

# PREFACE

THE FINANCIAL MELTDOWN THAT BEGAN in fall 2008 and the response to it exposed the inequalities of wealth, power and privilege in a way not seen since the Great Depression of the 1930s. Popular outrage came to a head in Canada and the U.S. over million-dollar corporate bonuses, paid from taxpayer-funded bailout packages, to the corporate decisionmakers who brought their firms to the brink of bankruptcy. Protests erupted across the continent as people wondered publicly, “Where’s my bailout?” and demanded a “hand up for the millions of working people on Main Street and not a hand-out to... overpaid executives.”<sup>1</sup> Workers in Canada, facing massive lay-offs or suspecting their employers of planning covert closures, occupied their workplaces, some even welding the doors shut from the inside, to underline their demands for the severance pay they are legally owed.<sup>2</sup> Workers in France went further, engaging in a spate of “boss-napping”—holding their employers hostage until they agreed to keep plants open or negotiate decent severance pay.<sup>3</sup>

While these workers, consumers and citizens blame the corporate elite — including their own bosses — for the crisis, governments have responded with industry bailouts, bankruptcy protection and loans that protect business without cushioning the blow for the rest of us. Far from protecting workers, the Conservatives’ \$3 billion bailout to the auto industry included demands for major wage, benefit and pension concessions from auto industry workers, including permanent job losses for thousands of them.<sup>4</sup> The government’s \$30 million loan to telecom giant Nortel included rich bonuses for corporate executives but not legally and contractually guaranteed severance pay for the company’s thousands of laid-off workers.<sup>5</sup>

Who is to blame for the crisis and where did it start? Will Canada suffer less and recover faster than other countries? Will government bailouts restore consumer confidence and correct the downturn? Contradictory predictions from various experts, including Nobel-prize winning economists, offer cold comfort. Implausible reassurances from Prime Minister Stephen Harper that the crisis in Canada will be shallow and short,<sup>6</sup> a prediction contradicted by no less an authority than David Dodge,<sup>7</sup> former governor of the Bank of Canada, give us little reason to believe our government has the knowledge or the capacity to address the underlying problems.

## BANKRUPTCIES & BAILOUTS

The chapters in this book offer genuine insights into the causes of the problem. They explain the events leading up to the crisis and offer very different prescriptions from those advanced by neoclassical economists, governments and business for solving it. This collection was inspired by a public forum on the crisis held in Winnipeg in November 2008. Several heterodox economists and a historian provided their perspectives on the causes of the crisis in language that was easily understood by ordinary people. The event was so popular that the auditorium filled to capacity and people were turned away. A sequel held a few weeks later filled the hall again. Clearly, people are hungry for answers they can trust.

This book, written in language accessible to non-specialists, provides a guide for those who are unwilling to trust the experts unquestioningly and who want to understand the dynamics of the economy and the financial system. It deciphers some of the terminology that obscures the workings of the financial industry and reveals the high-risk nature of some of the investment strategies that precipitated the crisis. It exposes a history of deregulation and a failure of government oversight but points toward deeper flaws in the system as the real causes. And it offers reason for hope, proposing remedies that would do more than put the deeply flawed system we have back on track. Rejecting a business-as-usual approach, it recommends ways to redirect public priorities away from those that merely support and encourage business to those that lead to human-friendly, environmentally sustainable and socially just outcomes.

This book came together very quickly. Within two weeks after the public presentations, several of us met and agreed to produce a book. We thank the authors not only for their insights but also for working to an extremely tight schedule. The book has been a pleasure to work on, as well as a great learning experience — we hope everyone who reads the book has the same reaction. Thanks, as well, to the folks at Fernwood Publishing. The efforts of Brenda Conroy, Debbie Mathers and Beverley Rach made it possible for this book to be produced quickly and enhanced what you will read.

*Julie Guard & Wayne Antony*

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*Foreword*

# A GREAT LEAP FORWARD?

*Cy Gonick*

ARE WE HEADED TOWARDS A REPLAY of the Great Depression, or is this just a severe recession? Where did it start? Who is to blame? How are we to understand this crisis? How can it be resolved? What does this crisis mean for the other crises — food shortages, climate change? These and other questions are beginning to be discussed in newspapers and journals, at public meetings and in books such as this one. The answers are not obvious. They will be debated for years to come.

## WHAT STARTED THE CRISIS?

In the conventional view, the current economic crisis started in the financial sector in 2007 — the subprime mortgage crash, the failures of Bear Stearns, Lehman Brothers, Fanny Mae and so on — and spread into the “real economy” in 2009. This is what it looks like on the surface, but to gain a real understanding of the roots of the crisis we must look back to the 1970s and the rise of neoliberalism.

Neoliberalism was instituted as a multifaceted policy initiative aimed at reversing the gains won after the Second World War: the remarkable wage advances and an expanded welfare state that brought a measure of security to those who fell by the wayside of the market economy and universal access to some essential services. These gains, mainstream economists argued, created the economic crisis of the mid-1970s, as far too much income was diverted to wages and benefits, social welfare and government services. They claimed that these policies increased prices and squeezed the rate of profit, causing declines in business investment and ushering in the era of stagflation.

The response was savage welfare reforms, including reduced access to unemployment insurance and welfare allowances, a moratorium on minimum wage increases and legislation to weaken the power and scope of labour unions. Freer trade and relocation of production to low-wage countries were calculated to increase international competition and pressure businesses to lower wages and push up labour productivity. Thus was born so-called globalization, which forced the entire world’s population to compete for jobs in the capitalist labour market. To lower labour costs, business computerized

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factories, offices and stores, and relocated production to countries that offered the cheapest labour and the fewest regulations.

The result was exactly as intended. In the U.S., for example, real wages (taking inflation into account), which had risen continuously for 150 years, from 1820 to 1970, stopped going up. Real wages today are at about the level reached in 1967! In Canada, real average earned income in 2004 was still no more than it was in 1982. All the action has been at the top. In the U.S., the average earnings of the highest 1 percent of the income pyramid rose 160 percent between 1975 and 2005. Compensation of CEOs at the top fifty U.S. companies is 350 times the average worker's pay, compared to "only" 40 times a worker's pay in the 1960s and 1970s.

Over the past thirty years or so, to maintain their living standards in the face of falling wages, workers (including the middle class and some professions) increased their hours of work, dug into their savings, added family members to the labour force and — when all this failed to fully compensate for falling wages — took out more and more debt. They borrowed against the increasing value of their homes, accepted the multiple credit cards urged upon them by the banks and credit companies and then proceeded to max out all of them. As a consequence of the debt binge, consumption spending in America continued to soar, enabling the U.S. economy not only to grow, but also to provide a seemingly infinite market for Asia's export-dependent economies and other U.S. dependent economies like Canada.

With productivity rising and real wages falling or stagnant, business looked for outlets to invest their profits. Industry — with East Asia, India, China and Russia adding new factories in record numbers — was awash with production capacity already far in excess of the world's capacity to consume with cash. Capitalists began to invest in all manner of new investment products invented by an obliging financial industry, and the state obliged by deregulating the banks and financial intermediaries. By 2008, only about 3 percent of all market transactions involved money that went toward expanding production. The rest is sheer speculation on the value of, often derivative, paper assets.

The key about derivatives is that they have no intrinsic value. Their value is "derived" from real things or other paper assets based on real things. As a way of spreading risk, loans and mortgages of all kinds were bundled together with other shady financial instruments and turned into securities to be traded internationally. Purchasers who rarely knew what was included in their packages were reassured by embedded credit rating agencies that graded these assets AA or AAA. Investors were further reassured by purchase of financial insurance that spread the risk so thinly that it seemed nobody could get hurt. These so-called credit default swaps allow holders of assets to pay someone else to assume the risk. These devices progressively separate

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lenders from the risk associated with lending, thereby causing risk to be underestimated.

The crisis first showed itself when the U.S. housing bubble burst, leading to mass housing foreclosures, a collapse of mortgage-backed securities and a crisis of the banks that held those securities. The banks then became reluctant to lend out money — in part because they needed to cover their own exposed position and in part because of growing uncertainty about the solvency of their corporate clients and other banks. Everything unravelled in September 2008, with the crumbling of the Big Five investment houses, including Lehman Brothers, by far the biggest bankruptcy in U.S. history. Until the financial meltdown, what looked like the beginning of a run-of-the-mill post-war self-correcting recession was actually the first severe economic crisis since the end of the Second World War.

### **GREAT DEPRESSION, TAKE TWO?**

There are striking similarities between this economic crisis and the 1929 depression: a property bubble, a frenzied stock market boom based on margin buying, clever Wall Street financial innovations and growing income inequality. But at its peak in 1933, U.S. unemployment hit 27 percent and the gross domestic product (GDP) had fallen 43 percent since 1929. Declines of this order will not be repeated. Social programs like unemployment insurance, universal pensions and social allowances are now in place to cushion the blow. More importantly, having learned a lesson from the Great Depression, governments the world over have rushed in to counteract the drop in business investment and consumer spending with massive public spending programs and tax cuts. Central banks are flooding banking systems with liquidity to spur them to renew lending operations and restore credit, and governments are bailing out giant financial and non-financial corporations on the verge of bankruptcy. In some ways this feels like the revenge of Keynesian economics. Having ruled the economic policy roost for a quarter of a century following the Second World War, Keynesian economics was unceremoniously dumped in the mid-70s after being blamed for stagflation. It was replaced by that rediscovered nineteenth-century concoction of deregulation, privatization and free trade under the rubric of neoliberalism. And so the cycle turns. Blamed for the excesses resulting in the financial meltdown and the economic crisis of 2008–09, the economic policy policymakers have returned to Keynesian economics.

### **WILL THE NEW KEYNESIANISM WORK IN 2009?**

The track record of Keynesianism economics is inconclusive at best. From a strictly employment point of view, Franklin Roosevelt's New Deal fell far short of the mark. There were 15 million Americans out of work when he

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assumed office in March 1933 and 11 million unemployed in 1937, when the economy turned down again. Full recovery from the Great Depression arrived only with rearmament and war.

Keynesianism has been given full credit for post-war prosperity, but a massive pent-up demand for goods and services, the baby boom and suburbanization, cheap raw materials, new technology, moderate wages, strong export markets, high levels of investment and a stable international order all combined to create a wave of expansion. The U.S. Marshall Plan, responding to the massive destruction of factories, buildings, homes and infrastructure in Europe, created unusual investment opportunities. Government fiscal stimulus boosted domestic demand too, but it was not the critical factor.

Keynesianism, having been falsely credited for thirty years of prosperity, was inevitably wrongly blamed for the stagflation (stagnant output levels together with raging inflation) that set in during the early 1970s. Though Keynes was not the architect of stagflation, a few decades of continuous near-full employment finally brought the capitalist economy to a standstill.

Michael Kalecki, a brilliant Marxist economist, predicted as much in 1943. A regime of permanent full employment, he said, is bound to shift the balance of power between labour and capital:

The social position of the boss would be undermined and the self-assurance and class consciousness of the working class would grow. Strikes for wage increases and improvements in conditions of work would create political tension.... “The sack” would cease to play its role as a disciplinary measure.... Discipline in the factories and political stability are more appreciated by the business leaders than [even] profits. Their class instincts tell them that lasting full employment is unsound from their point of view and that unemployment is an integral part of the “normal” capitalist system.<sup>1</sup>

So Keynesianism was turfed, replaced by neoliberal policies designed to re-establish unemployment, deregulate the economy, weaken unions and diminish the welfare state. The question is, will the new Keynesian economics of massive bailouts and stimulus provide the answer to the crisis today. There are plenty of skeptics. On the side of the critics, at least six different positions have emerged.

1. The astonishing global fiscal stimulus of deficits, bailouts and *de facto* nationalization of wide patches of the financial sector — already of unimaginable magnitude and scope — together with seemingly unlimited increases in the money supply to restore credit, may be sufficient to halt the free-fall of demand and bring about a recovery, providing they continue and even increase through 2009 at least. But this bailouts/stimulus

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strategy augurs a future where, at best, the next generation will be left with a huge inflationary hangover and an unprecedented tax burden to pay off massive public debt. At worst, the entire structure could collapse under the weight of potentially unmanageable government debts.

2. A fiscal stimulus far in excess of what was on offer in the early months of 2009 (two to three times Obama's first budget, for example) is required to overwhelm the mass layoffs being announced by the day, the dramatic slowdown in housing sales and housing construction, the precipitous decline in consumer spending and the freeze in business investment. All told, in 2009, global stimulus amounts to only 1.5 percent of global GDP, barely enough to have an impact on GDP in 2009 and to increase it by less than 1 percent in 2010. The concern is that ideological resistance (in U.S. and Canada, for example), fiscal inflexibility (in Japan and Italy, for example) and failure to acknowledge the extent of the crisis (in the E.U., for example) will deter public spending and public debt of the required amount.<sup>2</sup>
3. Even more worrisome is the failure to fix the banking system. After \$2 trillion in taxpayer-funded bailouts and capital injections for the likes of Citigroup and Bank of America, the U.S. banking sector remains paralyzed, creating a profound impact on vital credit lines to both businesses and households and sinking recovery of consumption and investment. With mountains of unsustainable debt, the banking system does not just need more cash, as has been proposed. According to New York University economist Nouriel Roubini, "the U.S. banking system is effectively insolvent in the aggregate, most of the U.K. banking system looks insolvent too and many other banks in continental Europe are also insolvent."<sup>3</sup> Roubini, Martin Wolf of the *Financial Times*, former Federal Reserve chair Joseph Stiglitz, Economic Recovery Advisory Board chair Paul Volcker and others say that U.S. efforts to dispose of toxic assets by taking them off the banks' balance sheets and injecting the banks with capital is doomed to fail. They urge rapid government takeover of insolvent banks, canceling of unsustainable debts and then a quick reprivatization
4. Compounding these problems is the unbalanced structure of global trade. William Greider of the *Nation* magazine summarizes it this way:

Given our grossly unbalanced trade, we [the U.S.] have kept the [world economic] system going by playing buyer of last resort — absorbing mountainous trade deficits and accumulating more than \$5 trillion in capital debt to pay for swollen imports, while our domestic economy steadily loses jobs and production to other nations. Renewed consumer demand at home will automatically "leak"



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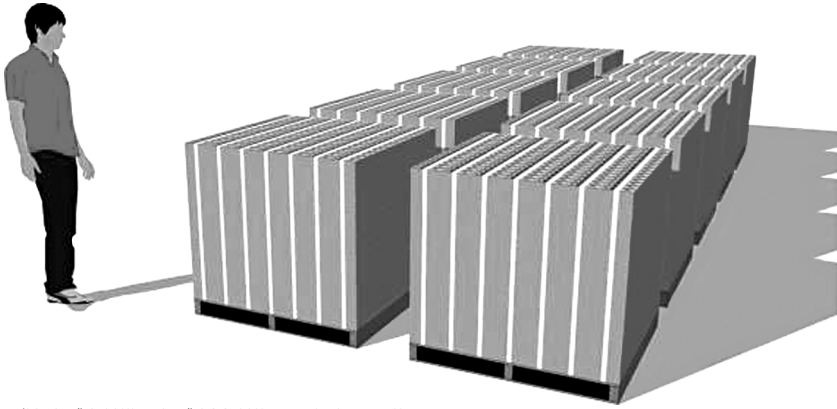
to rival economies and trading partners by boosting their exports to the U.S. markets.... This is the trap the lopsided trading system has created for recovery plans and it cannot be escaped without fundamental reform.<sup>4</sup>

Globalization has resulted in a synchronized worldwide crisis because all economies have become integrated with the U.S. at the core of the world economy. For instance, all the Asian economies, including the world's second and third largest, Japan and China, are export-dependent. Asian economies are integrated with China at the centre of a global supply chain that collects parts for cars, electronics and many other products for assembly and re-exportation to the rest of the world. Ultimately, they all serve the rich consumers of the world, especially the American consumer. With U.S. consumption levels slumping, Japan, China and the rest of the Asian economies are falling like dominoes. To fix the problem, Waldon Bello, of Focus on the Global South, calls for deglobalization — more self-reliant, less export-dependent economies with more emphasis by developing countries on regional integration.<sup>5</sup>

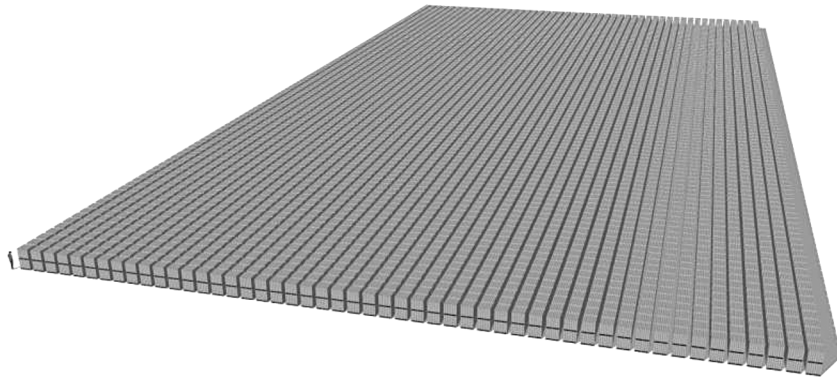
5. We could be heading towards nasty-sounding stag-deflation.<sup>6</sup> Massive industrial overcapacity along with a huge inventory of unsold housing stock will dampen new investment spending in industry and housing for years to come. Debt-burdened households, anxious about joining the growing mass of the unemployed, are cutting back on consumption spending. A glut of unsold goods and underutilized capacity, together with falling commodity prices and falling wages, means that deflation (falling prices) rather than inflation could be the next problem for world economies. Once deflation takes hold, it can spiral, deepening and prolonging recession, because consumers scale back spending in the hope that prices will fall even further. And because the face value of a debt is fixed and not adjusted to match deflation, the debt burden of households, businesses and governments will effectively rise. It becomes a vicious cycle that feeds on itself, that could result in several years of stagnant or falling output and high unemployment. Policy options are limited. Bank of Canada governor Mark Carney's proposal to print money until deflation goes away is no answer. According to Rubini, easing access to credit "is like pushing on a string when the problems of the economy are of insolvency/credit rather than just liquidity; when there is a global glut of capacity... because of years of overinvestment by China, Asia and other emerging markets; and strapped firms and households don't react to lower interest rates as it takes years to work out this glut." Rubini's solution is a combination of massive fiscal stimulus and extreme credit availability, along with immediate takeover of insolvent banks and a

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### *Bailing Out Capitalism: This Is What Just \$1 Trillion Looks Like*



*This is \$1 billion in \$100 bills, stacked on pallets.*



*This is \$1 trillion in \$100 bills, stacked two pallets deep.*

(We have made every effort to find the origin of this image but it is reproduced on “trillions” of websites and is uncredited.)

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- major reduction of mortgage and other consumer debt.<sup>7</sup>
6. Solving Class Conflict: Yet, even if all these obstacles were somehow overcome, another crisis would be generated from the contradictions of the recovery. This is what happened in the 1970s. Two decades of full employment and an expanding welfare state moved the social wage in favour of working people, squeezing profits. The current bailout/stimulus solutions are only temporary at best because they avoid the class conflict that is the ultimate source of crisis. As Richard Wolff argues, “Conflict between corporate directors and productive workers helped to produce

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both the wage stagnation of the last twenty-five years and the resulting surplus bubble that swelled and then burst in 2008. Class conflict has always contributed to capitalism's systemic instability."<sup>8</sup> Wolff says we need to insist that systemic solutions be part of public discussion and public policy.

Rather than acknowledging systemic causes of crises, blame is cast on every imaginable scapegoat. "Excessive greed" of irresponsible business leaders is one favourite — which conveniently ignores that Gordon Gekko's "greed is good" line<sup>9</sup> has been capitalism's mantra from Adam Smith to Milton Friedman. Michael Parenti reminds that, "capitalism breeds venal perpetrators and rewards the most unscrupulous among them."<sup>10</sup> Blaming inadequate state regulation is another favourite — but it ignores the fact that capitalists always find ways to evade or weaken state regulations that constrain them and that, in any case, once an immediate economic crisis is past, state interventions are eventually dispensed with.

Bailouts, (re)regulations, monetary and fiscal policies may help the world's economies get past this downturn, but by not addressing class conflict, they never solve the problem of recurring downturns. Moreover, they avoid even somewhat radical reforms like making the state the employer of last resort, in addition to its current role as banker or insurer of last resort, or nationalizing housing and the energy industry, not just the financial industry. These are good reforms but recurring capitalist crises are inherent in capitalism and nothing short of institutional changes that eliminate class conflict will change that. As Wolff argues, even nationalization that simply replaces shareholder-elected boards of directors with state-appointed boards of directors is insufficient. Reorganized enterprises with workers' collective boards of directors would remove a key cause of capitalist instability, but this would constitute just one far-reaching change towards transformation to a post-capitalist economy.<sup>11</sup>

## WHICH PLAGUE IS WORSE?

Governments have given approximately a fifth of GDP in public funds to the banks and other financial institutions to compensate them for their losses and to exchange their toxic assets for good central bank money. Yet comparatively little is available for fighting climate change, which, according to Nicholas Stern's report for the British government, will cost a fifth of the global national product over the next decades unless it is prevented.<sup>12</sup> Which plague is worse, asks the German economist Elmar Altvater: the massive losses of the global financial crisis or the astronomical costs of climate change?<sup>13</sup> Once the icons of Wall Street began crumbling in September 2008, climate change was fast forgotten, along with the energy crisis (peak oil), as were the billion

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people in the world suffering from hunger.

One way to view this is to consider that some year down the road the global economy will recover — at least until the next crisis occurs — but many of the losses of climate change are irreversible. Yet most are losses to the commons and affect corporate bottom lines only indirectly or over time. Capitalism is poorly constructed to transform the economy to a post-carbon world. After what we have experienced with capitalism's financial and economic holocaust, who among us is confident in the capacity of markets to reallocate investment from old energy to wind and solar energy and to avoid nuclear energy, the most dangerous in the world, and the tar sands, the dirtiest oil in the world? Or to avoid commercializing the seabeds and continuing the biofuel fiasco, which diverts more than a million tons of grain from human diets to North American car engines? Or that carbon trading — with a carbon-offset market that has so far produced only minimal improvement in the global carbon balance sheet — will not resemble the frenzied speculation in derivatives and credit swaps?

All the modern plagues are the product of the profit system and unbridled capital accumulation. Like people everywhere, new generations of Canadians are making this discovery and beginning to contemplate some of the very radical changes that are needed to make a different world. Where will this go? In the final analysis, there is a political crisis that is every bit as problematic as the economic crisis and the ecological crisis. Without a structured political movement capable of building a mass mobilization in the rich countries of the world there will be no enduring solution to either the economic or the climate crisis. This is clearly the most challenging political task of our time.

### NOTES

1. Kalecki, "Political Aspects of Full Employment," quoted in Gonick, *The Great Economic Debate*, p. 82.
2. See Krugman, "The Big Dither."
3. Roubini, "It's Time to Nationalize."
4. Greider, "The Crisis Is Global."
5. Bello, "Deglobalization."
6. See Roubini, "The Coming Global Stag-Deflation."
7. Roubini, "The Rising Risks of a Global L-Shaped."
8. Wolff, "Actually, It's the System."
9. Gordon Gekko was a leading character, a wealthy and unscrupulous corporate raider, in the 1987 movie, *Wall Street*, directed by Oliver Stone.
10. Parenti, "Capitalism's Self-Inflicted Apocalypse."
11. Wolff, "Actually, It's the System."
12. Stern, "The Economics of Climate Change."
13. Altvater, "The Plagues of Capitalism."

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