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THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

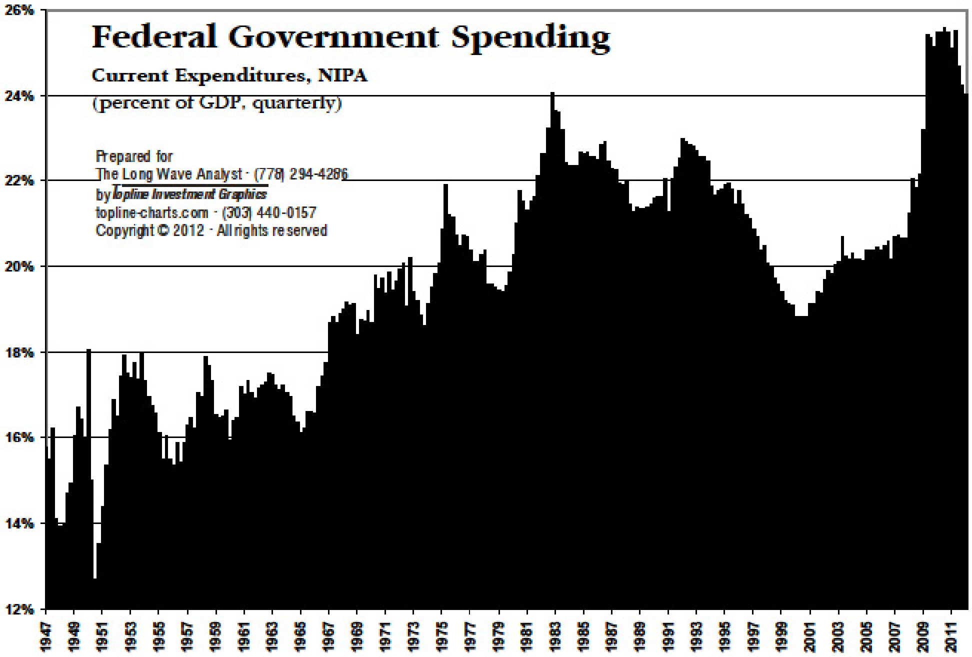
ECONOMIC WINTER

The Looming American Fiscal Cliff Crisis

In its most recent annual report on the long-term outlook for the U.S. federal budget, the Congressional Budget Office (CBO) warned: "The U.S. Government risks a fiscal crisis unless it makes significant changes in tax and spending policies. Without policy changes, within 15 years the U.S. national debt will exceed the historical peak set after World War II. In 1946, federal government debt amounted to 109% of the gross domestic product (GDP). This year, it's officially projected to reach 70% of GDP (unofficially, in excess of 100% of GDP). By 2037, the national debt would be almost twice the size of the economy; assuring higher interest rates, slower economic growth and much greater painful choices for lawmakers than they face today. The growing debt would increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government's ability to manage its budget. Such a crisis would confront policy makers with extremely difficult choices. To restore investors' confidence, policy makers would need to enact spending cuts or tax increases, more drastic and painful than those which would have been necessary, had the adjustments been made sooner."

The above notwithstanding, recently chronicled in The Privateer: 'The funded debt of the U.S. government rose by a total of $50 billion (U.S.) over the two decades between1946 and 1965. Over the next two decades, from 1966 to 1985, the funded debt rose by $1.6 trillion (U.S.). In the two decades after that 1986 to 2005, it rose just under $6 trillion (U.S.). In the six years between the end of 2005 and the end of 2011, it rose by another $8.1 trillion (U.S.). In the baby boomers formative years, it took the U.S. government a year to increase their funded debt by $2.5 billion (U.S.). Today, as the boomers retire, it takes the U.S. government 16 hours to do the same.

An investment in government debt is an investment in the future power of government to drain an economy of ever more of its means of creating wealth. This "wealth drain" is accelerating, more than five years after the necessity to write off malinvestments became obvious. What has delayed the final day of reckoning is the complete falsification of economic signals (from U.S. government departments and agencies) made possible by an orgy of new "money" creation. The great tragedy lies in the fact that the bedrock of this money creation is sovereign debt, the "asset" which is now regarded as the "safest" in the world. An "investment" in perpetuating the power of government OVER the economy, makes a future of economic penury a certainty. There can be no more terminal malinvestment than that … As Franz Pick put it; it is an investment in "guaranteed future confiscation." When Pick stated that in the early 1970s, the confiscation was still in the future. That is no longer the case today.'



In a new report which focuses on the short-term, rating agency Standard and Poors warned: "U.S. political risk may result in a sovereign debt rating downgrade by 2014. The credit strengths of the U.S. include its resilient economy, its monetary credibility and the American dollar's status as the world's key reserve currency. Weaknesses include its fiscal performance, its debt burden and what we perceive as a recent decline in the effectiveness, stability and predictability of its policymaking and political institutions; particularly regarding the direction of fiscal policy … Last summer's debt ceiling debate raised some concern about Congressional commitment to avoiding a default on U.S. Government debt. Although the 2012 elections could resolve the U.S. fiscal debate, S&P sees this outcome as unlikely. Politicians will likely avoid a sudden fiscal adjustment at the end of this year, which is part of the current law; as they seek to support an economy beset with an 8.2% (official) unemployment rate. S&P expects politicians in Washington will (not only,) extend the 2001 and 2003 tax cuts indefinitely, (but also,) index the alternative minimum tax for inflation after 2011. Recent shifts in the ideologies of the two major U.S. political parties could raise uncertainties about the government's ability and willingness to sustain public finances consistently, over the long term."

Meanwhile, in a recent Wall Street Journal op-ed by Robert Rubin – a former U.S. Treasury Secretary and currently a Co-chairman of the Council of Foreign Relations – entitled A Budget Grand Bargain Will Follow the Election, he argues: "While Congress' failure to reach a fiscal grand bargain last summer manifested the deep economic policy divide separating Democrats and Republicans, the so-called fiscal cliff will soon create an extraordinary second opportunity for a breakthrough compromise … Soon after November's election, several events will put serious pressure on both (political) parties, possibly providing the impetus for a serious fiscal program. The critical decision making period will be Congress' lame-duck session after the election and the first two or three months of the new Congress. These events are already understood: The 2001 and 2003 tax cuts for middle-class and upper-income taxpayers and the payroll tax holiday will expire at the end of 2012. The dramatic mandatory reduction in spending ('sequestration') required by last year's debt ceiling agreement will occur in January 2013. Moreover, the (statutory) debt limit must be raised again in late 2012 or early 2013. Each of these events is unacceptable for one or both political parties. Sequestration includes deep cuts to non-defense spending which Democrats oppose and similarly, deep cuts to military spending which makes Republicans (and many Democrats) recoil. Republicans oppose the expiration of tax cuts on upper-income Americans; Democrats oppose the expiration of the payroll tax holiday; and members of both parties oppose the expiration of middle-class tax cuts. As for the debt ceiling, the party in the White House will insist that it be raised (because there is no other responsible choice), while the other party may seek to use it as leverage to achieve other policy goals, as we have seen before.

Since some form of divided government after the election is likely, the parties will need to make an accommodation with each other to avoid chaos. Even if one party controls the White House and the Congress, it might still seek meaningful bipartisan participation to avoid sole responsibility for difficult decisions. The multi-trillion dollar question is what kind of accommodation it will be.

There is widespread concern about our elected officials' willingness to find common ground on tough issues. When the right choice is the tough choice, it can be all too easy to make the wrong one. Many experience people think that will happen, with the parties agreeing to kick the most difficult choices down the road by extending the tax cuts, cancelling the sequester, raising the (statutory) debt limit and resolving to study the problem. However, this time could possibly be different, thanks to five factors combining to create the best political environment for real fiscal action in a long time. The risks of inaction are apparent and will apply pressure on all policy makers: Sequestration and expiring tax cuts will have severe consequences and could cost the country 3.5% to 4% of gross domestic product (GDP) in 2013. A political punt would be a striking manifestation of our inability to govern ourselves and could heighten uncertainty and lack of confidence about future economic policy. That could have a seriously adverse impact on our economy and the markets. The months immediately following a presidential election are … the lowest pressure time in our political system. Most importantly, there is no choice available to Congress that does not involve significant changes to taxes and spending that members of each party will oppose. Unlike any situation that I can remember, Congress cannot simply maintain the status quo by failing to act. Doing nothing means tax increases and massive cuts in defense and non-defense spending. Kicking the can down the road require compromising with the other party on taxes and spending. Biting the bullet on the difficult choices will necessitate compromises and action as well. The compromises required for constructive action are substantially more difficult than the compromises necessary to punt, but taking the easy way out requires actions which come with their own set of political costs. The longer you avoid the tough choices, the deeper the hole gets, the greater the resulting crisis is and the harsher the necessary measures necessary to reestablish confidence and (economic) recovery."

If A Kingdom Be Divided Against Itself, That Kingdom Cannot Stand

A recent survey conducted by Bloomberg News suggested a majority of economists believe the U.S. will avoid plunging off a fiscal cliff in 2013, as lawmakers will find enough common ground in budget negotiations to avert an economic recession. Mark Zandi, chief economist at Moody's Analytics Inc., thinks: "Forecasters are pretty sanguine at the moment. While there will be a lot of (political) brinkmanship and some tumult in financial markets as policy makers grind through this; at the end of the process they're going to scale back that cliff significantly." David Greenlaw, a managing director at Morgan Stanley in New York notes: "If you go over the cliff, it's a virtual certainty that we will have a recession in 2013. The presidential election may deepen the divide between the executive and legislative branches (of government), which would increase the likelihood of a stalled decision-making process." Maury Harris, chief economist at UBS Securities LLC in New York lamented: "The fiscal cliff case goes back to what happened last summer. They kicked the can down the road. To me, the model of last summer is you postpone."

The threat of political gridlock re-emerging in Washington has also raised concern among policy makers at the Federal Reserve, including Chairman Ben Bernanke, who referred to the looming impasse as a fiscal cliff during an April 25th. press conference: "If no action were to be taken by the fiscal authorities, the size of the fiscal cliff is such that there's absolutely no chance that the Federal Reserve could or would have any ability whatsoever to offset that effect on the economy. Such uncertainty, combined with Europe's sovereign debt crisis gives central bankers a quite reasonable case for maintaining financing costs near zero through 2014. Congress needs to aim for long-run fiscal sustainability in a way that doesn't endanger the short-term economic recovery."

In a recent New York Times op-ed entitled The Debt Indulgence, reporter David Brooks cites society's increased level of tolerance for debt. "Today we are living in an era of indebtedness. Over the past several years, society has oscillated ever more wildly through three debt-fuelled bubbles. Firstly, there was the dot-com bubble. Then in 2008, the mortgage-finance bubble. Now, we are living in the fiscal bubble. In the United States, the federal government has borrowed in excess of $6 trillion (U.S.) over the last four years alone, trying to counteract the effects of the previous two bubbles. States struggle with pension promises that should never have been made. Europe is on the verge of collapse because (euro zone) governments can't figure out how to deal with their (sovereign) debts. Nations around the globe (are burdened) with debt-to-gross domestic product (GDP) ratios at or approaching 90% – the (inflection) point at which (economic) growth slows and prosperity stalls. Both Democrats and Republicans argue about how quickly deficits should be reduced. Moreover, everybody knows that (government) debt must be restrained at some point. The problem is that nobody has been able to, either find a political way, or muster the political will, to do it."

Judging from the relentless political rhetoric and banter emanating from both the Democratic side of the aisle and the Republican camp during the current election campaign, the American political polarization climate, resultant from budget deficit and statutory debt ceiling debates of a year ago, has hardened further. By early November, fifteen months will have been wasted by the U.S. Congress on these vital issues; as both parties focus their attention and talent on an election process which to foreigners, engulfs far too much time, effort and money than is really necessary. Indeed, the Democrats believe that even though they might not gain a majority of seats in either the House of Representatives, or the Senate, President Obama will be re-elected to his present office. Meanwhile, the Republicans have set their sights on capturing all three bastions to form a "united government", virtually enabling governance by decree. However, the most likely outcome will produce a divided government of some form or other which should prolong the agony of political gridlock in Washington.

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In the drafting of the U.S. Constitution at the Federal Convention in Philadelphia in 1787, the nation's founding fathers knew they had not constructed a perfect system of government. Indeed, they realized that for their system of democracy to operate effectively, debate and compromise were essential to its functionality. Congressmen, Senators and the President's administration would toil in the spirit of what was in the best interest of the United States as a country. In theory, a state of political gridlock should never occur because the parties would be able and willing to negotiate a compromise. Indeed, for two centuries this has largely been the American experience. In practice today, however, while American politicians appear to share common goals for the country, they differ greatly in terms of how such goals should be achieved. Accordingly, many Democrats and Republicans have made the mistake of allowing their relationships with their political adversaries escalate to an enemy plateau. When opposing politicians can respect each other as adversaries, they retain the opportunity for dialogue and the ability to compromise. However, if those same politicians resort to being enemies, they become "dead bears in the water."

The Taxpayer Protection Pledge: Grover Norquist's Hold on the GOP (2)

As previously reported in our Economic Winter of February 1st. 'Grover Norquist is President of Americans for Tax Reform (ATR), a taxpayer advocacy group he founded in 1985 at the behest of President Reagan. According to its website, ATR is a coalition of taxpayer groups, individuals and businesses opposed to higher taxes at the federal, state and local levels. ATR organizes the Taxpayer Protection Pledge, which asks all candidates for federal and state office to commit themselves in writing to oppose all tax increases. In the 112th. Congress, 238 House members and 41 Senators have taken the pledge. On the state level, 13 governors and 1,249 state legislators have taken he pledge. Norquist chairs the Washington, D.C. –based "Wednesday Meeting," a weekly gathering of more than 150 elected officials, political activists and movement leaders. The meeting commenced in 1993and takes place in ATR's conference room. There are now 61 similar "center-right" meetings held in 47 states. As a result, Norquist has been one of the most effective and powerful lobbyists in Washington for three decades.'

As recently reported in the Washington Post, 'In GOP activist circles, over the past generation the Taxpayer Protection Pledge has become the essential conservative credential for Republicans seeking elective office. Of the 242 Republicans in the House today, all but six have signed the pledge. Lately, an increasing number of GOP candidates for Congress are declining to sign the promise to oppose any tax increase, a small sign that could signal a big shift in Republican politics on taxes. Of the 25 candidates this year promoted by the National Republican Congressional Committee (NRCC) as "contenders" – the top rungs of a program which highlights promising candidates who are challenging Democrats or running in open seats – at least a third have indicated they do not plan to sign the pledge authored by anti-tax crusader Grover Norquist. Two of seven candidates promoted by the NRCC as the Young Gun Vanguard candidates, who are competing in open seats that are considered Republican-leaning, have also declined to sign. Norquist insists ATR is ahead of schedule in collecting pledge signatures from congressional committees for the year. He points out that the likely GOP nominee for President, Mitt Romney, has signed the pledge. However, there have been (some) defections.

Republican candidates declining to sign the pledge generally indicate that they nevertheless oppose tax hikes. However, some chafe against the constraint on eliminating tax loopholes, believing those restrictions limit Republicans' ability to negotiate seriously with Democrats on an agreement to tackle the nation's mounting debt. Richard Tisei, an NRCC candidate and former Republican state senator in Massachusetts declared: "I don't want to get tied up in knots. If there's a (tax) loop hole that can be closed which results in generating additional revenue that can be used specifically to pay down the national debt, I'm not going to lose (any) sleep. Also, I don't want to be bound by the pledge not to close it." The refusals among some new candidates come as a handful of incumbent Republicans who signed the pledge when they first ran for office are now publically rejecting it. Freshman Rep. Scott Rigell (R-Va.), who signed the pledge in 2010, recently posted an open letter to constituents indicating that he would not renew the promise as he runs for re-election: "I fear that the pledge could stand in the way of an open and comprehensible approach to tacking the mounting debt. Averting bankruptcy requires us to grasp the severity of our fiscal condition and summon the courage to speak boldly about the difficult steps needed to increase revenues and sharply decrease spending."

An erosion of support among GOP candidates would be especially significant because Norquist has long aimed to collect signatures from Republicans before they take office. He encourages candidates to use their pledges to help define their tax stance for voters. Once the pledge is signed, Norquist considers it binding for the remainder of the candidate's career in public service if he or she wins office. Ina an interview, Norquist noted: "The pledge is as strong as ever. In the pressure-cooker days of the debt ceiling debate last summer, Republicans held firm against tax increases and wrested an agreement from Democrats to lower deficits through spending cuts alone. That was when the pledge was tested and the commitment of Republicans not to raise taxes was really pushed hard. President Obama and the spending interests failed and Republicans and the taxpayers won."

Mr. Norquist cited several recent examples of Republican primaries in which ATR-backed candidates defeated Republicans considered less fiscally conservative: "This month, ATR helped Indiana State Treasurer Richard Mourdock defeat six-term Sen. Richard Lugar in a Republican primary. This week, Tom Cotton won a Republican primary in Arkansas after ATR called voters to inform them his opponent had not signed the pledge. Cotton is seeking a seat (in the House) held by retiring Democrat Rep. Mike Ross. The ATR pledge remains the best way to signal to wary voters that a candidate will not change his mind on taxes once in office. The pledge isn't what keeps them from raising taxes. It confirms to voters that they won't raise taxes because they're competing with several hundred years of politicians lying about this." Democrats have stated they will not agree to renew some of the tax breaks, or avert the defense cuts as Republicans want, unless Republicans agree to impose higher taxes on the wealthy. Any wiggle room for Republicans on taxes could dramatically reshape that debate. As a result of the GOP's sweeping successes in the 2010 election, the NRCC's targeted new candidate races include some districts where Republicans have little chance of winning in November. It is unclear how many of the new pledge refusers will make it to Washington.

However, after months of democratic attacks on the ATR and Norquist as obstacles to a debt agreement, some Republican candidates report that they are hearing from more voters who want them to reject the pledge than the opposite. Gary DeLong, a member of the Long Beach, Ca. city council, who is labeled as a contender for a House seat by the NRCC stated: "I am routinely encouraged on door steps and at town halls and candidate coffee meetings, to avoid the pledge. Voters want me to represent then and not special interests." Two Republicans vying to challenge Democratic Rep. Dave Loebsack in Iowa, have indicated they will not sign the pledge. In Indiana, former U.S. attorney Susan Brooks won the GOP nomination for a solid Republican seat, defeating three Republicans who had signed the pledge. Dollyne Sherman, a spokeswoman for Brooks, commented: "She's committed to lowering taxes because she thinks that's a key ingredient in restoring the nation's economy. However, she doesn't need to sign a tax pledge to do that." Sen. Tom Coburn (R-Ok.), a fiscal conservative who has tangled with Norquist, believes: "Candidates are beginning to understand that the ATR pledge's power has been exaggerated by Norquist and the media and that Norquist is wrong when he asserts that it is nearly impossible to win a Republican primary without signing the pledge. That's just Norquist patting himself on the back."

The President's Committee for Fiscal Responsibility

In a late May interview on CNN's Global Public Square, PCFR's co-chairs former Republican Senator Alan Simpson and former White House Chief of Staff Erskine Bowles, were posed the following question: "How can America fix her fiscal deficit and national debt problems?" Mr. Simpson had some strong words for his fellow Republicans: "You can't cut spending alone and get yourself out of this hole. You can't grow your way out of this hole and you can't tax your way out of this hole. If you want to be in politics, you must learn to compromise. Show me a guy who won't compromise and I'll show you a guy with rocks for brains."

Era of a Diminished Superpower

In a recent Financial Times op-ed, reporter Martin Wolf poses the question: 'What will be the role of the U.S. in the 21st. century? What is needed is serious reform. However, this has become impossible, because of the exploding role of money in politics and the rising intransigence of the Republican Party. In a system built upon divided government, regarding compromise as weakness risks repeated chaos.

In principle, the U.S. could maintain its frontier position in science and commercial innovation. However, as my colleague Edward Luce shows in hid thought-provoking new book, the combination of xenophobia with hostility to science, self-inflicted fiscal constraints and weird spending priorities, risks robbing the U.S. of its access to the world's talent and its commitment to world-leading research and innovation. Nothing captures the point better than this grim quote: 'In 1990, California spent twice as much on its universities as its prisons. Now it spends almost twice as much on prisons.' That the U.S. has the highest rate of incarceration in the world is, not only a social statistic, but also, an economic one. The same is true of the costliness and inefficiency of the U.S. health care system, which is the principal reason why long-term fiscal prospects look so grim.

The U.S. economy is no longer delivering the widely shared benefits it once did. In the last full business cycle, between 2002 and 2007, the top 1% of Americans captured almost two thirds of the rise in incomes, while 0,1% captured more than a third. Such a zero sum economy breeds disaffection and despair. The financial crisis has made the anger level far worse. All of this will also affect America's ability to play its historic role in the world. The looming fiscal squeeze will undermine military spending. More importantly, the financial crisis and other large mistakes have robbed the U.S. political, economic and social models of the prestige they enjoyed. While Europe is in no better shape, that merely means the west as a whole is less credible and so far, less able to serve as a leader.

Whatever happens within America, its influence will be smaller in the 21st. century than it was in the 20th. This is largely because others have learned so much from it. Even so, the U.S. could retain huge, possibly unrivalled influence, since its main rivals face even bigger challenges. Yet if the U.S. is to be what it can be, it must rediscover the pragmatism that long marked its policy making, notably in its responses to the many challenges of the 20th. century. No democracy can thrive if its citizens view their own government as their greatest enemy. If Americans choose to make their government fail, the U.S. is sure to do so as well.'

Summation

At Longwave Analytics, we have consistently focused our subscriber's attention to the similarities and parallels of today's global economic winter cycle to that of the early 1930s, exactly 80 years ago. Below are excerpts which will be of interest from a current article in The Telegraph U.K. – Spooky Parallels between the Great Depression and the Euro Crisis.

'In the popular imagination, the (economic) slump of the 1930swas set off by the sharp declines in share prices in the Wall Street Crash of 1929. In fact, the direct effect of the Crash was probably not that great. More important was the international banking crisis which followed the collapse of the Austrian bank, Kreditanstalt, in 1931. This time we have not (yet) had major weaknesses in share prices, but we have experienced a major asset price collapse, namely in real estate prices – in America, Spain and Ireland. As a direct result, we have certainly witnessed a major banking crisis. This was also a key feature of 1930s America. The depressing aspect of today's situation is that the banks are so weakened by the combination of losses on past loans and fears of euro meltdown, that even administered interest rates close to zero are not having much of a stimulative effect. Moreover, tighter regulation has made banks more risk adverse at just the time that economic recovery demands that they should be more enterprising.

Regarding policies to get out of the mess, there are both similarities and differences. In 2009, there was an international conference in London to try to sort the problem out. The same thing had occurred in 1933. Then, as now, it does not seem to have done any lasting good. In the 1930s, the possibility of reaching a global solution was hampered by the difficult relationship between the old hegemonic power, the U.K. and the new powers, Germany, the U.S. and Japan. Today, the U.S. is the declining hegemonic power, squaring off against China and the emerging markets. Then, a rigid fixed exchange rate system, the Gold Standard, was a key part of the problem. Today, this role is played by the euro. For good measure, we also have the informal fixed exchange rate system operating between the U.S. and much of the emerging world.

Just as today, the Great Depression occurred against the backdrop of the British Government struggling with a high level of debt. Indeed, the problem then was much worse. In 1929, the ratio of U.K. Government debt to gross domestic product (GDP) was 162%, compared to only 65% now. Interestingly, in America the equivalent figure was 14%. It did not reach 50% until World War II. Step forward the European Central Bank (ECB), which presides over an economic area roughly as large as the U.S. It has been hobbled by a combination of inexperience and the impossible political pressures created by the euro. As recently as July 2011, the ECB was raising its administered lending rate to head off a supposed inflationary danger. Interestingly, it also raised its administered interest rate in July 2008, just as the world was heading into an economic recession. The ECB is still refraining from cutting its administered lending rate to zero, as the economic situation surely demands.

In the early 1930s, the world also suffered from weak political leadership. In Germany, Weimar governments bumbled on ineffectively; in France, there was a rapid succession of weak leaders; in the U.K. there was the era of Stanley Baldwin and Ramsay MacDonald; in the U.S. President Hoover famously built a dam, but not much else. There were great leaders around from the past, such as Lloyd George in the U.K. – and those yet to come to power – Winston Churchill and Franklin Roosevelt. Indisputably, the current incumbents are pygmies by comparison.

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LATE NEWS

WALL ST. IN PANIC AS STOCKS CRASH

Attempt Made to Kill Italy's Crown Prince

STOCKS CRASH IN RUSH TO SELL; BILLIONS LOST

ASSASSIN CAUGHT IN BRUSSELS MOB; PRINCE UNHURT

Hollywood Fire Destroys Films Worth Millions

FEAR 52 PERISHED IN LAKE MICHIGAN; FERRY IS MISSING

PIECE OF PLANE LIKE DITEMAN'S IS FOUND AT SEA

High Duty Group Gave $700,000 to Coolidge Drive

CARNEGIE CHARGE OF PAID ATHLETES ROUSES COLLEGES

HOOVER'S TRAIN HALTED BY AUTO PLACED ON RAILS

WARDER SOUGHT TO KEEP SEA TRIP SECRET, AID SAYS

SOMERS NAMED AS HEAD OF NEW EXCHANGE BANK

Source: Getty Images

Ian A. Gordon, The Long Wave Analyst, www.longwavegroup.com

“Those who cannot remember the past are condemned to repeat it.” Santayana