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LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER

The Failure of Fiat Currencies

Introduction

Fiat currencies are paper monies issued and circulated by government legislation and decreed as a country's legal tender to function as a medium of exchange for all transactions of goods and services within its economy. Only the federal government has the power and the authority to issue currency notes for distribution throughout the nation. Fiat currencies, such as those currently in circulation within the world's major economies, such as the United States (Dollar), the United Kingdom (Pound), Japan (Yen), China (Yuan/Renminbi) and the European Union (Euro) are 'promises to pay', backed solely by 'the full faith and credit' of the issuing country, or countries. They are based upon an elastic and constantly expanding money supply, as compared to a commodity system where the currency is backed by a definitive supply of gold. Over the centuries, all paper money systems have eventually collapsed amid economic chaos, or, reverted to a commodity based system in order to avert economic disaster. In this Economic Winter, we will argue that the current monetary policies of some of the world's central banks – led by the U.S. Federal Reserve – are misguided by employing extensive quantitative easing (money printing) programs and facilitating an inexorable rising trend in outstanding global debt.

The Next Global Financial Crisis

In the most recent issue of Grant's Interest Rate Observer, publisher James Grant warns: "Tumbling commodity prices over recent weeks are a warning sign to investors that China's economic miracle is actually a gross manipulation of markets that eventually have a nasty ripple effect across the world. Something has changed and more significantly, people have noticed the change. The world's major central banks have been distorting the true price of assets, such as stocks and commodities, by suppressing interest rates and printing trillions of dollars' worth of currency in an effort to stimulate demand. Such policies by the People's Bank of China will prove particularly harmful given that they are layered on top of the central planning policies of the Communist Party. Efforts by the U.S. Federal Reserve and other central banks to jump-start demand have failed. Each new dollar or yuan added to the economy is having less and less of a stimulus effect and is instead further inflating asset and consumer credit bubbles. As China's economy continues to slow, commodity prices will decline further and it's possible that China will even slip into a recession. Today, financial crises arrive faster and more furiously. While it took 25 years for stocks o rebound from the Great Depression in the 1930s, it took only four years for stock markets to recover from the financial crisis of 2009. The accelerated cycles are the result of distorting policies and they leave governments and markets more accident prone. Investors should respond by keeping large amounts of cash, looking for buying opportunities in depressed sectors ... Keep in mind that the price of gold is the reciprocal of the world's faith in management of the world's central banks. Accordingly, investors should own some gold."

John Law: The Father of Paper Money

As a young Scottish financier, John Law was brilliant, daring and unusually ambitious. For killing a man in a duel over a woman he was forced to flee to Amsterdam in 1695, where he became a close student of Dutch trade and banking practices; then the most advanced in the world. Eventually, he sought out opportunity in Paris, where he soon became known to many of the foremost figures of French finance. Capitalizing on the weak and vulnerable French economy, he was able to persuade Philippe II, duc d'Orleans, Regent for the child King Louis XV, to support his extraordinary scheme for issuing unsecured paper money. Under his fiat currency system, anyone could get rich quickly, including Law and the Regent, who did. Law founded his own royal bank and soon controlled all of France's improving finances. To bolster the resulting orgy of uncurbed speculation, Law advertised the fabled riches to be found in the French colonies of the Mississippi Valley, particularly Louisiana, described as a land filled with mountains of gold and silver, plus precious gems to be plucked from the river's shoreline. In 1720, the 'Mississippi Bubble' burst, ruining thousands of investors. Law's whole monetary system quickly collapsed, so he fled to Venice.

The French Assignat

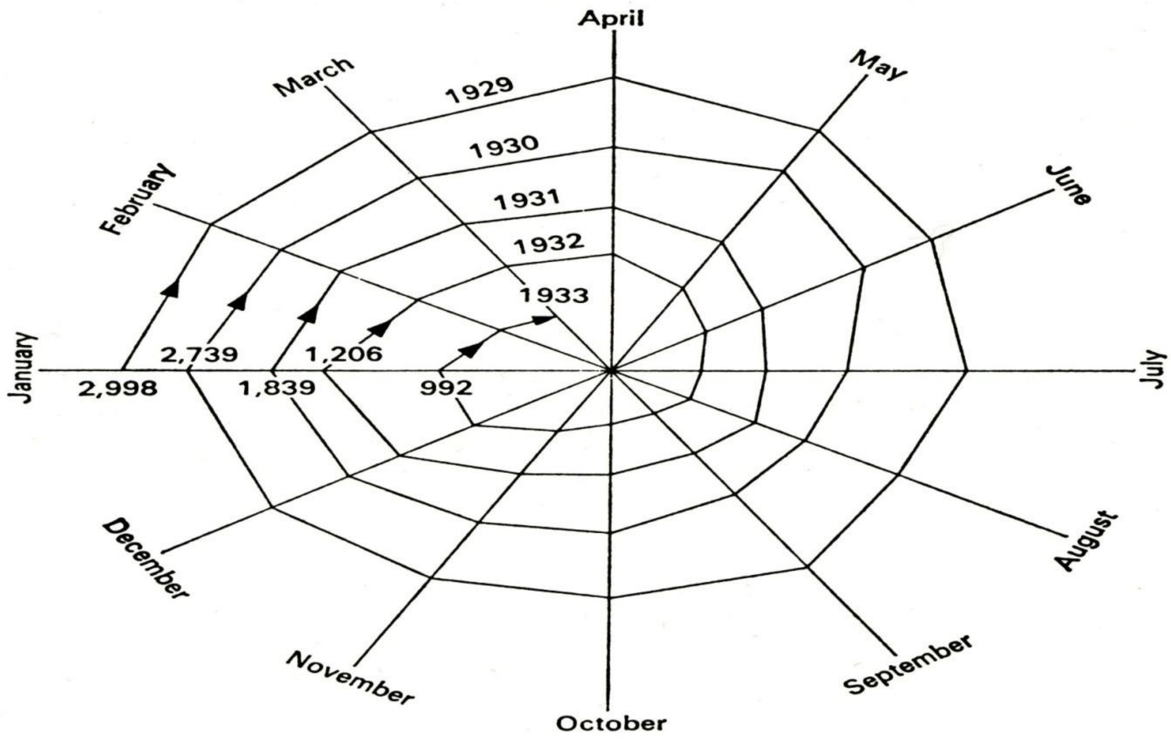
While France had been deceived by John Law and his currency magic, it didn't learn from the lesson. In his book, The Demise of the Dollar, author Addison Wiggin recounts: By 1791, France was ready to try paper currency again. The government, in an anti-aristocracy mode, confiscated property and other assets from the wealthy in exchange for assignats, notes which paid interest and operated like land mortgage notes. Far from solving the problem of economic disparity among the classes, the extreme measures only made matters worse. Within four years, inflation had risen by 13,000 per cent. Few instruments have declined to zero value as quickly as the assignats.

In a foreword to a book about the historical implications of French monetary policy, John Mackay described France's attempts at a fiat money system as: "the most gigantic attempt ever made in the history of the world by a government to create an inconvertible currency and to maintain its circulation at various levels of value. It also records what is perhaps the greatest of all government efforts ... to enact and enforce a legal limit of commodity prices. Every fetter that could hinder the will, or thwart the wisdom of democracy had been shattered ...But the attempts failed. They left behind them a legacy of moral and material desolation and woe."

Parallels to the 1930's

Within the current global economy, we can perceive a growing threat in the challenges facing the European Monetary Union. Not only, are there ongoing structural problems in several southern peripheral countries, but also, harsh austerity measures have exacerbated the currency bloc's daunting sovereign debt problem. As was the case in the early 1930's, when Austria's Kredit Anstalt Bank failed causing a domino effect through Germany, Great Britain, Japan and which culminated with the United States abandoning the gold exchange standard in 1933. Confidence had been lost in the banking system and in paper currencies to the point where thousands of U.S. banks failed and the populace sought to protect themselves by purchasing gold and the shares of gold mining companies. Since no country trusted another's currency, world trade collapsed, extension of credit was curtailed and the world's economies imploded into the Great Depression; sending the unemployment rate to 25% in the United States. In Europe today, we are already witnessing similar unemployment levels in Greece and Spain with the European Union experiencing yet another economic downturn. In the United States, nearly 50 million citizens are receiving food stamps while the official unemployment rate hovers close to 7%.

. The contracting spiral of world trade, January 1929–March 1933: Total imports of 75 countries (monthly values in terms of old U.S. gold dollars [millions]).



(in millions of dollars)

Spider Chart taken from: The World in Depression 1929 - 1939, Charles P. Kindleberger, University of California Press, 1986. P. 170

Xi Jinping and the Chinese Dream

As reported in the most recent issue of The Economist, China has made an extraordinary journey along the road back to greatness. Hundreds of millions have lifted themselves out of poverty, hundreds of millions more have joined the new middle class. China is on the verge of reclaiming what it sees as its rightful position in the world. China's global influence is expanding and within a decade its economy is expected to overtake America's. In his first weeks in power, the Communist Party's new general secretary and military commander-in-chief , Xi Jinping, has evoked that rise with a new slogan which he is using – as belief in Marxism dies – to unite an increasingly diverse nation. He calls his new doctrine the 'Chinese dream' which seems more designed to inspire than to inform. It is no coincidence that Mr. Jinping's first mention of his dream of 'the great revival of the Chinese nation' occurred in November during a speech at the national museum in Tiananmen Square, where an exhibition named 'Road to Revival' displays China's suffering at the hands of colonial powers and its rescue by the Communist Party. On November 15th. Mr. Jinping mentioned 'a better environment' toward the end of a list of what he said were the public's wishes. Better education and more stable jobs topped the list. In March, the Chinese dream was the main subject of his acceptance speech to the National People's Congress – China's parliament – on being appointed state president. In early April, at an annual forum attended by foreign political and business leaders on the tropical island of Hainan, Mr. Jinping predicted that the Chinese dream would be fulfilled by the middle of the century.

In 1820, as some historians calculate and Chinese commentators like to highlight, China's GDP was one-third of the world's total. Then the reversals of the century of humiliation brought it low. By the 1960's, China's gross domestic product had declined to just 4% of the world total. Now, it has recovered to about one-sixth of the world's GDP – and at least 90% of America's – in purchasing power parity terms, according to the Conference Board, a business research organization. Nationalists eagerly await the day when China's economy becomes once more the biggest in the world by any measure; a day which many observers expect to dawn while Mr. Jinping is still leader.

It is a well-established fact that the gold mining business is very productive in China, however, none of China's gold production ever leaves the country. Moreover, it is a well-known fact that China has been and continues to be a major buyer of gold bullion, especially on price corrections and in secret agreements with Australian gold producers. How much gold China has amassed in recent years is unknown, but it is believed to be substantial. At Longwave Analytics, we suspect it is Chinese policy to ultimately initiate a gold-based currency system with the renminbi replacing the U.S. dollar as the world's reserve currency. In Table A below, we discover that 37% of the increase in imports over the last 12 months into China is due to the massive amount of gold being imported. Gross imports increased by $82 billion (U.S.), but $32 billion (U.S.) of this increase were from gold imports alone.

Table A

For the 12 months ending	Gross Imports	Gold Imports (tonnes)	Value of Gold Imports	Imports excl. Gold
	(USD Bn)	(tonnes)	(USD Bn)	(USD Bn)
March 2012	1,772	546	32	1,740
March 2013	1,854	1,071	62	1,792
Change	**82**	**525**	**30**	**52**

Source: Bloomberg, General Administration of Customs (via Bloomberg), Census and Statistics Department – Hong Kong, Sprott Asset Management

The Return to Sound Money

In his 1952 book, **The Theory of Money and Credit**, author Ludwig von Mises expounds: The people of all countries agree that the present state of monetary affairs is unsatisfactory and that a change is highly desirable. However, ideas about the kind of reform needed and about the goal to be aimed at, differ widely. There is some confused talk about stability and about a standard which is neither inflationary nor deflationary. The vagueness of the terms employed obscures the fact that people are still committed to the spurious and self-contradictory doctrines whose very application has created the present monetary chaos. The destruction of the monetary order was the result of deliberate actions on the part of various governments. The government-controlled central banks and in the United States, the government-controlled Federal Reserve System were the instruments applied in this process of disorganization and demolition. Yet without exception, all drafts for an improvement in currency systems assign to the governments unrestricted supremacy in matters of currency and design fantastic images of super-privileged super-banks. Even the manifest futility of the International Monetary Fund does not deter authors from indulging in dreams about a world bank fertilizing mankind with floods of cheap credit. The inanity of all these plans is not accidental. It is the logical outcome of the social philosophy of their authors.

Money is the commonly-used medium of exchange. It is a market phenomenon. Its sphere is that of business transacted by individuals, or groups of individuals within a society based upon private ownership of the means of production and the division of labour. This mode of economic organization – the market economy or capitalism – is at present, unanimously condemned by governments and political parties. Educational institutions, from governments down to kinder-gartens, the press, the radio, the legitimate theatre as well as the screen and publishing firms, are almost completely dominated by people in whose opinion capitalism appears as the most ghastly of all evils. The goal of their policies is to substitute 'planning' for the alleged plan-starved market economy. The term 'planning' as they use it means, of course, central planning by the authorities, enforced by the police power. It implies the nullification of each citizen's right to plan his own life. It converts the individual citizens into mere pawns in the schemes of the planning board, whether it is called Politburo, Reichswirtschaftsministerium, or some other name. Planning does not differ from the social system that Marx advocated under the name of socialism and communism. It transfers control of all production activities to the government and thus eliminates the market altogether. Where there is no market, there is no money either. Although the present trend of economic policies leads towards socialism, the United States and some other countries have still preserved the characteristic features of the market economy. Up until now, the champions of government control of business have not yet succeeded in attaining their ultimate goal.

The Fair Deal Party has maintained that it is the duty of the government to determine what prices, wage rates and profits are fair ... and then to enforce its rulings by police power and the courts. Furthermore, it maintains that it is a function of the government to keep the rate of interest at a fair value by means of credit expansion. Finally, it urges a system of taxation which aims at the equalization of incomes and wealth. Full application of either the first or the last of these principles would by itself consummate the establishment of socialism. However, things have not yet moved so far in this country. The resistance of the advocates of economic freedom has not yet been broken entirely. There is still an opposition which has prevented the permanent establishment of direct control of all prices and wages and the total confiscation of all incomes above a height considered fair by those whose income is lower. In the countries on this side of the iron curtain, the battle between the friends and foes of totalitarian all-around planning is still undecided. In this great conflict, the advocates of public control cannot do without inflation. They need it in order to finance their policy of reckless spending and of lavishly subsidizing and bribing the voters."

Summation

The world monetary system failed during the third Longwave Winter in 1933. Eighty years later, the global fiat monetary system is in grave danger of collapsing led by the central bank monetary policies of the U.S. Federal Reserve, the Bank of England, the Bank of Japan, the Bank of China and the stated intentions of the European Central Bank. The Federal Reserve continues to implement its quantitative easing program of $85 billion (U.S.) monthly purchases of U.S. Treasurys and sub-prime mortgage securities, with the Fed's balance sheet approaching $3 trillion (U.S.). It is our view that Ben Bernanke will not seek another term as Fed Chairman when his current tenure ends next January. Accordingly, the current money printing program is likely to continue for another seven months, modified perhaps, but still intact. The Fed's exit strategy from this initiative has yet to be determined, let alone made public. Will the Fed ultimately reduce its holdings via sales in the open/secondary market, or will it simply allow its range of holdings to mature?

Meetings in Washington are scheduled to commence today to deal with the possible reinstatement of the U.S. statutory debt limit, which was suspended by the Congress in January at $16.4 trillion (U.S.). Since the national funded debt level now approximates $17 trillion (U.S.), the debt ceiling should be reset at about $18 trillion (U.S.) or, quite possibly, Congress could extend the suspension period for several months yet. In either case, as mentioned in our previous publications, it is absurd to believe that such debt levels will ever be repaid.

With the debasement of currencies likely to continue unabated, investors can protect themselves by owning gold bullion, gold coins and shares of gold-mining companies. **See also, Companies We Like: researched, reviewed and listed on our website by Ian Gordon.** If you must hold some fixed income securities in your portfolio, for reasons of capital preservation and a predictable income stream, ensure your holdings are of the highest credit rating possible and implement a laddered schedule over a mid-term maturity range.

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