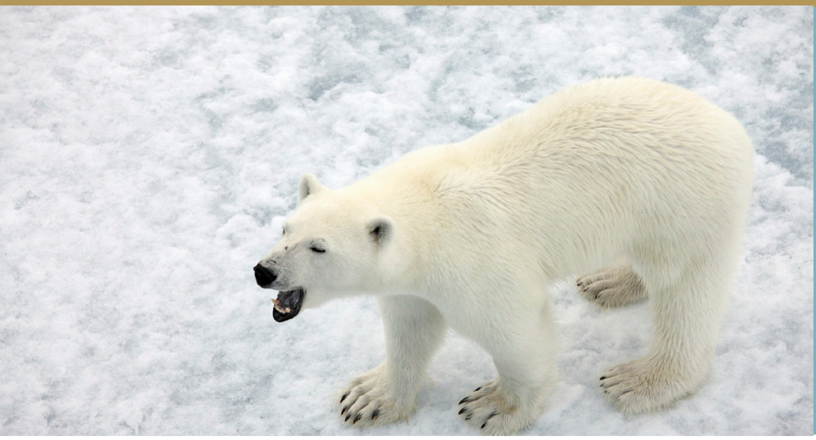
Volume 66 | Issue 1 . June19, 2015

LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER



The Impending Rise of China as a World Leader

Introduction

Over the centuries, several nations have taken their turn as a world economic leader, while frequently professing a military superiority as well. While these global leadership cycles have often exceeded 100 years in length, inevitably they have ended with dramatic and powerful domestic crises. In his book, The Rise and Fall of the Great Powers, author Paul Kennedy recalls: The Great Power struggles which occurred between 1660 and 1815 cannot be so easily summarized as a contest between one large bloc and its many rivals. Indeed, it was in this complicated period that while certain former great powers like Spain and the Netherlands were falling into the second rank, there steadily emerged five major states, i.e. France, Great Britain, Russia, Austria and Prussia, which came to dominate the diplomacy and warfare of 18th. century Europe and to engage in a series of lengthy coalition wars, punctuated by swiftly changing alliances.

This was an age in which France, first under Louis XIV and then later under Napoleon, came closer to controlling Europe than at any time before or since; but its endeavours were always held in check by a combination of other great powers. Since the cost of standing armies and national fleets had become horrendously huge by the early 18th. century, a country which could create an advanced system of banking and credit – as Great Britain did – enjoyed many advantages over financially backward rivals. However, the factor of geographical position was also of great importance in deciding the fate of the powers in their many and frequently changing contests. This helps to explain why the two flank nations of Russia and Great Britain had become much more important by 1815. Both retained the capacity to intervene in the struggles of west-central Europe while being geographically sheltered from them. Moreover, both expanded into the European world as the 18th. century unfolded, even as they were ensuring that the continental balance of power was upheld. Finally, by the later decades of the century, the industrial revolution was underway in Great Britain, which was to give that country an enhanced capacity both to colonize abroad and to frustrate the Napoleonic bid for European mastery.

Britannia Rules the Waves

For over a century prior to 1815, the Royal Navy had usually been the largest in the world. The main feature of the 100 years which followed Trafalgar was that no other country seriously challenged Great Britain's control of the oceans. Most assuredly, this fact enabled Britain to greatly expand its colonial empire. At its height, it was said that on a global basis, the sun never set on all British colonial possessions. Truly, for long periods of time particularly in many tropical areas, British interests in the form of explorers, missionaries, traders and settlers encountered no foreigners other than the indigenous peoples. From Australia / New Zealand to Hong Kong and from India to Canada, the British Empire was expanding at an average annual pace of about 100,000 square miles between 1815 and 1865. Certainly, all of the above combined with Britain's strength in the world of finance enabled the country to prosper like no other during the Industrial Revolution and literally, assume an economic leadership role on a global basis.

The Industrialization of America

World War 1 had an extremely positive effect on U.S. manufacturing production. For example, shipbuilding capacity had been enormously increased in the middle of the war to counter the sinkings by German u-boats; but after 1918, there were excess berths at ports across the globe. Whereas, the output of steel industries in continental Europe had declined during the war, steel production in Britain and the United States had increased sharply. Moreover, the financing of the First World War had caused economic and political problems of unprecedented complexity across Europe. Most European countries had attempted to pay their war debts by relying almost entirely on borrowing. Public debts, now uncovered by gold, rose precipitously and paper money, pouring out of the state treasuries, sent prices soaring. Given the economic devastation and territorial dislocations caused by the war, no European country was ready to follow the United States back onto the gold standard in 1919. Competitive devaluations of national currencies, implemented in a desperate attempt to boost exports, simply created more inflation and financial instability. This was all compounded by the related issues of intra-Allied loans and France's demand for substantial German war reparations. All the European allies were in debt to Great Britain and France and in turn, they were heavily in debt to the U.S. Inevitably, America had now become the world's greatest creditor nation.

Bretton Woods and the International Monetary Agreements

Indeed, by the early 1940s there evolved an extended debate about planning for multilateral economic institutions that would provide for greater economic stability than during the twenty year period following World War I. An international credit institution would be established to help countries finance short-term balance of payments deficits. This became known as the International Monetary Fund (IMF). In their book, Manias, Panics and Crashes, authors Charles Kindleberger and Robert Aliber cited: The debate about the IMF was primarily between the British and the Americans, who held different views about its structure and its financial resources. The British Keynes' plan provided for an institution that would have its own money or unit of account. Member countries would be endowed with deposits in this institution which they could then transfer to other countries to finance their payments deficits. The American view – the White Plan – was that each member country would transfer gold and its own currency in the form of a non-interest bearing demand deposit to the institution to endow its capital. Each member country would have a quota based upon the volume of its trade, as well as its gold holdings. The size of each member country's quota would determine the amount of gold and its own currency which it would transfer to the institution. A member country would be able to buy currency owned by the institution with its own currency; the amount of currencies that the member could purchase would depend upon the size of its quota. Since the Americans had all the money, their view prevailed, culminating in the U.S. dollar being established as the world's reserve currency.

The IMF's Articles of Agreement contained a set of rules for the management of the foreign exchange values of member country currencies. Each member country would be required to state a parity for its currency, either in terms of gold or in terms of the U.S. dollar; would be required to limit the variation in the foreign exchange value of its currency to a narrow band around its parity and would be required to obtain the approval of the IMF before changing the value of its parity by more than 10% relative to its initial parity. Despite the motivation to establish a credit institution that would help avoid a repetition of the experiences of the 1930s, the structure of the IMF meant it could not act as a lender of last resort because it did not have its own money. Instead, within modest limits, the IMF could lend money to countries to help them finance their current account deficits.

America Evolves into the World's Largest Debtor Nation

Accordingly, for over the last 80 years, the U.S. has played an economic leadership role on a global basis. However, in an effort to retain that position, over the last few decades America has drifted into an increasingly worsening debtor position, not only in terms of its accumulated national debt mountain, currently $18.2 trillion (U.S.) but also, at the state level. Earlier this month a report released by the Volcker Alliance – a government reform group founded in 2013 by Paul Volcker, former chairman of the U.S. Federal Reserve – warned that U.S. states relied upon faulty practices to balance their budgets; masking the true nature of their finances and leading to poor policy decisions. Indeed, many states remain under heavy financial pressure, with overall tax revenues – adjusted for inflation – barely recovered from their pre-recession peaks.

The report stated: “The ongoing fiscal stress is tempting states to continue and even intensify, budgeting and accounting practices which obscure their true financial position, shift current costs on to future generations and postpone the need to make difficult decisions on spending priorities and revenue practices. In state budgeting, there are problems hidden by a lack of truth and integrity. For example, mounting fiscal stress in Illinois, Detroit’s bankruptcy and the fiscal problems mounting in Puerto Rico demonstrate the importance of developing better financial policies. The never-ending sense of crisis leads to stop-and-go funding of vital state programs and stifles the need for serious policy change.”

As reported in the Financial Times, poor accounting techniques include shifting the timing of receipts and expenditures over many years, borrowing on a long-term basis to pay for current bills; using non-recurring revenues to cover recurring costs and delaying the funding of pension and health care retirement benefits. For example, to balance its budget, New Jersey has relied upon borrowing and other manoeuvers, including shifting money to its general fund which was intended for other programs. Budget gimmicks set states on a path of continually searching for ways to plug successive budget gaps. With its report, the Volcker Alliance aims to lay the groundwork for future research extending to the 50 states and to build a common approach toward responsible budget practices. Mr. Volcker elaborated: “The hope is by shedding light on these poor bookkeeping practices, it will make it more difficult for states to engage in these activities and address the problem.”

Volcker Alliance Chairman Paul Volcker.
Photo source: Financial Times

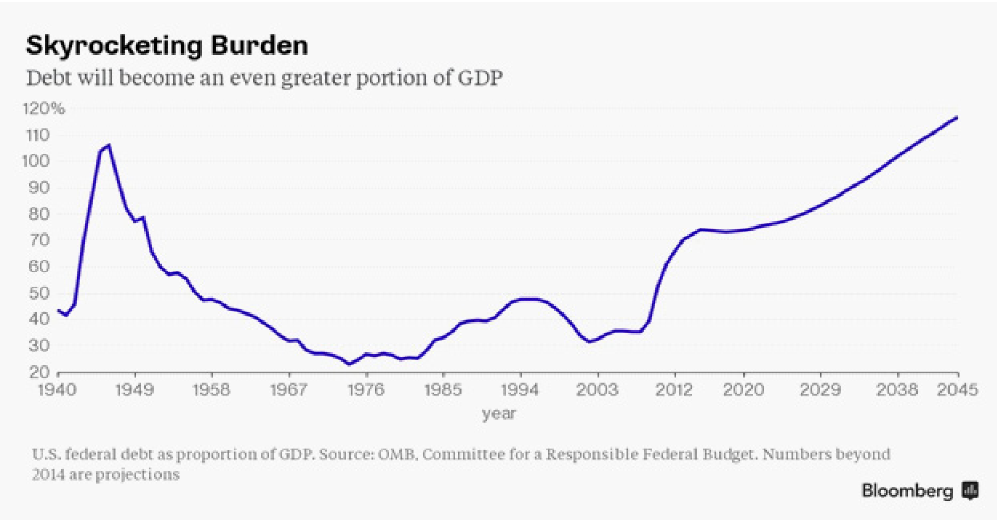
Illinois Supreme Court Rejects State Pension Cuts

As reported in the New York Times, last month the Illinois Supreme Court rejected changes that state legislators made to resolve a deeply troubled public pension system, leaving the state where it had begun – with a significant budget crisis and a vastly underfunded pension program – with no plan in sight. All seven members of the state’s highest court ruled that a pension overhaul which lawmakers had agreed to almost 18 months ago violated the Illinois Constitution. The proposed changes would have curtailed future cost-of-living adjustments for public workers, raised the retirement age for some and put a cap on pensions for those with the highest salaries. However, the Illinois Constitution clearly prescribes: “Benefits promised as part of a pension system for public workers shall not be diminished or impaired.”

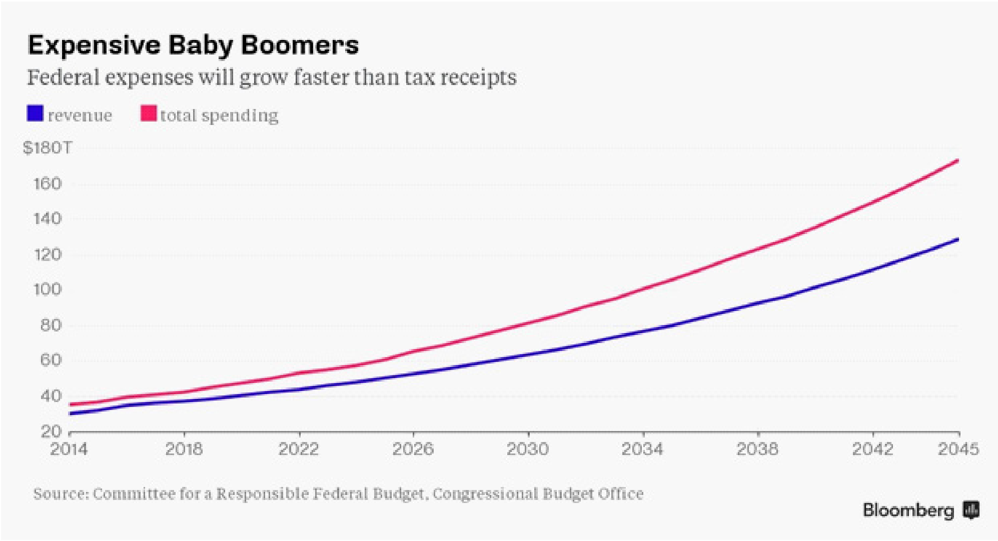
In recent years, many states have wrestled with paying their pension obligations, but Illinois’ problems have been among the worst, leaving public sector workers uncertain about their retirements, the state’s budget strained and the state’s credit ratings sinking. In his opinion, Justice Lloyd A. Karmeier wrote: “Crisis is not an excuse to abandon the rule of law. Rather, it is a summons to defend it. The Illinois General Assembly may find itself in crisis … but it is a crisis for which the General Assembly itself is largely responsible; moreover, it is a crisis which other public pension systems have managed to avoid.”

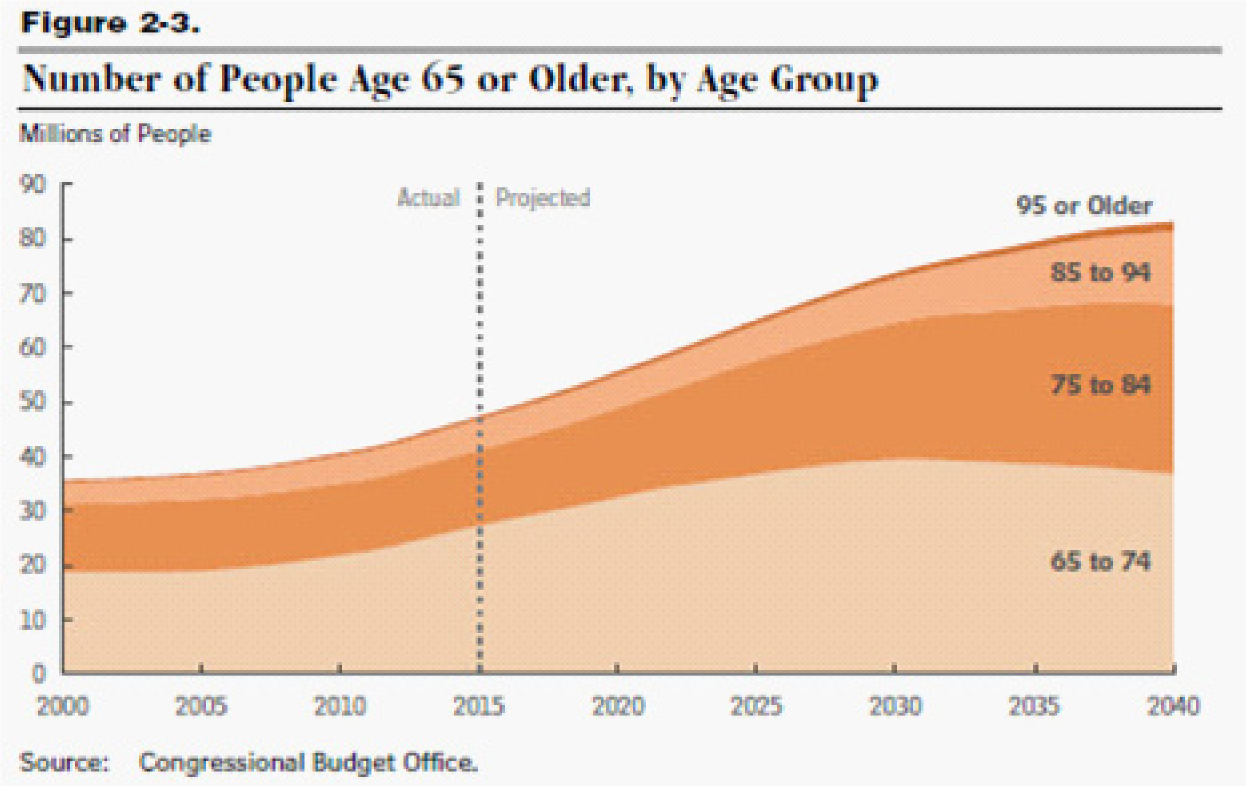
CBO Forecasts U.S. Government Debt to Reach 107% of GDP by 2040

Just this week, in a long-term fiscal report released in Washington, the non-partisan Congressional Budget Office forecast U.S. government debt held by the public will likely increase to 107% of gross domestic product by the year 2040 from 74% this year, citing an aging population and rising health care costs. The CBO report warned: 'With government debt already unusually high relative to GDP, further sustained increases could be especially harmful to economic growth. To put the federal budget on a sustainable path for the long term, lawmakers must make major changes to tax policies, spending policies, or both.'



In its outlook on the budget, the CBO cited the aging of the country will have profound impacts on the domestic economy. Firstly, there are direct costs from Medicare and Social Security. Federal spending for Social Security and the government's major health care programs is projected to rise to 14.2% of GDP by 2040; basically twice the average over the past 50 years. That's mostly due to the aging of the population, although it's also due to increased per person spending on health care and the increased usage of Medicare due to the Affordable Care Act. One startling fact: Medicare's average spending for an 85-year old is more than twice that for a 66- year old. Moreover, as Americans live longer, they are able to work longer: the CBO figures by an additional three months for every extra year on the planet.





Keith Hall, Director of the Congressional Budget Office.
Photo source: Bloomberg News

Fearing the Loss of Hegemony: The Concept of U.S. Retreat

In a recent article for Global Research, Binoy Kampmark, a lecturer at RMIT University in Melbourne, writes: The recent round of spring meetings at the International Monetary Fund (IMF) and the World Bank flutter with suggestions that American economic power is being shaded, be it by the republic's own dysfunction, or the emergence of other powers like China …While this would come as a surprise to some, the problem seems to be U.S. President Obama. They see the Obama administration as a regime in retreat, which is the theme of Bret Stephen's near fictional work. Indeed, America in Retreat: The New Isolationism and the Coming World Disorder already gives its readers two issues to stumble over: that there is an isolationism to speak of and that disorder would be a genuine problem. For Stephens, the first issue of the Obama retreat is reflected by the choice made by the U.S. president when he came to office determined to scale down America's global commitments for the sake of what he likes to call 'nation building at home.' Stephens assiduously ignores the vast, expansive and dangerous robotic reach of American power, typified by remote drone strikes; the backing of proxy regimes and such negotiating endeavours as the Trans-Pacific Partnership.

However, like his colleagues of that most myopic brand of history – the idea of empire – can see no reason for America to retreat from anything. For instance, take the adventurism in the Middle East … The efforts for the pacification of Iraq continue to linger in their destructive toll; although armchair militarists get goggle-eyed when it comes to the empirical world. Conservative columnist George Will was left wondering what the missing factor was in the state building process and came to a simple, if impossible conclusion: "Iraq is just three people away from democratic success. Unfortunately, the three are George Washington, James Madison and John Marshall." Then comes the issue of disorder, which takes the contractarian idea that, to achieve order in the international system, deals must be made with hegemons, whether one wants to or not. Stability is something gained by bedding the brute across the ocean and smaller states need to cozy up to bigger ones with greater zeal …Empires do check into the old home, get on the non-solids and eventually die from natural causes. Yet Stephens is cautious to suggest that, while America is in retreat, it is not in decline. This is in stark contrast to others, like Chris Lane of the George Bush School of Government and Public Service, who sees the U.S. as increasingly unable to play the hegemon's assigned role.

In any case, a power dedicated to causing more mayhem than policing stability doesn't deserve any titles in the hegemonic department. The otherwise war loving David Frum had to concede after Obama pushed the U.S. into another conflict in 2011 that: "Three wars is a lot, even for the United States." In Lane's final summation: "The epoch of American dominance is drawing to a close and international politics is entering a period of transition: no longer unipolar, but not yet multipolar." When the curtains will be finally drawn on the act that is the American empire is not for anybody to say, although the clock ticks with its usual grinding pace. While the nature of its power will continue to change, the question will be whether it occurs slowly, or whether the U.S. empire ages disgracefully.

Bank of China Becomes First Asian Participant in the London Gold Auction

As reported this week by the Daily Telegraph U.K., the Bank of China has gained entry to the London Bullion Market Association gold price auction which occurs twice daily and is widely used as a benchmark by miners, traders and investors. While China is the world's largest producer and consumer of gold bullion, no Chinese financial entity has ever played a major role in setting the price of gold.

Yu Sun, general manager of the Bank of China's London branch, commented: "The Bank of China joined LMBA as an initial member in 1987 and has been actively participating in the gold trading business in London for over 40 years. The Bank's inclusion in the gold auction should allow the gold price to better reflect supply and demand in the People's Republic, which is a major market for the precious metal." In the wake of the Libor-rigging scandal, a new electronic gold auction was established in March as a more transparent alternative to the century old London Gold Fix. Under the old system which was introduced in 1919, banks simply telephoned each other to set the price each day. Now, tighter regulation of systemically important benchmarks, such as gold bullion and Libor, makes them less vulnerable to manipulation.

Finbarr Hutcheson, President of the ICE Benchmark Administration, which administers the gold auction, noted: "The growth in daily volumes coupled with the increase in participation from around the globe, demonstrates strong market support for the independent governance and oversight we have implemented to bring transparency and trust to the gold auction." Since the changes, the number of participants in the gold auction has doubled to eight including: Barclays, Goldman Sachs, HSBC Bank, JP Morgan Chase London, Bank of Nova Scotia, Societe Generale and UBS. London is the world's largest market for over-the-counter gold trading with an average of $20.2 billion (U.S.) in the metal changing hands each day, as reported in April.

Volume 66 | Issue 1 . June19, 2015

LONGWAVE group

China's Five Year Plan and the End of an Era.

Researcher Alasdair Macleod writes: China is in the late stages of constructing its thirteenth 5-year plan, a process that commenced over a year ago and will result in a first draft in October. While the bulk of the plan will concern regional and domestic development, it is the international aspects that will concern the rest of the world. The plan, which will produce specific goals for 2016-2020, is already having an effect on China's foreign and trade policy. At its center will be a shift of emphasis away from trade with advanced nations, whose prospects are bound to subside towards their level of economic growth. Instead, in order to maintain the long term objective of 7% growth in gross domestic product, China will turn her attention to improving Asia's infrastructure, a policy for which the building blocks are now in place. The Silk Road Project is advancing from the drawing board.

The Chinese-led Asian Infrastructure Investment Bank (AIIB), which will arrange financing for projects totaling as much as $20 trillion (U.S.) over the next thirty years, was formally established this year. Working in partnership with China through the Shanghai Cooperation Organization (SCO) will be Russia, whose resources are central to Asia's modernization. The SCO will eventually cover a territory from the Bering Strait to the Persian Gulf. In order to obtain extra resources, China has already established a dominant presence on the ground in Sub-Saharan Africa, secured the undivided attention of the Middle East by being its largest customer and through its own diaspora, can count on the co-operation of the South-East Asian nations currently within the West's sphere of influence. At the end of the thirteenth plan, a substantial majority of the world's population will have become involved one way or another.

The implications for the West are becoming apparent. We have already seen how mainland Europe and Britain have clamoured to join the AIIB, despite their alliances with America. Unfortunately, America has been a Goliath to China's David: her mistake has been not to recognize the passing of her own era and embrace a future based on Asia. Instead, the U.S. has sought to be obstructive. China now knows that America will always be fundamentally uncooperative and that she must plan accordingly. This is why, with Russia's support, she is ditching the U.S. dollar. She has been discouraged by America's attitude into establishing a parallel financial and monetary system. In so doing, she needs to offer something better than the U.S. dollar as a currency because for her Pan-Asian development plans, she will need to attract long term funds from Western capital markets.

This is where the new BRICS bank enters the picture. Its priority will be to lessen the risk of Asian currencies which are less credible in international markets than the dollar, yen, euro or sterling, which are the constituents of the IMF's special drawing rights (SDR). The obvious way to do this would be to incorporate something all Asians understand as money and that is gold, which could be why most SCO member countries have been adding to their gold reserves. This would solve all cross-border currency issues within the SCO. While the West may not be initially impressed by such a development, a move by the BRICS bank to include gold in its own version of the SDR will in time highlight the relative weaknesses of a dollar-reserve system, particularly when Asia dumps its dollar reserves in favour of a BRICS super-currency.

This could mark the end of the era of pure fiat currencies, which began with the Nixon shock of 1971when the Bretton Woods agreement died. Competition from gold-backed currencies from Asia would be the most serious threat yet faced by American hegemony.

Summary

At Longwave Analytics, we believe that America's national debt mountain will reach $20 trillion (U.S.) – that is $20,000,000,000,000 – by the year 2020 at the latest. Moreover, in the next few decades America's aging population will increasingly place inexorable demands on domestic entitlement programs led by Medicare, Medicaid and Social Security. Accordingly, this will exacerbate America's demise as the world's largest debtor nation, reversing its position of eighty years ago. We also believe that the unfolding of these events, will combine with a rising international presence of China and dislodge America from its global economic leadership position. Particularly, if China were to reintroduce a gold-backed medium of exchange, we believe support would not only be forthcoming from many countries, but also, a Chinese economic outlook from a base as the world's largest creditor nation could likely encompass a dynastic 100-year time horizon.

Volume 66 | Issue 1 . June19, 2015

LONGWAVE group

Written By: Christopher Funston

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