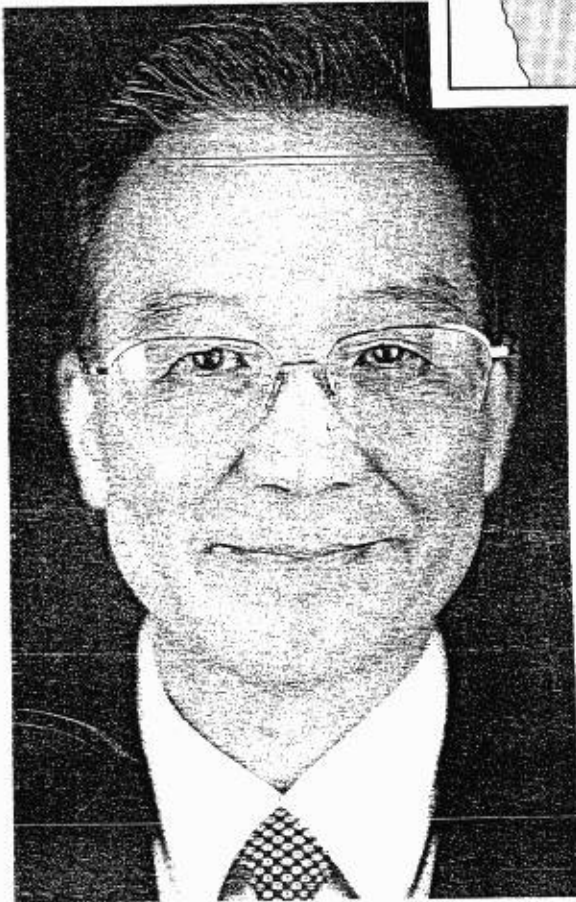


# Armstrong Economics™

The  
New  
FACE  
OF  
CHINA



Martin A. Armstrong  
former Chairman of Princeton Economics International, Ltd.

The  
SAVIOR  
OF  
Capitalism!

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This Report may be forwarded as you like without charge. It is provided as a Public Service at this time without cost. The contents and designs of systems are in fact copyrighted. At a future date, a book will be released **The Geometry of Time**. The charts are often reproductions of an earlier publication from 1986 also to be soon republished **The Greatest Bull Market In History** covering from 1900 up to the 1980s. Additional updating is underway to complete the Century and into the current time, providing a month to month history of the financial development of **Western Society**.

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# China

## The Saviour of Capitalism & The Next Reserve Currency?

No matter what the politicians may say about the otherside, the plain and simple truth is that the Free Markets are always controlling. No matter what those who would like to control the economy have to say, they are dead wrong.

It matters not if we are talking about Communism or Capitalism or the vain attempt to be just a little-bit-pregnant calling it socialism. Communism fell not because of Ronald Reagan and the threat of Star Wars. It fell because central planning does not work. Politicians behind the Iron Curtain could no more control the economy than could Republicans, Democrats, Tories, Whigs, Labour, or whatever label is attached.

The Premier of China, Wen Jiabao, is inheriting the next great shift in capitalism even though he states it is not China's job to save capitalism from itself. Ironically, he is doing a far better job than any politician in the West. He has displayed far more than just a human face portraying himself as grandpa Wen to a child trapped in the earthquake. He may be the last great hope for civilization.

There is the bizarre comments of former US Treasurer Hank Paulson that blamed the debt crisis on China. He told the press that the huge volume of savings of nations like China had in fact reduced the risk premiums around the world. I have never heard such a bullshit story like this ever before. Indeed, Mr. Wen has made it known that he too also finds it bizarre that the people who lend the money are blamed for the carelessness of the borrower who lost it. Try that excuse on your banker!

Mr. Wen has spoken clearly stating that the financial crisis was caused by the fact that the Western economies have persistently enjoyed running double fiscal and current account deficits, while maintaining high consumption on leveraged borrowing. The bankers, like Paulson, constantly demanded higher leverage so they could increase their percentage of returns relative to their capital. What Hank Paulson did on his insane blame-game is saying more-or-less, yes I am a drunk, but only because they make whiskey. It is like the gun arguments. Guns do not kill, people kill. If there were no guns, they would still cut your head-off with a sword. Keeping all weapons from such crazy people is a good idea, but we cannot tolerate an excuse that a murder took place because somebody else made the weapon. Likewise, Hank Paulson's attempt to excuse Investment Bankers because China lends capital that kept the interest rates lower disguising the risk, is not credible and a disgrace.



Wen Jiabao, Premier

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It might help to first define what is **Capitalism**. Webster's Dictionary provides the most widely accepted definition.

"[A]n economic system characterized by private or corporate ownership of capital goods, by investments that are determined by private decision rather than by state control, and by prices, production, and the distribution of goods that are determined mainly by competition in a free market."

The essence of **Capitalism** is essentially private ownership and the freedom to be what you want insofar as a profession is concerned, whereby your wages and earnings are determined by the natural forces of **free markets** that essentially is akin to the evolution process of nature - the survival of the fittest. Excess demand attracts the **Invisible Hand** described by Adam Smith (1723-1790) in his landmark publication the **Wealth of Nations** published in 1776.

There are other types of economic systems and theories that we can also turn to Webster's Dictionary for a definition.

**Collectivism** (1857)

"[A] political or economic theory advocating collective control esp. over production and distribution or a system marked by such control."

**Communism** (1840)

- "1 a: a theory advocating elimination of private property  
b: a system in which goods are owned in common and are available to all as needed
- 2 cap a: a doctrine based on revolutionary Marxian socialism and Marxism-Leninism that is the official ideology of the U.S.S.R.  
b: a totalitarian system of government in which a single authoritarian party controls state-owned means of production with the professed aim of establishing a stateless society  
c. a final stage of society in Marxist theory in which the state has withered away and economic goods are distributed equitably

**Fascism** (1921)

- "1 often cap: a political philosophy, movement, or regime ... that exalts nation and often race above the individual and that stands for a centralized autocratic government headed by a dictatorial leader, severe economic and social regimentation, and forcible suppression of opposition
- 2: a tendency toward actual exercise of strong autocratic or dictatorial control



## Socialism (1839)

- "1: any of various economic and political theories advocating collective or governmental ownership and administration of the means of production and distribution of goods
- 2.a: a system of society or group living in which there is no private property
- b: a system or condition of society in which the means of production are owned and controlled by the state
- 3: a stage of society in Marxist theory transitional between capitalism and communism and distinguished by unequal distribution of goods and pay according to work done."

The defining distinction between **Capitalism** and just about every other scheme, has been the central principle that the **Free Markets** will control no matter what, and that it is far too complex for politicians to try to control the economy and plan its development. All other schemes have been embraced by politicians both in Western culture as well as behind the Iron Curtain over the decades, simply because they purport that they alone have the power to alter our future, right all wrongs, and listen to the cheers of the people or to their silence for politicians must at all times know more than the average smuck.

No matter how loud one screams, there is no way to stop the cycle within this eternal sea of political change. People who lose their shirt, will rise up and then blame another group and demand government intervention. There were those who blamed the Christians in Rome for everything calling them atheists for they did not believe in the gods of Rome and their fathers, and thus the gods were angry and punishing the Romans. Sounds nuts! Pat Robinson and the Religious Right at first blamed the 9/11 attack on New York as the hand of God for the sinful ways of New Yorkers. This same thing can be used by every religion. It is why virgins were sacrificed to then satisfy the gods who would then bless them with crops. Mankind has a nasty trait of always blaming the other group for the current economic decline. Hitler pointed to the Jews and used that as the excuse for his slaughter.

No matter how hard politicians will try to label anyone who believes in **Free Markets** as if they are the latest cult because it flies in the face of what they want to believe, this is not a Republican thing. The economic conservative Republicans may claim to believe in **Free Markets**, but it was the Republicans that turned the entire Constitution on its head with the Patriot Act that has done nothing for terrorism but was responsible for countless tax prosecutions and even Elliot Spritzer, former Governor of New York, got caught because the bank flagged suspicious transactions that the Act requires them to do, yet it had to do with prostitution. It is like the Child Pornography laws being used to prosecute a 18 year boy for sending a nude picture of a 17 year-old girl who sent him a picture of herself. Everyone cheers when laws like this are passed, and suddenly you find they are used to imprison people that were never the subject of the so called intended purpose. Labels can be very dangerous.

We cannot create an economic system that defies the common sense logic of how the economy functions. **Capitalism** means private ownership, freedom to choose your profession, freedom to make mistakes like betting the house, win, lose, or draw, and the understanding that no matter what, the **Free Markets** will always dominate no matter what. If a product becomes too expensive due to the greed of the producer, there will be competition both legal and illegal no matter what you do. That plain trend of competition will in fact provide the check and balance no matter what. If DeBeers controlled the diamonds, demanded insane prices to the point that no one could afford them without selling body parts, demand would collapse forcing them to rethink their whole business plan.

# The Markets CAN be Manipulated but NEVER CORNERED

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Why is it with every economic decline, there are cries to kill **Capitalism**? The answer is not so hard to figure out. People always blame someone else for their own mistakes. Look at Hank Paulson who tries to blame the loss of investment bankers (Goldman Sachs included) on the fact that they became confused by China's consumption of US debt that kept interest rates low and misled them into then assuming risk was minimal. This is a joke, as was Paulson's slick attempt to hide a clause for absolute immunity from criminal prosecution for bankers.

The game has always been to blame the guy next-door. People do not like to have to atone for their own stupid mistakes and when they have to do so, turn to politicians and demand action. They will often even give up all their rights just to survive the immediate moment. This is why **Capitalism** is always attacked, yet it is the only real mechanism that continues to control even when people are confused.

The **Free Markets** cannot be controlled. They will always win just like nature. Indeed, **Horrace** (65-8BC) said that you can drive nature out with a pitchfork, but she will always come back. No matter how Government tries to control **Capitalism**, it will always prevail for Government cannot centralize the control of the economy any more than a trillionaire in the private sector. The whole theory of a monopoly is also absurd. I watched the Hunt brothers try to corner silver in the '70s. Everyone knew they were the big buyers, so once they tried to sell anything, the world jumped in front.

Thin markets can be manipulated short-term, but never cornered. If a monopoly even tried to control a industry, demand can always undo the best plans. No one can force a price that cannot be paid. James Fisk attempted to corner the gold market back in 1869 to force the price higher to compel the government to accept the "free market" price of gold for a return to the gold standard. Gold hit \$162 in 1869, and collapsed right back to where it started. Then there was Ogden Armour, who supplied the allies during World War I with food. When the **Panic of 1919** was over, he lost more money than Bill Gates could have ever imagined in a decline of 130 days straight. He died penniless with the record for all time of losing more than anyone. Still today, his name is remembered with hot dogs. There is no empirical evidence that a monopoly ever truly existed with success. The US relied on Marx to create the Anti-Trust Act thinking that the boom in corporate mergers would destroy jobs and allow prices to be manipulated. The **Free Markets** would prevent such an outcome just as labor unions discovered that they may possess the power to destroy a company, but they cannot control world competition. The monopoly theory has never been proven and yet it has been recognized that monopolies are necessary at times such as in the production of energy (electric). Just as you can drive nature out temporarily with a pitchfork, and yet she will always return, the same is true in economics. No matter how hard one tries, the fall of Communism in both China and Russia established one point - absolute control still cannot defeat the **Free Markets**.

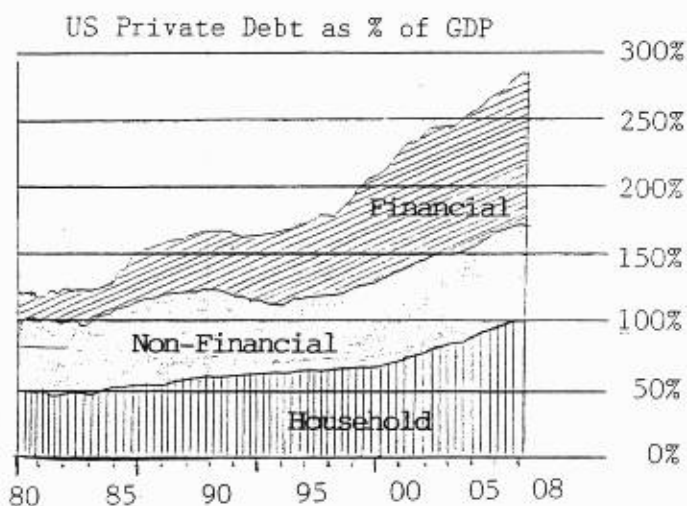
The **Free Markets** are more than a theory - they are a fundamental law that in fact dictates the interaction between people and societies. It means that while a government may be able to force its will upon the people and the economy, it just cannot be sustained. This is why groups can manipulate markets short-term, but in the end, they cannot corner markets. Without question, the organized manipulation of markets that has been carried out from commodities to currencies, produced the image that the Investment Bankers could do no wrong, the **Free Markets** won!

For years, there has been a group of Investment Banks and high networth people who have been banding together to manipulate markets. I explained in detail some of these manipulations in "It's Just Time." Nevertheless, this attempt to manipulate markets (not corner them) were targeted to create guaranteed trades. They would force a particular commodity, currency, or bond, higher, get the general public and trade to buy the high as they are taking their profits and reversing often into shorts, and then wait for the collapse. They have done this to so many markets, and often they have even bribed government officials such as Russia in Platinum and they even dug their claws into the IMF (International Monetary Fund) to get the inside track on the the loans to Russia so they could buy their debt at high yields counting on the IMF to bail them out. That was the real cause of the Long-Term Capital Management bailout by the Fed.

The latest economic crisis has been the same thing again. AIG issued CDS paper, assumed there was no risk at all, did not bother to create any collateral, and when everyone lent money assuming they could offset risk by purchasing insurance, you can see what you get. It has the total absence of any regulation of the big houses, because they are allowed to hire the very people who are suppose to be regulating them. There has never been a civil or criminal case brought against any of the big houses, no matter what mess they create. Why? Government is unwilling to expose their stupidity in allowing this to go on for so long.

Wen is absolutely correct. The root cause has been the leveraged borrowing. But there is yet another serious problem. To the right, we can see based upon the data from the Fed itself, that two significant trends have developed since 1980.

- (1) computers have allowed the creation of sophisticated derivative strategies;
- (2) household debt exploded because of abandoning the historical usury laws, that create a higher % of income paid to banks reducing any real consumption creating jobs.



The development of computers has enabled more sophisticated programs. However, these have been targeted at the short-term manipulations, ignoring the long-term sustainability under the **Free Markets** that always win. The modeling created by the Investment Banks has been seriously flawed, for they do not even attempt to figure out what to do or how to avoid a Great Depression. Their arrogance has been that their strength in numbers of banning together to manipulate markets short-term, would allow them to control the **Free Markets**. The Collapse of Russia proved they were wrong. Their arrogance allowed them to ignore that failure and the Fed was manipulated to bailout Long-Term Capital Management so they survived. Republic National Bank, merged its losses with unreported profits from Hermitage Capital, to reduce their loss in order to hold one to their AA credit rating. They hid at least \$100 million if not much more.

When Paul Volker raised interest rates to insane levels back in 1980 to stop inflation, he had to eliminate the historical usury laws. This allowed credit card rates to be raised from less than 8% to between 20-30%. This has led to a doubling of household debt, with less consumption to show for it. In other words, households spend a greater proportion of income to interest reducing job-creation and economic stimulus.



Volker's attack upon inflation using interest rates, yurned the entire economy on its head. During 1700s, Hamburg provided state consumer loans through a pawn shop. Citizens could borrow on various assets, but the interest rate was 6%. What Volker did was cut the silver-chains that bound the banking system with usury laws and once they were set free, they systematically expanded consumer debt through credit-cards in particular doubling the debt levels since 1980. The proportion of interest payments contributed to the decline in economic growth domestically from the manufacture and non-financial services industries, shifting that growth to the financial industry. The banks became bigger and bigger, at the expense of everyone else. Foreign products were corted at a higher volume to reduce prices to enable greater financing. The largest growth have been in the financial sector.

#### Adam Smith on Public Debt.

It is oxymoron to call public debt the flight "to quality" when in fact history illustrates that never has a single government ever paid off all its debt and avoided the inevitable state bankruptcy. Adam Smith (1723-1790), observed in his celebrated work, *Wealth of Nations*:

"When national debts have once been accumulated to a certain degree there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by bankruptcy."

(Public Debt) Book V, p1184; Bantam Classics 2003

Indeed, in the late 1500s, Britain had no national debt. Spain was deeply in debt constantly borrowing against the next treasure fleet coming from America, unable to be patient. When Spain lost its fleet, the Spanish Armada in its effort to conquer Britain in 1588, its inability to pay its debts ruined both Spain and Italy - its namkers. Smith observed:

"Like an improvident spendthrift, whose pressing occasions will not allow him to wait for the regular payment of his revenue, the state is in the constant practice of borrowing of its own factors and agents, and of paying interest for the use of its own money."

(PublicDebt) Book V, p1161; Bantam Classics 2003

Indeed, once a nation borrows, it seals its own fate. Smith's chapter on Public Debt is enlightening. He illustrates that where debts have risen to defend the state in times of war, in times of peace, the debts are never paid off. Since Smith's publication, there is nothing that has taken place to the contrary. The United States defaulted on its Continental Debt. It accepted the continental currency at very deep discounts. The new debt issued by the United States in US dollars, was paid off, but then there was the civil war. The US did not issue paper money until the civil war and the first notes were actually circulating forms of debt. They had an interest schedule printed on the reverse showing the longer the note was held, the more it was worth upon redemption. As interest schedules were dropped, this led to the term "greenback" meaning that there was nothing on the reverse but green ink.

At the time Smith wrote the *Wealth of Nations*, he stated: "The progress of the enormous debts at present oppress, and will in the long-run probably ruin, all the great nations of Europe has been pretty uniform." *Id./Public Debt, Book V, p1159.* That expectation was correct. Even on January 5th, 1775 at the start of the American Revolution, the national debt of Britain was 124.9 million pounds. A staggering number considering the pound would have been worth about \$10 in those days.



The arrogance of war has ruined the treasuries of all nations. The false image that war is good for the economy, was created by the fact that the United States was the arms dealer and bread basket for Europe both in World War I and World War II while never being invaded itself. This meant that there was (1) a flight of capital to the United States as a port-of-safety, and (2) the infrastructure was no damaged. The US, which was virtually bankrupt from its currency manipulation in 1896, ended up with 76% of the entire world gold reserves. That is why the dollar became the reserve currency. Wars that have cost America capital, Korea, Vietnam, and Iraq, have cost the nation in inflation and depreciation of currency.

A historical view of war and debt yields a different perspective. In ancient times before capitalism and international trade, whenever kings ran out of money, the way to increase capital and refill the treasury was to invade a rival. They would plunder all assets, and sell the survivors into slavery. This was the total and through destruction of the economy.

As international trade began to develop, the birth of capitalism emerged from the domestic economy where Adam Smith's Invisible Hand and the Free Markets allowed the development of a variety of trades. Taking this to the international level, introduced the ability for nations to rise and fall based upon capitalism rather than war. International trade became the alternative way to expand an economy.

Perhaps the greatest record of a monetary system is the coinage of Rome. No other time series allows us to see the effect of war, prosperity, conquest, and mismanagement of debt than the fate of Rome. So much of the systems that were once created by the Romans remain with us today right down to elections and our form of a Republic with representative government. This rich history has been known even to Adam Smith who studied the history of Rome to form his theory of the Invisible Hand. Smith pointed out:

"The Romans, at the end of the First Punic war, reduced the As, the coin or denomination by which they computed the value of all their other coins, from containing 12 ounces, that is, then raised two ounces of copper to a denomination which had always before expressed the value of twelve ounces. The Republic was, in this manner, enabled to pay the great debts which it had contracted with the Sixth part of what it really owed."

(Public Debt) Book V, p1186

There are but two methods of dealing with a national debt - (1) outright default whereby the political entity is replaced with a new one (Continental Congress is replaced by United States), or (2) devaluation of the currency that also reduces the repayment costs of the outstanding debt. Franklin Roosevelt devalued the dollar by 60% in 1934 creating inflation. The Roman As was to be one troy pound of bronze, 373.236 grams divided into 12 ounces. The As fell to about 295 grams in 241BC, 255 grams by 230BC, and 228 grams by 212BC. The denomination virtually disappears in the late period of the Republic (latin **Res Publica** = thing of the people). The progressive introduction of new currencies is a process of evolution with old denominations dying like dinosaurs. In the early stage of Rome, their silver coinage was minted in Greek denominations with the primary coinage being the Didrachm (6.92 grams) in 280-276BC. Gold first appears in 225-212BC also still in Greek form of a Stater. Only around 211BC do we see Roman silver denarius appear that becomes the new dominant world currency and the gold now appears also uniquely Roman, with a denomination of 60 As.

The First Punic War (264-241BC) was followed by the major devaluation of 240BC. We find by the Second Punic War (218-201BC) the evolution of the monetary system of Rome continued. Where at first Rome introduced a silver drachma as an equivalent for the dominant currency of the Greek Empire, this began to give way to a lower weight that became the denarius that is the name that has survived for more than 2,000 years. The Dinar, Denaro, are only variations, while the German word became phennig from which a penny is derived just as the word thalar became dollar. By the Third Punic War (149-146BC), the Romans not merely destroyed Carthage, they sold the entire population into slavery. Carthage was significantly defeated after the First and Second Punic War. Nevertheless, Carthage was made up of the legendary Phoenicians, the great sea power and merchants. Between the Second and Third Punic Wars, Carthage had turned to its comparative advantage - international trade. The Third Punic War was sparked more to destroy this power of international trade and to exploit it for Rome. In modern terms, it was a hostile take-over.

Capitalism through the natural flow of **Free Markets** creates a delicate balance of human interaction that always surfaces and prevails. Just as Carthage rose to the glory of international trade after losing two wars, it took sheer force to destroy that economy. No matter what we may believe, the natural evolution of interaction between people produces capitalism for each and every person will only interact when they derive some benefit. There are those who feel left out. They pull on the garment of politicians to right all wrongs by the force of laws. But any interference may be able to survive short-term like a concerted effort to manipulate a market, yet unable to corner it or control it indefinitely.

It may be one of the best kept secrets, but the concept of evolution predates Charles Darwin (1809-1882). The concept was first proposed by the leading Victorian philosophy of the day, Herbert Spencer (1820-1903). He noticed such patterns in life, and applied it to economics creating a theory of **Social Structure** that acted like a living organism. When Darwin expanded the observations of Spencer, he indeed became famous for the concept of evolution. Yet still, it was Spencer who coined the phrase "**Survival of the Fittest**" after reading Darwin's work.

Spencer saw the social structure as a living organism. Spencer was even a subeditor of the Economist. He believed that evolution followed dissolution, and that the rising popularity of Marxism creating socialism, would collapse and be replaced by individualism. Spencer saw the battle much as I have argued for the last 40 years as well - state v people. Spencer saw the contrast from a powerful state building a military infrastructure to secure its power with the industrial society. The military he saw as furthered by despotism and the industrial revolution as a trend toward individualism, that he described as civilized and good. Spencer saw the **Invisible Hand** of Smith at work and more-or-less predicted the fall of Marxist socialism taking the position that an industrial society evolves like all life-forms and order is achieved not by organized central planning by anyone, but is delicately adjusted to the needs of all parties.

## The Philosophy of "As If"

Hans Vaihinger developed the Philosophy of As if, in his *Die Philosophie des Als Ob* (1911), that mankind is willing to accept falsehoods or fictions in order to live under a belief or peacefully in an irrational world. Some women will turn a blind-eye to the unfaithfulness of a husband rather than face the reality. I have seen this also in reverse. I have seen this in religion, politics, and the worst of all, in the management of our economy. In other words, we exist "As if" it is a perfect and rational world, refusing to even contemplate that it is irrational, for that will present a situation that we do not wish to think about.

Vaihinger's Philosophy of As If, is the confrontation of reality. The system goes on and ultimately collapses because we pretend we are living in a world that is perfect where all wrongs are righted and that justice prevails. Just as the self-interest that drives the core of capitalism lies at the center of our economy, there are those who do not like reality, and thus cheat.

Government continues to issue debt, and we continue to buy it, yet there is no state that ever paid off its debt and stopped borrowing against its future. Yet we continue to exist. We get up every day and begin with the assumption that the world is rational when it is not, and we will somehow one day pay off the debt, when that can never happen in a democratic-republic. If an elected politician stood up and said we are going to stop all government programs, triple all taxes, and this new system will prevail without end until the national debt is paid, he will never get elected. So we do prefer to live in an irrational world pretending "As If" it is truly rational, and some miracle will happen and make it all better.

## Debt = The Destroyer of Civilization

Since it has always been the debt that is the destroyer of civilization, our future in the long-term is looking rather bleak. Just as the great empires all fell and the core of the economy was consumed by the next from Persia to Greece, Greece to Rome, Rome to the dissolution that was followed by a socialistic state that was then feudalism (one worked for the landlord, he allowed you to keep 20% of the food, gave you public housing, and in times of invasion, allowed you to run behind his castle walls), was replaced by the development of individualism after the Black Death had reduced the population so significantly, that labor became scarce.

The individualism that emerged following the Black Death, began a new age of government rising up once again against its people. We find the first real major tax revolt in England led by Wat Tyler in 1381. Once wages began to be paid for labor, kings began to look at individuals as a new source of revenue. Individualism is capitalism, and capitalism yields to the natural evolution of Free Markets and even under Marxism, absolute state control cannot replace the natural evolution of an economy for it is far too complex. Hence, the exertion of state power to create a so called social state, gives way to political self-interest and thus the Free Markets will inevitably force the attempted manipulation by the state, to simply fail. This is the cycle that destroyed all societies and that included the dreams of Karl Marx.

There appears to be an economic cycle of destruction that has never been even once avoided throughout all of recorded history of civilization. Debt is the driving force that always destroys civilization. We are about to enter the last stages of a debt crisis that will change the face of our modern world. We are not all going to die. Even the borders of the nations may not change. What we are talking about is the death of the political states - not the people.

We may see an attempt to avoid the entire mess by moving to a one world currency. This may be created as was the Euro, in an effort to follow the lines of how the Continental Congress died and was replaced with the United States. The transition was how the Continental Dollar died and was replaced by the United States Dollar. There would be some economic hardships. Those who believed in Government debt would be the most seriously effected as their fortunes disappear. Those who retained tangible assets, will survive. I had a client once, who purchased all the coinage in Germany a scrap metal when one government died. To his shock, the new government could not create new coinage, only paper currency. So they re-denominated the old coinage allowing it to be legal tender. His scrap piles ended up making him a fortune. This is what happens when one political entity dies.



I believe replacing all the currency of the Western nations with a new entity, perhaps for the old sake of nostalgia, we call it the As, or the Imperial replacement known as the Sesterius, or just the old fashion Denarius, will be the path of least resistance. Government are screwed. Marxism is dying, they just don't know it. The restoration of individualism is on the horizon. Government will fight tooth-and-nail to keep its power. But it is losing the battle because it cannot function in a real and practical manner. The opportunity for Obama to take the high road has never been so great. But the self-interests of politics is preventing still any real reform.

The Obama healthcare plan is a disaster. Trying to create a new program that will simply pay for 50 million uninsured, is not the way to fix the problem. The only way is to do the right thing - Tort Reform. But with so many lawyers occupying the Congress, there is zero chance, Republican or Democrat, that the right thing will be done. This will drive healthcare costs even higher, expand the herd for lawyers to file lawsuits against doctors, driving their insurance premiums higher, and the overall cost of healthcare through the roof. To make matters worse, why should any small business now pay for healthcare if they know the Government will do so anyhow? Paying for those who do not have healthcare without addressing the outrageous costs that go through the roof, will only create the final stage of a rally in the costs for healthcare that will no doubt send the national debt higher, and lead to a total bursting of the bubble no different than what we have just seen in real estate.

We may see currency devaluations, and at times there has been a competitive trend among nations to do so to increase their exports. I believe we will see the sequence of events thus as (1) devaluations, (2) unification into single world currency, and (3) reorganization of political states.

## China - The Defender of Capitalism?

It may seem stange, but Wen Jiabao is the great defender of Capitalism, he just does not know it yet. He professes to be a student of Adam Smith, and that is the saving grace. When I was invited to China by the Central Bank following the Asian Currency Crisis, many in Washington wanted to know my reaction upon my return. I met with people who were actual traders. China had sent these people to work on trading desks around the world and return with real experience, not book knowledge. I found the meeting extraordinary, and very uplifting. China had taken a path that was practical, and exciting. In the West, people with no experience get degrees and then proceed to tell the rest of us how it will be best if they dictate from above yet understand nothing of the real world. In China, I was taken to a special building in 1997 that was full of at least 100 people surfing the internet gathering data and knowledge. When I sat down, they brought in a team that had read everything I ever wrote. They knew what my ideas were, when they formed, and studied how. They showed me they were observing their economy tracking everything that moved. They showed me they were tracking 249 different varieties of tea. They were facinated observing that the same tea was trading at higher prices in the North compared to the South. When I asked where was the source of the tea, they pointed to a small region in the South of China. I explained that the price would rise the further from its origin for two main reasons; (1) transportation costs, and (2) novelty that the grass is always greener and better somewhere else.

My personal observation was an attitude strikingly different from Western forms of government. There seemed to be a willingness to stand back and observe as did Adam Smith, to understand what was taking place. During the Reagan years, I met with the US Treasury people. I was very concerned about the raising of interest rates and the long-term effect this would have on the economy. I was told, that was OK because we would be paying back the debt with cheaper dollars. There seemed to be no real and honest concern about debt, despite the pretense of conservative Republicans. It then dawned on me, that Hans Vaihinger was correct after all.



# China & The 224 yr Cycle of Political Political Change

## China - Important History

- ? - Hsia Dynasty
- c. 1766-1122BC Shang Dynasty
- c. 1122-771BC Chou Dynasty
- c. 770-221BC Tung Period

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- First General Government

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- 221-206BC Ch'in (Qin) Dynasty
- 202BC-220AD Han Dynasty
- 581-618 Sui Dynasty
- 618-907 Tang Dynasty
- 960-1279 Sung Dynasty
- 1275-1292 Marco Polo claims to visit
- 1279 Mongols conquered China
- 1368-1644 Ming Dynasty
- 1644-1912 Ch'ing or Manchu Dynasty
- 1842 Treaty Nanjing = British Hong Kong
- 1851-1864 Taiping Rebellion
- 1900 Boxer Rebellion (killing foreigners)
- 1912 Republic of China established
- 1917 Sun Yat-sen established rival gov't
- 1919 Sun Yat-sen reorganizes Nationalists
- 1928 Chiang Kai-shek lead Nationalist Gov't
- 1931 Japan invades Manchuria
- 1934-1935 Mao Zedong led Communist march
- 1937-1945 War with Japan shattered China
- 1949 Communists defeat Nationalists
- 1958 Great Leap Forward depresses economy
- 1962 border war with India
- 1966-1969 The Cultural Revolution
- 1971 China joins United Nations
- 1972 President Nixon visits China
- 1976 Mao Zedong dies
- 1979 China & US begin diplomatic relations
- 1980s Reform to relax Gov't controls
- 1989 Tiananmen Square protest

thus completing what is known as the **Three Sovereigns** era whereby **Huang-ti** also forms the first of the legendary **Five Emperors** said to have ruled between the 27th and 22nd Centuries BC. Some of these are remembered by **Confucius** who established moral values around 500 BC. The first dynasty known as the **Hsia** is said to have been founded by **Yu** who was a minister to **Shun**, one of the **Five Emperors**.

Therefore, our empirical history of China begins with the **Ch'in** or **Qin Dynasty** of a unification of China 221-206BC. It is interesting to note that the **Cycle of War** that effected Rome in the West, First Punic War 264-241BC and the Second Punic War 218-201BC, is the same general period of warring states that led to the birth of China as a single nation. The defeat of Hannibal (247-183BC) in 202BC marks the birth of the **Han Dynasty**.

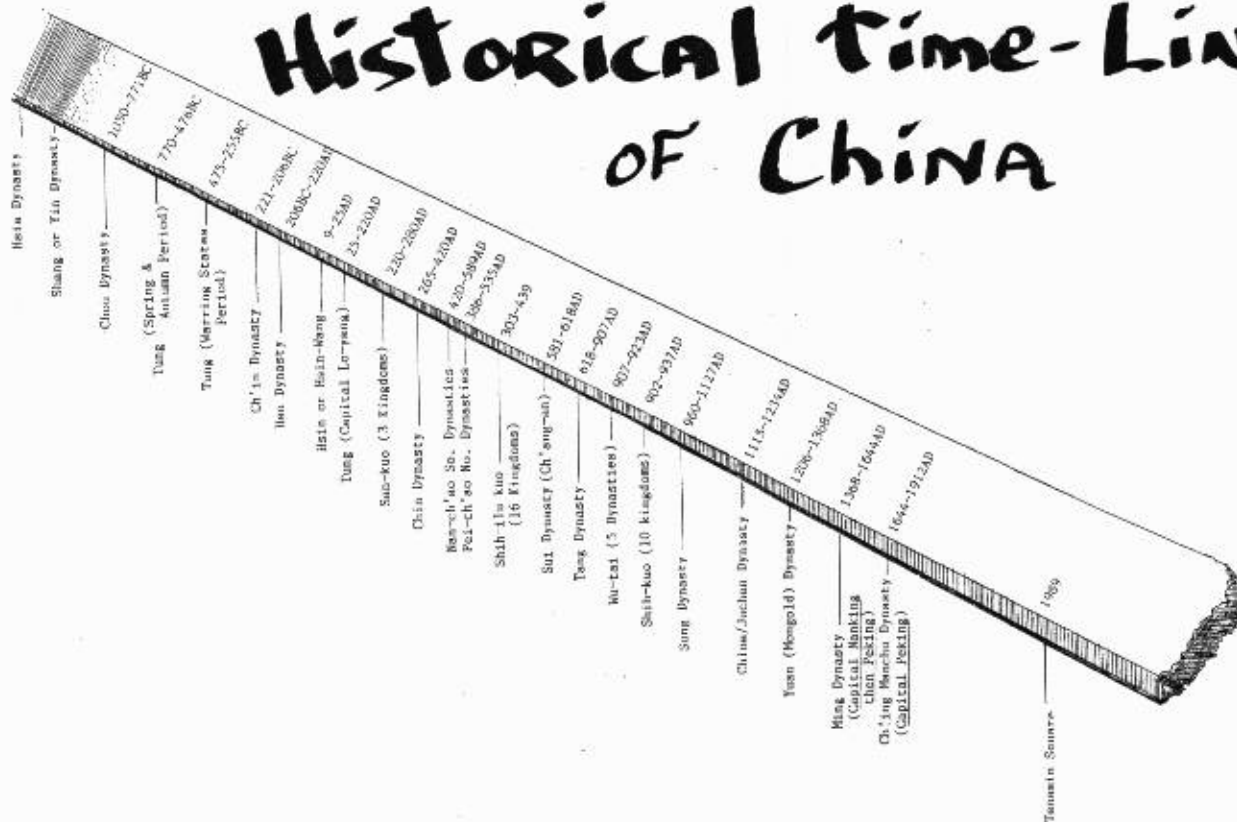
The historical view of China from a political perspective provides a rich, robust time series. Numerous states and dynasties have risen and fallen and with the exception of Rome, there is no other history that lends itself better to the analysis by the method of what I have termed - "**The Geometry of Time.**"

There are no contemporary records that have survived from the Hsia Dynasty. From the Shang Dynasty, we have oracle-bone inscriptions from ancestor sacrifice rituals. The traditional date for the beginning of the Chou Dynasty is 1122BC, but the latest proposed date is 1027BC. Many historians favour 1050BC. There was a competing throne between 770 and 760BC using the posthumous name of Hsi-wang.

The Ch'in dynasty ruled in its core native territory from about 255BC, well before it assumed the imperial title and throne in 221BC. Shih Huang-ti ascended to the throne in the state of Ch'in in 247BC and began annexing rival states during the **Warring States Period**, that was followed by the formation of his new Empire in 221 from which we derive the name "**China**" today.

The first of the mythical emperors of China was **Fu Hsi** whose birth is said to have been during the 29th Century BC. The second, **Shen Hung**, is said to have been born during the 28th Century BC. The third of the mythical rulers was **Huang-ti**

# Historical Time-Line OF CHINA



The history of China is very rich, and it lends itself to the **Geometry of Time** quite nicely. Perhaps this is also why Chinese themselves naturally believe in cycles for their long history is a story of the swinging forces of political change that have taken place between the state (despotism) and the people. Yet, long before there were formal relations with the West aside from the Silk Road that allowed for the international trade between China and Rome without formal awareness of each other's actual existence, there were strange correlations of trends.

We find debt crisis events in Europe, Japan and China with rising periods of interest rates long before formal relations. How such global contagions take place without formal relationships remain a mystery. This strange correlation between the East and the West spills over into war, political change, and economics.

There was a civil war in China during the same time period of civil war in the United States, 1851-1864, known as the Taiping Rebellion. It is possible that natural forces causing crop failures effecting worldwide also had the effect of rising tensions that may be reflected in different labels. This was preceded by the conflicts with Britain and the Treaty of Nanjing establishing British Hong Kong in 1842.

The conflict with Western cultures became the back-drop for the Boxer Rebellion in 1900 killing foreigners in China. Yet we see the same beginning of Marxism that purcolates and finally established the Republic of China in 1912. A rival government is set up by Sun Yat-sen in 1917, the same year as the Russian Revolution. We then see the dominant Nationalists rise reorganizing their power under Sun Yet-sen in 1919 and Chiang Kai-shek assumes control of the Nationalists by 1923. The Japanese invasion of Manchuria in 1931 perhaps was the final straw. This was followed by Mao Zedong who led the long Communist March in 1934-1935. This coincides with FDR and Hitler coming to

power also in 1933. The war with Japan truly shattered China (1937-1945), and thus laid the foundation for major political change when the Communists defeated the Nationalists in 1949. Mao's great leap forward in 1958, suppressed the economy of China, that was then followed by the **Cultural Revolution** 1966-1969. China began to look outward joining the United Nations in 1971, and President Nixon then established relations with China with his visit in 1972.

China began to view things practically more so than Russia. By the 1980s, China was embarking on a major effort to reform the economy and relax Government controls. When Tiananmen Square broke out in 1989, the first reaction was to purge the economic reformers, yet **Wen Jiabao**, cleverly survived. But the pendulum had reached its peak in Communism as the notion that central planning could replace **Individualism**, simply failed. It was as if someone sits in an office, never ventures out to the shop, does not even talk to the people that work there, and then tries to reorganize something he has no experience in doing. This is a total disaster. The **Mother of Necessity** is the invention of progress. It is the individual who sees the problem and takes action to solve it or to make a profit from a new emerging divergence. Those sitting in Ivy Towers cannot foresee even how to plan an economy for they cannot know what to do in anticipation, when it is always **experience** that drives **innovation**.

Indeed, it was Joseph Schumpeter (1883-1950) who saw the swing of the pendulum and sought to explain the business cycle also as a blending of Smith's **Invisible Hand**. These great waves of expansion, Schumpeter saw as waves of **Innovation** that drive the economy. For example, the invention of the railroad based upon the steam engine, then created an early form of the internet in modern terms. The railroads invented the mail order business and companies like Sears & Robuck emerged with a mail order catalogue that expanded the market from Chicago to around the nation. The railroads became the connection point and fueled the economic expansion. This was the same progress of **Innovation** that emerged in the Roman Empire with the construction of roads. Recent excavations in Scotland at Hadrian's Wall, have turned up letters from Rome showing that the mail service (communications) could reach from one end of the Empire to the other in about 1 week. This expanded Rome and its economy. The United States had introduced the first postage stamps in the United States in 1847. The railroads were the internet of the 19th Century and that **innovation** led to widespread economic progress.

The primary difference between China and Russia, was that the Russia sought to control thought and adopted a micro-management system. Stalin purged the society of those who were capable of creating **innovation** killing off the brain-trusts. China relied more on macro-management, and thus left the individualism intact. Russia had long suffered under the serf system of Ivan IV (1530-1584) who was known as "**The Terrible**" and ruled Russia from 1533 to 1584. Ivan confiscated land of his enemies, gave it to his supporters, but the fleeing of workers rendered the land worthless if there was production. By decree, Ivan bound all workers and their families to the land and thus created national slavery of the population in order to maintain property values. This long-term subordination of **Individualism** to the will of the state, demonstrates that the long-term mental state of Russia was one of state dominance for so long, that it became bred into the greater proportion of the population. Hence, China has boomed because it did not annihilate **Individualism** as took place in Russia truly extending back to Ivan the Terrible.

Therefore, to understand China, we must understand that **Individualism** is still the central core of the economy that was still there like a tree in winter. But come spring, it rises back to life. This is one of the primary reasons why China has risen so fast to emerge of a major world economy in the blink-of-an-eye. The degree of corruption is far less in China than in Russia or the United States for that matter. China is still going through an economic revolution that is dynamic.



## False Statistics

For years, I have warned that the trade statistics as portrayed by the press thanks to a lack of true understanding of the Government accounting, is likely to lead to more turmoil and confusion. During the 1980s, the Australian press covered my forecasts of their economy very closely because Australia as a whole was only focusing on their Current Account and traded the currency accordingly. The general top economic and brokerage forecasts kept warning the A\$ would decline because the **Current Account Deficit** was rising. I was even asked by the Australian Associated Press if I would agree to do a TV debate on the subject. I offered to do so, but my reputation tended to precede me. I had debated a top economic forecaster in Canada at Vancouver. When he kept trying to compare GDP of one nation to another, I made the point that economic statistics are not standard and every national government used different formulas to control the public perception. He got frustrated, and blurted out that he was tired of Americans coming to Canada and telling them what to do. That sort of made me famous because he lost his cool. Needless to say, the AAP could find no one willing to debate me on TV because they all knew the truth - the economic statistics have long been bogus and are politically manipulated to just achieve certain goals. If inflation in the 1980s was nearly 20% on the CPI, why is it in the last nearly 30 years it will never get above 3%? In 1980, 40% of the CPI in the United States was housing. It was replaced with rents using the view that housing is not the cost of living, but an investment.

The same problem exists between the so called **Current Account** that the press wrongly portrays this as the balance of trade. There is a second account that is the offset known as the **Capital Account**. The deficit in the **Current Account** is thus offset by the contrasting surplus in the **Capital Account**. Why does the press generally never discuss the **Capital Account**? Largely due to the fact that there is a serious lack of understanding of how these two accounts actually work.

It is true that the **Current Account** will move into deficit when buying more goods from overseas than are exported. However, post-1971, the floating exchange rate system has increased international capital flows by a conservative 1000% with only the exception of the Great Depression. The **Capital Account** reflects capital investments. Therefore, the purchasing of US bonds in the flight to quality that is taking place internationally, flows through the **Capital Account**. However, what is not understood, is that the interest payments on that debt, flow out of the **Current Account**. Therefore, the reason our forecasts in the 1980s was correct against everyone else in Australia, was because there was a huge capital inflow of investment that was going into the **Capital Account**, that will create a bigger **Current Account** deficit as dividends and interest payments flow out of the nation. Thus, a **Current Account** deficit at times is not based upon old world economics of closed economies and the limitation to international trade. As capital slushes around the globe, seeking the immediate gain or shelter, the **Capital Account** surplus grows, but the **Current Account** deficit also expands even if no change takes place in trade due to interest & dividends.

Between 1980 and 1985, the steep recession produced a dramatic bull market in the dollar. The German mark fell to nearly 4 to the dollar, the pound fell to virtually par, as did all other major currencies, and the politicians do not understand their own system. By 1985, James Baker spearheaded the idea of creating the G-5. Again, I wrote to the White House trying to warn that volatility would rise, they would cause a stock market crash by 1987, and the world was about to go nuts. The Chief Economic Advisor Mr. Sprinkle wrote me a several page letter basically stating I was the only person with such a model, and until there was some consensus, thanks but no thanks. Aside from the urgent requests when the 1987 Crash took place suddenly agreeing that volatility was the number one problem, it was the stupidity of the failure to just understand the contrast between the **Capital** and **Current Accounts** that has led to a vast domino effect of sheer economic madness.



# Current Account Reality

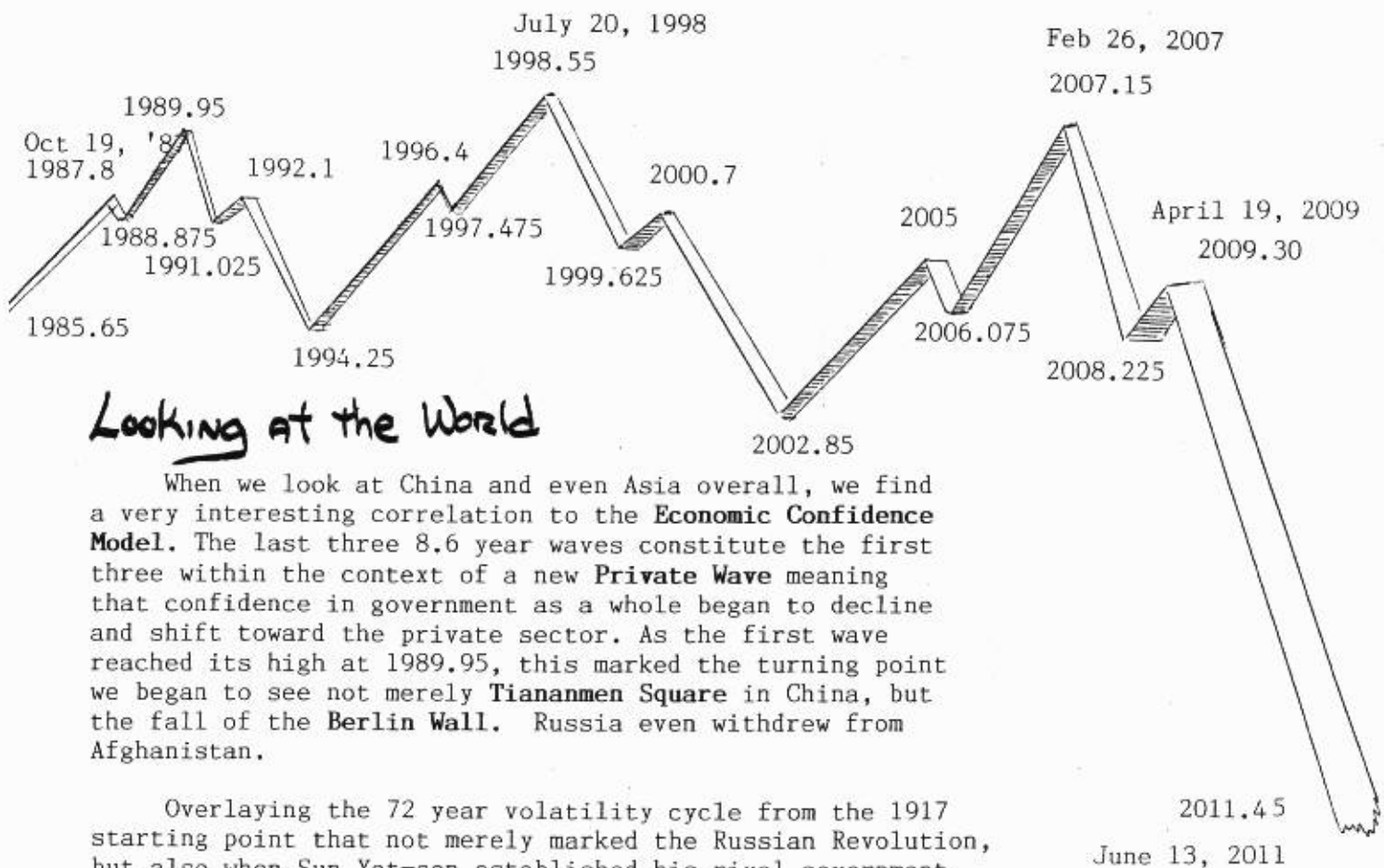
It is no longer purely trade that alters the fate of nations or sends panic down the spines of politicians. The Japanese purchased so much debt from the United States that they owned nearly 33% by 1987. By mistakenly attributing the **Current Account** deficit to purely trade, then it appeared the G-5 was necessary to force the dollar down to create more jobs and restore trade. However, the more capital investment came to the United States, the greater the **Current Account** deficit that was being driven by interest and dividend flows. The G-5 created the 1987 Crash, that was not driven by some fundamental change in the domestic economy, but was effected by international capital investment flows, driving the capital out of the US because the G-5 was talking about forcing the dollar down 40% that would have depreciated all capital investment in the country Of foreign investors. As Japan took its cash back, that caused domestic investment and set in motion the Japanese bubble two years later for the high in 1989.

Politicians just are clueless. They truly know not what they are doing. The reason this is all relevant now, is because we have the same problem today with China. China's **Current Account** surplus fell by 2.8% in December 2008 year over year. Some see this as a triumph compared to Taiwan's drop of 42% in December year over year, South Korea 17% and Japan 35%. Does this mean that China's economy is doing far better than the rest of Asia? Sorry to say, we have to look at the **Capital Account** and not mix trade with interest flows back to China. China's January 2009 numbers fell 17.5%. Unemployment has been rising in China despite the fact that the **Current Account** has not been collapsing into deficit because the decline in exports is being masked by the inflow of investment income.

Because there seems to be a misunderstanding of how trade and capital actually flow in a floating exchange rate system compared to the standard economic theories developed under a fixed rate system, the majority appears to be waiting for a huge adjustment to hit China. The January **Current Account** was \$39.1 billion that was under the November record high of \$40.1 billion. The first half of 2008 the monthly surplus was running at about \$16.5 billion compared to the explosion for the second half running about \$32.5 billion. Notice that there was a rise, yet unemployment is rising in China. This illustrates that there remains a deep confusion about the statistics and flows.

If countries are moved to create a trade war because of these numbers, they are making the same mistakes as were made in the Great Depression. The sharp rise in the dollar was creating an outflow of interest and dividends to Europe making it appear that there was a rising trade problem setting off Smoot-Hawley and the age of Protectionism. We may see the same problem again for there are political groups that are eager to exploit these numbers arguing to protect domestic jobs. But the surplus is rising because of interest and dividends, not greater exports and the loss of jobs in the US and Europe to China.

If China is going to invest in foreign companies, buy up foreign resources, and continue to invest in foreign bonds of the United States, there may be a continued rise in their **Current Account** as interest and dividends flow directly there. If we see a rise in interest rates because of excessive public borrowing, we will see the surplus in China flow to even higher levels. China's surplus in the **Current Account** almost doubled in 2008 second half as the economic decline steepened. This illustrates the desperate need to revise the capital flow accounts updating them to the new global economy. A rising **Current Account** surplus in China at this time is not a reflection of trade and a loss of jobs in the West. It is a reflection of China emerging as the international banker - a far cry from the days of Mao.



## Looking at the World

When we look at China and even Asia overall, we find a very interesting correlation to the **Economic Confidence Model**. The last three 8.6 year waves constitute the first three within the context of a new **Private Wave** meaning that confidence in government as a whole began to decline and shift toward the private sector. As the first wave reached its high at 1989.95, this marked the turning point we began to see not merely **Tiananmen Square** in China, but the fall of the **Berlin Wall**. Russia even withdrew from Afghanistan.

Overlaying the 72 year volatility cycle from the 1917 starting point that not merely marked the Russian Revolution, but also when Sun Yat-sen established his rival government to the communistic beginnings. This brings us also precisely to 1989.

We see the Asian Currency Crisis hit in 1997. But 1989 also marked the **Bubble-Top** in the Japanese Nikkei beginning what has been dubbed the "Lost Decade." Therefore, we can see that 1989 was rather a big target for Asia overall. When we look at the next big target, 1998.55, this marked the collapse of Russia, the contagion that also caused the widespread liquidation of positions on a wholesale basis around the world. This also created the collapse of **Long-Term Capital Management**, that became trapped in its Russian trades, and was forced to liquidate everything else. Hence, the major investment bankers were buying Russian debt assuming that the IMF loans were there and hence the risk was minimal, despite the high yields. The collapse of the IMF deal led the Investment Bankers into sheer chaos who ignored risk, in pursuit of that one riskless trade - the sure bet.

Gold bottomed with the next turning point 1999.625 and the Dot.Com Bubble burst with the major high in the NASDAQ for the next turn 2000.7. But the major turning point of 2002.85, marked the low in the NASDAQ, S&P 500 and the Dow Jones Industrials. Yet this turning point also saw political change again forming in China setting the stage for the rise to power in 2003 for **Wen Jiabao**. As we come to the next turning point in 2005, we end up with the peak in the short-term interest rates on the 5 year US notes on an annual closing basis with the lowest monthly closing being established in June 2006 in line with 2006.075 turning point. We see a brief rally, with a retest of the low in the 5 yr T-Notes for June 2007, but it was the major 2007.15 turning point that set the stage for Asia.

While there was a mini-crash or panic precise with the target of 2007.15 to the day that hit the Dow Jones, Europe and Asia, it also marked the high in the S&P Real Estate Index, signalling that was the turning point and real estate was the core market to be effected, but so did the Neikkei 225. Where the US share markets made a brief

recovery peaking October 11th, 2007 on the Dow, the February 2007 high remained the major high for the recovery rally in the Japanese Nikkei 225 Index (share market) and the real estate, that has collapsed also worldwide.

The mere fact that the Nikkei peaked precisely with the **Economic Confidence Model** on 2007.15, was a warning far deeper than most realize. The troubles that have been exposed in the US and European banking markets, were underway in Japan ever since the peak in December 1989. The core problem was the outrageous levels to which real estate in Japan reached. Office space in New York in 1990 when it was \$35 per square foot annually, was \$75 in London due to excessive taxes to the City, but this was pale in comparison to Tokyo - \$75 roughly per square foot per month! (based upon the financial districts in all cities). The real estate collapse was transferred to the share market because stocks were bid up based upon real estate values assuming profits that would never be materialized, yet viewed as if this was capitalization. When real estate collapsed, it took with it the share market.

Oddly enough, this economic crisis is widely attributed to the American Investment Bankers including AIG. Already, about half of the Collateralized Debt Obligations ("CDO") have gone into default. They relied on fictional models with no track record or back testing beyond a few years, to create such complex derivatives that were no different than the bubble in Japan. It is unlikely that CDOs will exist 5 to 10 yrs from now and the defaults to date in excessive of \$300 billion, are still likely to double before this is over.

Despite the fact that the epic center may have been the brain-trusts in the top American Investment Banks, the same trends spread around the globe. To make this worse, real estate declines have already been steeper in Europe than the United States in general, due to the fact that still a fair portion of mortgages in the United States are long-term fixed and not in default so far, even though housing values may be below the purchase and mortgage prices. However, Europe is facing yet still another problem that is not faced in the United States. The potential widespread defaults of Eastern Europe that are akin to the defaults of South America on the US banking industry decades ago.

Generally, European banks have lent heavily into Eastern Europe buying into the whole **Euro** experience. As a percent of GDP of the lending nation, there are some real alarming levels that warrant our attention. Austria has lent about 80% of its GDP to developing nations. This is a staggering number that warrants great concern. Consumer debt in the United States is about 100% of GDP. However, lending that much to foreign nations, is not wise from a domestic economic perspective. Next is 66% of GDP in the Netherlands. The risk here is that a single currency system of the **Euro** becomes vulnerable do to the actions of individual nations.

<u>European Bank Loans to Developing Nations as % of GDP</u>	
Austria . . . . .	80%
Netherlands . . . . .	66%
Belgium . . . . .	39%
Spain . . . . .	25%
Ireland . . . . .	17%
France . . . . .	16%
Portugal . . . . .	16%
Germany . . . . .	13%
Italy . . . . .	12%

When we look at the public debt level for Europe, we are in a serious situation that allows one to now begin to understand the flight to the dollar for now. The European banks are likely to suffer far worse than their American counterparts due to th excessive lending to Eastern Europe. This complicates the mix and when we then reflect these events back to China, we can see that despite the epic center being the United States, there may still be a lessor risk near-term compared to Europe. Just as the United States was the epic center for the debt crisis, China is the epic center for savings.