

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE
WINTER WARNING



Exit the Eagle –
Enter the Dragon

When U.S. President Barack Obama embarks on his Asian trip this week, his broad agenda will be well-paved with good intentions and lofty aspirations.

The President has long signaled that the United States wants to improve its working relationships with the powerhouse nations of East Asia. This resurrected U.S. initiative underscores the President's conviction that having economic and military influence in the area is critical to American interests. Indeed, in a recent forum at the Center for American Progress, U.S. Deputy Secretary of State James Steinberg commented: "We really see our engagement with East Asia as critical to our own future." However, given the growing economic presence of China in the region, America is certainly faced with an uphill challenge, especially in the theatre of international trade. As Singapore's former Prime Minister, Lee Kuan Yew stated in Washington last week: "If you do not hold your ground in the Pacific, you cannot be a world leader." The problem is that the Obama Administration needs more than good intentions because America is leaving itself behind, as the rest of the world tries to liberalize trade. U.S. Council of Foreign Relations official Evan Feigenbaum states it succinctly: "The business of Asia is business. What you've got is an Asian challenge to President Obama in the economic arena that his predecessors didn't face. Whatever good things the (Obama) administration is doing ... there is no substitute for economic engagement."

Today, America is the world's biggest debtor nation and China is the biggest creditor nation. In a recent special report entitled 'The Odd Couple', the financial publication The Economist states that "underlying their strategic competition is China's economic rise. Its huge foreign exchange holdings mean Chinese investment in the West will grow rapidly in the coming years and to cap it all, China

owns \$800 billion of American Government debt – enough to give it (the) power of life and death over the American economy. China's economy is still less than a third the size of America's at market exchange rates. Its Gross Domestic Product (GDP) per head is one-fourteenth that of America's. With America's economy in tatters and China's still growing fast, many politicians and intellectuals in both China and America feel that the balance of power is shifting more rapidly in China's favour. President Obama and his Chinese counterpart Hu Jintao must stress the need for (economic) co-operation and avoid playing up their simmering trade disputes, fearful of what failure to co-operate could mean".

According to the World Trade Organization (WTO), the U.S. is party to only five of the sixty-four trade pacts that have taken effect since 2005 – with Australia, Morocco, Bahrain, Oman and Peru. The Obama Administration has put on hold its participation in the Trans-Pacific Partnership, a group of eight Pacific nations interested in negotiating free trade deals. However, China and the Association of Southeast Asian Nations are currently creating a free-trade zone, modeled in part on the North American Free Trade Agreement. Meanwhile, South Korea, Japan and China have begun discussing the possibility of creating a free-trade zone between their countries as well. While President Obama is committed to free trade, analysts have criticized his administration for failing to enunciate a clear trade policy. Moreover, the Obama administration has adopted a more aggressive stance against dumping from China and other countries, prompting charges of protectionism from abroad. In her new book, Gravity Shift – How Asia's

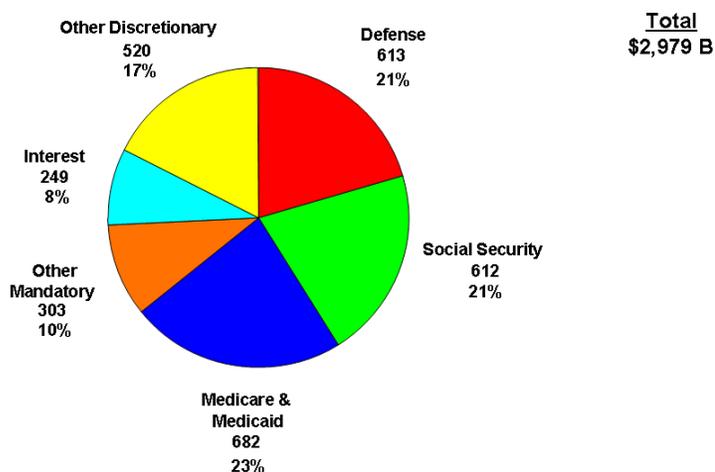
New Economic Powerhouses Will Shape the 21st. Century, author Wendy Dobson of the Rotman Institute for International Business anticipates by 2030, that China’s economy will be larger than those of the United States, India and Japan; though its population will be aging and its growth slowing. India will also come into its own, making major strides in modernizing its vast rural population and emerging as an innovative manufacturing powerhouse. A China-India free-trade agreement could well become the foundation of a co-operative Asian economic community.

America’s Date with a Destiny of Debt

Over the decades, successive entitlement programs created by Democratic Presidents have placed the U.S. Federal Government on the path to financial Armageddon. The three largest entitlement programs are Medicare, which provides basic health insurance for seniors; Medicaid, a subsidized minimum of health care for the poor; and Social Security. Medicare has an unfunded liability of \$36.4 trillion (U.S.) and Social Security’s is \$17.5 trillion (U.S.). President Obama has added to the government’s liabilities by several trillion dollars with his financial bailouts of AIG; General Motors; Chrysler; as well as a \$750 billion (U.S.) stimulus package; the ‘cash for clunkers’ program and the \$8,000 (U.S.) tax credit for first time home buyers. Add new health care taxes and insurance costs to the above list and the National Debt, already above \$12 trillion (U.S.), continues to soar. James Capretta, a fellow at the Washington-based Ethics and Public Policy Center states that the Obama administration is “almost doomed to repeat some of the histories of the 1960s entitlement expansion, which was disastrous from an economic standpoint.” Indeed, the U.S. national debt is projected by the Office of Management and Budget (OMB) to grow by another \$9 trillion (U.S.) over the next decade (These projections have always erred on the side of optimism). In the meantime, the Congressional Budget Office (CBO) the independent agency which costs out government programs, projects that left unchecked, “federal debt will continue to grow much faster than the economy over the long run.” Harvard University economist Kenneth Rogoff perceives “There is every reason to worry that the banking crisis has simply morphed into a long-term government debt crisis.”

According to the New York Times, “the White House estimates that the government’s debt servicing costs will exceed \$700 billion (U.S.) a year in 2019, up from \$202 billion (U.S.) this year. Also, it is estimated that the government will need to borrow an additional \$3.5 trillion (U.S.) over the next three years.” Moreover, the U.S. Treasury must refinance an enormous amount of short term debt which was issued during the recent credit crisis. Shockingly, Treasury Department officials estimate that 36% of the government’s marketable debt, or \$1.6 trillion (U.S.) is coming due in the months ahead. At a November 4th. meeting of the Treasury Borrowing Advisory Committee, comprised of fixed income markets experts who provide guidance to the government wryly commented that “clever debt management strategies can’t completely substitute for prudent fiscal policy.” The chart below depicts U.S. federal spending for fiscal 2008.

U.S. Federal Spending – Fiscal Year 2008 (\$ Billion)



Source: Congressional Budget Office

Long Wave Analytics believes that America's debt crisis will accelerate, since the economy is already in a depression, which will add substantially to the already massive debt levels. As the U.S. Treasury continues to borrow hundreds of billions of dollars, any failure to raise as much money at an auction as planned will send shock waves through the fixed income market. While bond investors are always wary of deficits, currently, there appears to be a belief among many that politicians won't allow projected government deficits to materialize. Surely, these bond investors are in denial: witness the budget problems of California this past summer. According to Standard & Poors, America has been spared a downgrade of its 'AAA' debt rating because of the "unique external flexibility" granted by the U.S. dollar's reserve currency status. As the American greenback continues its inexorable downward slide, eventually, its dominance will fade along with the government's 'AAA' credit rating.

The Vulnerability of a Fiat Currency

History is rife with fiat currencies (paper money) which have been debased in value by the massive debt problems of the issuing state. At the outset of the French Revolution, on September 19, 1789, the Committee of Finance proposed to the French National Constituent Assembly that an issue of 400 million livres in "assignat" mortgage notes bearing 5% interest, be printed for the purpose of paying for the government's most pressing debts. After some debate in the National Constituent Assembly, the confiscation of Catholic Church lands and possessions for the benefit of the State was legislated on November 2, 1789. The term "assignat" was initially intended to represent land assigned to the noteholders, but evolved into a currency used as legal tender. Since there was no control over the amount of notes to be printed, the value of the assignats ultimately exceeded that of the confiscated properties. Accordingly, within a few short years, massive hyperinflation ensued, to the extent that by 1792, "assignats" had lost most of their nominal value.

Eight months following the end of the First World War, in June, 1919, Germany signed the Treaty of Versailles. Article 231, the so-called 'war guilt clause', forced Germany to accept responsibility "for causing all the loss and damage" to its enemies "as a consequence of the war imposed upon them by the aggression of Germany and her allies." In the spring of 1920, the allies estimated their total war expenditures at 632 billion gold marks, or \$158 billion (U.S.). Moreover, the combination of the Weimar's insufficient taxation and excessive spending created enormous deficits in 1919 and 1920. As its financial needs increased sevenfold by 1923, the government decided to increase its dependence on the printing press. Notes in circulation increased to 663 billion reichsmarks by August and the floating debt exceeded one trillion reichsmarks. By the end of 1923, the annual inflation rate had reached 182 billion per cent, rendering the reichsmark worthless and all related forms of wealth fixed in that currency.

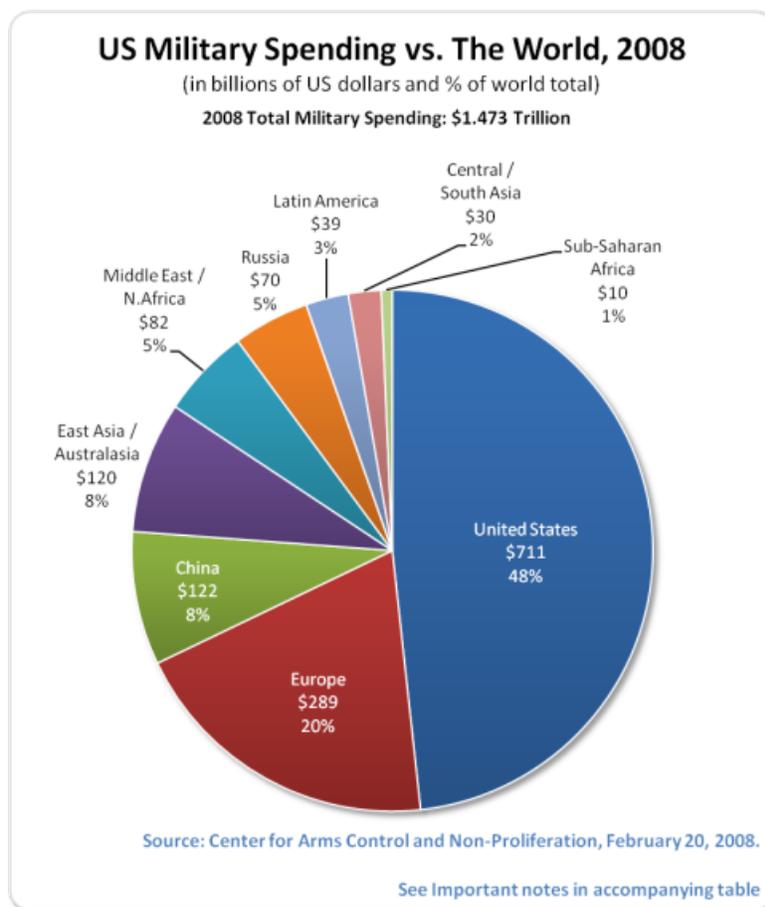
As Long Wave Analytics has maintained for many years, for America to attempt to cure its debt problem by issuing more debt, is unsustainable. While the examples outlined above are representative of hyperinflationary situations, make no mistake, currency debasement can also occur in a deflationary economic environment; as currently witnessed in Japan. It is apparent that America does not have an economic answer to its debt problem beyond the issuance of more debt. The U.S. government has embarked on the financial path of the Japanese, a dangerous route which could reduce its status to "Latin America" over time. Moreover, because exponential debt growth will not work, inevitable tax burdens will fall upon the American taxpayer soon.

Policeman for the World

While visiting Japan in his current Asian trip, President Obama will be discussing American troop levels and security in Okinawa with the Japanese government. The U.S. military presence in Japan totals some 47,000 troops with more than half of them stationed in Okinawa. While U.S. military bases are constructed for training and monitoring purposes; as well as the preparation and storage of equipment, the general public is rather unaware of the extent of their existence. Over the decades, the United States has established a worldwide military presence by establishing an integrated network of military bases and installations which virtually, covers continents, oceans and outer space. In 2008, the budget for the U.S. Department of Defense totaled \$613 billion (U.S.), representing 21% of the country's total budget. In effect, under the guise of waging a global "war on terrorism" the U.S. has succeeded in subjugating seventy countries to its military initiatives, but whose citizens are not necessarily supportive of American hegemony. Information available from the NATO Watch

Committee and the International Network for the Abolition of Foreign Military bases reveals that the U.S. operates and/or controls between 700 and 800 military bases worldwide. In total, there are more than 250,000 U.S. military personnel deployed worldwide. A review of the Okinawa bases, notwithstanding, the ongoing re-deployment of U.S. troops and military bases must be analyzed in thorough manner, with a view to reducing commitments to more reasonable and realistic levels. The annual cost of U.S. military operations on a global basis amounting to hundrebillions of dollars, together with the enormous financial demands of waging wars in Iraq and Afghanistan, are bleeding America dry.

The US defense budget is higher than at any time in its history, with the exception of what was spent during World War II. However, at that time the US was a huge creditor nation. Today, America is the largest debtor nation. Clearly, a choice will soon have to be made; does the United States continue to spend such a huge proportion of her budget on defense, or will she reduce that commitment to increase spending at home, in an effort to bolster her faltering economy? The US can't have it both ways. The decision might well be made by her creditors, who are effectively, financing American military ambitions.



China's Economic and Military Trajectory

China is the world's largest creditor nation and as such, will soon assume a global leadership role. The International Monetary Fund (IMF) estimates that China's share of the global economy will triple by 2050, surpassing America's current share of 22%. In 1995, China's manufacturing output was only 20% of the level of the United States. According to IMF data, it is now in excess of 60% and rising. Addi

tional IMF figures reveal a dramatic increase in annual per-capita income to \$3,180 (U.S.) in 2008 from only \$350 (U.S.) in 1993. China's current leaders are intensely focused on continuing the market and private sector reforms that have given rise to an economic powerhouse and their greatest concern is how to sustain it. Will China be able to offset a recent steep drop in exports of consumer goods to the West with a steady increase in domestic consumption? Personal income growth has mostly resulted from the mass migration of rural unemployed to the factories and construction sites in the big cities. With 30 million workers laid off during the current economic downturn and 20 million students graduating this year, at least 50 million people of the urban population will be job hunting. However, despite a 25% decline in the exports of manufactured goods, China's gross domestic product (GDP) is on track for an 8% growth rate this year, mainly attributable to a huge amount of government stimulus spending. Nevertheless, in its quest for world economic leadership, China's \$2 trillion (U.S.) of foreign reserves could make all the difference when compared to America's rapidly growing national debt of \$12 trillion (U.S.).

Even prior to the credit crisis, some scholars were questioning American economic dominance on the grounds that the Afghanistan and Iraq wars had damaged it both financially and morally. With so many researchers analyzing U.S. economic problems, the Chinese believe that the underlying dynamics of global geopolitics are already shifting in their direction. China is throwing its weight around much more on international issues in which America has a large stake. The U.S. Navy reports six incidents in recent months in the South China and Yellow seas in which Chinese ships have harassed U.S. surveillance vessels. China also sent ships to the Gulf of Aden this year to take part in operations against pirates and some scholars say the Chinese government will need to become much more involved in protecting its citizens abroad. In military terms, the U.S. dwarfs China and will do so for many years, even with Beijing's heavy investment in its armed forces, which boasts a four million man army. Interestingly, because of China's vast U.S. Treasury holdings, it is inadvertently funding the American military budget and then some. Even if China is convinced that American power is waning, it will still not be keen to open confrontation. Rather, China seeks an opportunity to exert more influence, by reining in the U.S. and molding its engagement with the rest of the world. However, China's new military is beginning to raise concerns throughout Asia, over an inevitable shift in the region's balance of power.

Moreover, according to China's official news agency Xinhua, recent remarks by General Xu Qiliang, Air Force Chief of the People's Liberation Army, are a reminder of another area of potential future rivalry between China and the United States. General Qiliang was quoted as saying "Competition between military forces is developing towards the sky and space, extending beyond the atmosphere and into outer space. This development is a historical inevitability and cannot be undone. The militarization of the sky and space is a challenge to the peace of mankind. In the face of this challenge, you don't have a voice unless you have power. Only if you have strong power can you protect and safeguard peace. As the air force of a peace-loving country, we must forge a sword and a shield capable of winning peace." Since American military experts have long warned of China's growing military capabilities, these remarks are certain to be interpreted in Washington, as a clear expression of Beijing's ambitions to counter U.S. power in space. (See also Winter Warning, September 28 /09 – The American Greenback Will Be Cast Into the Hazard).

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