unforeseen event like a sunspot. It can make her sell off her existing hat for as little as the entrepreneur agrees to pay. Bad mood can make the princess buy fewer garments than she is now used to. Then the entrepreneur may be unable to cut his production costs. He can be economically doomed. The economy will then pass through recession, maybe even massive depression. ■

The argument for Proposition 2.1 shows that capital stock of an economy increases only if profits are generated through sustainable demand for products at prices less than their opportunity costs. Consumer demand depends on many factors like higher utility of consumption, budget and degree of optimism. The features of the above island economy run parallel to that of a Japanese economy that has been stagnating over the last 15 years. Stagnation in Japanese economy is due to local consumption not rising any longer. It is also due to inability of Japanese producers to cut costs through manufacturing of their high quality products elsewhere in the world.

2.4 PILLARS OF SUCCESSFUL CAPITALISM

Pure capitalism comprises free markets with producers and consumers exchanging or trading assets at relative prices determined without any external control. A pure capitalistic economy is not bridled by interference of government regulators. No government agency in this economy forces selling or buying of products at controlled prices. Neither producers nor consumers are bound by any government rules for trading in such an economy. The above example of island economy is purely capitalistic: the entrepreneur freely sets as high a price for the hat as the moody consumer is willing to pay.

New capital creation and wealth accumulation in such a pure capitalistic economy depend on product prices, which are precariously dependent on consumer perception. If there is one (monopolistic) supplier of a product in great demand, he can arbitrarily set as high a price as consumers can afford, irrespective of production costs. Monopolists can potentially amass wealth through massive transfers of capital from consumers, as long as the product they sell is in great demand. Even oligopoly producers can collude to set arbitrarily large prices to become wealthy at huge costs to consumers.

As an extreme case, suppose that only a few entrepreneurs know how to produce food and that consumers' only wealth is their labor. Food is vital for human consumers to survive. To buy food for survival, they will be willing to give up every bit of their wealth, i.e., toil as slaves for food producers. This is why landlords in agricultural economies have engaged humans as slaves to produce food. Pure capitalism has historically led few landlords to enslave humans. It widens the disparity of wealth between skilled producers and consumers. This amounts to economic oppression of consumers by entrepreneurs. In the absence of a government, oppressed consumers can riot, leading to conflicts between the rich and the poor.

The meaning of success of a pure capitalistic economy is that the vast majority can buy high quality products and services at lowest possible prices. Pure capitalism can succeed only if producers compete, not collude. Competition drives the product price close to its production cost. Competition within pure capitalism allows anyone to produce by acquiring the requisite production technology for a competitive price set in free markets. The product price in a competitive free market economy covers all costs including the technology to produce. By setting the product price appropriately, an entrepreneur can earn his opportunity cost of capital, labor and technology. The opportunity cost of capital is equal to a fair rate of return consistent with the risk of investment.

Competitive product markets are not the only essential ingredients for pure capitalism to succeed. The capital market should also be competitive. This means that there should many lenders competing to supply capital at the lowest possible interest rates. Similarly, the labor market has to be competitive so that products can be manufactured at the least possible wages. The essential pillars of successful capitalism include competitive product, labor and capital markets. This means there should be absolutely no barrier for trading in goods and services, capital flows, and labor mobility. Only then pure capitalism can succeed. But there is no guarantee that it will.

2.5 PURE CAPITALISM AND MISERY

A pure capitalistic society is one in which the government does not interfere in markets for products, capital and labor. The government does not guarantee competition in the markets. If an entrepreneur has developed an inimitable technology to create a profitable product, it is unlikely that he will sell the production technology to other potential producers. By selling his production technology, the entrepreneur can create only undesired competition for his own product driving down his profits. The only price at which the entrepreneur may sell his production technology is equal to the total value of all future profits he expects to make by monopolizing his technology. For example, Intel and Microsoft have proprietary technologies that have propelled them to amass profits, despite mighty government interventions. Pure capitalism, which means no government intervention, will widen the gap between the rich and the poor.

In pure capitalism, an entrepreneur's success in enhancing his capital depends on potential buyers willing to pay higher prices than production costs. The entrepreneur's success will depend on generating consumer perception that a new product is more desirable than existing substitutes. This means that successful entrepreneurs are those who can establish marginal superiority of their new products, relative to existing substitutes, and, thereby, actuate transfer of resources from consumers via higher product prices. For such transfer to be successful, however, consumers must agree to purchase the new products at higher prices. It is not just consumers' perception of superiority of a new product, but their willingness to pay a higher price that defines the success of an entrepreneur. Consumers will pay higher prices to purchase a new product only if they are better off doing so. Does this mean that consumer wealth due to the purchases of new products can be increased? The following proposition provides an answer.

Proposition 2.2: *The growth of an economy is virtually dependent on consumer mood. Consumer wealth remains stagnant in a capitalistic economy. Consumer optimism enriches capitalists, but undermines consumer wealth.*

Argument 2.2: How can the wealth of consumers improve if they exchange some of their existing wealth (accumulated assets and incomes) for new products? This seems to be a puzzle because it betrays the laws of physics. For example, the moody consumer princess in the island economy described above owns C grams of gold at the beginning of the year when the new product (a laced hat) comes to market. Before the hat comes to market, she used to buy 10 pairs of garments per year for 300g. Again 1g is one gram of gold, used as the currency in the island economy. The princess is used to deplete her gold reserves by 300g every year due to her consumption of garments. At the end of the year of hat, her depleted wealth will be C-300g if she does not change her consumption of garments and does not buy the hat. Buying the hat will deplete her wealth further by 50g to C-350g. She will have at the end of the year, a hat valued at 50g and gold reserves of C-300g. The consumer is not becoming wealthier. She rather transfers to the producer an 20g more than the cost of production of the hat.

How is the market price of the hat determined to be 50g or some other figure? To answer this question, the consumer princess makes a decision before buying the hat. She compares (i) her utility of owning the hat plus the wealth that remains after paying for the hat, with (ii) her utility of not possessing the hat and remaining wealth. A comparison of the two levels of her utility gives her a maximum price for the hat she can pay to remain indifferent between owning and not owning the hat. The maximum price is also called the reservation price. She does not have to disclose the reservation price to the producer. She can bargain with the producer. The cost of production of the hat is 30g which is the minimum price the producer will accept. The producer does not have to disclose his minimum reservation price. The consumer and the producer will tend to haggle. But, generally, the producer sets a price for the new product. The hat will be traded in the market only if the consumer's maximum reservation price is greater than the minimum price acceptable to the producer. This process determines the price of the hat. A consumer will buy a product only if her reservation price exceeds the product offer price.

The princess will buy the hat for 50g if she expects to be happier with the hat along with the remaining wealth than with her pre-purchase wealth. But the consumer princess' wealth remains unchanged irrespective of her reservation price and decision to purchase the hat. Her new wealth will be exactly equal to her existing wealth, except that the wealth will be in terms of the hat and her remaining possessions. She may be more satisfied in owning the hat than not owning the hat if her reservation price for the hat is larger than 50g. But owning the hat does not alter her wealth. The value she accords to the hat determines the remainder of her material possessions.

Becoming emotional about a new product at the time of decision-making may induce a moody consumer to accord a very high reservation price for a new product, especially if it is a life-saving drug. Suppose that due to excitement she mistakenly reveals her reservation price for a life-saving drug as Cg. The producer will, after learning the reservation price of the consumer, fix the price of the new life-saving drug at Cg. The princess will buy it by giving up all her existing gold reserves with nothing else left to buy garments. This can make her naked and penurious. ∎

The objective of entrepreneurs is to create products and services that have emotional value for consumers. By creating emotionally enticing products, entrepreneurs can generate high profit margins to usurp most consumer wealth. These products can, however, be unprofitable if consumers are not emotional or if the existing pool of emotional consumers shrinks over time.

If the moody consumer princess living with a hat and just undergarments faces the advent of cold weather, she will need some garments. But the entrepreneur can exact unseemly prices from a penurious consumer, like subjecting the princess to perpetual servitude. A capitalistic society creates new capital by whetting on consumer preferences for products. But it can make consumers suffer from perpetual misery, eventually. The above proposition can explain any gradual decay in American household net worth for the absolute majority. It explains how 3000 new households are turning wealthy with net assets of twenty million dollars or more every year.

2.6 CONSUMPTION AND CAPITALISM

Some wily entrepreneurs can become very rich while a multitude of less shrewd households remain poor forever within a capitalistic society. The term "rich" refers to wealth or net worth, which is the value of assets minus the debt liabilities. The average net worth of a very few entrepreneurs can grow hugely while that of the multitude remains miniscule over time in a pure capitalistic society with a free markets, as shown in the following proposition.

Proposition 2.3*: Pure capitalism leads to a few ultra-rich capitalists with the rest of a society virtually toiling to survive. This can be branded as neo-slavery or economic bondage of the multitude by a few ultra-rich capitalists. Capital accumulation virtually depends on consumer demand. The growth of a capitalistic economy depends critically on demand for new and high profit margin products, especially by consumers who are unable to produce such products. Consumer decision to cut consumption can destroy a capitalistic economy.*

Argument 2.3*:* Focus on the capital accumulation process in a primitive society. Consider the Age of Agriculture with humans producing food. There is a free market with no controls on capital accretion. This is the case of a pure (unbridled) capitalistic society with free markets.

Suppose that there are 100 individuals producing and consuming 5 units of food per capita per year. Food is the only existing product in this primitive agricultural economy. Each food unit represents one unit of currency, called dollar. For example, if one unit of food is a kilogram, it can be priced one dollar. The size of this economy or the total annual output is 500 kilograms or 500 dollars.

Suppose that four agriculturists emerge subsequently as entrepreneurs with a new technology to make guns for their own use and for selling to the remaining 96 pure agriculturists. Gun producers continue agricultural production to satisfy their own food consumption. They continue to produce 20 units of food per year. In addition, they produce 20 guns per year. They expect to keep 8 guns for themselves and sell the rest to agriculturists. Guns are durable and food is consumed away at a rate of 5 units per person during the year of production. The gun price is expected to be 10 dollars. The annual per capita gun ownership for the whole society will be 0.2 per person, 2 per entrepreneur and 0.125 per agriculturist.

Agriculturists have to buy some guns out of fear. They have to toil harder than before the advent of guns. They have to produce an extra 120 units of food to buy 12 guns, in addition to 480 units of food for consumption of 96 individuals at a rate of 5 units per individual. The agriculturists are thus forced to produce 25% more food than before the introduction of guns.

If the expected gun sale materializes, agriculturists' wealth in the year will rise to 120 dollars. They consume the food, but store 12 durable guns, each priced for 10 dollars. Agriculturists' wealth thus increases to 120 dollars from nothing in the prior year. Gun producers' wealth rises to 200 dollars, comprising 120 dollars received by selling 12 guns to agriculturists and 80 dollars for the other 8 guns not sold. Gun producers collect sales proceeds as 120 units of food from selling their 12 guns to agriculturists. They store this food for future consumption.

The gun production is thus expected to raise the total wealth or assets of society from nothing to 320 dollars, which is distributed as 120 dollars among 96 agriculturists and 200 dollars among 4 gun producers. Production of 20 guns also raises the size or total output to 820 dollars from 500 dollars, which represents an income growth of 64% for the whole economy. This is due to productivity increase induced by guns.

Table 2.2
Income Growth Due to Gun Production

PRODUCERS OF	NUMBER		PRODUCTION (DOLLARS)		INCOME GROWTH DUE TO GUNS
	Before Guns	After Guns	Before Guns	After Guns	
Food	100	96	480	600	25%
Food & Gun	0	4	20	220	1000%
Total	100	100	500	820	64%

The growths in incomes of the gun-cum-food producers and pure food producers are 1000% and 25%, respectively, as presented in Table 2.2. The income growth occurs due to five factors:

- First, it has been possible due to gun technology portrayed as necessary to enhance security of people.
- Second, entrepreneurs continue to remain self-sufficient by producing own food. This means that entrepreneurial skills make them much more efficient than the others to produce guns as well as food.
- Third, the pure agriculturists have been scared by the new technology to become more efficient and diligent than they have been in the past. Their productivity rises somewhat

due to newly created security needs.

- Fourth, guns are perceived to be more valuable than basic needs like food.
- Fifth, some individuals threaten others with guns.

The phenomenal income growth of a primitive agricultural economy is based on an expectation that the newly made guns can be sold to the pure agriculturists. What will happen if the pure agriculturists do not buy the guns for any positive price because of no fear for their lives and no desire to toil? It is possible, for instance, that the 96 pure agriculturists may like to produce enough food to live and devote the rest of their time to meditation instead of sweating to produce more food to buy guns touted for security.

Humans do not necessarily enjoy owning guns. Many humans treat death even due to gun shots as fatalistic. Suppose that the pure agriculturists do not work any harder than necessary to simply produce their needed 480 units of food. Then their wealth will not rise. But they will also have more time to remain relaxed or attain spiritual bliss. They may find lives with more leisure and less work to be more enjoyable than one with guns, less leisure and more toil. It is a matter of the value system of pure agriculturists that will lead them to their decision of whether or not to buy guns. They will trade off their subjective valuation of gun ownership with fatigue from toiling to decide whether to buy guns them and, if so, how many at what price.

In the extreme case that pure agriculturists do not buy any gun, the wealth of entrepreneurs will not rise as much as expected. Suppose that there is no demand for guns from pure agriculturists. Assume then that the entrepreneurs will trade among themselves to set a market price of 10 dollars per gun for a total of demand of 8 guns. The wealth of entrepreneurs in this case will be 80 dollars since all the food they produce is consumed away. The size of the economy in this case will grow from 500 dollars to 580 dollars, comprising 480 dollars of output by pure agriculturists and 100 dollars by entrepreneurs. The reduced demand for guns results in a drastically smaller rate of growth of 16% or a rise of 80 dollars from 500 dollars. This growth rate is due to lack of fear of guns. It is just one-fourth of the economic growth possible when gun producers can scare agriculturists about security without guns.

Thus, the growth of a pure capitalistic economy depends very critically on the demand for new and higher valued products, especially by consumers who are not producing such products. Suppose that we brand the pure agriculturists as consumers of high value products and the gun producing entrepreneurs as capitalists. This example shows that a lack of consumer demand for new high valued products (guns) can decimate economic growth to a quarter of that possible with optimistic demand. "Economists" in this economy can forecast a demand for 20 guns, 10 dollars each. But if consumers really buy fewer guns, the realized economic growth will be below the forecast.

This example illustrates how consumer demand and price forecasts make growth of an economy virtual. Demand and price depend on value system and preference of consumers. Consumers may not like to own guns and consider death by gun shots as fatalistic. Consumer preference is subjective. It stems from judgment and culture of consumers. Economic growth is meaningless for a society of consumers not willing to grow their assets or toil for increased consumption. The size of an economy based on a subjective valuation of products is not an absolute barometer of the well being of individuals in that economy. Absent demand from consumers, the capitalistic dream for self-enrichment can be illusory and unattainable.

The American and European capitalists in the nineteen-nineties presaged massive future demands for telecom and wireless services from consumers across the entire world. They borrowed mind-boggling sums of money to lay underground and under-sea fiber optics cables to connect continents. They launched numerous geo-stationary satellites orbiting earth for wireless transmission. Such technology is hardly useful for poor Indian and Chinese consumers, who toil for producing enough food to eat, weaving some yarns to clothe and building simple shelters to live. Expecting such consumers to toil further to enrich mega global capitalists is irrational. Global consumer demand for telecom and wireless technology has not materialized as expected. Consumer demand for wireless phones is growing. The number of wireless phone users has grown close to 200 million in China and 60 million in India. The number of wireless phone users will continue to grow. But the expected profits of mega capitalists may not grow as much as expected.

2.7 ECONOMIC GROWTH AND HUMAN DEVELOPMENT

The above propositions illustrate weaknesses in unbridled capitalism. The national income or GDP growth is not a barometer of prosperity or human development. The United Nations Development Program (UNDP) uses per capita economic growth as a measure of human development. This measure is misleading, given the arguments of the previous section. Humans do not necessarily prosper or develop due to some virtual economic growth. A gun culture can raise income growth, as argued in the previous sub-section. But propaganda about guns being essential for security is needed to sell enough guns for such growth. Such propaganda leads to fear psychosis to force people to adopt guns as necessities. This makes them toil harder to survive. Massive build up of guns, aircraft, missiles and nuclear bombs has enhanced the GDP growth of developed nations. But such growth has arguably deteriorated safety and well being of all humans.

The 1995 UNDP Human Development Report responds to such criticism by saying: ``It is wrong to suggest that economic growth is unnecessary for human development. No sustained improvement in human well-being is possible without [GDP] growth. But it is even more wrong to suggest that high economic growth rates will automatically translate into higher levels of human development. They may, or they may not. It all depends on the policy choices the countries make." UNDP goes on to say: "The human development concept consistently asserts that growth is not the end of development - but that the absence of growth often is. Economic growth is essential for human development. But to fully exploit the opportunities for improved well-being that growth offers, it must be properly managed."

The per capita national income can grow if households can be lured to buy technology gadgets through advertisements and credit facilities. Such lures are designed to pander to household psychology to increase sales. Producers do not particularly care for long run prosperity of households. The households can erode their wealth, i.e., accumulated savings, due to endless purchases of industrial products and technology gizmos. They even mortgage their future incomes to buy commodities. Producers can shrewdly wangle the household savings of the vast majority by tuning their product advertisements into popular moods. The household net worth for the absolute majority may not rise even if the national gross domestic product grows. The national GDP growth cannot gauze the feeling of insecurity of the vast majority due to declines in its net worth.

Development of humans means expansion of their capabilities leading to freedom and prosperity, not possession of commodities for GDP growth. The GDP growth is a sum total of value additions to products and services. It is primarily a reflection of prosperity of suppliers who can create usurious profits. It does not reflect the prosperity of the vast majority of households in a nation. The UNDP index of economic growth does not reflect prosperity or human development of a society. It aptly measures prosperity of a few mega capitalists – those with opportunities to generate usurious profits. The GDP growth cannot gauge "human development" of smart mendicants enjoying spiritual pursuits by transcendental meditation for salvation. They are content with the bare minimum human needs. They pursue spiritual bliss instead of creating market value added products. Market based product value additions that reflect GDP growth cannot measure the prosperity of such individuals enjoying spiritual bliss.

Enhancement of prosperity and individual freedom should be main goals of a nation. This goal can be accomplished only through a rational system of governance that follows rational rules of law and constitution to facilitate public services like healthcare, education and communication. It is not acceptable if a nation fails to protect, for instance, the saints meditating in their ashrams against disease and persecution. The GDP growth will fail to measure human development or prosperity of the Tibetan society of monks happily striving for spiritual salvation. Establishing gun factories can raise economic growth of Tibet. But it will degrade human development by intimidating the meditating saints. A nation must provide the security needed by monks pursuing their goals of spiritual attainment. Invading a country to destroy the basic fabric of freedom of citizens for industrial production does not enhance human development. The Dalai Lama, a Nobel Prize winner for peace, is not happy after he fled Tibet along with his followers. The GDP of Tibet has grown tremendously after the Dalai Lama left. But such economic growth cannot compensate what the Tibetans lost due to subjugation of their souls.

Economists, primarily based in the developed nations, have unfortunately propagated a myth that the GDP growth leads to human development. The only real norms for human development should be the degree of freedom and the level of prosperity or net worth. Most people within the developed nations are perpetually bonded by massive debts and little net worth. Judging by the real norms, human development has not yet taken root even in developed societies. Many developing nations are also reeling under massive foreign debt. They have remained perpetually dependent, militarily and economically. It is thus impossible to have human development in these nations.

Household debt write-off is perhaps necessary to enhance human development in developed nations. Writing off the foreign currency loans of developing nations is similarly needed for human development. Both economic and political freedoms are essential for human development. Only freedom can induce societies to efficiently produce essentials like food, shelter and clothing needed for human development. Efficient production of such essentials is necessary to beget prosperity of especially impoverished nations.

Proposition 2.4: *Creation of high value industrial products and technological gizmos may enhance GDP growth. But such growth does not necessarily translate to prosperity of the absolute majority.*

Argument 2.4: Consider the Agriculture Age and the subsequent arrival of industrial gizmos (guns), as described in Argument 2.3. The world economy in the Agriculture Age consists of producers of basic goods like food and other basic products and services. Every country has been producing basic goods in the Agricultural Age. Then some countries in North become more entrepreneurial in producing both basic goods and gizmos. The remaining countries in South continue to produce only basic goods. Suppose that North succeeds in convincing South about the excitement of gizmos and the utility of toiling harder to produce more basic goods to procure gizmos from North. Then North will become phenomenally richer than South. How?

North is self-sufficient in production of basic goods. It also produces 20 gizmos. It exports 12 gizmos to South. South is also self-sufficient in basic goods. But South imports 12 gizmos due to inducements through advertisements, credit facilities and pressure from North. South cannot dictate the prices of gizmos because the trading within North determines the price as 10 dollars per gizmo.

Table 2.3
North-South Trade

REGION PEOPLE	PRODUCTION (DOLLARS)			EXPORT		PER CAPITA INCOME	
	Before Gizmo	After Gizmo		Food	Gizmo	Before Gizmo	After Gizmo
		Food	Gizmo				
North 4	20	20	200	0	120	5	55
South 96	480	600	0	120	0	5	6.25
Global 1100	500	620	200	120	120	5	8.20

Suppose that each unit of the basic goods is a dollar. South has no leverage to set prices of basic goods because North continues to produce such goods. South decides to buy gizmos from North at a price 10 dollars per piece. Then Southerners work harder to produce 120 more units of basic goods than they used to generate in Agriculture Age. This enriches North more than South as shown in Argument 2.3. The per capita income of North rises from 5 to 55 as the output rises from 20 units of basic goods to 220 units (20 units of basic good and 20 gizmos priced 10 units each) for a population of 4. South also raises per capita income from 5 to 6.25 due to its output rising from 480 units to 600 units for a population of 96 as shown in the Table 2.3.

Suppose now that South does not buy gizmos from North. Then, the per capita income of North will rise only to 25 units as the four individuals produce 20 units of basic goods and 8 gizmos valued at 80 units. North's per capita income is still much higher than South's stagnating at the primitive level of 5 units of basic goods produced by each individual.

It is important to note that the per capita income growth of a developed society (North in the example) depends critically on demand for high value industrial products like gizmos from less developed countries. Unless gizmos enhance the quality of life, wealth transfer from South to North does not enhance the quality of human life anywhere in North or South. It simply makes all individuals toil perpetually. The equation gets all the more exploitative with foreign currency loans to the developing nations to let them buy gizmos. ■

2.8 PROS AND CONS OF FREE TRADE

Is it obvious that free trading among nations is necessarily beneficial, mutually? Traditional textbooks on international trade portray a benign picture of free trading. They show how each country can specialize in manufacturing goods on which it has relative strength, export the surplus of these goods and import the shortfall in other goods. Such specialization generates consumer surplus for all countries in trade agreements. Under this traditional view, all countries engaged in free trading are likely to be better off due to the efficiency gained in producing specialized products. Free trading is thus argued to be better than autarky. In autarky, each country tries to produce all its needs, resulting in inefficiency of producing some goods for which its skills are not as good as those of others. This is a very sanguine view of international trade.

North and South in the example above do not specialize. They benefit from free trading. Both North and South produce the basic goods they need. North does not stop producing basic goods. It is a technologically developed like USA that relentlessly generates massive food surpluses even by giving farming subsidies. If industrial gizmos are considered to be luxury items not preferred by Southerners, it may not at all benefit South to trade. Benefits of free international trade as depicted in standard textbooks have swayed free trading proponents in favor of agreements like those under the World Trade Organization. Such textbook examples miss, however, extremely serious ramifications of free trading for developing countries that cannot attain self-sufficiency in production of basic necessities like food.

The ideal mutual benefits of free trading among countries belie the real world practices. Mega capitalists use their resources to penetrate the markets of developing countries. They sell their marginally better products at exorbitant prices to make quick profits. Then they run away from those markets. The profits generated from developing countries are plowed back to mega capitalists. This makes phenomenal capital growth within a few developed countries, though the vast majorities in these countries do not prosper. In the example above, the determination of gizmo price of 10 dollars depends more on trading within North. Such trading is dubious because the manufacturers are monopolistic or at best oligopolistic. They fix prices at some artificially high levels. They receive encouragements from their central banks chiming risks of deflation. The artificially higher prices result in transfer of wealth and perpetually stifle the growth of developing nations as compared to that of developed nations. Free trading results in 1000% growth in per capita income (5 units to 55 units) of North as compared to only 25% (5 units to 6.25 units) for South in the above example.

The nature of mega capitalism is such that it makes only a few entrepreneurs continue amassing their capitals. It gives rise to a huge disparity between the very rich and the rest even within developed nations. By extending pure capitalism to the entire world, the handful of mega capitalists will continue to garner wealth from the developing nations and use the power of wealth to recruit the best talents globally. These employees in turn will dominate the process of manufacturing of high valued products and hard sell them to the households across the globe.

Capitalism has the GDP growth of the developed world phenomenal. Can it be expected to generate the same kind of results for all nations in course of time? The difference between the capitalism practiced within a developed country like the U.S. and global capitalism is fundamental. Capitalism within a developed country is not entirely unbridled. It is regulated by a democratic government that has the power to collect more taxes from the rich to build public facilities that are equally accessible to everyone. A democratic government within each developed nation can alleviate the vices of unbridled capitalism by fostering competition among producers. There is no global democratic government to play such a powerful role to assure the well being of the teeming world.

2.9 CAPITALISM AND GLOBAL TRADE

The government within a capitalistic democracy preserves the following four important pillars of capitalism:

A. Unfettered flow of capital from savers to entrepreneurs.

B. Smooth shipment of goods from suppliers to consumers.

C. Unrestricted transfer of production technologies from the developers to producers.

D. Complete mobility of labor within the country.

It is necessary for a country to ensure that these four tenets of capitalism are preserved and facilitated. But this is not sufficient for a country to guarantee the fruits of capitalism for its citizens. For capitalism to benefit public, the country must follow a rational system of governance with a transparent legislative-judicial-monetary system that is being dynamically improved to reflect the current human wisdom.

Governments in the developed democracies have by and large adhered to the above four basic tenets of capitalism to achieve economic progress. Capitalism and rational governance system may not be sufficient, though, for prosperity of the absolute majority. But they are absolutely necessary for economic progress of a nation. For example, within USA, there is no restriction on the flow of capital from one state to another. Products can be shipped from one state to another without any interference from state governments of USA. Technologies can be bought or sold with no strictures on who can buy what technology within USA. State and federal governments and the laws of the land ensure that New Yorkers can live in California and Arkansans can live in Illinois without any restriction.

Proposition 2.5: *The global community will not succeed economically, as long as labor and technology are barred from trading across national boundaries.*

Argument 2.5: There can be free global trading of commodities and products and capital flows (tenets A and B) as under WTO. But this cannot guarantee unrestricted sale of technologies and complete mobility of labor (tenets C and D) across national boundaries. All the four basic tenets of capitalism that have made individual countries developed must also be practiced at the global level for any global economic success.

There is no global democratic government, let alone a transparent one, to monitor the tenets of capitalism. The United Nations (UN) acts like a surrogate of the establishments of the powerful nations dictated by the mega capitalists. The UN simply promotes the interests of mega capitalists. Absolute majorities anywhere in the world cannot simply trust the UN to solve the global economic chaos prevailing today.

It is not in the best interest of mega capitalists to establish democracies in the developing world. They merely want to serve their own economic and political interests through dictators ruling developing countries. They tend to ally with those developing countries that have kowtowing elites and rulers.

For example, President Suharto ruled Indonesia as a dictator for 30 years. This country has the fourth largest population in the world. The Indonesian ruling elite had eagerly pursued the economic interests of global mega capitalists. They recklessly purchased merchandise globally by borrowing foreign currency denominated funds in international capital markets. The ruling elite served its own interests too by running monopoly businesses with the help of external funds. As Indonesian imports surpassed exports, the country had to borrow externally to pay interests on its existing debts. This became a Ponzi game that could not be sustained. The business interests of the ruling Indonesian elite coincided that of the mega global capitalists. Businesses of global capitalists thrived due to selling of their exorbitantly priced products in Indonesia. Indonesia's trade imbalance grew as a result. Then international bankers siphoned off $140 billion of Indonesia's foreign exchange reserves in 1997 through currency games.

Mega global capitalism orchestrates economic rescues of countries like Indonesia which run out of exchange reserves and cannot pay for badly needed imports. The International Monetary Fund is pressed to bail out such beleaguered countries. The IMF lends some foreign exchange, devalues the currency drastically and tightens the economic activity of a developing country being rescued economically. This is called "bailing out" a developing nation from a crisis created by mega capitalism. The bailing out process invariably imposes severe austerity on common people of a developing country. It bonds the absolute majority through ever decreasing wages to continue producing cheap products for global capitalists. Then the same mega capitalists sell their cheaply made branded products in developed nations for usurious profits. The business and bank executives of developed nations are always in a win-win situation.

Indonesia had borrowed about $140 billion from developed nations as of 1997. Due to devaluation of its currency rupiah to 25%, this external debt-burden for common Indonesians has gone up four-fold. Common Indonesians obviously did not know of the Ponzi game being played by their ruling elite with mega global capitalists. They did not know that their own leader would tacitly collude with global business and bank executives. They did not know that their economic progress over thirty years would suddenly vanish due to the play between their rulers and mega global capitalists.

Many examples of collusion between mega capitalists and dictatorial regimes elsewhere are evident. Such collusion does not benefit the absolute majorities of people in either the developing or the developed world. It is designed to transfer wealth from the absolute majorities to mega capitalists and ruling elites. It drives the teeming masses in the developing world to poverty, destitution and abject misery.

In short, establishments in the developed nations acting at the behest of mega capitalists will not allow the UN to serve as a democratic world body; the way citizens in developed countries demand their own democratic governments to operate. This tragic reality simply suggests that global capitalism is a mirage of economic prosperity for humans on earth.

There are serious restrictions even on international flows of capital. It appears as if capital flows across national boundaries easily. But it is not so. For example, the government of Malaysia has to pay a heavier premium for raising capital compared to the cost of funds to the developed nations. The premium is an implicit barrier for free flow of capital. It would not exist under a rational global government.

Developed nations impose severe restrictions on selling their technologies to developing countries. Actual manufacturers of technologies in developed nations are eager to sell their technologies to needy countries. For example, India needs nuclear electricity generators from Western nations. Western suppliers are eager to sell. But they have been barred from shipping such technologies to the developing world. Just recently USA has agreed to lift nuclear sanctions on India. But uncertainties remain.

The mobility of labor from the developing to the developed world is also very restricted. For example, USA does not allow free mobility of labor from even a neighboring nation like Mexico with whom there is a free trade agreement. Developed nations have encouraged limited immigration of skilled workers from developing countries – as in the case of computer programmers from India to USA. Ironically, however, a lot of these skilled workers may help develop technologies that cannot be supplied to their own countries.

Pundits based in developed nations have been touting that global capitalism is meant to benefit all humans on earth. But in its current form global capitalism benefits only the business executives who engage skilled humans globally to generate surplus profits for their own prosperity. The number of households with more than twenty million dollars in net assets is rising by 3000 per year, while 90% of households have stagnant incomes and little in net assets in USA.

Most developing countries like India impose taxes on imports. They also levy taxes on profits of multinationals. Most global capitalists live in developed nations like USA. They invest and consume their profits wherever they live. By operating from developed nations, global capitalists simply repatriate their net profits from countries like India. This seems fair at first-blush, but it is not so. Common people in the developing world forgo the benefits of investment of global capitalists' profits in public infrastructure like hospitals, educational facilities or other charity.

In short, the global capital accumulation process leaves the common people in dire straits, especially in the developing world in dire straits. It only yields unseemly prosperity for a few people within the developed nations. Profits from everywhere pour into their controls.

Proposition 2.6: *Direct foreign equity, not debt, investment in the businesses of a developing country is beneficial to common people, especially if the control of these businesses rests with individuals living in the country and if the country has capital control.*

Argument 2.6: A business entity in a developing country can either (i) earn profits to pay dividends or (ii) lose and become bankrupt. In either case, foreign equity investment in the entity is less risky and more beneficial than foreign debt to the developing country.

In scenario (i) foreign owners of the business will receive dividends in local currency. This reduces the developing country's risk due to a sudden depreciation in its currency value and an associated jump in foreign currency debt repayments.

Scenario (ii) would unfold only if the business entity has paid too much in material and labor costs or charged too low product prices. Such overpayments and undercharges would have benefited the local labor, material suppliers and consumers in the developing country. Locals thus benefit when a foreign-owned business entity loses or becomes bankrupt. If a foreign-owned business entity situated in a developing country becomes bankrupt, foreign equity holders will simply lose their equity as the local banks take over. Losses to foreign equity holders are gains to locals.

Suppose that the principal owners of a foreign-owned entity live in the developing country where the entity is located. Then they will follow a reasonable dividend policy for long-run stability of the business. This will preserve employment which is beneficial to the developing country. Equity owners will also use their dividends in investment, consumption or charity in the developing country of their domicile. This is beneficial and less risky to a developing country where foreign equity owners of a business live. In addition, corporate taxes are paid to the local government before any dividend is paid out. Such taxes benefit the local economy. Interests on foreign debt are paid before taxes are paid to government. The government does not earn taxes on interest payments made by a business to its debt holders. Foreign debt is thus not as beneficial as equity investment in the business situated in a developing country.

Developing countries like India and China have solicited direct equity investments by foreigners and expatriates. They have allowed repatriation of dividends. In the cases of severe losses and bankruptcies of foreign entities, local banks (creditors) have taken over such businesses.

Southeast Asian countries like Indonesia, South Korea and Thailand made serious mistakes in early nineteen-nineties by encouraging their companies to borrow foreign currency loans for business operation. The risk of such foreign debt investments can be severe. Foreign lenders can engage in arbitrage profit making strategies based on currency manipulation. Foreign lenders of many Southeast Asian companies short sold the local currencies in early 1997. By this strategy, they borrowed sufficient rupiahs from a local Indonesian bank, for example, to exchange them to dollars for immediate repatriation at the stable exchange rate prevailing then. When all foreign lenders arbitraged like this, the Indonesian reserve bank lost all its foreign exchanges leading to a collapse of rupiah value by the end of 1997. Then the foreign lenders sold some dollars to generate enough rupiahs to pay off their Indonesian bank loans. Many foreign lenders had to pay barely one-fourth of the amount of dollars they had originally repatriated to repay their rupiah loans, making enormous profits in the process. Such arbitrage exerted enormous pressure on prices of many Asian currencies. As the local currencies lost their values, the effective cost of foreign debt capitals to developing countries increased tremendously. Within a few months of the first such crisis in Thailand in July 1997, many Southeast Asian companies became technically insolvent.

Only foreign direct equity investment can save the local companies in developing countries from the risk of currency devaluation that is artificially created through panic and paranoia. In general, developing nations should admit only foreign direct equity investments since foreign currency debt (short-term or long-term) is likely to drive healthy businesses into insolvency due to sudden irrational currency devaluation. This can ruin the local employment and cause inflation leading to riots.

Even within a country, short-term corporate debt is risky to business corporations because such debt can mature before profits are generated. Borrowing short-term foreign currency corporate debt can increase the risk of a developing nation due currency devaluation. Even long-term foreign currency corporate debt should be avoided. It is because businesses can face rapidly deteriorating balance sheets when outstanding debts are inflated due to sudden currency devaluation. Such devaluations can be artificially engineered to drive corporations out of business.

Foreign direct equity, on the other hand, is beneficial to a corporation in a developing country. It is because the value of equity entered in the balance sheet is after conversion to local currency. This equity value remains unchanged due to any currency value fluctuation. The market value of the stock is driven by local market conditions. Foreign investors can sell their equity stakes at market prices to get their proceeds in local currency for repatriation at prevailing exchange rates. Currency devaluation thus transfers risks to foreign direct equity investors, not to the developing country where the foreign-owned business is located.

The problem associated with foreign currency debt is that it is an obligation fixed in terms of a foreign currency. The higher the aggregate foreign currency debt of a developing country, the greater is the currency risk. A developing country should try to minimize its total foreign currency debt to the extent possible. Only then can it avoid an IMF-engineered currency devaluation and market manipulation by mega capitalists. Countries like India that have significant restrictions on conversion of local funds into foreign currency are less prone to manipulation by exchange arbitrageurs. Local exporters even in such countries can, however, depress the value of their currency to earn more from their foreign exchange earnings to own more of the nation's wealth. This creates social instability, addressed later. ■

2.10 RISK OF GLOBALIZATION

The term "globalization" is used to indicate free flows of capital and goods across national boundaries. This includes tenets A and B of capitalism, presented in the previous sub-section. In its current form, *globalization* is more like laissez faire global capitalism. Laissez faire capitalism did not benefit any nation that followed it. Nations like USA have, therefore, adopted optimally regulated capitalism. A society can implement optimal regulation only if it is ruled by rational democracy. Globalization can likewise benefit the absolute majority only if the global society is governed by global democracy.

Globalization can succeed only if a rational global democracy with the following features:

- ❖ Running transparent legislative, judicial, and monetary systems.

- ❖ Monitoring markets to foster free flow of capital, labor, technology and products across international borders.

Mega capitalists have, however, imposed globalization in the form of laissez faire capitalism on the world via the World Trade Organization. Their goal is to sell high priced goods in the developed world after producing them at low costs in the developing world. This benefits only them, not the absolute majority in any nation.

Mega capitalists use the IMF lending to the developing world as a ruse for self-aggrandizement by subjecting the absolute majority to economic bondage. They first engage governments in the developed world to borrow massive sums to lend through the IMF to rescue developing nations. These funds are then recycled back to the mega capitalists. This process mortgages the absolute majority in both the developed and the developing world. The absolute majority needs to appreciate how they and their future generations have been subjected to perpetual bondage due to debt. One may call this mega economic bondage a form of neo-colonialism by mega capitalists. It is not congenial for mankind. Human liberty and prosperity are at stake everywhere.

2.11 MYOPIA AND NATURAL RESOURCES

Is mankind advancing due to capital growth and new products? Does economic prosperity lead to long-term happiness? Intense business activities obviously deplete natural resources, degrade environment and cause friction among individuals. Humans cannot set fair market prices for depleting natural resources or degrading environment. The nature does not participate in a capitalistic exchange economy to set prices for limited natural resources. For example, crude oil reserves on earth are obviously limited. Yet, this natural resource is a lot cheaper than an equivalent quantity of man-made carbonated drink with virtually unrestricted supply. Mega capitalists control the supply of cheaply available commodities like artificial drinks to sell them for high profits. But they do not seem worried about pumping limited supplies of crude oil. They foster virtually unrestricted consumption of limited natural resources. This is myopia. Myopic capitalists have created virtual oversupply of naturally restricted products like oil, while limiting the supply of abundantly available products like artificially flavored water.

Such artificial supply and demand of a natural commodity drive the price leading to a dangerously lopsided global resource allocation among humans. Is this the contribution of capitalism to mankind? How are humans seduced by such myopic capitalism? There are fifty thousand nuclear warheads pointed at each other on earth. Is it because life is so short that everyone needs to be myopic to destroy humanity?

Why should gross domestic products, measured by virtual prices, be barometers for intellectual growth of human society? Per capita growth in GDP is not a meaningful measure of prosperity of the absolute majority in any nation. A significant number of people, especially in the developing world, are reeling under poverty despite high GDP growth.

Nearly a billion human beings on earth live in absolute poverty, according to the World Bank estimates. More than half of these people live within ecologically rich environments capable of yielding far more valuable biomass than the GDP measured by economists. Poverty could be perhaps alleviated in these countries if environmental resources are not heavily degraded.

These areas have witnessed massive deforestation, scorching due to heavy mining, soil erosion and disturbances in hydrological cycles. This has led to a complete disappearance of economic bases for people living in these areas. Bouts of massive flooding and drought with unsustainable agricultural production and precarious animal husbandry have plagued these poor regions.

Flood and drought cycles in China, India and Bangladesh vivid remind the severe ecological decays in these areas. Harsh economic needs have led to massive migration of the rural poor to urban ghettos. Urban areas face greater challenges due to poor sanitation and drinking water resources. Is the economic trade off between ecological degradation and the struggle to raise income justified? Steeped in humdrums of economic survival, the public remains nonchalant about ownership of natural resources. Mega capitalists exploit public apathy for self-aggrandizement.

3 REGULATED CAPITALISM

Individuals cannot always produce all of their needs. They depend on each other to satisfy some of their needs. Markets help in fulfillment of needs through exchanges of surplus *goods,* products and services. Markets succeed in engaging humans for division of labor to produce different goods because they allow trading of surpluses for shortfalls. Individuals who are unable to produce can still exchange their labor to fulfill their needs. Those who supply their surplus products are called capitalists. Those who exchange their labors to buy products supplied by capitalists are consumers.

Capitalists build plants and engage household workers on wages. Workers use their wages to buy goods supplied by the capitalists through markets. This is market system of exchange between capitalists and households on wages and salaries. If not monitored and guided by government, this system is *laissez faire capitalism*. Before the Great Depression, laissez faire capitalism was in vogue. But this form of unbridled capitalism was a fiasco. This is because mega capitalists are tempted to hoard critical goods instead of exchanging rationally with households. This happens as capitalists become monopolistic suppliers of human necessities like life-saving drugs. With no compunction, they can then wangle most, if not all, of the wealth of needy households. Banks in laissez faire capitalism exude tremendous market power to become usurious enough to swindle individual savers and borrowers. If a weak bank fails in such a system, depositors panic to withdraw their deposits. The spreading of news about banking failure creates systemic panic among all bank depositors, lining up to withdraw their deposits simultaneously. This is called banking run. It happened in USA during 1907 due to laissez faire capitalism. Such capitalistic pitfalls have led intellectuals like Karl Marx to ponder if laissez faire capitalism can meet human needs.

Economic progress depends on efficiency in resource allocation and utilization. A benevolent dictator or a centralized bureaucracy can theoretically achieve the most efficient resource allocation if it can learn the preferences, abilities, information, and endowments of all people in a society. In economics, such a dictatorial central planner obtains the first best or *Walrasian* solution to a resource allocation and utilization problem. This is the first-best solution because it is the most efficient by definition. It can be attained only by a *Walrasian* central planner operating as a benevolent dictator with all the information. The concept of benevolent dictatorship swept the imagination of the communist and socialist world.

The main difficulty in attaining the most efficient solution is that no central planner can gather all pertinent information about every individual in the society. Furthermore, an ostensibly benevolent dictator including a centralized bureaucracy can turn despotic in reality. Dictators can hobble freedom of people, choke their abilities, suppress their preferences and confiscate their endowments. The game of attaining the most efficient resource allocation can take a bizarre twist as in the former Soviet Union.

Without the information about endowments, preferences and abilities of all people, the government of a country should leave it to people to perform their best by letting them enjoy the fruits of their own efforts. The West has championed the concept of capitalistic democracy to let people do their best in allocating and utilizing resources efficiently.

Capitalists supply products to consumers for profits and lend their surplus profits to people, indirectly through financial intermediaries, to boost consumption. Consumers comprise the households on salaries and wages, governments and businesses. The core capitalistic objective is to accelerate the consumption of highly profitable products by facilitating credits to consumers.

This objective can be accomplished only if the consumer demand for borrowing grows, which is possible either when incomes rise or credit terms are lenient.

Proposition 3.1: *The central bank of a country can create a temporary illusion of prosperity by sufficiently lowering the interest rate or increasing money supply. This can create price bubbles that eventually burst.*

Argument 3.1: A central bank can lower the short-term bank rate of interest by its decree. It can lend commercial banks at such decreed low bank rate. Commercial banks in turn reduce their interest rates on deposit and lending. Lower deposit rates induce depositors to redeploy their funds elsewhere like real estate. Commercial banks set higher lending rates than the cost of their funds. But their lending rates go down after the lower decreed central bank rate takes effect. The lowered lending rate entices households to borrow more for higher consumption. The lower interest rate also induces governments and businesses to borrow for expansion, increasing employment and wages. A rise in wages lifts up people's illusion, generating thereby pseudo confidence in the economy.

Such a scenario unfolding due to the central bank decree can give capitalists an opportunity to increase prices of their products, may be with slightly higher qualities. Capitalists thus transfer wealth from consumers through higher profit margins and then to lend the surplus profits to accelerate credit supply.

Accelerating credit supply raises the debt-driven corporate profits. It then generates a widespread illusion of prosperity through bubbly asset prices that eventually burst. As the price bubble bursts, some businesses collapse, governments' budget deficits rise and many people lose their jobs and incomes.

Top business executives first observe the advent of any collapse in their own businesses. They exit the industry with golden parachutes and proceeds from sales of their capital stocks. This leaves the less informed common people with worthless scrip such as those of bankrupt Enron and MCI-WorldCom as in year 2002.

Table 3.1
Federal Funds Rates (1998-2005)

TIME	RATE	TIME	RATE	TIME	RATE
Aug 05	3.50	Jun 03	1.00	Mar 01	5.00
June 05	3.25	Nov 02	1.25	Jan 01	5.50
May 05	3.00	Dec 01	1.75	Jan 01	6.00
Mar 05	2.75	Nov 01	2.00	May 00	6.50
Feb 05	2.50	Oct 01	2.50	Mar 00	6.00
Dec 04	2.25	Sep 01	3.00	Feb 00	5.75
Nov 04	2.00	Aug 01	3.50	Nov 99	5.50
Sep 04	1.75	Jun 01	3.75	Aug 99	5.25
Aug 04	1.50	May 01	4.00	Jun 99	5.00
Jun 04	1.25	Apr 01	4.50	Nov 98	4.75

3.1 HOUSEHOLD NET WORTH, A MEASURE OF PROSPERITY

The per capita GDP growth fueled by easier credits is a pseudo measure of prosperity. Propaganda about GDP growth perhaps seduces common people to borrow and spend. This can go on until they discover that they have saved little for retirement and posterity. Such discovery will then keep them on tenterhooks perpetually. A rational barometer of prosperity that should be measured and broadcasted is the true per capita net worth after accounting for government and household indebtedness.

The true per capita net worth (wealth) is rapidly eroding for the vast majority of American households while the very rich are turning even richer. Democratic governments are kowtowing to mega capitalists instead of serving best public interests for long-run social stability. Governments must create economic and political environments conducive to earning fair rates of returns on investments in new business ventures. Only then capitals can grow to induce capitalists to invest in new businesses to create new jobs for society. But mega capitalists do not simply target for fair rates of returns on their investments. They seem to want complete control and economic bondage of the vast majorities of households.

Governments are paid to serve public interests like employment growth by creating environments suited for rational capital growth. Capitals can grow even when rates of returns earned on investments are fair enough. But tacit government support for usurious rates of returns on capital investments is tantamount to pandering to mega capitalistic goals. Such pandering can ultimately disrupt the system that benefits all. It is more costly to restore a disrupted system than to prevent disruptions through preemptive policy initiatives.

Credits have phenomenally expanded worldwide during the last decade. Easier credits have boosted consumption. But credit-based consumption growth amounts to mortgaging future incomes and cutting savings to almost nothing as in USA. This has shrunk per capita net worth of ninety percent of American households. The American household debt has swollen from about 50% of GDP in mid-eighties to 100% by the end of 2004. The Chinese domestic credit has ballooned to 163% of GDP from 105% just five years ago. Mega capitalism has decimated the average American household wealth of the vast majority to a level existing in 1965, except for the bubbly home equity values. This does not even count the indirect national debt of about $80000 per American household. This has to be paid through higher taxes in future. Table 3.2 gives the absolute growth in debt of the developing world. In 13 years, it has doubled its debt. Like for the U.S. this debt has contributed to growth in GDP of the developing world.

Table 3.2
External Debt in Billions of Dollars
(Source: World Bank)

REGION	1990	2003	GROWTH
East Asia & Pacific	234	526	225%
Europe & Central Asia	217	676	312%
Latin America & Carribian	445	780	175%
Middle East & N. Africa	140	159	113%
South Asia	124	183	148%
Sub-Saharan Africa	177	231	131%
Total	1337	2555	191%

Asian nations have accumulated more than $2 trillion in trade surpluses, deposited mostly in American and European financial intermediaries. Asian and American multi-millionaires have funded $12 trillion for household credits and nearly $8 trillion for federal government debt. Household credits have expanded by more than $3 trillion in last three years alone. A widespread belief prevails among lenders that American borrowers are safe bets due to income and employment stability. Historically, American home mortgage default rates have been about 1 percent. But financial disasters rarely have histories to go by. Outsourcing of high paying American jobs to other countries can increase household credit risks substantially. The mega global capitalistic system now depends on stability of American household incomes. But simultaneously it is also sapping this ephemeral stability by exporting jobs from USA and by reducing wages in the country. The current global capitalistic system acts like an animal to undercut the roots of a tree that provides it shade and food.

How long can the American households and government expand their consumptions by borrowing? They may soon realize that prosperity is not around the corner and outsourcing may increase the probability of job and income loss. But they are likely to make up for the massive erosion in their net worth by borrowing less, saving more and spending less of their incomes. Americans will quite likely adapt the strategy that the Japanese followed in the wake of their asset bubbles to consume less and save more for future financial security. A change in the American household behavior can squeeze the capitalistic expansion of the credit driven consumption in USA. If mega capitalists outsource high paying jobs on a massive scale to maintain their usurious profits, then lowered household incomes can trigger unprecedented defaults on household loans. Such defaults can naturally erode the capital surpluses which have been created usuriously. This will prove to be a costly solution of any brewing problem.

Mega capitalists are now striving for expanding their envelopes of debt-laden consumption to engulf the globe. Elitist rulers in developing nations misconstrue loans as aid. Prompted by personal kickbacks or threats to their regimes, they tacitly collude with mega global capitalists. They can play such games only until the absolute majority in the developing world wakes up to the dangerously looming foreign debt. Their games have been already exposed in countries like Indonesia, Russia, South Korea, Argentina and Brazil.

The International Monetary Fund is a lodestar of collusive mega capitalism. The IMF steps in with an ostensible goal of rescuing nations ridden by foreign currency debts and depressed currency values. A developing nation faces such predicament due to financial mismanagement, which saps national competitiveness affecting its exports adversely. Decreased exports and current account deficits stifle the ability of the nation to pay for its vital imports. It then leads the nation to borrow more foreign currency loans and to remain trapped in the rut. During the rescue, the IMF effectively converts mega capitalists' lending to businesses in a trapped developing country into sovereign public obligations, devalues the national currency and raises the specter of inflation. It leads to social unrest. By now the elite rulers and their fellow business executives in many debt-laden developing nations have already economically enslaved the public in collaboration with mega global capitalists.

Such collusive mega capitalism has so far succeeded in convincing voters in developed nations that their governments' funding to the IMF will be eventually recovered from the indebted sovereign nations. Countries like Russia, Brazil, Mexico and Argentina have defaulted. Brazil and Argentina were infused with fresh loans. After having defaulted in 1998, Russians need new IMF funds to service their existing debts. Common Russians have been disillusioned with collusive mega global capitalism orchestrated by their oligarchy. How can a country like Pakistan boost exports to pay off its $38 billion foreign loans? Pakistan needs more international funds to simply pay interests on existing debts. Will mega capitalists force their governments to bomb nuclear Russia or Pakistan to recover their debts?

How long can deceptions of voters within the developed world continue? To emerge from such deceptive rut, common people must learn the dire predicament of collusive mega capitalism that eventually decimates their true per capita wealth and prosperity. They must recognize that per capita income growth is a misleading norm of human well being. Racing behind a mirage of wealth leads to frustration. Emancipation from perpetual economic bondage is necessary in developed societies. The truth about household net worth of the absolute majority in developed countries like USA must be broadcasted periodically. Only then can common people extricate themselves from the clutches of mega collusive capitalism.

3.2 GOVERNMENT REGULATED CAPITALISM

Consumption needs of individuals drive the demands for *goods*, products and services. Producers can deliver such goods if prices they receive exceed their costs of production. Consumers will buy goods only if their preferences lead to greater valuations than the prices they have to pay. The ultimate consumers are household people employed in governments and businesses for salaries and wages. They contribute their labors to produce goods which they and producers consume, ultimately.

The capitalistic system functions through prices at which goods are exchanged for labors. This system is obviously nonpareil and desirable because it induces everyone to produce and invent, which are necessary to enhance human development and prosperity. But there is a potentially serious problem for the exchange mechanism to function smoothly all the time due to the way prices of labors and goods are set in reality.

A monopolist producer of life-saving drugs, for instance, can set exorbitant prices of such drugs relative to wages. Even the inventors of such drugs researching in the monopolist's laboratory may benefit little because of the ex-ante agreements they sign to keep discoveries secret. Without such agreements, the monopolist would bar scientists from using his research laboratory. This system guaranteed by governments allows monopolists to set high prices for badly needed goods. This leads to wangling by the mega capitalists the wealth of rest of the households. It subjects the vast majority to bondage at low wages. Within the capitalistic exchange mechanism a few capitalists can thus virtually enslave the vast majority. But consumers cannot perpetually tolerate unseemly low wages. Their simmering anger will lead them to organize to agitate against producers. Agitations disrupt supplies of goods, affecting everyone in society adversely. This is why governments must act in public interests to do the following:

- Continually monitor the capitalistic exchange system.
- Adopt preemptive policies to perpetuate fairness in prices.
- Foster capital growth at fair returns.
- Discourage usurious profits.
- Induce production of goods to meet consumer needs.
- Create new employment.
- Maintain social stability.

Without social stability, capitalism will collapse, virtues of capitalism will vaporize, and human prosperity will not follow.

To check monopolistic price gouging, governments in advanced nations like the U.S. have adopted antitrust regulations to promote competition. They have taken steps to break up such monopolies as the Standard Oil and American Telephone and Telegraphs (AT&T) into smaller competing units. AT&T was a telephone giant, generating usurious profits and operating very inefficiently before its break-up in 1983. AT&T was divested into several Baby Bells (regional local phone service providers) and a long distance carrier which became the diminished AT&T. This diminished AT&T has been recently taken over by one of the Baby Bells, the Southern Bell Company. The U.S. regulations prompted the emergence of competing long distance carriers like MCI, WorldCom and US-Sprint following AT&T's break-up. Under the new telecom structure, each Baby Bell provided local phone service in their operating zones with little competition. Recently, though, cable television companies are offering local and long distance phone service through cable lines and internet. Some long distance phone companies including the Ma Bell, AT&T, were also allowed to compete for local phone service by using Baby Bells' local networks at prices guided by government regulation. To prevent Baby Bells from overcharging local phone users, the state governments instituted regulatory commissions to ensure that phone charges (prices) represented the opportunity cost or the weighted average cost of capital of the phone company. Such elaborate government intervention is really necessary to thwart monopolistic price gouging that hurts prosperity of the vast majority. Without government regulation the free market exchange system will lead to transfers of irrationally large amounts of household wealth to monopolistic producers. Microsoft and Intel are other examples of monopolies being currently scrutinized by the U.S. government from time to time.

This form of capitalism marked by government monitoring and regulation has evolved from the unbridled laissez faire capitalism. Now the governments regulate mega capitalism. It is needed to channel the virtues of capitalism towards human prosperity. It is socially sub-optimal to protect either consumers or producers, selectively. The goal of the government should be to protect against degeneration of capitalism induced by mega capitalists or excessive trade unionism.

Capitalism and democracy can be characterized through a few simple and fairly robust propositions.

Proposition 3.2 *(Laissez faire capitalism is untenable): Define pure (laissez faire) capitalism as one in which surplus goods, capital and labor trade at prices determined by supply and demand without government interference. Assume that only a small fraction of people, say less than five percent, has an unparalleled level of talent and ability, and that all human beings are compelled by their baser instinct to aggrandize wealth and power. Then, laissez faire capitalism is incompatible with any form of government including democracy that stands for the welfare of the absolute majority.*

Argument 3.2: Suppose there is no government in a society with a small minority of able (talented and skilled) individuals. If the able minority is selfless with no lust for wealth and power, it will simply advance the frontiers of human knowledge to benefit the entire human society. Such a minority will trade its surplus talent for free, leading to a benevolent society in which the able individuals work hard to uplift common masses of people. Such a society is the equivalent of the mythological Ram Raj in ancient India or the Riba-free Islamic utopia of Prophet Mohammed. This society will follow laissez faire capitalism to build capital and supply goods and services to everyone at reasonable prices. In this society, the able minority is simply motivated by evangelism, as opposed to baser human desires for wealth and power.

If, however, the able minority is motivated by power and wealth, it will wangle most resources from common masses, use their talent and skill to kill or emaciate weak humans, build fortified enclaves with strong defense and offense against the rest of humanity. This may lead to social anarchy. This society is inconsistent with a democratic system of government expounded by the Greeks: a numerical majority ruling the society.

3.3 REGULATED CAPITALISM ON TENTERHOOKS

Competition for supplying a product in demand is not feasible if there is only one dominant monopolistic producer. A monopolist will adopt a pricing policy to extract as much as customers can pay through their labor. He will prevent entry of potential entrepreneurs into his industry. This is a strategy of a monopolist like Bill Gates, the richest person in the world. The only way to prevent a supplier or a cartel from gouging the price of a product arbitrarily is to have the government intervene in public interest. The government should follow transparent policies defining the conditions under which it will step in to check price fixing. But it is necessary for a society to bestow the government with the power to arrest arbitrary price setting behavior of entrepreneurs.

Governments can thwart price gouging by monopolists. But they cannot contain price rises in sectors with captive consumer bases and highly skilled workforces, as in aircraft, healthcare, insurance, energy and education sectors. The prices of goods in such sectors will keep increasing due to tacit collusion among suppliers comprising cartels of highly skilled workers and captive consumer bases. Only lower consumer demands or greater public protests can dampen price rises in these sectors. Governments cannot do much. Managements in such sectors are diffuse and drawn from highly skilled workers like professors, engineers and doctors. They can set norms to generate low enough operating margins for profits or surpluses. But lower norms cannot contain rising prices of goods they supply. Why? Such sectors foresee their customer orders. Entry of new producers to such sectors is prohibitively costly. The can set prices to generate the desired low margin after production costs. But it is impossible to contain their production costs – salaries, wages, bonuses and perquisites - of highly skilled workforces who effectively control managements. Managers not having the same level of skills as that of the workforce cannot administer these industries easily. The margin of profit in these sectors can be deceptively low or negligible. But production costs can still rise exponentially due to tacit mutual collusion among highly skilled workforces raising their pays and perquisites. They raise the prices of their products and services as much as their customers can afford. It is to recover artificially raised pays and perquisites in these sectors. Governments cannot regulate such price fixing. But optimal public policies can be established to tax the large incomes at higher rates and to cut household credits of the absolute majority.

Consider the case of Boeing and Airbus. They are two competing but oligopoly manufacturers of aircraft. They do not generate much profit because of substantial production costs. The prices of aircraft have gone up as much as consumers (airlines) have been able to bear. The airlines' ability to pay for rising prices of aircraft depends on the level of competition in the airline industry, the cost of airline operations and the fare air travelers can afford. A sufficiently competitive airline industry generates little profit for itself. It uses most of its revenues to pay for the aircraft, which are over- priced due to high wages and perquisites of highly skilled workforce in the aircraft industry. Air travelers thus pay for high wages and perquisites of managers and workers of the duopoly of aircraft suppliers. The vast majority in the developed world are air travelers.

The government cannot control rising air travel costs borne by the vast majority due to the duopoly price fixing in the aircraft industry. The U.S. and the European government establishments seem to exhibit strong motivations to not control these costs. They may believe that by remaining passive, they foster massive transfer of wealth from air travelers of the rest of the world into their countries. But only the vast majority in the developed world who need to travel by air bears the brunt of such passivity. The competition between Boeing and Airbus can cut their production costs only as much as their skilled workforces can accept for their comfortable living. Competition between Boeing and Airbus may have reduced wage raises of their workers somewhat. But even the reduced wage raises in Boeing and Airbus are exorbitant in comparisons to that for the absolute majority. It is true, though, that the relatively rich air travelers in the developing nations bear the high wages in the aircraft industry in USA and Europe. But the rich within the developing countries amass their wealth within their countries by the same capitalistic process, i.e., by gradually aggrandizing wealth from the vast majority. Thus the absolute majorities in both the developed and developing worlds ultimately bear the high wages of the duopoly aircraft producers. Government passivity is not in the best interest of the absolute majority anywhere. Subsidizing the aircraft manufacturing industry is still worse and sub-optimal for the prosperity of the absolute majority in every nation.

The democratic form of government has been accepted, willy-nilly, by many relatively homogeneous societies like the Greeks, French, English, Spanish, Germans, Americans, Japanese and Indians. Still democracy is not the ideal form of government for all people in a democratic society because it suppresses the minority view in governance. It accepts only those minority opinions that also appeal to the majority. Ruling a democratic nation by an able and shrewd minority of mega capitalists is still possible through crafty policies as long as the majority fails to perceive such policies as harmful. In the pre-Great Depression era, for example, a talented minority of capitalists articulated laissez faire capitalism as the only way to prosperity for the majority. Until serious economic devastation wrought by the Great Depression became transparent to all, the majority had failed to fathom the real dangers of unbridled capitalism.

The real danger is potential social instability due to the concentration of wealth in a minority of a democracy. This wealth is, actually, a reflection of the extent of the economic bondage of the absolute majority with democratic power. The absolute majority in the U.S. has realized eventually that the pre-Great Depression era laissez faire capitalism was responsible for ruining its prosperity. It had then wielded its democratic power to tax capitalists' profits, monitor markets to foster competition, and abolish monopolies. How will the absolute majority act this time? It may optimally vote for cutting its debt by fiat and to raise huge taxes on the usuriously generated wealth. Huge household debts are due to sub-optimal wages that create usurious profits for the mega capitalists. The government establishments even in the developed nations are willy-nilly backing mega capitalism. Mega capitalists have, therefore, wielded enormous power to gouge both product prices and household wages to create their usurious profits stored as household credits of the absolute majority.

USA boasts about its freest capitalistic system and markets in the world. But it is still helpless. It still can employ antitrust laws to check arbitrary price-fixing behavior of entrepreneurs. If competition is not feasible for some products or services, the U.S. government may not hesitate to break-up enterprises like AT&T and Standard Oil. The government has encouraged the emergence of other long distance phone companies like MCI and U.S. Sprint to compete with AT&T. Such divestitures have generated genuine competition in the long distance phone markets and reduced the cost of long distance calls drastically. But it still has left the newly created local phone companies, the Baby Bells, as monopolies within the areas they serve. State governments in USA have elaborate schemes to regulate local phone bills. But local phone users continue to have complaints about high charges and low quality of service. The local phone companies are also fighting in court against the introduction of competition within their local phone markets. The government wants to promote such competition by forcing Baby Bells to offer their networks at fair prices to competitors.

The U.S. government has investigated Microsoft and Intel and many other companies against anti-competitive practices. Microsoft has forced computer suppliers like Dell and Compaq to not install on their computers the Netscape web-browsing software that directly competes with Microsoft Internet Explorer. Since these computer makers need Microsoft Windows to sell their computers, they have complied with Microsoft's threat. Intel has also allegedly prevented competition against its computer chips.

3.4 OPTIMAL REGULATED CAPITALISM

Capitalism's virtues can enhance human prosperity. But its inherent vices must be contained through optimal regulation to serve best public interests. Many nations have therefore promptly empowered their democratic governments to regulate, intervene, and discipline markets. This is to circumvent irrational consumer fear and promote fair markets for labor, capital and products. Countries like USA have enacted antitrust laws to empower governments to thwart monopolistic price gouging. Such laws have not helped, however, in staving off the real problems like massive erosion in household net worth. This is due to explosion in debt and decline in real wages of the absolute majority, which has the authority in a democracy but seems unable to veer the society towards equitable prosperity.

Smart mega capitalists have stayed ahead in their games. They have outmaneuvered the absolute majority and democratic governments in powerful nations through effective propaganda. The absolute majority rarely deciphers long-term adverse effects on its prosperity of policies like deficit-based tax cuts and defense build-up *before* enactment through propaganda blitz and lobbying by mega capitalists and their political sponsors. By the time the absolute majority learns about the inequity in wealth wrought by such policies, mega capitalists will have moved on to new wealth transfer schemes. The income tax cuts, payroll social security tax increases and defense build-ups during nineteen-eighties sounded good on the surface even to the absolute majority. The absolute majority also enjoyed some tax cuts, made some extra retirement savings through social security and felt fortified by national defense. Therefore, they did not complain.

But under the veneer of these feel-good policies, the U.S. national debt has mounted from about US$80 billion in late 1970's to nearly US$8 trillion now. The absolute majority has landed up paying more of the government budget through social security payroll taxes, while the rich have become ultra-rich. The absolute majority is now facing greater social security benefit cuts than the ultra-rich under a current government proposal. A social security system that guarantees more retirement benefits than actuarial values of contributions could not viable. But it was instituted to please the absolute majority.

The mega capitalists have effectively hoodwinked the absolute majority and made the democratic power of the latter useless. The governments even in democracies seem to collude with unscrupulous capitalistic players to operate barely within laws or create new furtively fair laws for self-aggrandizement. The absolute majority should think of the potential ramifications of policies that may sound universally beneficial but effectively transfer wealth to mega capitalists. Public establishments even in developed societies may be barely trained or competent to thwart systematic wealth transfer devises enacted through laws pushed by a fringe for self-aggrandizement. It is thus optimal for the absolute majority to vote for cuts in household credits and to levy greater taxes on wealth and income of the richest.

4 OPTIMAL REGULATION

Laissez faire capitalism is not compatible with democracy. But there is no form of governance which is more acceptable to a civil society than democracy. Then what form of capitalism is suitable to a civil society? It is democratic capitalism with optimal government monitoring and regulation in best public interest. The best public interest should be judged by *higher real wages and lower prices of everything else*. The real per capita wage is almost stagnant in USA over the last three decades. It has perhaps fallen precipitously for the vast majority of Americans, especially, after factoring in the steep rise in healthcare cost and college tuition.

4.1 OPTIMAL MONETARY AND BANKING POLICY

A government working in the best public interests must welcome falling or deflating prices of products, commodities and other human needs. It is because deflating prices are welcome to the vast majority of households languishing in stagnant real wages. But the U.S. central bank, Federal Reserve Board (FRB), warns about dangers of deflation in product prices. Product prices have been rising over the past two years. But prices were falling during late nineties, when the FRB expressed its fears about deflation and raised interest rates, apparently to stop irrational exuberance in stock markets. A nation must mandate the mission for its most important financial institution, the central bank. An important government agency like the FRB must have a well defined goal that serves the vast majority of Americans. The FRB has openly expressed that its interest rate policy is meant to fight inflation. The FRB should then explain why it is still scared about deflation.

The price of capital is reflected by the yield to maturity of government treasury securities. This price is determined by market forces of the supply of money by lenders and demand for money by borrowers. A falling price of capital serves the best interests of the absolute majority of a society. It makes their mortgage loans and other credits cheaper, serving their best interests. The most important public financial institution of a democratic country should serve the best interest of the absolute majority. But the FRB does not seem to be happy about the yield to maturity on the ten-year U.S. Treasury Note not rising along with the short-term bank rate it has been raising lately. The ten-year U.S. Treasury yield has been hovering around 4% despite the decreed short-term central bank rate rising from 1% in 2003 to 3.5% now. The FRB has called it a conundrum. Why? If the price of capital is determined by market forces of supply and demand for capital, there is no conundrum. The ten-year yield is not rising because there is an abundant supply of capital generated usuriously from lower household wages. The households cannot borrow more to boost consumption.

U.S. Banking Panics and Federal Reserve: Federal bank deposit insurance did not exist when the Wall Street Panic of 1907 occurred. Rural banks then lost confidence on national banks in the wake of severe economic depression after the unemployment rate reached 20% in the fall of 1907. National banks drained their reserves due to withdrawals of deposits by rural banks. Reserves could be replaced according to the federal law. This law allowed national banks to sell bonds and stocks or borrow new funds or call for repayments of loans outstanding with customers. When many banks attempted to sell bonds and stocks, markets crashed. This forced national banks to ask customers to repay outstanding loans as per Treasury regulations. Many businesses, farmers and households were unable to repay their loans on demand. They were forced to be bankrupt. This was a domino effect. The public was frightened by the specter of losing their deposits. They stormed into any bank rumored to be in financial strains. Anyone who could not withdraw his deposits before the bank ran dry of funds lost his savings all together. The scale of crisis was so huge that banks across the country suspended withdrawals. Several prominent banks in New York collapsed. Millions of people lost their deposits as thousands of banks failed. The crisis was terminated when a phenomenally wealthy banker, J.P. Morgan, made short-term loans to important New York banks to help them weather the storm.

Debates on Wall Street and in Washington then reached a consensus to start an institutionalized J.P. Morgan. It was to have an institution that could provide emergency liquidity to a banking system to prevent potential panics from starting. A bipartisan Congressional body called the National Monetary Commission was formed in 1908, following the panic of 1907. Its report set the stage for the Federal Reserve Act of 1913. Under this act, a decentralized banking system and monetary authority (Federal Reserve Board and twelve Federal Reserve Banks) was formed to avert such crises by providing the liquidity necessary to meet the economy's needs. This act was amended in 1933 and 1935. The FRB is administered by seven members (governors) appointed by the U.S. President to determine general monetary, credit, and operating policies for the system, and to formulate rules and regulations necessary to carry out the purposes of the Federal Reserve Act.

The Glass-Steagall Act, first enacted in 1932, took the U.S. off the gold standard. It greatly increased the ability of the FRB to influence the money supply. The Banking Act of 1933 made banking safer and less prone to speculation through the federal guarantee of bank deposits. The Federal Deposit Insurance Corporation was formed by the U.S. Congress in 1933 to insure bank deposits up to $100000 per account holder. The acts of 1932 and 1933 were reactions of the government to cope with the economic problems which followed the financial crash of 1929. The Banking Act of 1933 also separated the activities of banks and securities firms. It prohibited commercial banks from owning brokerages. The Glass-Steagall Act has been repealed in 1999.

The Act of 1913 gave the FRB the responsibility to set monetary policy. According to the FRB, monetary policy refers to influencing the availability and cost of money and credit to help promote *national economic goals*. The FRB controls three tools of monetary policy: (i) open market operations, (ii) the discount rate, and (iii) reserve requirements.

The federal open market operations are purchases and sales of the U.S. Treasury and federal agency securities. They are the principal FRB tools for implementing monetary policy. The short-term objective is to achieve a desired quantity of reserves or a desired price of capital, the federal funds rate. The *federal funds rate* is the interest rate at which depository institutions lend balances at the FRB to other depository institutions overnight. The *discount rate* is the interest rate that the FRB charges on lending through its *discount window* to commercial banks and other depository institutions. The reserve requirements are the amount of funds that a depository institution must hold in reserve against specified deposit liabilities. Within limits specified by law, the FRB has sole authority over changes in reserve requirements. Depository institutions must hold reserves in the form of vault cash or deposits with Federal Reserve Banks.

The history of the FRB shows that its actions have increased economic instability. The *national economic goals* that the FRB vows to accomplish through its monetary policy are not specified anywhere. Between November 1998 and August 2005, the FRB has changed its rates thirty times, by merely reacting to Wall Street. The FRB was responsible to exacerbate the severity of the Great Depression of the 1930s by shrinking the money supply dramatically.

In the absence of an unambiguously stated national economic goals being pursued by the FRB, assume that the FRB is supposed to achieve the following national goals:

i. To regulate money supply through interest rate. It is to raise or lower the bank rate when inflation is expected to rise or fall, respectively.

ii. To facilitate smooth operation of the inter-bank payment system through the system of twelve Federal Reserve Banks.

What has the FRB done lately with respect to mission (i)? During 1999 inflation was absent and deflation was an issue. But the FRB raised interest rates, apparently to punish the stock market. Should it be a goal of the FRB to control prices of stocks or other assets like real estate? The FRB had signaled unambiguously that it did not like rising stock prices during late 1999 and early 2000. Major investment banks took cues from these signals to establish massive short positions in early 2000 and then began trading on the short side. Passive investors like those banking on stock mutual fund for their retirement savings lost massively. Household sentiments dipped due to serious losses in values of their portfolios. Businesses trimmed their investments in new ventures and started outsourcing their jobs. This happened due to the FRB's rate hikes in a period of price deflation. How did this help the vast majority of American households? What national economic goal did it serve? Would the stock prices not self-correct without the FRB dangling a dagger of higher interest rates during a period of deflation?

4.2 PUBLIC INTEREST, USURY AND CENTRAL BANK

The public interest must be well defined and mandated for a civil society. Central Banks like the FRB must be held accountable for taking policy actions, which are consistent with such mandated public interest. A common interest of individuals of a society is *higher real wages and lower prices of everything else*. If this is accepted as the best public interest, it can be measured only by accumulated net savings, which are held in financial and real assets. This can be assessed only by the value of net assets, which is the difference between the values of assets and liabilities of a household. The value of net assets is also called net worth.

Any household's desired goal has to be to increase its net worth. This is obviously the goal of producers, who state it explicitly to increase sales and raise profits. So, there exists *unanimity* among households about the goal of increasing household net worth. Governments working in public interests must therefore mandate that their Central Banks collect net worth data from every household, periodically. Only growth in per capita household net worth, especially of the absolute majority, should be broadcasted periodically. Only this measure can depict the economic prosperity and long-run stability of a society.

The price of everything but labor must go down in the best public interest. Lowering the price of capital (rate of interest) is in the best public interest. Central Banks, especially the FRB and the Bank of England, try to attain a zero real rate of interest by making the nominal bank rate equal to the rate of inflation. The oldest known reference to *interest rate* is found in Hindu Vedic manuscripts dating from 1,500 B.C. A Hindu lawmaker Vashistha instituted a special law around 500 B.C. to forbid the higher castes and warriors from exploiting the lower castes by charging interest on loans. Even Prophet Muhammad in 600 A.D. provocatively suggested an interest (*riba*) free economy. In 1745, the Catholic teaching on interest rate (usury) was expressed by Pope Benedict XIV in his Vix Pervenit. It strictly forbids the practice of interest rates. The Bible states (Exodus 22:25): "*If thou lend money to any of my people that is poor by thee, thou shalt not be to him as an usurer, neither shalt thou lay upon him usury*." Judaism also forbids a Jew to lend money at interest to another Jew. Famous spiritual leaders and philosophers have denounced the practice of charging interest rates on money. They include Plato, Aristotle, Cato, Cicero, Seneca, Plutarch, Aquinas, Muhammad, and Moses. In the United States, *usury laws* are governed by states to specify the maximum *legal* interest rate on loans.

A policy of keeping the nominal rate equal to the rate of inflation is not necessarily consistent with the best public interest. If the nominal interest rate has to fall below the rate of inflation due to demand and supply for capital, the Central Bank acting for the best public interest must not tinker with the market forces.

Unfettered supply and demand for capital determine the true prices of capital or the true rate of interest of an economy. Estimates show that usurious profits have gravitated to a few mega capitalists who have accumulated a whopping $11 trillion. This amount has been stored in the form of credits to households in perpetual economic bondage. The supply of capital has enormously increased. But indebted households with dwindling incomes have lost appetite to pile on more debts to spend. Natural economic forces have emerged to exert downward pressure on interest rates. The ten-year U.S. Treasury yield has been hovering around 4%, despite rapid rises in bank rates decreed by the FRB recently. Lower costs of capital are in best public interest. Yet, the FRB seems puzzled about the ten-year U.S. Treasury yield not rising along with its decreed raises in bank rates. The following questions naturally arise about the largest central bank on earth:

- Why should the FRB not feel happy about the lower cost of capital determined by natural economic forces (supply and demand for capital) in capital markets?

- Why should market forces respond to the FRB fiats on prices of capital?

- Why should the FRB decree on the price of capital?

- Didn't the mandarins of capitalism criticize fixing of prices by central planners in communist countries?

- How are the decrees on the price of capital made by the FRB different from communist decrees?

- Do central banks promote usury? At whose behest?

The public should have some solace that the FRB does not control the long-term rates of interest. The FRB still tinkers the market's determination of these rates by decreeing on short-term rates. It is very possible and likely that the prices of capital determined by supply and demand will stay substantially below that the FRB wants. It is puzzling, though, that the FRB wants higher prices of capital, which is inconsistent with the best public interest as stated above. The usuriously accumulated capitals will, of course, be decimated due to the low, if not negative, interest rates. Negative interest rates in USA are possible and not surprising, given the recent Japanese experience.

The U.S. has the largest number of banks (about 14000) than in any other country. Competition among banks serves the best public interest as it yields the lowest possible price of capital. A multitude of banks compete to render credits at the lowest possible interest rates with the best possible service to the public. Countries with few national banks cannot render efficient service and cheap credit to public. Efficient banking means providing the best quality of service at the lowest possible cost. The only way to bring efficient service to bank customers is to have enough number of banks to compete for the quality of service at the lowest possible cost.

4.3 OPTIMALITY OF GOVERNMENT REGULATION

The U.S. establishment may still promote the theory of laissez fair capital markets for the developing world. But it does not allow its own capital markets to be completely free. Laissez faire capitalism is detrimental to public interests, as proved by history. Such unbridled capitalism has proven to be a fiasco in USA. This form of capitalism should not be exported to the developing world. The U.S. government heavily regulates and monitors banks which represent about 60% of the size economy.

An unregulated (free) market system is theoretically optimal only if people operate rationally under all circumstances. It is like saying that communism – which guarantees equal prosperity for all - is the best form of governance of a society if the dictators at the helm are benevolent and fully informed about all individuals. If people are prone to irrational panics, unregulated free markets will inevitably collapse as soon as some jittery event unfolds. To prevent future crises in the banking and monetary system, the U.S. Congress passed the Banking Act in 1933 to establish a safety net with federal government insurance of bank deposits. After the implementation of government deposit insurance, depositors were no longer scared of losing their deposits in failed banks. The U.S. Federal guarantee of bank deposits has prevented sudden eruption of a systemic bank run epidemic after 1933. Such a guarantee has been hailed as a marvelous innovation within laissez faire capitalism. Multitude of banks can compete on price of capital and quality of service while depositors do not panic irrationally because of the built-in government guarantees. This proves the necessity of government regulation in making capitalism succeed as stated in the following proposition.

Proposition 4.1 *(Optimality of government regulated capitalism): The government acting in the best interest of people will not support free* *capital markets.*

Argument 4.1: See the preceding discussion and arguments. ■

Has the government intervention in the banking industry solved the problem of society? It surely has solved the problem of banking panic and runs. It has also fostered delivery of quality banking service at competitive prices. The U.S. has not witnessed such runs after the banking safety net was introduced. But the deposit guarantee has given rise to a new problem. Banks are required to pay for the insurance of deposits to the government. Banks, of course, pass this cost effectively onto customers by paying a lower rate of interest on deposits or charging a higher rate of interest on loans. The spread between the rates of interest on loans and deposits widens due to the federal guarantee. Thus, the guarantee does not come without a cost. The society obviously understands that depositors wanting safety should pay an extra price, i.e., accept a lower rate of interest than expected on deposits or pay a higher rate of interest than expected on loans.

The government guarantee of bank deposits is not the end the social problem arising from panics when bankers embezzle or gamble away deposits. The government guarantee creates fresh problems. How much should banks pay the government in lieu of the insurance? Obviously, banks would like to pay as little as possible for the deposit guarantee and advertise this guarantee to attract as much deposits as they can. The American government had been charging a flat deposit insurance premium rate until 1992. A flat insurance rate meant that the cost of the guarantee, per dollar of deposits, is fixed irrespective of the risk of bank assets. Such a flat rate encourages banks and Savings and Loans Associations (known as thrifts) to take heavy risks, which amount to gambling on depositors' money. The government deposit guarantee forces taxpayers to bear any loss to banks on their risky gambles like lending to less creditworthy customers. But gains from such gambles flow entirely to bank stockholders. Losses from risky gambles may also wipe out bank shareholders' equity capital. But considering that most banks operate with low equity capitals of about 10% of assets, shareholders are prone to gamble soon after they learn about a depletion of their equity in the bank, especially when the equity is totally wiped out. Gambling for a bank with no leftover equity is better than being closed because a gamble may result in good returns giving bank owners a chance to recover their equity before regulators step in to examine.

The rules for closing banks prior to 1992 were *ad hoc*. As long as a bank had a positive equity before 1992, it could not be closed because bank lawyers would sue the regulators for closing banks with positive equities. Regulators then had to wait until a bank's equity turned decisively negative. Bank managers would use all accounting loopholes to keep their equity positive even while they gambled. Banks would also employ lobbyists to plead their case with legislators and insist on not closing the banks to retain local jobs and banking facilities. This kind of an *ad hoc* bank regulatory system turned out to be a disaster. By late eighties, USA had witnessed an unprecedented rate of failure of banks and thrifts, costing taxpayers an estimated three hundred billion dollars. Volumes of research done during this period showed that the government had to adopt minimum capital standards and risk-based deposit insurance systems. In December 1991, the U.S. Congress enacted new laws by which deposit insurance premiums had to be based on risks and banks had to maintain a minimum level of economic net worth in order to remain in operation. The higher the economic net worth of a bank, the lower is the premium. In addition to ensuring that banks maintained a minimum level of economic net worth, bank examiners developed an overall risk rating of banks, called CAMEL. Since 1993 deposit insurance premiums have been based on the economic net worth and CAMEL rating of a bank.

The system of bank examination and regulation has not come cheap. It has powerful critics which include members of the U.S. Congress. To solve the irrational banking panics in a system of multitude banks competing for price and quality of service, a government has to institute the deposit guarantee; this is the *first degree of intervention* that many critics do not yet appreciate. The critics argue that failure of huge investment banks like Drexel with $200 billion of assets and no deposit guarantee has caused few ripples in the economy, let alone panic. This, they point out, is due to debt holders becoming smart and the monetary system turning robust as compared to the fragile system that existed before the Great Depression.

Continuation of the government deposit guarantee creates a *moral hazard* that risk-based bank deposit insurance and capital standards cannot solve. It is because deposit insurance premiums cannot be calibrated to the exact bank asset risks. The bank asset risk is impossible to measure accurately. Critics mention that the mathematical model for determination of insurance premium is not perfect and such models cannot be applied to many other types of risk (in addition to risks of loans) inherent in a bank's activities, such as more complex derivative assets. To thwart the abuse of deposit guarantee, the government has to devise a very elaborate system of measuring economic net worth and bank asset risks to levy penalties (deposit insurance premiums) on banks and to determine if a bank should be allowed to remain open. This is the *second degree of intervention*.

Critics point out that the second degree of intervention is unnecessary if the first degree of intervention is abolished. The U.S. employs about 8000 examiners at an annual cost of about $1.5 billion for bank examination and billions of dollars on bank regulation via agencies like the Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and the Office of Thrift Supervision. The banking sector represents the most predominant component of the U.S. free market system with about $8 trillion in deposits in a $12 trillion economy. Thus, the greatest free capitalistic system in the world can be easily branded as heavily regulated by government. Is this optimal for society? That is, do such regulations serve the best public interest?

4.4 SAFE BANKING

The public interest with respect to banking will be served only if the following goals can be achieved:

- Containment of moral hazard due to reckless gambling of government insured bank deposits.

- Prevention of potential banking panics and runs of the type that happened in 1907.

- Elimination of inefficient regulations and examinations.

To achieve the above goals, capital market gurus argue for universal banks, which are (i) investment banks with insured deposits in subsidiaries and (ii) commercial banks with some subsidiaries performing investment banking functions. Universal banks are legally feasible after the repeal of the Glass-Steagall Act in 1999. But are they safe for taxpayers? Will they serve the best public interest?

The Glass-Steagall Act had prevented commercial banks from conducting investment banking functions. The purpose of this Act was to avoid a repetition of the Great Depression era recklessness. The argument in favor of universal banks is that legal firewalls can be laid around subsidiaries – called special purpose vehicles (SPV) – to conduct investment banking business for regulated commercial banks. Firewalls are theoretically sound. But they are practically fragile. The failure of corporate behemoths like Enron and MCI-WorldCom due to SPVs with firewalls should be alarming. Such SPVs for federally insured banks create new unforeseen risks for taxpayers if some mega banks implode. Universal banking will not reduce moral hazard. It may likely enhance gambling of government insured bank deposits.

Government regulators obviously prefer to continue their business of bank examination. They are not particularly opposed to universal banking because it will not stop government deposit insurance of bank deposits or regulatory examination of banks.

Government regulatory examinations could not prevent massive failures of banking institutions in the late 1980's that cost taxpayers about $300 billion. The nature of moral hazard is such that until a banking crisis erupts, the associated risks to taxpayers remain dormant. There is no theoretical argument that universal banking and current bank regulatory practice can reduce the moral hazard risk to taxpayers. Universal banking cannot be optimal for the public, even theoretically, because of the inherent moral hazard problem. Banking regulation is also not optimal for public because it stifles the most important industry and it cannot eliminate the moral hazard problem.

There is an optimal solution - to the problems associated with moral hazard and government regulation - that is in the best public interest. It is to enact a law to create enough number of *safe banks* to serve panic-prone depositors, and to let the other banks operate as universal banks without regulation. Safe banks will invest exclusively in government securities, accept no more deposits than liquidation value of such securities, and issue no liabilities (like debt) except common stock and preferred stock.

Government agencies often argue in favor of continuation of bank regulation because deposits need to be guaranteed by the government to preclude a rare catastrophe of banking panics and simultaneous withdrawals of deposits. They remind taxpayers about banking panics, which cause huge systemic losses to the economy. But banking panics can be avoided by having enough safe banks that invest only in government securities. Safe banks will draw the panic-prone depositors. Safe banking will optimally obviate the government guarantee of bank deposits. It will also eliminate the elaborate and costly bank regulation that stifles the industry and economy. Is the current bank regulatory regime continuing due to vested interests of government regulators? One has to perhaps wait for the next catastrophe in bank failures to get an answer.

4.5 SPECIAL NATURE OF BANKING

Why should any government regulate commercial banks as in the U.S. and most other countries? American commercial banks were not regulated prior to 1933. In principle, a deregulated banking system should operate like any other industry. Companies in other industries raise debt and equity capital to fund business operations. They pay fixed coupon interests to bondholders and distribute parts of residual profits to shareholders as dividends. Bondholders and shareholders take risks consistent with expected rates of return on their investments. The expected rates of return may differ from the promised coupon interest rates on debt or the dividend payment rates on common stock. Investors choose how much to invest depending on their expected returns and risk tolerances. Like any other business, banks also have stakeholders. A bank's stakeholders include depositors, bondholders and shareholders. They can consciously choose investments like those in non-banking businesses. How are banks then different from non-banks? Does the difference naturally lead to regulation of banks?

Banks fund their operations by borrowing very liquid demand deposits. They also raise other debts. The maturity of such deposits and debts is shorter relative to that of loans made by banks to fund projects. Banks must pay claims from demand depositors and debt holders, whenever such claims are due. They use some equity funds with indefinite maturity. But the real assets (projects) they fund are highly illiquid. Typical bank assets include home mortgage loans and business loans extended over as long as thirty years. Banks cannot ordinarily demand repayment of an outstanding loan balance, unless the borrower defaults. This makes bank assets (loans) illiquid. To recover delinquent loans, banks incur legal and transaction costs. To sum up, banks realize returns from their assets over longer terms, whereas they need to commit repayments to depositors and bondholders over shorter terms. This creates mismatch between maturities of bank assets and liabilities, unlike in non-banks.

If all depositors and short-term bondholders of a bank withdraw their funds at the same time out of panic, the bank can have serious difficulty in meeting these obligations and may even fail due to lack of sufficient funds. Panic at the level of one bank may spread to other banks, causing a run on bank deposits and a systemic collapse of the banking system as it happened in the U.S. in 1907. In many instances, banking panics may be irrational. But once a run spreads over the entire banking system, there may be serious repercussions of credit squeeze and depression in the economy. To contain the irrational fear, the U.S. Congress instituted a system of providing government guarantees for bank deposits as discussed earlier.

While a government guarantee of bank deposits avoids irrational banking panics and runs, it can create *moral hazard* in the banking industry. Once insured, depositors simply relax and stop monitoring banks, as the government stands by to pay them off should their bank fail. Moral hazard means that banks can take government guaranteed deposit funds to invest in highly risky bets. Bank shareholders can lose their equity if such bets do not turn favorable. But they can leverage to benefit enormously when the bets turn out successful. For example, suppose that a bank has $10 in equity funds, $90 in demand deposits and no other stakes. Then the leverage (equity-to-debt ratio) is 1:9. This is a relatively high degree of leverage compared to typical non-banking firms with leverage ratios of about 1:1. Banks generally operate with high degrees of leverage. If the entire $100 is invested in loans earning 6% rate of interest annually and depositors are paid 2% rate of interest annually, the bank makes $6 from loans and pays $1.8 to depositors per year, earning a net $4.8 from operations, which is 48% rate of return on equity of $10. Leverage thus magnifies the profits of bank shareholders. This tempts bank managers to take risk in the best interest of shareholders. But the bank's borrowers can default to pay only a part of their promised 6%. Then the bank's shareholders will lose some of their capital. The most that shareholders will lose is $10. This is relatively small when compared with a potential loss of $90 to taxpayers due to the government deposit guarantee.

The deposit guarantee solves the problem of banking panics. But it creates a new problem of moral hazard by which the government and taxpayers remain liable for unfavorable bank bets. The U.S. has incurred hundreds of billions of dollars of losses during late nineteen-eighties in rescuing many savings and loans associations called thrift banks. To recover such losses in future and to prevent moral hazard, the U.S. has instituted a system of risk-based deposit insurance and minimum bank capital standards. Banks are required to pay a certain percentage of their outstanding insured deposits as a price for the deposit guarantee and this price varies with the level of risk of a bank. The greater the risk of a bank's assets, the larger becomes the deposit insurance premium rate. Every bank has to maintain a minimum level of capital as a percentage of assets under the scheme in the U.S. Banks failing to meet the minimum capital standards are not allowed to remain in operation. The insurance premiums are deposited in a government managed deposit insurance fund, which is required by law to have at least 1.25% of total bank deposits. Bank insurance premium rates are adjusted to maintain this level funding of the deposit insurance fund.

4.6 SPECIOUS ARGUMENT FOR BANK REGULATION

History shows that credit markets cannot freely operate without causing serious disruptions like the Great Depression. This has given rise to a fundamental presumption that the government deposit guarantee must continue. The government depends on this presumption to justify its monitoring and intervention of banks which offer deposit guarantees. The challenge then is how best to calibrate optimal intervention policies, given that the government deposit guarantee must continue. The U.S. has tried to devise policies on bank capital and deposit insurance premium standards that are optimal under the restriction that deposits must be guaranteed. The goal is to devise policies that are consistent with competitive and rational capital markets. Once such policies are implemented, the government's involvement will simply be cursory, just to ensure that bank depositors do panic irrationally.

How to devise such policies?

This is done in a hypothetical scenario of only rational behavior with no panic and a completely deregulated baking industry. In this scenario, markets will impose on banks some optimal debt covenants and set the price of risky bank debt. Debt covenants may take the form of restricting the bank to maintain a minimum net worth (assets minus liabilities) or equivalently a maximum leverage ratio. Any bank violating such debt covenants can be taken to bankruptcy court under corporate laws. The price of risky debt means that bondholders demand, from banks taking higher risks, consistently higher interest rates. This hypothetically deregulated ideal banking industry is devoid of irrational panics and runs. One can attempt to derive estimates for the covenants approximately by using equilibrium theoretical models. These estimates can be implemented as optimal bank regulatory policies. These are theoretically optimal policies. Such policies have two components for each regulated bank: (i) a minimum equity-to-assets ratio and (ii) a risk-based deposit insurance premium. In principle, such equilibrium-based estimated regulatory policies are not really regulations or strictures on the banking industry. They are consistent with free market and a deregulated banking industry with no irrational panics. These policies are theoretically optimal for taxpayers. They can theoretically circumvent both irrational panics and moral hazard. They are summarized in the following proposition.

Proposition 4.2: *Assume that government insurance of bank deposits is the only way to avoid banking panics and runs. Then, taxpayers find it optimal to regulate banks with minimum bank capital and deposit insurance premium policies which can be derived in a theoretical model of economics.*

Argument 4.2: See the preceding discussion and arguments. It has been proved in a mathematical model in Journal of Finance. ∎

Is the assumption in Proposition 4.2 reasonable? Is there any alternative to the government deposit guarantee that is less costly to taxpayers? What are the problems with bank regulation based on such assumption?

4.7 PROBLEMS DUE TO BANK REGULATION

The size of the U.S. banking industry is about 60% of GDP. It is heavily regulated. To avoid a repetition of banking panics and runs, the U.S. government decided to insure bank deposits. Bank depositors have been rescued. But banks' propensity to gamble through high leverage has cost the U.S. taxpayers about $300 billion in late 1980's. The global banking industry has now accumulated a total US$217 trillion in the face values of credit derivatives and other such financial instruments. The true economic worth of these financial instruments is less, maybe about one-tenth of the face amount, but still very significant. Such instruments allow banks to raise massive sums through special purpose vehicles called conduits and master trusts against incomes from consumer and credit card loans in their portfolios. Banks effectively sell off the icings of their cakes while holding enormous residual risks for taxpayers. This allows banks to generate massive short-term profits, while effectively passing on the risk to taxpayers.

How has this predicament arisen? This is almost like the failed laissez faire capitalism. The government regulators are simply trying to play a catch-up game to retain their jobs, while the shrewd banking mandarins are aggrandizing wealth at huge impending future costs to taxpayers. The U.S. decision to insure deposits has ushered an era of mega regulation of banks. The economic argument favoring such a decision is that somehow bank regulators will act like *private surrogates* of taxpayers, implementing policies in the best public interest.

If a regulatory institution acted like a private surrogate of taxpayers, it would observe the following:

i. Collect an actuarially fair price of deposit insurance from a bank as long as it is optimal to do so.

ii. Close an ailing bank optimally, when immediate closure is less costly than leaving the bank open.

iii. Allow banks to choose their own asset compositions and capital, generating the expected returns consistent with their risks in equilibrium.

Suppose that bank regulators implement policies which a private surrogate of taxpayers would. Then taxpayers could achieve the best of both worlds with virtually deregulated banks and no banking panics and runs. Such policies would allow universal banking by giving banks the leeway to choose their own asset compositions and capitals. Banks would of course transfer their deposit insurance costs to depositors via lower interest rates on deposits. But panic-prone depositors should accept the lower interest rates (in equilibrium) in lieu of the protection they receive from government guarantee of deposits. Actuarially fair deposit insurance premiums would avoid a transfer of wealth from taxpayers to insured bank depositors. Optimal bank closure timing would prevent transfer of wealth from taxpayers to uninsured large depositors who tend to promptly withdraw their funds following the first news of trouble at a bank. Proposition 4.2 sums up this sanguine view of bank regulation.

Given a bank's risk and capital position, an actuarially fair deposit insurance premium could be calculated theoretically. But what would be the private surrogate regulator's minimum bank capital requirement (bank closure rule), when banks were allowed to choose their own capitals? It could be shown that banks would voluntarily maintain a minimum positive threshold capital level within a competitive and unregulated banking world with free entry and exit. Consistent with this theoretical argument, the U.S. Congress enacted in 1991 a constant minimum required capital of about 2 percent of bank assets, and asked the Federal Deposit Insurance Corporation (FDIC) to calibrate risk-based deposit insurance premiums. The minimum capital rule amounts to foreclosure of banks with positive net worth. Research in 1989 has shown that foreclosure of banks with positive but dwindling net worth is optimal, assuming that government deposit insurance is the best public interest. Before enactment of the foreclosure law, ailing banks could resort to courts until their statutory capital reserves were depleted or funds were gambled away through various ruses. The new stringent bank capital requirements strengthened banks to attract funds from the rest of the world. This perhaps helped the U.S. economy to expand rapidly.

Table 4.1
Risk of Double Leverage to Taxpayers

	PARENT BANK	SUBSIDIARY SPV	CONSOLIDATED BANK + SPV
Equity	$8	$100	$8
Debt	$92	$900	$992
Assets	$100	$1000	$1000
Capital %	8%	10%	0.8%
Minimum Regulatory Requirement 8% Met ?	Yes	Yes	**No**

But it is shocking how some of the major banks are now heavily leveraged through special purpose vehicles (SPV), created as bankruptcy remote entities like conduits and trusts. SPVs are frequently maintained as off-balance sheet activities, separated from parent banks by "firewalls" which appear safe theoretically but are fragile in the real world. A major bank can have as much as 25% of its assets in a conduit or trust. SPVs ideally circumvent bank regulatory laws at enormous risk to taxpayers. For example, a major bank can use $8 in equity capital and $92 in insured deposits, i.e., a total of $100 as equity of an SPV Conduit to raise fresh funds of $900 in new notes and papers against the Conduit's assets comprising consumer loans and credit card loans. This means, the parent bank uses a double leverage by which $8 in equity leads to a total borrowing of $992 to fund loans in the conduit. The parent bank satisfies 8% minimum regulatory capital requirement. Even the Conduit in this example has equity of 10% of its assets ($900 borrowed plus $100 in equity). But, the whole bank skates on thin ice by having only 0.8% of assets as capital on a consolidated basis. This is one-tenth of the bank capital requirement set by regulators. Such double leverage not only circumvents bank regulatory laws, but also exposes taxpayers to enormous risk as depicted in Table 4.1.

Another potentially devastating transfer of risks by banks to taxpayers is taking place under the veneer of a healthy banking industry. This is the very ubiquitous credit derivative scheme which banks use to sell off creams of their loans for immediate profits, while the risk piles up for later days. By this scheme, loans are not sold by a bank. Only derivative based on loans are written (short-sold) by the bank. Short-selling of credit derivatives for lucrative premiums enhances current profits, boosting managerial bonus and incentives tied to bank stocks.

Consider, for example, suppose that a bank uses $8 in equity and $92 in insured deposits to fund mortgage loans of $100 at 6%, as in Table 4.2. The expected default rate on mortgage loans is estimated at 1% of the principal. The expected loss is $1 out of $6 of interest payment per year promised by the mortgage holder. Then the bank is expected to receive $5 per year from the $100 mortgage loan. The bank then sells a credit derivative which guarantees a payment of the first $5 of the bank's mortgage interest to the buyer of the derivative. The derivative buyer is a money market mutual fund that pays a guaranteed 2% rate of return. The mutual fund can invest by paying $250 for the credit derivative that promises to pay $5 per year without default. This annual payment generates 2% rate of return on $250 invested in the credit derivative. A regulated and federally insured major bank like Citibank may sell such credit derivatives. Then the risk to the mutual fund of 2% return on its investment is almost zero because legally the government cannot alter the agreement with the SPV. Since the mutual fund investors are assured of $5 per year, they will generate a guaranteed 2% on their investment in the fund that buys the credit derivative for $250. The credit derivative sale boosts the bank's immediate profits by $150.

Table 4.2
Profits from Credit Derivatives

	FUNDS LENT	ANNUAL INTEREST	EXPECTED INTEREST LOSS
Bank to Mortgage Holder	$100	$6 at 6%	$1
Money Market Fund To Bank	$250	$5 at 2%	0
Bank's Profits	$150		

If the bank efficiently uses its profits, it may be fine because it can bear unexpected increases in the risk of default on mortgage loans. But managements tend pay themselves excessive perquisites and bonuses from such profits. Suppose that the bank pays off the $150 profit in bonus and perquisites to its executives. Then also taxpayers will not bear any risk as long as the *actual* default in mortgage loans is still 1% of the principal, as expected. But if the actual mortgage loan loss is greater than 1%, the bank will fail and taxpayers will bear the burden. If the housing price bubble bursts, many banks with such credit derivatives will fail. It may lead to a repeat of bank runs of 1907.

4.8 ONLY SAFE BANKING CAN SERVE PUBLIC INTEREST

Bank regulators unwilling to relinquish their grips over banks have attempted to resolve the seething risk problem in many different ways. One way is to set bank capital requirements and deposit insurance pricing standards based on public rating of bank assets. This will allow rating agencies like Moody's, S&P and Fitch to rate bank asset pools. Bank regulators will define risk weights for each pool to set minimum risk-weighted capital requirements. This approach can avert the criticisms leveled against government examination of bank assets. But it raises new problems about the efficacy of rating procedures of public rating agencies. There can be serious problems in public rating norms used by Moody's, S&P and Fitch. Recent research shows that the existing rating norms are seriously flawed. Unless public rating methodologies are corrected, reliable ratings of bank assets by public rating agencies will not emerge.

The other approach available to bank regulators is to let banks estimate their own risk weights for various asset pools using internal models. But bank regulators will impose a penalty in terms of extra capital requirement on a bank if its actual loan loss differs from its ex-ante estimate. Such a capital penalty rule may discipline banks to strive for best internal models and more accurate risk-weights. The recent Basel accord on bank regulation aims at standardized and internal ratings-based (IRB) approaches to measure credit risk. The Basel Committee on Bank Supervision at Bank for International Settlements (BIS) says, "Safety and soundness in today's dynamic and complex financial system can be attained only by the combination of effective bank-level management, market discipline, and supervision. The 1988 accord focused on the total amount of bank capital, which is vital in reducing the risk of bank insolvency and the potential cost of a bank's failure for depositors. Building on this, the new framework intends to improve safety and soundness in the financial system by placing more emphasis on banks' own internal control and management, the supervisory review process, and market discipline. Banks will measure their own credit risk, market risk and operational risk using their own models."

The question that still remains is: will the new BIS approach thwart piling up of risks on taxpayers due to credit derivatives and other such financial instruments? A more crucial question is whether the complicated, patchy and unsatisfactory regulations are necessary at all. Regulation obviously keeps banking economists and regulators employed. But it also muzzles them perennially to uncover a satisfactory solution which may be optimal from the point of view of taxpayers. The piling up of residual risks at banks should be prevented or priced correctly with incentives for banks to maintain sufficient reserve to absorb potential future losses. With bank managers looking for short-term gains and not fazed by future risks to taxpayers, the current regulatory approach will never be a solution in the best interest of taxpayers.

A solution suggested by many capital market theorists is to deregulate banks completely. Banks will then slice their assets into homogeneous risk pools for funding by investors in capital markets. Investors will fund each respective slice protected by firewalls within a bank. Firewalls demarcate a legally distinct entity for each asset slice, backing liabilities due to corresponding investors' funds. The funding for an asset slice and the corresponding rate of return paid by a bank will depend on economics of supply and demand and on the risk-return trade off in capital markets. The riskiest asset slices may not be marketable. The least risky slice of a bank may comprise primarily of government securities funded by depositors unwilling to take any risk. The other slices can be rated by public rating agencies and be sold to interested investors accordingly. This approach will make every slice priced according to its risk. It will also obviate the necessity for bank regulation. This approach results in universal banks with no regulatory intervention and no government guarantee of bank deposits. It is like the approach that prevailed prior to 1933 in the era of failed laissez faire capitalism.

Current arguments in favor totally deregulated universal banks are that credit and capital markets have become sophisticated enough to withstand any shock. Even the failure of the largest investment bank (Drexel Burnham) has not dented the economy. The problem with this approach is, however, that it fails to address irrational banking panics and runs that engulfed the U.S. in 1907 when deposit insurance was unavailable. There is no economic model to address irrationality. The current wisdom is that panic-prone bank depositors have to be insured by the government. Government regulators have exploited this wisdom to remain entrenched in the process of regulation. They seem to be nonchalant about the hundreds of billions of dollars in losses to taxpayers due to moral hazard in the banking industry.

But there is a better alternative to government guarantee of bank deposits. It is safe banking. It avoids moral hazard. It is less costly to taxpayers as shown in the following proposition.

Proposition 4.3: *Define a "safe bank" as one whose assets comprise only government securities and cash, who accepts no more deposits than the liquidation value of its assets at any point in time, and who issues no liability (like debt and notes) other than preferred stock and common stock. It is optimal for taxpayers to have enough number of safe banks to serve panic-prone depositors and to let other banks operate as universal banks without any government regulation. The only government regulation needed is to monitor that safe banks do not deviate from their charters.*

Argument 4.3: The panic prone depositors will be drawn to the safe banks. There will never be any systemic banking panics and runs. Such panics had prompted the U.S. Congress to insure bank deposits and to establish regulatory institutions to contain moral hazard due to gambling on insured bank deposits. Absent the possibility of banking panics, deposit insurance is unnecessary and bank regulatory institutions are be redundant. Elimination of costly and redundant bank regulatory institutions is then optimal for taxpayers. Investors with surplus funds seeking greater risky returns can gravitate to universal banks, like they currently are doing with investment banks offering checking facilities. It will then usher an era of an almost deregulated banking industry. Deregulation will free the bank regulatory noose on the economy. It can also avert problems associated with potential credit crunch due to bank regulation. Credit crunch had contributed to severity of the Great Depression. A minimal monitoring of safe banks will cost little to taxpayers. Safe banking will cease transfers of massive risks to taxpayers by bank managements. ∎

The safe banking proposal can be easily implemented, given political will of the U.S. Congress. The Congress will, of course, be forced to act after any fresh catastrophic failure of banks. The U.S. has witnessed an expansion of $3.5 trillion in new credits during the last three years. It is primarily in the home mortgage market. There is no reason to assume that the U.S. assets somehow rose in value more than this colossal new credit even after the terrorist attack of September 2001. It seems that the U.S. home mortgage market is ballooning without much real support and will likely burst sometime. The U.S. government controlled Fannie Mae is a major bank of mortgage bankers. It is already facing serious problems about its misstated profits. Its failure can make many major banks default massively. Unless the U.S. Congress acts, preemptively, it will be forced to react afterwards in the wake of any uncontrollable bank failures. Safe banking is the only optimal alternative available to serve the best interest of taxpayers.

4.9 OPTIMALITY OF PROGRESSIVE TAXATION

Governments can function only by collecting taxes from people. The following proposition shows that progressive taxation is optimal for a capitalistic democracy.

Proposition 4.4 *(Tax the rich more than the poor): Suppose that a society institutes a democratic government to collect taxes as a part of the profits generated by capitalists and asks the government to use the tax revenue to (i) provide security to all, (ii) build civic amenities like roads, parks, schools and hospitals accessible to all, (iii) enact and enforce transparent rules, and (iv) build defense so that every individual can pursue creativity, entrepreneurship, and innovation. Then there exists a tax structure with the rich paying more than the poor for the society to be stable.*

Argument 4.4: If a government does not exist, capitalists' wealth and profit-generating businesses cannot be protected against possible looting and riots by the majority of common people. Common people may resort to anarchy because they directly enrich capitalists by consuming products at prices higher than production costs including materials and wages. Common people earn wages from production centers. They are also willing to pay higher prices for finished goods than production costs because capitalists employ capitals. This tacit mutual agreement between common people and capitalists can be shattered without a government.

If there is no government, each capitalist will employ a private security force. The total cost of security for all capitalists in a society will be huge. Capitalists will compete independently. They cannot easily create successful markets to sell profitable products. Markets, after surfacing, will break down as soon as common people discover that the rich are getting richer. Common people will perpetually agitate against the rich in the absence of a government. Perpetual agitations are common in nations without civic governments.

A government is thus necessary to protect capitalists and to educate common people that capital growth is necessary for their employment. It serves the best interest of capitalists and common people to nurture an open market system, transparent rules of governance, a common security force and public goods like roads, parks, healthcare centers and educational facilities. This is necessary for a stable society which appreciates the importance of smooth trading of goods and labor. Profits and capital growth are possible only in a stable open market system. Capitalists enriching from such a system will find it in their best interests to pay sufficiently higher parts of their profits as taxes to maintain the system. The richer one becomes, the greater is his want for security, transportation and communication facilities; and so, he is willing to pay more. The government should thus tax the rich at higher rates than the households on wages and salaries to maintain a stable open capitalistic system. ■

4.10 HOUSEHOLD NET WORTH AND PROSPERITY

In a democracy, an absolute majority of elected legislators can amend constitutions and laws to serve the best interests of people they represent. In fact, even a simple majority (50%) of popular votes often translates into an absolute majority of law-making legislators in democracies like USA and India. If absolute majorities are sufficient to change laws of democratic nations, why are central banks not mandated to measure and report per capita income and net worth of such majorities? Voters and households are almost one-to-one. It is thus important for the government to measure per capita statistics for the absolute majority.

Nations currently collect data on individual incomes and national gross domestic product, not on household net assets. They measure per capita income and GDP. Growth in national GDP is portrayed as an indicator of prosperity. The per capita income or GDP is an average across all individuals. It is not a valid measure of economic well being of the absolute majority.

The absolute majority should be in the middle. Per capita net worth or net income for either the topmost or the bottommost absolute majorities will be affected by extreme outliers. The per capita income and net worth growth of the absolute majority is crucial for social stability. These measures should be measured and broadcasted, periodically.

Income or GDP growth is not a true indicator of prosperity as argued earlier. The most glaring deficiency of using a per capita national income measure to gauze prosperity is that incomes do not necessarily translate into increases in wealth. Indeed, wealth or net worth should be measured after accounting for personal debt, government debt and the expected loss in government lending to other countries. This conclusion is stated in the following proposition.

Proposition 4.5 *(Measures of Economic Prosperity): Per capita income and net worth of the absolute majority of a society are optimal indicators of economic prosperity.*

Argument 4.5: See the preceding arguments. ■

The American per capita income has remained stagnant over the last 40 years. Per capita income is a dubious measure of prosperity for two reasons. First, per capita real income for the absolute majority is most important because it can change the U.S. government and its policies. Second, per capita income does not guarantee prosperity or wealth. The absolute majority of American households is perhaps turning less prosperous. The U.S. productivity has risen phenomenally over last thirty years.

Productivity is measured by the national income divided by the total number of officially recorded hours worked by all people. Productivity can rise if the number of hours worked off record increases. Casual empiricism indicates that many are working from homes during nights and weekends for hours that are not recorded. This is increasing as the fear of losing jobs due to outsourcing rises. The productivity increases with relatively stagnant per capita income show that people are working harder over longer hours than before. Toiling harder than ever before does not point to enhanced prosperity.

Mega capitalists are few in number. The very rich in the U.S. comprise fewer than the top 5% of all American households. They virtually control product prices and wages of those who depend on jobs. They are able to create usurious profits by paying low wages compared to rising product prices. They store their usurious profits effectively as household credits. But the absolute majority comprises the indebted households. It has the power to form government to cut household debts and raise taxes on the usurious profiteers. The debt laden prosperity in U.S. is more like economic bondage for the absolute majority by the usurious profiteers. The current system is tenuous at best. Only a powerful and innovative nation like USA can take the lead to meliorate the system. In the best interest of social stability preemptive policies are called for, globally.

The developing world owes the G7 countries about US$2.5 trillion. G7 countries are USA, Canada, UK, France, Germany, Japan and Italy. This amount should be multiplied by a factor of about four to account for the recent currency devaluations in developing countries to measure the real impact of foreign debt on the developing world. Much of the $2.5 trillion lent to the developing world may not be repaid.

Table 4.3
Trade Growth, GDP and Population (Source: World Bank)

REGION	EXPORT 1990 % OF GDP	EXPORT 2003 % OF GDP	GDP 2004 BILLION $	GDP-PPP 2004 BILLION $	POPULATION 2003 MILLION
East Asia & Pacific	47	71	2367	9459	1870
Europe & Central Asia	-	67	1768	4038	472
Latin America & Carribian	23	42	2018	4286	541
Middle East & N. Africa	47	50	600	1719	294
South Asia	17	24	879	4115	1448
Sub-Saharan Africa	42	53	543	1407	719
High Income	32	38	32715	31004	1001

About 99% of global poor and middle class (excluding the poor and middle class in G7 countries) must pay the G7 countries a staggering sum. In addition to the external debt, the developing nations have vast amounts of internal debt owed to the rich in their own countries. At a meager annual per capita income level of $300-$1500 for the global poor and middle class, the debt burden is simply astronomical. The net worth of 99% of people in the developing nations will probably be a mind-boggling negative number. This is obviously a flawed global capitalistic order.

What percent of American households is indebted and by how much? Data on household assets and debts are not collected. The FRB conducts a periodic survey for such data. But surveys do not tell the whole truth. One can reasonably guesstimate that about 95% of households may be indebted. What is known is that the indebted families in the U.S. together owe about $12 trillions to their lenders. The indebted federal government owes about $8 trillion, which is the indirect debt for all households. The lenders are distributed across all net worth households in the U.S. But the top lenders have lent about $12 trillion. They are the ones who have created usurious profits to lend.

The developing world holds about $1.7 trillion in dollar reserves in the U.S. Federal Reserve Banks. This is mostly due to its exports to the U.S. These exports account for low wages and raw materials used by exporters of the developing world. There is hardly any usurious profit component in these reserves. The U.S. businesses (middlemen) buy these exports from the developing world to sell at marked up prices to the American households and governments. These U.S. middlemen generate usurious profits that they lend to the indebted.

Table 4.3 presents relative strengths of various regions of the world. The per capita GDP of the developing world is still very small compared to that of the developed (high income) group countries. This difference is somewhat mitigated with by the GDP on a purchase power parity basis. The huge disparity in per capita GDPs of the two worlds is due to high valuation of industrial goods manufactured primarily in the developed world. East Asia and Pacific region has been able to close some of the per capita GDP disparity, as compared to the other regions. It is because this region has kept currency value low to make skilled labor cheap and disciplined. This has yielded relocation of global business enterprises to manufacture goods by a workforce that is skilled, cheap, and disciplined. South Asia and Sub-Sahara have failed to catch up.

5 COMPETITION, OWNERSHIP, PATENTS

A main social goal is to keep product prices as close to production costs as possible. Only a democracy can achieve such a goal by inducing a multitude of product suppliers to compete genuinely with free entries and exits. But many democratic countries also have laws to grant patents for new products and technologies, and to protect the rights of patent holders. These laws grant patents to those who apply for patenting even slightly newer ideas or technologies based on existing human knowledge. Current laws prohibit production of patented products by anyone other than patent holders. The prohibition lasts for a fixed number of about fourteen years. But such prohibition impedes competition. It hurts the social goal of supplying products at lowest possible prices.

- ❖ Do patent laws serve the long run public interests of civil societies?

- ❖ Should initial public offers for ownership of enterprises be made right at the time of launching products and services?

- ❖ Should entrepreneurs have the discretion about the times of initial public offers?

These questions are addressed in this chapter.

5.1 COMPETITION AND BUSINESS OWNERSHIP

A mega capitalist can acquire all competitors to monopolize the market. As a monopolist, he can then earn usurious profits by overcharging consumers. In dictatorial societies, he can even bribe the dictators to perpetuate exploitation of consumers. But he cannot easily bribe democratic governments. A democracy can therefore serve the best public interests. Only a democracy can induce competition among capitalists to produce human needs as cheaply as possible. Competing producers can earn fair returns on their investments by keeping product prices higher than input costs. They need not generate usurious profits.

A government establishment can enter the production business with a view to supplying goods at lowest possible prices. Communist and socialist governments have tried this idea. But communism has failed to beget prosperity. It is because decreed equal pays in cooperative communes do not motivate skilled workers to produce their best. China has given up the idea of cooperative communes and embraced capitalism. Even socialism of the type practiced in India has not enhanced prosperity. The experience of a highly bureaucratic India in the field of production of goods has been a disaster. India has wasted vast amounts of scarce capital. Government ventures have invariably turned inefficient due to vegetating bureaucratic managers and unionized labor. Bureaucracy driven government enterprises operate worse than even monopolies. They result in overpriced and inferior products. This is mainly because no entity has the authority to credibly monitor government managers of public enterprises.

A democracy should not prevent any entrepreneur from producing even the products patented by others. It is not just the right of every entrepreneur to supply any product or service needed by public. Granting every entrepreneur the freedom to produce even patented products induces competition that leads to efficiency. Efficiency leads to the availability of the best quality products at lowest prices. A democracy should also diffuse monopolistic behavior by preemptive strategies. Monopolies arise from concentration of ownership. This leads to the following proposition.

Proposition 5.1: *A democracy should mandate that private enterprises offer complete ownership of their ventures as soon as products or services are launched. The public offers for ownership should be made at share prices determined in transparent auctions open to all, including venture capitalists. This policy should exclude enterprises making binding commitments to never sell their equity stock to public. Entrepreneurs unwilling to offer ownership of their enterprises, ever, should not be forced to offer such ownership.*

Argument 5.1: It follows from the preceding discussion. See also the following arguments. ■

Unless an enterprise pre-commits at the time of launching its products to not sell its stock to public, it should be optimally obligated to offer ownership to public at share prices determined by markets. The public should not be forced to own any enterprise. But entrepreneurs should be given no choice over which enterprise to own privately and which one to sell to public when. Entrepreneurs should not be given any choice on the time of offering ownership of business enterprises to public. Currently entrepreneurs make initial public offers just before expected high profit growth. This allows them to overprice such offers for public. The public lands up paying exorbitant prices of shares of companies with hyped up profit growth. The current law of granting the freedom to an enterprise to choose the time of initial public offers of its shares introduces a classic moral hazard problem. Moral hazard unduly penalizes the public and benefits the enterprises with superior information. The existing practice is not in the best public interest. The moral hazard problem can be alleviated by mandating that entrepreneurs have no discretion in timing offers of ownership of their equity stock to public. Venture capitalists currently choose when, if at all, to make their firms public. This has invariably subjected the public to an unfair disadvantage.

Genuine public participation in business ownership can indeed diffuse capitalists' risks due to unexpected fall in profits. But the timing and extent of ownership of new businesses should be completely transparent. Ownership should be open to public without conditions. It should be as soon as products are allowed to be launched for sale. Launching a product requires certain procedures for registration with the government. A new requirement should be added to make the offer of ownership to public as soon as the product is launched. If an enterprise does not want to go public ever in future, it should be required to state that in writing. If the public lands up buying products sold by an enterprise, it should also have the right to own equity stock of the enterprise right at the time products are launched.

New entrepreneurs will enter an industry which is earning exorbitant profits. Governments may have to facilitate entries of entrepreneurs willing to produce even patented products. Such facilitation is necessary is because the existing producers create barriers to new entry into an industry generating usurious profits. They make trivial distinctions like brand names for their products. They may even introduce predatory pricing policies to drive new entrepreneurs out of business. By predatory pricing policy, an existing monopolistic producer or a duopoly may simply cut product prices sufficiently to make new producers lose in the industry. After driving the new producers out of business, the monopolist and duopoly raise prices. This behavior is contrary to the social goal. New entrepreneurs may enter with massive capital to survive the price cuts from the existing producers in an industry. But a society cannot depend on such possibilities.

5.2 PROTECTING PATENT RIGHTS

The objective of fostering competition in public interest is at odds with granting protection of patents in most capitalistic societies.

Proposition 5.2: *Patent laws are designed only to perpetuate dominance by mega capitalists. Inquisitive humans will continue to advance frontiers of knowledge, irrespective of protection of patent rights. They never needed inducement to invent in the past. Neither do they need patent laws for new inventions. Inventors rarely enrich themselves due to patent laws.*

Argument 5.2: The optimal form of government for a civil society is democracy with transparent rules, which are dynamically updated by an elected legislature and upheld by an independent judiciary. This form of government and transparent rules of law are rational for civil societies, though they may not be ideal for everyone. They act in the best interests of public. They establish competitive markets with multitudes of producers earning fair returns on invested capitals. Competitive product markets ensure that households are not over-charged for their needs. They are in best public interest. Competitive product markets also ensure that individuals choosing to produce expect to get enough revenues to cover their costs including opportunity costs on their invested capitals.

Granting patents and copyrights is fine. But prohibiting production of new goods and technologies by all potential entrepreneurs will definitely raise production costs. This is against public interest and hence sub-optimal for a civil society. Emergence of several entrepreneurs willing to produce a new product or technology obviously implies that they expect to earn at least their opportunity cost of capital on investment in such productions.

The existing patent laws do not serve the best public interests and should be repealed. Permitting only the patent holders to produce a patented product or technology will generate usurious profits for a few mega capitalists. Such permission is detrimental in long run interest of a civil society. An absolute majority of informed households in a democratic capitalistic society will not enact such laws in its best interest.

Protections of patent rights prevent new entrepreneurs from producing and supplying an existing patented product or a similar one at lower prices. Proponents of such protection presume that the human desire to invent and develop intellectually depends on the lust for wealth. They also presume that advancement of a society will be stymied without such protections. These are fallacious assumptions because most inventors and intellectuals who have advanced frontiers of human knowledge were not driven by lust to be wealthy. For example, Newton who advanced human knowledge in physics and mathematics, Einstein who propounded the atomic theory and the theory of relativity, Marconi who invented radio waves, Edison who devised electricity and many other great scientists were not driven by capitalistic greed.

Most of the advancements in science and technology have been made in academic institutions dedicated to enhance frontiers of human knowledge, as opposed to helping capitalists widen the rich-poor chasm. Only capitalists are driven by greed to tinker scientific inventions and innovations to make saleable products. Capitalists need patents on production processes only to preempt competition. A bright example is the case of Bill Gates who has made no inventions but has become the richest person on earth. It is because he could successfully patent computer software under the U.S. patent laws. In the incipient stage of his enterprise, called Microsoft, Bill Gates developed a disk operating system (DOS) using the then existing freely disseminated know-how on computer operating systems, notably Unix, and adapted a very rudimentary version of it for a micro computer chip. Such adaptations were not being patented at those times.

The genius capitalist in Bill Gates prompted him to seek a patent for a lousy product to make it proprietary. He then innovated to improve on it with the help of technically competent partners. He simply transplanted into his products many new innovations made in the academia and elsewhere. The patenting norm - before Gates succeeded in patenting knowledge - was to make such innovations freely available as copyrighted materials in public libraries. Breakthrough software like Unix remains free, yet the inferior DOS has been patented. It is the brilliant capitalist, not inventor, in Bill Gates that exploited the U.S. patent laws. These laws have been originally designed for and by mega capitalists for usurious profits. They are not for betterment of human society or for intellectual advancement of the human race. They are anti-democratic. They negate the social goal to produce goods and services efficiently. ■

Protecting patents has advanced the cause of only mega capitalists, not public. Such protections can jeopardize capitalism due to unexpected reactions of the absolute majority of households facing mountains of debts. Protections always cause social distortion both within a nation and throughout the world. Global household misery can only accelerate due to such lopsided protections.

Governments tried and failed to break-up the Microsoft juggernaut. Even strong antitrust laws meant for such break-up did not help. How can governments prevent knowledge from flowering? Why should governments even legislate to protection businesses that seek to confine human knowledge produced everywhere almost freely? Should the Greeks have patented the knowledge of democracy and taken punitive actions against countries that adopted this form of government? Should the Chinese have patented dynamite to prevent the British from taking the idea to make guns for colonizing the world? How about the nuclear knowledge that immigrated to USA? USA has used imported nuclear knowledge to dominate the rest of the world. Suppose that the scientists, who invented the nuclear technology, patented it. Who could then protect such patents when a mighty government infringes it?

The idea that one nation like USA can procure talents from all over the world to dominate others sounds marvelous. But is it sustainable? Mega capitalism may eventually help in spreading technology globally. It thrives by producing at low cost and selling at high price. Mega capitalism will be drawn to the talents in the developing world to produce technological goods cheaply and sell the same in the developed world for usurious profits. China, Taiwan and South Korea have already become high technology manufacturing hubs. India has been recently roped for production of nuclear and aircraft technology. Russia and Eastern Europe are not stoppable. Officials may mutter fears about China. But businesses keep flocking to China to produce goods cheaply. Mega capitalism shows its fear of the Chinese military power, while it continues to enjoy usurious profits by producing in China. To safeguard its power, mega capitalism now wants to prop up India. India wants technology to meet its energy needs. But it is unlikely to join wars, given its history of not waging wars even to win its independence. Mega capitalism does not want wars as much as pervasive fears about it. It wants to sell its defense hardware and other gizmos to the developing world for usurious profits. It also wants to engage the cheap developing world labor to produce other goods cheaply for sale to households in the developed world for usurious profits. Mega capitalism in this way keeps the absolute majority in both the worlds in perpetual economic bondage. It saps the vitality of the humans everywhere for usurious profits and ultimate control.

The absolute majority may discover the game of mega capitalism. It may stop borrowing more to increase consumption. It may force legislators to cut household debts and increase taxes on usuriously created wealth by fiat. Highly indebted developing countries may also come under pressure of their publics to stop repaying foreign loans. The recent electoral win of socialist forces in Brazil may be the harbinger of global consumer awakening. The absolute majority will likely discover that patenting products and knowledge is not sustainable in the long run and will ban it globally.

Mega capitalism somehow exploits households. It uses researchers to generate patentable technology for sops. This has worked marvelously up to about 1990 in USA. American capitalists drew talents from all over the world including India and China. But many of the impoverished innovators from India and China formed their own technology-based businesses within USA that needed little monetary capital to be successful. Silicon Valley in California is dotted with Indian and Chinese entrepreneurs who became very rich as a result of explosion in the value of their capital stocks.

Many successful entrepreneurs from developing countries are first-generation Americans who continue to nurture interest in their motherlands. They have been instrumental in economic development of their countries through investments of their new capital generated from American consumers. Globalization has been pushed to create new markets in developing countries to generate profits. But this push has not resulted in much profit from selling in the developing world. Their usurious profits are due to low wages paid to the developing world workers and high prices received from selling cheaply made products to households in the developed world. The main losers are the absolute majority in the developed world and the gainers are the usurious profiteers. Globalization has basically raised the degree of economic bondage of indebted households in the developed world.

5.3 INNATE HUMAN DRIVE TO INNOVATE

Proponents of patent rights argue that patent protections induce innovations because of the human desire to profit from newly innovated products. This argument is not tenable. There are two fundamental human traits: One is the *baser* desire, which is common to all animals. The other is the *intellectual* faculty, which is unique only to humans. Most human beings possess both the traits in varying degrees. They may change the degree of their traits over time. Some humans are extreme with one or the other trait predominant.

People with predominant intellectual ability or skills to innovate and invent are likely to do so irrespective of any artificial inducements like pecuniary benefits implied by patent rights. Empirically, geniuses have not been driven by lust for wealth. Their creativity is independent of the incentive granted via patents. The idea that inventors will invent only when they are induced to gratify their baser lusts for wealth through protected patents seems to be a pure capitalistic imagination that belies empirical facts. Most patent owners are capitalistic ventures that employ talented scientists to innovate and patent products and technologies. These scientists are generally driven by their zeal for intellectual development and gratification of innate curiosity.

The Nobel Prize in various fields of science is considered as a credible measure of intellectual innovation. Empirically, most, if not all, of these prizes have been granted to individuals affiliated to academic and not-for-profit research institutions. The Nobel Prize in science is based on freely available professional research publications. So, patenting for pecuniary benefits cannot be the motivating factor for such research. The monetary part of a Nobel Prize and the insignificant probability of winning it make the expected value of winning nearly zero. Such low expected values do not induce capitalists to invest in potential Nobel Prize winners. This is why few capitalists, if at all, have invested on Nobel Prize oriented research for profits.

There is a distinction between (i) a capitalist turning evangelical at old age and dedicating accumulated wealth for research that may generate Nobel Prizes, and (ii) a capitalist investing in Nobel Prize oriented research. The expected net profit from investment in Nobel Prize oriented research is nearly negative because the chances of winning are low. This is why no capitalist invests in such fundamental research. But capitalists jump on development of patents based on such research findings for usurious profits.

The pecuniary expected benefit of engaging in a prize winning research is not the incentive that impels intellectually curious humans to seek the truth and discover natural mysteries. Furthermore, no amount of monetary reward can propel a hard core capitalist to invent.

The Nobel Prize committee has obviously not granted its honor to all geniuses that made path-breaking contribution to human development. For example, there is no Nobel Prize in mathematics, yet many mathematicians have made significant contributions to human knowledge. The incentive of wealth through patent protection laws has not generated seminal contributions to advancement of humanity.

In the course of their search for truths, geniuses have made seminal discoveries, often as serendipity. These discoveries have often led to the creation of innovative products, which capitalistic entrepreneurs patented purely for profits. For example, the 1998 Nobel Prize in Medicine was awarded to Robert F. Furchgott, Louis J. Ignarro and Ferid Murad for their discoveries concerning nitric oxide as a signaling molecule in the cardiovascular system. This discovery lead to the development of a commercial drug, called Viagra, to treat male impotency. Pre-tax profits at Pfizer, which makes Viagra, increased by 38 percent to $628 million in the second quarter of this year. [Financial Times 10 July 1998]

Several questions arise on such accumulation of wealth by business owners. First, what percent of the humanity benefits from this drug? Second, do Pfizer scientists benefit much out of the huge profits that the company is plowing in? Third, would Pfizer scientists have produced Viagra if patent laws did not exist? Only a negligible fraction of humanity could benefit from the new drug and Pfizer scientists must have benefited relatively very little from Pfizer profits. On the third question, researchers relentlessly pursue for new discoveries. Many succeed, while many others fail; and failure is not necessarily because of not trying.

There is also an element of fortuity in the efforts of talented scientists. The research atmosphere comprising facilities, apparatus and colleagues is necessary to facilitate discoveries. But there is no proof that patent laws ever speed up invention. Scientists in institutions like National Aeronautics and Space Administration and other government laboratories and universities relentlessly strive for advancement of human knowledge and their only crucial motivation seems to be peer recognition and credit.

Talented humans from other nations are debarred from conducting research in such facilities. It is due to mega capitalists' paranoia that diffusion of knowledge may subvert their game of domination of other nations. But artificial barriers stifle progress of humanity as a whole. Human talent pools are spread everywhere, in poor regions of Asia as well as in Europe and USA. Concerted efforts should be made to tap all human talents for betterment of humanity. Mega capitalists should desist from yoking such talents to perpetuate a game of domination. Such games are neither tenable nor desirable.

5.4 OPTIMAL ALTERNATIVES TO PATENT LAWS

Instead of patent laws, a civil society would be better off instituting sufficiently large prizes for new product inventions. Such prizes will go directly to the inventors. These prizes should be similar in spirit to the private awards currently available like the Nobel Prize. Governments should institute prizes to be awarded to inventors of new products and abolish the patent laws.

The National Science Foundation in USA and many U.S. government departments currently offer grants to conduct research in focus areas. These grants are meant to promote research, not to reward new product innovations. In contrast, the idea of establishing government prizes is to promote development of new products. But the government prizes should be paid only after development of new products which the public finds useful. The government then should make the know-how freely available to any producer.

The government should not be the only agency to institute such prizes. There can be private capitalists who can institute prizes and can take the lead to create new products without any exclusive rights protected by the government. Companies should conduct in-house research for development of new products. They should keep their technologies proprietary to make profits through free markets. The society should not, however, permit the government to grant protection to any capitalist for exclusive rights to produce any product.

The market forces should determine the degree of competition for supplying a new product. The first company that developed a technology for a new product should not be forced to freely distribute its technology. Governments should not interfere with private efforts. They should simply abolish the patent laws that debar competing entrepreneurs from developing alternative products based on a new technology first developed by some entrepreneur. Many companies can develop the same technology based on new knowledge. The government must not intervene to protect the first company that developed the production process (technology) by granting patent. Governments should allow all entrepreneurs to be free to compete for introducing a new product for consumers. This will ensure that the best quality products are available to consumers at the cheapest possible price. This will also prevent a handful from capitalizing on technology based on a diffused and pervasively created body of human knowledge. For example, no entrepreneur should be barred from producing equivalents of Viagra to compete with Pfizer. A democratic government should not interfere with market forces by artificially instituting patent laws that only help a few mega capitalists in extorting households.

Once a veterinary medicine was once found to be a good for treatment of human cancers. The company patented the same veterinary drug in low doses to sell to humans for 36 times of the prior price for animals. This shows how patent laws are misused for pure extortion.

The justification that the protection of patents is necessary for human development is fallacious. Consider again the case of Unix computer operating system developed by some scientists at Bell Labs and made available freely. The scientists were not induced by greed to develop this remarkable product, although Bell Labs' owners (AT&T) wanted to patent it. The U.S. government did not permit patenting of Unix because of AT&T's monopoly position. Microsoft merely adapted some of its features to develop the DOS and then superimposed another freeware, X-windows, developed and distributed freely by Massachusetts Institute of Technology. Microsoft then called its proprietary product MS-Windows.

It was a mistake for the government to protect Microsoft's patent for its proprietary product. But no one could suspect that a fervent capitalist could forge a team of technologists to transform some innocuous Microsoft products using seminal ideas like the graphical internet browsing software developed at the University of Illinois and successfully market them to eventually dominate the world of computer software. All that the capitalist Bill Gates succeeded in doing was to exploit the protection granted under the U.S. patent laws and develop a captive market to sell its patented proprietary products. These products based on common human knowledge would have been free-ware, had the patent laws not existed or had the government not made a mistake of granting patent to Microsoft.

The success in developing a captive market for a brand is valuable in a free market system. No contention should be made about a capitalist's wish to capture such values. But a captive market could generate monopolistic rents for Microsoft only because of the distorted patent laws that have vitiated the usefulness of capitalism for a society. The government embroiled in correcting a distortion due to patent laws could not succeed in reshaping Microsoft under antitrust laws.

A society would not encounter such situations had it grasped that protecting patents were fundamental problems underlying the lopsided distribution of wealth of a society. Patent rights yield a few rich capitalists at a huge cost to common masses. Most of the world's wealth is now concentrated in the hands of less than 500 rich capitalists. By using governments to enforce patent rights, mega capitalists mete injustice to humanity. The absolute majority should rise to protest against such injustice, lest the human society will suffer as a result of the avarice of a microscopic minority.

Patent rights are granted for a limited period of 14 years. Capitalists that sponsor scientists to develop patents have only limited time for accumulation of wealth. But such arguments in favor of patent laws are specious. Capitalists are innovative enough to perpetuate their wealth accumulation by adding or deleting minor features of an originally patented product to obtain a new patent for virtually the same product. Mega capitalists are smarter than bureaucrats, who grant patents and enforce infringements. When patent rights were first proposed to be enacted into law, mega capitalists perhaps easily influenced legislators through specious arguments in favor of such rights.

Consider again the glaring case of quintessential capitalist Bill Gates. He is simply producing a new version of virtually the same product every other year by incorporating fractionally new ideas developed by scientists working in various universities. He receives protection for the same fixed number of years, under patents and intellectual property rights laws. He is thus able to indefinitely extend the protection for a product initially based on freely available knowledge.

Mega capitalists seem to be making a mockery of the government. It is because the absolute majority of households is oblivious of long-term impacts of mega capitalistic designs on their prosperity. Legislatures funded by mega capitalists exploit voter myopia to collude tacitly with the sources of their funds until the public discovers it. Mega capitalists have successfully lobbied with successive elected leaders about dubious virtues of such protection through propaganda. Patent winners are extolled in the media owned by mega capitalists. The whole society is being indoctrinated to create patents. Patent winners do receive some pecuniary rewards, which are significant as compared to those not winning the patents. Such rewards simply blinker the patent winners in fathoming the shenanigans of mega winners of patent laws, the mega capitalists. The media owned by mega capitalists remains reticent about the truth that patent laws help only the mega capitalists aggrandize unseemly riches. One hopes that the vast majority will be eventually convinced that patent laws enrich only mega capitalists. These laws do not improve social welfare in the long run. Neither do they help the process of invention significantly.

The current public mood appears to favor patent laws. Will the mood change after learning about the negative impacts of patent laws on the long run prosperity of the vast majority of households? Most people racing after a mirage of wealth may still vote for such patent laws because of inherent myopia about long run deleterious impacts of such laws on society. Such myopia is evident from the way the vast majority remains currently oblivious of an ever-degrading environment due to rapid industrialization. They willy-nilly accept such industrialization for their economic growth and employment. Everyone tends to harbor hopes to strike it rich and cave in to the mega capitalistic exploitation leading to long-term negative consequences.

Protecting copyrights is fine. Seminal academic literature is merely cited, not patented, nor even copyrighted. Most professions simply grant credits to publishers to avoid plagiarism. There should be laws against plagiarism. But capitalists who basically make marginal changes to seminal inventions with the help of talented scholars must not be rewarded by a society at the cost of immense human suffering.

Advanced nations have been forcing the poor nations to protect patents and intellectual property rights under World Trade Organization agreements. The national rich-poor disparity will now become global. The protection of patents is a subtle form of human rights abuse inflicted on the vast majority by a few mega capitalists. Human development will likely be stifled by WTO agreements on protection of patents of mega capitalists.

The argument is not about blaming Bill Gates and others, who may have legally made best use of the current patent laws. It is about optimality of repealing such laws in best public interest.

6 MEGA GAMES IN CAPITAL MARKETS

About sixty-five percent of business administration graduates across the world, especially in USA, specialize in the field of finance. It is not clear where they all are employed. But the cream of finance graduates lands up in *Investment Banks* (IB) with salaries in the range of $100,000 to $150,000 per year. Prominent IBs include Merrill Lynch, Goldman Sachs, Morgan Stanley, Salomon Smith Barney, JP Morgan Chase, Citigroup, and American Express. Merrill Lynch has been the largest IB on earth after failure of Drexel Burnham Lambert. Hundreds of thousands of top business graduates trade stocks as their profession. Do they enhance social prosperity? What are the games of trade and who benefits from them? Should the existing law on short-selling of financial securities be repealed in public interest? This chapter deals with such questions.

6.1 TRADING AND SHORT-SELLING

Why are individuals who do not own a stock permitted to borrow its shares to sell in open market? Borrowing financial securities to sell the same in open markets is called *short-selling*. In markets for real assets like homes, such short-selling is not permitted. One cannot borrow residential premises owned and occupied by individuals to sell those premises in the market.

Brokerages facilitate lending financial securities for short-selling by hedge funds and individuals. Mutual funds do not sell securities short. Security account holders are required to sign brokerage agreements to lend their financial securities for others to sell short. Brokerages themselves are permitted to short-sell securities by borrowing from their own clients' accounts. For example, as soon as some negative market event unfolds or a company releases bad news, brokerages or their proxy hedge funds offer blocks of shares for sale at ask prices below the previous closing price. Large sell orders induce selling by clients. As market makers, brokerages are not permitted to sell securities short. But market makers can send signals to their client and proxy hedge funds for selling securities short.

Proposition 6.1: *Professional trading substantially reduces social prosperity. Banning short-selling of securities can enhance social prosperity.*

Argument 6.1: Professional traders buy financial securities like common stocks and bonds and other hybrids issued by companies such as IBM and General Electric. They buy from current owners of securities to sell at higher prices to new owners. Traders set *bid* prices to buy and *ask* prices to sell. The trading profit is equal to ask (selling) price minus bid (buying) price, less transaction costs.

Profits are positive only if current owners of a security can be induced to sell at bid prices and new owners are ready to buy the same at higher ask prices. This is possible due to cycles of fear and euphoria for owning a security. When fear prevails, current owners are motivated to sell and the price falls. When euphoria builds, everyone who does not own the security wants to buy and the price climbs.

It is a valuable strategy to induce fear among current owners of a security to let the price fall and then to build euphoria to raise the price of the same security. The fear-euphoria cycle does not have to be in any order. It can be first euphoria and then fear. But the law must allow *short-selling* to permit traders to borrow securities they do not own to sell them during euphoria. The *current law permits short-selling.* Traders can legally borrow sufficient number of shares of a security at higher prices during euphoria. They will need to buy the same number of shares at lower prices during pervasive fears about the same security in order to redeem the borrowed shares. They earn profits by buying at scare-based fallen price of a security, after short-selling it at a higher price ahead of time during euphoria. This way they squeeze wealth from the actual sellers (current owners) and the actual buyers (new owners) of a security.

Professional traders succeed at the expense of actual sellers and buyers and other smaller traders by timing the fear-euphoria cycles. Their success is mainly due to their skills as well as unfair pre-Great Depression era short-selling laws designed by them:

i. They can quickly gather relevant valuable data and conduct espionage on companies (issuers of securities).

ii. They have the ability to change perception about a security through analytical reports, media events and trading tricks.

iii. Their principals are *market makers* and *specialists* who exchange and clear security transactions in exchanges.

iv. They can trade ahead of others due to valuable information available only to their principals (market makers and specialists) who see through all the orders from actual buyers and sellers.

v. Current security laws do not permit small traders and investors to see large pending orders. The specialists and market makers are allowed to see all pending orders from all buyers and sellers.

vi. Current laws make information about all orders from all traders to be available to market makers and specialists, who are affiliated with IBs and their proxy hedge funds.

vii. Brokerage firms, employing professional traders, pay significantly lower transaction fees than that they levy on smaller traders.

Professional traders thus succeed to squeeze wealth from actual sellers and buyers and smaller traders of financial securities during fear-euphoria cycles.

Suppose that an IB incurs a one-time investment cost of $50000 to create a trading facility for each trader. Each trader is paid annually $100000. Assume an opportunity cost of capital of 6% on the IB's capital investment. The cost of $50000 invested in creating a trading facility for a trader at 6% is $3000 per year. The IB must therefore earn a minimum annual net profit of $3000 per trader. To earn a net profit of $3000 and pay for his salary, the trader must squeeze $103000 every year from the actual buyers and sellers of securities.

An alternative to the trading business of the IB is to lend its capital of $50000 to home mortgage borrowers at 6% and earn an equivalent $3000 in interest income every year. A professional trader with a good business degree is obviously creative enough to squeeze investors a total of $103000 annually. His creativity pays for his salary and the return on the IB's capital investment in security trading business. Instead of squeezing wealth from investors, however, the trader can use his creativity in an alternative field like education in high schools to receive as much as $100000 annually. The society can be better off by $51.5 billion annually if just 500000 traders are transferred from the business of squeezing others' wealth to more productive services for society.

Existing security trading practices and unfair laws are causing colossal losses to the society. Social prosperity will be dramatically enhanced by banning short-selling and mandating a transparent display of all orders, available to all traders on real-time. ■

It is obvious that social welfare will improve tremendously if the same trading talent can be harnessed for education instead of squandering it on squeezing investors. Squeezing wealth this way is hardly glamorous because it amounts to robbing by sophisticated means under patently unfair security laws. Capitalistic greed lures the best and brightest of society, basically to squeeze wealth from the vast majority of households. This is a colossal wastage of human talent. Capitalistic greed also entices IBs to chase mirages of potentially higher returns, only to earn about the same as on ordinary investment like mortgage lending. Massive layoffs in investment banking businesses, unprecedented losses in trading activities and closure of many trading outfits and brokerages during the last several years show how hard it has been to continue squeezing households consistently.

A concept of *incentive-compatibility* of *self-interested agents* is being hammered into the minds of business school students. This creates graduates so self-centered that they remain oblivious of degradation of common human welfare wrought by their own deeds. There is a tendency in the academia to justify through mathematical models whatever the market does, even if it means that households are squeezed of their wealth. Academia should focus on *normative theories* on improving social prosperity. It is not really useful to develop theories to rationalize results of autistic self-interested pursuits.

Internet-based trading and increased ownership of financial securities by households have made stock trading a favorite pastime in USA, as stock prices ballooned through year 2000. American stock markets have become the biggest online casinos, ever invented by humans. This has subjected professional traders to competitions from household traders. If everyone attempts to trade for squeezing each other's wealth, who will lose? Common sense tells that they will all lose since the stock price balloon stops inflating after a certain size. After the stock bubble collapsed, the mood in stock casinos has reversed due mounting losses to every player. It makes harder for professional traders to squeeze the retail investors all the time.

Trading tools confined to only the professionals until early nineteen-nineties are widely available. They have made it difficult for professionals to squeeze household wealth. Some well-publicized methods of squeezing wealth include collusions between IBs and their own stock analysts. For example, stock analysts employed by IBs have upgraded securities offered for selling to public by firms paying hefty underwriting commissions. Offering firms create shares at little cost and sell them off at inflated prices to the public by building a momentum through analyst exaggerations of future earnings. IBs also obtain windfalls from selling specially allocated quotas of free shares. Regulators have woken up after massive wealth losses to households due to such unfair tactics. Ironically, however, their incessant barrages of negative post-mortem reports have helped the same IBs sell securities short and squeeze wealth from the remaining long-term investors. Recent regulations promote to create pure security research firms independent of investment bankers. This will give some choice to investors between independent research reports and IB analyses. But will the independent research firms have sufficient unencumbered resources for accurate analyses? Can they effectively countervail IBs' media access?

Major investment bankers own or establish affiliate relationships with smaller brokerages. IBs can thus have information about all client accounts in these affiliates. The aggregate information on margin debts of clients and positions on certain securities can be very useful for investment bankers. Their strategists can device trading strategies based on aggregate client information to squeeze clients' wealth.

Short-selling increases volatility in stock prices. On a bad day for the market or for a stock, short-sellers not owning shares add to the downward pressure on price. Short-selling thus lowers the price of a stock below its fair value. Once brokerages make enough money from short-selling based on their own client accounts and to force a significant drop in the stock price, they reverse the game. By a reversal they extract wealth from retail short-sellers by pushing the price upwards through block bids at prices above the previous closing price as soon as some positive information arrives. An *artificially depressed* price of a stock indicates that most sellers have sold and many retail traders (and smaller players) have taken short positions. Big brokerages learn about the retail short positions by observing client accounts and their margin debt balances across all their affiliate trading houses. After gathering such information, big brokerages respond to any positive information by pushing the price upward through blocks at higher and higher bid prices. The stock price then rises to a higher level than the fair price. Big brokerages again make money from their short clients and other retail short traders. When the price rises to a sufficiently high level, big brokerages begin to sell short again.

Short-selling thus makes the price of a stock drop far below its fair level and to rise irrationally above the fair level. The short-selling law was due to powerful brokerages and investment bankers in the pre-Great Depression times. Obviously those who benefit from this law do not want to change it. But it causes severe price volatility at huge costs to public. This law is not in the best interest of a society and should be repealed optimally.

One main reason for NASDAQ index of stocks to balloon to its 5000 level by March 2000 is squeezing of short-sellers by the biggest players. As stock prices rose, companies investing in each others' stocks reported stupendous earnings growth, making the short squeeze work very effectively. Consumer confidence during that time jumped up. It made spending to grow phenomenally. This made revenue growth of companies appear to be sustainable. Markets scaled up to dizzying heights, making even judicious short-sellers like Templeton lose heavily and close their funds after covering short positions at the height of the bubble in March 2000. Once many such relatively smaller hedge funds perished, new money inflow into stock investments leveled off. Then the biggest players resorted to reverse the game. By reversing the game, they began squeezing holders of long positions, instead of squeezing holders of short positions. This resulted in steep price drops, resulting in underperformance of many technology companies that were still reporting growing earnings. Consumers also curtailed spending as their stocks faltered and the boom busted. These arguments lead to the following proposition.

Proposition 6.2: *High stock price volatility, caused primarily by short-selling, is very disruptive for real activity in the economy, resulting in unsustainable expansion and then painful retrenchment. The major beneficiaries of short-selling are the biggest players in capital markets. Institutionalized short-selling during the pre-Great Depression laissez faire capitalism had caused havoc.*

Argument 6.2: See the preceding arguments. ■

Short-selling should be banned in the best interest of society. It is the mother of all evils in capital markets. Institutions holding short positions currently should be required to file their positions to facilitate regulators in tracking their analysts while talking negatively about companies. Short-selling and then engaging security analysts to downgrade a stock is as immoral and unethical as it can be. Short-selling of securities is one of the vestiges of pre-Global Depression era of laissez faire capitalism that failed miserably. Market makers and specialists should also be forced to disclose their security holdings in secret inventory accounts, if any.

During nineteen-nineties, international investors too had joined the spree of rising stock prices in USA. Asian exporters and Middle East oil barons trusted their American investment bankers for storing and enhancing the values of their export wealth in specially managed funds meant for very wealthy clients. The Russian oligarchs who shrewdly wangled most Western financial assistance in hundreds of billions of dollars also joined the American casino during late nineteen-nineties.

The American stock price balloon inflated to peak in March 2000. The funds that fueled the price bubble were new U.S. government borrowings made to rescue crippling economies in Latin America, South East Asia and Russia. These funds mostly gravitated to the rich in those countries who brought them back to the U.S.

securities markets. Stock prices rose beyond control. So did American household and corporate incomes. Corporate incomes rose due to trading gains from investments in other companies as prices rose everywhere. Household incomes rose due to employees cashing their stock options and security trading gains. Exporters from countries like China and Japan kept their surplus funds in the U.S. There were thus abundant inflows of new funds into the U.S. securities markets. These funds originated from the U.S. government borrowing primarily from American households. Smart investment bankers first noticed the peak of inflows from activities of their rich clients. IBs went short in bubbled-up securities as soon as they noticed stock sell orders from their rich clients. The balloon deflated because no newly created funds could fuel its growth. Then the richest players shifted most funds from equity to debt.

Experience gleaned from trading and investment banking shows many mind-boggling strategies to squeeze wealth from the less endowed absolute majority of households. These are called *potential strategies to squeeze wealth* because of difficulties to prove them without investment bankers' proprietary trading data and active regulatory support. Investment bankers can squeeze wealth from naïve investors by colluding with managers of mutual funds, bond rating agents and government regulators. They can use many uncommon and abstruse trading tricks to transfer wealth from retail traders and naïve buy-and-hold mutual fund investors. These are presented as *potential collusive strategies* to provoke the vast majority of households who have lost due to such strategies. The goal is to prod legislators and regulatory agencies to investigate amoral, barely-legal and illegal practices of financial markets. Only the regulatory agencies such as the Security and Exchange Commission and the Commodity and Futures Trading Corporation can force the investment bankers to release proprietary data from their own trading books and from the books of their on-shore and off-shore affiliates to evince the truth.

Unless there is public uproar, regulatory agencies or legislators rarely act. The public does not react seriously without clear-cut exposures. This chapter is intended to clear the hogwash in capital markets of a civil society. At a minimum, these collusive trading stratagems can be viewed as potential schemes, which may ruin investor confidence. They may implode the mutual fund industry unless new preventive regulations are put in place.

Current law permits short-selling of a security by brokerages and mutual fund principals (Chairman and BOD) based on borrowing the security from their clients and mutual funds. This law induces a breech of trust between a mutual fund company and mutual fund holders and between a brokerage and its clients. It induces naked robbery of the vast majority of American mutual fund investors by a few mutual fund company principals and brokerages. This law must be repealed in the best interest of American mutual fund investors to avoid potential social instability that may erupt due to such robbery.

The current security laws permit a mutual fund company's principal to short-sell securities by borrowing from its mutual funds held by retirees and other passive investors. Fund managers' pays and bonuses are directly controlled by their fund company's principals (Chairman and CEO). If these principals are allowed to short-sell securities by borrowing from mutual fund accounts, then they can easily transfer wealth from retirees and passive investors by giving pecuniary inducements to subordinate fund managers. These laws thus permit naked robbery and severe breech of trust between fund investors and mutual fund company principals. These laws must, therefore, be repealed in the best interest of the vast majority of households, lest social and financial instability may ensue as it was during the Great Depression.

Preceding arguments show that social prosperity and stability can be enhanced by new regulation, as in the following proposition:

Proposition 6.3: *Principals of mutual fund companies should be optimally debarred from borrowing securities from their mutual funds, directly or indirectly through hedge funds, for short-selling.*

Argument 6.3*:* See preceding paragraphs. █

The current laws also permit brokerage houses to short-sell securities by borrowing from their own clients. While the clients are not under the control of a brokerage house, they are often induced to buy a security as brokerages give false support through fake block buy orders below best bid prices. Brokerages or their proxy hedge funds often succeed in creating irrational exuberance through fake supports at bid prices. They remove their supports after clients have bought enough of a security at rising prices, even with margin borrowing. Brokerages and their proxies then reverse their strategy. They create irrational panic by offering large blocks of shares at decreasing ask prices to induce rapid fall in price to make clients sell off at losses. Artificially induced irrational exuberance and panic succeed because investors do not buy or sell a security for any reason other than increasing their wealth. Individuals and fund managers keep selling [buying] securities whose prices keep dropping [rising] up to a threshold. Irrational exuberance-panic cycles trigger volatility that took NASDAQ to 5000 and then 1100 in about a year. Brokerage houses and their proxies thus transfer wealth from their own clients and mutual funds. This is strategic robbing permitted by current laws by which brokerages and their proxy hedge funds can short-sell a security by borrowing the same from their own clients. Again no claim is being made about the truth which cannot be ascertained without the private trading data.

There must be another new optimal regulation in the best public interest:

Proposition 6.4: *Brokerages should be optimally debarred from borrowing, directly or indirectly through proxy hedge funds, securities from their clients for short-selling.*

Argument 6.4: See preceding discussion. ∎

The Securities and Exchange Commission and other regulatory agencies must be mandated by new laws to collect data on trading at brokerage houses, mutual fund companies, and their hedge funds. Such data must be available for independent research in public interest. Mutual funds are shrinking and hedge funds are growing. This should lend indirect proof that hedge funds are used as conduits for wealth transfer discussed above. Some day the whole society can wake up to panic like banking panics and runs that preceded the Great Depression, unless laws on short-selling are amended.

6.2 MUTUAL FUND COMPANY

Mutual funds are marvelous because they diversify risk of investors, pooling their savings for investment in many securities. But these financial marvels have been hijacked by unfair laws that permit the formation of companies to operate mutual funds. A company structure has principals or owners: the Chief Executive Officer, Board of Directors, and shareholders. These owners control fund managers who make decisions to buy or sell securities for mutual funds in which retirees and others invest their savings. Principals can influence decisions of their fund managers through pay raise, bonus and perquisites. This company structure can be detrimental to the interest of mutual fund investors. This structure should be abolished by law to serve public interest.

Investment bankers facilitate in acquiring or disposing stocks for mutual funds. Many mutual fund companies are doing it themselves. This saves investment banking fees for the trades. The saving can be big because mutual funds buy and sell large quantities of stocks. But the saving is entirely retained by the fund company. It does not accrue to fund investors who are charged the fund company's trading commissions. There may be some saving for fund investors if trading commission of a fund company is less than investment bankers' fees.

More importantly, such facilitation in trading for mutual funds results in huge losses to fund investors, equal to the ask-bid price differential earned by the fund company. A fund company buys at low enough bid prices from existing owners of securities in the open market to sell at higher ask prices to fund managers. Mutual companies can profit tremendously from the difference between ask and bid prices, because transaction quantities are huge. This profit basically flows as unseemly huge pays, bonuses and perquisites to top managers of a fund company. Empirical tests based on stock prices of fund companies will be misleading because little of a fund company's profits may accrue to common stockholders.

It is obvious that mutual company principals are turning incredibly rich by nibbling the savings of mutual fund investors. In addition, a fund company's principals can also have their private hedge funds to transfer savings of fund investors through trading in collusion with fund managers. Only trading books of private hedge funds where mutual company principals have invested can show the extent of malpractice, if any.

Fund managers can directly trade shares for their funds, making a mutual fund company structure entirely unnecessary.

Proposition 6.5: Mutual fund company structures should be optimally abolished in the best interest of a society.

Argument 6.5: See the preceding discussion. ∎

Individuals know how to make profits by buying a security at a low price and selling the same at a high price. But it is hard to know what a low price is. Prices of common stocks of firms becoming bankrupt can sink to zero, like those of Enron and MCI-WorldCom. Naïve mutual fund investors may lose due to dependence on fund managers not responding quickly to sell off stocks heading towards bankruptcy. Thus, a mere knowledge of the buy-low-sell-high principle is not always useful.

6.3 LOSSES TO MUTUAL FUND INVESTORS

Passive investors and retirees who trust mutual fund managers may not know of any tacit collusion of these managers with investment bankers and fund company principals. Fund managers are generally paid less in salaries and perquisites than investment bankers and mutual CEOs. Fund managers may long to become investment bankers or mutual CEOs by ingratiating the gratitude of bosses. They may tacitly collude to sell some stock from public portfolios at a loss after an investment banker or mutual CEO sells the same stock short from a privately held hedge fund. Repealing the law on short-selling will naturally avert such strategies.

Proposition 6.6: Mutual fund investors can lose tremendously due to collusion of fund managers with IBs or mutual company CEOs.

Argument 6.6: For example, an IB or mutual CEO short-sells 1 million shares of ABC at $10 per share with an understanding that the mutual fund manager will later sell 1 million shares at a lower price of $8 per share. This transfers $2 million from passive mutual investors to the IB or mutual CEO. This is because the mutual fund manager colludes with the IB or mutual CEO by signaling to the latter about the intention to sell 1 million shares of ABC at $2 less per share.

If passive investors invested in this stock on their own, they could sell 1 million shares at $10 per share, judging by the IB's success in selling 1 million shares at this price. But the mutual fund manager fetches them only $8 per share due to his collusion with the IB or mutual CEO. Passive investors thus lose $2 million due to their trust on a potentially sly fund manager. The IB or mutual CEO basically sells short ahead of time with full information that he can buy the shorted shares from the fund manager at a much lower price. Stock prices often drop without any real information, but it is the clandestine sharing of information between a fund manager and investment banker that may be the cause for such price drops. Again these arguments are based on potential actions and on facts about tremendous increases in wealth of fund managers, principals of mutual companies, and investment bankers.

A fund manager may also inform an IB or mutual CEO ahead of time to buy some stock at a sufficiently higher price than the current trading price. Then the IB or mutual CEO can accumulate shares at the lower price because of a guarantee that the fund manager will buy those shares at a significant premium. This is again a case of price rise without real information release by the company or other outside sources. The information on collusion between a fund manager and an investment banker often leads to price rises and drops without any information *ex post*.

Such collusion is very hard to prove unless the Security and Exchange Commission is willing to investigate instances of collusion. There has been, however, a dramatic rise in private mutual funds and hedge funds since late nineteen-nineties. There has been also a rise in direct open market purchase and selling by public mutual fund companies through their own brokers. But there may still be collusions between the brokerage arms of such companies and their mutual fund units.

The author's correspondence with the SEC in 2001 for the potential trading between mutual fund managers and IBs or mutual CEOs triggered serious interest by SEC attorneys judging from their responses. New laws to ban trading after hours were enacted by the U.S. Congress in 2003. But, more crucially, the U.S. is yet to enact the above proposed laws to serve the best interest of the absolute majority. The author is still in correspondence with the U.S. Congress, SEC, Federal Reserve Board and White House on reforms in public interest. This book is intended to trigger public interest to persuade the U.S. Congress to pass legislation on such proposals that will make the capital markets fair and trustworthy.

The traders, investment bankers, mutual fund managers, and mutual fund company CEOs are obviously acting in their best interests by making the best use of the current laws. The argument here is not accusation against anyone. It is about the current law not serving the best public interest. The purpose is to help enact new reforms that will make the society financially stable with mutual trust among individuals.

If current laws continue, passive investors can someday simultaneously withdraw all their funds from public mutual funds. In fact, there are murmurs that the vast majority of households now save only in government securities. This is a main reason for the yield on the ten-year U.S. Treasury not rising in response to significant raises in short-term rates made by the Federal Reserve. Passive investors may have suspected some of the collusive games in capital markets. They may wonder why legislators are unwilling or unable to reform the unfair laws. One hopes that this does not lead to a catastrophe in the mutual funds industry. This may be the biggest financial time bomb waiting to implode under the roof of mega capitalism. The Great Depression resulted after banks nibbled away savings and depositors reacted by mass withdrawals of their deposits. The government then stepped in to regulate banks to restore depositors' confidence. In the wake of panic driven withdrawals from mutual funds, the government may be forced to regulate mutual funds and hedge funds to stem the tide of another great depression.

Proposition 6.7: *An investment bank can make tremendous profits by inducing privileged large clients to borrow margin debt at zero interest rate to buy stocks. The investment banker just needs to short-sell the stock and then induce the price to drop helped by analyst downgrades.*

Argument 6.7: For example, suppose that some IB's client holds 1 million shares of Infospace during a period in which this stock's price has fallen steeply from $140 to $100 per share, before this stock was split. This client has lost $40 million due to a price decline, despite the analyst's strong recommendation to buy the stock. After the client's portfolio drops to $100 million, the IB indicates to the client to borrow $100 million to buy another 1 million shares. Following the advice, the client owns 2 million shares valued $200 million, but owes $100 million to the IB as margin debt. If the price rises to $120 per share, the value of 2 million shares will rise to $240 million to fetch a net portfolio value of $140 million after repayment of $100 million of borrowed margin debt. The client is thus given to believe that he will make up the original value of his portfolio equal to $140 million. The IB engages analysts to assist the client in restoring confidence in markets and reminds of the wisdom of buy-and-hold strategy.

The IB, however, borrows his client's shares to sell them short in open market to depress the price after the client is choked with margin debt. When the price drops to $80, the client is advised not to lose trust in a good stock, but to sell enough of his holdings to meet the margin call requirement. By the margin debt rule, the equity (value of shares less margin debt) cannot drop below the amount borrowed at anytime, although the IB may apply some discretion for a favored client. When the price drops to $80 per share, the client's net portfolio (equity) value drops to $60 million, which is $160 million for the value of 2 million shares at the new price of $80 less $100 million in margin debt. The interest on margin debt is suppressed from the calculation to keep it simple. The IB advices the client to sell $40 million worth of stock to repay a part of margin debt, bringing down the margin debt from $100 million to $60 million, equal to the reduced value of equity of the client. The client is thus forced to sell 500000 shares for $80 per share leaving 1.5 million shares valued $120 million.

The IB continues the above process. When the stock price reaches a sufficiently low value, the IB confiscates the account of a trusted client. For example, the IB engages in heavy short-selling to bring down the price to $60 from $80 through secret campaign with private clients like families and friends asking them to sell Infospace shares short.

Then the IB asks its own analyst to publicly downgrade the stock and the stock price suddenly drops to $42. At this price, the IB is legally allowed to seize the account of his client because the net portfolio value is only $3 million: $63 million in the value of 1.5 million shares at $42 per share less $60 million in margin debt. Then the IB sells to itself the client's 1.5 million shares at $42 per share for a total of $63 million. The IB credits the client's account $3 million after recovering its margin debt of $60 million at the end of the game.

Table 6.1
Client Loss Due to Brokerage Short-selling

ACTION	SHARE PRICE $	SHARES MIL.	STOCK VALUE MIL $	MARGIN DEBT MIL $	ACCOUNT VALUE MIL $
Before IB short-sells	140	1	140	0	140
Client makes margin debt to double shares	80	2	160	100	60
client dells 0.5 Mil shares to meet margin Call	80	1.5	120	60	60
Analyst Downgrades	42	1.5	63	60	3
Client Sells 1.43 mil shares to pay off margin debt	42	0.07	3	0	3

The price keeps dropping due to the orchestrated panic, short-selling, and analyst downgrades. If the price drops to $30, the IB may call the client to say how nice it is to have a credit of $3 million, instead of losing it all.

In the game, the IB basically sells 1 million shares short at $100 per share while simultaneously advising the client to buy these extra shares. At the end, the IB then buys the shares from the client at a bargain price of $42 per share, making a profit of $58 per share, i.e., a total profit of $58 million by squeezing a trusted client. Investment banks can potentially squeeze billions of dollars of wealth from many wealthy clients through shrewd manipulation due to the short-selling law. How else would they be turning unseemly rich while the vast majority is forced to toil for pittance with declining household net worth.

Investment bankers basically begin selling short as soon as their major clients order to sell their positions or simply express concern about falling portfolio values during a time of falling prices. When large, once-favored clients express intentions to sell, IBs respond with a strategy to squeeze as much wealth as possible from such clients as Saudi Sheikhs who have stashed billions of dollars made from oil exports in various investment banks in USA. Investment bankers' clients include individuals managing money in pension plans and mutual funds for naïve investors.

During rising stock prices too, for example before March 2000, an IB or its proxy HF can likewise squeeze clients by advising the latter to sell short. While they do so, the IB buys shares to raise the price before the close of the day. Suppose that the price rises subsequently due to manipulation and analyst up-grades for the stock. Then a client short-seller's margin account declines in value to trigger margin calls. This can allow the IB to force the client to buy enough shares to cover the short position at a much higher price. The IB basically buys low while advising clients to sell short and then manipulates the stock price upwards through media propaganda and analysts upgrades. This is to force clients to cover their short positions at higher prices than they paid at the time of going short.

Most wealthy clients entrust their investment bankers to manage accounts with billions of dollars pouring over time. Such clients can hardly keep track of the day-to-day transactions. Investment bankers can enter buy and sell orders on behalf of their clients and transfer wealth by nibbling bit by bit over time. Portfolio values of many ultra rich clients may be held high with worthless scrip at artificially inflated prices obtained through manipulation. Only when some of the ultra rich clients liquidate their positions do they know the true worth of their investment after the atrophy due to Wall Street's mega games.

Business schools argue about non-existence of consistent arbitrage opportunities. This amounts an assertion that the scheme described above cannot last forever. How does it matter when most wealth gravitates to a few mega capitalists through amoral games played over even a short stretch of time? They may discover newer games ad infinitum by hiring fresh talents! The only risk of such amoral games is some comparatively miniscule government penalty like $100 million or instructions to sack a few traders and analysts. But the game will go on until and unless short-selling is banned.

6.4 BUY HIGH AND SELL LOW FOR PROFITS

Every retail investor tries to buy a stock at a low price to sell it at a higher price for profit. For example, every trader may like to sell a security at $10 per share after buying the same security at $9 per share to make a profit of $1 per share. This is the standard buy-low-sell-high strategy. Now-a-days smaller traders can get the same trading tools that professionals use. It is, therefore, not easy for the professional traders to make profit by the standard buy-low-sell-high strategy.

The standard source of profits for the professional traders has been through selling or buying large orders for rich clients by trading ahead of time with other traders who are deprived of pertinent information about such large orders under the current law. The Security and Exchange Commission has considered but failed to implement a completely transparent open order book system that displays all large and small buy and sell orders for everyone to consider before trading. This failure is due to strong objections from major investment bankers who benefit tremendously from hidden large orders as they can trade with perfect information about their clients' reservation prices with the rest of the uninformed market. Now that many rich clients have also bitten dust in the mega games, the scope of profiteering by mega players has shrunk drastically. It is true that the market self-corrects in course of time. But the self-correction process turns the vast majority of people paupers, while a few ultra-rich grow even richer. This is mainly due to unfair laws that allow collusion among mega players and render government agents impotent.

Stock markets are now filled with a multitude of retail traders competing nimbly with professional traders. How will the price move in this new environment? Suppose that professional traders notice true holders of a stock submitting simultaneous sell and buy orders to earn the bid-ask spread. Professional traders will then sell short to drop the price sufficiently by making the true shareholders nervous to sell at much lower prices. Such professional strategies lower the price sufficiently. But unless there are buyers at higher prices and sellers at lower prices, professional trading or individual trading yields little and the market is stalemated. The stock markets in USA have perhaps reached such a state of stalemate. This may eventually lead to another round of selling as people are laid off and fear sweeps across the country. The question is whether there exist other trading strategies that can squeeze wealth from passive investors and retail traders.

Proposition 6.8: *Buying a security at a higher price and then selling it at a lower price can be profitable to an investment banker or its proxy hedge fund that holds a short position in the security and operates affiliate accounts in island nations (e.g., Cayman Islands) beyond the purview of the U.S. corporate laws.*

Argument 6.8: An investment banker who holds a significant short position (say 1 million shares of a company called ABC) can make money by buying ABC shares at high prices and selling at lower prices to their affiliate accounts. If recorded closing price of ABC stock is $1 less than the previous closing price, the value of the IB's portfolio advances by $1 million. Enhancing the closing value of a portfolio is important to induce money inflow to enlarge the IB-managed hedge fund (HF).

Suppose that ABC stock has traded at $10 per share throughout some day and that the previous day's closing price was also $10 per share. The IB-HF short-seller too buys some shares at $10 per share. But just before the close he offers a large block of shares at $10. This makes other bidders to stay off. Then the IB-HF sets a bid at one of its affiliates, say, $9 and sells to that bid the shares it bought during the day to make the closing price of the day fall by 10% as compared to the previous day's close. Although ABC trades throughout the day at $10 per share, the recorded closing price becomes $9 per share. Doing so enhances the closing value of IB-HF portfolio, which is marked to the market everyday. Marking a portfolio to the market means computing its value at a day's closing prices. Accountants and fund investors pay attention to the net worth of IB firms based on portfolios marked to the market. By selling the shares at $9 to its affiliate account after buying at $10 per share, the IB-HF loses neither cash nor the shares. But it changes the perception about the value of the stock by end of the day. This triggers nervousness and selling by shareholders on the following day.

Suppose that the IB-HF's affiliate account is held in remote Cayman Islands, outside the purview of the U.S. laws. Then the end of the day trade at a loss of $1 per share will record a loss for the IB-HF. This loss can be deducted from the IB-HF's taxable incomes earned from U.S. businesses like mortgage investment. This tax deduction will generate a positive cash flow of about 33% at the marginal tax rate. It can thus pay a short-seller IB-HF to buy a security at a higher ask price and then sell it at the lower bid price. This strategy squeezes government tax revenues and induces stockholders to sell off at lower prices for the IB-HF to cover its short position eventually. The short-selling law makes it possible. This law is not in the best public interest.

6.5 FAKE BLOCK TRADES AND PRICE MANIPULATION

The specialists in NYSE control the exchange of shares from sellers to buyers. In NASDAQ, market makers buy shares from sellers and then sell to buyers. Technically, the NYSE specialist can do exactly the same thing as the NASADAQ market maker, namely, buy shares from sellers at a lower price and sell them to buyers at a higher price. The specialist generally does not buy from sellers until he finds buyers for those shares at a higher price; so does a market maker in NASDAQ. Sometimes specialists and market makers may take risks to buy or short-sell depending on the trading behavior of a stock, especially, when they know about some investor buying or selling the security in large quantity.

Market makers and specialists are brokers. They are not legally permitted to trade ahead of investors. They are supposed to execute exchanges of shares for pre-announced commission rates. But in the real world, the temptation is so high that brokers invariably trade (directly or through proxy hedge funds) ahead of retail investors or passive mutual fund managers. The inventory positions of brokerages are not required to be disclosed by law. Even if a brokerage holds 99% of shares of a stock in its inventory, it does not have to reveal these holdings in any regulatory filing. The Security and Exchange Commission (SEC) currently does not require brokers to reveal their inventory positions. Neither does the SEC stipulate any maximum percentage of outstanding shares of a stock that can be held long or short in the inventory of a given brokerage. The SEC, however, requires annual public reporting by individuals, mutual funds and institutions holding long (not short) positions consisting of more than 5% of outstanding shares of a stock. The SEC should mandate filing of all long and short positions held by brokerages and hedge funds. The SEC should even require companies to maintain a list of all holders of long and short stock positions in their websites for transparency.

If a brokerage holds a long position on most shares of a stock, it can severely rig the stock price upward or downward on slightly positive or negative information, respectively, about the stock. Brokerages are parts of IBs. An IB operates through its own investor accounts and trading accounts in many affiliates. Such accounts are often held in hedge funds, which are not within the purview of the current regulation. It is easy to act in unison by setting bids and asks from these accounts to raise the price of a stock if an IB-HF owns most of the shares in these accounts. Raising the price becomes credible when some positive information is released. An IB-HF holding most outstanding shares of a company can tacitly scare its chief executive officer (CEO) by pushing down the stock price unless the CEO shares valuable information before releasing it to public. CEOs often have no choice between a rock and a hard place. Such scare tactics are credible because most CEOs own significant number of shares and stock options whose values sink as the stock price falls. New regulation on full disclosure prohibits sharing of valuable company information with anyone including IB-HF analysts before it is publicly released. But in the name of research, IB-HFs can exact valuable information ahead of its public release when they control most outstanding shares and the market price of a stock.

6.6 FAKE BLOCK TRADES AND PRICE MANIPULATION

For widely held stocks like IBM, Microsoft and Intel, IB-HFs cannot easily manipulate prices because they cannot afford to own most shares of such companies. The question of exacting information ahead of public announcement does not arise in such cases. These companies follow the laws on full disclosure strictly. But they too are prone to espionage, which cannot be controlled.

The second tier stocks are prone to manipulation through large price volatility, because IBs and proxy hedge funds can hold most shares long or short. But IBs can make money only when there is wide participation of retail traders and passive investors' fund managers.

To establish credibility in stock price swings, trading volume has to rise and there has to be significant change in inflow and outflow of money into a stock. Money inflow into a stock is positive when more number of shares trade at ask prices than at bid prices. Positive money flow shows significant buying at ask prices. Negative money flow shows significant selling at bid prices. The standard inference from positive money flow is that some investors with private knowledge eagerly buy at ask prices. When positive money flow occurs with a spurt in volume of trade, naïve investors jump into a buying binge. Investment bankers intending to dispose of a large number of shares of a stock exploit such naïve investor behavior by artificially creating positive money inflows.

Proposition 6.9: *Investment bankers with proxy hedge funds holding a large number of shares of a stock can artificially increase money inflow and trading volume. They will do this to dispose of the stock at higher prices to mutual fund managers and naïve investors, who believe that positive money inflows signal arrival of good information.*

Argument 6.9: If the price of a stock rises with appreciably large volume of shares traded, many people presume that such a price rise is genuine. Professional investment bankers take advantage of such belief by engaging in fake trades. For instance, suppose that the best bid (buy) price for a stock is $10 per share for 1000 shares and the best ask (sell) price is $11 per share for 100 shares at some time during a day. The *best bid* price is the highest of all prices at which various traders and investors want to buy the stock at a time. The *best ask* price is the lowest of all prices at which all traders and investors are willing to sell the stock at that time. If the best bid price exceeds or equals the best ask price and the number of shares on the bid and ask match, the trade is executed. For instance, in the above example, if someone offers to sell 1000 shares at an ask price of $10 per share when the best bid is $10 per share for 1000 shares, a trade will be executed at that price.

Suppose that an IB-HF owns most of the shares of a stock in its various accounts and knows that the fund managers who own the rest of the shares are unlikely to sell on a day. Suppose also that this IB wants to raise the price ahead of some positive information known through espionage or soon after a public release of such information. Then this IB will engage the market maker of some affiliate-A to buy large blocks, say 100000 shares in each block, at a price close to the best ask price from another affiliate-B. These affiliates are registered trading entities, but are generally exclusive to trade in unison with the IB-HF with respect to the stock. Affiliate-B does not submit an open offer for sale of 100000 shares and affiliate-A also does not show its bid for the block of shares. This ensures that no one else in the exchange knows of an impending block transaction. Suppose that affiliates A and B enter their block bid and block ask orders simultaneously for 100000 shares at $10.99, when the best bid is $10 and the best ask is $11 per share. This order is executed instantaneously. The whole market sees it and the stock exchange records a block trade at $10.99 per share for 100000 shares. The affiliates effectively transfer among each other the same IB-HF's shares at a much higher price with increasing volumes recorded legitimately by the exchange. Naïve traders and fund managers thus observe someone buying 100000 share blocks at a price close to the best ask price.

An affiliate can also buy 100000 shares for one account at the prevailing best ask price of $11 per share from another account selling the same. Such block trades among accounts within an affiliate do not disturb the shares at the best ask price offered by other traders in the exchange. Suppose that a trade, just before the block trade, was executed at the bid price of $10 per share for 1000 shares. Then the block trade will make the price jump 10% to $11 per share on a ten-fold increase in volume due to transactions among affiliates of the same IB-HF. Such price jumps often scare other short-sellers and lure the naïve traders and investors not accustomed to such tricks. At least the scared short-sellers unaware of these tricks will rush to buy.

Otherwise, their account values drop and, if on margin debt, they can forfeit their accounts altogether. When short-sellers buy out of panic, naïve retail traders jump in to buy a stock rising in price. The artificial rise in volume induces many to take long positions in the stock. The IB-HF who triggers the price rise begins to sell after the price increases substantially where it can be sustained due to purchases by new investors. When an upward price trend on increased volumes is established, standard investment tools will record money inflows into the stock and strongly signal to buy the security. Such tools are in the domain of technical analysis. They are based on price and trading volume data. They are thoroughly misleading. Empirical research conclusions derived from such price and trading volume data are not reliable. Academic theories that explain such conclusions are not useful. A creative IB-HF can also induct a band of mutual fund managers ready to sink passive investors' retirement savings by raising price and volume through fake block trades. It lets the IB-HF to sell off its worthless scrip to individuals lured by its tricks. ■

An IB-MF can likewise lower the prices of securities on which it is heavily short by trading fake blocks at lower bid prices through its affiliate accounts. Many mutual funds have a policy of not holding penny stocks, those trading below $5 per share. This induces IB-HFs to depress the price to the penny stock range to induce sell off by mutual fund holders. The price often falls to an insanely low level due to a domino effect. The retail investors and traders jump in to buy a stock that falls significantly in value. But they sell off at losses as the price falls farther. Once in penny stock range, the price drop depends on the whims of IB-HFs and the level of fear among retail traders, as the funds dump their holdings to run for exit. To trigger sell off by passive mutual fund investors, an IB-HF with a heavy short position sets a downward price trend with artificial money outflows on heavy trading volumes.

Colossal wealth transfers from passive investors to smart mega capitalists are feasible and can be observed in the real world. IBs have chief trading strategists to direct all their affiliates for concerted moves to swing prices through fake block trades. They can also influence the price through analyst rating upgrades and downgrades and by enticing reporters on popular business channels like CNBC and Wall Street Journal. All that is necessary to influence reporters and television talk show hosts is to engage them to trade in concert for profits. For example, an investment banker or its proxy hedge fund may simply offer tips to reporters and talk show hosts about analysts' views and subsequent upgrades and downgrades on a stock before the rest of the market knows. There are perhaps too many such cases for regulators to contemplate catching the colluding usurpers of public's wealth. It is possible that such game will degenerate to a point at which only a few naïve traders and fund managers will be left to play into such tactics. But by then a lot of wealth will have been transferred to a few mega capitalists.

An IB-HF will not succeed in manipulating prices when another prominent IB-HF takes opposite positions. For instance, if IB-HF-1 is short and pushes the price down by trading fake blocks at lower and lower bid prices. After the price reaches some irrationally low level, IB-HF-2 may buy all the shares offered and may even catch some of the fake blocks offered by short-seller IB-HF-1. IB-HF-2 may eventually squeeze IB-HF-1. The game of IB-HF-1 to lower the price will succeed only if the difference between bid and ask prices is substantial and the bid price keeps dropping as a result of fake block trades at lower and lower bid prices. But if IB-HF-2 persistently buys from all other scared shareholders, the bid-ask price difference will be negligible to generate insignificant profit for short-seller IB-HF-1. IB-HF-1 can no longer reduce the closing price or generate trading profit. IB-HF-1 cannot therefore enhance its portfolio value by trading on short-side any longer. IB-HF-1 will also be unable to generate positive cash flows from reduced taxes by buying high and selling low. At this stage, IB-HF-1 will begin to cover its short position and then accumulate a long position. After substantial long positions by both IB-HF-1 and IB-HF-2, the stock price can dramatically rise in response to even trivially positive information, because both IB-HF-1 and IB-HF-2 can have profit opportunity by squeezing other short-sellers of the stock, as long as the company generates credibly good revenues and earnings.

6.7 BUY CALL OPTIONS TO INDUCE BUYING STOCK

Options are securities that confer rights to buy or sell stock at a pre-stipulated price called strike price on or before a pre-specified date called maturity date. There are two types of options, calls and puts. A call option written on a stock is a right to buy a share of the stock for the strike price. A put option written on a stock is a right to sell a share of the stock for the strike price. One who sells options is called an option writer, generally an institutional specialist. Options can be used to hedge risk or to speculate.

The risk of buying options is considerable because the whole amount used for buying options can be lost when the options cannot be exercised. For example, consider a call option on stock ABC with a strike price of $20 and time to maturity of three months. This option will expire unexercised if the stock price stays below $20 before maturity. If the purchase price of the call option is $2, this amount will be lost, entirely, should the option expire unexercised. Only if the stock price exceeds $22 before maturity will the option holder have a chance of recovering $2 plus some profits. If $2 is invested in ABC stock, underlying the same option, not all of it will be lost even if the stock price stays below $20. Investments in a stock will become worthless only in the event of bankruptcy of the company.

The risk to an option writer is also enormous. In the above example, suppose that the stock price rises to $50 per share in three months when the call option holder chooses to strike. Then the call option writer will lose $30 because he has to buy the stock for $50 to deliver it to the option holder for $20. The call option holder has a right to buy the stock for $20 and he will do so when it trades at $50. This is risky to call option writers. At the time of selling call options, option writers therefore hedge their risks by buying enough of the underlying shares for delivery to striking call option holders.

Proposition 6.10: *IB-HFs that hold most of the shares of a stock can simply buy a bunch of call options on the stock to force the option writer (some other institutional specialist) to buy enough of the stock for hedging. This can boost the stock price for the IB-HF to sell to traders buying a stock with rising price.*

Argument 6.10: If the IB-HF holds most of the shares, the supply is restricted. The stock price can, therefore, rise substantially as the call option writer buys the stock to hedge his risk of selling call options to the IB-HF. When the stock price rises, speculators join in to buy the stock and short-sellers panic to cover. Sometimes the price rises dramatically as happened during late nineteen-nineties. The IB-HF owning a junk stock then sells to a rising demand that is created artificially by buying call options on the stock. ∎

An IB-HF with a short position can depress the price of the stock by buying put options written on the stock. The put option writer will have to sell the stock short to remain hedged. This is because in the event of a price drop below the strike price, the put option holder will exercise the put to sell the stock for the strike price. Then the specialist will have to buy the lower priced stock from the put option holder by paying the higher strike price. This is risky to the put option writer. He, therefore, sells the stock short at the time of writing the put option to hedge this risk. He can then cover his short position by buying the stock from the striking put option holder. The IB-HF who is short in a stock can induce selling of the stock to lower the price by acquiring some put options. When the IB-HF acquires the put option, the option writer sells the stock to hedge. The price of the stock falls. Then the momentum for selling the stock may build as a result and even accentuate in a bear market. When the price drops sufficiently, the IB-HF covers his short position at a lower price than the price at which he sold the shares short, thus making a windfall.

7 GLOBAL DEMOCRATIC CAPITALISM

Global markets serve to exchange the surplus produce of various nations. A *global market system* comprises rules enforced by an entity like the World Trade Organization to bind the participating nations. Such a system can serve, in principle, people across countries to exchange their surplus produce with each other. The main question about such a system is: can the WTO serve the best public interests by framing and enforcing rules?

Even the mighty U.S. government entities are unwilling or unable to protect the best public interest against unscrupulous practices of mega capitalism. How can the WTO serve the best interests of billions of people in countries like Russia, Latin America, Africa, India and China? Who can guarantee the global public their basic economic rights when no *global government* exists? The fledgling global market system is a form of laissez faire capitalism with nations acting disparately in the best interests of their respective groups of capitalists. Mega capitalists within a nation set the agenda for their societies. Which group of capitalists will set the agenda for the global society? This chapter delves into these issues.

Mega capitalists practiced laissez faire global capitalism in countries like USA without government interference until the free market exchange system collapsed due to panics by public. Laissez faire capitalism was a fiasco in USA. It will similarly fail utterly at the global level. The WTO cannot help. Even a global democracy will be as impotent as the U.S. democracy is about serving the interest of the absolute majority. Indicators point to mega global capitalism facing rough waters. The East Asian, Russian and Latin American currency devaluations are serious signals for a potential economic catastrophe ahead. Brewing agitations of vast majorities of people in South Asia, China, Indonesia and Middle East cannot be easily suppressed. Major nations like China, India, Brazil, and Russia will not embrace laissez faire global capitalism. The current mega capitalistic order cannot enhance prosperity of the absolute majority even in the developed world, as described through several propositions in this chapter.

7.1 GLOBALIZATION AND GLOBAL DEMOCRACY

Mega capitalism appears to have taken over a mighty U.S. establishment without any qualm to intimidate the world. Its global strategy includes the following:

A. Forcing developing nations to protect patents and intellectual property rights.

B. Flaunting and using American military might to extract limited global natural resources like the West Asian oil at prices substantially cheaper than carbonated water, such as Coca Cola and Pepsi.

C. Keeping the rest of the world divided so that warring neighbors like India-Pakistan, North Korea-South Korea, China-Taiwan continue to support armaments factories of mega capitalists.

D. Aligning diplomatic and military power to prevent developing nations from building their own security needs including endogenous nuclear power to preempt potential challenge to an unsustainable concept of supremacy.

E. Dictating social, political and economic order in the developing world to align with a strategy of perpetuating mega capitalistic dominance over masses everywhere.

The wish underlying mega capitalism is to dictate, from cocoons of security, policies and politics nationally and globally. A perception has been created to suggest that mega capitalism has succeeded in USA and is ready to take over the world. This perception is as ephemeral as asset price bubbles. It is not clear that the vast majority of U.S. households are prospering. Growth in economic prosperity can be ascertained only by proper periodic measurement of per capita household net worth of the absolute majority. Suppressing information about what households consider as measures of their prosperity will only make any simmering discontentment brew within.

The absolute majorities in developed nations may continue to hope that their governments will eventually beget prosperity to them by thwarting mega capitalism. A democratic government can theoretically protect the interests of an absolute majority of voters. But the reality seems very different. Mega capitalism has taken over the democratic government agenda to adopt self-serving policies by stifling prosperity of the absolute majority of households. Specious arguments are broadcasted through controlled media to portray myth:

- Patent laws enhance human innovation.
- Debt-driven consumption boosts household prosperity.
- Short-selling provides liquidity to protect values of financial securities.

Such specious arguments are nefarious designs to wangle wealth from the vast majorities of households everywhere.

Sketchy reports suggest that the number of household with $20 million and more in net assets is rising at a rate of 3000 per year, while 90 percent of households are not seeing income growth in USA. Data on net assets of all U.S. households are not available. Such data are not collected, perhaps, to help propagate the specious arguments of mega capitalism. Suppression of information on economic weakening of the vast majorities in democracies, if happening under the veneer of GDP growth statistics, is not sustainable for very long.

Democracy and capitalism with freely accessible markets are vital for prosperity of a civil society. But to make the vast majority prosperous, the governments must admit that income growth does not measure household prosperity. They must propagate the truth that the household net worth is the only valid yardstick of prosperity. The same mega capitalists are, indeed, relentlessly pursuing for enhancements in their net assets. Why should democratic governments trumpet myths about per capita income growth and not collect data on net assets of all household? Arguments for patent laws, short-selling rights and debt-driven consumption must give way to propagation of truths. The truth is that these arguments are specious. They only help the mega capitalists in usurping wealth of the rest.

Spreading the tentacles of mega capitalism to the rest of the world to perpetuate propagation of myths and suppression of truths will not materialize for several reasons. First, the vast majorities in regions like South Asia, Africa and China are already reeling under abject poverty. Second, the vast majorities in advanced countries may uncover the myths and demand truths. Third, the majorities in developed nations may realize the necessity of a democratic global government for establishing a global civil society with free trading and capital markets, like at the national level. They may see that virtues of democratic capitalism can benefit households elsewhere only if there is global democracy. But there is no guarantee that global democracy will ensure prosperity through capitalism for majorities of households in all countries. Democracies even within developed countries cannot guarantee such prosperity through capitalism. Without global democracy, it is almost impossible for majorities of households in developing countries to be more prosperous with global capitalism than otherwise.

Governments serving the best public interest are vital for prosperity of majorities of households in all countries. They would do the following:

- Publicly distinguish between myths and realities affecting prosperity of majorities.
- Propagate truths and facts to counter specious arguments and public propaganda of self-interested mega capitalists.
- Thwart Ponzi Games imposed on unsuspecting majorities. Ponzi Games slyly force households and governments to borrow more and more from mega capitalists. This is neo-bondage or perpetual economic bondage of a vast majority of households by a fringe of mega lenders.
- Checkmate nefarious designs of few mega capitalists.

The reality is that mega capitalism has not yet proved its success in making a vast majority of households prosperous, particularly in USA. The true measure of prosperity has to be established and announced periodically to make any assertion to the contrary. If mega capitalism has not measurably brought true prosperity for a majority in the bastion of such capitalism, how will it achieve a bigger goal of global prosperity? The global majority may have to hallucinate about their prosperity without even a globally elected democracy, let alone public interest oriented governments. Only a global democracy will have the authority to tax people and to maintain global law and order. Free global trading and capital markets without such global democracy will be simply chaotic. Most proponents of free global trading and capital markets are from G7 countries: USA, UK, France, Germany, Canada, Japan and Italy. None of them has proposed to establish a democratic global government or some other international government to resemble democracy. Neither have they professed that such democracy is a prerequisite for prosperity of majorities in all countries through free global trading and capital markets. Are the mega capitalists and supporting G7 policymakers simply myopic? Or, they are working in their self-interests to establish oases of prosperity in their own countries. Do they contemplate global prosperity through visa quotas to elites from other nations?

Proposition 7.1 *(Justification for Global Democracy): Suppose that a nation can prosper only through democracy with transparent rules of law, an efficient judiciary, and a system of taxing the rich more than the poor. Then the global humanity cannot prosper without global democracy, judiciary, and rules of law equally applicable to all global citizens.*

Argument 7.1: See the preceding arguments. ∎

The need for global democracy to advance humanity on earth does not necessarily imply that the advanced nations will agree to form such democracy with a global tax system. Mega capitalism relies on usurpation of wealth of a majority. It will never allow global democracy to take root on earth.

7.2 FREE MARKET GLOBAL CAPITALISM

Free market capitalism can be a trap for the majorities, particularly in developing nations. Its advocates are based mainly in USA and

Western Europe. But they preach selectively. Their sermons mislead the world. How? Consider, for example, the sermon about competition to drive down prices to benefit consumers. The U.S. government indeed intervenes to correct price gouging by monopolistic producers and tacitly colluding cartels. Proponents of free markets make uproars when such interventions are not made. But there is utter silence about tacit government prod to the American aircraft makers to merge. It is obviously a strategic decision to outmaneuver the European rival, Airbus. As discussed earlier, air travelers bear wages of aircraft manufacturing workers. These wages are significantly higher than those of the developing world. They are supported by air travelers even in the developing countries. Such high wages have resulted directly from a duopoly of global aircraft makers due to tacit government encouragements. This is strategic, not driven by principles of free markets. It does not bother the proponents of free markets. But against whom is this strategy designed? The vast majorities in developing nations subsidize their air travelers and thereby support profligacy of aircraft manufacturers in developed nations. It is primarily due to a strategic abandonment of free market principles.

Free market capitalism can improve prosperity of common people only if a democratically elected government guards against price gouging by a monopolist or a cartel. The champions of free-market enterprise do recognize this. Countries that do not have democratically elected governments are likely to fail in enhancing prosperity of common people. Western free market proponents and governments correctly support this argument. But they are selectively oblivious of their own principle of monitoring markets to deliver fruits of capitalism to common people. They are silent about the necessity of globally applying their own principle for majorities everywhere else to receive the benefits of capitalism. Capitalism can serve best interests of majorities on earth only if it is optimally regulated by a democratic global government. There is no guarantee. But a democratic global government, elected by all in the world, would have naturally allowed transfer of aircraft production facilities and technologies to cheaper areas on earth or permitted migration of skilled workers to Boeing and Airbus to cut production costs, tremendously. This would have surely benefited majorities even in developed countries. But it would have hurt the beneficiaries of mega capitalism with strategic designs. Mega capitalism has been designed and is operating for bondage, not prosperity, of majorities. Optimally regulated global capitalism and democracy can thwart such evil designs.

A top-notch computer programmer receives an annual remuneration of about $10,000 per year within India. When the same programmer is transferred to USA, he is paid about $100000 per year. Yet, USA has a very limited quota for immigrants from India. Free market champions in USA will find it appalling if any state within USA restricted immigration of workers from other states. A democratically elected federal government in USA cannot contemplate about imposing restrictions on migration of workers across state boundaries. Doing so will vitiate the basic tenets of democratic capitalism.

Why are the champions of free global markets oblivious of the incongruity in their sermons? An internally consistent and coherent approach would call for a democratic global government before advocacy for free global markets to deliver the fruits of democratic capitalism. There is abundant research on free market economics in premier academic institutions. Many highly paid professors of finance, economics and political economy have been instrumental in promoting democratic capitalism. Many academic gurus are running the mammoth American economy and preaching from their cocooned chambers of luxury and safety the virtues of free global capital markets to world. These intelligent individuals have written tomes on the importance of a democratic government and on the necessity of government monitoring of markets to foster competition and transmit the virtues of capitalism to majorities. How have they missed their own research while sermonizing for free global markets without global democracy? Their own work would have directed them to advocate for a democratically elected global government. A democratic government in the U.S. is necessary to monitor and promote market competition and to pass the resultant benefits to all American households. Is instituting a global democracy, duly elected by global voters, then not essential to foster competition in global markets so that fruits of capitalism reach all? There is not much published to show the necessity of a democratic global government for monitoring and promoting competitive global markets.

7.3 INTERNATIONAL WAGE ARBITRAGE PROFITS

The world now has international financial bodies like the International Monetary Fund and the World Bank, a political entity like the United Nations, and a trading organization like the WTO. But to argue that these are substitutes for a global democracy will be truly specious:

- Firstly, mega capitalists effectively rule powerful developed nations with massive military powers to dictate terms for the IMF and WB.

- Secondly, the IMF and WB have been created with an explicit goal to lend poor nations with no means to pay for their import needs. This is to extend the borrow-to-spend tenet of mega capitalism to the whole world.

- Thirdly, global citizens have not democratically created these international institutions, which are not answerable to any global electorate.

- Fourthly, these international financial institutions have historically forced a needy poor country to drastically devalue currency and to tighten money supply. These measures amount to forcing needy poor nations to export domestic products and labor for pittance.

To achieve their goals, the international institutions entice poor nations to keep borrowing under the rubric of aids to remain in economic bondage, forever. This is like motivating the U.S. households to borrow and spend by taking credit from producers generating their surplus capital from usurious profits, which stem from sub-optimal wages. This form of economic bondage by mega capitalism has enveloped developed countries as well as poor nations. Political independence of nations or democratic freedom of absolute majorities of households within developed countries has been replaced with eternal economic dependence on mega capitalism.

Mega capitalists funding banks in developed societies and international financial institutions tacitly suppress fair pricing of labor by restricting free flow of human capital across global borders. This preserves the borrowing power of households in developed nations to buy goods at high enough prices made by the mega capitalists at cheap costs in developing nations. The consuming households in developed nations continue to pay high prices for products made with low wages paid to workers in developing nations. The surplus profits from high prices and low production costs gravitate to the mega capitalists, who then lend such profits to everyone else for perpetual bondage. Free flow of workers across countries will decimate the usurious profits of mega capitalism. This is why mega capitalism is opposed to free flows of workers across countries. But free flows of humans with valid job offers will undoubtedly enhance prosperity of the absolute majorities everywhere.

Market competition within USA is successful because there are no interstate barriers against free flow of production inputs - labor, material and capital. International financial institutions promote free capital (not labor) flights by facilitating currency devaluation and tight monetary policy in the developing world. They have often taken steps to trigger developing currency runs. Currency has tempted productive citizens of developing countries to emigrate even with their capital converted to currencies of developed nations. This has tightened supply of human talents and monetary capitals in needy nations, mostly in Africa, Latin America, South Asia and East Europe. Currency devaluations are designed for capital flights. They may induce some emigration, but not establish free flow of workers with valid job offers.

The current form of *globalization* is laissez faire capitalism in a global scale. It is mega capitalism. Its proponents want to develop pools of cheap developing world labor willing to toil for pittance. They want to hold households in developed countries captive to pile on debt to buy at high prices the merchandize, cheaply acquired from the developing world. Mega capitalists thus get usurious profits as the difference between the high price of merchandize sold in the developed world and the cheap cost production in the developing world. Usurious profits are possible due to: (i) manipulative devaluation of currencies of the developing world, (ii) blocking immigration of workers with job offers in the developed world, and (iii) willingness of households and governments in the developed world to pile on "cheap" debt to buy "cheaper" merchandize. Usurious profits are stored as credits with households and governments in the developed world.

7.4 MEGA CAPITALISM AND UNITED NATIONS

To sustain globalization in its current form, the mega capitalists really need formidable powers of their governments to maintain the barriers for free flow of labor, not capital. They need to flaunt military might to induce the whole world to buy weapons by reeling under economic bondage. This globalization thrives due to protection of mega capitalists within secured enclaves, with the power to set high product prices in the developed world and low wages in developing countries. This globalization is antithesis of democracy anywhere. It is opposite the idea of free markets for all factors of production including labor. It generates only economic bondage, not freedom of the absolute majority anywhere. Making the United Nations democratic really counters the thesis of mega capitalism.

Proposition 7.2: *A democratic United Nations or a global democracy is necessary for economic prosperity of global citizens. But it is not optimal for mega capitalists with a goal to remain economically and militarily super-powerful in the world.*

Argument 7.2: Democratic governments with rational rules to intervene, discipline and regulate markets are necessary to make nations developed. Similarly, a global democracy with rational rules is necessary to make the world developed. Absolute majorities of households can still be indebted to mega global capitalists. But they will have the global democratic power to rationally cut household debts if usurious profits have created such debts. Usurious profits stem from lower wages than that the informed labor can bargain for. It may thus be rational to cut household debts or tax the rich at substantially higher rates. Majorities will vote for such rational policies in their best interests as long as production and employment will not be affected.

The long run social stability and prosperity of a nation can be sustained only by optimal government policies like higher taxes on the rich or household debt cuts. Lower debt reduces economic bondage of the absolute majority. Higher taxes generate funds for public facilities like transportation, communication, education, healthcare, and recreation. Public facilities are enjoyed by all. They are necessary for social stability. Nations need democracies, good public facilities, and rational rules of law to attract monetary and human capitals from all over the world needed to sustain long run prosperities. This implies that the global society can prosper only though a democratic global government with an authority to follow rational rules like taxing the rich everywhere to build public goods in poor countries. This will obviously transfer resources from mega capitalists of the developed world to the developing world and weaken their power. They cannot support an awesome military by transferring economic resources to the developing world. The mega capitalists with a goal of remaining super-powerful will, therefore, not support global democracy. One hopes that they will not tinker democracies in the developed world. ∎

Social stability is a prerequisite for prosperity. Stability can be maintained in a democratic society only through economic justice to absolute majorities. Justice does not mean equality as decreed in communism. Absolute majorities in civil societies have accepted that only democratic capitalism can ensure equality of each vote to frame governing rules and reward entrepreneurship for efficient production of goods needed to enhance prosperity. The fringe of mega capitalists prefers to curtail its tax burden. It wants to control the government to protect markets to extract usurious profits from absolute majorities of households. It also desires cocooned enclaves with publicly paid security system. Each mega capitalist household pays significantly higher amounts of taxes than each household among the majority. This apparent fact is at the core of mega capitalist propaganda for further reductions in their tax burdens. But lower taxes are not necessarily rational. It is because the source of usurious profits of mega capitalists is underpayment of wages to absolute majorities of household workers. Underpayment can be judged only by comparison of actual wages with optimal wages. Optimal wages are just wages at which capitalistic ventures generate returns slightly above the opportunity costs of capital. A cursory look at the rate of growth in net assets of top one percent of households in USA will show that their wealth is rising at far greater real rates than the real bank interest rate, with far less risk than faced by the absolute majority. This can be ascertained accurately only after data on net assets of all households are collected.

Such mega capitalism may not last long in a democracy that grants equality of vote to change policies on taxes, household debt and wages. It must have already dawned on the smart mega capitalists that they cannot camouflage the truth under the veneer of positive GDP growths forever. They must have therefore supported missions like hunting for oil and waging wars off shores for more human and monetary capital inflows. Such missions will also not succeed because absolute majorities in the rest of the world will not buy mega capitalism without the power of global democracy needed to restore economic justice. The absolute majority in each country may soon realize that the propaganda of globalization is simply to nurture illusions of prosperity everywhere in order to fatten mega capitalists.

7.5 A MODEL FOR GLOBAL DEMOCRATIC CAPITALISM

The proposal for global democracy may appear wasteful to vast majorities living in developed societies. But it may not be. Consider *optimal global democratic capitalism* in a hypothetical world having the following features:

A. **Optimal immigration:** Allow any individual to immigrate with a valid job offer at any wage from a legitimate secular entity like government, educational institution or business. This optimal immigration law will mean repealing the current practice of certification by state labor departments in USA for immigration. This process requires a recruiting entity to prove that local candidates are inferior to the foreigner being hired and that the wage paid to the foreigner is not lower than that for similarly skilled people in the state. This law is irrational or sub-optimal for the absolute majority of households in developed societies in long run. It induces producers to relocate their businesses to other countries, amounting to gradual losses of jobs from a developed society. The enterprises unable or unwilling to shift from developed countries face lesser competition from potentially new producers. The existing law prevents new producers from paying lower wages to talented foreign workers to compete. It supports the entrenched enterprises in charging exorbitant prices to the absolute majority. Less competition saps innovation and efficiency in production. It increases the cost of goods and services to absolute majorities of developed societies. The existing law does not protect current pays of workers in developed societies as purported. Wages for absolute majorities have remained stagnant in USA for decades. It is because local businesses use very credible threats of outsourcing to cut pays of existing workers. They also retrench workers to rehire them later as consultants for less pay and more work. The existing immigration law has no benefit for absolute majorities of households in developed societies. It should be repealed by the optimal immigration rule suggested above. If this optimal rule is adopted, in long run, many low-paid skilled workers from various parts of the world will immigrate to developed countries. But after some time, jobs will not be available and so some new equilibrium will be reached in which (i) outsourcing of jobs will not be feasible, (ii) many current employees on high pays will become entrepreneurs, (iii) usurious profits of entrenched mega capitalists will be eliminated, and (iv) products will be available at lowest possible prices. The suggested optimal immigration will not dampen net incomes of most households in developed societies. Just imagine the benefits of a flood of qualified foreign doctors and cheap medicines into developed societies. Healthcare costs will be reduced tremendously for the majority of households. Those still preferring to be treated by existing doctors at higher costs will be free to do so. Current doctors will be on their toes to render better service to their patients. Current medicine producers will be forced to cut exorbitant costs of their medicines. The proposed optimal immigration rules will definitely cut usurious profits and household debts.

B. **Civilian police and no national militaries:** The biggest costs to nations are due to militaries. If global democracy is adopted with rational representation of peoples, such militaries will prove to be redundant. There will obviously be disagreements for a common global constitution and equality of votes. But nations in a hypothetical global democracy will need only police forces to maintain law and order. Current national boundaries in a global democracy could still be retained for effective implementation of the rules of law within a region. Now, nations maintain awesome militaries to dominate each other, but fritter away global natural and capital resources that could be alternatively used for human development.

C. **Free flows of technology, products and capital across national boundaries**. If national militaries are rendered redundant, there is no need to confine technology and innovation to any specific region. It is costly to humans to do so. Technology freely available at prices determined in markets will lead to greater innovation and creativity. It will improve efficiency of production of human needs.

China now maintains distinct economic zones to restrict mobility of people from one zone to the other. It is to avoid crowding of an economically developed zone by less-skilled people from other zones without the means to live. The productivity of a developed neighborhood is adversely affected if its talented and skilled workers are hassled by influxes of unskilled people from other regions. Indian metropolitan slums have definitely inhibited productivity of skilled individuals, judging from the spurt in productivity of the same types of individuals who migrate to less intrusive regions in India and abroad. Influxes of unskilled people hobble productivity of a developed neighborhood because skilled individuals will have to devote a considerable amount of their energy for protection against crime and intrusion from people with no means to live. Slum-afflicted metropolitan centers do not attract productive people from other parts of the world, inhibiting thereby the economic progress of a nation like India. National boundaries and even zones within each nation are thus necessary to enhance productivity of all humans. A global democracy with national boundaries and without competing nationalistic militaries is likewise viable.

The current strategy of military and economic domination of vast majority of global households will be rendered impotent if a global democracy is established. Military hegemony simply does not make economic sense for prosperity of global human society.

India wants to make the United Nations democratic with each member nation having one vote on all international affairs. This is a far milder medicine for global prosperity than global democracy with (i) one vote for each franchised individual on earth and (ii) one treasury for tax and other revenues collected internationally. No country has yet demanded global democracy. But the current logic that democracy is good for a nation obviously extends to the whole world.

7.6 SUPREMACY OF CAPITALISM

A century of research and experimentation on capitalism and communism by people in various parts of the world shows that there is some hope for capitalism to succeed globally only through a global government mediating markets to correct capitalistic aberrations. Mandarins of developed nations know that optimal interventions by democratic governments, devoid of misleading public propaganda, are crucial for human prosperity. How are they then preaching that laissez faire global capitalism will make the global society prosperous without global democracy? May be they are not worried about prosperity of global society, like the laissez faire capitalists in pre-Great Depression era did not worry about the vast majority. But post-Great Depression era capitalists do not want to repeat social instability due to laissez fair capitalism. They now profess optimal government intervention to restore enough economic justice to public needed to maintain stability within their nations. They have to admit that global stability is impossible without economic justice and prosperity for mankind.

7.7 GLOBALIZATION AND INEQUITY

Mega capitalism banks on propaganda blitzes to boost spending by piling debts. It trumpets virtues of GDP growth. But it suppresses the deteriorating prosperity of the absolute majority. It hopes to blinker absolute majorities in developed nations. These strategies are designed to enrich and empower a few mega capitalists. They are being extended to the whole world through buzzwords of globalization.

Global democracy is needed for global prosperity. But it cannot be established in prevailing mega capitalism and globally divisive national militaries. There is some hope, though, that countries like Russia, China, India and Brazil will not let mega global capitalism thrive through propaganda of globalization. The absolute majorities of households in developed societies will also recognize the perils of mega capitalism sooner than expected by its proponents.

Globalization has spawned incredible inequity globally. For example, the world needs, but cannot have about $13 billion per annum to provide basic health services to all the people in the developing countries. Yet, consumers in developed countries spend $17 billion annually on pet foods. The annual reproductive health needs of women in developing countries can be met by an additional $12 billion, which is the expenditure on perfume for women in developed countries. Developing countries cannot find an extra $9 billion to provide drinking water and sanitation to those lacking. But just the European consumers spend $11 billion annually on ice cream alone. Globalization cannot achieve any semblance of fairness without global democracy.

Globalization will widen the chasm of prosperity between majorities and mega capitalists. But the majorities of households in developed countries will eventually learn about declines in their collective prosperities due to usurious profits flowing from sub-optimal wages. They may then vote for fair policies within their own countries and against the current form of globalization. During 1980-2002, about 15 countries experienced remarkable economic growth with rise in income for their 1.5 billion inhabitants, while about 100 countries experienced an economic decline with falling income for 1.6 billion people. More than 1.3 billion people now live in abject poverty, globally. The United Nations Development Program estimates that about 20 per cent of humans, the poorest, now share a puny 1.1 per cent of global income, as against 1.4 percent in 1991 and 2.3 per cent in 1960. Over 800 million people suffer from hunger or malnutrition. More than a billion people have no access to basic health care, education or drinking water. Two billion humans do not have access to electricity. About 4.5 billion or 80% of world population has no access to basic telecommunications, let alone latest technology.

7.8 CONSEQUENCES OF GLOBALIZATION

The developed countries that saw incomes rise did not necessarily have their majorities prosper. A recent study (April 2005) by the Center on Budget and Policy Priorities shows that households have been gaining much smaller shares of income growth than corporations after-tax corporate profits climbing to their highest levels as a share of national income since 1929. Wealth is highly concentrated among a few, globally. Those with $1 million or more in liquid net assets were 236000 in China, 61000 in India and 2.27 million in the U.S. as of 2004.

The developed countries now subsidize their farmers at a rate of $1 billion a day to induce overproduction for driving down global prices of farm produce. This makes farmers of poor nations unable to compete with the subsidized farm produce of developed countries. The WTO - formed in 1947 with 23 developed nations and aggressively pushing the developing nations to be a part of it - is mostly a farce of free global trade. This is designed to drive the majorities of households poorer. The WTO is the face of mega global capitalism.

How should the developing countries respond to the imposition of a lopsided global market system on them, given that there is neither a global democracy nor any hope of a democratic global order to nurture equitable prosperity? It can be argued that trade barriers and capital flow restrictions like those in China and India are economically optimal to the respective societies. China can embrace democracy to join Taiwan and grant autonomy to Tibet. India and Pakistan can come closer to revitalize a South Asian economic block, which can join the Middle-East in a trading block. Russia can form a confederation of former Soviet states. East Asian nations can forge a trading block. Each block can trade with a common currency and aim to enhance prosperities of majorities of their households before joining a global trading arrangement through WTO.

The non-alignment movement had started as a front for developing countries to maintain political independence from the mighty militarist nations. Trading blocks among the developing nations should and perhaps would now form to establish economic independence to preclude further transfers of economic and human wealth from their shores to developed countries. This may eventually lead to global democracy. It is because the respective trading blocks may eventually recognize the futility of 50000 nuclear bombs and missiles pointing at each other for mutual annihilation.

7.9 RATIONAL SYSTEM OF GOVERNANCE

Prosperity is hobbled by *"the system of governance, stupid"* in most developing countries. Globalization cannot succeed without rational governance in the developing world. A rational system of governance includes:

i. Fixing responsibilities of each government official about execution of specific public service functions within pre-stipulated time limits.

ii. Granting requisite authorities to every responsible official.

iii. Holding officials accountable for non-execution of assigned functions within time limits.

iv. Removing officials lapsing in their assigned duties.

v. Filling positions at every level of government hierarchy by competition among all qualified candidates from outside and inside the government.

vi. Having non-bureaucratic public recruiting agencies.

vii. Punishing severely for corruption or actions taken against public interest.

The rational system of governance is the most important public infrastructure any nation needs to prosper. It will ensure efficient deployment of public funds on physical infrastructures like roads, healthcare centers, electricity supplies, water resources, communication and education. Such infrastructures will contain emigration of productive talents from developing countries. They will also attract skilled individuals from other nations.

Poverty in developing countries is not mainly due to policies of developed countries. It is mainly due to an irrational system of governance that sucks up public funds through corruption and fails to build high quality social infrastructure.

Developing countries with poor infrastructures cannot contain emigrations of their valuable human and monetary capitals. Such emigrations adversely impact national competitiveness, as measured by net exports. If a country cannot export as much as it needs to import for survival, it piles on foreign currency debts, leading to devaluation of its currency. Mega capitalists step in to manipulate to worsen the devaluation further. Devaluation leads to inflation of imported goods. If the country has to import vital necessities like food then social instability ensues.

USA now imports $700 billion more than it can export. But its nonpareil system of governance attracts massive influx of productive human talents and financial capitals from the rest of the world. Asian exporters to USA have preserved their surplus net exports of about $2.5 trillion in Federal Reserve Banks. This helps keep the interest rates low in USA. But it has not enhanced prosperity for the absolute majority because of usurious profits created by sub-optimal wages and high product prices.

If not remedied by prompt preemptive policies, especially by the U.S., current globalization can create global instability, which may be worse than the Great Depression. The only feasible optimal policy options available are raising massive taxes from usurious profiteers and cut the debt by the U.S. Congressional decree.

7.10 SOCIAL OBJECTIVE AND WELFARE

A nation should define the well being of its society. In economics, a nation must choose its objective with absolute clarity and pursue policies to accomplish this objective. Politicians often chant that they stand for their supreme national interest without clearly specifying what this interest is, how it serves common people they represent, and how to accomplish any such objective. It is not easy to specify the goal of a nation. It is nevertheless possible to define a reasonable objective for a democracy. It is based on individual preferences.

A common assumption in economics is that an individual seeks to maximize the expected utility of his current and future consumptions. This is done subject to his budget constraint that the current consumption does not exceed the endowment (current wealth or net worth) plus fresh incomes. The budget constraint prevents an individual from spending more than his net savings plus income. Specifying the utility (preference structure) for the entire life of an individual and dealing with his uncertain future incomes will involve many mathematically intricate assumptions. The main problem is how to designate an individual to represent the national objective. Economic theories assume the existence of an agent representing the entire society. This is not practically useful. In a democratic society, there are many unequal individuals with vastly disparate preferences. Democracies franchise individuals above certain ages with equal vote to choose their representatives to enact rules of governance. But individuals cannot be made equal.

It is reasonable to assume, however, that a nation should strive for improving the utilities of at least an absolute majority of individuals. It is also reasonable to assume that these individuals have *common preferences:* current consumption and savings made for future consumption. No precise mathematical specification is needed. The extra complication is unlikely to add to human understanding. Individuals can be assumed to maximize their current consumptions and savings for future consumptions. They can accomplish this objective if their wages rise and prices of needed goods and services fall. The *goal of a nation* representing such individual preferences should thus be to strive for containing the current prices of goods and services and for improving wages. This national goal will naturally promote individuals' objectives of improving current consumptions and savings for the future.

The notion of containing commodity prices originated in 1500 B.C. in Hindu Vedic manuscripts and later practiced by the world's first documented "economist" Vashistha, advocating for a zero interest rate. A zero interest rate means that the price of capital is nil. Reducing the interest rate of an economy is the first step to peg the rate of increase in prices of goods and services to the price of capital. The U.S. Federal Reserve Board and other central banks in developed societies harp on stability of product prices. They help contain product price inflation by altering the short-term national interest rate at which banks lend each other or borrow from the central bank. In any case, a central bank's objecting should be consistent with the national goal.

The deflation in prices of most goods and services has been a boon to the American economy. The real per capita American wage had remained notoriously stagnant over last four decades preceding. President Clinton won the election partly because of his ability to convince voters that he would raise the real wages.

To raise American wages, he pursued a policy to restrict immigration of low-wage Mexican workers by shifting American factories to Mexico through North Atlantic Free Trade Agreement. The U.S. follows a strict policy of severely restricting the inflow of labor from developing countries, lest it will lower American wages. The improvement in real wages achieved during Clinton Administration has, however, proved to be illusory in the wake of massive American job losses during the subsequent five years. Fundamental problems on achievement of the national goal persist. Savings are still notoriously small for most Americans as compared to that of the Japanese and other Asians. The per capita net worth of the absolute majority of U.S. households is negligible. The unreported true per capita real-wage and net worth for the absolute majority of Americans households, who have the political power in a democracy, must have declined substantially if not exactly to the levels of the Great Depression era.

7.11 AN EXAMPLE OF USURIOUS PROFITS

Globalization *appears* to benefit a majority of households in USA. It has kept the interest rate historically low. It has also made the surpluses generated from global exports available as cheap credits to American households and governments. But the surpluses from global exports are due to increased consumption by households and governments.

Suppose that Wal-Mart buys a garden tool for $3 from China and sells it to an American household for $10, which is lower than last year's price. Wal-Mart lends $7 with no interest for a year to induce the household to buy the cheaper tool with a down payment of $3. Wal-Mart and its middle-men in China generate a gross profit of $7 and pay little to sales clerks. They pocket nearly $7, which is usurious by any standards. The American households employed as store clerks benefit little. Most of the tool's cost of $3 is material, leaving little for Chinese workers.

Mega capitalists basically swallow most of the surplus profits, generated due to sub-optimal wages paid to households in China and USA. They store their usurious profits as credits to households and governments in USA. Mega capitalism thus creates *economic bondage* of the vast majorities of American and Chinese households in this example. It has virtually controlled the U.S. government to legislate banking and credit laws to protect usuriously generated profits.

Democracy of USA or socialism in China has not perhaps made the vast majority in either country prosperous. Public officials in either country have not succeeded in protecting public interests. They also devise ways to enrich from such usurious profits. They migrate from public service to mega capitalistic ventures in USA or collect kickbacks in the developing world. Either way, they seem to be protecting the system of usurious profits.

Majorities in China, India, Latin America, Russia and Middle East are perhaps seething under the veneers of global economic growth. In the above example, the global economy grows $7 because it is the net additional value of products after costs of raw materials and wages. This net value or growth in economy thus flows to mega capitalists as new net assets. It is stored as new credits of households and governments. Such new credits increase the degree of economic bondage of households and governments.

Absolute majorities across nations may eventually realize that they face economic injustice due to usurious profits, which are created by sub-optimal salaries and wages. Any discontentment that is simmering under the veneer of the GDP growth may eventually explode.

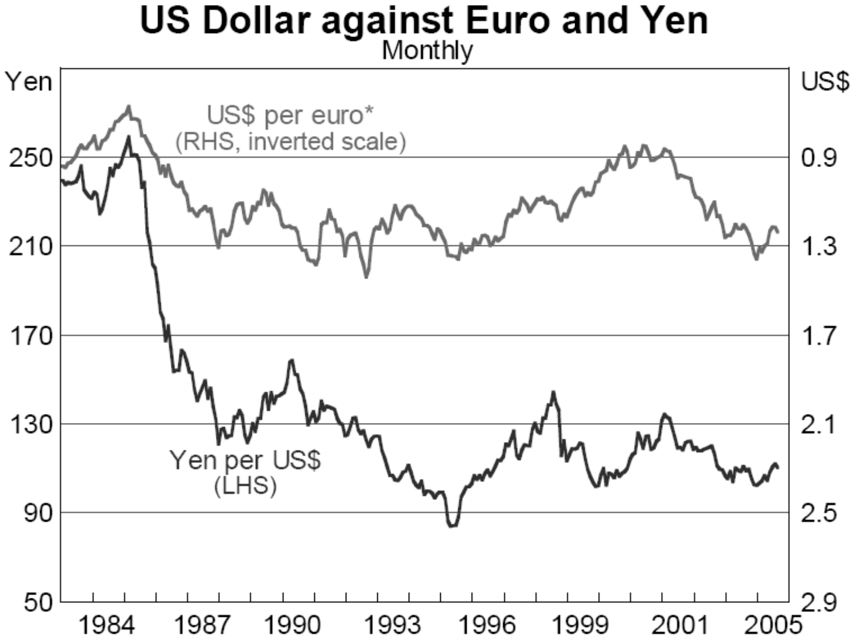
8 EXCHANGE RATE DYNAMICS

Conventional wisdom is to let the international currency exchange rates be determined by markets on the basis of the purchase power of a standard basket of goods and services across different nations. But markets do not always operate rationality. They are often driven by greed, fear, and uncertainty. Currency traders exacerbate such factors to make profits from actual buyers and sellers of currencies, financial securities and even real goods and services.

- ❖ What should be an optimal exchange rate?
- ❖ Do all countries face a generic set of fundamental factors that determine the exchange rates?
- ❖ What is the role of International Monetary Fund (IMF)?
- ❖ Why developing countries face currency crises, but the developed nations do not?
- ❖ Does the export of a developing country in terms of a hard currency like dollar rise after massive devaluation of its currency value?

This chapter analyzes these questions. Manipulation of relative prices of currencies is at the heart of globalization to create usurious profits from trading. Relative currency values can lead to dramatic shifts in business activities and jobs across national borders. Central banks can directly upset the true values of their currencies like the Chinese devalued yuan in 1994. This can trigger chain reactions on relative currency values. Mega global capitalists generally play with global currencies, after taking cues from direction of central banks from time to time.

Figure 8.1



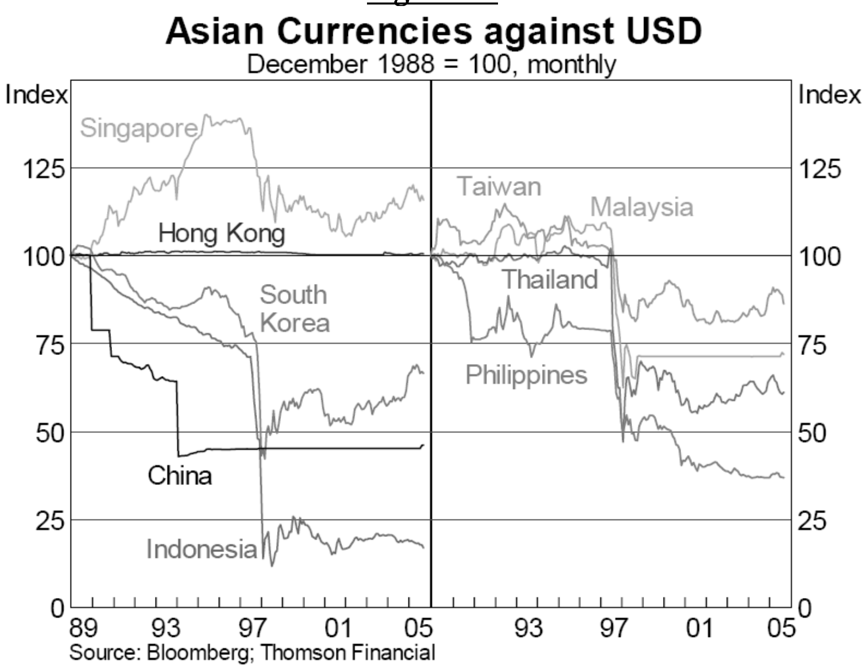
* US$ per ECU until 31 December 1998.
Sources: Bloomberg; Global Financial Data, Inc.

Usurious profits can be generated from trading in currencies, financial securities and other real goods. Biggest capital market players can create major reversals in currency values, like in Latin America in mid nineteen-nineties and in Asia in late nineteen-nineties. Figure 8.1 shows the relative prices of the three main hard currencies: dollar, euro and yen. The relative prices of these currencies have been highly volatile. Figure 8.2 shows decimation of Latin American and Asian currencies after devaluation of yuan in 1994. Mega games on relative values of currencies transcend standard economics. Propositions in this chapter focus on this mega picture.

Figure 8.2

Argentina managed its currency peso through a *currency board regime* during April 1, 1991 to January 6, 2002. Peso was pegged one for one to the U.S. dollar. Argentina could not maintain the monetary liabilities of the currency board because it was not fully backed in hard foreign currency assets. Argentina's currency board also participated in activities like purchasing government securities, regulating commercial banks, and acting as the lender of last resort. These reasons undermined Argentine currency board's primary goal of maintaining the peg with dollar. Argentina's exchange rate regime was basically a fixed exchange rate regime with a hard dollar peg. Due to dollar's appreciation in the late nineteen-nineties, the peso was pressures as the Argentine exports became less competitive in the world market. Argentina also was running massive fiscal budget deficits for some years. The government raised income taxes in 2000 to balance its budget. It then levied a tax on financial transactions in 2001. These efforts failed as Argentina's economic recession worsened. The climbing budget deficits created fears of an impending devaluation of peso. About $20 billion Argentine capital fled the country in 2001. Peso interest rates climbed to a range of 40% and 60%. This further weakened the government's budget position. At the end of 2001, Argentina adopted a dual exchange rate system. It offered better deals to exporters. This created a loss of confidence on peso. The government then froze bank deposits. It started a financial crisis. In January 2002, Argentina abandoned its fixed currency exchange rate regime for a floating rate regime.

Figure 8.3



Following the Asian currency crisis, Japan proposed to create an *Asian Monetary Fund* in 1997. Japan's proposal called for an institution to offer financial policy coordination. This was opposed by both the United States and the IMF. The Japanese proposal was shelved. But the Chiang Mai Initiative in 2000 allowed such coordination among the ASEAN nations, China, Japan, and South Korea. The purpose was to provide liquidity to member countries facing currency crises.

8.1 GLOBAL TRADE AND CAPITAL CONTROL

If the absolute majority in the developed world is not prospering, what can be the plight of the developing world? Will globalization help them?

Proposition 8.1 *(Global Trade): Under the current world order of global laissez faire capitalism, global trade will hurt most developing nations without capital and currency controls and trading curbs.*

Argument 8.1: The current world order is characterized by an absence of democracy for global society. No global government regulatory mechanism currently exists to rectify aberrant mega capitalistic behavior. In particular, global antitrust laws and government enforcing authorities do not exist to punish or break-up mega monopoly businesses. The current world order is simply laissez faire global capitalism without democracy to protect global consumers. The social welfare of USA plummeted due to laissez faire capitalism leading to Great Depression, despite democracy. International laissez faire capitalism without global democracy will decimate the welfare of the vast majority of global households. Especially those living in the developing countries will be hurt unless governments protect the absolute majorities against mega global capitalistic games. ∎

Unrestricted global trade, capital flows and exchange rates are optimal for mega global capitalists, but not for the absolute majority in the developing world. To illustrate this further, one has to identify economically significant differences between developed and developing nations. The following propositions show the fundamental attributes that distinguish the developed nations from the developing world.

Proposition 8.2 *(Capitalistic Propaganda): Developing countries pay significantly higher interest rates than the rates paid by developed nations to borrow from the same global capital markets. Deliberate negative propaganda by capitalistic lenders led by the International Monetary Fund help magnify a developing country's true foreign debt repayment risk. Such propaganda guarantees unwarranted transfer of wealth to the mega capitalists from the developing countries with foreign currency debts.*

Argument 8.2: Consider the reality in 1999, when the U.S. government was paying an annual rate of interest of about 5% on dollar funds borrowed in the U.S. capital market. India was then paying 7.5% on dollars borrowed from the same market. The difference of 2.5% is the country specific risk premium. India's external debt of about $90 billion then was 25% of its GNP, as compared to the U.S government debt of $6 trillion or about 60% of GNP. India was then having a trade surplus, as opposed to a huge trade deficit of U.S.A. This suggests that India could repay its debt much more easily than USA could. In fact, India never reneged in making debt repayments. Neither had India hinted at declaring moratorium on its debt obligations. Why did the capital market then consider India riskier than USA? There are several potential reasons.

First, most people in developed nations were uninformed about India. Those that were informed thought about this country as a remote exotic land with uncommon culture, tradition, race, religion and practices. An incessant barrage of lopsided information disseminated by the mega capitalist-dominated media within the developed countries accentuated the investor fear of lending to India. Such self-serving capitalistic propaganda forced India to pay a higher rate of interest to mega capitalist lenders including the IMF.

Second, India has not succeeded in borrowing funds in terms of its own currency, rupee, in the international markets. This is partly because India had not granted complete autonomy to its central bank, the Reserve Bank of India (RBI), even after gaining freedom in 1947. In early nineties, the RBI was made almost independent. Monetary policy of India was not transparent until 1991. Like in most other developing countries, Indian government deceived citizens about its monetary policy by increasing money supply without announcement. The monetary policy is a trust between a nation and those who hold its fiat currency. The fiat currency represents the real goods and services it can buy. By printing more fiat money for the same quantity of real output in a country, the government erodes the buying power of its currency. Increasing the amount of currency without informing transparently about it constitutes a breech of trust. The current holders of a nation's currency will unknowingly lose the buying power of the currency after more of it is created secretly. Citizens in a democracy will not vote for the government's clandestine printing of money. The smart global money lenders suspecting a nation's secretive monetary policy will not lend funds denominated in the currency of the nation because of a fear of devaluation. After borrowing, the nation may simply print new money that will drive down the value of currency and global debt denominated in the currency.

India has been having an effectively independent central bank by 1999. Even then, global markets charged 50% extra cost of capital to it than USA. This risk premium is by design of mega capitalistic lenders including the International Monetary Fund.

The IMF then was charging about 8% to 9% or even more in some instances on its loans to rescue developing countries that could not balance trades or have foreign exchange reserves. In free capital markets, rates are set by forces of supply and demand for funds and by the market's perception of risk of the borrower. But Federal Reserve Board studies show on how Black American borrowers are denied credits more often than White borrowers with the same risk attributes. Racial prejudice of capital markets is one of the reasons for slower progress of Black Americans. Concocted prejudice raises perception about risk. India used to raise money by paying premiums even to informed non-resident Indians because of the necessity to meet current debt obligations and import needs. These premiums were accentuated by propaganda about weakening India's economy due to nuclear tests.

Third, global investors demand greater risk premiums from the developing countries facing political instability like in Africa or Latin America. Higher risk premiums increase the borrowing cost of indebted countries. Mega capitalists thus transfer wealth to their shores by bribing and arming political factions in developing countries to create new instabilities or to perpetuate existing problems. Covert political disturbances and propaganda about poverty and destitution in the developing world are mega capitalistic designs to transfer wealth from the developing world.

A sovereign developing nation pays a higher interest rate on funds borrowed in dollars or euros or yens than the rate paid by the developed world. The difference between the interest rate paid by a developing country and that of the developed world is its risk premium. Global investors perceive a greater risk of lending to a developing country than to the developed world. Such risk perception is the source of risk premium or extra interest rate paid by a developing nation. It is specific to each developing country. Some developing countries pay higher interest rates than others. But they all pay more than the developed world pays on funds borrowed in dollars, yens or euros.

Risk premiums paid on developing country debts are not entirely due to negative propaganda orchestrated by mega lenders based in developed nations. Actions of developing nations are greatly responsible for such risk premiums. It is ultimately the confidence of global investors that determines risk premiums on developing country debts. Such confidence can be played down by means of negative propaganda made by mega global lenders. It can also be amplified by irrational actions of developing country governments facing precariously low foreign exchange reserves and high foreign currency debts.

Developing nations generally need capital controls to force their own exporters to voluntarily bring home their profits from abroad. These exporters perceive real risks from the developing country government confiscating their foreign currency deposits in local banks. Such risks do not exist for funds held in the developed world. Exporters of a developing country also fear that their government may convert their foreign currency deposits into local currencies created recklessly in the country. In May 1998, Pakistan froze foreign currency accounts of its own citizens. In September 1998, Russia declared a moratorium on foreign debt repayments. The risk of losing some foreign currency deposits in developing country banks is actually genuine. South Korean banks have permitted holding of bank deposits in foreign currencies as well as in their own currency, won, on fictitious names. In the wake of their foreign currency crisis in 1997, the South Korean government announced plans to abolish the rule of not seeking the correct identity of bank account holders. But such plans increased the South Korean financial crisis in 1997-98 and so the policy to abolish weird bank rules was postponed indefinitely.

The above described risk factors increase the tendency in developing countries to export human and financial capitals. Even oil exporters from Saudi Arabia and Mexico trust the American banks more than their own state banks. Such distrusts of exporters on their own governments generate fears among global investors to demand positive risk premiums on their lending to developing countries. Some of these risk premiums can thus be justified. But such premiums can be artificially raised through negative media propaganda against developing countries.

Economic crises of developing nations can be accentuated by negative propaganda orchestrated by mega capitalists and their political patrons in the developed world. Then rational theories of economics do not work. Irrationality takes hold of markets as nervous international investors panic and run. Then human and monetary capitals exit developing countries facing such crises of confidence. When foreign currency deposits dwindle, the developing country borrowers of foreign currency loans feel the pressure to buy foreign currency at exorbitant prices in terms of local currencies. This bumps up developing country risk premiums substantially above the rational or panic-less equilibrium levels. Capital controls introduced in countries like China, India and Malaysia during 1990's can obviate panics and void irrational components of developing country risk premiums.

Developing country governments, especially in Asia, have taken solid steps to contain undue panics created through negative propaganda of mega global capitalists. They have built large reserves of currencies of developed countries: dollar, euro and yen. China currently accumulates $130-160 billion in surplus exports annually. It does not allow exports of capital from its shores by private citizens, although some amount sneaks through Hong Kong and Taiwan. The Chinese central bank (People's Bank of China), however, collects the surplus exports in foreign currencies by exchanging its currency yuan at a fixed rate of 8.10 yuan per dollar. The Chinese central bank has thus accumulated $711 billion of exchange reserves, held primarily in dollars and euros in American and European central banks. Hong Kong and Taiwan together hold about $375 billion of their accumulated surplus exports as reserves in the developed world. The greater China region has effectively checkmated the potential panics about their currencies and capital flights. Even Southeast Asia and South Asia have improved their foreign exchange reserves, though not as strongly as greater China and South Korea have achieved. The recent rising oil prices are good to check profligacy and to conserve scarce energy. But they are negatively affecting Asian foreign currency reserves.

It is interesting that a developed country like Japan facing no panics has chosen to accumulate $840 billion of reserves, held in Federal Reserve Banks due to surplus exports. As a developed nation, Japan can simply float its currency yen without its central bank (Bank of Japan) purchasing dollar to check yen's rise. But Japan is accumulating foreign currency reserves by keeping its currency at an artificially lower value. Its purpose could be to prevent China from becoming a developed country with its yuan held as a reserve currency by other nations. A freely floated yen will rise against dollar and euro to even out the massive current export surpluses of Japan. But it will make Japanese products costlier in Europe and USA. It will then induce global businesses including the Japanese to relocate to China. Global businesses are already flocking to China. Japan does not prefer more migration of its own businesses to China.

The developed nations, especially USA, have been the ultimate destinations of surplus capitals of the wealthy global exporters. During 1992-1998, massive Japanese, Mexican and Saudi Arabian trade surpluses entered the U.S. banks and financial institutions. These surpluses have thus provided cheap credits to households and governments in USA. Asia has lately lent nearly $2.5 trillion of its surplus exports as cheap credits to American households and governments.

Proposition 8.3 *(Exports and currency devaluation): A developing country's export volume measured against the developed world's currencies like euro, dollar or yen does not always increase due to devaluation of its currency. Induced devaluations are mega capitalistic schemes to transfer wealth from vast majorities of global households of developing nations dependent on external debt for their net import needs.*

Argument 8.3: If a country devalues its currency with respect to dollar or euro or yen, its export revenues measured in its own currency increases even with a stagnant volume of exports. For example, following yuan devaluation, Chinese exporters get more yuans for the same volume of exports measured in dollar. By devaluation, developing country governments create more money for exporters for the same export volume. Currency devaluations are government decrees to increase the domestic net assets of exporters, who may do nothing more in return. They do not necessarily motivate exporters to export more. But they encourage emigration of productive human talents of the country.

According to conventional wisdom, devaluation should motivate exporters to boost their volume of exports. Depreciating the yen has boosted export volumes of a developed country like Japan. The devaluation of yuan has boosted export volumes of a developing country like China. But many developing countries have not boosted their exports by depreciating their currencies.

Exporters of many developing countries have upper limits to their globally competitive production capacities. These limits do not rise due to devaluation of currencies of their countries, as well as for exporters in Japan, China and South Korea. Many top American, European and Japanese manufacturers produce their brands in China. They increase their outputs from Chinese facilities if yuan is devalued. But not many American, European and Japanese producers are based in India. The Indian exporters cannot easily enhance their volumes in response to a drop in the value of rupee. The number of good cars that Indian exporters can produce is limited. In fact, the number of good aircraft India can produce is zero even if rupee is drastically devalued, unless Western manufacturers relocate their production facilities to India. No matter how drastically Indian rupee devalues, the number of aircraft India can export will continue to be zero in the foreseeable future. Increases in export volumes of a developing country do not necessarily translate into higher revenues measured by a hard currency like dollar, euro or yen. To increase export revenues in terms of a hard currency, a developing country must be able to raise its export output potential sufficiently.

If a developing country's currency depreciates, exports measured by a hard currency can increase up to some maximum capacity. Once at maximum capacity, export volumes and hard currency revenue of the country will stagnate without responding much to further currency devaluation. Export revenue in terms of a hard currency is not always fully elastic with respect to a developing country's currency value. But developing countries tend to boost exports of their raw materials and human talents when their currency value depreciates. This is consistent with observations for Southeast Asia and South Asia. India has enhanced its exports measured in dollar. But it is mostly due to raw materials and skilled human labor, not manufactured goods. Devaluations of currencies in Southeast Asia raised their export volumes, but not revenues measured in dollar. Developed nations imported greater volumes of goods from these countries for the same price. ■

Mega capitalists have benefited by perpetuating enmities in the developing world. For example, Pakistan was carved out of India in 1947. Enmity has pushed the newly de-colonized nations to borrow foreign currency loans to pay for ammunitions made by mega capitalists. The developed world does not borrow in developing country currencies. Neither does it maintain reserves of developing country currencies. But mega capitalism fosters enmities among developing countries to induce them to buy ammunition by borrowing hard currencies (dollar, euro or yen) and to hold reserves in these currencies. Rulers of certain developing countries allied with mega capitalists are often addicted to foreign currency loans obtained as aids. As a result, most developing nations currently owe massive amounts of debt to the developed world directly or through the IMF and World Bank. Mega capitalism then manipulates downwards the values of indebted developing country currencies in relation to hard currencies. These developed countries are not being able to earn enough of hard currencies which they need to buy ammunition and food. This way they have accumulated massive hard currency denominated debts. They need more hard currencies to buy food and ammunition. By borrowing more hard currencies, they plunge deeper into economic servitude and internal chaos, famine, disease, and malnutrition. Mega capitalism has thus artificially concocted the global rich-poor divide. It has enormously enriched a few mega capitalists like the arms contractors and subsidized mega food producers in the developed world.

The U.S. establishment has followed a tacit, if not always explicit, strategy of keeping developing countries' borrowing cost significantly high by creating and promoting instability around the world. For example, in late October 1998, the U.S. ambassador to India Richard Celeste made a series of statements on Kashmir designed to fester the wounds of South Asia, while Pakistan and India negotiated for improving their bilateral relations. He said, for example, "the bitter territorial dispute over Kashmir should be settled in as per the will of the people." He also said that Kashmir is a concern of the international community outside South Asia.

"The purpose of the visit was to listen and learn, to meet as many people as possible and to better understand the situation in Kashmir," Celeste has said. If the U.S. establishment is really concerned about improving the plight of South Asians, the first thing it should do is stop meddling in the region. The West is instrumental in creating and nurturing a Frankenstein in Pakistan, by sending billions of dollars worth of military hardware, raising this poor country's external debt to $38 billion. Absolute majorities of American households do not benefit from their tax dollars loaned to Pakistani army generals to buy ammunition from defense contractors in the U.S. These defense contractors generate usurious profits from such deals. Usurious profits mean sub-optimal wages to American workers. These usurious profits are lent back to American households and governments. The U.S. households have thus piled up debts directly on their own and indirectly through government borrowing from usurious capitalists. The vast majorities of households in Pakistan are also indebted heavily. The only ones who profit enormously are mega defense contractors in the developed world and top military generals in the developing countries. This has spawned anger among people in the developing countries, leading them to resort to terrorism whose victims are innocent citizens everywhere.

After the tragic World Trade Center bombing, the Central Intelligence Agency has spread fears of Islamic fundamentalism. But these fundamentalists were created by the same CIA, which has even failed to read its own intelligence reports before the WTC attack. If the goal is to control the limited global natural resources, it should be transparently stated with costs and benefits to the absolute majority of American households.

Just examine a hypothetical scenario that USA becomes the only country with a command over all global natural resources. Can this solve the oil problem? Under this scenario, the rest of the nations may be enslaved, at least economically, and many Americans will be driving super limousines and bigger Sports

Utility Vehicles. The developed world with 13.5% of global population consumes 54.2% of total consumption of oil, as shown in Table 7.1. The U.S. now consumes 25.6% of global oil supply. By controlling all oil reserves of the world, the U.S. will eventually consume 100% of the oil production. At some point there will be no oil left on earth and the unbridled consumption habits will automatically perish a powerful society, unless new sources of energy replacing oil emerge. The rest of the nations with consumption habits sinking to Stone Age can survive in this hypothetical scenario. Thus, a search for alternatives to oil and conservation of the existing global natural resources should be the priority of the U.S.

Suppose again that the above hypothetical scenario of the U.S. becoming the supreme power becomes a reality and scientists invent good alternatives to oil before oilfields go dry. Then also the declining wealth of an absolute majority of American households and growing underemployment will likely rage them like the angry Saudis to commit unexpected shocks within the country. No one knows whom the raged Americans may target, if at all. But any target will likely be symbols of freedom that humans cherish and are trying to establish everywhere.

Saudi Arabia alone has pumped out more than $1 trillion worth of its oil since Gulf War-I, but is still a very indebted nation with massive unemployment. Where did the Saudi oil revenues perish? Most of it went to American defense contractors and the rest was nibbled away by Wall Street where the Saudi rulers hoard their wealth. These facts (not religious fanaticism) should explain why most of those who rammed into Wall Street and Pentagon were Saudi nationals.

Table 8.1
Global Oil Consumption and Population

2001 REGION	DAILY OIL CONSUMPTION MIL BARREL	DAILY OIL CONSUMPTION % OF GLOBAL	POPULATION IN MILLION (2002)	PERCENT OF GLOBAL POPULATION
World	77.0	100	6228	100
United States	19.7	25.6	288	4.6
European Union	14.5	18.8	392	6.3
Japan	5.3	6.9	127	2.0
Canada	2.2	2.9	32	0.5
Developed World	**41.7**	**54.2**	**839**	**13.5**
China	5.0	6.5	1309	21.0
Russia	2.3	2.9	145	2.3
Brazil	2.2	2.9	180	2.9
India	2.1	2.7	1034	16.6
Developing World	**35.3**	**45.8**	**5389**	**86.5**

Mega global capitalism is spearheading propaganda of 'freedom' around the world through saber rattling. But it has already trapped the land of freedom with deep economic bondage. This may be eventually learnt by the absolute majority, when they and their governments cannot repay their debts and their governments cannot collect the massive loans made to countries like Pakistan, Russia, Latin America and Africa. The absolute majority has toiled hard for sub-optimal wages. It has mortgaged most of its current tax dollars and future taxes from posterity due to government debt. This debt has been partly consumed by an establishment which effectively helps, willy-nilly, in recycling the rest back to defense contractors and dictators in the developing world. The absolute majority of Americans may eventually decipher stratagems of mega capitalism: (i) to stifle their prosperity due to sub-optimal wages and (ii) to wangle meager resources from poor regions of the world to fill the coffers of armament barons and third-world dictators. They may also learn how in the process they have remained economically bonded despite their democratic power. The writing off the third world debt amounts to soaking the defense barons and military dictators. These beneficiaries are squarely responsible for the bitter animosity in the developing world facing potential nuclear war that can devastate a beautiful earth.

Mega global capitalism's strategy of raising developing countries' borrowing costs is not always tacit. For example, the U.S. establishment slapped sanctions against India in the wake of nuclear tests in May 1998, with an express purpose of prodding the international capital markets to tighten their lending to India. During the propaganda blitz, the U.S. State department bragged about new sanctions inflicting a cost of at least $20 billion to the Indian economy. The U.S. establishment had hoped that the Indian currency would collapse, forcing India to beg the IMF again for new loans at high interest rates. But the non-resident Indians lent more than $4 billion through Resurgent India Bonds in a matter of weeks at about 7.75% rate of interest in that year. The mega capitalistic strategy of sanctions to capitulate the Indian economy did not work. It nevertheless increased the risk premium by about 0.75% which hurt the Indian poor. The sanctions raised investor fear, bringing down the Indian stock market badly.

The long-term impact of raising a developing country's risk premium can be devastating and incalculable. For example, when the South Korean economy collapsed in late 1997, no lender would lend the government for any risk premium. Sovereign South Korean bonds became worse than junk bonds. It created a perception that perhaps South Korea was going to be drowned in the Pacific Ocean. Indonesia and Thailand also faced similar problems of issuing bonds overseas during their currency crises, when they needed such loans badly. The developing country risk premium (extra borrowing cost above developed countries' interest costs) has remained a risk for developing economies. It is a mega capitalistic tool for economic colonialism that benefits only the mega capitalists.

The Chinese government frequently complains about the Western media's interest in filming poverty and destitution while suppressing positive developments in China. The Western media controlled by mega capitalists seems to enjoy filming of dirt and filth in India while keeping their cameras off the skylines in cities like Kolkata. It cannot be operating without tacit advice from their mega capitalist bosses. India is, of course, filled with squalid slums and rural poverty. But the negative propaganda about it is a shrewd devise to raise risk premiums on loans made to developing countries by mega capitalists.

Proposition 8.4 *(Currency and Capital Controls): A developing country facing artificial or natural constraints can find currency and capital controls optimal for its people, although such controls are not optimal for developed nations facing no such constraint.*

Argument 8.4: The prescriptions made by experts in developed nations about currency and capital markets for developing nations are not generally optimal. The constraints facing developing nations outlined in Propositions 8.1 and 8.2 can make currency and capital controls optimal. Negative propaganda can significantly drive down the value of currency of a developing country with a relatively small economy.

Short-sellers take advantage of potentially negative events like the Indonesian riots or the Malaysian crony capitalism during 1997. They also benefit from false rumors designed to accentuate panic selling of the developing country currency at lower and lower prices, as manipulators post fictitious trades to precipitate currency runs. During currency runs, everyone who holds the currency like the Indonesian rupiah tries to convert it to some hard currency like dollar. This means the country's capital flies off-shores, draining its foreign exchange reserves.

Such countries are generally dependent on imports of basic necessities like food and oil. With little or no foreign exchange left in its central bank, the country is forced to borrow more foreign exchange at exorbitant interest rates to import basic necessities. The domestic prices of these basic necessities can dramatically rise depending on how deep the currency devaluation is. Rise in product prices degrade social welfare of the country, leading to riots as it happened in Indonesia during 1997. It is thus optimal for developing countries with small economies to impose currency and capital controls to restrict currency trades and imports. $\blacksquare$

The U.S. establishment prodded by mega capitalists had sharply reacted to the Malaysian currency and capital controls imposed in September 1998 because of a fear that such controls would pervade the developing world. Such controls can make it difficult, if not impossible, to stabilize developing country risk premiums and to prevent transfer wealth from the developing world to mega capitalists.

8.2 MEGA EXCHANGE RATE STRATEGY

Mega global capitalism has subjected the developing world to a form of *neo-colonialism* through the following strategies:

i. Inducing the export-dependent developing countries to export their cheap merchandise and labor for high-margin and high-priced products made by mega capitalists.

ii. Restricting technology transfer to the developing world.

iii. Forcing the whole world to protect patent rights.

The expectation underlying such strategies is that, in the long run, this scheme will keep prices low and consumptions high for the absolute majority in the developed world. This will suppress the truth about usurious profits earned from sub-optimal wages to majorities of households at least in the developed world. The absolute majority in the developed world is potent due to its democratic power to change policies. Suppressing the truth is essential for mega capitalism to continue to create usurious profits through sub-optimal wages. Its success depends on perpetuating the mirages of prosperity for the absolute majority everywhere. The mirage is to let everyone believe in catching up with the prosperity of mega capitalists. But the reality is that households everywhere are being choked with massive debts for themselves and their governments.

Mega capitalism ensures engagement in its ventures of the most talented people from all over the world. This strategy will never enhance prosperity of the teeming world. It has not begot prosperity to the absolute majority in the developed world. To avoid transfers of their human talents, the developing countries will optimally adopt their own schemes to protect their human and monetary capitals as well as currency values. They will likely maintain their cultural identities so that a significant part of the emigrating citizens may return to serve their motherlands as in China and India. The developing countries may also ingrain emigrating citizens with native culture through school and college curricula. They may improve their educational institutions to train children. They will improve the systems of their governance for social progress so that human capitals do not emigrate. Such measures will ensure that the talent pool of the populated developing world is not diminished, while a significant number of culturally integrated emigrants return with new ideas, capitals and skills. The capital and currency controls stabilize the economic environment within a developing country. This helps in inducing emigrants to return and invest, provided the country also adheres to rules of law and enhances infrastructure facilities.

Developing countries may optimally be very careful about following the advice of the establishments of the developed world on free trade, capital and currency policy. Instead of enhancing prosperity, social upheaval may result if barriers of trade and capital flow are naively removed by developing countries. For example, East Asia, Latin America and Russia have followed the advices of the developed world's establishments for free trade and capital flow during the 1992-2002. Then the mega global capitalists everywhere including in the developing world enriched themselves enormously. But governments and majorities of households everywhere piled on massive amounts of debts to be paid by their posterity. It has resulted in riots and insurgency everywhere. Terrorism is perhaps the most negative outcome of iniquity spawned by the globalization advice.

The developing countries that allowed complete freedom in trades and capital flows did not foresee the impact of such freedoms on prosperity of their societies. It is as if they watched the great performance of top football players, and then joined the field due to excitement. But they got bruised and mangled. The developing countries are not yet as efficient in monetary management as the developed nations. Developing countries are forced to borrow hard currency debts at premiums while the quantities of their exportable (quality) merchandises are limited.

8.3 OPTIMAL CURRENCY POLICY FOR DEVELOPING WORLD

Currency devaluations do not necessarily increase exports of developing countries. Most developing countries are laden with massive foreign currency denominated debts. Their currencies have been devalued drastically to induce production of maximum possible quantities of exportable goods. Further devaluations in the values of their currencies will not raise exports measured by hard currencies or barrels of oil. Oil should be a benchmark to gauze exports and currency reserves because oil is the most important commodity, next to food, for survival of most industrial economies. During the last three years, China has doubled its dollar reserves to $711 billion, while the oil price has climbed more than two times. India has increased its foreign currency reserves by barely 40% during the same time period. Indian rupee and Chinese yuan have fallen about 33% since 1994. But Chinese exports have risen much faster from $65 billion in 1990 to $600 billion in 2004 than India's $18 billion in 1990 to $70 billion in 2004. About 65% of Chinese exports are, though, due to Western and Japanese brands made in China. But these results show equal depreciation of currencies can result in dramatically different export performance. It is because most developing countries have capacity constraints on production of high quality industrial and technological goods for exports. The developed world also imposes restricted quotas on imports of cheaper items like apparels and electronics from the developing countries. Even countries like China and East Asia cannot export unlimited quantities of their high quality light manufactured goods to the developed world that produces such items locally.

Despite steep currency devaluations, most Asian countries have not increased their exports in terms of oil price, which has risen three-fold during the last three years. Developing countries also fear that households in the developed world may eventually cut consumptions of cheap imports due to the declines in their net asset values. China seems to have understood these problems, as it has been reluctant to raise the value of yuan. China has raised the yuan value by only 2% from 8.27 to 8.11 yuans per dollar in July 2005 and has pegged it to a basket of currencies including euro, yen and dollar. But yuan has declined about 30%, which is as much as dollar has fallen, against euro over the last three years. This shows that China considers growth as more important than its currency value. But there is a risk in a policy of keeping the value of currency low to create jobs by attracting foreign investors, as stated in the following proposition.

Proposition 8.5: *The optimal value of currency of a developing country is determined by trading off (i) employment growth due to induced foreign investments against (ii) social and banking instability, as the currency value is lowered, given other factors like purchase power parity unchanged.*

Arguments 8.5: Consider the Chinese yuan, which is a hot topic of discussion now. Is yuan overvalued? China does not agree that yuan is overvalued. Only due to pressure from the rest of the world, China raised the value of yuan recently by 2% vis-à-vis dollar. What is the optimal value of yuan? Currency values are determined by markets based on relative purchase powers. But there are other forces in addition to purchase powers of currencies, especially, of developing economies that face greater constraints.

Beijing's low fixed yuan-dollar exchange rate has been immensely successful in (i) neutralizing the mega capitalistic game of currency manipulation because the yuan is calibrated to dollar which is in the domain of the U.S. Federal Reserve Board, and (ii) making China a manufacturing hub to create millions of jobs for the Chinese.

But the costs of decreeing a low yuan-dollar exchange rate are: (a) potentially brewing social instability due to widening wealth disparity between a few foreign currency earners (exporters and expatriates) and the vast majority, and (b) possibly a latent explosion of non-performing bank loans. Only 20% of profits made on Western and Japanese brands made in China flow to Chinese factories. These points are explained below.

- Low yuan value results in creation of more fiat money than necessary in a few private accounts belonging to exporters and expatriates. Excessive money held in bank deposits leads to sub-optimal lending, which results in increased non-performing bank loans.

- Only the Chinese government authority can survey if social discontentment is brewing and if the volume of non-performing bank loans is exploding, since such data are not available to public.

- Based on such survey, only the Chinese authority should determine the yuan value by trading off job growth against banking and social instability.

- Yuan is, de facto, trading at a higher value than its official rate because of the possibility of default in bank deposits of foreign currency earners. This poses a potential danger of bank runs and panics, which can whittle the confidence of international investors in yuan and Chinese economy.

- Bank runs and panics would erase any hope of making yuan a reserve currency of the world. Making yuan a reserve global currency should be a major Chinese strategy to undo the mega capitalistic currency manipulations made to transfer the Chinese wealth off shores.

The above logic was first presented by the author in a seminar in August 2003 at the Hong Kong Monetary Authority. A few weeks after the seminar, the HKMA Chief met with his counterpart from the People's Bank of China to establish a new bank regulatory authority to monitor non-performing bank loans. Then in a few months China has infused $60 billion to recapitalize equities of its ailing banks. Many Chinese in Shanghai have been withdrawing lately vast sums of their bank deposits in sacks of currencies to lend directly due to perceived risks of bank defaults. Resentments of the have-nots in China towards the haves have escalated.

Constraints faced by developing nations with massive foreign currency loans and trade deficits may make policies on free trades and capital flows sub-optimal and potentially explosive. How? Suppose that a developing country has already devalued its currency to the lowest possible level to generate the highest volume of exports to serve foreign currency debt and imports. This lowest threshold currency value defines the maximum level of deprivation policymakers can adopt for the majority of the country who depend on imports of necessities. Devaluation makes critical imports like food and oil expensive. Any further devaluation below the lowest threshold currency value can only enrich a few exporters at huge costs to vast majority of households in the country. Exporters would earn more of the devalued currency for the same quantity of their production. This enhances their domestic wealth. Devaluation thus shrinks the relative wealth of absolute majority who cannot export, but depend on imports. The minimum threshold value of a developing country's currency can be called the *subsistence level* that should not be breached by policymakers. The currency value can drop below its subsistence level due to unforeseen factors beyond the control of policymakers. Then common people will riot and investors will panic and run for conversion of the developing country's currency to hard currencies. For example, before July 1997, the price of a standard basket of goods in Indonesia was about one-sixth of that in a developed country like USA. After devaluation of the Indonesian rupiah (Rp.) from Rp.2500 to Rp.12500 per dollar, the price of the same basket of goods dropped to one-thirtieth in dollar terms. Exporters could suddenly find themselves very rich. Common people in such instances will not necessarily suffer, except for envy towards exporters, if the country does not need to import basic needs like food and oil. Indonesia, however, imports basic necessities like food. When the price of food rises five-fold, common people are likely to get into the riot mode because of the pain of buying food at five times the price before devaluation. In such instances the IMF advises developing countries to stop subsidizing basic needs of common people. This exacerbates resentment of the vast majority of people. The above argument is summarized in the following proposition:

Proposition 8.6: *Devaluing a developing country's currency below a minimum threshold (subsistence) level does not generate more exports, but it certainly increases the possibility of chaos in the country.*

Argument 8.6: See the preceding arguments**.** ∎

8.4 CURRENCY ARBITRAGE

Before reaching a chaotic state, a developing country is likely to be in some state of transient equilibrium; like Indonesia was during 1991 through early 1997, with its currency trading at a steady level. Assume that in such an apparent equilibrium condition, the country starts a new regime of free capital flows and currency exchange. As soon as arbitrageurs observe the government's reluctance to lower the value of the currency, they devise arbitrage profit making trades.

Proposition 8.7: *Arbitrage trading profits can be generated from a developing country like Indonesia or any of its companies like Telekom offering a substantially higher rate of interest on foreign-currency (dollar) loans than the borrowing cost in the foreign country (USA). Arbitrage profits can be enhanced through kickbacks to the developing country's government and business executives.*

Argument 8.7: Suppose that an arbitrageur borrows:

i. D dollars of foreign currency loans in global capital markets like Singapore or New York to lend to local businesses with government ownership in a developing country at an interest rate equal to the cost of foreign funds plus developing country risk premium plus admissible profits.

ii. Enough of the developing country's currency from local banks to exchange into *D* dollars for immediate repatriation.

The highest rate of interest on foreign currency loans made to local businesses in the developing country will depend on the need for foreign capital and corruption in the country. Corrupt rulers can permit depraved colluding business executives to borrow at substantially higher interest rates depending on the amount of kickbacks the arbitrageur offers. This strategy generates an instant arbitrage return equal to the developing country risk premium plus arbitrage profits minus kickbacks. Corrupt business and government executives pocket the kickbacks. The arbitrageur recognizes the profits as income. In its balance sheet, it carries the loans to the developing country's businesses as assets and the amount borrowed in the local currency as liability. The arbitrageur's only potential risk is due to any rise in the value of the developing country's currency. But he knows that the country has been having steady exchange rates that will only fall when other arbitrageurs engage in the same stratagems in tacit collusion with the ruling elite. They all know that trade imbalance is mounting and current account deficits are rising, making the steady value of the currency unsustainable.

Table 8.2

Currency Arbitrage Trading and Profits

ARBITRAGEUR'S ACTION	BALANCE BILLION $	BALANCE BILLION RP
July 1, 1997 (Rp.2500= $1) Borrows $1 billion at 6% in U.S. and lends to an Indonesian Company in dollar at 9%.	Debt: 1 Asset: 1	Debt: 0 Asset: 0
July 1, 1997 (Rp.2500= $1) Borrows Rp.2500 billion at 10% from Indonesian Bank to exchange the funds to $1 billion at the Reserve Bank of Indonesia and repatriates the sum to U.S.	Debt: 0 Asset: 1	Debt: 2500 Asset: 0
June 30, 1998 (Rp.13750 = $1) Borrows $0.2 billion from U.S. to convert to $2750 billion to repay loan with Indonesian bank.	Debt: 0.20 Asset: 1.09	Debt: 0 Asset: 0
Net Profit	0.89	0

For example, Indonesian rupiah was trading at Rp.2500 per dollar when the demand to convert rupiah to hard currencies suddenly ballooned in the wake of Thai bhat crisis in early 1997. Investors suspected that Indonesia was reluctant to devalue rupiah below the level of Rp.2500 per dollar. This level was not quite the subsistence level for the value of rupiah then. But even if this was low for rupiah, the demand for conversion of rupiah to dollar shot up in a few weeks following the Thai crisis. Rupiah then slid dramatically. Arbitrageurs' positions are secretive and it is difficult to pin down how much of arbitrage was done by whom. Hedge funds, operating through major global banks, can employ equity of $2 billion to bet $200 billion. Such bets were enough to wipe out all Indonesian foreign exchange reserves of about $140 billion by August 1998. Just setting a declining trend for rupiah was enough to create panic among the wealthy Indonesians to convert their rupiahs into dollar.

To calculate arbitrage profits, suppose an arbitrageur in Citibank uses $1 billion of funds from American depositors at 6% rate of interest and lends it as a dollar-denominated loan to Indonesian Telekom at 9% on July 1, 1997 when the exchange rate is Rp.2500 per dollar. Suppose further that the exchange rate drops to Rp.13750 per dollar by June 30, 1998.

The arbitrage strategy involves borrowing Rp.2500 billion at about 10% interest rate per year from a local Indonesian bank on July 1, 1997 and then exchanging this sum at the Indonesian Reserve Bank for $1 billion for immediate repatriation to Citibank. On June 30, 1998, the Citibank arbitrageur owes the local Indonesian bank Rp.2500 billion plus 10% interest amounting to a total of principal plus interest equal to Rp.2750 billion. To repay this sum, the arbitrageur draws $0.2 billion from Citibank and converts these dollars to Rp.2750 billion rupiahs at the devalued exchange rate of Rp.13750 per dollar on June 30, 1998. The Indonesian government owned company, Telekom, owes Citibank

$1 billion plus 9% interest, i.e., a sum of $1.09 billion as of June 30, 1998.

Thus, the Citibank arbitrageur's profit as of June 30, 1998 is $0.89 billion, which is $1.09 billion from Telekom minus $0.20 billion used on this date to repay the rupiah loan to the local Indonesian bank. The arbitrage profit of $0.89 billion is on no initial investment because the initial sum of $1 billion lent to Telekom has been repatriated to Citibank on July 1, 1997. Citibank could bet billions to drain all foreign exchange reserves of a country like Indonesia. All foreign banks did so to drain out $140 billion of Indonesian reserves. ■

The Chinese Indonesians converted nearly $60 billion worth of rupiahs into foreign currencies out of fear of riots in 1997. This capital fled Indonesia in a matter of six months. The rupiah plummeted to a historic low of Rp18.000 per US$ by December 1997. Riots ensued. President Suharto was ousted. It wiped out his thirty-year legacy of improving the Indonesian living standard. He had raised Indonesian per capita income from $350 in 1967 to $3500 by July 1998. The per capita income fell to the same level as existed when Suharto took over the reign of Indonesia. The fallen rupiah currency cannot lift Indonesian exports. This defies the economic sermon touted by mega capitalists. The restrictions facing a developing country are not necessarily congenial for free capital flow and exchange rate. The benefits of mega capitalism did not flow to the absolute majority in developed countries. It went to a few mega capitalists and deprived 231 million Indonesians.

The Indonesian monetary system went haywire after mega global capitalists usurped Indonesian foreign exchange reserves. The Indonesian central bank was flooded with rupiah received from arbitrageurs who had borrowed the same from local banks and had repatriated the exchanged dollar. Indonesian banks had exhausted their rupiah funds with little left to lend to local consumers and businesses. But the Indonesian central bank was holding all the rupiahs with no monetary mechanism to recycle the same. Dollars were needed to import foods. Importers attempted to raise dollars from private individuals because of scarcity of foreign currency reserves at the central bank. This sharply raised interest rates on dollar loans and lowered the value of rupiah further. Then the imported food price rose sharply. It led people to riot and demand for a regime change. At the end of the mega currency game, mega capitalists had usurped about $140 billion from Indonesia. They had raised the debt burden on common Indonesians 5.5 times as the currency took a beating from Rp.2500 to Rp.13750 per dollar in just one year.

8.5 DEVELOPED VERSUS DEVELOPING CURRENCY

Developed countries do not borrow foreign currencies and so face no serious risk from devaluation. They can thus afford to freely float their currencies and permit their companies to borrow as much as lenders wish to lend. The central bank of a developed country with no foreign currency loans has no chance of depleting its foreign exchange reserves. There may be irrational exuberance or fear from time to time in a developed economy. But a developed country's economy cannot collapse due to falling currency value. Developed countries hold no foreign currency debts and so pay no risk premiums like developing countries do. Hedgers, speculators and arbitrageurs can still trade on developed countries' currencies.

For example, the Japanese yen fell from about 90 yens per dollar in 1990 to 147 yens per dollar in 1998. The fall in the value of yen in 1997 was dramatic. Many hedge funds were heavily short in yen because the Japanese economy had stopped growing for a long time. Japanese exports are very elastic with respect to the fall in the value of yen. As the hedgers pursued hard to depress yen, Japanese annual trade surplus against the U.S. ballooned to about $140 billion, annually, posing enormous pressure on dollar by October 1998. It was clear from various press reports that many hedge funds had to cave in because their expectation of a complete collapse of yen against dollar did not materialize.

Even if yen had collapsed to 200 per dollar, there would be no harm on the Japanese economy due to absence of foreign currency debt and resilience of Japanese exports to capitalize on falling yen. The main aspect of the Japanese economy is stagnant growth due to a leveling off of consumption by satiated Japanese households who are saving most of their incomes. This, per se, is not a serious problem. The main problem facing Japan and other developed countries is that their banks have lent heavily to developing countries who cannot repay their loans. The developed world has proposed to write off its loans made to poor African nations. But the vast amounts of its loans are outstanding with major nations in Asia, Europe and Latin America. Mega capitalism's economic bondage of majorities of households across the world lingers on.

The Asian currency crisis could be due to yuan's massive devaluation in 1994. It could have worsened due to crony capitalism, heavy short-term borrowing and growing current account deficits. But depreciations in currency values should not lead to collapsing economies and riots. The developed world does not face such crises despite crony capitalism, short-term borrowing and growing current deficit. Only the presence of foreign currency debt in a country can cause economic and social upheaval when the currency value falls precipitously. The developed world does not carry such debt by design. It rather induces the developing world to borrow foreign currency loans to set the stage for crises during a fall in currency value.

Malaysia is the only developing country that refuses to carry foreign currency debt. It did not face the social and economic crises after its currency, ringgat, fell in sympathy with other falling Asian currencies in 1997. Malaysian central bank - Bank Negara - required that private companies wanting to borrow foreign-currency loans exceeding 5 million ringgit must first obtain its approval. The approval was generally given only for investments that would generate sufficient foreign exchange receipts to service the debts. Companies were not allowed to raise external borrowing to finance the purchase of properties in the country. Malaysia this followed a policy to limit private sector external loans to corporations and individuals with foreign exchange earnings. This enabled Bank Negara to meet its external obligations from export earnings.

Brazil, Argentina and Chile have carried huge foreign currency debts. They have faced serious economic and social upheavals whenever their currencies fall precipitously due to shortages of foreign currencies for debt and import service.

8.6 INTERNATIONAL MONETARY FUND

The International Monetary Fund and other international lending agencies often rescue crisis prone developing economies by lending more foreign currency loans. The new foreign currency loans made to the developing world mostly recycle back to the developed world through capital flights, currency runs, defense equipment purchases, or other imports.

The IMF and the U.S. struggled hard to save the Russian currency, ruble, from collapsing in 1998. But this approach of lending more and more foreign currencies to developing countries like Russia and Brazil appears futile. Curing the structural ailments afflicting these countries is more important than treating their mechanical symptoms. Are the developed world and the IMF serious to cure the serious financial cancer facing an indebted world? Then they should take equity positions in these economies. For example, the IMF can buy the Russian ruble or Brazilian real. It should use this policy to signal to markets to stop manipulating these currencies downwards. The central banks in these countries must operate through transparent monetary policies. The developed nations should help a crises ridden developing country with food and medicine. Crony capitalism is also rampant in USA with the IMF helping to rescue mega capitalists from their loans to Latin America. The new loans granted to the developing nations being rescued are mortgages against promises of unborn future generations of the U.S. Such promises are basically the usurious profits created in the names of mega capitalists and their future generations.

The International Monetary Fund and the World Bank were formed in July 1944 at the International Monetary and Financial Conference, Bretton Woods, New Hampshire, USA. The basic goals of the IMF, as stated in its official website, are as follows:

(i) Expand and facilitate growth in international trade for high levels of employment and real income.

(ii) Maintain orderly exchange arrangements.

(iii) Avoid competitive exchange depreciation.

(iv) Establish multilateral payment systems.

(v) Eliminate foreign exchange restrictions.

(vi) Fund balance of trade payments by needy countries.

In reality, the IMF facilitates mega global capitalists to sell their products to the developing world at exorbitant prices. The developed world lends to the developing nations facing balance of payment crises through the IMF. The IMF gives annual advice on behalf of mega capitalists even to countries that have not borrowed its funds. The IMF executive director's policy prescriptions are not mandatory for a developing country. But the IMF expresses strong advices for the country to follow. This IMF advice basically benefits only mega capitalists.

The IMF policies are usually sub-optimal for the advisee country. For example, the IMF has in 1998 offered some advice to India after recognizing: "policies of the new [Indian] government are broadly geared towards maintaining domestic demand and providing a boost to growth by increasing public investment, particularly in infrastructure." It says that reviving "the fiscal reform process would help lower interest rates, improve debt dynamics." These are fine. But the IMF also argues: "If sustained downward pressure on the rupee were to re-emerge, the interest rate policy should again be actively used to resist overshooting of the exchange rate." The Indian government is advised for "further liberalization of foreign direct investment and portfolio equity flows." The IMF says that a tight expenditure policy would "help restore low inflation and improve market sentiment." In short, the IMF wants India and most other developing countries to implement the following measures:

IMF Advice-1: Cut import duties to encourage imports.

IMF Advice-2: Tighten public expenditure.

IMF Advice-3: Eliminate capital controls.

IMF Advice-4: Raise interest rate to steady currency value.

8.7 IMF ADVISE ON CUTTING IMPORT DUTIES

Proposition 8.8: *The IMF Advice-1 on cutting import duties to encourage imports can be exactly the opposite of what a developing country needs optimally to prosper.*

Argument 8.8: By this advice, the IMF basically asks the developing world to keep buying exorbitantly priced products from mega capitalists until exhaustion of all exchange reserves.

The price of an imported product includes high wages of the developed world, if measured in terms of currencies of the developing world. The developed-developing country wage differential for similar skills is significant. It is not because the developed world forces workers to toil harder. High wages of the developed world are mainly due to manipulated exchange rates and barriers to mobility of workers across national borders. Imports from the developed world force the developing countries to pay for such manipulations and barriers orchestrated by mega capitalism.

Importing high priced goods without duties can still benefit households and create high quality industrial products due to competition in the developing world. Industries in developing countries will strive for production of low-cost substitutes to high priced imports. They may compete fiercely for price and quality. Such competition can eventually eliminate inefficient local industries that cannot produce comparable qualities for lower prices. But existing inefficient local industries will fight for their turfs by bribing the government to impose import duties to raise prices of imports artificially to make imports unattractive to consumers. Punitive import tariff serves self-interests of myopic government decision makers. But barring entry of imports chokes local innovation and efficiency. It makes consumers pay more for low quality domestic products as happened in India until 1990.

The IMF, therefore, seems right in its advice on cutting the import duties that feed vegetating bureaucracies and costs the vast majority of households in the developing world. But what seems right is not necessarily so. It is naïve to presume that the IMF serves the interests of the majority of households anywhere. To see how, consider a global company that uses a predatory product pricing policy when it enters developing countries. By a predatory pricing policy, it sets the product price low enough to eliminate its competitors in the developing world. Once all competitors exit the industry, the predatory global company raises the price sufficiently to make up for previous losses. It can then use parts of profits to bribe the ruling elite of the developing world to prevent emergence of new local rivals. Then the developing world is dictated by mega global capitalists, as in Brazil and Argentina. It will eventually be left with few local industries to earn foreign currencies to pay for the imports and debt services. The developing world will then face deteriorating trade imbalances and current account deficits. It will then be forced to borrow from the IMF and mega global capitalists at exorbitant interest rates. The developing world's currencies then drop to abysmally low values with no hope of rising with faltering exports.

Mega global capitalism has already bonded Latin America and Africa economically. Its foray to bond Asia has not succeeded. But South Asia is still vulnerable to economic bondage, should the warring neighbors willy-nilly fall into the well-laid trap of buying exorbitantly priced Western arms. The Latin American countries that have escaped the clutches of mega capitalism are oil exporters like Mexico and Venezuela. East Asia and China have escaped the trap due to their resilience to produce quality goods for the developed world.

Mega capitalism has not enhanced prosperities for the majority of households even in the developed world. It is due to usurious profits and sub-optimal wages. Majorities of households everywhere are thus under economic bondage of mega capitalists, thanks partly to the IMF Advice-1. The IMF prescription is thus deceitful and its logic is specious. ■

The decision-makers of a developing country who blindly follow the IMF Advice-1 are either myopic or depraved or both. The IMF often gives examples of economic growth in developed nations accruing from liberalized trade policies. But it fails to mention the developing world's constraints that make its advices sub-optimal. These constraints have been artificially created to prevent the developing world from borrowing in their own currencies from the IMF, World Bank, international financial institutions, international commercial banks, and the international capital markets. The indebted developing world can be helped if new funds are lent in local currencies, like Brazilian real, to avoid dangers of currency devaluations and economic hardship.

By lending through the IMF, government establishments of the developed world merely pass on their taxpayer funds as loans to public in the developing world. It is to repay the loans of mega capitalists made beforehand to the developing world at usurious interest rates. The indebted developing world would default on such loans and not pay any interest to mega capitalists if the IMF were not to step in to rescue. Mega capitalists thus collect relatively usurious interests from taxpayers of developed countries under the aegis of their government establishments and the IMF. Establishments of the developed world's democracies are supposed to serve the best interests of the majority. But they do not. Collecting debts from most of the developing nations is impossible unless their repaying capacities and currency values improve.

Global investors cannot trust the central banks of the developing world because of reckless creation of money, often clandestinely. It is, therefore, sub-optimal for the global investors to lend in the developing world currencies. Asking for lending in the developing world currencies is merely academic. It serves as a test of the ostensibly altruistic motives of the international lending agencies. The developing world can solve its problems only after it produces all its needs or creates environments (peace among warring nations and transparency of monetary policies) to not need industrial goods (including defense gizmos) it cannot produce. The IMF Advice-1 to the developing world is a real disservice. The IMF has not been created, however, to serve the developing world.

Should a developing country invariably not import any industrial item it does not produce? It is better to produce the vital needs by importing technology than to buy goods made overseas even if it means borrowing foreign currency. Importing technology for production of vital necessities like medicine and biotechnology can lower the risks of devaluation of the developing world currencies. Domestic production of vital human necessities will contain inflation in their prices after currency devaluation. The developing world should optimally develop technologies to avoid dependency on imports and to minimize risks from the IMF conditions implemented after currency devaluation.

The strength of a country lies in producing its own needs locally and in improving its exportable production capacity. Any industrial product like engines needed in vast quantities should be produced locally even by importing the needed technology. Technology to produce vital household needs is crucial for stability and prosperity of the developing world. Prosperity of majorities in developed nations depends on rising standards in the developing world. But many of the technologies needed to raise standards in the developing world are researched and created in the developed world. New technologies are created due inquisition and endeavor of talented humans present everywhere in the world. Human prosperity cannot be enhanced by confining technologies to certain national boundaries by military power. Humans everywhere long to discover, innovate and create new technologies needed by society. To fulfill their innate inquisitiveness, they do not hesitate to emigrate to environments conducive for such fulfillments. Restriction of human knowledge and wisdom to certain boundaries is a tenet of mega capitalism. It cannot enhance prosperities of majorities of households. Global prosperity depends on free trading of technologies. It rests on free propagation of knowledge and wisdom.

If mega capitalism restricts markets for technology, the developing world may find it optimal to block free trading of goods and capitals. Even corrupt Indian, Chinese and Malaysian bureaucracies can find it optimal to restrict free trading and capital flows. The exchange rate regimes in these countries do not allow easy arbitrage profits based on developing country risk premiums and currency trading. With foreign exchange reserves building up, developing countries like China and India may find it prudent to repay their foreign currency loans. India has paid some of its World Bank loans in March 2003. It is optimal for the developing world to eliminate its foreign currency debts, though doing so needs concerted efforts.

8.8 IMF ADVISE TO TIGHTEN PUBLIC EXPENDITURES

The IMF often advises the developing countries to tighten public expenditures. If it means the trimming of highly bloated bureaucracies in developing countries like India, the IMF is absolutely right. The Indian bureaucracy consumes 90% of government revenues in staff salaries and pensions. Yet, it refuses to perform its public service duties without kickbacks. To make any decision, it puts up files at different levels of the hierarchy with no one responsible or accountable. This system is designed to grease palms of bureaucrats and ministers at all levels. India's exports are mainly raw materials and labor. Indian expatriates send home $23 billions, annually. This is more than the income tax revenues of the country. These funds are borrowed by the government for development projects planned for the poor. But borrowed funds do not reach their targets. They are mostly recycled back to officials and contractors in charge of development. Physical infrastructure remains shoddy because officials in charge of monitoring the quality of public works collude with contractors to usurp the allocated funds. The Indian bureaucrats work about 35% of their scheduled hours in office. They spend most of their times to discover how not to perform their duties to public to extract kickbacks. Once in government through civil service examinations, they vegetate through their careers, waiting for calls from bosses to devise schemes to usurp public lands and development funds. Corrupt officials rise to the helms of lucrative public sector enterprises and departments. They have squandered vast amounts of scarce capital of India in many public sector enterprises by making them sick and bankrupt. Indian decision makers trumpet about increasing employment in public sector. But they recklessly create government jobs for their kith and kin or for kickbacks from unrelated candidates seeking employment. They operate as a band connected through relations and shady deals to usurp public lands and development funds. They are individually smart. But India's system of governance induces lethargy, inefficiency, sycophancy and corruption without accountability to public. Reckless borrowing to fund such a system of governance has made countries like India dependent on foreign currency loans. It invites economic dependence and loss of political freedom. The same government staff could be much more productive in the private sectors. Indians are very entrepreneurial and talented. They have marvelously succeeded in software, apparel and agriculture. They have proved their skills, productivity and entrepreneurship, globally. But the colonial system of governance system they inherited in 1947 is incapable of harnessing their strengths. It nibbles away capital even before investment. India has not been able to attract much foreign direct investments despite cheap skilled labor. Improving bureaucratic efficiency is vital for developing countries for investment, employment and prosperity. The IMF makes an important advice to the developing world on cutting unnecessary government expenditures, if it means to improve bureaucratic efficiency.

Only the government can create public goods like roads, dams, bridges, parks, schools, hospitals, and other physical infrastructure to facilitate growth of private enterprises. But the most important social structure needed to create such public goods is a rational system of governance. Developed nations have prospered by creating public goods for attracting human and financial capitals for growth. Cutting investment on public goods is not beneficial for people or economy. But in the name of creating public goods, bureaucracies have reigned to ruin economies through inefficiency and kickbacks. The developing world should not let this continue if it wants economic and political freedom. It should use the IMF Advice-3 to reform dysfunctional bureaucracies to serve public. It should open all bureaucratic posts at all levels to competition by non-government candidates. It should prevent bureaucrats from manning public employment commissions. Only competition can breed talent and efficiency, even in bureaucracy.

8.9 IMF ADVISE ON CAPITAL CONTROL AND INTEREST RATE

The IMF can be selective in its advices. It can advise some developing countries to devalue currencies and others to hold the currency values stable by increasing the interest rate. For example, the IMF has advised India and China to not devalue their currencies. China has been indeed advised to revalue its currency. But the IMF has pressured East Asia and Latin America to devalue their currencies. The IMF produces little research to show that such selective policies are optimal for public in these countries facing different constraints. It is not hard to see that the IMF policies for the developing world are optimal for enrichment of mega capitalists based in the developed world. China and India have a lot of foreign direct investments. Dividends on these investments, earned in yuan and rupee, can be exchanged at the highest possible rates into dollars if these currencies are not devalued. This will eliminate the exchange rate risk of the dividends paid by China and India on the investments of mega capitalists based in the developed world. The IMF encourages India or China to hike the domestic interest rate to maintain a strong rupee or yuan policy, ignoring completely the negative effects of higher interest rates on prosperity of Indian or Chinese households. There is no point in arguing about validity of the objective of the IMF directors. It is to serve best interests of mega capitalists, not the majorities of households in the world. There is no hope that the IMF policies will benefit the public even in the developed world. The governments in developing countries should bear the blame for not doing enough research before joining the IMF bandwagon. The lure of camaraderie with rich capitalists lands them in situations that ultimately hurt public everywhere.

During the 1997 East Asian currency crisis, Malaysia did not need the IMF assistance. But at the behest of the Malaysian Finance Minister, Anwar Ibrahim, the government followed the IMF prescriptions. It led to a serious deterioration of the Malaysian economy between July 1997 and September 1998. The IMF policies were accepted in July 1997. Prime Minister Dr. Mahathir Mohammed of Malaysia fired his Finance Minister in September 1998. In defense of its Southeast Asian policy, the IMF had then said: "The exchange rate was initially allowed to depreciate, but the fall in the value of the currency was limited by a temporary tightening of monetary policy, which led to sharply higher interest rates. The aim was to stop the drain on reserves by letting the exchange rate adjust, but keep inflation under control and restore market confidence." During the time the IMF policies were in place in Malaysia, Dr. Mahathir had said, "the ringgit has depreciated significantly and now we have to pay 60 percent more for every dollar." At the same time, the Kuala Lumpur Stock Exchange index, comprising blue chip Malaysian companies, lost two thirds of its market capitalization since the crisis began in July 1997. Dr. Mahathir favored capital and exchange controls to insulate the economy from the "continuing contagion effects of a volatile financial environment." Dr. Mahathir added, "To contain the severity of economic contraction, the government had to reassess the IMF prescription of a tight monetary and fiscal stance and decided to adopt expansionary macroeconomic measures and easy monetary policy. A thorough study was undertaken by the National Economic Action Council on alternative approaches that could save the nation." Dr. Mahathir has suggested that the government chose an unorthodox approach, different from that suggested by the IMF. Clearly, Malaysia was disillusioned by mid-1998 with the IMF prescriptions that were designed to help the mega capitalists. The IMF is not beholden to better the plight of a developing country. The IMF has developed the expertise to articulate policy recommendations for developing countries which sound furtively irrefutable, but latently lucrative only to mega capitalists. The IMF imposes such policies by enrolling articulate rulers with self-enrichment agenda within the developing world, such as, the ex-Finance Minister of Malaysia, Anwar Ibrahim.

The IMF simply does no research in behalf of the majorities of households in the developing world. It does not need to. If the IMF does not succeed to convince the rulers of a developing country for its policies, its global mega capitalist patrons use their respective government establishments to issue warnings and sanctions. For example, the U.S. establishment issued a series of veiled threats to Malaysia soon after the latter announced capital controls in 1998. The Malaysian controls amounted to hurting capital flows and the returns to mega capitalists. There was no research showing that capital controls would not serve the best Malaysian public interests. Indeed, strong empirical evidence shows that enormous foreign direct investments have flown to China despite its capital and exchange rate controls. If international companies see a stable exchange rate economy and the potential to repatriate profits and dividends, they will not hesitate to invest in a developing country. The warnings against Malaysian capital controls simply exhibited fears of the U.S. establishment, voicing mega capitalists' interests, that similar controls in other countries would choke usurious profits of mega capitalists operating though hedge funds on currencies and securities. Usurious profits can be made only if global capital markets are unfettered *and* global labor is forced to be immobile.

Hedge funds can badly hurt the developing world if capital controls are absent. This was clear after Russia announced stronger capital controls following Malaysia in 1998. These steps by developing countries jolted the U.S. and European financial institutions like Credit Suisse First Boston and Long-term Capital Management.

With respect to the IMF advice on imports by developing countries, ample caution must be taken in best public interest.

Proposition 8.9: *Exporting basic goods and services may not be desirable for a developing country. Importing rapidly expanding technology should be curtailed.*

Argument 8.9: The consumer price index (CPI) is based on a basket of basic goods and services. This basket may include products which can be exported. If a developing country exports such basic products, their supply will be curtailed. It will then raise the price of the basket within the country. This will raise the

CPI. As the CPI rises in a developing country, the central bank raises the nominal interest rate. This will decelerate the economic growth, increase unemployment and diminish competitiveness of the country. Thus, exports of basic goods and services are not necessarily beneficial for a developing country.

Developed countries usually export technological and industrial products and services with exorbitant prices and high profit margins. These items are generally not part of the CPI. The pressure of inflation from such exports is minimal. Cheap imports are deflationary to a developed country.

Free trade is by and large beneficial to mega capitalists. It is detrimental for people in developing countries that can export only basic goods. Developing nations should follow the path of the developed ones to promote exports of only engineering and technological products, if they can make like China, South Korea, Taiwan and Japan. They should limit exports of basic products consumed by common people.

The real dilemma faced by a developing nation is whether or not to allow direct imports of products based on advanced technologies for which close substitutes are not available indigenously. For example, computer technology has rapidly advanced since 1986. An IBM PC-AT that was selling for $4000 in 1987 can be had free from governments and companies disposing of this junk. Some of the most advanced PCs can now be bought for as little as $1000. Importing rapidly advancing technological products is sub-optimal for a developing country because scarce resources will be used up with little left for indigenous research. Such imports can be paid only by increased exports of basic goods or foreign currency loans. Exports of basic goods raise current inflation, stifling prosperity. Foreign currency loans increase the risk of economic dependence. They increase the specter of future inflation due to rising costs of imports. They act like albatross for national prosperity. ■

Mega capitalism has perhaps created the IMF as an effective weapon to countervail the potency of passive resistance championed by the hero of freedom, Mohandas Karamchand Gandhi. The IMF has been quite effective in transferring wealth from majorities of households everywhere to a few mega capitalists. There was no justification for the IMF to praise economic management in Indonesia in early 1997 and then ask the country to steady the exchange rate at Rp.2500 per dollar, when the balance of payments of the country was deteriorating fast. The IMF could not have been oblivious of the short-selling of rupiah actually taking place at that time to drain out Indonesia’s $140 billions of foreign exchange reserves.

Absolute majorities even in developed societies are under bondage of debt and sub-optimal wages. Governments of the developed world borrow to fund the IMF to lend collaborating rulers and dictators in the developing world. The funds are then siphoned back to mega capitalists via imports of defense gizmos and food, consultancies and supplies. The public in the developing world owes but cannot repay the loans to the public in the developed world. These colossal losses to the majorities everywhere have been transferred as usurious profits of mega capitalists. The IMF serves as a conduit for such transfers.

8.10 CENTRAL CURRENCY TRADE REGISTRY

The price of a currency freely trading in several locations can be manipulated if there is no central registry for the trades. This is especially easy if the volume trade in the currency is low. Central registries for currencies do not exist. This is a novel idea. It will look weird to major dealers of hard currencies like dollar, euro and yen.

Instituting a central registry for a currency is equivalent to banning all trades on the currency except those that pass through the issuing central bank of the country. The central bank that issues its national currency can institute a central registry. It will require recording of all trades on its currency in its own computer system for recognition as legitimate trades anywhere. The prices of its currency from any trade that does not pass through the central registry are simply not recognized as legitimate. If this is done, manipulation of the currency's price based on fictitious trades is impossible.

Currency price manipulations are ubiquitous. They can negatively affect small economies like Malaysia and Thailand. Rampant manipulation of the Malaysian ringgit during 1997-1998 led to the Malaysian government banning overseas trading on ringgit. Malaysia fixed the exchange rate at 3.8 ringgit per dollar in October 1998. This was a remarkable step.

There is a unique central registry for every stock traded in major stock exchanges around the world. But such unique registries did not exist for Malaysian stocks before October 1998. Malaysian stock prices could be easily manipulated through trades in Singapore exchange. Malaysia no longer recognizes stock trades that do not pass through its central registry in its stock exchange. The Malaysian experience as well as the existence of central registries for stocks in all major exchanges shows that such registries prevent manipulation of prices. Every currency should, therefore, have a central registry for all trades to pass through it. Such registries can prevent manipulation in prices of currencies. Major currencies do not need such registries because manipulation of their values against each other is not easy due to high trading volumes.

Multiple exchanges can list and trade the same stock. But there is a unique registry for every stock traded in any major exchange. All exchanges that trade such a stock have the same information about trades and ownership records. The same computerized information is mirrored in multiple exchanges trading the same stock. Before 1998, Singapore Stock Exchange had a Central Limit Order Book (CLOB) trading system to trade the Malaysian stocks. The CLOB permitted trades among shareholders without recording the transfers of ownership from sellers to buyers in a unique registry. There was no unique registry for all shares of a company in Malaysia. This was weird. There has been a single registry of all shares of a company listed in any major exchange like the NYSE, AMEX or NASDAQ.

Shares held long minus those sold short must equal the number of shares issued by a company. This equality cannot be guaranteed without a unique registry that records on real time the trades and ownership of a stock. A unique registry is crucial to ban the creation of virtual shares for short-selling.

Consider a case without a unique central registry for a stock. Suppose that a company has issued a total of 100 shares, owned by just one shareholder and held in a brokerage account. These shares can be borrowed by some trader willing to sell them short to depress the stock price. The short-seller has to return the borrowed shares eventually. If the price drops after short-selling, the trader profits from the difference between his selling and buying prices. But the short-seller can make a fake sale with a colluding buyer at a fictitiously low price for display at some exchange without any record in any unique registry. The short-seller's purpose is to show to the current legitimate shareholders that the price has dropped. If the current shareholder panics to sell his shares at the fictitiously low price, the short-seller will profit by covering (buying) the shares. Short-sellers serve their interests in depressing share prices by all means like fake trading. A unique stock trade registry will update share ownership as soon as legitimate trades are executed. It will automatically prevent recording of fictitious trades and prices.

Before October 1998, Malaysia allowed multiple registries for trading and ownership data for the same stock. But these registries could maintain differing data on the same stock. Manipulation of stock prices through fictitious trades was thus easy. Speculators could create an unlimited number of virtual shares for fictitious short trades to depress stock prices unexpectedly. If existing shareholders do not lend their shares, then the unique central registry system can curtail currency price manipulation for short-selling profits. Shares cannot be created virtually if a unique central registry is maintained for every stock. The Malaysian government banned the CLOB trading in October 1998.

Currencies do not generally have unique registries or centralized exchange clearing systems like that for stocks and bonds. Virtual currency trading is possible for currencies without unique central registries. China and Malaysia have some form of central registries for their currencies. All yuan and ringgit trades have to be recorded at central banks, People's Bank of China and Bank Negara of Malaysia, respectively. Global trades in yuan and ringgit that are not recorded at Chinese and Malaysian central banks are illegal.

Malaysia had permitted global trades in ringgit before October 1998. Then a hedge fund could borrow a vast sum of ringgits from a Malaysian bank to exchange it to dollar. If the hedge fund sold the ringgits to any bank operating within the Malaysian central bank (Bank Negara) clearing system, the total amount of ringgits would remain equal to the amount of currency in circulation. The hedge fund could, however, sell the ringgits to a bank account in Singapore without clearing this transaction through Bank Negara. Then the same ringgits could be borrowed by a second Singapore bank account for sale to a third account. A fourth Singapore bank account could borrow the same ringgits from the third account to sell to a fifth Singapore bank account, and so on. All these accounts could be held by the same hedge fund. The ringgit sales could thus be artificial. But every artificial ringgit sale could depress the exchange value of ringgit. This could create a perception of huge supplies of ringgits for conversion to hard currencies. The actual amount of ringgits created and supplied by Bank Negara could be lower. The artificial trades simply increased the velocity of conversion of ringgits. This is different from the velocity of circulation of fiat money within an economy. Increasing the velocity of conversion of ringgit created panic sell off by true ringgit holders before October 1998. This led to deeper depreciation of ringgit than implied by fundamentals of Malaysian economy.

Malaysia banned offshore ringgit trades in October 1998 to thwart artificial velocity of conversion of ringgit. Malaysia *announced* on September 1, 1998 to ban the ringgit trades. On that day of *announcement*, the ringgit value rose from about 4.2 to 3.8 per dollar because the Singapore banks had to buy ringgits to cover their short positions. The Malaysian government then fixed a value of 3.8 ringgits per dollar. This blocked usurious profiteering from currency trades through manipulation.

Proposition 8.10: *A globally floated currency exchange system is viable only if all foreign exchange trades across the world are cleared through a unique computerized trading registry for each currency. Short-selling in currencies should be banned in best interests of majorities of households in all countries.*

Argument 8.10: A unique registry for each currency will prevent creation of virtual amounts of the currency not supplied by the central bank of the country. Some hedge fund can still trade between its own accounts to manipulate exchange rates. But it will not succeed when its trades clear through a central registry for the currency. The central registry is an exchange system with all buyers and sellers of the currency at any time the market is open. Manipulative trading is impossible when other traders and the central bank can buy or sell the currency depending on market conditions. Unique central registries will stop artificial velocity in currency exchanges.

Hedge funds can still borrow a currency to exchange it through the central registry. This is short-selling to depress the price of a currency artificially. The interest rate on such borrowing can be jacked up by the lending bank. But raising interest rate is costly to a society. Artificial strategies like short-selling create usurious profits by inflicting losses on majorities. They should optimally be banned by making short-selling illegal. ■

Volatilities in prices of even major currencies like dollar, euro and yen can be contained by creating unique central currency registries and banning short-selling. As discussed earlier, the dollar once fell massively by about 20% against yen in October 1998. This was due to large hedge funds unwinding their yen carry trades. It was strange that dollar was falling against yen, despite Japan experiencing its worst recession then. While the U.S. economy was poised to slow down, it was far from being in a stage of recession. Hedge funds had been creating massive virtual yen funds since 1990 when Japan entered recession. Yen had experienced a steady decline against dollar since 1990 till 1998. On its creation, the euro was priced 1.00 dollar. Its price has been volatile since then, falling to 0.87 and rising to 1.35 dollars. Dramatic swings in even major currency values in short spans of time are partly due to hedge fund manipulations designed to generate usurious profits for mega capitalists.

Speculation about the American economic rout has been behind the recent depreciation of dollar relative to yen and euro since late 2002. Such speculation has not been possible with yuan despite China being the largest export powerhouse of the world. This is because China has made trading in its currency illegal. China and Malaysia effectively have central registries for their currencies, making the virtual creation and trading of their currencies impossible. But these countries have instituted bureaucratic controls on values of their currencies vis-à-vis dollar. Setting currency pegs too low can cause other risks like banking and social instabilities discussed earlier.

The volatility in currency values can disrupt real activities. Leveraged exporters can be bankrupt if their domestic currency suddenly rises in value. They will receive less in domestic currency from the same volume of exports. But they need to bear preset obligations in local currency like debt repayment, wages and material costs. If net exports are less than the preset local currency obligations, they will be bankrupt. If the domestic currency value falls, imports will become expensive for producers and households dependent on such imports. Households depending on imported food can riot when the food cost rises due a lower domestic currency value. Similarly, businesses that depend on imported capital equipment and technology will see their production costs rise due to a decline in currency value.

A currency may never trade at its true value. Even the true value of the currency may not be known. But manipulative volatility in its price is unwarranted and socially disruptive. Centralized exchange clearing systems for currency trades can alleviate problems associated with currency price manipulation.

9 GROWING NATIONAL PROSPERITY

The wealth of a nation flows from its resources. The most important resource of a nation is the system of its governance. Democracy is not necessarily the best system of governance. It can be chaotic like in India or autarchic like in USA. The Chinese system of governance may appear to be dictatorial. But it is more like a rule by a single party which elects leaders through intense elections starting at the village level. Electoral success in China is based on the ability of a contestant to solve social problems. Electoral success in democracies depends more on propaganda than on substance. The current top ten functionaries of China are all engineers and even the past president was an engineer. This shows why China is the engineering goods manufacturing hub of the world. Even USA achieved its success due to policies that were supported across party lines. The wealth of a nation thus depends on unity of leaders on policies that enhance prosperity for the majority of households.

9.1 JUDGING OPTIMALITY BY NATIONAL CONSTRAINTS

Over the last twenty years, the Chinese economy has been growing tremendously. It has been possible due to (i) conscious efforts to maintain stability through capital and currency controls, (ii) improved government decision making and (iii) nurturing an atmosphere to induce wealthy expatriates to return with their capital, skills and zeal to help develop the nation economically. As a result, China has tripled its per capita income during the last two decades to about $1400 in 2004. On a purchase power parity basis, the per capita income is nearly $6000. This is still far behind the U.S. per capita income of $37000. Yet, China has become the second largest economy on a purchase power parity basis. It has attracted massive amounts of new foreign direct investments reaching $60 billion in 2004 and is still growing at a rate of 9.1% as of 2004. The total foreign direct investment in China has reached $700 billion over last 15 years. Only one-tenth of it reached India during the same period. The external capital infusion represents almost one-tenth of total new investment in China. The Chinese are generating massive trade surpluses, raising foreign exchange reserves to $711 billion as of June 2005 from $53 billion in 1994 when it devalued its currency by 33%. On a per capita income basis, China is still way behind the developed world. But it is turning wealthier at an astounding pace.

Contrast China with the Southeast Asian nations that appeared to prosper quite well through the most part of nineteen-nineties, but stumbled due to serious runs on their currencies in 1997. This was mainly because Southeast Asians did not have currency and capital controls. Chinese controls saved the economy from such currency and capital runs. Malaysia was the only Southeast Asian country that introduced currency and capital controls in 1998 and succeeded in thwarting a free-fall of its economy. The Indian economy did not suffer from the Southeast Asian malaise because of currency and capital controls. These empirical facts show that currency and capital controls are optimal for economies that face constraints, real or artificially imposed by mega capitalistic propaganda.

9.2 GOVERNANCE IN PUBLIC INTEREST

Optimal policies can emerge only if the governance system is geared to envision long-term public interests, all the time. During the Southeast Asian crises, propaganda on corruption and mismanagement accentuated fear among residents in these countries, precipitating currency devaluation that transferred wealth to mega capitalistic short-sellers. This was at least partly due to tacit collusion between the ruling elite and mega global capitalists, as happened in Indonesia.

India circumvented the currency crisis of 1997. But it has been struggling to emulate the Chinese economic growth model of engaging wealthy expatriates in national development. Despite political freedom, decision-making in India is nontransparent and complex. India receives a paltry few billions of dollars annually as foreign direct investment. The Indian manufacturing sector has not received much foreign direct investment. It is because manufacturing plants need land and electricity that bureaucrats with self-enrichment agenda do not grant without kickbacks. The Indian software and jewelry exports have skyrocketed, however, during the last decade because these businesses can successfully operate within homes and backyards escaping the bureaucratic interference. India's bureaucratic excesses are exemplified by the fact that its national carrier, Indian Airlines, is ordered to impose a levy on non-resident Indians and foreign travelers. No other airline in the world practices such discrimination.

The advent of political competition in India during nineteen-nineties is definitely an important achievement as it has produced zealous rulers willing to improve decision-making and cut red-tapes to make the country an economic juggernaut. The Indian economy is not as dependent on exports as China's. India is thus less vulnerable to global recession or depression. Indian entrepreneurship is ahead of China's, judging by success of the private sector. India has produced some world class corporate houses like Infosys and Wipro. On entrepreneurship front China is far behind in private business management. Chinese growth is based on Western and Japanese entrepreneurs who use docile cheap Chinese labors to produce their brands for developed markets. Strong unionism and lethargic bureaucratic decision making in India has so far kept massive foreign direct investments at bay. But the most crucial sector of an economy is banking. Indian banking sector, though inefficient, is more transparent and stronger than China's. The single most crucial factor that hobbles India is a colonial system of governance it inherited on independence in 1947.

Prosperity of democratic nations like India depends on reforms in labor laws, transparency in government decision-making, and mechanisms to detect and punish delinquency and depravity in bureaucracy. Labor laws must permit the capitalistic entrepreneurs to replace unproductive workers so that production costs remain below the prices that can be afforded by consumers and households. Only then the productive workers can remain employed.

A democracy needs a constitutional mechanism and relevant rules of law to effectively monitor and nab the corrupt government officials. Laws should protect whistle blowers who help catch looters of public wealth.

Democracies like India should also replace their cadre-based promotions of officers with mechanisms similar to that of the U.S. to hire senior executives through competition open to every qualified citizen. Laws should be enacted to hold heads of government departments responsible and accountable for (i) defining how every decision (e.g., for granting a permit) is made, and (ii) assigning a single officer to act as a facilitator to deliver results within a stipulated time limit. If there are more than a stipulated number of lapses, the responsible officer should be removed by law. Simply transferring a delinquent officer for punishment, as practiced in India, is not punitive. Transfers may serve as palliatives for employees willing to work in new environments. An officer with a tendency to vegetate or collect kickbacks will continue to do so wherever he is transferred. Such transparency in governance is necessary for a country to advance economically. In fact, the thousands of procedures of dealing with the government can be made available to people on the government's internet websites with the responsible officer's name, phone, fax and e-mail address for each procedure. Such systems will eventually help prune existing dysfunctional bureaucracies at the federal, state and local levels.

In short, a society can prosper only by employing a system that is dynamically resilient to adopt the best ideas on governance. For example, if a society intends to nurture a historically underprivileged class of people like some castes and tribes in India, a law should be enacted to give some preference to these people in education and employment in government. But such laws should not permit the creation of a new elite class with birthrights to usurp opportunities without merit. Quota laws must exclude families with government jobs to claim preference in education and employment. These laws should benefit only the underprivileged classes. They should prevent enrichment of a few rich elite "underprivileged" families as in India now. The current Indian law, designed for social transformation of its underprivileged classes, has all but degenerated into establishing another elite class. This new elite class of the "underprivileged" is perhaps the most privileged in India. It is interested only in grabbing political opportunities to usurp public wealth or occupy government jobs. This has also created a new class that blocks merit from governing a society.

9.3 LOWERING PRICE FOR PROSPERITY

To study how the American economy grew phenomenally during nineteen-nineties, consider again the economic objective of a nation. Prosperity comes by a national objective of maximizing the household income and minimizing the real costs of a needed basket of goods, products and services. A national objective of equality for all has proved to be disastrous, judging from human experience under communism. The nation must at least strive for minimizing the *price* of the needed basket of goods, if it cannot raise wages. This macro-economic variable *price* is the number of units of currency of the nation per unit of the needed basket. *Price* is a function of supply and demand for the basket of goods.

As long as the demand does not rise faster than the supply, the *price* will fall. As the inventory level increases on the shop floor and the warehouses, *price* falls until consumption rises in response to the fallen *price*. *Price* rises when inventories fall. Thus, *price* dynamically depends on net supply and demand for the basket of needed goods at any time. By liberalizing the import policy, a country effectively induces producers from all parts of the world to increase the supply as soon as the current net supply, not demand, falls. But producers in other parts of the world will supply (export) only if their production cost is sufficiently less than the current *price* at destination to generate profits.

What happens when there is no further room left for reducing the *price* or improving wages, as persisted in USA and Europe before 1990? The producers then collaborated with their governments to strike deals to use cheaper labor in other nations. The Americans, Europeans and Japanese producers thus ventured into Mexico, Taiwan, China, Indonesia, Malaysia, Thailand, South Korea, and Philippines. These countries with cheap skilled labor were enticed to compete for producing goods at lower prices to satisfy the demand in the developed world.

The process of trade liberalization introduced during 1992-1998 spawned unprecedented volumes of imports of goods from Asia and Latin America to USA. This is because the cost of production outside USA has remained very low as compared to the American *price* level. Due to the U.S. trade liberalization rule, China and East Asia competed fiercely. It led to Chinese currency yuan's devaluation in 1994. Then China remained ahead of other developing countries in supplying goods to Western markets at lower *price*. The yuan devaluation effectively forced the Chinese workers to toil for low wages in factories producing for the developed world. This has also made Chinese exporters' income comparable to those in the West.

Competitive exports from the developing world enhanced the U.S. objective of reducing the *price* level. This process of product outsourcing to nations with lower labor costs is sanguine for societies as long as the vast majority reaps the benefits. The difference between the *price* in developed nations and the low cost of production in the developing world is the profit of middlemen. It is important that such middlemen generate fair returns on their capitals. But greed takes over to wangle most, if not all, the benefits of such globalization. As a result, the *price* has not fallen much and the wage level has not risen at all for the vast majority in the developing world. Mega capitalists have succeeded in maintaining the developed world's *price* intact through calibrated and shrewd propaganda that *price deflation* has adverse effects on the economy. Deflation adversely affects only the fortunes of mega capitalists, not majorities of households.

During late nineteen-nineties, the U.S. establishment lost track of the social objective of reducing *price*. It seemed as if it was satisfying the mega capitalists by offering specious reasoning that deflation was harmful to an economy. As discussed earlier, there was no inflation during 1999. Yet, the Federal Reserve Board raised interest rates several times to alleviate the *detrimental* effects of consumer deflation then. Higher interest rates increased the price of capital and dampened business activities. It lowered production and thwarted deflation. This helped only the mega capitalists.

Unneeded interest rate hikes of 1999 hit the U.S. households from *four* directions:

(i) Higher interest payments on debt.

(ii) Opportunity loss from deflating consumer prices.

(iii) Subsequent job losses as mega capitalists had to retrench workers to boost profits that were falling under deflationary pressure.

(iv) Massive erosion in household portfolio values.

The absolute majority in the most developed nation has not thus prospered. To be certain, the household net worth data should be collected and broadcasted periodically.

Proposition 9.1: *The current form of globalization does not enhance prosperities of the vast majority in a developed nation. But it makes mega capitalists richer.*

Argument 9.1: A survey report published on January 22, 2003 by the Federal Reserve Board says that economic inequality grew in nineteen-nineties. It says that the wealth of the top ten percent of household surged 69% between 1998 and 2001, from US$492,400 to US$833,600. In contrast, the lowest 20% of the households increased their net worth by only 24% to US$7900. The median accumulated net worth of the families at the top was 12 times the net worth of the rest of the American households in 1998, rising to 22 times in 2001.

The Federal Reserve Board survey has been based on 4000 families. This sample is not representative. It excludes households of the ultra-rich like Bill Gates as outliers. The top few households are obviously outliers. Sampled data do not perhaps include true net worth figures of top households.

The net worth figures in the Federal Reserve survey takes only the assets like home and stocks and direct liabilities like home mortgage and consumer loans.

The surveyed household net worth includes market prices of common stocks and homes. Stock prices can decline due to lower corporate sales and earnings. Many companies like IBM, General Electric, General Motors, Ford and Telecom companies are all laden with massive debts with negligible net worth. Their market values based on current earnings estimates are perhaps substantial. Corporate earnings cannot grow indefinitely for such major companies. General Motors and Ford are already experiencing massive losses due to declining sales. Bankruptcies of mega corporations like Enron, MCI-WorldCom and United Airlines show that households counting for the values of their shares in such companies may not realize them.

This survey excludes the indirect government debt which consumers are obligated to pay in future. The Federal, state and local governments have borrowed vast sums of money. This is the indirect household debt to be paid through higher future taxes. It is about $95,000 per household.

Subtract the indirect government debt from household net assets. Then realistically discount the common stock values from the Federal Reserve Board's net worth estimates. It will perhaps leave 99% of U.S. households as bankrupt with substantially negative net worth.

This is alarming because the absolute majority of voters in the most powerful democracy on earth seems to be blindfolded by mega capitalism.

Globalization has not raised real wages of the vast majority of workers in even developing regions like China and Southeast Asia. The Chinese middlemen have earned all the profits like their American counterparts and have lent these profits to banks, which have subsidized the building boom in the country. The Chinese debt has expanded at an alarming rate over the last five years. This means that most of the surplus generated from globalization has gravitated to mega capitalist exporters living in the developed world and other enclaves like Hong Kong and Taiwan. Absolute majorities of households in developed nations as well as the toiling workers in the developing world have not been able to benefit much from globalization. Only the mega capitalists have accumulated usurious profits from lower costs of production by squeezing (i) household consumers in developed nations by holding consumer prices steady and (ii) labor in the developing world by holding wages low. Such expropriation has not been possible from a democratic India with unionized labor.

9.4 DEMONETIZING DEBT TO ENHANCE PROSPERITY

The government of China has been effectively borrowing the surplus profits from its rich exporters through state-owned banks to invest in the hinterlands, its western regions. The Chinese government may someday decree to write off private deposits in losing state banks to compensate for bank loan losses. Cutting debt by government fiat is called demonetization. This can happen in any country. Suppose that a government owes $100 to lenders and depositors of state banks. The government may decree that the lenders and depositors will receive only $50. By this decree, the government confiscates 50% of the private funds loaned to banks. Demonetizing demolishes the trust of private lenders on government. It will make very hard for the government to raise funds in future, either directly or through banks. Any national government can resort to demonetization as its last step to solve monetary crisis.

Proposition 9.2 *(demonetize global debt): If all governments across the world simultaneously demonetize (cut by fiat) all debts (consumer, government, corporate and international) by the same percentage (say 50%), they may prevent a potential Global Depression. No country, corporation or individual will face any special difficulty in raising debt funds in the wake of such a concerted step, which sinks for good the usurious profits generated over the years due to sub-optimal wages. This is a rational step to restore economic justice and social stability, not only within the developed nations, but also globally.*

Argument 9.2: Cutting debt will improve net worth of the absolute majorities of households, releasing more of the income for consumption. Households will then be enticed to consume again, preventing any potential Global Depression. Imagine the boon to the global economy when the U.S. government cuts $4 trillion of its outstanding debt by fiat and invests a small part of it on public goods like schools and healthcare globally. All borrowers will be equally stigmatized due to 50% default on their debts. They will all have equally lowered credit scores. All lenders will sill have 50% of their savings to lend. They cannot banish all borrowers. Governments and household borrowers will have no problems in raising new debt in future.

Demonetization is a form of economic justice for majorities of indebted households and governments. It countervails mega capitalism that has usurped usurious profits by paying sub-optimal wages. Demonetization is optimal for social stability and long run prosperity. ■

There is a good possibility that the development of public goods like schools, healthcare, transportation and communication in China will be ultimately subsidized by demonetizing bank debts. These debts are from exporters' surplus profits. They have been possible due to low exchange value of yuan and low wages to Chinese workers. A socialist China may likely demonetize its bank debt in the best interest of its social stability and long run prosperity, unless the Chinese government becomes a capitalistic democracy like USA. The absolute majorities of households even in USA can vote for demonetization after they see how the source of massive lending they have supported has grown as big as it is. They may realize that usurious profits accruing from sub-optimal wages have been lent back to them. After such realization, they can vote for demonetization in the best long run interests of their society.

During the Great Depression, the American government indeed undertook a step similar to demonetization. At the time of utter despondency during 1989-1991, there was a talk among some American lawmakers to demonetize debt. It may be harder to implement such a drastic step in the American society now with 14000 private banks. This is because the government will have little control over uncontrollable banking panics and runs, which will ensue after any demonetizing effort.

India has written off debt of agriculturists from time to time. But this has mostly benefited the rich, who are connected to government decision makers and who borrowed in the name of agriculture with no intention to repay their loans. Such practice of the government invariably kills the trust of genuine global and local investors in a nation. Local savings then flow into real estate which does not create new jobs in the nation. Real estate prices are so inflated in India that rents do not cover even one-fifth of the cost of capital. In developed societies, real estate rents are quite comparable to the cost of capital invested in real estate. It is because of the trust of investors that their funds saved in banks will not be siphoned off by colluding ministers and bureaucrats.

9.5 CAPITAL INFLOWS AND PROSPERITY

Households in the developed nations have already noticed that they have benefited little from globalization. There have been sporadic demonstrations against mega capitalism, recently. Agitators have protested against policies of the World Bank and the International Monetary Fund. Mega capitalism has responded to such agitations tactfully. It has embarked on new games to prove the efficacy of globalization on prosperity of majorities of households in developed societies. One approach is to engineer political instability and war in the developing world to trigger fresh emigration of monetary and human capitals to the developed societies. Fresh capital inflows can lower the *price* of borrowing for consumers living in developed nations. This *price* of capital moves just like the price of goods in response to supply and demand for capital. The price of capital is also called *interest* *rate.* It depends on the demand for borrowing and supply of net capital funds available in banks. Net capital is like an inventory of funds available to be lent. If borrowers have the ability to repay and banks have a lot of unused funds, then *interest rate* falls to facilitate new lending. As the *price* of capital (interest rate) drops, debtors rush to refinance their existing home mortgages and other debts. This leads to savings in periodic debt repayments that free up funds for consumption. It thus pays mega capitalists to orchestrate flight of capital from other parts of the world. By raising the net capital supply, a country can boost consumption. Interest rate falls when net capital supply increases. Then interest payments by households fall, raising the disposable income for consumption. But this strategy does not always work for every country. The developing world may not subscribe to war mongering any longer. Also all countries cannot simultaneously induce capital flights. Even the same country cannot boost economic growth perpetually through capital flights.

During nineteen-nineties hundreds of billions of dollars reached American capital markets from all over the world like Japan, Saudi Arabia, Russia, Indonesia and Mexico, leading to a technology stock price bubble. Exporters from many countries like Japan, Saudi Arabia and Mexico still consider USA as a safe haven to store wealth. The long-term interest rates did not budge down as much as the Federal Reserve Board cut the short-term bank rate during 2002-2003. The long-term interest rate is a function of supply and demand for capital borrowed for long-term loans like home mortgages. The steady long-term rates show equilibrium between the supply and demand for capital in USA. This equilibrium was not disturbed even by major events like the Iraq war. Recently the FRB has hiked the one-year bank rate to 3.5%. Even then the long-term rates – determined by supply and demand for long-term loans – are not moving upwards. The yield on the ten-year U.S. Treasury Note is still hovering around 4%

even after the recent hikes in bank rate from 1% (in June 2003) to 3.5% (in August 2005). This shows that the long-term interest rates are in some state of equilibrium. They have rendered the FRB guidance on interest rates redundant for now.

The FRB cannot fix the long-term rates. Fresh dollars from exporters of oil and other commodities are still being stored as reserves in the U.S. The supply of capital in USA is increasing due to the rise in oil prices, increased reserves from net Asian exports, and rising corporate income tax revenues. These increased capital supplies are, however, used up by fresh credits to governments and households and net imports. The FRB is raising the bank rate to (i) ensure that the surplus exports that are now being stored in USA do not migrate, and (ii) dampen the U.S. demand for credits.

Some net exports from Asia and oil producing nations are already being channeled to Europe. Iran is now reserving its net exports in euro. Its central bank does not maintain an account in FRB. It wants to start trading in oil futures contracts in Teheran. Iraq had planned to switch to euro before the recent war. The *mighty dollar* is now on very shaky grounds. After the downfall of the Iraqi regime, the U.S. declared that Iraq would trade in dollar and maintain its reserves in FRB. If the U.S. does not succeed in keeping Iraq hooked to dollar, the interest rate on dollar loans will rise. In anticipation of this possibility, the FRB may be raising the bank rate.

Dollar has recently dropped significantly against euro. Its drop against yen is not as significant because the central bank of Japan steps in to buy dollar by selling yen as soon as yen ascends. Japan has accumulated $840 billion in reserves as of July 2005. Dollar has been indeed wedded to the Chinese yuan. China had fixed yuan at 8.27 yuans per dollar in 1994. China's large trade surplus, despite costlier oil imports, shows that yuan should trade at a higher price in terms of dollar. China has raised yuan's dollar value by 2% in July 2005, when it has pegged yuan to a basket of currencies including dollar, euro and yen. But yuan is still bonded to dollar. Dollar is, therefore, not falling as much as it could due to the ballooning U.S. trade deficits of $700 billion annually. Nevertheless dollar has fallen. It indicates that some significant flight of capital from the U.S. has already started.

Asian and other developing nations store their net exports as reserves in dollar, euro or yen. These reserves are basically claims of a country's central bank on the central banks in USA, EU and Japan. Maintaining such reserves is important for nations who have to pay in these reserve currencies for their needed imports of oil, capital equipment and technology products.

9.6 OPTIMAL WAGE FOR PROSPERITY

The biggest question now is: how will the U.S. government and households repay their massive debts of about $8 trillion and $11 trillion, respectively. Household debts have risen from about 96% of personal disposable income in 2000 to 113% in 2004. Such debt build up in a society does not connote prosperity. It is economic bondage due to usurious profits in mega capitalism. Every dollar borrowed has been obviously lent.

How have the lenders created a total of $19 trillions in credits against households and governments of the most powerful nation on earth?

The net global trade surplus of about $2.5 trillion has been stored as foreign exchange reserves. This has been borrowed by the U.S. governments and households through the FRB. Out of this, Japan has lent $840 billion. The remaining $1.7 trillion has been lent by central banks of relatively poor nations like India, Pakistan, Bangladesh and China. The foreign exchange reserves of these poor nations are mainly the wage component of their exports because workers are paid in local currencies created in these countries equivalent to the reserves. Deducting $1.7 trillion from the total U.S. debt of $19 trillion gives about $17.3 trillion, which includes the usurious profits of mega capitalism stored as credits to the U.S. households and governments. These *usurious profits* are due to (i) pittance paid to workers of poor exporting countries, and (ii) high product prices charged and sub-optimal wages paid to the U.S. households.

The argument is not about whether the usurious profits are fair. It is about sustaining such profits in equilibrium. The stability and peace in societies governed by democratic capitalism is more critical than protection of usurious profits. The usurious profits indicate that vast majorities of households have not obviously received optimal income through salaries, wages and other payments.

No one knows what the optimal income is. But the democratic power of an absolute majority of households within a nation will eventually lead to a sustainable equilibrium in which significant parts of the credits are simply eliminated by fiat. It is no longer an issue of giving debt relief to poor African nations. It is debt write-off for the absolute majority of households in the richest nation on earth. Such debt write-off can be legitimized only by new laws that can be enacted by the new representatives of the absolute majority of indebted households. Only a democracy can achieve optimal stability through such new laws, enacted and implemented peacefully for long run prosperity of the society. A democratic restoration of equilibrium will be a remarkable feat. An absolute majority of American households can demonstrate such a feat, perhaps before others, to lead the world.

9.7 CUTTING CONSUMPTION FOR PROSPERITY

The other alternative for American households is to cut their consumptions drastically. It is like following the trails of the Japanese after their stock prices crashed. The Japanese have been diverting most of their disposable incomes towards savings for retirement and children's education. The Japanese investors lost fortunes as Tokyo stock prices dropped 80% in early nineteen-nineties. The American technology stocks have also suffered comparable losses since peaking in March 2000. Many American households lost bundles of their savings in these stocks. The Japanese economy refused to respond to many textbook type fiscal stimuli injected during nineteen-nineties. The Japanese central bank massively increased money supply and yet failed to make the economy grow. The Japanese government lessened regulation of banks and economy. But it resulted in failures of many banks and corporations, soaring unemployment, and weakening household consumption. Prices of consumer goods and capital then dropped. The rate of interest dropped to zero, yet few households borrowed for consumption. Increasing money supply should have stimulated Japanese demand, but it did not. The increase in money supply has raised incomes, but the Japanese are saving most of their incomes to make up for massive losses from declines in asset values. If the government supplies more fiat money, incomes will rise but consumption may still not take off. Japanese households need to consume less and save enough to pay for rising costs of their children's education and longer post- retirement lives.

The Japanese households have been feeling financially insecure ever since their asset price bubble collapsed. Mega capitalists have taken the majorities of Japanese households for a ride on a path to virtual prosperity through borrowing for consumption. Increased consumption raised stock prices and enticed everyone to buy stocks when the mega capitalists sold off to lock in usurious profits. The same game has been repeated over and again in many other countries. People get drawn to rising stocks like insects fly to a heated light source designed to kill them. Mega capitalists know this human psychology and lighten the market by raising prices through manipulation in order to grab the savings from majorities unable to fathom the trap.

The majorities of American households too have been lured to lose their life savings to mega capitalists locking in their gains as the U.S. stock price bubble began to collapse. They will now need to save enough by consuming less to generate enough for their children's education and longer post-retirement living. Mega capitalists have accentuated the sense of financial insecurity for the vast majority of households.

Households' financial insecurity may be due to corporate scandals and stock price bubbles. But if they cut consumption to save more, where will they channel these savings? They will perhaps follow the Japanese in not buying stocks again. Many American households have indeed used their new savings and borrowed more to buy multiple homes or government securities and certificates of deposits. As a result, housing prices have skyrocketed in many parts of USA. If these house prices collapse due to rising interest rates, what will the households do next? They will obviously have no choice other than using their democratic power to restore equilibrium by cutting household credits significantly through new laws.

Lower household consumption can lead to deflation in prices of basic needs. But it will also reduce corporate profits, which will dampen stock prices and make investments in equity unattractive. Risks associated with financial and real asset prices are thus enormous. Realizing this, households can divert their savings to safer investments like bank deposits and government securities carrying very little interest. Long-term interest rates are not rising despite FRB significant hikes in bank rate. This may be due to household unwillingness to invest in risky equity. Lower consumption thus leads to deflation in the price of capital, even to a negative interest rate.

The central bank faces a *dilemma* about following developments which are beyond its control:

(i) Decreasing household needs to borrow and consume.

(ii) Increasing risk of capital flight from USA.

Capital flight is not worrisome if the U.S. government cuts its expenses sufficiently. This means pulling out of overseas ventures and trimming bureaucracy. But it will still not solve the problem of massive usurious profits, which have been generated from sub-optimal wages and stored as household and government credits. Any collapse in housing prices may optimally lead to an exercise of democratic power to cut household credits by fiat, unless interest rates can turn negative due to massive cuts in government expenditures. This dilemma is endemic across central banks of EU, China, India, Brazil and Russia. The U.S. should take the lead to maintain prosperity of the majority of households everywhere.

10 ECONOMIC DELIVERANCE

Freedom is meaningless without economic independence, which cannot be achieved with bondage of debt. At least the absolute majority in a democratic nation must achieve economic freedom. The absolute majority has the democratic power to govern and make rules to enhance its prosperity. It can force public institutions like the central bank to collect and publicize information on household net worth growth, periodically.

The absolute majority in the developed world is already bonded through massive debts owed to mega capitalists. The net worth of a household indicates its prosperity. This yardstick of prosperity is faltering for the vast majority. The GDP growth is not an indicator of prosperity of the absolute majority. Globalization or laissez faire capitalism in a global scale will not beget prosperity of the majority. Mega capitalism propagates myth to the contrary.

The absolute majority even in the developing world is being disillusioned due to economic bondage by home-grown mega capitalists. Mega capitalism in the developing world has forged with the same forces in the developed world. It is to bond the absolute majority everywhere with credits. These credits come from usurious profits created due to sub-optimal household wages.

10.1 ECONOMIC SATYAGRAHA BY ABSOLUTE MAJORITY

The bonded absolute majority seems meek, economically and organizationally. They cannot easily counter propaganda of mega capitalism. Many in the developing world have resorted to violence. But violence never begets prosperity. What is then a peaceful alternative to beget prosperity of the absolute majority?

Principles of *Economic Satyagraha* are optimal if they can be consciously practiced by the absolute majority:

1. Control desires to curtail consumption and increase saving.

2. Develop skills and knowledge for self-reliance.

3. Be rational to avoid orthodox religious beliefs.

4. Live within thy means.

These principles are necessary for economic deliverance and prosperity. People in developing nations like India, Russia and Brazil are already suspicious about bondage via debt. They do not see prosperity dawning on them as advertised. They see the tentacles of mega capitalism more vividly than the absolute majority in the developed world. They may succeed in forcing their rulers to take steps for deliverance from economic bondage.

10.2 TENETS OF EQUITABLE DEMOCRATIC CAPITALISM

How should the absolute majority in the developing world attain economic deliverance? It is through the following tenets of *equitable democratic capitalism*:

A. Collect data on net assets of all households, periodically.

B. Repeal patent laws.

C. Ban short-selling of financial securities.

D. Reduce nominal interest to zero.

E. Cut household debt of the absolute majority.

F. Adopt safe banking law.

G. Raise taxes on the very rich significantly.

H. Cut government debt to zero.

I. Support global democracy.

Previous chapters make economic justification for each of the above optimal tenets of equitable democratic capitalism. The first tenet is very urgent. The absolute majority has the right to know whether its net worth is rising or falling. It has the democratic power to govern and enact rules that enhance its prosperity indicated by its net worth. It should no longer allow itself to be hoodwinked by mega capitalism.

The above tenets of equitable democratic capitalism have been subverted by the current laws that were furtively crafted and implemented via lobbying by self-aggrandizing mega capitalists. A democratic capitalistic society should repeal these rules to beget prosperity for the absolute majority of households.

The majority harbors temptation for striking itself rich under the current laws on (i) protection of patent rights, (ii) short-selling of financial securities, (iii) lower tax rates, (iv) higher government and household debts, and (v) chaotic globalization. The stories of success portrayed in media pander to temptation and euphoria of the majority. The majority cannot realize that it is impossible for it to reach the height of prosperity displayed by the mega capitalists through their controlled media.

Will continued confusion of the majority adversely affect the long-run prosperity of mega capitalists? Yes, quite likely. The absolute majority in the developed world is already bonded. It will eventually realize that its bondage is due to its borrowing of the usurious profits created from sub-optimal wages it accepts. It will then seek economic deliverance from mega capitalism via democratic policy reforms.

A new peaceful revolution for economic deliverance may eventually surface. It may be like the political emancipation forces, unleashed by Gandhi. The Japanese have, for instance, stopped profligate consumption. The Americans and Europeans may follow suit in a quiet revolution to abandon wasteful consumption. Trade unionism may likely reemerge with full vigor to bargain for higher wages and salaries. Then mega capitalism cannot create usurious profits. Cutting consumption can turn the interest rate negative. Many telecom and airline companies in USA and Europe have been generating negative returns on capital investments. An economy can have a negative interest rate if the demand for new capital shrinks across industries due to decline in consumption.

The American prosperity of 1992-2000 was ephemeral. It could not be sustained because of several reasons:

1) Debt-driven consumer demand in the developing world could not be enhanced. The funds lent to the developing nations have been already used up on purchases from the developed nations or usurped by mega capitalists and the ruling elite in the developing world. Fresh boosts in consumption by the developing world needs fueling through new loans from the developed world. But taxpayers of the developed world will unlikely tolerate creation of more public debt to recycle the funds again to mega capitalists and their patrons in the developing world.

2) Capital flight from the developing world has decimated its currency values. For example, Indonesian rupiah (Rp.) was trading at Rp. 2500 per dollar in July 1997. But now it is at Rp10000 per dollar, a 75% loss. Malaysian ringgit lost

about 40%. Other Asian currencies lost similarly. The ruble collapsed, leading Russian debt moratorium. Only the South Korean won has regained most of its lost value lately. Capital is now flowing out of USA to these regions.

3) Developing countries cannot even repay their foreign currency debts because their exports are not rising even after deep devaluation of their currencies. In fact, the developed nations have agreed recently to write off debts of some heavily indebted poor nations in Africa.

4) Many commercial banks in Europe and America had to write off portions of their lending to the developing world. Since commercial bank deposits in the developed world are insured by the government, taxpayers will ultimately pay for losses on bank loans to the developing world.

5) Developed nations may also have to write off parts of their loans to the IMF and World Bank.

Ultimately, the taxpayers of developed nations bear huge losses due to poor public policies. Such policies are generally adopted at the behest of self-aggrandizing mega capitalists. The absolute majority should optimally learn about such schemes and use its democratic power to preemptively thwart mega capitalism. It will otherwise discover that it has turned poorer by the turn of every mega capitalistic scheme.

Whether or not the interest rate inches up in USA, asset prices are likely to deflate, eventually, unless the rate falls dramatically to the negative range. Any virtual prosperity now being supported by a bubbled up home equity can vanish like a dream. Stock prices have already deflated. Real estate prices have not burst yet. The panic moves by the Federal Reserve Board to cut the interest rate to 1% staved off a potential catastrophe.

But lower short-term interest rates generated usurious profits only for mega capitalists. They borrowed short-term loans at 1% to lend home mortgages at 6%. The FRB had to raise the short-term bank rate eventually as inflation picks up.

The common people in the developed nations go through nightmares about their fleeting prosperity. But this is less serious than the predicament of billions of people in abject poverty in the developing world who cannot even dream of anything but nightmares. One wonders how globalization has failed to bring prosperity to the absolute majority anywhere.

Mega capitalism has not fully succeeded in transplanting its game in two most populous nations, China and India. These two countries have failed miserably in many fronts like human rights in China and poverty in India. But perhaps due to their ancient thinking, they have so far circumvented mega capitalism. They seem to have shrewdly encouraged direct foreign equity investments in their economies and desisted from borrowing heavily. Southeast Asian currencies went through competitive devaluation following the Chinese devaluation in 1994. But they slid to abysmal values due to irrational panics and currency runs. Panics and runs were due to unfettered withdrawals of foreign currency deposits and flight of domestic capital off shores. China and India did not permit unfettered withdrawals or capital flights. They trusted their capital and foreign exchange control regimes, despite criticisms from Western champions of free global markets. They withered over the manipulated crisis thrust on Southeast Asia. Their model was later mimicked by Malaysia in October 1998.

People within developed nations, especially USA, are perhaps firm in their belief that lawmakers will ultimately solve massive debt problems by demonetizing debt. American net imports of about US$1.9 billion per day are currently funded by exporters around the world. It is true that some of these exporters are stationed in USA. But a vast portion of funding of imports is from Asian countries. Any hint on demonetization can make mega capitalists located in USA to transfer their funds to remote islands or even to China and India to avoid new American government controls. The consequences will be nightmarish when investors run away from USA.

The strategy of engineering social and political turbulence in the developing world to induce monetary and human capital inflows may have run its course for mega capitalists. This is especially true after China and India have become powerful enough to withstand military and economic threats.

It is naive to expect the formation of a global democracy with the power to collect taxes from developed nations to monitor markets and to enhance prosperity of the rest of the world. But, at the same time, such a global government is absolutely necessary for enhancing prosperity of the absolute majority everywhere.

Each country should devise its optimal policies depending on the constraints it faces at any given time. The policies which are optimal at some time may not be so later. Even India and China may find that free markets are optimal at some point in future. Optimality is to be judged by equitable prosperity for the absolute majority. Whether it is China or India or the developed nations, *equitable democratic capitalism* should be the only norm of optimal governance of societies.

10.3 ECONOMIC SATYAGRAHA BY THE DEVELOPING WORLD

Champions of free markets have failed to argue that a democratic global government is essential for global capitalism to succeed. This is bizarre because no one else will advocate for a democratic global government. Obviously, the government establishments in the developed world will not talk about global democracy. They are not necessarily following policies in the best interest of their absolute majorities. The question then is: how should the developing nations respond optimally?

The developing nations may be poor. But they recognize that global democracy is necessary to beget prosperity of their absolute majorities. They see gloom in a rudderless global capitalistic system. But they still control the vital ingredient necessary to make mega capitalists richer. It is the demand for the products of mega capitalists. The demand stems from desire, which modern economists have characterized as preference or utility. A developing country can control the demand for mega capitalists' products by educating citizens to restrain their desires.

The utility theory has won Nobel Memorial prize in economics. This theory forms the foundation of modern free-market economics. The most interesting aspect of this theory is to link individual desires or preferences for products to demands and prices. The relative utility or desire to have a computer in exchange for food produced by an individual sets the price of a computer in units of food. The willingness to give away ten tons of food grains for a computer sets the computer's price as ten tons of food grains. Thus, underlying the demand is the basic desire of a human being. Individuals of a country may prefer living in the wild, by consuming food and meditating for salvation, to having imported computers. Then the value of computers will be zero in their country. This will prevent mega capitalism from wangling their wealth comprising food stock and labor. Developing nations may respond to the onslaught by the mega capitalism the way it is detailed in the following proposition.

Proposition 10.1 *(Economic Satyagraha): Suppose that mega capitalists do not agree to establish a global democracy with a unified global tax system. Then, developing nations' households will find it optimal to follow Economic Satyagraha, by which they stop buying exorbitantly priced goods.*

Argument 10.1: The households in a developed democracy can keep consuming goods produced by mega capitalists. They can afford to be nonchalant about any usurious profits created due to their sub-optimal wages. This is because they can eventually force their democratic government to raise taxes on the mega capitalists and cut household debts. This possibility can restitute equity for the majority in a developed nation. But households in the developing countries cannot demand such equity from either the mega global capitalists or the governments of developed countries where mega capitalists reside. It is, therefore, not optimal to consume products of mega capitalists residing in developed nations unwilling to adopt global democracy.

Economic Satyagraha is the developing nations' potent weapon against mega global capitalism. The question is whether it can eventually lead to global democracy and a globally equitable tax system. This is possible when every resourceful nation builds up its defense with nuclear weapons and missiles and when no single nation corners all natural resources such as human talent, oil and minerals. This is obviously sub-optimal for human society. But it is the only optimal response of the developing world to current mega global capitalism. Crude oil reserves are spread across many nations like Russia, Saudi Arabia, Iran, Iraq, Mexico, Indonesia and Venezuela. Human talent, the engine for technological progress, is also abundant in all major societies. This means that the developing world can succeed in its optimal response to mega capitalism. It may eventually lead to global democracy with no international rivalry and wasteful national defense expenditures.

Economic Satyagraha is tacitly taking its course. Transfers of wealth to some developing nations like China and South Korea has been taking place of late. Despite rising oil prices, China is importing significantly less than it exports to the developed world. Oil rich gulf countries have also stopped importing much from rich nations. They are generating huge trade surpluses due to rising oil prices.

Free market economists trained in prestigious American schools have taken charge of economies in developing countries like India and China. But they have shunned free capital markets. If China and India have withstood the trying test of 1997 currency runs that afflicted Southeast Asian economies, it must be because they anticipated a chaotic global capital market system without a global political order. No proposal for global democracy has come, though, from the Indian or Chinese policymakers. Any Chinese demand for global democracy will obviously not be credible, given their communist regime. India has always sought, however, a more democratic United Nations and an equitable global order. While the Chinese are unable to articulate their philosophical opposition to democracy, they have stressed on order and stability within their society. The Chinese may have figured out the perils of free global trading and capital markets and hence have maintained capital and currency controls. The Chinese have only recently joined the World Trade Organization after many rounds of negotiations about the terms of trading, especially on patents and intellectual property rights.

Developing countries have no rationale to join a free global trading and capital markets regime without global democracy, even if the distorted patent protection requirements of the WTO are eliminated. They should optimally have global democracy with the power to tax mega capitalists to fund global public facilities. Such demands, though, will not be met. Economic Satyagraha then is the only optimal strategy of the developing world. In fact, this is the only potent strategy available even to the absolute majority in the developed world to thwart mega capitalism.

The absolute majority in a developing nation can enhance its prosperity by optimally practicing Economic Satyagraha until the establishment of global democracy, needed to attain equitable democratic capitalism. The goal is economic deliverance from the bondage of mega capitalists. Economic Satyagraha in a developing nation means to practice the following five principles:

A. **Control desires***:* Control (a) temptation for unwarranted consumption and (b) distaste for saving.

B. **Build defense***:* Build military defense against potential invasion from mega capitalists residing in other nations.

C. **Become self-reliant***:* Create the technology to produce all basic needs like food and medicine in the nation.

D. **Stay rational***:* Dissociate from orthodox religious dogmas to practice rationality to seek and expand knowledge.

E. **Live within thy means***:* Borrow no foreign currency loans and pay off all such existing loans.

10.4 PLEADING FOR ECONOMIC SATYAGRAHA

Even the ancient human civilization teaches to control desires to attain freedom and prosperity. The lust to become wealthy during the American or Japanese stock bubbles lured many to forfeit their valuables. The Saudi Royal family has perhaps lost a large part of its trillion dollar oil fortune due to mega stock games of Wall Street. People in rich nations guzzled the oil to degrade the environment and transfer their incomes to car producers. Thus the oil surplus and household incomes are transferred to Wall Street and auto barons. Who authorized the Saudi royals to squander natural resources away? The law of supply and demand fails to deal with such a vital commodity as oil. The true monopolistic supplier of oil (Nature) is absent from setting a price of a scarce resource needed by humans addicted to automobiles. Oil will perhaps last for fifty years. The absolute majority of households in the developed world will then become destitute.

The developing world may then be living in the Stone Age. Humans from all over the world should optimally pool their talents together to search for alternatives to oil and conserve energy. They should optimally thwart mega capitalists' self-aggrandizing schemes like perpetuation of national rivalries through wasteful national military expenditures.

Social prosperity depends crucially on innovation in governance, economics and technology. Controlling desires is not meant to suppress the quest for knowledge. It is meant to reduce unwarranted consumption and to enhance savings for investment in production of knowledge. Economic independence is not viable without technological progress. Human mind cannot be dissociated from seeking knowledge.

To prosper, a country must produce technologies needed by households. This is the principle of self-reliance. It is spiritual pragmatism, not abstinence. Pragmatic spiritualism is a rational quest for knowledge. It is needed to enhance social prosperity. It is consistent with equitable democratic capitalism, not with mega capitalism.

Peace is necessary for prosperity. A society can be in peace only if individuals rationally discover truths without being prejudiced by orthodox religious dogmas. Such discovery will create scientific knowledge needed to produce human needs efficiently. It will lead to prosperity without subjugation by mega capitalists.

A developing nation may be tempted to import heavily to advance fast. This may exacerbate current account deficits. This is living beyond means. It creates balance of payments problems. This may lead to dramatic declines in currency values as happened in East Asia. Policymakers may hope that their currency will regain its original value. The largest net importer is USA. But depreciation in dollar has not caused much anxiety to the American economy. It is because USA does not make foreign currency loans. Most developing countries do. Developing nations with foreign currency loans must not go by the example of the U.S. trade and budget deficits. Foreign currency loans can make a developing country's currency value vulnerable to mega speculators and arbitrageurs. The fond hope that a developing country's currency value will regain its original value may never materialize. A developing country living within its means will have no foreign currency loans. Its currency is unlikely to suffer from speculation.

Restoring currency values to their fundamental levels after precipitous falls is impossible for some developing countries like Malaysia and Indonesia. This is due to several reasons:

- Stringent laws on foreign ownership of local properties.

- Reluctance of people from developed countries to move to take advantage of depressed currencies in the developing world.

- Preference of exporters to keep their country's currency depressed to buy more assets in their country, by using more of their currency exchanged from the same volume of their exports. Exporters can also manipulate their currency and capital markets to influence their governments. Such manipulation is impossible if many foreigners or expatriates can be attracted to live in the country with a depressed currency value. This can happen if foreigners and expatriates are induced to attach the same value to assets as locals do. They will do so only if the system of governance and physical infrastructure of the nation is improved.

The political and economic systems of developing countries can be as transparent as in developed countries. Yet, the reluctance of rich foreigners to move to a developing country makes it harder for the latter to restore currency and asset values. Temporary currency devaluation may self-correct for a country with enough expatriates returning with their riches to compete with local exporters in buying local assets. To induce expatriates to return, the country must have a transparent political and financial system. In any case, developing countries should not engage in profligate imports with a fond hope that their currencies will recover after falling. Living within means is thus crucial for developing countries. This is surely an optimal response to mega capitalism.

There is no need to attach a lot of importance to exchange value of a currency as long as a country is self-reliant and is living within its own means. The sum total of all incomes is the gross national product of a country. Measuring the strength of a country by the GNP is misleading. This is because skills and strengths needed to produce all basic human wants within a country have nothing to do with income disparity across countries. The income disparity measured by a certain hard currency is mainly due to barriers on free flow of human capital across nations and international military rivalries induced by mega capitalism. These barriers make the currency exchange rates virtual and artificial. The same computer programmer earning $10000 annually in India increases his income ten-fold when he walks over to USA. Mega capitalism has created the barriers to immigration. It has done so to retain the artificial differences in incomes for the same skills across nations. A top Indian nuclear scientist getting $15000 annually is able to engineer the same controlled thermo-nuclear explosion as an American scientist receiving about ten times as much. If a developing country cannot be induced to buy artificially high priced merchandise from mega capitalists, the barriers and artificial exchange rates will be irrelevant to the prosperity of households in the country.

For a country to prosper, the skills of its people must advance to generate needed products and services. Developing countries need not pay attention to income disparities across nations arising out of artificial curbs on human migration and currency exchange rates. Endogenous production of needs will obviate imports at exorbitant prices. If India must rely on the West for some of its needs, it will have to pay ten times more than the cost of producing the items endogenously. This is a transfer of wealth from India to the mega capitalists due to artificial barriers and exchange rates.

Producing all human needs efficiently within a nation is an essential prerequisite to make the nation prosperous. This is a sub-optimal strategy for the global humanity. But it is optimal under the constraints imposed by mega capitalism. Self-sufficiency in production of all needs is necessary for freedom and prosperity of a society, given the barriers created by self-aggrandizing mega capitalists. Dependency on foreign currency loans through the IMF or WB or directly from the developed nations is a trap for the majorities of households of a developing country. This trap is designed by self-serving mega capitalists.

Larger developing countries with greater diversity in skills and services are better positioned to prosper than others. Free market assumes that the currency exchange rate will ensure parity in the true value of a basket of goods and services across countries. But artificial barriers in terms of mobility of skilled people across boarders cannot bring exchange rates to their true levels. Barriers on migration are not racially motivated. They are motivated by mega capitalism. Barriers are a reality. The developed world needs to be careful to open its markets for products at exorbitant prices to prevent transfer of wealth to mega capitalists. Opening up the markets as prescribed by self-serving mega capitalists will only increase the foreign currency loans to economically subjugate the majorities of households in the developing world.

The perils of foreign currency debt can overwhelm a developing nation and subject its citizens to eternal poverty. If, however, a developing country awakes at the first sign of trouble - as in India during 1991 or in Indonesia in 1998 - to correct the system, they can eventually recover from the foreign currency debt spiral. Preventive policies are better than the post-mortem response to calamities.

The developing world should optimally follow transparent monetary and fiscal policies. This would eventually help them raise domestic-currency denominated debt in international capital markets. This is a strategic necessity for the developing world. The developing countries should induct only direct equity investment from foreign countries with agreements to repatriate profits. Profits repatriated as dividends can be converted only at the prevailing exchange rate, circumventing any pressure on currency value. Dividends are also taxed before repatriation. Allowing local companies to raise foreign currency debt can be risky to a developing country. It is because such debt involves repayments of interests which are not taxed before repatriation. Any foregone taxes mean less public facilities for common people than would be feasible if foreign equity investments were sought. Foreign currency debt repayments are also fixed obligations denominated in a foreign currency. They can adversely affect the exchange rate if foreign exchange reserves deplete at a time of repatriation, as happened in East Asia. A decimated currency value can invoke unwarranted interference by mega capitalists and the IMF. Policies prescribed thereafter by the international authorities will invariably generate inflation, unemployment, high interest rates, and social chaos.

The problem of foreign debt would not be as severe as it was in East Asia in 1997 if the international lenders had a long-term interest in prosperity of the regions they were lending. If the German and Japanese lenders to Indonesian companies preferred to live in Indonesia due to lower cost of living, there would be a flood of immigration into Indonesia. Such immigration would have restored the currency and property values in Indonesia.

Instead of foreign lenders flocking to Indonesia, local wealthy Chinese Indonesian lenders deserted the country with their money due to a fear of prosecution by common Indonesians. Indonesians rioted against the wealthy Chinese who had made significant contribution to the economy. The process of economic demise fed into political and social unrest, which accentuated the collapse of the Indonesian economy.

The Texan economy also had collapsed during late nineteen-eighties due to debt-driven building of over-capacity for production and office facilities. It was somewhat similar to that of East Asian over-capacity build up. But people from the rest of USA flocked to Texas to avail of the low cost of living. Texas revived in a few years due to immigration. Such immigration could have solved the East Asian crisis. If there were sufficient number of people from around the world to compete for acquisition of assets in a country with a decimated currency, then the system would have self-corrected. If, however, there are only a limited number of individuals willing to buy the assets of the country with a devalued currency, any restoration of normalcy will be almost impossible because there will be no competitive bidding for assets.

The principle of living within means may make the Asian juggernauts like China and India replace their foreign currency loans with global bonds issued on their currencies. The Chinese and Indian bonds can be traded like the U.S. or Japanese Treasury securities. Future foreign investments in these countries will then carry the same type of exchange rate risks as in any developed nation. These nations still face hurdles. China did not even have a central bank until 1995 to pursue transparent monetary policies necessary to thwart transfer of wealth. The central bank of India gained some independence only in 1991. These two giant nations with massive production capacities are yet to recognize the games played by mega capitalists in tandem with the IMF and the World Bank. The People’s Bank of China and Reserve Bank of India have not yet gained the same level of independence as the Federal Reserve Board of USA and Bank of England of UK. A central bank's independence from governmental interference is crucial to pursue transparent monetary policies to win the trust of global investors including the mega capitalists.

11 EPILOGUE

Democracy grants equal rights to all. Yet, it has made only a tiny fringe ultra-rich. The absolute majority sill chases after a mirage of wealth.

Democracy has fostered inequity. This is ironical, but true. The absolute majority cannot prosper before resolving this paradox of inequity within democracy.

How does a tiny fringe turn ultra rich and dominant in a democracy in which the absolute majority enjoys power? The fringe first campaigns for enhancing prosperity of the absolute majority. It makes credible promises to get the vote. Promises like tax cuts and defense build up nurture hopes for prosperity and security. Once in power, the fringe makes the government borrow from it the usurious profits it creates from businesses with the government. The businesses are based on furtive schemes that appear to beget prosperity and security of the absolute majority. Mega capitalism is thus born. It lends the furtively accumulated usurious profits as credits to governments and households. The absolute majority thereafter is subjected to debt bondage by a tiny fringe. The fringe continues with newer sly stratagems to grow its income and wealth and bond the majority to toil for sub-optimal wages. By the time of discovery of such asymmetric wealth creation schemes, the fringe has grown richer.

The continuation of wealth of a fringe depends on its skills to create and perpetuate mirages of mass prosperity and security. Consider a *mega strategy*: (i) Create a belief among the majority that an invasion of Iraq will enhance security and beget prosperity for all. (ii) Don't tell that the cost of war is $250 billion or the annual interest cost on these funds is more than Iraq's oil revenues. (iii) Don't hesitate to sacrifice ordinary Americans as soldiers in war. Who turns wealthier from this strategy? Iraq war has raised public debt enormously, soaked the fringe further with new tax breaks, and made defense contractors and oil barons richer.

The mirage of prosperity and security lures the absolute majority to vote for some articulate fringe into power. The fringe keeps inventing new asymmetric wealth transfer schemes for self-aggrandizement. Like thirsty nomads in a desert endlessly race behind a mirage of water, the absolute majority follows the fringe to become wealthy some day. That day rarely comes, if at all, for the absolute majority. But the fringe-controlled media perpetuates a myth that only *mega strategies* can beget social stability and prosperity. The media's incessant portrayal of success stories of only a few of the poor turning rich are designed to delude the absolute majority. The media rarely debates why data on net assets of individual households are not collected. Is it to suppress the truth about real prosperity of the absolute majority? Perpetual delusion of the absolute majority is vital for a fringe to stay in power in a democracy. It is necessary to maintain tranquility about disquiet due to inequity.

The absolute majority cannot easily decipher inequitable wealth transfer schemes until it is too late. It stays steeped in its quest of a mirage of prosperity. A small tax refund makes it forget enormous tax breaks usurped by the fringe. It cannot fathom the future tax burden on its posterity due to repayment of household and government debts owed to a fringe. This decays the long-run prosperity beyond immediate comprehension.

The fringe has imposed on the American society a mega Ponzi scheme of borrowing forever larger and larger sums to grow consumption. Ponzi schemes eventually unravel. The mega Ponzi scheme too will crack. The absolute majority will then discover how it frittered away prosperity despite its democratic power.

Economic theories are based on maximization of the utility of wealth. This is because an individual's utility rises as the wealth increases. But the economists who have championed such utility theories have mysteriously failed to institute a system of measuring and disseminating information on household wealth of a society.

Democracy has lost its tooth. It has become a façade for autarchy. An autarchic cartel is prospering through the toothless democratic capitalism. It is not a stationary group of individuals. It can comprise a fringe of Romans, British or Americans. But it behaves similarly towards the absolute majority everywhere.

Capitalism encourages entrepreneurship. This generates human needs efficiently. Communism forces people to work on equal wages offering little incentive to ingenious individuals to produce their best. Capitalism has triumphed over communism. But capitalism has turned avaricious with a goal to amass wealth by subjugating others. Mega capitalism makes the majorities race behind mirages of wealth. It controls material resources, charges high product prices and pays low wages to people who actually produce wealth. It lends the usurious profits to households and governments to boost consumption. Both prices and wages are controlled by autarchic mega capitalists.

The net disposable income is falling in a developed nation like USA. The household net worth has also shrunk, if not turned negative, for the vast majority. The true barometers of prosperity of a democratic nation should be per capita wealth of the absolute majority of households, voting adults to be precise. *Democratic capitalism* can be *equitable* only if the per capita net worth of the absolute majority of households is measured and broadcasted periodically. By learning any deterioration of its net worth, the absolute majority can then vote for policy reforms. Households may not know even their own net worth precisely. Rising values of their homes may be very deceptive. If a relatively small but significant number of them try to sell their homes at the same time prices will fall precipitously. Individuals may know their own net worth. But learning about any deteriorating trend in the net worth of the middle absolute majority of households will embolden them to vote against autarchic policies. This possibility may have alarmed autarchic rulers to not gather individual household net worth statistics.

The absolute majority of households may eventually learn about any erosion in its prosperity due to mega capitalism. It will then use its democratic power to adopt equitable policies. Only consciousness of the truth about prosperity of the absolute majority can pave the way for equitable democratic capitalism. This can eventually usher an era of global democracy, and eliminate the costly trans-national military rivalry.

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