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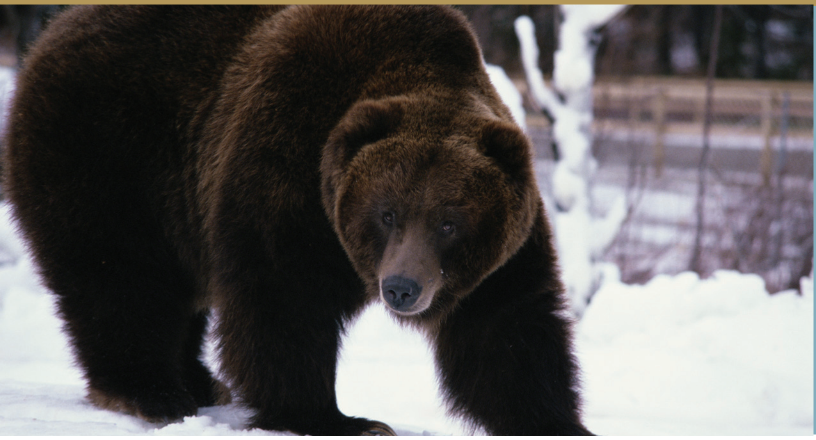
LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING



The International Debt Crisis

An Historic Presidential Condemnation

Recognizing the dangers posed by a nation's adoption of a credit based monetary system, Thomas Jefferson – the third President of the United States of America from 1801 to 1809 – succinctly summarized: "The central bank is an institution of the most deadly hostility existing against the principles and form of our Constitution. I am an enemy to all banks discounting bills or notes for anything but coin (gold and silver coins). If the American people allow private banks to control the issuance of their currency, first by inflation and then by deflation, the banks and corporations that will grow up around them will deprive the people of all their property, until their children will wake up homeless on the continent their fathers conquered." This was quite a prescient warning from the third U.S. President, exactly two hundred years prior to the beginning of the current global economic downturn. Indeed, as far back as 1792, Mr. Jefferson had advised President Washington that to charter a national bank was unconstitutional because Congress had not been delegated the power to incorporate a bank; not under its powers to tax, to borrow, or to regulate commerce. Mr. Jefferson argued: "The still unratified Tenth Amendment held that 'the powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people' … To take a single step beyond the boundaries, thus specially drawn around the powers of Congress, is to take possession of a boundless field of power."

The Villainous Subterfuge of the Central Bank

"An extraordinary reversal of roles is taking shape, whereby the large developed economies of the west (not to mention the emerging market economies) are becoming the servants of global financial activity, rather than its masters. An important by-product is the diminishing economic significance of the individual. The promise of economic freedom held out by the dismantling of state ownership and control has been subverted by a personal and collective enslavement to debt. The parallel accumulation of financial wealth since the early 1980s has obscured this painful reality, but history warns that this situation is unsustainable. When stripped of their capital gains in equities and bonds, today's rising generations will appear overburdened by interest payments and debt repayment schedules. Far from commencing a golden era of economic liberty and economic choice, millions are teetering on the edge of debt default and misery … The author holds central banks largely responsible for the deterioration in economic and financial management since the early 1980s. The criticisms of unaccountability, negligence and inconsistency are directed at the institutions rather than the individuals working in them. Central banks have presided over a drastic reorientation of the financial system with only a belated regard for global stability. These untamed intellectual powerhouses have not demonstrated their readiness to be trusted with such a large measure of economic power. The role of central banks in both developed and emerging countries is ripe for urgent reappraisal.

Apart from financial mismanagement, the only other essential ingredient of the west's predicament is the personal and collective addiction to debt. Indeed, the most significant aspect of financial mismanagement is the failure to confront debt addiction and warn of its consequences. A secondary charge is that central banks have reduced the transparency and stability of the financial system through the promotion of complex innovations which encourage the assumption of risk without responsibility. It is unnecessary to appeal to conspiracy theory in any shape or form to explain the fragility of modern financial structures and institutions … In an age of unprecedented sophistication; the need for level-headed supervision of the financial system is paramount. Whatever freedoms an open society affords, access to unlimited credit facilities cannot be counted among them. In the same way that currency counterfeiting undermines the value of money, reckless offers of credit alongside phony promises of wealth precipitate financial ruin and the misery of large-scale bankruptcy.

In their extreme forms, both counterfeit currency and reckless credit expansion pose a direct threat to the authority of government and the rule of law. Without a legal system and a law enforcement agency, no one would be truly free to pursue his or her own affairs. It is no less true that a centralized authority with powers to sanction and regulate the total supply of credit must circumscribe the financial freedom of individuals. The alternative in both cases is anarchy: the denial of property rights, of access to compensation or redress and a rejection of social responsibility. For the moment, anarchy in the global financial markets masquerades as an agent of national prosperity and personal freedom. It is a compelling disguise, underpinned by many clever arguments and supported by many persuasive advocates. There are some falsehoods that are easily exposed and thwarted, while others are so subtle and complex that they can remain undetected for long periods. The longer they last, the greater the collective delusion and the greater the subsequent disappointment. But one day the mist will clear, exposing the true extent of past follies. The author contends that the leading economies of North America and Western Europe have fallen victim to a dangerous illusion, related to the anarchic development of global capital and credit markets. On one level, the thesis is very straightforward: that both citizens and governments have become heavily addicted to borrowing and no longer care about the consequences."
Debt and Delusion – Central Bank Follies That Threaten Economic Disaster by Peter Warburton 1999. See also, Winter Warning, May 30, 2011 – Fed Up With The Fed.

Ensnared by the Demon of Debt

The current poster child for terminal indebtedness within the euro zone economic theatre is an unfolding Greek tragedy. Indeed, the government of Prime Minister George Papandreou had its debt-rounded shoulders firmly pressed against the wallpaper, as it survived a confidence vote from the Greek parliament. Hanging in the balance is a possible July funding of 12 billion euros ($17 billion U.S.) from the International Monetary Fund (IMF). Luxembourg's Finance Minister Luc Frieden recently commented to the press: "The Greeks must bring to Parliament their austerity measures and their privatization package and they have to implement those measures."

Before the vote, Prime Minister Papandreou called upon Parliament and the people to show responsibility and seize "a critical opportunity to seize the country from default. All Greeks have the duty and the ability to change this country. Our foreign creditors are giving us a helping hand amid difficult times." During the current sovereign debt crisis over the last few years, Greece's continuing problem has been a lack of domestic stability and unity. The population seems to lack an inert and strong work ethic to pull together as a nation and rebuild the economy – long plagued and hindered by a tradition of bribery and corruption. Moreover, it is difficult to make economic progress when tax evasion/avoidance is considered a national virtue – there is no free lunch in this life! The above notwithstanding, Greece's immediate problem is that its finances need an injection of new money at an affordable cost.

In any event, Prime Minister Papandreou must face an even greater challenge this week, when the Greek Parliament votes on the new slate of measures, including tax increases, wage cuts and state privatization, which are required by the European Union (EU), the European Central Bank (ECB) and the International Monetary Fund (IMF) before it releases the next segment of aid that Greece needs to meet its expenses through the summer. John Lipsky, acting managing director of the IMF has recently confirmed: "That needs to be done before we can move forward and we are hopeful that the conditions can be met with alacrity. Greece must receive the 12 billion euro payment before July 15th. or, it will default on its sovereign debt." IMF policy prevents it from disbursing aid to a country that cannot pay its bills for the next 12 months. Euro zone finance ministers publically acknowledge that under the current 110 billion euro bailout, Greece will run short in March 2012, when Athens is expected to be able to return to the bond market for funding. Also, at the appropriate time, the ministers confirmed they were prepared to arrange a second loan package for Greece totaling about 120 billion euros, in order to support the country over the longer term.

Greek protesters gathered in the thousands ahead of the confidence vote. Source: The Times of London

In a worst case scenario of a Greek default and debt restructuring, of the countries which report data to the Bank for International Settlements (BIS), the following 23 countries have a loan exposure to Greece: Australia, Austria, Belgium, Canada, Chile, Finland, France, Germany, India, Ireland, Italy, Japan, Netherlands, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Taiwan, Turkey, United Kingdom and the United States; together with a global assortment of banks, collectively have a total loan exposure of 291.566 billion euros (about $417 billion U.S.) – China's loan exposure, if any, is not disclosed. Importantly, this is why both France and Germany are so desperate to rescue Greece from impending default; in order to protect their domestic banking systems – both highly exposed to Greek debt – from collapse.

The Banking Crisis of 80 Years Ago

In his book, A History of Money and Banking in the United States, 2002, author Murray N. Rothbard recounts: "The major banking crisis began with the bankruptcy of the Boden-Kredit-Anstalt of Vienna in May 1931, the major bank in Austria which had never recovered from its dismemberment at Versailles … Rather than permit the outright liquidation of their banking systems, Austria, followed by Germany and other European countries abandoned the gold standard during 1931. However, the key to the international monetary situation was Great Britain, the nub and the base for the world's gold-exchange standard. British inflation and cheap credit, and the standard that had made

Britain the base of the world's money, placed enormous pressure on the pound sterling, as foreign holders of sterling balances became increasingly panicky and called upon the British to redeem their sterling in either gold or U.S. dollars. The heavy loans by British banks to Germany during the 1920s made the pressure after the German monetary collapse still more severe. However, Britain could have saved the day by using the classical gold-standard medicine in such crises: by raising (administered) bank interest rate sharply, thereby, attracting funds to Britain from other countries. Furthermore, in such monetary crises, such temporary tight credit and checks to inflation give foreigners confidence that the pound will be sustained, and they then continue to hold sterling without calling on the country for redemption. In earlier crises, for example, Britain had raised its bank rate as high as 10% early in the proceedings, and temporarily contracted the money supply to put a stringent check to inflation.

However, by 1931deflation and hard money had become unthinkable in the British political climate. So, Britain stunned the financial world by keeping its bank rate very low, never raising it above 4.5%, and in fact continuing to inflate sterling still further to offset gold losses abroad. As the run on sterling inevitably intensified, Great Britain cynically, repudiated its own gold-exchange standard; the very monetary standard that it had forced and cajoled Europe to adopt, by coolly going off the gold standard in September 1931. Its own international monetary system was sacrificed on the altar of continued domestic inflation.

The European monetary system was thereby, broken up into separate and even warring currency blocs, replete with fluctuating (foreign) exchange rates, exchange control and trade restrictions. The major countries followed Britain off the gold standard, with the exception of Belgium, Holland, France, Italy, Switzerland and the United States. Currency blocs formed with the British Empire forming a sterling bloc, with parities mutually fixed in relation to the pound. It is particularly ironic that one of the earliest effects of Britain's going off gold was that the overvalued pound, now free to fluctuate, fell to its genuine economic value, at or below $3.40 (U.S.) to the pound. So, Britain's grand experiment in returning to a form of gold (standard) at an overvalued par had ended in disaster, for herself as well as for the rest of the world."

Today's overwhelming global debt problem stems from the fiat monetary system in force since 1931; under which the world's central banks have printed vast quantities of paper money. Indeed, it was that very monetary failure, which enabled us at Longwave Analytics, to anticipate the collapse of the current monetary system. "The history of currencies is the history of their destruction. Currencies are born to be destroyed and all paper values denominated in a currency will be destroyed with it" (Franz Pick). **See also, Special Edition, The Long Wave Analyst, January/February 1998 – The U.S. Dollar and the Long Wave.**

The Risk of European Union Debt Contagion

The myriad of debt and financial problems currently affecting Greece, notwithstanding, euro zone members Ireland, Portugal, Italy, Spain and even France itself, are not immune to the potential communicability of EU debt contagion. According to a recent special report in The Economist: "What is unusual about the Italian peninsula is the south's failure in recent years to catch up with north in any way at all. Data from the Bank of Italy shows that gross domestic product (GDP) per person is over 40% lower in the south than in the center and north; and has been for the last 30 years. A third of Italy's population lives in the south, making it 'the largest and most populated underdeveloped region in the euro area,' according to Mario Draghi, the (central) bank's governor … A rosy view of Italy's economy relies on two assumptions that are only half right. The first of these is that Italy is an export-led economy like Germany. There are indeed lots of successful Italian exporters. The second assumption is that a high level of domestic savings, which tend to be conservatively invested in government bonds, or simply parked in bank accounts, insulates the economy from trouble … A better argument for Italy's robustness is that its public debt is so vast that investors cannot afford to abandon it: Italian Treasurys comprise the third largest bond market in the world. For investors who want exposure to bonds denominated in euros, there are not enough other places to go. This apparent strength comes with its own hazards, however, namely vulnerability to a sustained rise in interest rates. Each percentage point rise in interest rates costs Italy an additional 1% of GDP in debt servicing, a scary prospect for a country that has no (economic) growth."

Meanwhile, westward across the Mediterranean to the Iberian peninsula, we find the once-booming Spanish economy still mired in a flat economic growth trajectory, suffering from a 23% unemployment rate, tolerating high bond yields and enduring deficit-cutting austerity measures that are inflicting considerable pain on the population. Spain's endemic residential construction meltdown will take considerable time to recover, since the country's banks still hold thousands of homes in inventory. In municipal elections on May 22nd. the electorate punished the Socialist Party of Prime Minister Jose Luis Rodriguez Zapatero by giving the conservative People's Party, led by Mariano Rajoy, a record ten point lead. If successful in the March, 2012 national elections, a Rajoy government economic team plans to pass a new austerity package, cut corporate taxes and enact more labour reform; with or without union consent.

The United States of America Risks Financial Armageddon

The United States Conference of Mayors

Over the last four years, U.S. municipal finances have eroded as a result of an imploding real estate market, declining property tax revenues and excessive debt accumulation. According to a new report compiled by IHS Global Insight for the United States Conference of Mayors, nearly 50 metropolitan regions – or more than one out of seven – are unlikely to restore all the jobs lost in the last 4 years until after the year 2020. Among those municipalities are Cleveland and Dayton, Ohio; Detroit, Michigan; Reno, Nevada and Atlantic City, New Jersey. Detroit, which lost 323,400 jobs and Reno which lost 36,000 jobs, are not expected to regain all of those positions until after 2021. The report predicts America's 363 metropolitan statistical areas tracked by the U.S. Labor Department will only generate enough jobs to equal levels in the first quarter of 2008, by the first half of 2014. The forecasts do not account for the number of jobs that need to be created just to account for normal population growth. James Diffley, a senior director at IHS Global Insight commented: "As a result, even when the economy regains the jobs lost since (early) 2008, the unemployment rate now at 9.1%, is likely to be significantly higher than the 4.4% it was before the (financial) crisis."

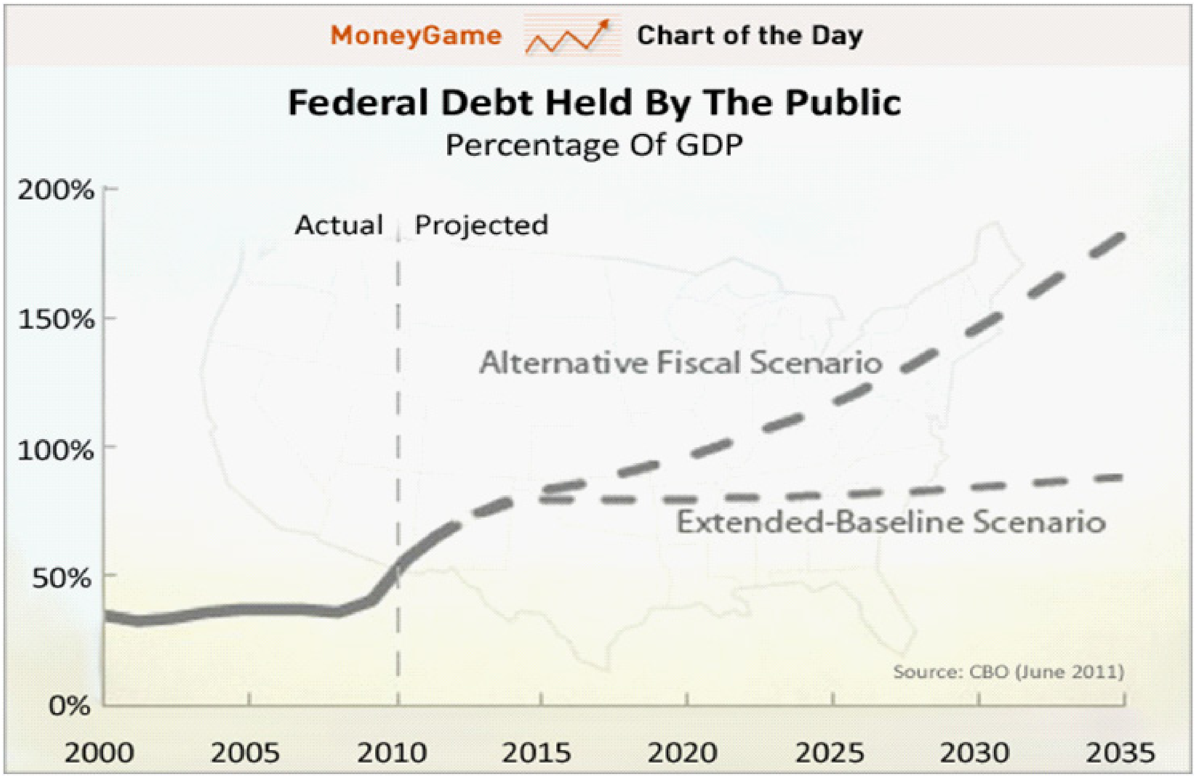
Still in One Hell of a State

According to the New York Times, in a speech last week to a conference on fiscal responsibility hosted by the Chicago Federal Reserve Bank, New York State Lieutenant Governor Richard Ravitch announced a new research initiative to untangle the finances of the states and shed a light on their hidden debts: "Whereas there is enormous public attention to the federal deficit, the problems of the states are very serious and nowhere near very well understood. People have to understand this, and address it with the same degree of gravitas as the federal deficit problem." Mr. Ravitch will lead the project together with Paul A. Volcker, former Federal Reserve Chairman, who together have assembled an advisory board which includes several former cabinet members. The project will research the causes of the current fiscal problems of the states, to what extent they are the result of the 2008 financial crisis, and to what extent they are structural. The new research team will also study the way that states are carrying out "mandates," the services they are required to provide under America's federalist system. The panel will begin by studying the states of New York, Texas, Virginia, Illinois and California.

The Congressional Budget Office

In its most recent report for long-term U.S. Federal debt, the Congressional Budget Office (CBO) notes that America's debt as a percentage of gross domestic product (GDP) was 40% in 2008, but projects it will likely reach 70% by the end of 2011 – the highest percentage since the end of World War II. In its most likely scenario, the CBO projects that America's public debt will be 101% of GDP in 2021 and 190% of GDP in 2035. The CBO warns: "The U.S. budget outlook, for both the coming decade and beyond, is daunting. The retirement of the baby-boom generation portends a significant and sustained increase in the share of the population receiving benefits from Social security, Medicare and Medicaid, Moreover, per capita spending for health care is likely to continue rising faster than spending per person on other goods and services for many years (although the magnitude of that gap is very uncertain). Without significant changes in government policy, those factors will boost federal outlays sharply relative to GDP in coming decades under any plausible assumptions about future trends in the economy, demographics and health care costs.

According to CBO's projections, if current laws remained in place, spending on the major mandatory health care programs alone would grow from less than 6% of GDP today, to about 9% in 2035 and would continue to increase thereafter. Spending on Social Security is projected to rise much less sharply, from less than 5% of GDP today to about 6% of GDP in 2030; and then to stabilize at roughly that level. Altogether, the aging of the population and the rising cost of health care would cause spending on the major mandatory health care programs and Social Security to grow from roughly 10% of GDP today, to about 15% of GDP 25 years from now. (By comparison, spending on all the government's programs and activities, excluding interest payments on debt, has averaged about 18.5% of GDP over the past 40 years.) That combined increase of roughly 5 percentage points for such spending as a share of the economy, is equivalent to about $750 billion (U.S.) today. If lawmakers ultimately modified some provisions of current law that might be difficult to sustain for a long period, that increase would be even larger.



According to the CBO, the Alternative Fiscal Scenario presents the more likely outcome.

The Blog of CBO Director Douglas Elmendorf

"CBO's projections in most of the report understate the severity of the long-term budget problem because they, neither incorporate the negative effects that accumulating additional federal debt would have on the economy, nor do they include the impact of higher tax rates on people's incentives to work and save. In particular, large budget deficits and growing debt would reduce national saving, leading to higher interest rates, more borrowing from abroad and less domestic investment – which in turn would lower income growth in the United States. (Chapter 2 of the report presents estimates of the economic effects of growing debt and the impact of those economic changes on the trajectory of debt under both scenarios.) Rising levels of debt would also have other negative consequences:

• Higher levels of debt imply higher interest payments on that debt, which would eventually require higher taxes, or a reduction in government benefits and services.

• Rising debt would increasingly restrict policymakers' ability to use tax and spending policies to respond to unexpected challenges, such as economic or financial crises

• Growing debt would also increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government's ability to manage its budget and the government would lose its ability to borrow at affordable rates."

The Debt Crisis of 80 Years Ago

In his book **The Coming American Revolution**, 1934, author George Soule recounts: "Public debts have also increased tremendously in recent years. The federal debt, of course, had its big growth during the War, then was gradually reduced until 1929, when it began to mount again during the Depression. In 1933, it was 11.2% of the total debt in the United States. Whether it is a serious element of rigidity depends upon the fiscal policy of the government. If the government borrows more during a depression, in order to maintain or increase its expenditures, it utilizes credit resources which would otherwise be idle – since private enterprise can usually borrow little at such a time – and the spending of the money helps to maintain a higher level of (economic) activity than would otherwise be the case. If it then pays off its debt during periods of prosperity, it helps to counteract the expansion of debt incurred at such a time by private enterprise. Thus, the government can theoretically, help to neutralize the injury caused by the rigidity of private debt.

There remains to be considered the method of levying taxes to pay the interest and amortization charges. If graduated income and profits taxes are used, these charges are paid by those best able to pay them, and no appreciable addition is made to fixed costs. But if sales taxes, import duties, excise taxes and the like are resorted to, the tendency is to increase the costs of business and stiffen their rigidity. The trouble is that private interests act in such a way as to prevent the government from pursuing a sound fiscal policy. They interfere with the rapid paying off of the debt during prosperity, because this means high income taxes. For the same reason, they oppose expansion of the debt during depression. They also favour taxes which raise prices instead of those which tap surplus incomes and profits.

State and local government debts are an extremely serious element of rigidity, because the charges upon them are paid so largely out of property taxes. These taxes are not varied with ability to pay, like the income tax, but depend on the assessed value of the property and hence become an element of fixed cost, which tends to hold rents up during a period of depression. When, through dire necessity, property taxes cannot be collected in full, the states and municipalities have to continue to meet capital charges, and hence discharge employees or reduce their salaries, or in extreme cases do not pay them at all. The creditor benefits at the expense of the large, and on the whole indispensible class of public employees – teachers, firemen, policemen engineers and the like. Popular purchasing power is drastically reduced by this item alone. The unemployed, dependent largely upon local relief, suffer. The plight of the local government and its employees is made worse when tax collections are so small as to make default necessary. Up to February 1, 1933, 1,120 public units in the United States had defaulted on their bonded obligations. The rapid growth of cities has made this problem far more serious, whenever it arises at all, for it has brought an expansion of fixed debt out of proportion to the growth of the country's population.

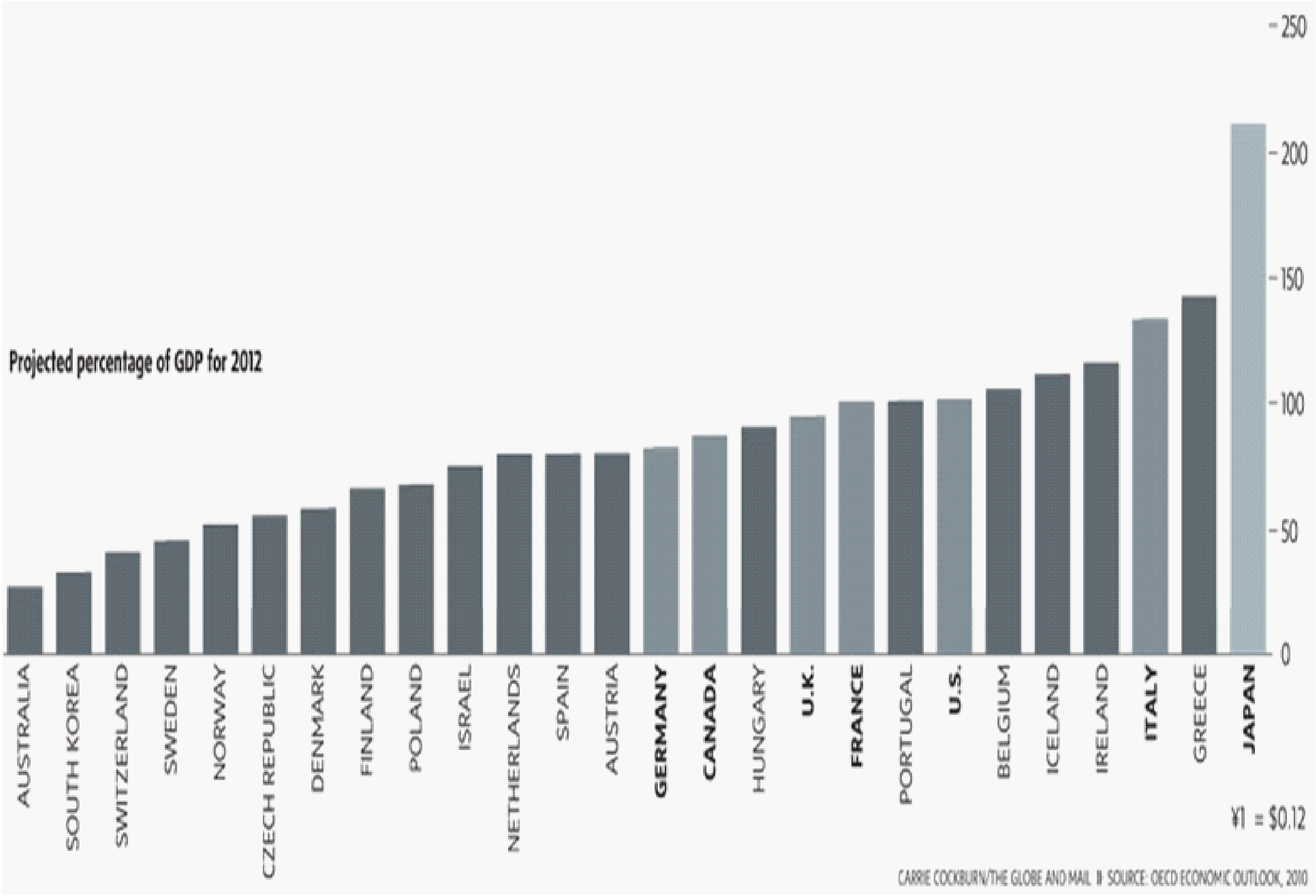
Certain theorists, notably the Technocrats, have called attention to the fact that fixed debt has for many years shown a tendency to grow more rapidly than production or the national income as a whole. They believe this fact is in itself a menace, as if the interest paid on debts were drained out of the national income and did not come back again into the market as a demand for goods and services. Of course, those who receive interest may spend it again, just as if the money had been paid out to wage earners, or had been given directly to universities and hospitals, or devoted to old-age pensions. The mere payment of large amounts of interest is not in itself a cause of the interruption of economic activity. But in a more subtle and intricate sense, the rapid growth of debt does accentuate the problems inherent in large-scale capitalism. It signals the fact that more and more areas of activity are coming within the influence of financial institutions. It creates greater rigidity in costs, so that when a readjustment is required by a falling off of demand, what takes place is a reduction of output, rather than of price. It thus prevents the smooth operation of a system which tries to depend on the automatic and unplanned adjustments of laissez-faire. Since larger and larger sections of heavy industry are dependent upon new investment of capital to create a market for their products, any danger to the long-term debt already in existence acts to discourage new investment and thus to injure the important industries making capital goods. The chief difficulty arises when the debt stops growing, and it does whenever the spasms of the system endanger the payment of past debt.

The rigidity of debt charges as compared with other streams of income sticks out like a mountain peak from the recent figures on the national income calculated by Simon Kuznets of the National Bureau of Economic Research. The total national income paid out shrank 40% from 1929 and 1932. But interest paid shrank only by 3.2%, while wage payments in mining, manufacturing, construction, steam railroads and certain other transportation fields had fallen by 60%.

Conclusion

On the subject of Greece, while we don't expect that a default is imminent, we believe that a default is inevitable. Possessing one of the world's most inefficient taxation systems, a lack of stability and unity among its population and mired under an enormous debt burden, the risk of an imminent default and a restructuring of the country's debt are on the rise. According to London-based economists at Barclays Capital and Fathom Consulting, private investors will be required to accept "haircuts" (losses) of 70% on their holdings of Greek sovereign debt, in order to place the country back on a sustainable financial path. Piero Ghezzi, Barclay's manager of economics research determines: "To achieve 'solvency', Greece needs to write off about 60% of its debts."

Projected Sovereign Debt to GDP Ratios for 2012



By drawing comparisons with the previous Kondratieff winter cycle of 80 years ago, we have shown how history repeats itself during an economic downturn with the tightening of credit, high unemployment, innumerable bank failures, municipal defaults, the collapse of the housing market and all engineered and orchestrated by the self-serving private motives of the central banking system. Given the painstakingly slow pace to pass any legislation in the U.S. Senate, the United States Congress will likely arrive at a short term compromise on the statutory debt ceiling issue sometime in July; only to be revisited again early next year. In any event, the bottom line is by the end of 2012, the U.S. national debt will likely total $16.5 trillion (U.S.). The chart on the previous page reflects the economic outlook for 26 national economies for 2012, as depicted by the Organization for Economic Cooperation and Development (OECD). At Longwave Analytics, we believe these GDP forecasts will prove to be overly optimistic, as the global economy slides further towards a state of depression, brought about by excessive global debt levels. In the previous Kondratieff winter of the 1930s, U.S. gross domestic product collapsed by 45%, which will likely be exceeded this time, since the U.S. debt picture is much greater. During the 1920s, the U.S. was actually paying down debt, so by 1929 the American national debt totaled only $15 billion (U.S.). Globally, paper (fiat) money currencies are currently in a state of collapse, mirroring the collapse of the previous Kondratieff winter which brought down the world monetary system in 1931. Throughout all of history, paper (fiat) money systems have never survived; but have been replaced by currencies backed by tangible assets such as gold.

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