Financialisation, Gold & World Economic Primacy

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Summary and conclusion

History suggests that every 100 years a new nation state arises to dominate the world economy. In the 1400s the Italian city states – Venice, Florence, Genoa & Milan - stood astride and were central to the world's trading system. In the 1500s Portugal & Spain in alliance with the Austrian Hapsburgs took up the mantle. By the 1600s it was the turn of the Dutch (i.e. in the guise of the United Provinces of Netherlands). That was then followed by a period of French dominance in the 1700s and then British in the 1800s and more recently the US this past century. Approximately every 100 years, a new power emerges to take on the mantle of world economic primacy (table 1).

Kindleberger, in his seminal work, World Economic Primacy 1500 – 1990 (published 1996), identifies the typical life cycle and characteristics of an emerging world economic power from its arrival onto the world stage through to its twilight years as its global predominance starts to wane. In the book he neatly summarises the "usual progression in the national cycle from trade to industry to finance".

"In **the first stage**, trade is likely to be competitive and aggressive, ready to acquire foreign technology by less than honourable means, and to disguise its product as foreign during the learning process. Growth is frequently export led, occasionally import substituting in competition with the products of other countries. Protection is designed for the incubation of infant industries."
P.212 World Economic Primacy 1500 – 1990 Charles P Kindleberger

Table 1: Rule of Thumb – World Economic Primacy; the 100 Year Cycle

Century of Predominance	Leading world economic power
C15th	Italian City States
C16th	Portugal & Spain/Hapsburgs
C17th	United Provinces of Netherlands
C18th	France**
C19th	Great Britain
C20th	United States

Source: CP Kindleberger "World Economic Primacy, 1500 – 1990", Longview Economics
**although France's status as the world's leading economic power in the C18th is questioned by some scholars

Important disclosures are included at the end of this report

"The **cycle in finance** ***(i.e. the final phase)*** starts with the promotion of trade and industry through short and sometimes long-term capital lending, and ultimately moves to trading assets and preoccupation with wealth rather than output. Merchants and industrialists graduate from risk taker to rentier status, and conserve flagging energy. Consumption out of given incomes rise, savings decline. Various interests push their concerns at the political level, and if enough do, they block effective government action. Income distribution tends to

become more skewed, the rich richer, the poor poorer. With greater access to the reins of political power, the wealthy are likely to resist some ethically appropriate sharing of national burdens, such as the cost of defense, reparation, infrastructure, and other public goods."
P.213 Kindleberger

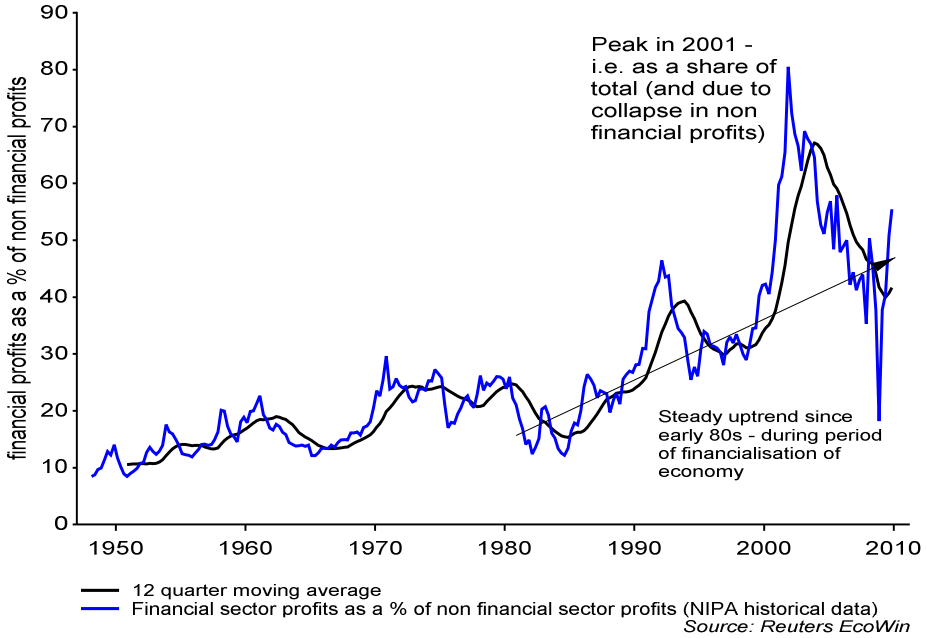
Stage 1 is clearly the stage at which China (and to a lesser extent India) currently reside. China's trade surplus speaks to its export led growth. Its alliances with foreign companies are one of its key methods of acquiring foreign technological know-how (in the mould of recently industrialised Asian countries like S Korea, Japan & Taiwan) which it then uses to build up its own industries (e.g. today's growing Chinese car industry). Its trade is competitive and aggressive.

America, meanwhile, sits at the other end of the spectrum, resembling the final phase of the life cycle where global predominance starts to wane – i.e. the period of financialisation.

Section 1: Fiat Currency & America's Financialisation

Overview: Since the end of the Breton Woods international monetary system in 1971 and the introduction of the $ based fiat currency system, the US in particular, and other western economies as well to varying degrees, have become increasingly financialised. Total US domestic debt (incl. the financial sector) has risen from 150% of GDP in 1971 to 360% today. US financial sector corporate profits have risen from a modest share of total US profits to a current majority share (i.e. from an amount equal to 23% of total non financial profits to 55% in Q409 – see fig 1); while US financial sector debt has risen from 11% of GDP to 108% today (fig 3) as the US has run an almost permanent current account deficit since 1971, i.e. borrowing from the rest of the world, and as leverage has built up in the system.

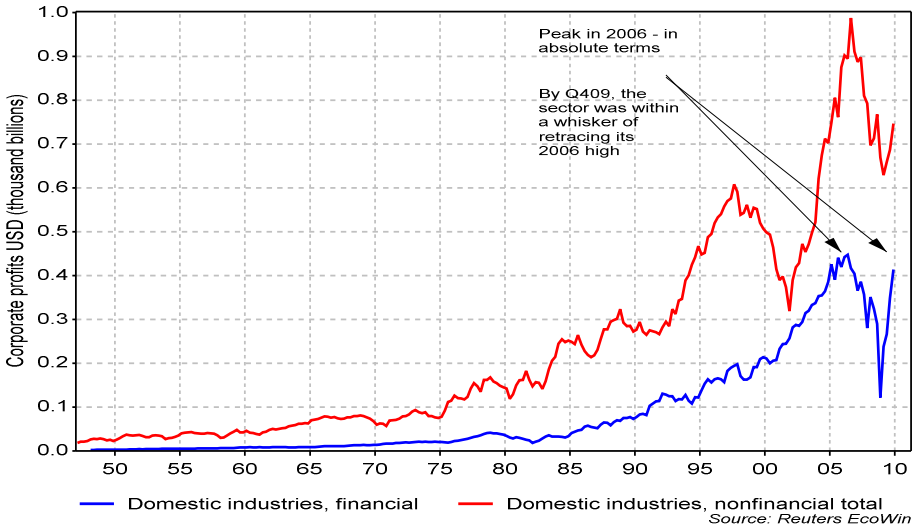
Fig 1: US Domestic Financial sector profits as a % of Non Financial sector profits (%)



From 1950 through to as late as 1990, financial sector profits were typically between 10 and 25% of total domestic non financial profits. Since 1990, that share has been consistently above 25%, except for Q42008

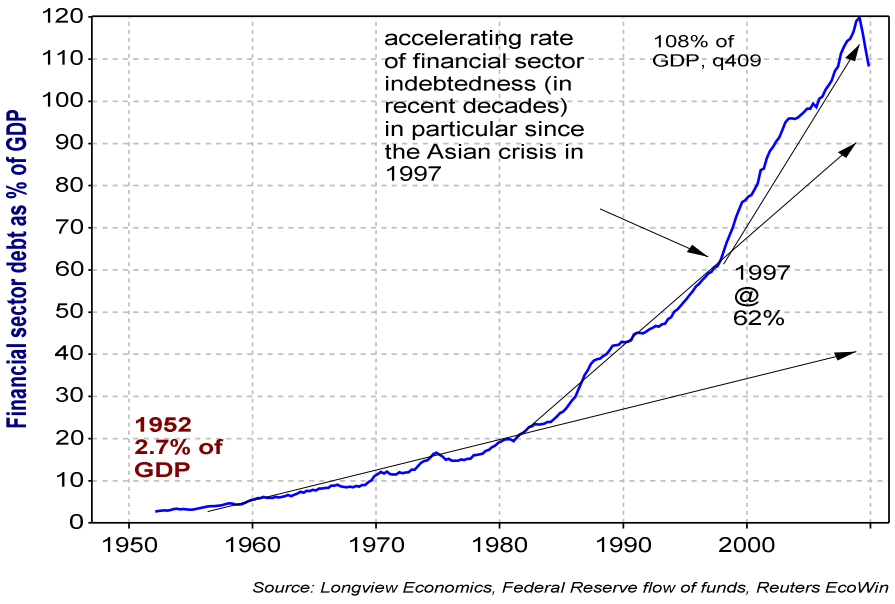
In contrast to the growth of finance, manufacturing and trading strength has deteriorated sharply, as China and other emerging economies have taken global share in manufacturing: US manufacturing employment is back at its end of WWII lows (i.e. 11.5 million – fig 4). With that deterioration of blue collar work, the employment rate amongst prime working age men (i.e. 25 – 54 year olds) is also now at record lows (i.e. 80% - see fig 5) - levels not experienced since the Great Depression; while America's global export share has shrunk notably since 2000 (fig 6). These factors are all related and are all consistent with Kindelberger's pattern of factors that point to the beginning of the end of American global economic primacy (1).

Fig 2: US Domestic Financial sector & Domestic Non Financial sector profits (US$)



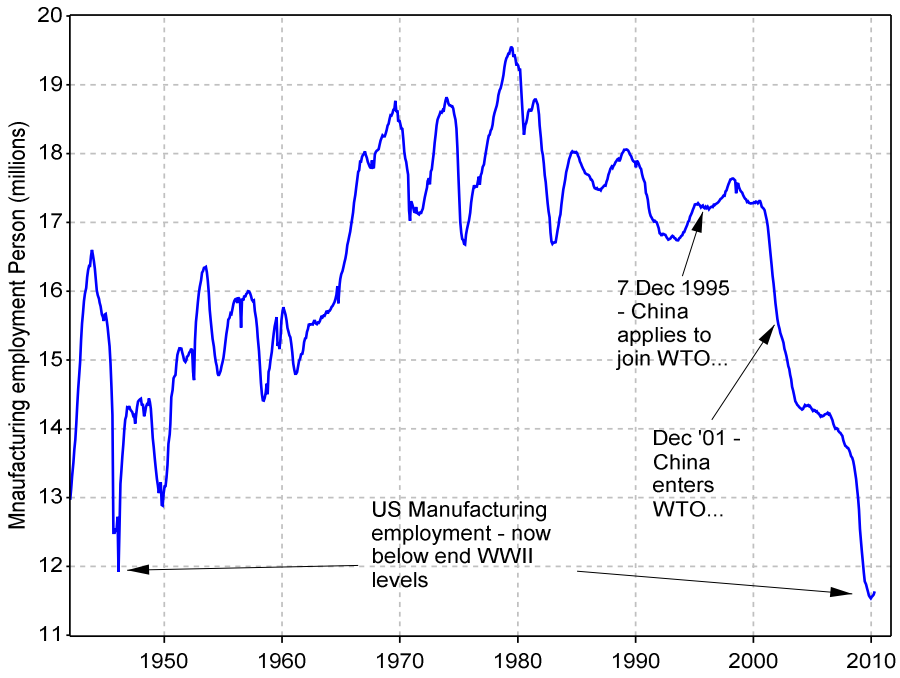
Because of the reflation of the system, the US domestic financial sector profits have (almost) regained their profit peak of 2006

Fig 3: US Domestic Financial sector indebtedness as a % of GDP



At the end of the Breton Woods international monetary system, US financial sector debt was equivalent to 11% of GDP – i.e. the sector was primarily performing its basic function of intermediating between lenders and borrowers, i.e. providers of capital and users of capital – since 1971 and in particular since deregulation began in earnest in 1980, that indebtedness has accelerated such that its now 108% of GDP

Fig 4: US manufacturing employment – absolute numbers of jobs (1945 – 2010)

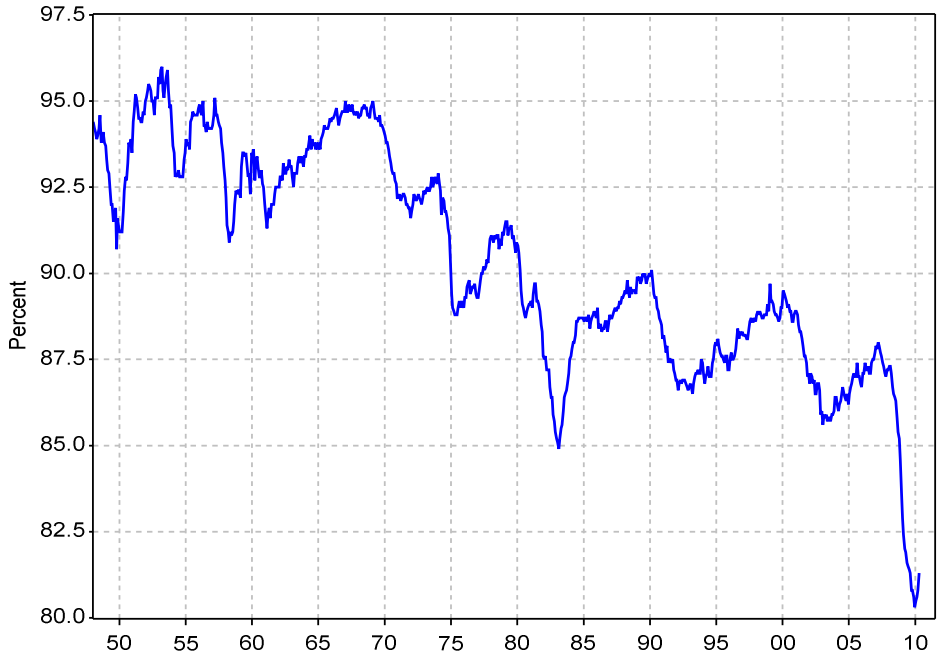


Source: Reuters EcoWin

Since the entry of China and other emerging market economies into the world trading system, US employment in manufacturing has fallen sharply, almost consistently, such that its now below levels post WWII.

As a result of such a sharp fall in blue collar worker jobs, employment rates amongst prime working age men is at record lows

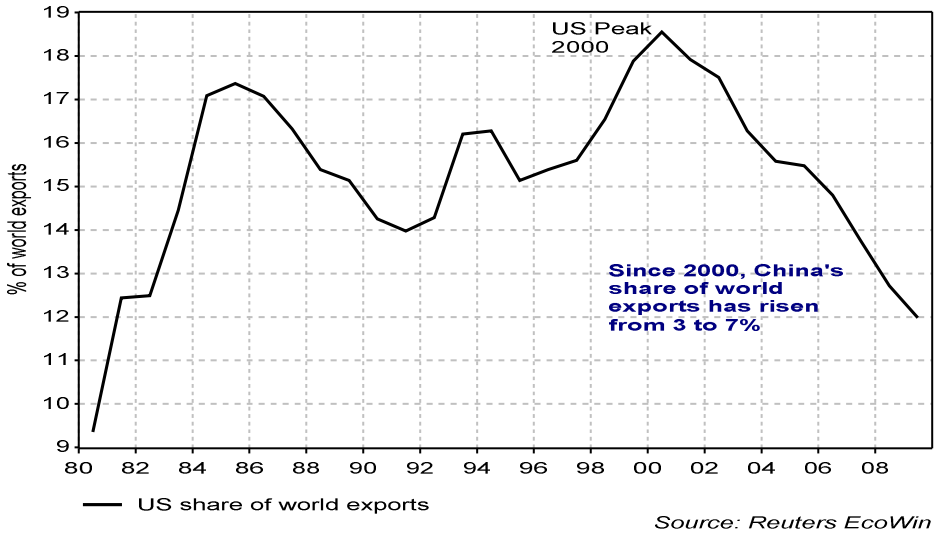
Fig 5: US employment rate – Prime working age men (I.e. aged 25 – 54 years old)



Source: Reuters EcoWin

As China has entered the world trading system and America has increasingly financialised its economy, the employment rate amongst prime working age men (which in a healthy economy should be close to 95-100%) has continued to fall these past 40 years

Fig 6: US Share of world exports (i.e. as % of total world exports, US$ denominated)



As America's share has fallen, China and other emerging markets have experienced a rising share of world exports. China's share has risen from 3 to 7% of world exports

NB This fall in share has occurred during a period of general US$ weakness (i.e. since 2000)

For further analysis of these issues please see Longview Economics, Quarterly Asset Allocation No 1, November 2009: "Will the US$'s Reserve Currency Status Persist?"

Section 2: America's Financialisation – the on & off balance sheet threats

Two specific sources of risk have arisen as a result of the financialisation of the US economy over recent decades. Levels of risk associated with both have increased as a result of the actions of the authorities during this latest financial crisis. Those 2 sources of risk are: i) The significant On-Balance sheet indebtedness of the US economy; and ii) Off balance sheet contingent liabilities (2).

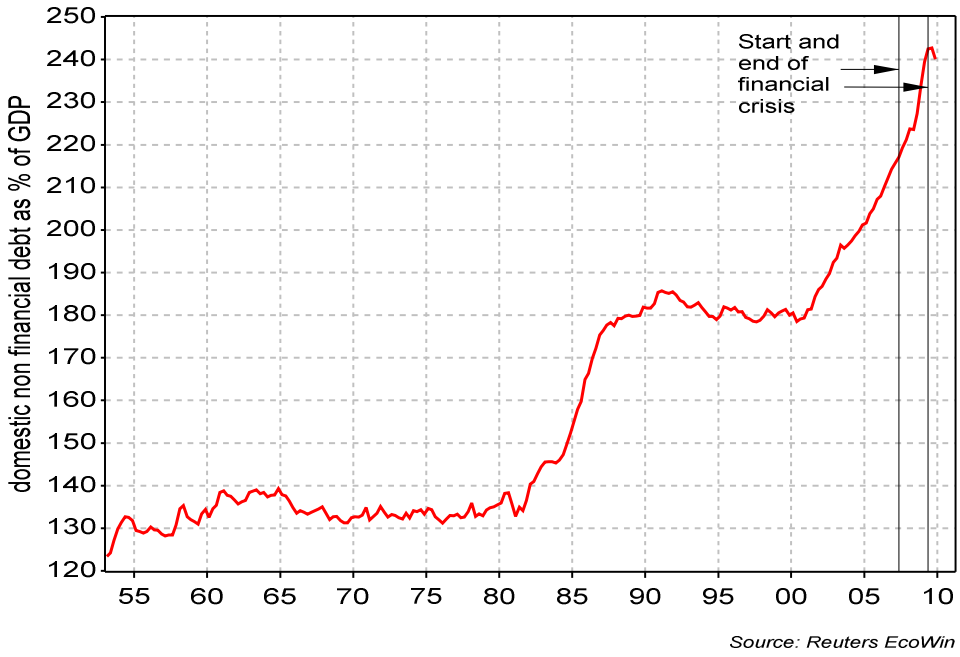
During this financial crisis, the actions of the authorities have made it clear to financial market participants that certain banks are 'too big to fail' and that its policy approach to a debt crisis was to encourage further economy wide borrowing. Total non financial domestic indebtedness increased from 215% of GDP at the start of the crisis (q1 2007) to 242% by its end (i.e. q2 20009), albeit it has stabilised these past 2 quarters (currently 241%), as the US sought to borrow its way out of a borrowing crisis (fig 6a). While banks, which had been deemed too big to fail, became bigger (i.e. primarily through mergers with failed companies, e.g. Bear Stearns & JP Morgan) and therefore now pose a greater threat to financial stability.

The bailout of AIG by the US government, for example, was one particular example of that 'too big to fail' concept. AIG was a key writer of 'CDS's (i.e. credit insurance) on mortgage and housing related products. As such it was liable to make significant payouts when the housing market fell. The size of those payouts pushed AIG into bankruptcy. Rather than allow AIG to fail, the Federal Reserve and US Treasury, after its experience with Lehmans' failure, backstopped the company and provided it with loans (and equity capital) so that it could meet its obligations. If AIG had been allowed to fail, the interconnectedness of the system coupled with the size of some of the largest financial firms (i.e. with balance sheets of US$2 trillion

versus US nominal GDP of US$14 trillion) would have ensured widespread bankruptcies across the western financial system coupled with a significantly larger recession-depression than occurred. For these reasons the authorities considered it imperative to backstop AIG and save the system.

Because the banks are deemed too big to fail, however, the vast majority of their indebtedness has become a contingent liability of the US government.

Fig 6a: US total domestic non financial debt to GDP



Source: Reuters EcoWin

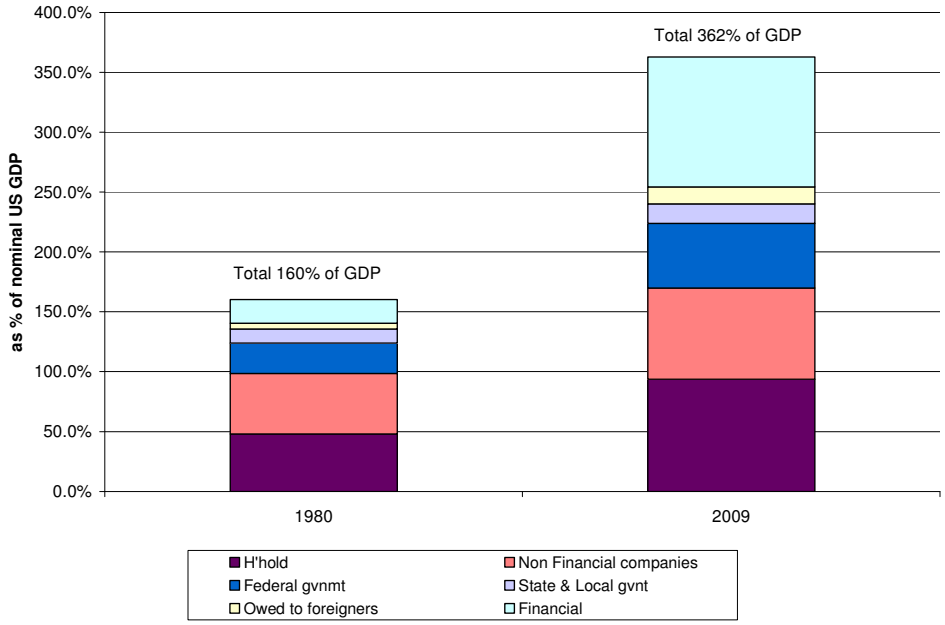
Domestic non financial debt has increased both in absolute and relative terms over the course of the financial crisis

Section 2a: On balance sheet debt & US financialisation

Given that inability of large US financial institutions to be allowed to fail, their liabilities have therefore become the 'implicit' liabilities of the US government. That has now added a further layer of liability/debt to the US government's balance sheet. As the chart below shows, relative to 1980, the levels of economy wide 'on balance sheet' debt, have risen dramatically during this period of financialisation. Total US debt to GDP (including the financial sector) has increased from 160% of GDP in 1980 (an amount typically considered very manageable for a developed economy) to 362% of GDP today. Of that total, 179% of GDP is either explicitly or implicitly backed by the US government (i.e. federal debt PLUS state & local debt* PLUS Financial sector debt)

Of further note, however, the 2009 total doesn't include future rising government indebtedness as a result of continuous fiscal deficits throughout the CBOs' forecast horizon (i.e. "averaging US$600 billion" per annum over the next 10 years) nor any potential liability for any derivatives related default (see section 2b below).

Fig 7: US total indebtedness (On B/S): 1980 and '09 compared (% of respective nominal GDP)



During the past 30-40 years as a result of the financialisation of the US economy, there has been a significant build up of leverage in the system, which is now sitting on top of the US economy

*Recent fiscal stimuli and support for local and state budgets through those stimuli demonstrate the Federal government's bias towards (probably) bailing out local and state government if and when necessary

Section 2b: Off balance sheet liabilities

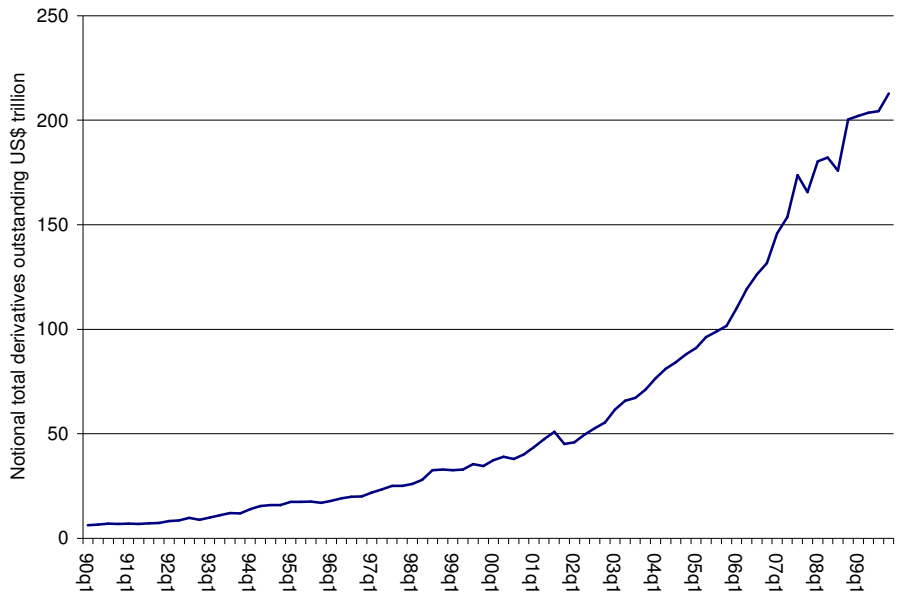
On top of the On-Balance sheet debt, much of which the US government is either explicitly or implicitly liable for, there are also 2 specific off balance sheet contingent liabilities which also ultimately fall upon the government's shoulders:

i) The NPV (net present value) of the government's future Medicare, Medicaid and Social Security costs. Discounted to present value, these equate to approx 276% of GDP (see quarterly asset allocation no 1, November 2009 for full detail).

ii) The Off Balance sheet obligations of the major US banks who are deemed too big to fail (i.e. all the important banks operating in the derivatives market – the OCC reports that 5 US insured commercial banks account for 97% of the sector's entire volume in OTC derivatives). Of note amongst those off balance sheet liabilities are the big banks' outstanding positions in the derivatives market.

Since the late 1980s/early 1990s, the derivatives market has grown exponentially with compound growth of over 20% per annum. At the start of the 1990s the US commercial banks' total notional outstanding derivatives stood at US$6 trillion – i.e. approx 100% of US GDP. Today that total has risen to US$212 trillion, i.e. 1470% of US GDP (NB current US GDP is US$14.4 trillion). US commercial banks account for 1/3rd of the global market. The BIS reports that the global market equates to US$616 trillion in notional outstanding value.

Fig 8: Notional value of outstanding derivatives of US insured commercial banks (US$trillion)



Derivatives have grown rapidly these past 2 decades (from almost a standing start in the 1980s). The current total notional outstanding derivatives held by US commercial banks, equates to US$212 trillion (i.e. 14.4x US GDP). The global total outstanding notional of derivatives is US$606 trillion (i.e. ~11x global GDP)

Because of US accounting conventions, however, these amounts are reported as considerably smaller amounts on the commercial banks' balance sheets. The process of reducing the notional outstanding to an asset and liability, under US accounting conventions, has 2 stages: i) initially the derivatives receivable amounts are valued at what's termed 'Gross Fair value' – based either on an actual traded price, or a price imputed by the banks' models; ii) the derivatives receivable and derivatives payable are then, to the extent permitted by accounting, netted off and reduced to a derivatives trading asset and derivatives trading liability. The netted off amounts are then shown as part of the total trading assets and liabilities in the consolidated balance sheet of the banks.

In the case of JP Morgan, for example, the company reports a total notional LONGs plus SHORTs exposure to derivatives of US$78.7 trillion in its notes to its accounts. Those amounts are then reduced to a gross fair value of US$1.56 trillion on the receivables and US$1.52 trillion on the payables (i.e. in aggregate ~ 3.0% of the notional outstanding value). Those amounts are then netted off against each other down to an asset of US$80 billion and a liability of US$ 60 billion (see table 2 below). The original notional outstanding of US$78.7 trillion is therefore reduced to a small percentage (i.e. 0.3%) of its notional outstanding amount, before being shown on the Consolidated Balance sheet. By way of reference, JP Morgan's balance sheet assets totalled US$2,031,989 million (i.e. US$2 trillion) as @ 31 Dec 2009. Total liabilities were US$1,866,624 million (i.e. US$1.9 trillion).

This practice is, of course, in line with US accounting policy.

Table 2: JP Morgan – from notional to the Balance sheet

	US$ millions
1. Total notional outstanding*	78,733,000
2a. Derivatives receivable – gross fair value	1,565,518
Netting (b):	(1,485,308)
=3a. Consolidated Derivative trading **assets** on B/S	80,210
2b. Derivatives payable – gross fair value	1,519,183
Netting (b):	(1,459,058)
=3b. Consolidated Derivative trading **liabilities** on B/S	60,125

*NB represents the sum of gross long plus gross short

(b) U.S. GAAP permits the netting of derivative receivables and payables, and the related cash collateral received and paid when a legally enforceable master netting agreement exists between the Firm and a derivative counterparty.

Source: JP Morgan Company Accounts

Of note, most of the derivative assets, because they are traded OTC and not on exchange, are valued using in house valuation models. JP Morgan, in the notes to their accounts, lay out the GAAP approach to valuing these assets (see accounting policies below). Level 1 is based on quoted prices and therefore straightforward. JP Morgan's level 1 derivatives represent, though, only about 0.1% of the total derivative assets & liabilities. Level 2 is valued using prices for "similar assets and liabilities" as inputs to the models – this is the bulk of the derivatives assets and liabilities; while level 3 valuations incorporate "one or more inputs to the valuation methodology (which) are unobservable and significant to the fair value measurement"., i.e. entirely dependent on the quality of the assumptions of the modeler (and their risk control). Level 3 assets account, in JP Morgan's accounts, for approx 3% of total derivatives assets – i.e. US$46 billion receivable and US$35 billion payable (see table 3). Of note, JP Morgan's level 1, 2 and 3 split is typical of the major US commercial banks.

Accounting policies:

"Valuation Hierarchy

A three-level valuation hierarchy has been established under U.S. GAAP for disclosure of fair value measurements. The valuation hierarchy is based on the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows.

- Level 1 – inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- · Level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- · Level 3 – one or more inputs to the valuation methodology are unobservable and significant to the fair value measurement. A financial instrument's categorization within the valuation hierarchy is based on the lowest level of input that is significant to the fair value measurement."

Source: JP Morgan 2009 annual report and accounts, P.157

Table 3: JP Morgan Level1, 2 & 3 derivative assets – Dec 2009

	Level 1	Level 2	Level 3	Netting	Total fair value
Derivatives receivable	2,344	1,516,490	46,684	(1,485,308)	80,210
Derivatives payable	2,038	1,481,813	35,332	(1,459,058)	60,125

Source: Company accounts

Given the in house nature of the valuations of many of these assets coupled with the size of not only the notional amounts (i.e. US$616 trillion) but also the gross fair value (i.e. ~US$3 trillion, for example, for JP Morgan alone), **times of extreme market stress** have the ability to generate highly significant movements in asset values and therefore generate significant losses for those on the wrong side of the trade (NB derivatives are by definition a zero sum game). This was clearly the case in the last financial crisis with AIG and other investment banks (UBS, Bear Stearns, Merrill) amongst others, major losers while a number of hedge funds, parts of Goldmans and Deutsche, were some of the key winners. Those on the wrong side of the trade therefore become at risk of default (i.e. as per AIG). That in turn heightens counterparty risk, since currently these derivatives are traded off exchange (although that may change with current legislation being considered in the senate), and therefore, as in the case of AIG, also financial stability risk.

It was with this risk in mind, that Chairman Bernanke wrote a letter to key US lawmakers last week warning that "Forcing these activities out of insured depository institutions would weaken both financial stability and strong prudential regulation of derivative activities". If the derivatives trader is outside of the Fed's jurisdiction and fails, the Fed doesn't have authority to provide emergency loans to the company to backstop it. Hence the risk of a failure of the entire financial system is heightened.

Given that interconnectedness, and therefore the US authorities' view that these financial institutions are too big to fail, these risks ultimately fall onto the balance sheet of the US government (as a contingent liability) along with the contingent liabilities created by future entitlements programmes.

Implications & Conclusion

What is also clear from the authorities' response to this last crisis, however, is that rather than allowing the system to deflate and deleverage during a crisis, the Federal Reserve will create new money (i.e. commercial bank reserves) and use that money to engage in QE in order to reflate the system and ensure that financial stability is not threatened.

It's this expectation coupled with the risk inherent in the size of both the On-Balance sheet debt and Off-Balance sheet contingent liabilities which heightens the attractiveness of gold (i.e. as it increases the risk, and likely eventual quantity, of money creation). As highlighted in Longview Letter no 37: "The History of Quantitative Easing" May 2009, central banks which issue their own currency have the ability to create as much money as they deem necessary. That is the Fed, unless stopped by a change in legislation, has the ability to print as

much money as it needs to fill any holes created by bank defaults or excessive fiscal deficits. By doing that, though, the Fed will continue to eat away at global confidence in its ability to maintain the US$ as a store of value and therefore the ability of the US$ to retain its status as the world's reserve currency.

As Kindleberger explains, in the early stages of an emerging world power, the purpose of the financial system is to:

"promote trade and industry through short and sometimes long-term capital lending...." –
quotation continued below...

i.e. intermediate between savers (i.e. lenders of capital) and borrowers (investors of capital) and to engage in the process of capital allocation, and therefore wealth creation, in the economy.

In past decades, however, large parts of the US financial system, most notably the large banks, have become self serving, rather than a promoter of trade and industry. Their existence is no longer primarily about putting together lenders and borrowers, their primary raison d'être has become to trade assets. As Kindleberger states:

".....and ultimately (i.e. in the final phase of world economic primacy) moves to trading assets and a preoccupation with wealth rather than output. Merchants and industrialists graduate from risk taker to rentier status,"
Continued from quote above...

Indeed perhaps Hernando de Soto, author of the mystery of capital, has the most engaging analogy:

"The increase in the number and kind of derivative contracts--including some, like credit default swaps, that were traded over the counter rather than on exchanges--created a new kind of shadow economy, De Soto argues.

"It reminds me of the way we used to navigate on the coast of Peru," he says. He explained that you'd have close-in sailors navigating by keeping an eye on the coast, then farther-out sailors who navigated by watching the boats that were watching the coast, and so on. "Somehow you got very far away from the coast.""
Forbes magazine 14 December 2009, Shining a Light on Shadow Economies

Notes:

(1) Although it's worth highlighitng that Kindleberger notes that decline from a position of world economic primacy, at least in recent centuries, has been a relative decline not an absolute one.
(2) We could also add a third risk – that of the Federal Reserve's obligation, as lender of last resort and provider of global dollar liquidity, to the overseas financial system

Appendix 1: Derivatives – an overview

The tables below give some general overview of the data on global and US derivatives market.

Table 4: Notional outstanding Derivatives Total (US$bn) – **US Insured commercial banks**

	Q4 1991	Q4 2009
Total notional outstanding	**7,340**	**212,808**
Equity & Commodity	109	2,664
Credit	NIL	14,036
Foreign Exchange	3,394	16,553
Interest rate	3,837	179,555

Source: US Comptroller of the Currency

Table 5: Notional outstanding Derivatives Total (US$bn) – **Global market**

	June 1998	Q4 2009
Total notional outstanding	**72,134**	**614,674**
Equity & Commodity	1,717	9,535
Credit	NIL	32,693
Foreign Exchange		49,196
Interest rate	42,368	449,793
Unallocated	9,330	73,456

Source: BIS, Semiannual OTC derivatives statistics

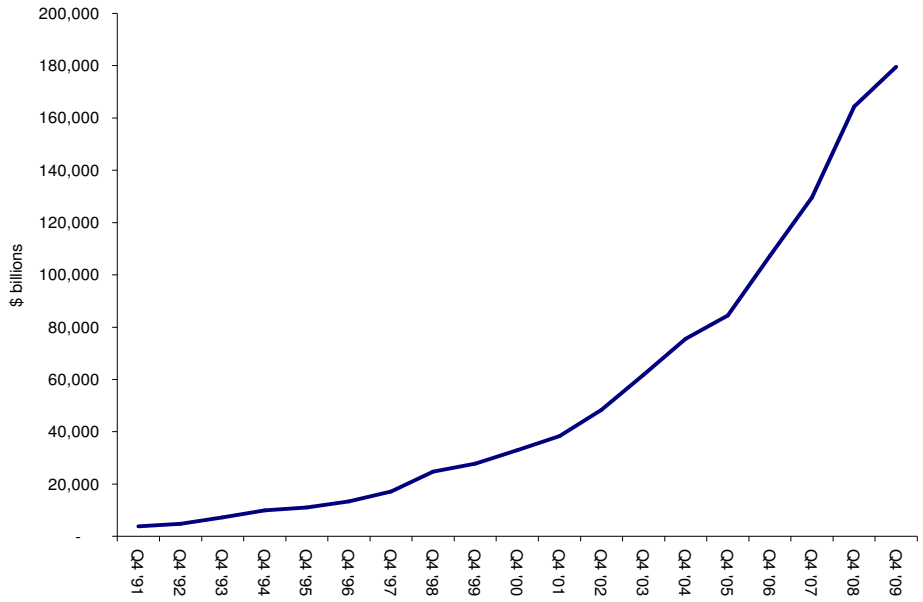
Table 6: Gross Market Value – Total Derivatives (US$bn) – **Global market**

	June 1998	Q4 2009
Total contracts	**2,580**	**21,583**
Equity & Commodity	228	1,255
Credit	NIL	1,801
Foreign Exchange	799	2,069
Interest rate	1,160	14,018
Unallocated	393	2,440

Source: BIS, Semiannual OTC derivatives statistics

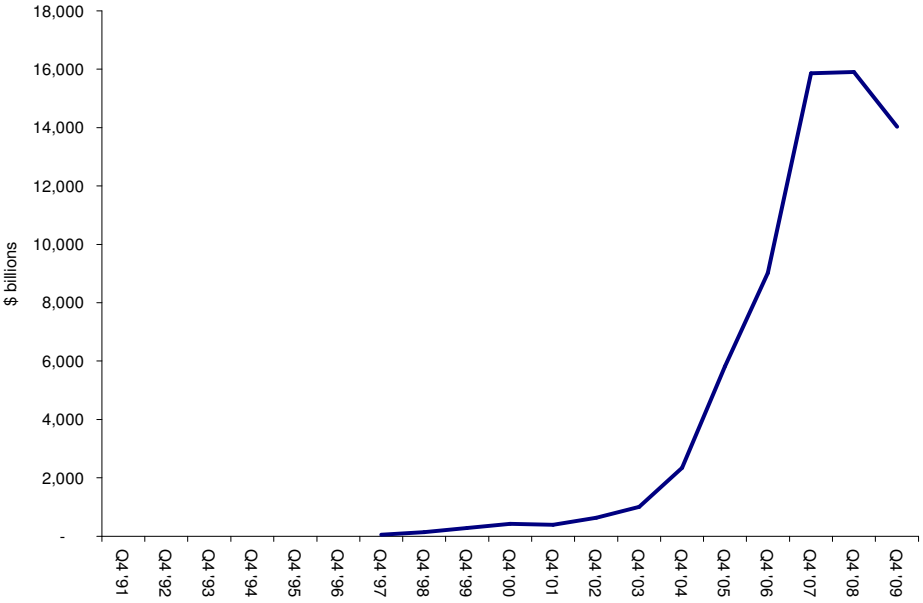
Appendix 2: The Growth of various sub segments of the derivatives markets

Fig 10: US commercial insured banks – notional outstanding interest rate derivative contracts



The interest rate derivatives are the largest of the 5 key contracts with total outstanding notional (amongst the commercial banks) as high as US$179 trillion.

Fig 11: US commercial insured banks – notional outstanding credit derivative contracts



The CDS market having started in the mid 1990s, has grown rapidly such that it's currently a US$14 trillion notional market

Fig 12: US commercial insured banks – notional outstanding Equity & Commodity derivatives

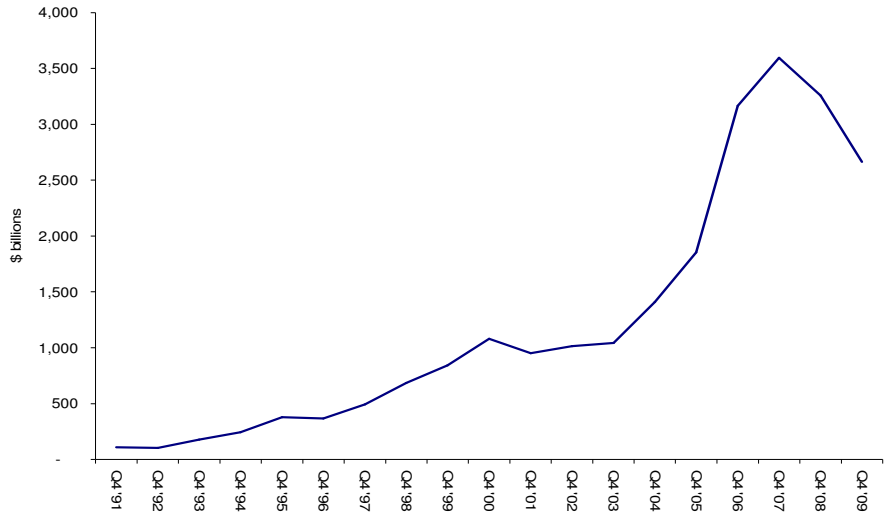


Fig 13: US commercial insured banks – notional outstanding Foreign Exchange derivatives