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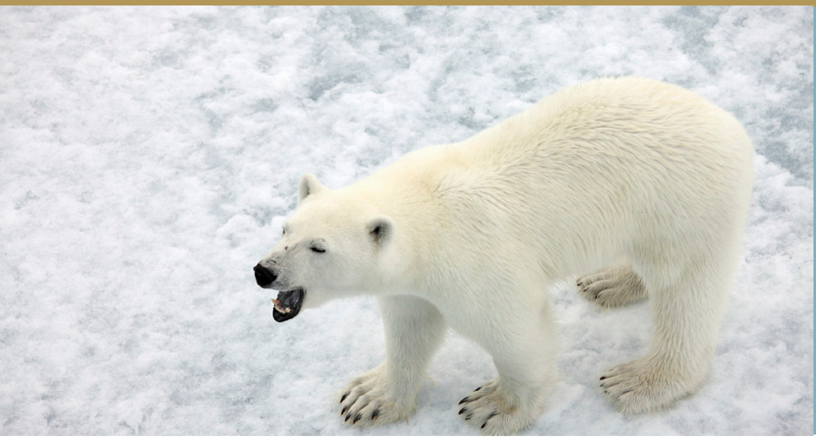
THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

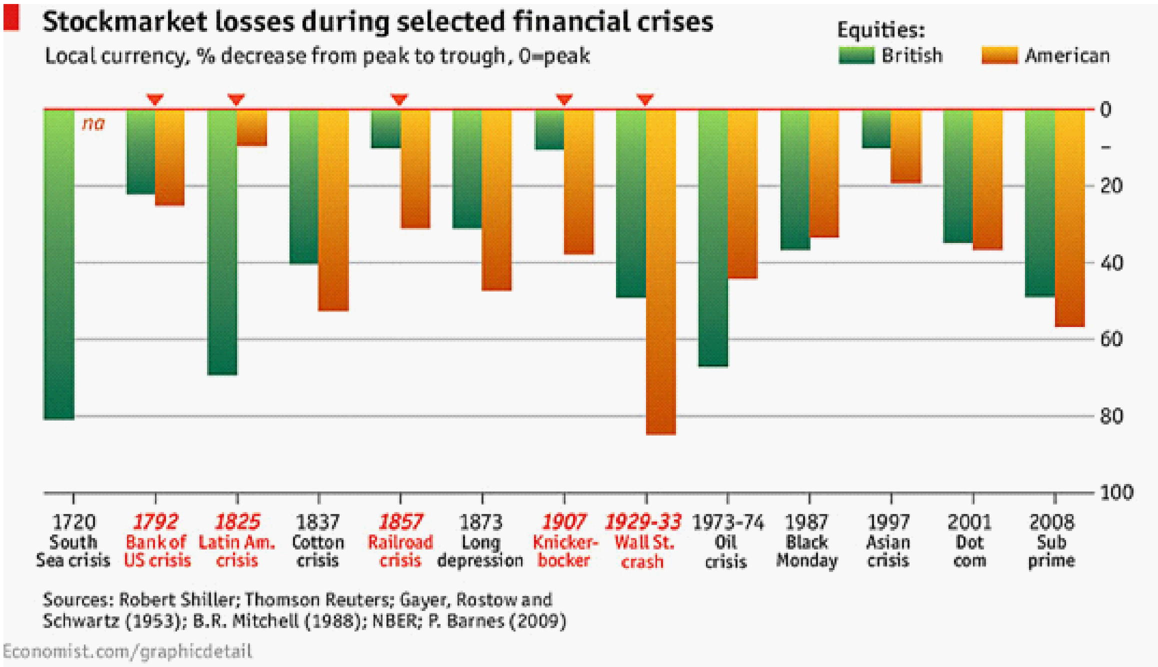
ECONOMIC WINTER



Desperate Acts to Retain the Paper Monetary System

Introduction

Within the current global economic environment, central bankers – of the world's developed economies and those of emerging markets alike – remain obsessed with the struggle to incorporate monetary policies which will engender renewed gross domestic product (GDP) growth in their respective economies. These central bankers have been led by the example of the U.S. Federal Reserve, whose implementation of a multi-year quantitative easing program, i.e. the $4.5 trillion (U.S.) purchase of U.S Treasurys and mortgage-backed securities, has been coupled with the maintenance of historically low administered interest rates; such as the present 0% – 0.25% range for the Federal Funds Rate. Complicating the global GDP growth challenge has been the persistent increase in the debt levels of many sovereign credits, once again led by the United States, whose national debt level now exceeds $16.8 trillion (U.S.) – that's $16,800,000,000,000 (U.S.). Within the context of the above, it behooves us to visit a few historic examples of paper money systems which, while well-marketed, met with an inglorious fate.



John Law – The Father of Paper Money

In his book of the above title, author Robert Minton describes John Law as a young Scottish financier, brilliant, daring and unusually handsome. For killing a man in a duel over a woman, he was forced to flee to Amsterdam where he became a close student of Dutch trade and banking practices, then the most advanced in the world. Returning to the British Isles in 1700, via special arrangement with the Crown, he failed in his attempt to convince the British Parliament of the need for a national bank, so in frustration he departed for France. In Paris, he was soon known to many of the foremost figures of French finance and with the economy critically shaky, he was able to convince Philippe II – Regent for the child King Louis XV, to back his extraordinary scheme for issuing unsecured paper money. Under this system, anyone could become rich quickly. Law then founded his own Royal Bank and soon controlled all of France's improving finances.

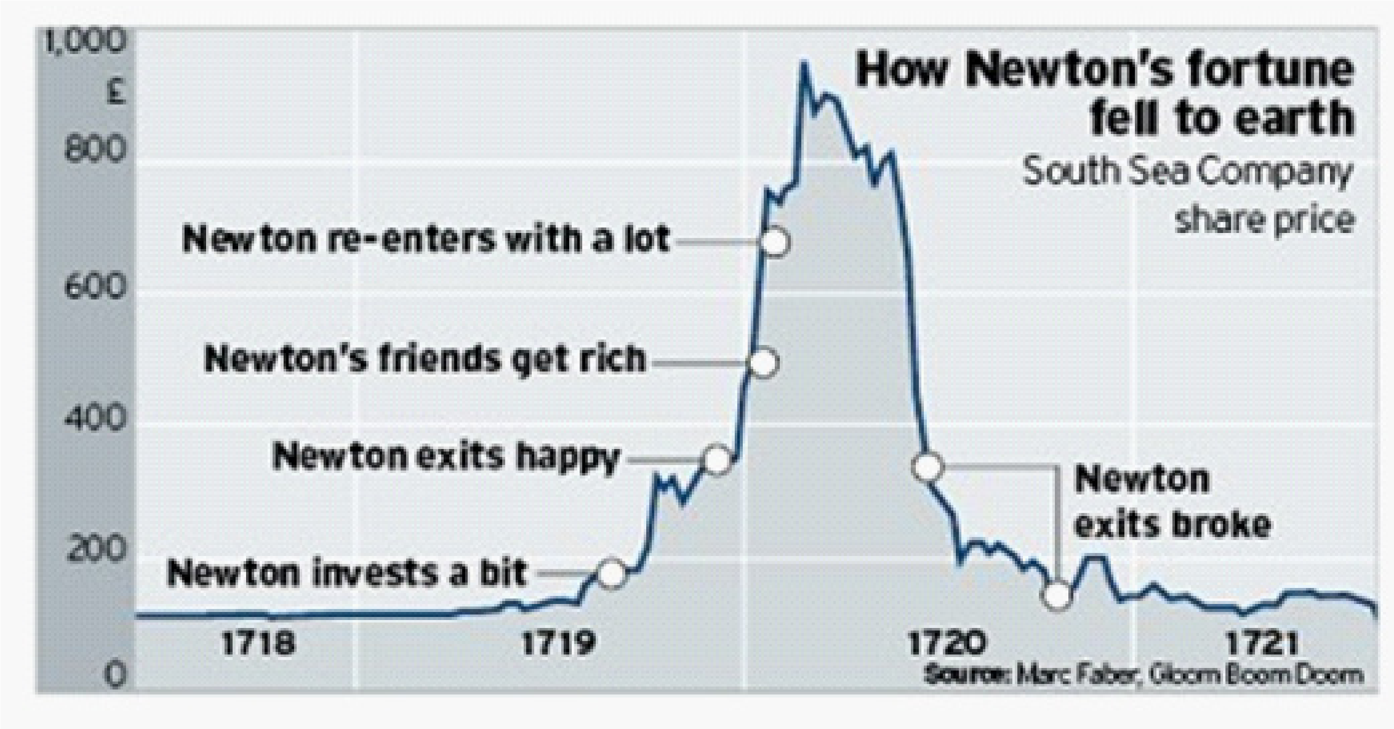
Portrait of John Law by Alexis Simon Belle.

To support the resulting orgy of uncurbed speculation, he 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 and precious gems to be collected from the river shores. In 1720, the 'Mississippi Bubble' burst, ruining thousands of investors. Soon thereafter, Law's whole monetary system quickly collapsed and he fled to Venice. After supporting himself ably for nine years with his mathematical knowledge of gambling, he died there unattended and unmourned.

The South Sea Bubble

As recently revisited by the Daily Telegraph U.K., Investment Editor Richard Evans cited: The South Sea Company was an unusual business. Founded in 1711, it was promised a monopoly on trade with Spanish South American colonies by the British government, in exchange for taking over the national debt raised by the War of Spanish Succession. However, the trade concessions turned out to be less valuable than hoped. In January 1720, when the company's shares were trading at 128 pounds, the directors circulated false claims of success amid fanciful tales of South Sea riches, so in February the share price rose to 175 pounds. That same month, the company convinced the government to allow it to assume more of the national debt in exchange for its shares, beating out a rival proposal from the Bank of England. With investor confidence mounting, the share price climbed to about 330 pounds by the end of March.

However, the South Sea Company was part of a wider flurry of speculation on the stock market. Equity issues by newly formed companies were seen as appearing like bubbles; so sometimes 1720 was known as the 'bubble year.' In June, at the behest of the South Sea Company, the British Parliament passed the 'Bubble Act' which required all shareholder-owned companies to receive a royal charter. When the South Sea Company received its charter, it was perceived as a vote of confidence in the company and by the end of June its share price had reached 1,050 pounds. However, investors began to lose confidence in early July and by September the share price had plummeted to 175 pounds, devastating investors. Indeed, one investor who lost a fortune was Britain's greatest physicist, Sir Isaac Newton, Master of the Royal Mint from 1699 until his death in 1727, remembered for unofficially moving pound sterling to the gold standard from silver in 1717.



As the above graph illustrates, Newton invested early and then sold out after realizing excellent returns very quickly. However, Newton made the mistake of re-entering the market much closer to the peak and then hung on even after the bubble had burst, selling only once the share price had collapsed to well below his cost. Reportedly, Newton lost 20,000 pounds, the equivalent of about 3 million pounds in today's terms.

Sir Isaac Newton 1642 - 1727 Photo source: PA files.

"I can calculate the motion of heavenly bodies, but not the madness of people."

Fiat Money Inflation in France

In his treatise by the above title of a century ago, author Andrew Dickson White wrote that early in the year 1789, the French nation found itself in a deep financial embarrassment: there was a heavy debt and a serious deficit. Indeed, the vast reforms of that period, though a lasting blessing politically, were a temporary evil financially. There was a general lack of confidence in business circles; capital had become scarce and a general economic stagnation ravaged throughout the land. There was prevalent a general search for some short road to prosperity: ere long the idea was set afloat that the great need for the country was more of the circulating medium and this was readily followed by calls for an issue of paper money. The trend in favour of paper money became so strong that an effort was made to bridge it by a compromise. So, during the last months of 1789 and the first months of 1790, there emerged discussions in the National Assembly looking to issues of notes based upon the landed property of the Church, which was to be confiscated for that purpose. Eventually, the finance committee of the National Assembly appealed to the patriotism of the French people with this declaration: “Let us show to Europe that we understand our own resources; let us immediately take the broad road to our liberation instead of dragging ourselves along the tortuous and obscure paths of fragmentary loans.”

So, by launching the new paper money, the National Assembly proclaimed: “These assignats, bearing 3% interest as they do, will soon be considered better than the coin now hoarded and will bring it out again into circulation.” The initial result of this issuance seemingly vanquished all difficulties. However, soon thereafter another result emerged: times grew less easy; so by the end of September – within five months after the issue of four hundred millions in assignats – the government had spent them and was again in distress. Indeed, over the next few years subsequent issuances of assignats increased so rapidly that rampant inflation and then hyper-inflation ensued and by mid-1796 forty-five thousand millions of assignats had been printed. By May 1797 assignats had become virtually worthless and the reign of paper money in France ended in the complete financial, moral and political prostration of France, from which only a Napoleon could raise it. Even when hard pressed financially, Napoleon insisted: “While I live I will never resort to irredeemable paper.” He never did and from this determination in 1803, France commanded all the gold and silver she needed until the Battle of Waterloo in 1815.

The Folly of Elastic Money

In his book Paper Money Collapse, author Detlev Schlichter recounts how the recent financial crisis has exposed the instability of the global financial system. While there is always plenty of talk of reform, only a few economists are yet willing to consider that the root cause is the limitless supply of paper money. As cited above, all paper money systems have either collapsed in chaos, or society has returned to commodity money – usually based on gold – before a total currency disaster occurred. Such controversial conclusions clash with today’s general consensus that elastic state money is superior to inflexible commodity money. Moreover, the majority of economists believe that expanding the money supply is harmless or even beneficial as long as the inflation rate remains low. A great many people working in the financial markets, in the media and in monetary policy positions are unwilling to appreciate the underlying problems with elastic money and the danger it presents.

The U.S. Dollar’s 70-Year Dominance Is Coming to an End

In a recent Daily Telegraph article, journalist Liam Halligan wrote: Seventy years ago the Bretton Woods agreement marked the moment the dollar’s unquestionable supremacy was secured. Since then, global commerce has been conducted largely in dollars and leading economies have held the greenback as their primary reserve currency. The same system remains intact today, with the lion’s share of commercial settlements worldwide still clearing the U.S. banking system; even if the parties involved have nothing to do with the United States. Meanwhile, the dollar’s hegemony continues to be cemented by the operations of the International Monetary Fund (IMF) and the World Bank. Founded at Bretton Woods, they are both Washington-based and controlled by America. The advantages this system bestows upon the United States are enormous. Reserve currency status generates huge demand for dollars from governments and companies around the world, as they are needed for reserves and trade. This has permitted successive American administrations to spend far more than is raised in taxes and export revenues, year-in and year-out. So, America doesn’t worry about balance of payments crises, since it can pay for imports in dollars the Federal Reserve can just print. Indeed, Washington keeps spending willy-nilly as the world buys ever more Treasurys on the strength of regulatory imperative and the vast size of the U.S. debt market.

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A Nation in the Red

In his book of the above title published earlier this year and which focusses on the U.S. government debt crisis, author Murray Holland concludes: Our government debt is rising every day. Our population is shifting as more people retire and fewer are able to find work. Our social programs, including the Affordable Care Act (Obamacare), are not only adding to our financial burden, but are also, hindering our domestic economic growth.

The United States is in very deep financial trouble. Firstly, the concept of repaying $16.8 trillion (U.S.) in debt is not even a remote possibility over the next 100 years even if the government produced small surpluses. Then, because the country is recording such large deficits, the national debt is increasing and getting worse, indeed much worse. In addition, the government has approximately $70 trillion (U.S.) in unfunded liabilities which must be resolved. This means it needs to either decrease the benefits – primarily under Medicare and Social Security – or to increase taxes, or both. Pray that the market for the national debt remains open so the United States can keep borrowing to repay the money it previously borrowed and then, it will have to re-borrow to repay the money it just borrowed. There is no chance the bond market will not change its demeanor over the next 100 years. It will certainly experience periods of higher interest rates and bond yield levels. It will also witness times of lack of demand for Treasurys, due to economic pressures and geopolitical events around the world. Even under the Obama administration budget deficit trend, interest expense for outstanding Treasury issues will exceed $1 trillion (U.S.) a year by 2022.

The scenario of worse-than-projected tax receipts for the government, along with considerably higher than disclosed liabilities, is a recipe for disaster for the United States. The effects of the financial system collapse witnessed in Greece will be the same with the collapse of the U.S. financial system because the laws of economics are the same everywhere and cannot be changed by the government. They are as powerful as the laws of nature. If you are not terrified at the thought of the collapse of the United States, you should be. Almost everyone in the world will be negatively affected, particularly the poor. With all the clever people in power in the United States, it should terrify every citizen to know that America now has the ninth worst debt to gross domestic product (GDP) ratio in the world.

Summation

We have recounted how John Law, the brilliant Scottish economist of his day hoodwinked French investors and France's aristocracy alike with his Mississippi Bubble paper money scam of the early 1700s. Separately, we recalled how the British government orchestrated the founding of the South Sea Company by issuing paper shares in a company which possessed no assets, no business and virtually no business plan. Also, we revisited the revolutionary period in France which resulted in the assignat's disintegration into a hyper-inflationary heap. Little wonder that these schemes and many Ponzi schemes since have ended in financial disaster.

Today, we witness the United States Congress merrily digging its way deeper into a Debt Trap of its own making, seemingly oblivious to the mid-term and long-term consequences of same. In point of fact, there exists in the Congress, in the Obama administration, in the media and on Wall Street, a national belief that America can print paper money and grow its economy as its route map out of debt. With annual GDP growth expectations of 2% to 3% over the next several years, this is a completely false hope! At Long Wave Analytics, we expect the U.S. national debt to reach $20 trillion (U.S.) by the year 2020. The only U.S. agency which has any foresight on the country's debt situation is the Congressional Budget Office (CBO), to whom few Americans are listening. See also, Economic Winter, It's Still the Debt, Stupid – March 21, 2014 and The Week That Was – September 15, 2014 to September 19, 2014.

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