Volume 9 | Issue 2 . September 28, 2009

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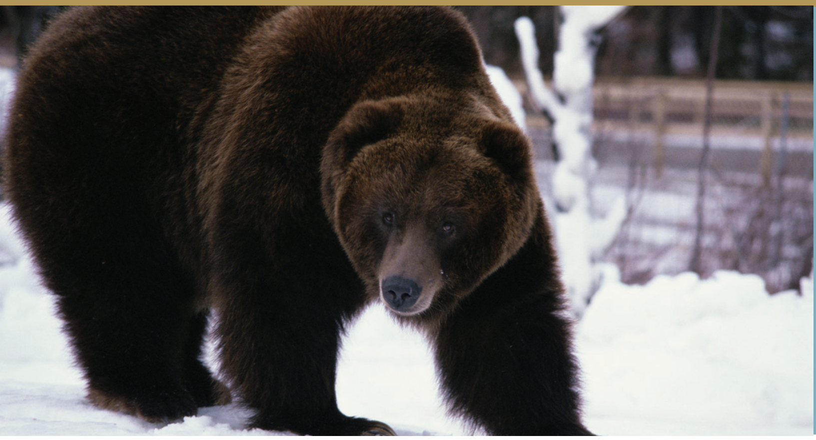
THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING



The American Greenback Will Be Cast into the Hazard

In September, 1931, the world monetary system collapsed and the unfolding banking crisis prompted Americans to buy and hold gold as the ultimate currency and "treasured store of value."

In April 1933, in order to protect American gold reserves, President Roosevelt denounced American gold hoarders and confiscated all privately held gold. By the end of the Second World War, since the United States possessed the highest amount of gold reserves of any modern economy, the United Nations Monetary and Financial Conference at Bretton Woods in July, 1944, sought to circumvent this disparity by designing a new international monetary system. It was decided to establish a quasi-gold standard whereby, countries were guaranteed the right to convert their American dollars into gold at rate of $35 (U.S.) per ounce.

Jacques Rueff, French economist and an advisor to French President Charles de Gaulle, described the arrangements of Bretton Woods for the Americans as "the wondrous secret of deficits without tears. They could give without taking, lend without borrowing and buy without paying." Indeed, in a speech on February 4, 1965, President de Gaulle himself stated that "the time has come to establish the international monetary system on an unquestionable basis that does not bear the stamp of any country in particular. On what basis? Truly, it is hard to imagine that it could be any standard other than gold. Yes, gold whose nature does not alter, which may be formed equally well into ingots, bars or coins; which has no nationality and which has, eternally and universally, been regarded as the unalterable currency par excellence."

By the late 1960s, however, some countries, led by France decided they held too many dollars and began increasingly converting their U.S. dollars into gold. Accordingly, as was the similar situation with President Roosevelt in the 1930s, President Nixon suddenly decided to close the gold window on August 15, 1971. Subsequently, the international monetary system morphed into an arrangement of floating exchange rates, with a faith-based fiat American dollar being globally accepted as the world's reserve currency. In his book, "The Monetary Sin of the West" Monsieur Rueff states that "Since the abandonment of the gold standard, i.e. the only system that ever worked, the world has been moving from one crisis to the next, from deflation to inflation, from economic boom to bust."

Indeed, the United States has gradually abrogated its responsibility as the manager of the global reserve currency by flooding the world with dollars, as a result of its international trade deficit, current account deficit and fiscal deficit. Since March of this year, the U.S. Dollar Index Future – Spot Price, which Intercontinental Exchange Inc. uses to track the American currency against the yen, euro, Swiss franc, British pound, Swedish kroner and Canadian dollar, has steadily fallen by nearly 15% to the 76 level. This orderly decline in the dollar has prompted commentary from several high-profile sources. Nobel Prize-winning economist Joseph Stiglitz has commented that the dollar has a high degree of risk and "the current reserve system is in the process of fraying, so there is a need for a (new) global reserve system". Ian Gordon, President of Long Wave Analytics, has written and spoken of the evils of fiat currencies for many years. This quote from December, 1998, applies equally in the present market: "Today the only thing backing the dollar is debt. It makes far more sense to buy gold today as a hedge against banking failure and dollar depreciation."

In a recent article, the Wall Street Journal stated "a loss of faith in the dollar would be a major blow to America's international reputation and would raise its borrowing costs in the (global) financial markets. If the dollar were dislodged as the world's premier reserve currency, it could temporarily slow the wheels of global finance and trade, until another currency replaced the greenback as the dominant (global) medium of exchange." Claire Dissaux, managing director of global economics and strategy for Millennium Global Investments, a London investment firm specializing in currencies, reports that "There has been a lot of disappointment (in the U.K.) with the way the U.S. credit crisis was handled, but the dollar's loss of influence is a steady and long-term trend."

Throughout all of 2008 and to date in 2009, domestic and foreign investors alike have been accumulating dollar denominated investments in a perceived flight to quality and safety. However, some emerging economies such as China, Russia and Brazil have been expressing doubts about the dollar and the need for re-examining its reserve currency status. Simultaneously, while these countries have not curtailed their purchases of U.S. securities, they are ever vigilant for opportunities to diversify their portfolio holdings. The two largest foreign holders of U.S. debt are China and Japan. According to the most recent data compiled by Treasury International Capital (TIC), foreigners, including private investors and central banks, bought a net $207 billion (U.S.) in long-term Treasurys in the first half of 2009, $97 billion (U.S.) more than in the previous six months. In addition, according to the latest Fed flow-of-funds data, American households held nearly $644 billion (U.S.) in Treasury debt in the first quarter, up from $267 billion (U.S.) in the prior quarter. In a CNBC interview last week, Julian Robertson, legendary chairman of Tiger Investment, stated that the U.S. is "borrowing so much money that we can't possibly pay it back, unless the Chinese and Japanese continue to buy our bonds … because if they don't, it's almost Armageddon" for America.

In his book, "The Dollar Crisis", author Richard Duncan states that "The dollar is destined to collapse because the U.S. economy will soon no longer be able to generate a supply of secure U.S. dollar-denominated investment vehicles sufficiently large to enable the rest of the world to recycle its annual half a trillion dollar current account surplus. The countries running current account surpluses against the United States need to continue buying U.S. dollar-denominated assets to avoid converting their dollar surpluses into their own currencies. Conversion would cause their currencies to appreciate and their exports to decline, throwing their economies into crisis. To avoid that scenario, the surplus nations have to buy either existing U.S. dollar-denominated assets, or new dollar-denominated assets as they are issued."

In a May 24, 2004 speech in Tokyo, Ferdinand Lips, then Chairman of TopGold AG of Switzerland, commented that "Today, money has no more gold backing. Today our money is created by the central banks and by the banking system. Our money is created out of thin air, out of nothing. Today's system of paper money is still very young. It depends solely on the belief that the debts upon which it is based, will be repaid someday. A single one-off event, that could shake this belief and thus the foundation of the financial system, is a robust upsurge in the dollar price of gold. Our fiat system has made it possible that a mountain of debt could be created, the highest in the history of mankind. This enormous (U.S.) debt burden is the biggest threat to the future of our world economy."

The Deteriorating U.S. Debt Dilemma

The fate of the American dollar is inextricably intertwined with the exponential growth trajectory of U.S. Government debt. The United States has been the world's greatest debtor nation since 1988 and at present, there is no end in sight to its soaring level of indebtedness. America's national debt is swiftly approaching $11.9 trillion. Accordingly, U.S. Treasury Secretary Tim Geithner has asked Congress to increase the statutory debt limit from the current $12.1 trillion because it will likely be exceeded by mid-October /09. Both the White House Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) have raised their base line estimates of the Government's deficits over the next decade that will likely result in the near doubling of the U.S. national debt to the $20 trillion range. Also, both of these government entities have projected the U.S. nominal gross domestic product (GDP) to levels in the low $20 trillions (U.S.) on that timeline, meaning from either agency perspective, the U.S. national debt is expected to reach 75 - 80% of nominal GDP by 2019. However, we are presently in the grip of a Kondratieff winter season and Long Wave Analytics is forecasting that U.S. nominal GDP could be halved during the next decade amid a deflationary economic environment, to the $7 trillion (U.S.) level, resulting in the national debt ballooning to 270 – 300% of GDP.

Mr. Duncan further cites that the "the international monetary system is unstable. Because the post-Bretton Woods system has no inherent adjustment mechanism to ensure balanced trade, giant trade imbalances have arisen. Those trade imbalances are flooding the world with liquidity and generating excessive credit creation. Even if the dollar does not crash immediately, that does not mean that the global economy would stabilize, even temporarily. So long as the dollar remains at, or near its current levels, the U.S. current account deficits will continue to generate unsustainable asset price bubbles around the world." Included in America's debt load are the current economic stimulus packages and various government aid initiatives; as well as future spending obligations for Social Security, Medicare, Medicaid, global military obligations, the cost of foreign wars in Iraq and Afghanistan, and other entitlements which the U.S. Government cannot possibly meet without raising taxation levels, cutting back on spending programs, or, a combination of the two. The biggest risk for America is that unless it cuts spending systematically, year-after-year, it may be thrust into the same position that Ireland currently finds itself – a disastrous debt compound trap.

At the State level, declining revenues from income and property taxes leave U.S. states facing new budget shortfalls which may force spending cuts on essential services, such as health care, education and welfare. According to data released by the National Conference of State Legislatures, a research group, lawmakers must close a projected cumulative budget gap of $143 billion for fiscal 2010. States which are forecasting budget deficits between 30-40% of total revenues include California, Nevada, New York and Alaska. States which are forecasting budget deficits between 20-30% of total revenues include Arizona, Washington, Wisconsin, Illinois, Florida, North Carolina, New Jersey, Connecticut and Vermont. Moreover, many states are already projecting deficits for 2011 and even 2012, when federal stimulus money will be minimal. By way of example, the State of California recently rescinded its IOU issuance program, having received a $1.5 billion (U.S.) stop-gap 5-year loan at 3% from JP Morgan Chase. So, since Californians had voted against raising taxes and reducing spending last June, the State's answer was to fight the budget deficit problem by issuing more debt; which is, of course, the road to ruin. California, with a population of 35 million (more than Canada) may prove to be a leading indicator for this style of financial acumen – as goes the Golden state, so goes America!

In a recent report by the Hong Kong and Shanghai Bank (HSBC), currency trader David Bloom states "The whole picture of risk-reward for emerging market currencies has changed. It is not so much that they have risen to our standards, it is that we have fallen to theirs. It used to be that sovereign risk was mainly an emerging market issue but the events of the last year have shown that this is no longer the case. What is occurring is an epochal loss in the relative wealth and economic power of the old G-10 bloc of rich countries compared to rising regions of the world. The euro, yen, sterling, Swiss franc and other mature currencies will be relegated along with the U.S. dollar in this great process of rebalancing, but the greenback will bear the brunt."

The outlook for the U.S. dollar is obviously, closely linked to the performance of the U.S. economy. While there have been some recent economic statistics that suggest the U.S. economy is stabilizing, the continuous flood of foreclosures in the housing sector and the likelihood of the unemployment rate moving higher, suggest otherwise. Moreover, while the U.S. savings rate has improved to 5.2%, the highest level since 1998, it has not been in place long enough to replenish household and investor losses of the last three years. David Walker, head of the Peterson Foundation and former head of the General Accountability Office, states that "unless we see a dramatic fiscal course correction, we are likely to see all sorts of negative consequences, including a reduction in (economic) trend growth rates and growing international distaste for holding American debt." Mr. Walker is among a growing body of observers who believes America's deteriorating debt position could have consequences for the country's national security – even compromising its superpower status. Pointing to the U.K. which saw its 'AAA' credit rating put on negative outlook earlier this year, Mr. Walker says the U.S. faces a similar prospect unless it changes course. Furthermore, in a recent speech, World Bank President Robert Zoellick commented that "The United States would be mistaken to take for granted the dollar's place as the world's predominant reserve currency" – which was immediately refuted by the White House.

We can draw some economic parallels to the critical events of the early 1930s within the current Kondratieff winter cycle, which began in the year 2000, by the recent failure of 115 American banks in the last two years; the multi-billion dollar bailouts of the largest U.S. banks and insurance companies deemed "too big to fail" by the Federal Government; the collapse of the housing market; an unemployment rate approaching 10%; the equity and fixed income market losses in millions of investment portfolios; soaring government budget deficits at the federal, state and municipal levels; several multi-billion and multi-million dollar investment frauds; a pension crisis in both the public and private sectors; the near destruction of the automotive industry; the emergence of distrustful consumers who have been transformed into savers; the huge increase in personal and corporate bankruptcies and a looming crisis in the commercial real estate industry to unfold in 2010.

At Longwave Analytics, we are saying that the worst of the economic downturn is yet to come because the U.S. Government stimulus packages have only delayed the inevitable. The private sector has only transferred its "toxic assets" to the balance sheet of the Federal Reserve and the U.S. Treasury. These "assets" will, not only, prove difficult to unwind, but also, likely be sold at a loss. Moreover, instead of experiencing an economic recovery, as most investors expect, the United States will catapult into the second great economic depression, attendant with a massive devaluation of the dollar. Worse still, with Barack Obama likely to be a one-term President, the American electorate, engulfed in debt and facing inevitable tax increases to pay for soaring government budget deficits, could ultimately embrace a political alternative of scary proportions.

Early in the last Kondratieff winter period (1929-1949), when Great Britain was forced off the gold standard in September, 1931, it precipitated the demise of the world monetary system. In the early years of the current Kondratieff winter, it appears that the world monetary system based on the U.S. dollar is on the verge of collapse. The United States has become the world's largest debtor nation and for far too long, it has taken advantage of the dollar's reserve currency status by simply creating dollars to make international purchases. The dollar's pivotal role within the international monetary system is now in question, just as the pound's reserve currency status was found wanting in 1931.

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