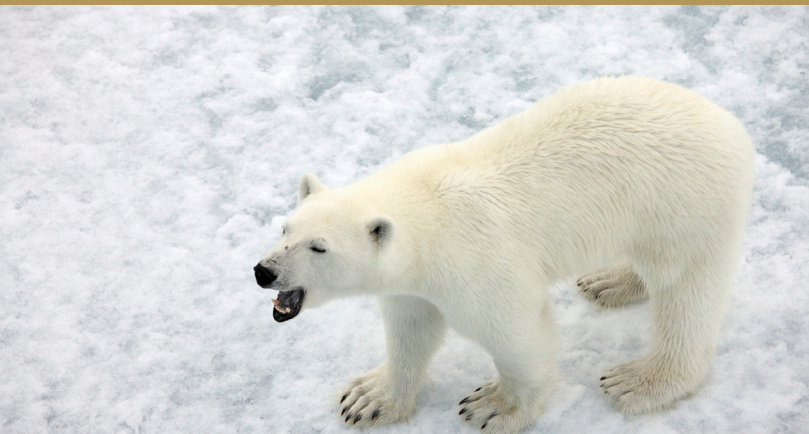


THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER



Implications of the Impending Collapse of the Fiat Paper Money System

Introduction

From the paper money system introduced in France by John Law in 1716 to the French National Assembly's assignat currency used as legal tender from 1789 to 1796, the issuance of unsecured paper money systems has a disturbingly long history in world commerce dating back to China in 177 B.C. Indeed, in every instance, since no control was established to limit the amount of fiat paper currency to be printed, an exchange rate collapse became imminent. Over the past five years sovereign debt levels have soared on a global basis with Japan and the United States leading the charge, with euro zone countries such as Greece, Spain, Portugal and Italy close behind. If one revisits the financial situation of Europe in the early 1930s, we can yet again uncover Long Wave winter parallels to what is occurring within the European Monetary Union (EMU) today.

The Collapse of the Credit Anstalt Bank of Vienna

The first opportunity to halt the international disintermediation came in May 1931 with the collapse of the Credit Anstalt Bank of Vienna, the leading Austrian Bank. The central bank had maintained high interest rates to keep funds in Vienna, which in turn contributed to the softness in the economy and large loan losses as asset prices declined. The May 11th publication of the Credit Anstalt's statement revealed that it had lost 140 million schillings, about 75% of its capital. The Austrian government asked the League of Nations for financial assistance because the League had organized the stabilization loans in the 1920s and the League turned to the new Bank for International Settlements (BIS) which had been es-

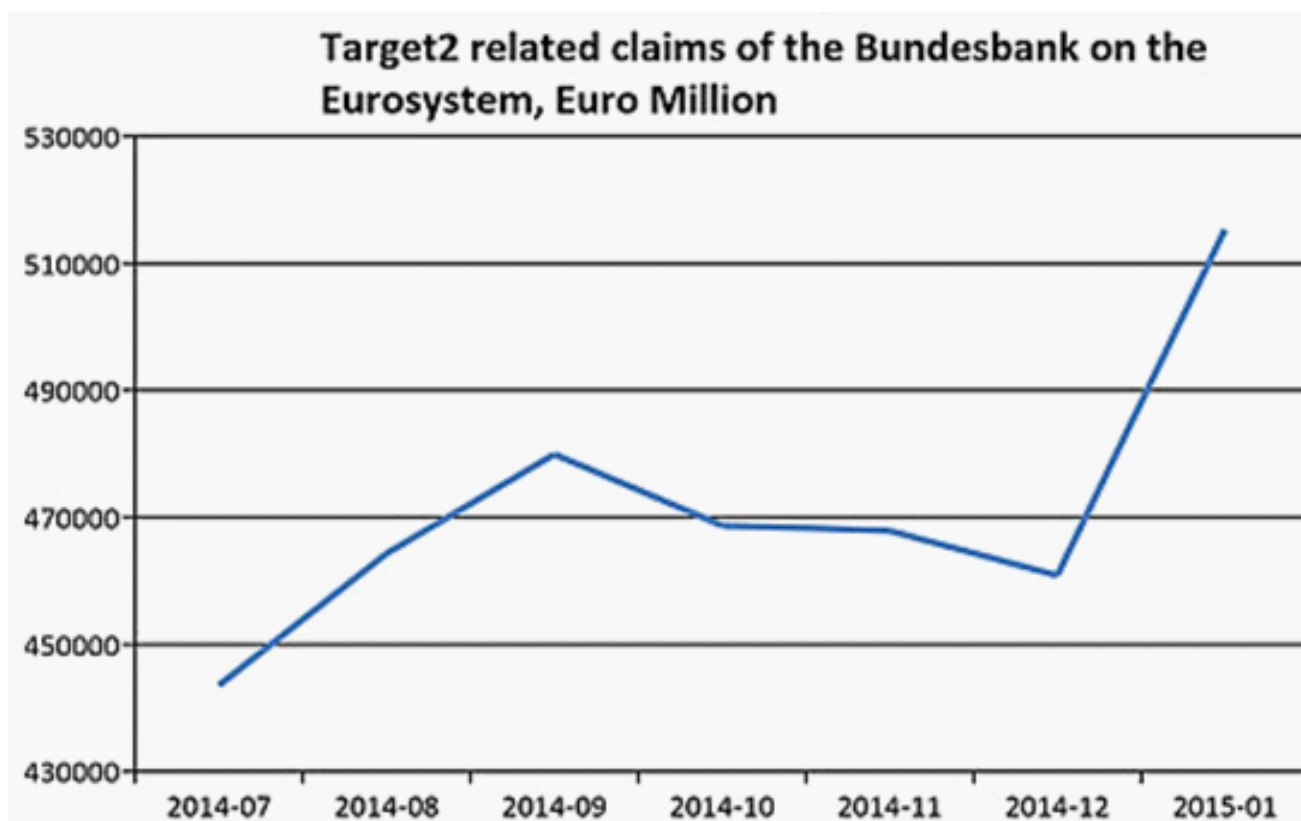
tablished under the Young Plan of 1930 to assist in the transfer of German reparations. The Austrian government wanted to borrow 150 million schillings (\$21 million U.S.). During the last two weeks of May, the BIS arranged for a loan of 100 million schillings from eleven countries. By June 5th. the funds from the loan were exhausted and the Austrian National Bank requested another loan which was arranged by June 14th. Increasingly, depositors were demanding gold instead of cash when withdrawing savings from their bank accounts. The Credit Anstalt's default had precipitated the demise of the gold exchange paper money system.

The bank run then shifted to Germany. The German banking position was weakened by excessive speculation, large loan write-offs, fraud, quarrels among the bankers, banks which had been buying their own shares and depleted liquid reserves – the full range of classic troubles – initially causing the failure of the Danatbank on June 17th. The speculative pressure then turned to Great Britain, with the Federal Reserve Bank of New York and the Bank of France each lending \$125 million (U.S.) to the Bank of England. Five aspects of the 1931 story are especially striking: (1) the inability of Great Britain to act as a lender of last resort; (2) the unwillingness of the United States to act as a lender of last resort apart from the inadequate loan to the Bank of England; (3) the desire of France to gain political objectives with respect to Austria and Germany; (4) the paranoia of Germany after 1923, preferring anything to a hint of inflation; and (5) the irresponsibility of the smaller countries.

This one banking failure was enough to bring down the entire world monetary system based on gold. Soon after Austria and Germany defaulted, Great Britain followed suit, being forced off gold in September 1931. The United States resisted until President Roosevelt assumed office in 1933. By then so much gold had been taken out of America, not only by foreigners but also by Americans, all of them certain that America would have to abandon gold backing for the dollar. This left the newly installed President with no choice, since the government was left with insufficient gold in order to support the currency.

A Greek Default Would Wreak Financial Havoc Within the EMU

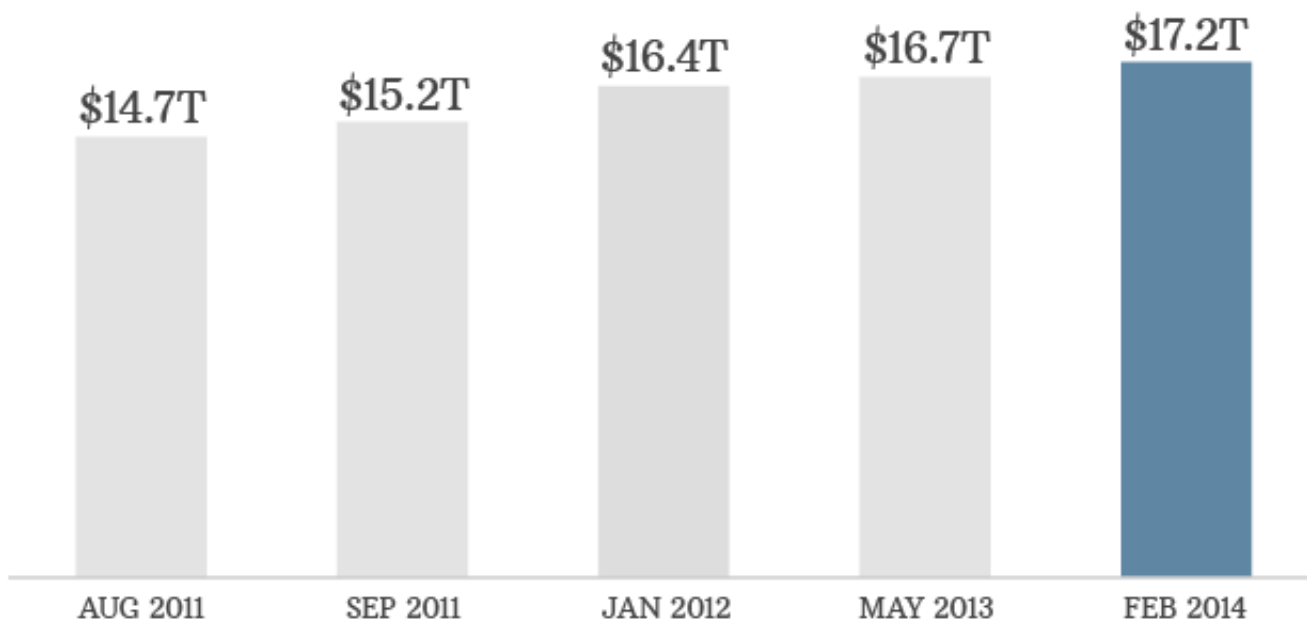
A parallel financial situation to the Credit Anstalt default is currently unfolding in the sovereign debt arena within the European Monetary Union. The potential political detonating pin for Greek contagion in Europe is an obscure mechanism used by the euro zone's nexus of central banks to settle accounts. If Greece is forced out of the euro under acrimonious circumstances – a 50/50 risk given the continued refusal of the creditor core to acknowledge their own guilt and strategic errors – the country will not only default on its EMU rescue packages, but also on its Target2 liabilities to the European Central Bank (ECB). In normal times, Target 2 adjustments are routine and self-correcting. They occur automatically as money is shifted around the currency bloc. The U.S. Federal Reserve has a similar internal system to square the books across regions. This will turn nuclear if the EMU dissolves. The Target2 debts owed by Greece's central bank to the ECB rose to 49 billion euros in December, as capital flight accelerated on fears of a Syriza victory. By now they may have reached 65 billion or 70 billion euros. A Greek default – unavoidable in a Grexit scenario – would crystallize these losses. The German people would discover instantly that a large sum of money, committed without their knowledge and without their vote in the Bundestag, had vanished. Events would confirm what citizens already suspect; that they have been lied to by their political class about the true implications of ECB support for southern Europe and they would strongly suspect that Greece is not the end of it.



Source: Daily Telegraph U.K.

Beware of the Ides of March

The U.S. debt ceiling suspension, approved by Congress in February of last year at \$17.2 trillion (U.S.) is scheduled to expire on March 15th next. The Department of the Treasury is permitted to borrow as needed in order to pay the bills and avoid default. Thus, we can expect a new debt ceiling to be set above \$18 trillion (U.S.).

Debt ceiling increases

SOURCE: CONGRESSIONAL RESEARCH SERVICE

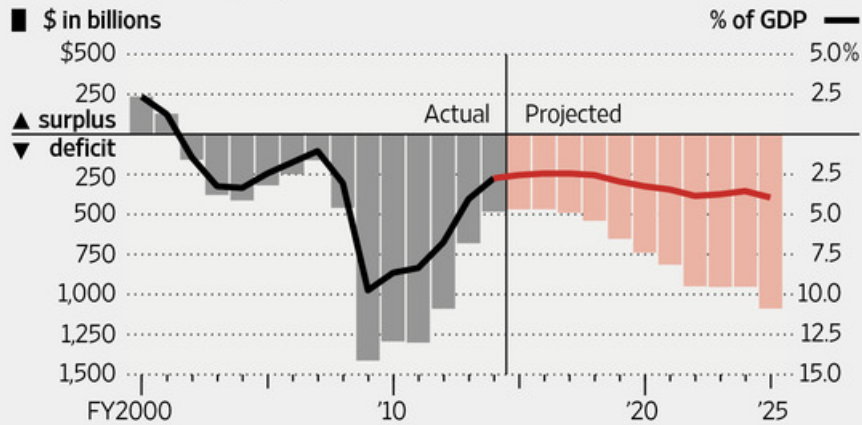
The Inexorable Rise in U.S. National Debt Will Destroy the Dollar

Since the yield on 10-year U.S. Treasuries has risen back above the 2% mark, currently trading at 2.10%, bond traders, individual bond investors and portfolio managers are beginning to realize that the inexorable climb in America's national debt – currently in excess of \$18 trillion (U.S.) – is finally starting to force the yields on outstanding U.S. Treasuries into higher ground; the country's low inflation rate notwithstanding. Suffice to say, there is no need for investors to hope, wish and pray from the sidelines that the U.S. Federal Open Market Committee (FOMC) will raise its Fed Funds Rate, currently in the 0% – 0.25% range, because it is just not going to happen. Rather, the Fed Funds Rate will be a lagging indicator compared to U.S. Treasury yields in the open market, resulting in a strengthening yield curve. The FOMC will not raise the Fed Funds Rate because that makes it more expensive for the Department of the Treasury to service the outstanding debt mountain. A stronger yield curve means it will be more expensive for Uncle Sam to market new Treasury issues and higher bond yields mean lower bond prices. See also, *The Week That Was – FOMC Minutes Confirm Support for Stable Fed Funds Rate*, Tuesday, February 18, 2015.

Deficit Attention

The Congressional Budget Office projects the federal deficit will narrow over the next few years before widening again in 2018.

Federal budget surplus/deficit

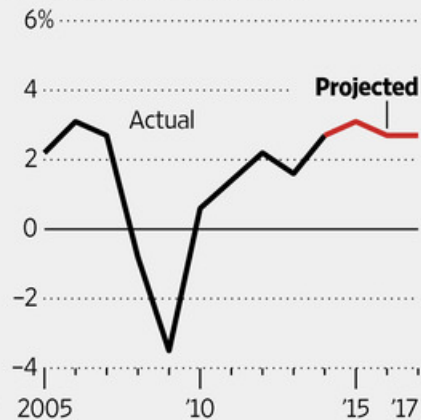


The CBO also forecast continued solid gains in gross domestic product, and expects growth in employee compensation.

Gross domestic product



Employee compensation



Note: Fiscal year ends Sept. 30. Economic forecasts are for calendar years and are adjusted for inflation. GDP data are fourth quarter vs. a year earlier. Compensation is total wages, salaries and supplements. 2014 GDP and compensation are estimates.

Source: Congressional Budget Office

The Wall Street Journal

The Financial Ramifications Would Be Widespread

A loss of confidence in America's financial leadership leading to a collapse of the current fiat money system would spell serious ramifications for investors, as well as the citizenry in general. Highly indebted State and local governments would declare bankruptcy, negatively affecting pensioners and current employees alike. The existing credit system in the domestic economy would collapse and people's savings accounts would be in jeopardy at the banks. Indeed, as in the 1930s, we could see a run on the banks as depositors withdraw their money and buy gold, not paper gold ETFs, but physical gold, in order to protect their purchasing power. Unlike the early 1930s, America today is the world's largest debtor nation, which means it is definitely in a more precarious financial situation than ever before. More and more countries are not using the dollar as the intermediary currency in their trade transactions.

Moreover, it is estimated about \$62 trillion (U.S.) of poorly regulated credit default swaps are outstanding globally in both individual and institutional investment portfolios. In Europe eventually, default contagions could spread to other Club Med countries such as Spain, Italy or Portugal. Undoubtedly, a euro zone reduced by 20% or more of its present membership would be unlikely to survive.

Summation: Greece Is Fixed?

Following an eleventh hour series of meetings in Brussels today, euro zone finance ministers have announced that they've agreed to give Greece four months of breathing room in which to get its financial house in order. In that time frame, Greece will either work out a debt restructuring program with its creditors, or create a fully-functioning economy capable of managing the developed world's second highest ratio of government debt-to GDP. Moreover, the Greeks will do these things while increasing the number of public sector jobs and limiting the privatization of public assets. More bureaucrats, richer pensions, stricter labour laws ... this is straight out of French President Francois Hollande's playbook, which in turn was cribbed from a long line of European social Democrats. All of whom failed miserably for a fairly basic reason: after government reaches a certain size, making it bigger is a net negative, i.e. it costs more than it produces so the country becomes poorer. A shrinking pie doesn't allow major constituencies to keep what they have, everyone starts squabbling, the place becomes ungovernable and the architects of the plan get shown the door.

Giving the Greek-left four months in which to formulate a new economic policy – without a currency that it can devalue – is just giving the global financial markets a vacation from this particular worry. By definition, vacations must end, so come June 30th. Greece and the rest of the euro zone will be right back where they were yesterday, although with even more debt.

So, the questions become:

1. How can a government hire more people and tighten regulations while simultaneously, paying off debt? The answer is that it can't. The two are mutually exclusive in the short run and four months is the shortest of short runs within the realm of fiscal policy.
2. Why would a Greek citizen keep euros in a Greek bank knowing that the crisis will return in a mere four months and the main tool for fixing the country's finances is aggressively accelerated tax collection, which means they are coming for your money one way or another? The answer is that they wouldn't. A few months of breathing room just gives savers a chance to get out in a leisurely, rather than panicked way.

There simply isn't a political fix for this much debt. Although delaying the day of reckoning has worked beautifully for stock market investors and incumbent politicians, it has also allowed the developed world to dig itself into a deeper hole of debt. So, Greece and the rest of the euro zone now receive another four months to borrow, spend and hope for the best; while the best recedes further toward the horizon until all that's left is a menu of really painful options. It's not a surprise that putting them off is easier than facing them head-on.

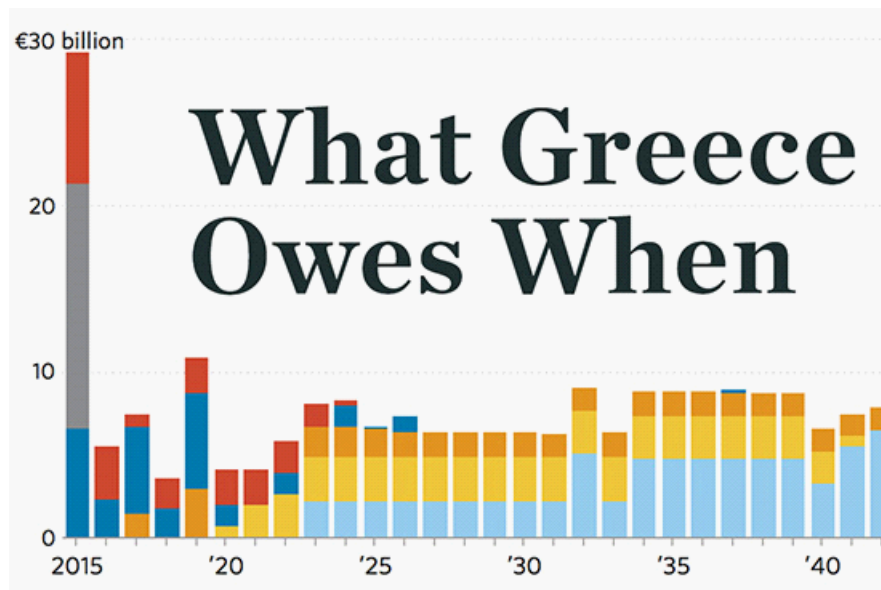
The collapse, when it comes, will be sudden; the ramifications will be horrible. Most banks will fail. Indeed, it is likely that the privately owned central banking system will lose all credibility and governments will once again take control of their currencies. A new world monetary system will evolve out of the chaos and most likely it will be based on gold. Russia and China are preparing for this eventuality.

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Source: Wall Street Journal

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