The Destruction of the Irish Economy

by Jeremy James

The Wright report on the review of the performance of the Department of Finance in the 10 years to end-2010 has just been published on the Department's website. For anyone who is genuinely concerned about the way this country's economy has been torn asunder over the past few years, this report is a shameless and mind-numbingly pointless exercise. It does not give a single convincing insight into the real reasons the Department stood back from its statutory responsibilities, from 2004 if not earlier, and allowed an utterly unprincipled and unscrupulous 'government' to do appalling damage to our economy and the fabric of our nation. The Department was the organisation best equipped to call a halt to the maverick schemes and cynical exploitation of the outgoing 'government', but it did absolutely nothing of substance to prevent this catastrophe. Its spineless attitude beggars belief.

If you want the viewpoint of a former longserving member of the Department's middle management cadre, please see the attached submission which Robert Pye made to the review group on 10 October 2010 (which fact is recorded in the official report).

Be warned, the exploitation of the Irish people is far from over. In addition to further draconian budgets which will do even more economic damage than the last one, we can expect to see a sizeable portion of our public assets pass into foreign ownership over the next few years. These will probably include ESB, Bord na Mona, Coillte, RTE and a host of other state-owned companies. Remember, the members of the incoming 'government' sat complacently in the Dail during the past 10 years while their outgoing counterparts went on the rampage. The sharks and jackals who control the international banking system will face no real opposition to their goal of stealing what remains of our wealth and completing the final destruction of our sovereignty.

Such are the needs of the New World Order.

[The submission which Robert Pye made to the review committee on 10 October 2010 follows **below**.]

4 March 2011

TO: Mr Rob Wright, Chairman of the Review Panel established by the Minister for Finance to conduct an Independent Review of the Department of Finance

- Review of the Department of Finance -

Submission by Robert Pye, employee of the Department 1979-2010

Disclaimer
At the outset I would like to state that none of the comments and opinions expressed in this submission should be taken as a reference to any individual civil or public servant, whether past or current. They should be interpreted as referring exclusively to (a) the Department (or other relevant organisation, as appropriate) as a corporate entity, or (b) the senior management cadre, broadly conceived. This is not to imply that individual civil and public servants did not make very serious mistakes in the run up to, and in the aftermath of, the fiscal and banking crises, but merely to clarify that this submission makes no pronouncement – good, bad or indifferent – in relation to any individual.

Key Players
The key players in the fiscal/banking débâcle are those normally identified in public and media discussion of the issues in recent months, plus one group which is ordinarily never mentioned, as follows:

> The Ruling Elite: This is not the cartel of bankers and developers, nor even a combination of the cartel and other influential interests, but the quasi-dynastic consortium which has ruled Ireland for generations.

Credentials
Even though I was an Assistant Principal in the Department for 26 years (1984-2010) – a rank which does not normally have close regular contact with senior management – I enjoyed exceptional proximity to the higher management tiers of the Department since 1994 when I was assigned, firstly to the programme of reform of the public service, and then to strategic management co-ordination within the Department. I was also secretary during that time to both the Assistant Secretary Group and the Principal Officer Group, as well as the Departmental Partnership Committee. I was thus unusually well placed over a period of fifteen years to observe the inner workings of the Department, its management dynamics, its decision-making processes and its changing organisational structure.

I was responsible for co-ordinating the preparation of all Statements of Strategy published by the Department since 1997, as well as all Progress Reports thereon, the Department's official Risk Management Strategy, its framework of assignments of responsibility for all officers at Principal level and above, and all progress reports on change management developments and initiatives across the Department. I was also responsible for co-ordinating the preparation of the Department's Annual Output Statement which was used by the Oireachtas Finance and Public Service Committee in its annual meeting with the Minister as the basis for its review of the progress or otherwise made by the Department in achieving its strategic objectives. I organised the Department's annual conferences in the period 2000-2007 and participated in a drafting and advisory capacity in the major Organisational Review of the Department in 1995, as well as in a lesser review in 2000. I also attended occasional meetings of the Management Advisory Committee (MAC) between 1994 and 2008.

I greatly enjoyed my work and found it both challenging and rewarding. I was allowed a high degree of autonomy and, for the most part, there was a clear willingness on the part of management to both hear what I had to say and to give it due consideration. Many of my ideas and suggestions over the years were implemented. I enjoyed a good working relationship with virtually all managers at Director level and above and got to know many of them on a more personal level.

I feel it is important to provide this career-related information in order to establish that I am well qualified to comment on the Department, its workings and its management. As it transpired, very few people would have had such a broad overview of the Department or such regular contact with the top three layers of management over such a long period.

I also have extensive experience of organisational and systems issues within the civil service as a whole through my work on computerization. For example, I was the sole author of the ESRI report, ***An Overview of Civil Service Computerization 1960-1990***, which was published in 1992, and spent six years with the Department's IT strategic planning function (1988-1993).

I also served in the Department's Economics Unit in 1994-1995 and as deputy Gilt Dealer for the Department in 1987-1988, which included oversight of the Stock Exchange.

For the record I would point out that I did not accept three or more offers of promotion to Principal level in the period 2000-2008, partly for family reasons, but also because I had long been concerned at the extent to which the Department is influenced, if not controlled, by the political system.

General Comment on the Department's Management

In my experience, the Department has always had a strong management team and has always striven to promote a high level of professionalism. Like most organisations, it may have one or two weak performers in some areas but, broadly speaking, these have never been a serious impediment to the achievement of its objectives. In the main, the Department's managers (PO level and above) are hard working and committed. Many have acquired a good deal of experience in various sections, as well as in other Departments, and have a high standard of educational attainment. On the whole, in my experience, its managers take real satisfaction in delivering a high quality service.

The introduction of a formal MAC structure in 1994 (which superseded the less structured approach which had operated hitherto), along with the creation of the Assistant Secretary Group in 1997 and the Principal Officer Group in 1999 [dates approximate], greatly improved the strategic management process and raised awareness across Divisions of the goals being pursued by other senior managers and facilitated the identification of common issues and concerns. As a result senior managers have had more direct contact with one another over the past ten years and a better understanding of their respective roles in the overall management of the Department.

While the Department could not be regarded as a perfect administrative machine, it was definitely not dysfunctional. In my opinion, the principal causes of the fiscal/banking débâcle cannot be traced to structural or systemic weaknesses within the Department. Neither can they be attributed, in any realistic sense, to skill deficiencies among its senior managers.

The real problems lay elsewhere, as I shall shortly demonstrate.

No one wants to hear bad news

My first real acquaintance with a major flaw in the Department's modus operandi came in 2004. My wife had inherited a small sum of money which she wanted me to invest on her behalf. So I studied the markets to determine which sectors were most likely to perform well during the next 10-15 years. Perhaps being an amateur economist has its advantages because, after 3-4 months of reading and analysis, I came to a conclusion which was widely at variance with that of my colleagues, namely, that the world economy was set for a major dive in the very near future.

In fact, my analysis suggested that, given the serious imbalances in Ireland's economic profile, a major global shock could have a devastating impact on both our fiscal position and our banking system. So I wrote a series of papers which I circulated internally on a personal basis to a number of senior managers.

I wrote as a private individual for two reasons. Firstly, I was 'trespassing' on the work of other sections (which is a major taboo in the Department) and, secondly, there would be no onus on the Department to disclose any of my papers under Freedom of Information since they were written and received in a personal capacity (I did all of my research, analysis and writing in my own time). The scenario I was describing in my papers was very different from the official view being taken by the Department and promoted widely by politicians. I also published in a private capacity to prevent the Department from placing an embargo on the release of my papers at a later date.

Appendix A attached lists the grades of those officers who received one or more of my papers, as well as the papers supplied in each case (I have not named any of the individuals concerned but the reader can be assured that most of them were very well placed).

Appendix B attached comprises all 7 papers, plus a draft article which I wrote for submission to *The Irish Times* in January 2007 (which was officially blocked by the Department.)

The response to my first paper was very disappointing. So I tried again. Struck by the validity of my arguments, one officer (at PO level) was prepared to hold a workshop to discuss the issues. However, he was promoted to Assistant Secretary rank outside the Department a couple of weeks later. Please note that he was the ONLY person who at any time called for a wider discussion of the issues in any of my papers. The ONLY person.

I persisted and managed to get a meeting with 3 well-placed Assistant Secretaries. The meeting, which took place on 13 October 2004, lasted about 40 minutes. They agreed that the risks I had identified were legitimate but not with the high rating I had ascribed to them or with my overall conclusions. They argued that one of my main recommendations – that the state should run a large budget surplus for several years – was simply untenable on political grounds. (A large surplus could have been placed in a sinking fund and used to reflate the economy after the tsunami struck. It would also have greatly reduced the rate of growth in public expenditure and thus lessened the severity of the impact.)

I continued to write papers until end-2005 when I finally gave up. Despite repeated efforts to spark a debate, I got absolutely nowhere. Apart from the brief, unproductive meeting of 13 October 2004, I had no serious feedback from anyone to any of my seven papers. While three recipients gave some very informal feedback (two POs and one Assistant Secretary) and were broadly in agreement with my analysis, they showed no willingness to express their opinion more openly within the Department.

I made one final attempt to raise the alarm in January 2007 when I wrote a long article for submission to *The Irish Times*. Given my position within the Department, I felt I was obliged (rightly or wrongly) to first submit it to the Department for 'approval' to send it (but not to endorse its contents). However I received an official written notification from the head of Corporate Services Division informing me that I could not send it.

The entire experience was extremely exasperating. I was confronted with a side of the Department that was utterly baffling. It was patently obvious to me that no one wanted to raise the possibility that the so-called 'soft landing' would turn out to be a calamitous crash. Such a spectre was politically unacceptable and could not be debated.

The Seven Papers and the proposed *Irish Times* article

The arguments sets out in my seven papers were fairly straightforward. Instead of taking a purely domestic stance on the Irish economy, they focused on the geopolitical factors which would have the greatest bearing on its development in the years ahead. I could see that there would be no point in highlighting the potentially devastating property bubble or the unconscionable growth in household and developer debt – these factors were already receiving attention in the media. Besides, if I commented too much on the Irish economy I would be accused of second-guessing the work of another section of the Department – which is severely frowned upon. So I focused instead on geopolitical analysis, partly because it was not being conducted in a systematic fashion anywhere in the Department and partly because it added a whole new dimension to the debate. Overall the geopolitical angle gave me all the space I needed to sound the alarm.

I won't try to summarise my arguments except to note that they correctly predicted each of the following:

- the global credit crunch of 2008;
- the Wall Street banking crisis;
- the calamitous damage caused by financial derivatives;
- the extent to which the international financial system was being operated in a fraudulent manner;
- the sharp collapse in the Irish stock market in 2008;
- the potential collapse of the Irish banking system in 2008/9;
- a major fiscal shock to the Irish economy in 2008/9;
- the very significant increase in pension fund deficits;
- the price of oil at end-2007 (two years in advance);
- the progressive destabilisation of the Middle East;
- the continued marked deterioration in US budget and trade deficits;
- the substantial increase in commodities and precious metals;
- the abysmal response by G20 and OECD leaders to the crisis;
- the very significant deepening of US indebtedness.

We have yet to see the collapse of the US dollar, but this cannot be far off. Neither have we seen the huge burst of inflation predicted in my papers, but this will come if, as expected, Europe and the US print fiat money on a grand scale to pay for the so-called stimulus and bail-out packages. (This used to be described as recklessness in the UK and elsewhere, but today it is known as Quantitative Easing.)

So what went wrong in Ireland?
Before we can establish what went wrong in the Department, we need to examine the forces that were shaping the Irish economy in the period 2000-2008.

When a serious crime has been committed one must ask *Cui Bono?* The debate in the media to date in this regard has been very poor. Over 50 billion euro (and counting) has been transferred from the Irish people to a relatively small number of unknown beneficiaries. This is being described as a necessary expedient to protect both international bond holders and the Irish banking system. However, whether it is justified or not – and I am firmly of the view that it is hideously misconceived – when considered purely as a system of intervention it is completely lacking in transparency.

The Irish people are still not being told who the ultimate beneficiaries of this gargantuan transfer of wealth really are. Not one euro has been 'lost' in the débâcle. Not one. Instead there has been a massive transfer of wealth between the Irish middle class and an elite group of insiders. When a mother of two defaults on a loan of €2000 from her local credit union, it is described as a crime and the woman is put in prison for a few months, but when €50 billion goes missing, and powerful vested interests are involved, it is described as an unfortunate occurrence.

There is really no point in examining the conduct of the Department of Finance during this period (2000-2008) unless this central reality is acknowledged. A theft of this magnitude does not occur without the deliberate connivance and planning of a number of people in key positions, both in Ireland and abroad.

At this point I should state categorically that I don't believe the Department was wittingly complicit in this crime. <u>As far as the Department is concerned, the central question is not its complicity but its failure to recognise the gravity of what was happening and to raise the alarm</u>. We will now look at the reasons for this.

Why the Department failed in its responsibility
The attitude taken to my seven papers, and the deliberate frustration of my attempts (such as they were) to carry the debate to a wider audience, is itself a significant indicator of the attitude prevailing within the Department. But what exactly was that attitude?

It might help to compare it with the attitude taken to another public policy issue – Decentralisation. This 'scheme' was foisted on the civil service without debate, planning or analysis of any kind. It was purely a political initiative to garner votes in provincial areas and generate large capital projects (through the construction of office accommodation) for well-connected developers. At a stroke it dealt a nasty blow to the Public Service Modernisation programme which was predicated on many principles which Decentralisation contravened – one size fits all, segregation of staff, reduced mobility, communication bottlenecks, empire building, over-specialisation, the proliferation of administrative overheads, the duplication of functions, organisational inflexibility, etc.

While some Departments already had a species of decentralisation under way, it was being carried out strictly in line with their specific needs, in support of their strategic objectives, and in accordance with their own timetable and business requirements. What is more, the Decentralisation scheme ran completely counter to another important government policy, the National Spatial Strategy, which sought to optimise the distribution of national resources and infrastructure across regional locations, using agreed criteria and planning parameters – all of which were ignored by the Decentralisation scheme.

So if any Government or Ministerial initiative deserved to 'resisted' by the Department, this was it. How exactly such 'resistance' might have been exercised is a matter of conjecture, but the question never arose since the attitude of management during this period was one of unquestioning obedience. When the logic of the Decentralisation scheme was challenged at a meeting of the Departmental Partnership Committee in 2003/2004, in circumstances which could not be regarded as either unreasonable or disrespectful, the officers concerned were swiftly rebuked. They were told in no uncertain terms by a very senior manager that the role of the Department was to advise the Government on policy matters and, once the Government had made a decision, it was the Department's statutory duty to implement it without question. No vacillation or second-guessing of any kind would be tolerated.

This was not a once-off incident. It was the prevailing attitude, hammered home again and again by senior management. We might advise the Government that white was white, but if the Government decided that white was black, then the Department was deemed 'legally' required to preach the same message to all and sundry – without question.

This may seem somewhat comical, but for the Irish taxpayer it was far from amusing. The Government which came to power in 1997 quickly realised that it could get the Department to do virtually anything it wanted, without any significant resistance. And the more it got its own way, the more brazen it became.

Let me give a number of examples to illustrate this. Please consider each of them very carefully since they paint a very bleak picture indeed and highlight the disturbing inability of the Department to exercise a moderating influence on some of the more eccentric, partisan and irresponsible policies pursued by the Government (It is not known whether any senior civil servant stood his ground with the Minister during this period, but it is generally believed that at least one did, a very capable and widely respected individual – but he was abruptly transferred outside the Department):

- The feverish expansion of expenditure in the Health Sector, despite the well-known structural difficulties in that sector, the fragmented and unconvincing nature of its management, the serious lack of systems to ensure the effective allocation of resources, and the startling absence of any evidence that the increases already made were having any effect.

- The introduction of a series of dangerously pro-cyclical Budgets from 2001 which stoked inflation and undermined competitiveness.

- The introduction at great cost of a state-subsidised scheme (SSIAs) to encourage saving when no such encouragement was needed and no clear strategic objective was being achieved.

- The Decentralisation Scheme [which we have already discussed].

- The uncritical pursuit of major infrastructural projects at costs far in excess of the norm in other countries. The state was probably paying a premium of 30-40 per cent minimum on every euro it spent on such projects. For example the LUAS project – a mere 16 miles of track – cost €780m when projects of a similar size in most other European countries would, as widely reported, have cost somewhere between €250m and €400m.

- The complete failure to identify the cartel being operated by a number of construction companies whereby each tendered for a public contract at a grossly inflated price and a pre-selected under-bidder, also a member of the cartel, secured the contract – also at a greatly inflated price. According to media reports in 2008 (I believe) the fair market price for all large public construction contracts was being inflated by this cartel by 30-40 percent. Of even greater concern is the apparent failure by the Government to publish information about the companies concerned or to explain the steps, if any, being taken to recover the over-payments or impose meaningful financial penalties.

- The Tribunal gravy train is one of the most outrageous misuses of public funds that one could possibly devise. Fee structures (which are already excessive) were applied on a semi-permanent basis to a situation for which they were never designed. Well over half of public expenditure on the legal costs of Tribunals over the past 15 years has been a complete waste. The abuse was so brazen and so flagrant that it is truly astonishing that the Irish public (or the Department) could have allowed it to continue.

- The Department has a central role in formulating policies that support price stability and competitiveness. This gives it a direct interest in the pricing practices employed in such major sectors of the economy as the retail grocery trade and the sale of pharmaceuticals. However, as consumers have long argued, and as the experts have finally admitted, both of these sectors were over-charging by 25%-30% during most of the boom and yet no effective action was taken to rein them in.

- Another obvious abuse, which should also have drawn considerable ire from the public, was the Benchmarking scheme. Instead of having one system of pay determination, public servants now had two – and each operated without any obvious regard to the other. If the standard Partnership arrangement was fair, then there was no justification for Benchmarking. On the other hand, if the standard Partnership arrangement was unfair, then workers in the private sector were being deceived by the state. One cannot have it both ways.

  To crown it all, the papers relating to Benchmarking were withheld from the public. This ensured that the entire exercise and the spurious principles which underpinned it were hidden from objective scrutiny. It is unclear how strenuously the Department argued against the Benchmarking scheme, if at all. However if it did its efforts were singularly unsuccessful. The scheme added billions to the public service pay bill and did enormous damage to Ireland's competitive-ness.

Further disturbing examples could be given of Government policies which should have drawn a powerful response from the Department, but these should suffice.

Other major players

Before proceeding to examine the property bubble and its toxic effects, we should pause for a moment to consider the role of other major players in the débâcle. Any assessment of the Department should have regard to the concomitant failures by bodies which were meant to be supporting it in the stewardship of the economy.

The Central Bank should have taken radical action as early as 2004. While flagging the possibility that the ever-expanding bubble could trigger a banking crisis, it did virtually nothing to address the explosive growth in credit, the cavalier borrowing policies of the major banks, their indiscriminate liberality in relation to a small circle of developers, or their unbelievable reluctance to implement responsible lending criteria. Its failure in this regard could well amount to criminal negligence. (I can recall a Sunday newspaper article in 1992/1993 by Mr Cathal Guiomard, a former employee of the Central Bank. I believe it took the form of a letter to the Governor. In the article he tore the Central Bank to shreds, citing a ream of evidence which seemed to support his lacerating appraisal of its many defects. If even half of his criticisms were well founded, it was a seriously dysfunctional organisation even then.)

The role played by the office of the Financial Regulator was so negligent that it is difficult to even talk about this organisation without exploding in fury. Let that comment suffice.

And then we have the NTMA, which manages a major international investment portfolio on behalf of the state and is thus obliged to monitor and forecast significant geopolitical risks. What warning did it give the Department? What steps did it take to alert key figures in the Department to the gathering storm clouds? If it was aware of the impending international crisis, why didn't it ensure the Department was fully apprised of its intelligence? And if it was not aware, why was it managing an international investment portfolio of over €20 billion?

Next we have the ESRI, whose Quarterly Reports are meant to reflect the harsh realities of the market place. Why was its analysis so wide of the mark? It has about fifteen 'Professors' who are meant to be leaders in the field. Most enjoy a rank and remuneration above that of Assistant Secretary. What is more they are not as hampered as civil servants by the need to couch their pronouncements in politically anodyne language. The Institute should have been sounding the alarm continually and in no uncertain terms from 2004. Instead it too lacked the moral courage to state plainly what was actually happening and propose radical remedial action.

Among academics, it would appear that only Morgan Kelly of UCD had a true grasp of developments. His articles in *The Irish Times* were both cogent and informative and should have spurred a number of economists to snap out of their complacency. The fact that they did not is further evidence of the depressing herd mentality which affects the vast majority of Irish economists.

The Department's response to the growing crisis

The inflation in property prices throughout the period 2000-2008 was perhaps the most obvious sign that a major economic crisis was building up. Even the dogs in the street knew that if this bubble burst – which is normally what bubbles do – then the consequences for the economy were potentially catastrophic. The Government response was abysmal. The three so-called Bacon Reports would have little or no impact on the problem – and just about everybody in the Department knew this. As long as cheap credit was freely available, prices would inevitably go up. In order to slow property price inflation, it would be necessary to severely tighten the availability of credit. One didn't need advanced skills in economics to see this.

The bubble yielded huge revenue increases in VAT, income tax and stamp duty. The Government's appetite for cash was simply voracious. However virtually every senior manager in the Department knew – of should have known – that its conduct was economic recklessness of the highest order. What is more, it was impacting directly and in a very punitive form on members of society who were too gulled by media propaganda to recognise what was happening. For example, a family of four which wished to move to a home with an extra bedroom could end up paying over €60,000 in stamp duty, virtually all of which it would have to borrow. This was on top of the extra money it would have to borrow to buy the larger property. Thus the Government was forcing middle income families to increase their borrowings significantly in order to make a massive lump sum donation to the state. And when the state got its hands on the money, it immediately spent it. Frankly, this was economic madness of the worst kind, and yet the Department stood by and let it happen.

The Government had no incentive whatever to take corrective action. It was reaping a colossal revenue windfall, most of which it then channelled into **current** expenditure. As an egregious violation of the most basic principles of economics, this is probably impossible to beat.

Many commentators bleat about the need for greater specialist skills in economics and financial management in the Department, but this is nonsense. The mistakes which were made had nothing to do with skills. They were due rather to the appalling inability of the Department to impress upon the Government the sheer recklessness of its policies.

It has also been suggested that the Department was in some sense 'weakened' by the enlarged role played by the Department of the Taoiseach in the past ten years or so. This too is a red herring. The Department of Finance suffered no statutory diminution of any kind in its responsibilities. It was just as 'powerful' in the period 2000-2008 as it had been at any time in its history. The question really is whether it was prepared to exercise that power in the interests of the Irish people or to roll over like a compliant poodle and let a ruthless cartel of international bankers and investors extort billions from the Irish taxpayer.

The Department could not come to grips with the fact that it would have to confront the Government and fight furiously to defend both the banking system and the public finances. Instead it simply contented itself with "advising the Government" and including the occasional cautionary comment in its Memorandums. If papers released to date under FOI are any indication, these cautionary comments were no more than spineless academic observations at a time when a series of thundering rebukes were absolutely essential. By end-2006 the Department should have been in open revolt against the patently insane policies being pursued by the Government.

During this period (2000-2008) I had the opportunity to observe the Assistant Secretary Group in action. This comprises all managers at Director and Assistant Secretary level across all Divisions (about 14 in all). These individuals also get an opportunity to attend the weekly meetings of the MAC on a rotating basis (3-4 at a time). The public has a right to ask whether and to what extent this group of well paid senior civil servants addressed the unfolding crisis over this period. What recommendations did it make? What steps did it take to alert top management to the calamity that was then unfolding? The answer, sadly, is very little (and I'm being kind here – the correct answer is probably "none at all".)

In other words there was little if any recognition within the Department that a truly major crisis was brewing. Most accepted the conventional view that a "soft landing" was the most likely outcome. This seemed to be predicated on the belief that as long as cheap and ample credit was available from the international money markets, the banks could continue to find the necessary liquidity to sustain their operations and could gradually tighten their lending policies as soon as the property market reached a natural plateau. This was not just wishful thinking of the worst kind by the banks but a serious criminal violation of their legal requirement to avoid any activity that might threaten their solvency or long-term viability.

In my seven papers I concentrated on trying to show that the international money market itself was on the brink of a major crisis. So, just at the point where the Irish banking system was most over-stretched, its supply of cheap liquidity would be severely reduced, if not cut off completely. <u>No one in the Department wanted to hear this message</u>.

[The Department already had good reason to keep a close watchful eye on at least one major bank. AIB almost destroyed itself in 1985 when it bought ICI – an incredible blunder by any reckoning – and had to be bailed out by the state at considerable cost. Then, in the course of the 1990s, it deliberately defrauded the Exchequer of hundreds of millions in taxation revenue by encouraging thousands of its clients to open illegal off-shore accounts. Furthermore, it knew full well that the ethical standards applying in Anglo-Irish Bank were even lower than those of AIB.]

The perception that the international financial system was sufficiently robust to withstand a major shock was reinforced by the absence of a section or unit within the Department to monitor and analyse geopolitical risks. It was not that such risks were being ignored, but their potential impact on the Irish economy was not being analysed in a convincing or systematic way. Instead the Department was content to adopt a standard textbook approach, factoring in geopolitical factors where they appeared to be relevant in a given context, but otherwise failing analyse the global environment in its own right, with particular reference to the United States. Had they done so they would have seen that most of the opinions published in *The Economist*, *The Wall Street Journal* and *The Financial Times* were just that, opinions.

If a person like myself, with no formal qualification in economics, could see the huge inconsistencies and incongruities in the Government's policies and the shock that would shortly explode on the international stage, there is no reason why the many skilled and capable managers within the Department could not have done likewise.

The attitude to my papers

This leads inevitably to the question – why were my papers ignored? Why didn't the Department host a workshop to explore these issues? Why was there no debate whatever on the questions raised in my papers?

The answer? – I don't know.

Perhaps I was speaking above my station, or treading on people's toes. Or perhaps people were just too busy to take on another burden. Or perhaps I was raising issues which were too sensitive politically. Why did some senior managers agree with me in private but took care never to voice this view across the Department? Why did the Department block my proposed submission to *The Irish Times*?

I believe the same attitude of supine resignation which gripped the Department and rendered it unable to confront out-of-control politicians, also made it unable to debate or even acknowledge the validity of the issues raised in my papers. After all I was recommending a series of budgetary surpluses at a time when the Government was arrogantly proclaiming its intention to *Spend Spend Spend*. I was also recommending a major shift in the investment strategy being pursued by the NTMA in relation to the National Pension Reserve Fund. No one in the Department appeared to be willing to take on a challenge like that.

In fairness, I must stress that most managers at Assistant Secretary and Director levels were putting in long hours during this time. Most were dealing with matters which were politically sensitive and very time-consuming to address. I can safely say that, in my experience, all officers at that level were pulling their weight and many were going the extra mile to deliver results. However none of this excuses their role in the calamity that ensured.

Conclusion

So what went wrong? The answer ought to be obvious. We were allowed to think outside the box, <u>but under no circumstances could we speak outside the box</u>. If the Government said black was white, then black was white. The Department simply lacked the moral courage to confront politicians whose policies were plainly ludicrous. It was not helped by a political system in which one party ruled without restraint for over ten years, with virtually no opposition of any kind. A senior civil servant, even a tough person with a lot of experience, would find it difficult to confront a Minister who was not facing any meaningful resistance in the Dail.

The Department also tried to justify its stance by interpreting its legislative remit far too narrowly. It is not enough to say that the Department is statutorily required only to provide advice to the Government and then implement its decisions. This is not what the legislation says. **There is a statutory duty of care on the Department to act only in the public interest and to defend the public finances and the banking system <u>in all circumstances</u>. Its failure to do this in the lead up to the fiscal/banking débâcle is inexcusable, while its failure thereafter to preserve the integrity of the public finances raises extremely serious questions about its own independence and integrity.**

This devastating failure must be balanced against the sinister strategy adopted by the by the Ruling Elite who, deliberately and systematically, siphoned off (and continue to siphon off) vast sums of money from the Irish middle class. This is by far and away the most serious crime ever committed in modern Irish history. It is doubtful whether the Department realised, until it was too late, just how cynical and venal the enemy really is. Indeed, I believe it still does not understand the role and influence of the Ruling Elite or their stunning disregard for the welfare of the Irish people.

This group is working hand in hand with its counterparts abroad to establish a New World Order, which entails the destruction of independent sovereign states and the creation of a system of global governance controlled by the international banking cartel. They are using systematic economic sabotage to bring this about. Iceland was first. Next come Greece, Ireland and Portugal, to be followed, presumably, by Spain, Hungary and the Baltic states. The Department, alas, appears to have no understanding of this agenda or its pernicious implications for our country, our independence and the welfare of future generations.

Robert Pye
Greystones
10 October 2010

APPENDIX A

Recipients of Economic Shock papers

	June 2004	July 2004	Sept 2004	Feb 2005	May 2005	Aug 2005	Nov 2005
Second Sec Gen			x	x	x	x	x
A/Sec #1		x	x	x	x	x	x
A/Sec #2			x	x	x	x	x
A/Sec #3	x	x	x	x	x	x	x
A/Sec #4	x	x	x	x			
A/Sec #5	x	x	x	x	x	x	x
A/Sec #6	x	x	x	x	x	x	x
A/Sec #7					x	x	x
PO #1	x	x	x	x	x	x	x
PO #2	x	x	x	x			
PO #3	x	x	x	x	x	x	x
PO #4	x	x	x	x	x	x	x
PO #5		x	x	x	x	x	x
PO #6						x	x
PO #7	x	x	x	x	x	x	x
PO #8	x	x	x	x	x	x	
PO #9	x	x	x				
AP					x	x	x

The grade listed is that obtaining at the time the individual received his/her first paper. Several were promoted over this period and some are now at Secretary General rank.

APPENDIX B

Papers prepared in my own time and circulated privately to the individuals listed in *Appendix A*

#1: **Preparing for the Coming Economic Shock and its Aftermath** **(June 2004)**

#2: **Preparing for Turbulence on the World Markets** **(July 2004)**

#3: **The Imminent Tsunami: Why the World Economy is on the Threshold a Major Recession** **(September 2004)**

#4: **Countdown to a Global Economic Shock** **(February 2005)**

#5: **The World Economy: A House of Cards** **(May 2005)**

#6: **Ask not for Whom the (Lutine) Bell Tolls** **(August 2005)**

#7: **Eight Reasons why a Global Economic Shock is Inevitable by end-2008** **(November 2005)**

Article drafted for submission to The Irish Times (January 2007)
(which was blocked by the Department):

#8 **Why a Global Economic Shock is Now Looking Inevitable**

Discussion Paper for limited circulation,
by Robert Pye, Greystones, Co Wicklow.

Preparing for the Coming Economic Shock and its Aftermath

The principal economic shocks of the past forty years have been oil related, 1973 (the Yom Kippur War) and 1979 (the collapse of the Iranian regime). Other shocks, though significant, did not have nearly the same impact on the world economy – Black Monday (1987), the Sterling Crisis of 1992, the Asian crisis of 1997, the Dot Com bubble of 2000 and the Twin Towers attack in 2001. These lesser shocks were largely the result of systemic errors or irrational, and essentially reversible, episodes in the markets.

The oil crises of 1973 and 1979 had a fundamental and enduring effect on the world economy, even though only one commodity was involved and no major cost-increasing crisis developed in tandem. Their impact on both national economies and international markets was both sharp and severe. <u>Appendix A</u> shows the impact on key economic indicators in Ireland in the year following both events, while <u>Appendix B</u> shows the severity of the movements in key market indices.

It should be clear from these statistics that, despite the reduction in dependency on oil in most major economies since 1979, the impact of another oil shock of comparable magnitude would be very significant.

The 1973 shock saw oil prices jump from $15.01 to $23.87 a barrel, an increase of 63%. The corresponding figures for 1979 were $29.83 and $44.89 (66%). It should be noted that neither increase was accompanied by an *interruption* in the supply of oil.

The questions one must now ask are:

(a) Is another oil crisis looming?

(b) If so, what impact will it have?

(c) What steps could reasonably be taken at this juncture to mitigate the effects?

Is Another Oil Crisis Looming?
The answer to the first question is almost certainly yes. In fact the evidence for this is far stronger than the evidence available before the two previous shocks. The geopolitical climate is remarkably stormy in comparison to that prevailing in 1973 and 1979. While there is a wealth of evidence to support this view, the main indicators are as follows:

(i) The war in Iraq has escalated out of control. It has now become a guerrilla war for which the Islamic extremists have prepared. Protracted guerrilla wars are virtually unwinnable without the use of overwhelming force. Even then, the high operational costs and disturbing casualty rates limit the extent the which this option can be pursued. The possibility of restoring equilibrium, according to many commentators, is virtually nil. The plan to establish "democracy" in Iraq is misconceived since it implies rule by the majority, who in Iraq are the Sh'ites. Neither the Sunni minority nor the Kurds would allow this. Furthermore, the Kurds see the current unrest as a golden opportunity to create a Kurdish state. This is a further destabilising factor that could even draw Turkey into the conflict.

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(ii) The success of the strategy adopted by the Islamic extremists in Iraq will embolden their colleagues in other countries, notably Saudi Arabia. Repeated attacks on oil infrastructure and personnel, notably engineers, will at some point make military intervention by the US inevitable. There are several million foreign workers in Saudi, many of whom will leave the country if the abductions and executions continue (The UK have recently allowed non-essential diplomatic staff to leave). Military intervention will enjoy strong popular support among the US electorate, at least initially.

(iii) There are strong doubts internationally whether Saudi internal security is completely reliable. Al Qaeda subversives and sympathisers may already be employed unwittingly by the security forces and members of the royal family. This means a co-ordinated strike could have sudden and dramatic consequences.

(iv) The existing US government has consistently stated that it will not allow extremists to undermine its foreign interests and that it will take whatever action it considers necessary to defend those interests. It has already intervened militarily in two Islamic countries where the stakes were much lower than they are in Saudi. Also, as early as 1998, the neoconservatives were calling for the use of pre-emptive military intervention in the Middle East.

(v) The option of invading Saudi Arabia was actively considered by the US in 1973, according to a British intelligence memorandum released at end-2003. Seizure of the oil fields, the memo says, was "the possibility uppermost in American thinking [and] has been reflected, we believe, in their contingency planning." (Washington Post, 1 January 2004). Commenting on the same disclosure, the International Herald Tribune said, "Many Saudis, who believe America invaded Iraq to secure access to its oil, say they cannot exclude the possibility that their country will be next." (8 January 2004).

Few commentators seem willing to refer to the possibility of military intervention in Saudi by the US. The most telling observation that I can find is by Irwin Stelzer, director of economic policy studies at the Hudson Institute: "A final lesson for policymakers: prepare for the day when Osama Bin Laden and his associates are in a position to topple the Saudi regime and withhold supplies of oil, causing an economic trauma in industrialised countries and a humanitarian catastrophe in the undeveloped world...The invasion of Iraq was not about oil. But the next American intervention in the Middle East may well be." [Sunday Times, 20 June 2004].

What impact will the coming oil crisis have?

Given the statistics in Appendices A and B, there is every reason to believe the coming oil crisis will be just as disruptive as its predecessors. While world dependency on oil has fallen somewhat since 1973, it still constitutes a primary input to economic activity. It also affects all countries, so there is no reserve economy to drag the rest out of recession.

As Stelzer suggests in the above quotation, the aim of Al Qaeda is to deny America access to Saudi oil, not simply to push up the price. This would suggest that the resulting demand around the world, including the growing demand by China, could push the price close to $100 a barrel.

There is another major factor will may well make this oil crisis even more disruptive than the first one. The US was winding down its campaign in Vietnam at that time and was able to pump more resources into the economy. This time the reverse will happen. The ongoing cost of the war in the Middle East (Iraq, Saudi and possibly some of the smaller neighbouring countries) will be a very significant drag on the US economy.

Even without the coming escalation in military costs, the US economy is not in very good shape. The budget deficit is running at record levels and showed little sign of abating even before the entry of America into Iraq. There are also indications that the true cost of the war in Iraq is not being factored in, so that the underlying deficit is probably much higher than the official figure. The trade deficit is also historically high, and growing.

The current recovery is being fuelled by a weak dollar policy, tax rebates and historically low interest rates. None of these will be available once the crisis erupts.

Americans also have a very high level of personal debt and a great dependency on the stock market and buoyant property prices to fund their retirement plans. Economic growth in the past 25 years also means that the amount of money in the various markets, both US and global, is substantially greater than it was in 1979. Consequently the shock to the markets, when it comes, could have a correspondingly greater effect.

These developments – the growing budget and trade deficits, a significant increase in the price of oil, the substantial ongoing cost of financing the war, and the shock to the markets – will frighten those Asian economies which are currently propping up the deficit by buying Treasury Bills. If they are to continue funding the deficit, they will expect a higher rate of return and compensation for the falling dollar. Thus higher interest rates appear inevitable.

There will be a further reason for higher interest rates. The cost of the war for the US will be funded only in part through taxation and borrowing. The bulk of the cost will be covered by a substantial increase in the money supply. This will lead to high and sustained inflation.

The resulting global recession will be deep and enduring.

What steps could reasonably be taken at this juncture to mitigate the effects?
There is nothing that can be done to avoid the crisis, but it may be possible to take certain steps to mitigate its effects. These include:

- Aiming for a budget surplus for the next 5-6 years. This will leave more room for a stimulus to the economy when it needs it most.

- Denominating a greater proportion of the national debt in the currencies which are likely to be weakest after the crisis hits, in particular the US dollar, and switch as much as possible out of Swiss Franc (which will appreciate strongly against the euro).

- Introduce amending legislation to enable the annual contribution to the national pensions reserve fund to be invested in infrastructure until 2010. Also enable a significant proportion of the accumulated reserve to be used for the same purpose.

- Review price control legislation and identify further statutory safeguards.

- Consider a possible strategy for discussion with the social partners for compensating workers for rising inflation. The threat of wage driven inflation is a serious one. Some mechanism will be needed to contain wage demands.

- Greatly curtail the availability of credit to domestic borrowers. Many home owners will be caught for an extended period with negative equity.

- Encourage the major financial institutions to shorten their positions in those sectors of the market which will be most exposed when the crisis hits.

- Be prepared to factor in the increased cost of national security and the loss of revenue from a significant fall in tourism.

Signs of an imminent invasion

While it is unclear when the US will move into Saudi, whether 2005, 2006, or 2007, there are a series of signs which ought to mark a step closer to that event:

(i) The election of Bush in November. (The election of Kerry, while not ruling out an invasion, would widen the range of options.)

(ii) A significant increase in the American defence budgets for 2005 and 2006.

(iii) A further significant increase in the terror premium on the price of oil. This is currently around $10 a barrel. If it goes to around $30, bringing the price of oil to $60 a barrel, then big business will expect, or even demand, military intervention in Saudi.

(iv) Introduction of compulsory military service. Given the extent to which US forces in Iraq are already over-stretched, the draft appears inevitable. The timing of its introduction will likely reflect the general time-scale being adopted by the US government.

(v) A sharp rise in military stocks will be a clear sign that investors expect an invasion. Since there is a loose correlation between investor sentiment in the US and public opinion, the Government will likely take this as a sign that the public will not oppose an invasion.

Some closing remarks

I have kept this paper as brief as possible. Naturally, a great more could be said about the likelihood and timing of the impending crisis, the factors which appear to make it inevitable, and the best way of dealing with the effects. Indeed, the effects themselves are not so easy to pin down since much depends on the political response of a wide range of players. For example, would Russia guarantee cheap oil to America in return for support in dealing with the growing crisis around its own southern borders? Will America offer Middle Eastern oil under its control only to those countries who assist it in conducting the war? Will the availability of portable nuclear devices, and the real possibility that they may be used in a western city, lead to pressure for a withdrawal by the US?

Some readers may be take comfort in the possibility that the Democratic candidate will win the Presidency in November. However, this is unlikely. Al Qaeda will want to retain the existing regime and can be expected to take whatever steps may be necessary to sway American opinion in that direction. There is also growing evidence, in the US media and elsewhere, that a large proportion of Americans see the current conflict as a religious one. If so, then they are more likely to stay with the existing regime.

<u>Conclusion</u>

Western economies should pursue a budgetary and economic strategy over the next 5-6 years which takes due account of the emerging oil crisis and its significant adverse consequences.

28 June 2004

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APPENDIX A

Inflation

CPI average 1971-1973:	9.7%
CPI average 1974-1976:	18.7%
CPI average 1977-1979:	11.5%
CPI average 1980-1982:	18.7%

Growth

GNP (constant 1995 prices)

1972	21,548
1973	22,487
1974	23,305
1975	23,496
1976	23,836
1979	27,447
1980	27,916
1981	28,487
1982	28,001
1983	27,667

Interest Rates

(3 month interbank rate)

1971	6.61
1972	7.05
1973	12.14
1974	14.60
1978	9.86
1979	16.02
1980	16.30
1981	16.66

APPENDIX B

Gold

Average gold price 1973:	$97
Average gold price 1974	$159
Average gold price 1979:	$306
Average gold price 1980:	$612

Oil

Crude Oil Prices (inflation adjusted)

1972:	$13.89
1973:	$15.01
1974:	$23.87
1975:	$24.42
1978:	$23.65
1979:	$29.83
1980:	$44.89
1981:	$59.88

Dow

Dow IA (monthly average in January)

1972	902
1973	999
1974	855
1975	703
1979	839
1980	875
1981	947
1982	871

Discussion Paper by Robert Pye, Greystones, Co Wicklow.

Preparing for Turbulence on the World Markets

It is impossible to predict how a national economy will develop over a period of years without also making a number of assumptions about how the global economy will develop over the same period. This is particularly true of Ireland, an extremely open economy, not just in terms of trade but in terms of its dependence on FDI and the global factors which determine international fixed capital investment.

This paper looks at the international situation and attempts to answer a central question: What particular action should the Irish authorities take to mitigate the effects of a major global economic shock sometime in the next few years?

To answer this question satisfactorily we must look, firstly, at the reasons for believing that a major shock is on the way and, secondly, if it is coming, the likely depth and duration of its aftermath.

Is a major economic shock on the way?
Many commentators believe that the combined effect of major imbalances in the markets and the evolving political situation in the Middle East make a major shock inevitable. The various factors cited are discussed below.

The US National Debt
The US national debt has been growing at a faster rate than at any time in history. It took off during the Reagan years, rising from 900 billion, when Reagan took office, to 2600 billion at the end of his second term. During this short period, it almost trebled. Four years later, at the end of the Bush (Sn) presidency, it had jumped to 4077 billion, an increase of 56% or thereabouts in just four years. After moderating somewhat during the Clinton administration, it took off again when another Republican President took office in 2001. Today it stands at 7260 billion (about 68% of GDP).

A total national debt of 68% of GDP is not necessarily excessive by international standards, but it is a cause of concern. As the world reserve currency, the stability of the currency must be measured by more rigorous standards than those applying to other countries. In that context, a national debt of 68% of GDP – and rising – is a matter of concern.

The US Budget Deficit
It is not just the absolute size of the national debt that matters, but its expected rate of increase. As we have seen, the three Republican Presidents since 1980 have all taken a very profligate approach to budgetary matters. The current administration has made it clear that this policy will continue if, in their estimation, the economy appears to warrant it. For example, in the 3-year period 1999-2001, the budget had an average surplus of 163 billion, while in the period 2002-2004, it had an average deficit of 351 billion. This swing is also without precedent and far in excess of what the markets had expected.

The apparent weak dollar policy
The current administration appears to be boosting production by allowing the dollar to weaken, making exports more attractive. This runs counter to the stated policy of most previous administrations in recent decades, who sought to maintain a strong dollar and make the US markets attractive to investors. The US dollar strengthened in the nineties as capital flight from the currency crises (starting with Brazil in 1992, then Mexico, Japan, South East Asia, Russia, Argentina, Europe, Turkey and Brazil, again) created demand for the US dollar.

A continuation of the weak dollar policy will make it harder to entice other countries to continue buying Treasury bonds to prop up the budget deficit. At present foreign players make up around 40% of the deficit, mainly China, Taiwan, South Korea and the UK. They have also been funding a sizeable proportion of FNMA borrowing. They see benefit in doing this at the moment since it holds down their currencies and helps exports.

There is also a wider and more long-term concern. Ever since the Bretton Woods Agreement in 1944, the US dollar has been the world reserve currency Globalisation would have been impossible without a high level of international confidence in the dollar and the fundamentals underpinning it. If the US authorities are no longer seen to have a strategic interest in this role, then the resulting increase in risk will add further upward pressure on global interest rates, a pressure that would not abate for many years.

Under Bretton Woods, all major currencies were fixed against the dollar, which in turn was supported by gold. The US held about three quarters of the world stock of gold at that time. Up to 1971 it was possible for anyone to enter a US bank and exchange dollars for gold. In effect, gold was the primary currency. Inflationary pressures forced the US off the gold standard in 1971. Since then the world has relied on fiat money, backed only by the promises of central bankers to protect the value of their currencies. In the view of many, the Federal Reserve is no longer fulfilling this role and the current administration seems to be prepared to print fiat money as required.

Personal and corporate indebtedness

Both personal and corporate indebtedness are at an all-time high. Home owners borrowed on the rising value of their properties in an attempt to exploit the very low rates of interest. Corporations also tried to take advantage of the low rates of interest to borrow for investment and, in many cases, to speculate. Increased interest rates will hit both, leaving little room for further consumption or investment to offset an economic shock.

Trade deficit

The trade deficit is also running at a very high level. Americans are importing far more than they are exporting, even though the dollar has fallen significantly against other currencies over the past year or two (The deficit of course is also helping to drive down the dollar). The increased borrowing by home owners is probably a major factor in this imbalance. While this is likely to correct itself as interest rates rise, there is still evidence that cheaper imports will continue to fuel a significant deficit, especially if the yuan remains fixed against the dollar. A continuing high deficit will weaken the dollar further and add weight to the argument that the US authorities no longer wish to maintain its role as the main reserve currency.

Significant expansion in money supply

The US money supply has grown significantly in the past few years – see Table A. The authorities appeared to allow this to happen to dampen the risk of deflation. Whatever the arguments in favour of this policy, it has had the effect of greatly increasing the risk of general price inflation. Two other markets have already inflated significantly – the stock market and the property market. There is no scope therefore for the increase in M3 being absorbed by either of these markets. This means it will very likely flow into general prices over the next year or two, unless interest rates move upward. Even then, there is a limit to how far they can go without hurting the economy.

Table A
M3 ($bn)
Seasonally adjusted

May 2004	9212
Nov 2003	8842
May 2003	8725
Nov 2002	8479
May 2002	8169
Nov 2001	7956
May 2001	7554
Nov 2000	7034
May 2000	6770
Nov 1999	6457
May 1999	6193
Nov 1998	6003
May 1998	5679
Nov 1997	5411
May 1997	5139
Nov 1996	4939
May 1996	4783

The expansion of the money supply has been extraordinary. During a period when GDP grew by 50%, M3 grew by 93% (GDP was 7,694 in 1996 and is estimated to achieve 11,525 in 2004) . No statistic in this paper is more revealing.

Social Security and Medicare

For much of the Clinton presidency efforts were made to come up with a better system for containing the ever-increasing cost of Medicare, but without success. Meanwhile costs have continued to climb. The US social security system, which operates on a pay-as-you-go basis, is also very expensive. The Baby Boomers are retiring and the combined cost of these two schemes is expected to rise rapidly in the coming years. Since many depend on both schemes to foot a significant part of the cost of their retirement, there will be a general expectation that the Federal Government will continue to fund them. However, the current administration is trying to set up a separately funded scheme to cover some or all of the cost of social security. Many commentators, including Paul Krugman (a), believe that this is financially unsound and will only lead to further uncertainty among investors.

A hike in interest rates

The above scenario makes a hike in interest rates inevitable. This will have several very obvious effects: a fall in the stock market, a slowdown in the economy, falling tax revenue, reduced investment, and higher debt service costs for consumers who borrowed on the strength of their greater stock wealth (prior to 2001) and rising home property values. There is also a possibility that interest rates will not be able to rise high enough to offset the rise in inflation, leading to negative rates of return. This will hurt pensioners and the Baby Boomers coming up to retirement who are relying on interest income to support their lifestyles.

Reaction by investors

The threat of rising interest rates, inflationary pressures, a weakening of the dollar, a fall in the stock market, and an unsustainable budget deficit could cause investors to panic. This is particularly true of small investors who are looking for a steady income stream in retirement. Many could be expected to move their investments abroad. The large investment institutions may get the same idea. If this happens, the authorities may have to introduce exchange controls. This will be a very visible sign to the international community that something is seriously amiss with the US economy.

Investors will also be very concerned by any indication from the Government that their accrued Social Security and Medicare entitlements, which they will need in retirement, may not be met in full. Given life expectancy at age 60 and the standard of living that people have grown to expect, this could be a very unsettling discovery and lead to further disenchantment with the financial system, loss of confidence in the administration and general unrest.

Market sentiment
Recent experience has shown how vulnerable the markets are to adverse news of any kind. Many were hurt by the Dot Com bubble and are anxious not to suffer another hit. As Stiglitz observed, "For all the talk of the New Economy ending the business cycle, the changes of the Roaring Nineties actually may have increased our economic vulnerability, by making the economy more sensitive, more responsive to shocks." (b)

The recession of 2002 was, according to *The Economist*, "one of the shallowest on record", which would lead one to believe that the lessons have not been learned. The same lack of realism which fed the Dot Com bubble is still around. This would suggest that the bad news, when it comes, will lead to considerable volatility in the markets. This could cause problems for the banking sector, who are already greatly exposed on foot of the remortgage boom fuelled by the property bubble. If that bubble were to burst at the same time, and there is reason to believe it would, it could lead to a number of bank failures and a marked contraction in lending.

The rush to commodities
There is a vast amount of investment money in the US markets which, when disturbed by a stock market contraction, will seek value somewhere else. As mentioned above, some investors will try to move their investments abroad, but the scope for this is likely to be restricted by currency controls. Since the money will have to go somewhere, many analysts believe there will be a rush to commodities. There are several reasons for this:

- The commodities market has been in a bear phase for about two decades. All the interest has been in the stock market. Since bull cycles in commodities have occurred at intervals in the past, another one can reasonably be expected.

- There has been a significant increase in demand for commodities from the growing economies of China and India. This has not yet fed through very strongly into prices but is expected to do so.

- Investment in commodity production has not kept pace with potential demand. This will lead to shortages in some sectors and drive up prices.

- The world demand for oil will reinforce the view that other commodities may be running out or, at least, proving more expensive to extract. Also, global climate changes may affect perishable commodities.

It is worth quoting Jim Rogers on this (Rogers was the co-founder with George Soros of the Quantum Fund). In a recent interview in *The Guardian* he is quoted as saying:

> "The American dollar is a flawed currency and will collapse in value before the end of the decade, taking with it the prosperity of the American nation. Investors should be buying commodities – platinum, lead, wheat, sugar, oil, the sort of assets that haven't been fashionable for a quarter of a century or more." He went on to say, "The US owes the world $8 trillion. We are the world's largest debtor nation by a factor of many times and our foreign debts are increasing by $1 trillion every 21 months. That's terrifying." (c)

Rogers is not alone in taking such a pessimistic view. Warren Buffett has Berkshire Hathaway sitting on a cash pile of $36 billion because he is unable to find value in the market, $12 billion of which is in foreign currencies. (d)

George Soros is also intensely critical of the Bush administration, primarily because of what he perceives as its gravely mistaken economic strategy and its neglect of the international financial system. As evidence of this he is committing some $15 million in 2004 to back the Democratic candidate (e). He has also railed against the dangers posed for the world financial system by the Neo-conservative ideology in his book, *The Bubble of American Supremacy* (2003).

When leading experts such as Rogers, Buffett, and Soros – who, it should be noted, are all active players in the market, not analysts sitting on the sidelines – are concerned that a major economic shock is on the way, we ought to be listening.

What happened to the 30 year bond?

In 2001 the Treasury announced that it would no longer be issuing a 30-year bond and has since redeemed all outstanding 30 year bonds. This took the markets by surprise. It might be taken as a sign that the authorities recognised that the long-run rate of inflation would prove greater than projected and that the cost of compensating buyers for this risk was simply too great. In other words, confidence in the performance of the economy in the longer term had diminished.

Bond yields generally are giving a similar picture. The long term historical average for the yield curve is 1.35 percentage points (i.e. long maturity bonds attract 1.35% more interest than short maturity bonds). Long term interest rates are driven by expectations of future inflation and expectations of future growth. The yield curve at the moment is very steep (4.1%), so either investors expect significant future growth or significant future inflation (The difference is even more pronounced in historical terms if the higher rate (5.24) is taken as a multiple of the lower (1.14)). Given the fundamentals at the moment, it is hardly credible that expectations of future growth are significant, therefore a sizeable chunk of the investment community must believe that inflation is set to rise fairly sharply.

The fragility of the financial system

The fragility of the world financial system has long been noted. A structure designed in the Sixties and Seventies is now expected to handle colossal movements in capital, in a vast array of instruments and derivatives. Hedge funds, which hardly existed in the Sixties, now exert an influence out of all proportion to their productive usefulness. A handful of players can bring down a currency or distort a market in ways unimagined in the Sixties. There is a growing disparity in almost all markets between the nominal value of an asset and its real underlying value. The system itself promotes this by providing no incentive to the large financial institutions and brokerages, who make enormous profits from commission and transaction costs, to narrow the disparity. Extensive deregulation in the US has not helped (Enron, WorldCom, Anderson, etc).

The real Government debt, according to its own economists, was $44 trillion in 2002. This includes the national debt, social security and medicare liabilities. This is far in excess of the national debt proper, which we have already discussed. A White House spokesman confirmed the $44 trillion estimate and said, "There is no question that Social Security and Medicare are going to present [future] generations with a crushing debt burden unless policymakers work seriously to reform these programmes." (f)

It is sometimes argued that debt is not a net liability in the true sense since each debtor is often a creditor. This is valid to an extent in a small system, but as the system expands and the numbers of players increases, the associated risk grows exponentially. Take a circle of ten people, each owing a million dollars to the person on their right. The total nominal debt (which will show in the statistics) is 10 million, but the net indebtedness of the group as a whole is zero. However, if one person defaults all ten suffer. If we increase the circle to 100, and one person defaults, then 100 suffer. In other words, the larger the circle the greater damage done if just one player defaults.

The collapse in 1998 of Long Term Capital Management, a major hedge fund, was a vivid demonstration of this risk. If the Federal Reserve had not stepped in and guaranteed its liabilities, a long string of major financial institutions would have collapsed along with it. What is more, the time available for successful intervention was extremely tight (about a day). The faster the financial markets operate, the more complex and less transparent they become, the greater the risk that the next LCTM-type collapse will spread through the system before corrective action can be taken.

Increased military spending
On top of the many adverse factors described above is a new and especially worrisome development – the growth in military spending.

As stated in an earlier paper (g), the war in Iraq is out of control. If the US pull out, the region will collapse into civil war, with the risk of destabilising neighbouring countries, including Saudi Arabia. This would almost certainly jeopardise oil supplies and send western economies into turmoil. So the American military are stuck in Iraq for 10 or 15 years. This will be eat up the peace dividend that came at the end of the Cold War and saved the US taxpayer around 2% of GDP per annum (This was a major factor in promoting economic growth during the Nineties). The American public can now expect to spend an additional 2% or more of GDP every year for the foreseeable future to fund the Iraq war as well as the ongoing campaign in Afghanistan. This does not take account of the crisis that could emerge if Saudi becomes unstable in the wake of increasing terrorist activity and the US is obliged to maintain an active military presence in the Arabian peninsula as well.

As Huntington (h) observed the modern Islamist movement is taking advantage of the large increase in the population of Moslem countries over the past two decades. There is now a substantial cadre of young, unemployed men in these countries, filled with militant religious ideals, who will be more than willing to participate in a general campaign against US intervention in the Middle East and its support for Israel.

It is almost impossible, therefore, to see the US budget deficit falling below 500 billion anytime over the next ten years. It may even hit a trillion. There is every reason to believe that this will be unsustainable by conventional means – raising taxes and/or borrowing – and that the authorities will allow the money supply to expand even further. It is possible to see why Rogers says the dollar will "collapse in value before the end of the decade".

In this context, it is worth citing a revealing excerpt from the preface (2003) to the English translation of 'After the Empire' by Emmanuel Todd, a researcher at the French National Institute for Demographics Studies in Paris (Todd gained renown for predicting the collapse of the Soviet empire in his book, 'The Final Fall: An Essay on the Decomposition of the Soviet Sphere' (1976):

> The domestic and foreign deficits of the United States are skyrocketing. Indeed leaders around the world are wondering more and more if the central regulating power of the world economy is not heading toward a sheer abandonment of the basic rules of capitalist reasoning. Its adventurism is not just military, it is also financial. One can predict that in the years or months to come financial institutions in Europe and Asia with heavy investments in the United States will lose a lot of money – the fall of the stock market being only the first stage in the disappearance of foreign holdings in the United States. The dollar is dropping, but no economic model allows one to predict how low it will go since its very status as reserve currency is becoming uncertain. (i)

A possible scenario five years from now

In light of the above analysis, which is based mainly on undisputed data, it is worth asking where the world economy will be in five years time. It is difficult to envisage a sanguine scenario. There are too many factors militating against a happy outcome. The world economy will likely slip into recession within two years and several economies, including the US, may slide further into a depression. (Here we define these terms in the usual way: A recession as at least two consecutive quarters of decline in gross domestic product. If it lasts more than a few quarters and is associated with rising unemployment, a general decline in prices and a loss of purchasing power, it becomes a depression.)

The stock market will suffer, interest rates will rise, and investment will fall. At present, most large economies are either sluggish or moribund. China, the only one that has been doing well up to now, is slowing down, so there will be no large economy in a sufficiently fit state to help pull the others out of recession. In addition, the growing loss of confidence in the dollar will hamper international trade and investment. Other large economies will also suffer as the US exports its own inflation. Both the loss of confidence in the dollar and the gradual increase in global inflation will put other currencies under pressure, promoting speculation and increasing the risk of capital flight from more vulnerable economies.

As noted earlier, these developments are very likely to generate a rush to commodities. Oil will soar in price, not just in response to speculation and demand, but as a result of the growing uncertainty in the Middle East and the possible interruption in supplies.

The US may put considerable pressure on other countries to help it fund its military campaign in the Middle East or to supply troops. This will lead to discord and hamper efforts to develop a coherent strategy to address the growing international crisis.

It should be noted that none of this analysis takes into account the effects of possible terrorist attacks on western assets or centres of population. Neither does it take account of a major destablisation of the Middle East which could arise from a military incursion by Israel into Islamic territory (eg bombing of Iranian nuclear facilities).

How will these developments affect Ireland?
It is hardly necessary to spell out in detail how these developments will affect the Irish economy. However, there are a few factors which ought to be highlighted since they could impact significantly on budgetary and industrial policy.

<u>The euro</u>
The euro should benefit from the weakening of the dollar. Increasingly reserve funds are moving out of dollars and into the euro. This trend will accelerate. However, it will do harm to both Irish and EU exports to the American market. The turbulence in the markets will also discourage the UK from adopting the euro. It could also be expected to dissuade the ECB from admitting any of the ten new member states.

<u>FDI</u>
A weakened dollar could also be expected to reduce the volume of FDI from the US. It is unclear what effect the introduction of exchange controls might have. There is a strong possibility however that existing US firms in Ireland will be content to stay put and perhaps even to expand their operations here, circumstances permitting. Foreign earnings will be more attractive in the new environment. The IDA might even be able to persuade US firms with manufacturing bases in other countries (such as Indonesia and Malaysia) to relocate some or all of their operations to Ireland on the grounds that it offers a more stable political environment.

<u>National Pensions Reserve Fund</u>
As a state, Ireland is uniquely poised to take advantage of the coming rush to commodities via the NPRF. At end 2003, the fund had assets equivalent to 8.7% of GNP, with shareholdings in 1286 companies across 23 markets. The NPRF Commission should be asked to review its strategy in this area and consider the scope for switching a large portion of its assets from shares to commodities (It is unclear what proportion is already in commodities). This would yield a double bonus – avoiding the big losses that would be incurred by keeping a major portion of its assets in shares and reaping the gains from a bull market in commodities. The windfall could then be used to mitigate the effects of the global downturn (This would necessitate legislative change, preferably with all-party agreement).

<u>National Debt</u>
It would make sense to denominate as much of our national debt as possible in US dollars. Any small increase in debt service costs due to rising US interest rates relative to euro-zone rates would be more than offset by the fall in the dollar. An opportunity like this should not be missed.

Attracting skilled migrants

The coming US draft will be a matter of great concern to most American citizens and their families. Many skilled workers of Irish extraction may wish to relocate from the US to another country. This could represent a significant amount of human capital for a small economy like Ireland. The policies pursued in various sectors should be geared towards attracting these migrants and their assets.

Pay inflation

It is generally accepted that, once pay-driven inflation takes hold, it is very difficult to bring under control. The existing system of pay determination, based largely on partnership, has evolved in recent years in a climate where the general economic outlook has been exceptionally good. The advent of benchmarking in the public service has reinforced the expectation that everyone should enjoy the proceeds of growth, in full and with minimum delay. In addition, the public service unions have a disproportionate influence on the entire wage determination process, both public and private. This means that the inability-to-pay concept has been all but forgotten. As demonstrated by recent events, workers will expect immediate compensation for any general increase in inflation, both current and expected.

The existing system of pay determination will need to be re-examined and suitable mechanisms introduced to slow the pace at which inflation feeds into pay. This is not an easy problem to solve, but is potentially one of great importance to the economy as whole.

18 July 2004

Notes

(a) *The Great Unravelling* (2004), Paul Krugman
(b) *The Roaring Nineties* (2003), Joseph Stiglitz, p.200.
(c) *The Guardian*, 3 July 2004
(d) *The Economist*, 13 March 2004
(e) *The Guardian*, 12 November 2003
(f) *Financial Times*, 30 May 2003 [cited in (j)]
(g) *Preparing for the Coming Economic Shock and its Aftermath*, R Pye, 28 June 2004
(h) *The Clash of Civilisations* (1996), Samuel Huntington
(i) *After the Empire* (2002/2003), Emmanuel Todd
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Discussion Paper for limited circulation,
by Robert Pye, Greystones, Co Wicklow.

The Imminent Tsunami: Why the World Economy is on the Threshold a Major Recession

Background

In two earlier papers [(1) (2)] I set out reasons why I believe the world is heading toward a major economic shock. The factors behind this centre mainly on the worsening condition of the US economy and the obvious reluctance by the current administration to take the necessary evasive action. The US current and trade deficits are unsustainable, the federal debt is growing at an alarming rate, the implicit liabilities (social security and medicare) are grossly underfunded, and the war in the Middle East – and its associated costs – is escalating out of control.

The response to the two earlier papers has been muted. Some readers have said that the depth of the US economy is such that it can quite easily rally in the face of such pressures and that a small hike in income tax would quickly bring matters under control. This attitude seems to be fairly widespread but in my view, and the view of many economists, this attitude is gravely mistaken. I will attempt to set out below the reasons for this assessment and why the Irish authorities have time to make some significant changes in policy to mitigate the impact of this tsunami before it strikes.

What some commentators are saying

In my earlier papers I cited the words and actions of Jim Rogers, George Soros, Paul Krugman and Warren Buffett, all of whom expressed real concern at the direction the US economy is taking. Rogers sees the dollar taking a major dive in the next 4-5 years, Soros is highly critical of the failure of the current administration to support the world financial system, Krugman is of the view (which is stated very strongly in his New York Times column) that the industrial elite are deliberately steering national policy toward their own commercial ends, while Buffett has clearly stated that the stock market is greatly inflated and is sitting on a cash pile of $36 billion, one third of which is *not* in US dollars.

<u>Ken Rogoff</u>

The Irish press is finally giving vent to this view. In *The Irish Times*, 24 September 2004, economist Jim O'Leary [(3)] said that the US dollar is heading for a major correction. Referring to the massive US budget deficit, which is funded mainly by east Asian central banks (China and Japan), he says: "If you have formed the impression that this is not a sustainable situation, you are not alone. Some of the world's foremost economists are convinced that a major and potentially very painful correction must occur." He refers approvingly to a paper by Ken Rogoff [(4)], 'The Unsustainable US Current Account Position Revisited', July 2004 (http://emlab. berkeley.edu/users/obstfeld/ca_v2.pdf). Rogoff, who is chief economist at the IMF and a professor at Harvard, is not given to making radical predictions. Along with his co-author, Maurice Obstfeld, he argues that the dollar must depreciate by 20% to 40% to get the American economy back into balance, and says:

> "The real question is not whether there needs to be a big exchange rate adjustment when the US current account closes up. For most plausible shocks leading to global rebalancing, this is a given. The real question is how drastic the real effects are likely to be. This is an open question...[but]...The rest of the world is not going to have an easy time adjusting to a massive dollar depreciation. It is also the case that world derivative markets have exponentially expanded in comparison with even ten years ago. With little reliable data on counterparty risk, there has to be concern that a massive dollar movement could lead to significant financial problems that are going to be difficult to see before they unfold (e.g. along the lines of the collapse of Long Term Capital Management in 1998)."

They also argue that the unfolding crisis with the dollar is more akin to that of the 1970s than the 1980s. The decline at the end of the 1980s, when the Reagan era current account deficit closed up, was "relatively benign". However, the 1970s saw many of the conditions that exist today – large budget deficits, soft monetary policy, open-ended security costs (Vietnam) and pressure on oil. For this reason they conclude that "the outcome could be much more severe than it seemed during the 1980s dollar collapse." This is far removed from the benign scenario envisaged by Greenspan.

Ferguson

Another commentator who has taken a pessimistic view is Niall Ferguson, the economic historian. In his book, 'Colossus: The Price of America's Empire' (2004), he states [(5)]:

> "So vast is America's looming fiscal crisis that it is tempting to talk about the fiscal equivalent of the perfect storm – or the perfect earthquake, if you prefer...the dynamics of fiscal overstretch really do have much in common with the dynamics of natural disasters. We can know only that, like a really big earthquake, a big fiscal crisis will happen. What we cannot know is when it will strike, or the size of the shock." [p.276]
>
> "Here, then, is one possible scenario. Bondholders will start to sell off as soon as a critical mass of them recognise that the government's implicit [Social Security and Medicare] and explicit liabilities are too much for it to handle with conventional fiscal policy and conclude that the only way the government will be able to pay its bills is by printing money, leading to higher inflation." [p.277]
>
> "...the magnitude of the problem is such that most Americans, including those who consider themselves well informed about the nation's finances, find it quite simply incredible. Indeed, the main reason why America's fiscal crisis remains latent is precisely that people refuse to believe in its existence. And they are able to do this because the United States has imperceptibly come to rely on East Asian capital to stabilize its unbalanced budgets." [p.262]

The threat of Islamic fundamentalism

The really interesting aspect of the conclusions reached by both Rogoff and Ferguson is that they both attach relatively little significance to the growing crisis in the Middle East. They both expect the ongoing wars in Iraq and Afghanistan to impose a fairly constant strain on the US economy. However, neither presents any argument to justify this assumption.

One of the leading analysts on Islamic fundamentalism, Jason Burke, makes the following telling observation in his book, 'Al-Qaeda' (2003) [(6)]:

> “The ousting of Saddam Hussein is widely seen throughout the Islamic world as a strategic move to secure oil – Allah’s gift to the Muslims – and protect Israel. This perception that a belligerent West is set on the humiliation, division and eventual conquest of the Islamic world is as much a root cause of Muslim violence as relative poverty or government repression. The militants believe they are fighting a last-ditch battle for the survival of their society, culture, religion and way of life. They believe that the Crusades never ended and that they are now fighting in a desperate war of self-defence. They understand, as we in the West also believe, that self-defence can justify using all sorts of tactics that might be frowned on in other circumstances. They believe, as we think too, that they are fighting to preserve their lives, societies and culture.” [p.288]

In other words, the US is embroiled in a war in the Middle East which is set to escalate further, at considerable additional cost to the US economy. To date the Americans have lost 1060 men under arms in Iraq. This is a very large number for a zone which is meant to be under tight military control. The number of Iraqi civilian deaths is also extremely high. Reliable estimates put it somewhere between 15,000 and 30,000. Despite recent comments by US Defence Secretary Rumsfeld, there is no possibility that the US will withdraw from the region. If it did, the conflict would quickly turn into civil war and spill into neighbouring regions. The damage this would do to American (and global) oil interests would be immeasurable.

So, if the war is getting worse and America is committed to a conflict lasting 10-15 years, then one must assume that the costs of containment will continue to increase. So far the US has been fighting with minimal manpower and conventional technology. If Bush gets a second term (which he is almost certain to secure) the Neoconservatives will do what they have always said they would do and expand the theatre of operations, primarily to subjugate Iran.

Israel has also said that it would not tolerate the continuation of the Iranian nuclear weapons programme. Analysts are predicting a major military strike by Israel or the US to destroy this programme and make it impossible for Iran to either develop a nuclear capability or retain the material needed to produce a number of dirty radioactive bombs which could be used against US or Israeli cities. It is important to note that the use of such bombs by terrorist groups would make it very difficult for the US to identify the country or regime that ultimately sponsored the attack. Therefore, the reasoning goes, they must do all they can to prevent such a programme from developing further.

It must also be remembered that the fall of Iran in 1979 was a major shock to the US. The Neoconservatives are determined not to let this happen again to their "interests" in the Middle East, especially Saudi Arabia.

Huntington [7] draws attention to the huge expansion in the Muslim population in the Middle East in the past 20 years or so. This means there is now a vast number of unemployed young men to swell the ranks of the fundamentalist insurgents. What future do they see for themselves in a land wracked by war? Add the uncompromising message of the fundamentalists and the steady flow of funds from regimes opposed to the US and you have an ever-worsening situation.

The increasing tension in the area and interruption to supplies will continue to push up the price of oil. The recurring spikes of the past few months can be expected to translate into a permanent increase in the baseline price of oil from around $35 a barrel at the start of the 2004 to $50 or more by end-2004 and a good deal more by end-2005.

Bond holders

International bond holders are playing a canny game. They are continuing to concentrate on short Treasuries to ensure that, when the crash comes, the US government cannot inflate itself out of debt at their expense by printing more money. The 30-year bond has gone since bond holders were demanding too high a yield to justify selling it. These are further signs that many players in the market believe a major correction is on the way.

The only pillar holding up the market is the continued willingness of the East Asian central banks to buy federal debt. They are trying to keep their currencies down vis-a-vis the dollar to support their exports. Naturally, both the US government and the East Asian economies have an interest in maintaining this mutually beneficial cycle. But a slide in the dollar, which depends on many factors beyond the control of the US government and the East Asian economies, would wipe billions off the foreign reserves held by the latter. This could hit the fragile banking system in China and precipitate a crisis.

What would the impact on the dollar be if the East Asian economies stopped buying US Government debt? *The Economist*, 13 December 2003, quoted the answer given to this question by Jim O'Neill, Chief Economist at Goldman Sachs – "Potentially catastrophic."

Expansion of derivative markets

In the quotation given above, Rogoff notes with concern "that world derivative markets have exponentially expanded in comparison with even ten years ago." He suggests that this could give rise to unpredictable adverse effects. Look, for example, at the growth in hedge funds in the past decade, from 1500 funds managing $200bn in 1993 to 6000 funds managing $850bn in 2003. These are sometimes viewed as massive international casinos, capable of causing serious instability in the markets. As *The Economist* recently stated, there is reason to be concerned about this, especially with more and more banks setting up hedge funds of their own in an attempt to increase earnings.

Those who are sceptical about the risk of a major international economic crisis sometimes cite the depth and integration of the world capital markets as the principal reason for believing that any serious imbalances can be managed in a controlled way. For example, Rogoff refers to a talk given by Greenspan at end-2003 in which he puts forward this view. However, since hedge funds are an ever-expanding feature of the markets which Greenspan and others expect to behave in a rational and mutually supportive (albeit self-serving) way in a crisis, it is very difficult to be sanguine about the scenario that is now emerging.

Denominating oil in dollars

After OPEC decided in the early 70s to price oil in dollars, the currency entered a kind of 'oil standard'. This helped to make the dollar the world reserve currency, increased demand for dollars, and attracted huge amounts of capital into the US economy. The US is therefore hotly opposed to any attempt by oil-producing countries to switch the denomination of this commodity into another currency. As soon as Iraq switched to the euro, it was invaded. Iran has been threatening to switch, as has Chavez in Venezuela. It has been speculated that the invasion of Iraq and the attempt to topple Chavez were driven, at least in part, by the desire to prevent the switch.

If it ceased to be the denominating currency for oil, the dollar would quickly depreciate and the vast amount of petro-dollars currently circulating outside the US would make their way back into the US economy and cause both serious inflationary problems and consternation in the banking system.

Implications for Ireland

The tsunami is coming and there is nothing the Irish authorities can do about it. The impact on the world financial system will cause investors to flee the stock market and put their money into the traditional safe havens, notably gold and other precious metals. A bull market in commodities can be expected. What is more, it will likely continue for many years as both the stock market and the bond market take a hammering.

Two golden opportunities

These developments give rise to two major opportunities which hardly arise even once in a generation:

(1) to transfer the greater part of the NPRF into commodities (precious metals, industrial metals, oil, etc)

(2) to convert the greater part of the national debt into dollars.

The risks behind these initiatives are very small, while the potential benefits are enormous, perhaps as much as €10 billion by 2015.

Banking system

The level of mortgage lending in recent years has been running at record levels. Borrowers will be exposed to a substantial hike in interest rates as the international crisis develops and property prices enter a downward spiral. Since the level of exposure by Irish banks in this market is very high, there is a real risk that the collapse in asset values could cause one of them to go under. The Central Bank actually hinted at this possibility in a recent report.

Inflation

The thirst for capital by the US government will push up interest rates to painful levels, but this will not be enough to contain the inflationary effects of oil price increases. The US government will also resort to printing money to finance its war in the Middle East and cover the ever-growing cost of social security and medicare. This can be expected to feed into the world economy and promote global inflation.

In light of this, the Irish authorities will need to have some way of containing pay expectations. The existing two-tier system of public service pay determination, involving both general round increases and benchmarking, may prove very unsuited to the containment of pay pressures in this changed environment. The power of the public service unions in the overall pay determination process may also prove a significant barrier to containment.

Growth and Exports

There is no doubt that, as Rogoff notes, a major depreciation in the dollar will be bad news for the EU. Growth can be expected to stagnate for several years and economies with overly generous social benefit systems, such as Italy, may run into serious difficulties.

Timing

The really big question is when this crisis in the world economy will occur, followed by its daunting list of adverse effects. It could commence with either the predicted dollar slide or with a major collapse in the stock market which takes the dollar down with it. Most commentators are reluctant to fix a time line for this but there is good reason to believe it will get rolling during the latter half of the next Bush presidency (c 2007) – the tax giveaway at that stage, in anticipation of the Presidential race in 2008, would be enough to cause panic amongst bondholders. A major terrorist strike on a Western target, especially an American city, could accelerate this.

It is worth noting that many investment firms in the US are advising their small clients to switch their dollars into euro in anticipation of the coming depreciation. If this trend gathers pace and larger players get involved, it alone could act as the trigger.

Conclusion

The reader is referred to the earlier paper of 18 July [2] for a more detailed examination of the Irish options. However one looks at the problem, the coming tsunami will necessitate a re-think in several major areas of public policy, including pay, financial regulation, debt management, pension funding, capital investment, budgetary policy and taxation.

28 September 2004

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Discussion paper for limited circulation

Countdown to a Global Economic Shock

by Robert Pye, Greystones, Co Wicklow

> "Nobody can say when the fall will come or whether it will turn into a crash, but when even Alan Greenspan, the chairman of the US Federal Reserve, says there is a 75 per cent chance of a dollar crisis in the next five years, be sure trouble lies ahead."
>
> - Will Hutton, The Observer, 14 November 2004

Introduction

The first three papers in this series stated that a major economic shock is coming, that it will be deep and painful, and that steps should be taken wherever possible in an Irish economic context to mitigate its effects. **(1) (2) (3)**

This paper, seven months after the first, states that the factors giving rise to the shock continue to worsen and that, in essence, the tsunami is getting closer. The purpose of this paper is to highlight the main indicators and show how their cumulative adverse effect is rapidly pushing the global economy toward a major crisis.

Fundamental cause

The fundamental cause of this crisis is the massive misallocation of capital both within and between the major economies. The US is living way beyond its means. Since it is the major world economy by far, accounting for about one third of global output, and custodian of the world reserve currency, the necessary correction, when it comes, will have a strong negative impact on the markets.

Most economic commentators accept that a correction is necessary and that it should take the form of a managed depreciation of the dollar. However, there is no indication that a managed or phased depreciation is possible. This worked when it was last tried – the famous Plaza accord of 1985, when the leading economies co-operated to produce a depreciation in the dollar that was acceptable to the markets. It can be argued, however, that even the Plaza accord was flawed and that it was one of the main factors behind the shock of 1987.

This time there is virtually no co-operation between the US administration and its main counterparts. For example, the highest profile American at Davos was a Hollywood actress. There is no public sign that the US administration is trying to negotiate a solution with China, or that it even recognises the need to do so.

The Geopolitical Climate
A seismic shift is taking place in the balance between the world powers. The Bush administration acknowledged this when, in 2002, it stated the following in its National Security Strategy:

> Our forces will be strong enough to dissuade potential adversaries from pursuing a military build-up in hopes of surpassing, or equalling, the power of the United States. **(4)**

While it might be reasonable to imagine that the US government would pursue such a strategy in a covert manner, its willingness to state its intent in such a public manner is the mark of an administration that does not see much point in negotiated solutions.

The current situation is like the realignment of tectonic plates, of which there are five: the US, China and the main Asian economies, Europe, Russia, and the Middle East. The key question for the first three is: Where will it source its oil in the decades ahead? The last two hold the answer.

In a shrewd piece of analysis in *The Sunday Times*, economic analyst and neoconservative sympathiser, Irwin Stelzer, sketched out the following scenario **(5)**:

- Governments have taken control of the world's oil and gas industry from traditional commercial enterprises.
- These governments have interests hostile to America's.
- China is forging closer economic ties with Iran, Venezuela and Canada to protect its future supply of oil.
- Russia is courting Germany, Japan and China with a view to securing its longer term strategic objectives in exchange for oil and gas.

Stelzer concludes: "Add the emerging relationship of China and Russia, and you have something for American planners to worry about."

One might add a further point not noted by Stelzer, namely that Japan will increasingly see its future with China, not the US.

At no time in its history has the US been so vulnerable to its enemies. It is increasingly apparent that Russia and China, acting in concert, have the power to inflict real economic damage on the US by restricting its access to oil. This is why the US entered Iraq and why it has no intention of leaving. It also why there is every reason to believe it will pre-empt any interruption to its supply of Saudi oil by intervening militarily in that country sometime in the next five years.

The escalation of tensions between the US and the Islamic world was underlined by the recent public declaration by both Bush and Rumsfeld that either the US or Israel may find it necessary to use military force against Iran to neutralise its growing nuclear capability. Since China is already courting Iran and is in a position to fill any gaps in Iran's nuclear programme, the US threat is directed at a wider audience.

In light of these developments, in conjunction with the stated aims of the neoconservatives, it is clear that the US policy of pre-emptive intervention will continue and that the scope for achieving high-level international co-operation to resolve the growing economic crisis is very restricted indeed. It is further complicated by the fact that China has succeeded in amassing a huge quantity of US dollars in its foreign reserves which, if converted into another currency, would deal a serious blow to the American economy, albeit at cost to itself.

The prevailing mindset

The prevailing mindset is incredibly rigid. Many commentators continue to assume that the Asian economies will continue to buy American dollars and prop up the alarming US budget deficit, purely to ensure that their own currencies continue to be competitive. This assessment takes no account of the geopolitical climate sketched out above or of the speed with which massive quantities of capital can move between markets, whether in response to an international incident or in hope of speculative gain. Neither does it take any account of the growing cost of American involvement in Iraq. The latest estimate of the cost to date is €300 billion, around double what had been expected. This is roughly €150 billion a year and rising. Given that military experts believe no progress can be made without at least doubling the number of military personnel in Iraq (from 150,000 to over 300,000) the cost is bound to grow significantly. (There is also talk of establishing permanent military bases in the region, which will push the cost even higher.)

The popular mindset in America, as projected by the media and accepted by the majority of its population, is that democratic stability can be achieved in Iraq, that Middle Eastern oil is secure, and that the cost of the war is containable. Not one of these assumptions stands up to critical scrutiny. The Sunni minority will never accept Shia control, the main sources of American oil are in deeply unstable zones, and the cost of military intervention is set to increase even further. When a critical mass of American investors wake up to these facts, the markets will be in crisis.

When the first paper in this series was written the price of oil was around $40 a barrel. It has since risen to €50 a barrel and is expected by many commentators to hit €60 by the end of 2005. Increased demand, interruptions in supply, and speculative movements in the markets are expected to push the price even higher, perhaps to €100 a barrel by end-2008.

Depth and elasticity of the markets

For several years capital has been too readily available to virtually anyone, at unsustainably low rates. This has led to a huge misallocation of capital, both within and between national economies – inflated currencies, bubbles in several markets, and huge trade imbalances. As stated earlier, this misallocation is the chief cause of the coming crash.

It has been argued that the depth and elasticity of the markets will be enough to absorb the waves created by the necessary correction, but there is a flaw in this reasoning. Markets are only elastic when prices can adjust with reasonable fluency to reflect real underlying values. It has been over eight years since this could seriously be asserted. The key price, the price of money, is far too low and as a result it is distorting all other prices. The bond market, the equity market and the property market are all significantly over-valued.

The depth of the markets can only be relied upon when the major players, especially the main financial institutions, are confident that the necessary capital can be found at short notice and at low cost to defend their positions. This implies minimum levels of transparency, liquidity and confidence. Financial derivatives now play such a big role in most markets that it is almost impossible to be confident that no indefensible exposures can arise.

As one well-known commentator has said, “Global *laissez-faire* may break down in an unmanageable crisis of the world’s stock markets and financial institutions. The enormous, practically unknowable virtual economy of financial derivatives enhances the risks of a systemic crash." **(6)**

It is this lack of confidence ("nervousness") on the part of the major players that could trigger a rush that would destabilise the markets.

It has also been argued that the US economy has been here before and came away unscathed. However, the context has changed in two very significant respects, as The Economist noted:

> "For almost two decades, economists have worried about America's current-account deficit and predicted a plunge in the dollar and a hard landing for the economy. The dollar did indeed fall sharply in the late 1980s, but with few ill effects on the economy. So why worry more now? One good reason is that the current-account deficit, currently running at close to 6% of GDP, is almost twice as big as at its peak in the late 1980s, and on current policies it will keep widening. Second, in the 1980s America was still a net foreign creditor. Today it has net foreign liabilities and these are expected to reach $3.3 trillion, or 28% of GDP, by the end of 2004." **(7)**

Greenspan and other factors

The head of the Federal Reserve, Alan Greenspan, is scheduled to retire in 2006. For reasons that are probably not justified, the markets appear to have confidence in his stewardship. Since all the principal appointments by the current administration in recent months have been highly conservative, there is a growing concern that Greenspan's replacement will be nothing more than a mouthpiece for the White House. This alone could trigger a selling spree.

Greenspan also tried to 'talk down' the dollar recently, a clear sign that the Federal Reserve is very concerned about the state of the US economy. It is extraordinary that the principal spokesman for the world's reserve currency should find it necessary to make a pronouncement of this kind. The re-appointment of John Snow as Treasury Secretary is a further indication that the current administration has no real intention of defending the currency.

There is also concern that Congress may decide to place all blame for the mounting economic woes on the self-serving stance adopted by other economies, notably China, Japan and the EU, and push through a series of protectionist policies in response. Since labour costs in China are ridiculously low in comparison with the US, and since they are likely to remain so for many years to come, considerable damage could be incurred by the US economy if and when China moves into these areas of industry where it does not currently have a presence, notably the manufacturing of cars, trucks, computers, and airplanes. Europe's Airbus has already overtaken Boeing, so there is no reason why, with current rates of technological transfer, China could not compete successfully in these markets within a few years.

The reported growth in output and employment in the US may be exaggerated. If Chrysler or General motors builds and sells an extra car, that's a real increase in output. If Microsoft run off an extra 1000 copies of Word or Access, that too counts as a similar increase in output, even though virtually nothing has been produced. In other words, 'old style' economic growth reflected a more substantial enrichment of infrastructure and a more widespread distribution of benefits than that produced by the 'new economy'. Each extra job created in 1980, say, when the US manufacturing base was about 40% greater than it is today, was more economically productive than each extra job created in 2004, many of which are temporary, part-time, or service-based.

Stephen Roche of Morgan Stanley, by far the most vociferous champion of the view that a major global crisis is imminent, has argued that a currency correction will not, of itself, relieve the pressure. The contraction in the US manufacturing base over the past 20 years (since the Plaza accord) means that a major fall in the currency will not deliver the export-led windfall that might formerly have been expected. In his view, unless American consumers cut back significantly on imports and save far more than they currently do, the problem will only get worse.

The pensions funding shortfall
The increasing recognition in both the US and the EU that many pension funds will be unable to meet their liabilities, particularly as large numbers of them are switching from 'defined benefits' to 'defined contributions', is making the baby boomers very uncomfortable. This is not helped by the threat in the US to privatise social insurance. This will make matters worse by diverting tax revenue to pay existing pensions which would otherwise be funded from social welfare contributions. The fear is that the administration will use this device to reduce the level of benefits. This could induce persons approaching retirement to switch their existing assets out of US dollars to compensate.

Another problem with the baby boomers is that they have probably been the single greatest factor behind the stock market boom of recent years. It is fairly well accepted that the principal investors are those in the 45-60 age bracket with an income surplus to invest. This cohort is due to contract significantly in the next ten years, with a corresponding contractionary impact on the markets.

It should be noted that the foregoing concerns about pension costs take no account of the significant additional expense that increased longevity is bound to entail.

<u>The debt bubble</u>
The average American has been borrowing heavily to support a high level of consumption over the past several years. This has led to yet another bubble, perhaps the most volatile of all – a debt bubble. The level of personal saving is virtually zero. Credit card debt has doubled since 1990. If interest rates continue to rise, as they will, consumers will be hurt and domestic demand will contract, with implications for growth, tax revenue and social security.

<u>Inflation as a solution</u>
With a debt portfolio of almost €8 trillion to service, rising interest rates, a massive budget deficit, increasing costs in Iraq, and a large cohort of baby boomers on the brink of retirement, there is real concern that the current administration is planning to inflate its way out of debt. In his book, *Colossus*, Niall Ferguson stated that this expedient will not work as well as it did in the 1970s, for the following reasons:

> "First, much of the government's tradeable debt is of short maturity; indeed, fully a third of it has a maturity of one year or less. That makes it much harder to inflate away because any increase in inflationary expectations forces the government to pay higher interest rates when it seeks to renew these short-dated bonds. Secondly, Social Security benefits are protected against inflation through an annual inflation adjustment. Medicare benefits are also effectively inflation-proof because the government unquestioningly pays whatever bills it receives. Thirdly, government workers are not likely to sit idly and watch prices outpace their wages. For all these reasons, a rerun of the 1970s would not in fact solve the federal government's fiscal problems." **(8)**

However, he goes on to note that the government could default, not on its tradeable liabilities but on its non-tradeable, implicit liabilities such as Social Insurance. It could also remove the three obstacles listed by Ferguson by (i) issuing fewer short maturity bonds, (ii) removing inflation-proofing from social security, and (iii) introducing legislation to freeze public service pay and prevent industrial action.

The growing Islamist threat

The threat from Islamic insurgents and terrorists is growing stronger. The longer Iraq is in turmoil, the more disaffected young men will be drawn to the ranks of the insurgents. The demographic bulge in Islamic countries will ensure a strong supply of males in the 16-30 age bracket for many years to come. The same leaders and political activists who fought furiously for nine years to throw the Russians out of Afghanistan will be just as committed to throwing the US out of Iraq.

An ex-CIA operative reported some months ago that Bin-Laden sought approval from a senior Muslim cleric to inflict major casualties on the US mainland. The cleric is understood to have approved four million fatalities and eight million displaced persons. This would suggest that the terrorists possess or are confident of obtaining portable nuclear devices.

The Islamic world also possesses a major weapon which is hardly ever adverted to in the media, namely, the Grand Ayatollahs. Shia Islam has seven. These possess extraordinary influence over the general population. Their word is law. It is not inconceivable that one or more of these senior clerics will at some point issue an order to expel the infidel. If that happens, the whole population will rise up.

Kondratieff cycles

While predictions based on theoretical models are often flawed, usually because they ignore or fail to take proper account of changing circumstances, there is strong evidence to suggest that capital markets go through a cycle lasting five or six decades in which debt imbalances accumulate to the point where a major correction is needed and a new cycle begins. The best known of these is the Kondratieff cycle. While none of the analysis in this series of papers depends on the theory of Kondratieff cycles, it is nonetheless worth noting that the theory does predict a major collapse in the markets over the next 2-3 years.

Some statistics

The table in Appendix A gives some telling statistics about the US economy. Perhaps more important than the statistics are the underlying trends. The picture they give is of an economy that is way out of balance. America's enemies on the world stage can be expected to exploit this situation to their advantage and to engineer circumstances that will strain its economy even more.

Conclusion

There has been no improvement in the global economic situation since the first paper (June 2004). If anything, it has only got worse. The trend depicted in Appendix A is very depressing. The US authorities appear to have no strategy for dealing with the problems confronting them. What is worse, they are not prepared to acknowledge their potential severity. Commentators outside the US appear to be far more concerned about the emerging situation than those within the US.

The resulting shock, or perhaps series of shocks, will almost certainly result in a global depression. The Japanese slowdown that began in 1990 was triggered by high levels of corporate debt, croneyism in the banking and financial sectors, and a collapsing property market. It persisted for 15 years because Japanese consumers refused to consume, despite numerous attempts by the authorities to induce them to part with their savings. This is a foretaste of the way global consumers are likely to behave after the tsunami strikes. People will look for a secure means of saving to protect their long term interests. The price of commodities and precious metals will soar.

The implications for public policy in Ireland, as well as some suggested ways of mitigating the impact of the coming shock, are set out in earlier papers.

2 February 2005

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APPENDIX A

Indicator		Comment	
Budget deficit	4.3% of GDP ($412bn) in 2004	**increasing**	3.7% in 2003
Trade deficit	set to exceed $600bn in 2004	**increasing**	$496bn in 2003
Inflation	3.26% (Dec 2004)	**increasing**	1.88% in Dec 2003
Exchange rate	1.3569 (against euro on 1/1/05)	**falling**	1.2582 on 1/1/04
National debt	$7.633 trillion	**increasing**	$7.009 trillion 31/1/04
Gold	$421 (on 01/02/05)	**increasing**	$400 on 01/02/04
Oil	$48.20 on 31/01/05	**increasing**	$33.05 on 31/01/04 [West Texas Intermediate]
Growth	3.8% in 2005	**slowing**	4.4% in 2004
Personal saving rate	0.2% approx. [Nov 2004]	**falling**	4.0% at start 1999 2.0% approx mid-2003
Consumer credit, mortgage and other debt	$9.3 trillion (April 2003)	**increasing**	$7 trillion (January 2000)
Refinancing of family property	$125bn in 2004	**unsustainable**	$86bn in 2001
Military fatalities in Iraq	1400+	**increasing**	Far in excess of what was expected in 2003
Cost per annum of Iraq	$150 bn	**increasing**	Original projections were half this rate

Note: This table does not include several other significant indicators, including the non-funding of social security and medicare (an estimated liability of $45 trillion), the extra costs implicit in increased longevity, and the real rate of interest (which has been negative for several years).

Discussion paper for limited circulation

The World Economy: A House of Cards

by Robert Pye, Greystones, Co Wicklow

> "Central banks are supposedly the guardians of money. Yet between them they may have created the biggest liquidity bubble in history."
>
> - The Economist, 26 February 2005

Introduction

The first four articles in this series were devoted to a simple proposition, namely that the world economy is heading for a major crash sometime in the next 3-5 years, followed by a long-lasting and painful contraction. This article takes up some of the earlier arguments in light of recent global developments.

Dependence on oil

It is frequently argued that world dependence on oil is far less than it was in 1973 and 1979 and that, therefore, the impact of an oil shock will be correspondingly smaller. This argument fails to take into account two vital factors: (i) the world economy still has no alternative to oil for a significant proportion of its economic activities and (ii) the price of oil is no longer determined in the way it had been up to about 2000 (see next section). The shock to date has been muted by the fall in the dollar relative to the euro, thereby disguising the full extent of what has been happening. The real shock will come when speculation, hoarding, increased world demand, limited refining capacity, and interruptions in supply all conspire to generate huge spikes in the price. This will continue to drive up the baseline price. This situation will not be helped by the fact that many of the key players have a vested interest in pushing up the price. In addition, competition among speculators will only add to the pressure, with banks and pension funds getting into the game. In short, the price of oil in say, 5 years time, will be significantly above its current level. Even without a major terrorist incident, it could hit €100 a barrel before end-2008.

OPEC and the price of oil

The price of oil in the past was controlled by OPEC, but this is no longer the case. OPEC is virtually powerless. There is practically no elasticity in supply. Even a significant new find would make little impression on the price. The markets also appear to be working on the basis that traditional commodity pricing mechanisms are no longer applicable to the world oil market. The price of a commodity that every economy needs, especially one in short supply, will not necessarily follow a linear progression. They know it is worth whatever the buyer is prepared to pay and that it is in the interest of financial stakeholders to keep pushing the price up. In short, the price of oil over the past 30 years gives no indication whatever of the direction it will take in the future.

Look at Japan
Greenspan and others have been trying to paint an upbeat scenario, where the depth and liquidity of the world capital markets will maintain enough buoyancy to keep the world economy afloat for years to come. This seems rather naïve when one looks at the economy of a country like Japan. In a booming international environment, with low interest rates, high domestic savings, low national debt, and significant demand for its exports, it has been largely moribund for about 15 years. Not even the leading pessimists in the early 90s predicted this outcome.

If the main engine of the world economy, the US, were to falter, most other economies would be faced with a situation even worse than that faced by Japan over the past 15 years. How would countries such as Germany, France, Italy, Korea, or Indonesia fare, given that their existing fiscal position and economic profile is significantly weaker than that of Japan in 1990?

Worsening double deficits in US
The twin deficits in the US continue to worsen. The trend in each case is even more unnerving than the absolute amount. The US economy needs to import €2bn a day to just stay where it is. Many of its economic indicators are being massaged by the authorities to give the impression than the underlying position is healthy and sustainable. For example, increases in employment are being heralded as strong growth signals, when in reality they fall far below what could be expected at this point in the cycle and, to a greater extent than ever before, comprise jobs that are temporary, part-time, low-paid and non-industrial. Talk about low interest rates and low inflation ignore the fact that real interest rates have been negative or close to zero for several years. This is a very unhealthy sign in an economy that is meant to underpin global performance.

The low rates of interest have also fuelled a property bubble, not just in the US but in most major economies (Germany seems to be the exception). This means that when interest rates rise, as they will, they will impact severely on domestic demand and damage world trade.

There is a further problem whose magnitude is not generally recognised. The extent to which the US relies on profits from financial firms has grown ten-fold in the last twenty years or so, from 4 per cent of overall profits in 1982 to more than 40 per cent. The increase in other large economies has not been nearly as great. As a whole, the financial sector makes up nearly a quarter of America's overall stockmarket capitalisation, up from 5 per cent in the 1970s. This changing pattern would suggest that when it hits the shock will cause a great deal of pain.

Developments in China
China is in a bind. It depends heavily on the US as a consumer of its exports. To keep this stream flowing, it must continue to buy US treasury bonds and, in the process, accumulate a huge surplus in dollar reserves. This surplus is then used to bolster the fragile Chinese banking system. If the dollar were to fall significantly, the Chinese banking system would take a hard knock. But if China tries to get out of dollars before this happens, it could trigger the very problem it is trying to avoid.

According to many commentators, the only way around this is to allow the Renminbi to gradually appreciate against the dollar, preferably by fixing it against a basket of currencies. However, this does not appear to be attractive to the Chinese authorities who will still witness a fall, albeit a gradual one, in both their exports and their foreign reserves. It also fails to take account of a major strategic factor, namely that the Chinese are seeking to usurp the US on the world stage over the coming decades and that an outcome that hurts the US may be just as attractive as one that helps China.

M3 and institutional weaknesses

The purpose of a central bank is to control the money supply. M3 among all the major economies has increased substantially over the past 15 years, outstripping GNP growth by a long distance. So far this massive increase in liquidity has not translated into inflation because it was soaked up, firstly by an equity bubble (which has not completely burst) and later by a global property bubble. When interest rates hit a critical level, they will trigger a collapse in the latter, releasing a huge flood of money that will feed partly into general prices and partly into commodities.

The Economist had some revealing comments to make about global liquidity in its issue of 26 February 2005:

> ...global liquidity has been expanding at its fastest pace for at least 30 years. This deluge largely reflects the combined effects of American and Asian monetary policies. Our measure of "global liquidity" consists of the sum of America's monetary base (notes and coins plus banks' reserves held at the Federal Reserve) and foreign exchange reserves held by central banks around the world. In both 2003 and 2004 this rose at annual rates of more than 20%. In no other 2-year period since 1975 has liquidity increased by so much...Central banks are supposedly the guardians of money. Yet between them they may have created the biggest liquidity bubble in history.

Institutional controls over the world financial markets are weak. There is no international consensus on either the problems or the possible solutions. The level of distrust between the major economies seems to be lower than it has been at any time since the 1930s. The attitude that gave rise to Bretton Woods and the Marshall Plan is nowhere in evidence. There is a high level of cynicism regarding the goals of key institutions like the IMF, the World Bank and the WTO. Even apparently independent institutions like the ECB are seen to operate within a framework determined largely by political considerations. On the other hand, the power of the unregulated sector – hedge funds, international investment funds, multinational companies – has increased enormously.

For better or worse, the perception exists that the world economy is not being properly managed and, of greater concern, that a co-ordinated response to a global shock will not be forthcoming.

No one in control

The sense that there is no one is control is nowhere more evident than in the US. A flavour of the situation that now prevails may be found in a recent article from The Economist, *Not exactly major league* (19 March 2005):

> "Mr Bush generally prefers businessmen and true believers to academics and Wall Street types. It is hard to claim that economists guarantee success: witness, for instance, the Clintons' economist-packed health-care plan. All the same, Mr Bush is plainly chancing it – especially if an economic crisis of some sort were to happen…
>
> What would Mr Bush's team do if there was some sort of international economic crisis, such as a dollar crash?
>
> …given the lack of strength within the administration, the risks now are surely higher [than in 1987]. Mr Bush should be crossing his fingers that nothing goes wrong."

It is telling that a major periodical on world financial matters should speak so frankly, not just about the quality of economic leadership in the US, but about the real possibility of a global economic crisis.

Threat of terrorism

The threat of terrorism should be kept under constant review and factored into the way world interest rates are likely to evolve. Interest rates, as the cost of renting capital, include a risk premium to reflect the possibility that the capital may not be repaid in full. Thus economic terrorism alone may force up the cost of capital. For example, the Sunday Times (8 May 2005) stated that one of its reporters succeeded in getting agreement from an international arms dealer to supply him with 3 rockets with a range of 8 miles and a radioactive warhead containing 400 grms of caesium-137 and strontium-90 at a cost of $500,000. It is reasonable to assume that one or more international terrorist organisations have already obtained such weapons. They are easy to prime and operate since no knowledge of nuclear fission is required. As a 'dirty' bomb it would cause very few deaths, but would contaminate an area of several square miles and render it uninhabitable for a year at least. If one of these was detonated over a major commercial centre, such as the Square Mile or Wall street, the interruption to business and the loss of rental income would cause major economic damage. The prospect of further attacks would add significantly to the cost of doing business in major commercial centres around the world.

Iraq and Iran

The invasion of Iraq is increasingly been seen as a disastrous venture by the US. The so-called Iraqi government has taken over three months to form and is hardly more than a loose coalition of conflicting ethnic interests. The insurgency is as strong as ever, fuelled by an extreme ideology that will not rest until the US is driven out of the Middle East. The presence of the US military in Muslim territory is only serving to radicalise more and more of the local population. This is a war the US cannot win. Costs will mount, as will the death toll. Eventually the insurgents will be sufficiently organised to hit oil infrastructure. When this happens, the real cost of the war will become apparent.

The Iranian nuclear development programme is also a growing cause of concern to both Israel and the US. Since China is known to have links with Iran, international and regional tensions can only increase further.

Dollar slide

Given the many factors outlined above and in earlier articles, a significant slide in the dollar is inevitable. Depending on how this happens, it can be expected to set off a painful chain of events.

One effect of a fall in the dollar will be a significant drop in foreign competition, allowing indigenous US firms to push up their prices, thus fuelling inflation even more.

World trade will take a severe knock and growth will fall, very likely to recessionary levels. The US authorities will have to push up interest rates to support the dollar and curb inflation. This will hit consumers and slow growth even further. The real damage will come when the equity markets take a hit and pension fund managers see an escalation in their liabilities.

The first central bank to rush to the door and convert its dollars holdings into another currency will also set a match to a pile of dry tinder.

The real question then will be, Who will invest and where? Everyone will rush to commodities and precious metals. This is probably why the National Pensions Reserve Fund recently changed its strategy and has begun to invest for the first time in these assets.

What preparations can be made?

The world economy is a house of cards. There is nothing a small member of the EU can do to influence these coming events. However, there are a few simple measures which, if taken now, could help to reduce the damage when the house of cards takes a tumble:

(a) Denominate a significant proportion of the national debt in US currency to exploit the coming collapse in its value.

(b) Put a far greater proportion of the National Pension Reserve fund into commodities and precious metals. (The proportion being converted by the NPRF managers is far too low and the projected time scale much too long.)

(c) Modify the existing pay determination structures, which are possibly too responsive to worker demands, to reduce the risk of a wage price spiral.

(d) Aim as far as possible to accrue an annual budget surplus which could be used to boost the economy in a troubled post-shock environment.

12 May 2005

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Previous articles in this series:

- 28 June 2004
- 18 July 2004
- 28 September 2004
- 2 February 2005

Discussion paper for limited circulation

Ask not for Whom the (Lutine) Bell Tolls

by Robert Pye, Greystones, Co Wicklow

> "...by avoiding deflation [through loose monetary policy], central banks have allowed private sector debts to grow even more, in the US and UK at least. That has made the scale of the potential problem even greater. When things do go wrong, they will be very nasty indeed."
>
> – Philip Coggan, Financial Times, 2 July 2005

This paper is less an analysis of specific factors contributing to the impending crisis in the global economy than a survey of the general pattern of risk that has emerged and which continues to worsen.

Volcker

Let's start with comments made by Paul Volcker, the chairman of the Federal Reserve from 1979 to 1987, in *The Washington Post* on 10 April 2005. Volcker is known for his objectivity, his sober judgement, and his deep knowledge of financial markets. Referring to the arrangement that currently exists, whereby the US feeds its voracious appetite for capital by borrowing on a grand scale from China and other Asian economies, he says:

> The difficulty is that this seemingly comfortable pattern can't go on indefinitely. I don't know of any country that has managed to consume and invest 6 percent more than it produces for long. The United States is absorbing about 80 percent of the net flow of international capital. And at some point, both central banks and private institutions will have their fill of dollars.
>
> I don't know whether change will come with a bang or a whimper, whether sooner or later. But as things stand, it is more likely than not that it will be financial crises rather than policy foresight that will force the change.

He raises the possibility of a solution based on a concerted policy response comprising a substantial appreciation of the yuan, a significant increase in EU consumption (along with major structural reform), and the introduction of measures to "forcibly" increase the US rate of internal saving. He goes on to say:

But can we, with any degree of confidence today, look forward to any one of these policies being put in place any time soon, much less a combination of all?

> The answer is no. So I think we are skating on increasingly thin ice. On the present trajectory, the deficits and imbalances will increase. At some point, the sense of confidence in capital markets that today so benignly supports the flow of funds to the United States and the growing world economy could fade. Then some event, or combination of events, could come along to disturb markets, with damaging volatility in both exchange markets and interest rates. We had a taste of that in the stagflation of the 1970s -- a volatile and depressed dollar, inflationary pressures, a sudden increase in interest rates and a couple of big recessions.

Volcker clearly does not see a managed response to the growing crisis. At some point an event or "combination of events" (such as an event similar to 9/11) will trigger a major slide in the markets, with long and painful repercussions across the global economy. The outcome he sees emerging is broadly the same as that cited in earlier papers in this series – a significant fall in the dollar, strong inflation internationally, a major hike in interest rates, and a deep recession.

China

The first risk factor is China. The extremely high level of investment in that economy in recent years is underpinned by a fragile banking system. A sharp slowdown in the world economy could reveal the weaknesses in that system – high exposure to default by creditors, a high concentration of foreign reserves in the US dollar, little depth in domestic consumption, and only modest experience in managing a major financial crisis. There is also a high level of cronyism in the Chinese business system, a strong command-economy ethos, and a less than transparent method of recording financial liabilities.

The recent adoption of a managed floating exchange rate has done nothing to date to bring about the degree of appreciation in the yuan that is needed to address US concerns.

China is still a one party state, with no adequate means for rival factions to give vent to their views. This means that internal political pressures can develop suddenly and in ways that are difficult to predict. The Americans have never demonstrated a convincing ability to read the strategic intentions of foreign powers. A failure to understand what is happening in China during a crisis – whether economic, military or political – could have very unpleasant consequences. For example, just how far are the Chinese prepared to go in pursuit of their strategic objectives in relation to Taiwan or the South China Sea, or in opposing US attempts to widen its sphere of influence in the Middle East, in particular Iran? Would US intervention in Iran be taken by the Chinese as an opportunity to assume control over Taiwan?

China is currently exposed to two major environmental risks, either of which could precipitate the kind of large scale social disturbances that would facilitate the seizure of power by hawks and hardliners. The first is the risk of famine brought on by a prolonged drought. As the celebrated scientist E O Wilson observed in a study of biodiversity in a global environment (2002):

> "...the groundwater of the northern plains [which supports two-thirds of China's agriculture] has dropped precipitously, reaching an average 1.5 metres (5 feet) per year by the mid-1990s. Between 1965 and 1995 the water table fell 37 metres (121 feet) beneath Beijing itself....The extremity of China's condition makes it vulnerable to the wild cards of history. A war, internal political turmoil, extended droughts, or crop disease can kick the economy into a downspin. Its enormous population makes rescue by other countries impracticable."

The second environmental risk is the growing likelihood of an avian flu pandemic (H5N1) that could affect the human population. Many medical experts give this risk a high rating.

Nuclear

The next major risk is that of nuclear terrorism.

Iran has long been concerned that either the US or the Israelis could carry out a military strike on its nuclear development sites. The reality of this threat was demonstrated recently when the UK, France and Germany offered to 'protect' Iran against the possibility of (US) military intervention if it promised to put its nuclear plans on hold.

Iranian determination to press ahead with its nuclear programme has only increased with the election of Ahmadinejad, a known hardliner, as president.

Given the intensity of terrorist activity in Iraq in recent months, it is increasingly clear that the Sunni minority, who ruled the country under Saddam Hussein, are prepared to provoke a civil war with the Shia majority in order to secure a permanent power base in the region. Since Iran is mainly Shia, and since the Kurds are also pressing for a homeland in northern Iraq, the resulting conflict could well destabilise the entire region.

Bush recently made a major strategic decision when he authorised the sale of civil nuclear technology to India, a country which has never signed (and shows no intention of ever signing) the nuclear non-proliferation treaty. This runs completely against longstanding American policy, which has always opposed the release of nuclear technology or materials to countries that had not signed the treaty. Clearly, America wants a nuclear ally in the region to balance Pakistan on one side and China on the other. This shortsighted decision will only encourage the Iranians to continue with their own nuclear programme.

Pakistan is ruled by a military junta. Any semblance of democracy in that country is an illusion. General Musharraf and his cronies live in fear that the terrorists will target them at some stage. It is believed that they have tolerated a strong Al Qaeda presence in the northern province in return for a temporary entente. When it no longer suits Al Qaeda to continue with this arrangement, a major heave against Musharraf is inevitable, especially when nuclear missiles are part of the spoils.

Economic indicators

The main global economic indicators all continue to worsen. In the US, the trade and budget deficits show no sign of moving away from their general downward trend, while the national debt, which takes no account of implicit liabilities (such as pensions and medicare), is growing steadily. Some economists reckon that the trade deficit, which is already drifting toward 7 per cent of GDP, will reach 8 per cent by 2010. The improvement in the dollar, from 1.35 to 1.22 against the euro, says more about Europe than it does about the US economy. The property bubble continues to expand, representing the biggest financial bubble in history, according to *The Economist*. Real incomes in the US have shown little increase over the past 10 years, and household savings are virtually nil. Domestic consumption is being fuelled by asset-price appreciation and related high levels of household borrowing, which is at an all-time high. Real interest rates are close to zero, while increases in employment are well below those normally seen at this point in the cycle. The influence of the unregulated or loosely regulated sector – hedge funds and investment consortia – on the stability of the financial markets continues to increase. Investors are borrowing to invest in order to take maximum advantage of the low interest rate, thereby distorting equity prices and leaving themselves exposed to interest rate increases. Many corporate investors are much more highly leveraged than in the past, and therefore more vulnerable to volatility and sudden movements in the markets. Oil is now over $65 a barrel, compared to $40 a year ago, while, tellingly, oil futures with a maturity of 5 years are also selling at €65. Domestic demand in almost all markets outside the US is muted. A sudden fall in equities would add greatly to the strain already felt by pension funds, who are faced with increased demographic longevity, significant underfunding, and the imminent retirement of baby boomers. Many high profile industrial investments, such as General Motors and Ford, are at or close to junk bond status. Demographics also show that the proportion of the population in the 45-60 age bracket, which is the group that has been investing most in the stock market in the past decade, is set to fall sharply over the next few years. There also strong signs that Chavez in Venezuela will continue to take an anti-American line, both in relation to oil supply and in relation to foreign policy in the Latin American zone.

The only ray of sunshine is the introduction by China of a floating exchange rate mechanism. However, given that this alone is unlikely to lead to a significant appreciation of the yuan relative to the dollar, it is a very tiny ray indeed.

Financial system

The world financial system itself is far from stable. Not only is it much larger that it was, say, 15 years ago, but it contains much greater and faster transnational flows of capital (which caused the Asian crisis of 1997), and a variety of risks that that are not properly understood, mainly due to a lack of transparency and the role of contagion in transmitting problems from one market to another in ways that are difficult to predict. As Andrew Large, Deputy Governor of the Bank of England, said in November 2004, "the search for yield" in an environment of low interest rates is encouraging investors, banks, and hedge funds to converge on similar trading strategies, raising "the prospect of one-way markets developing and market liquidity evaporating in response to a shock."

The situation is not helped by the fact that net US overseas liabilities has risen steeply to around 25 per cent of GDP. In other words, when all financial flows into and out of the country are taken into account, the US owes the world one quarter of all output. If current trends continue, and there is no indication whatever that they will not, then the US current account deficit could reach 8 per cent of GDP by 2010, pushing net external liabilities to around 90 per cent according to one estimate. One can expect the markets to panic before that happens, if only because the increased strain on the dollar will increase the cost of supporting the budget deficit and generate an unsustainable feedback loop.

In the words of Warren Buffett (March 2005), the US is fast changing from an 'ownership society' to a 'sharecropper society', paying substantial rent annually to a third party in order to operate.

Lessons from history

Every decade throws up a fresh wave of economic commentators who are convinced that the old rules no longer apply. The 'new economy' gave us the Dot Com bubble, a bout of wholesale irrationality which drew little cautionary comment from institutions, such as the Federal Reserve, which ought to have dampened enthusiasm before the crisis became unstoppable. The same institutions are now ignoring the crisis that is rapidly coming down the tracks.

Niall Ferguson, professor of history at Harvard University, has drawn attention to the parallels between the existing situation and the years leading up to the Second World War. Both moments in history were preceded by a long period of globalisation, huge international movements of capital and commodities, major technological advances, and an international financial system almost wholly dependent on the economic health of a single hegemonic super-power. There is a major difference on this occasion though. The UK was a net exporter of capital in the period 1870 to 1914, while the US today is a net importer. Unless the rest of the world can continue to feed its incredible appetite for capital, its currency will collapse, with dreadful implications for the global economy.

As Ferguson observed, "Today no one can be sure how stable the international monetary system is, but one thing is certain: it is no more stable than the system which preceded World War I." In fact, we could go further and assert that it is less stable. At least the world financial system prior to WWI sought to maintain stability among the major currencies through the operation of the gold standard. Today, the bewildering capacity to create fiat money, even by the world's reserve currency, stands in marked contrast to this earlier, more robust arrangement.

Just as Britain tried to stem German expansion in 1914, with disastrous consequences, the current regime in the US has stated that it will act to impede Chinese expansion. For Balkan terrorism, we now have Korean, Iranian and Pakistani nuclear ambitions, plus a major global insurgency among Islamic militants. This insurgency has stated that its chief aim is to drive the US out of the Middle East by undermining its economy. One of the principal ways it will do this is by attacking global oil refining and distribution infrastructure. A motor boat packed with high explosives could cripple an oil tanker. A small plane packed with high explosives could cripple an oil refinery. A band of school boys with high explosives could cripple a pipeline. Given that standards of living in Saudi have been falling consistently over the past 15 years, while the proportion of unemployed and disaffected youth has swollen significantly, the internal stability of that country is even worse than that of Iran prior to its collapse in 1979. For these reasons, US intervention in Saudi Arabia and other parts of the Middle East appears inevitable.

Sentiment

So why aren't investors being more cautious? One can only suppose that the main driver is sentiment, much as it has always been. The fundamentals are only important when the majority of investment decisions are informed by reason and logic. While the average US investor (and consumer) continues to buy the line peddled by Greenspan and others (which seems to ignore geopolitical factors entirely), then one can expect the aggregate assessment to be bullish, or at least upbeat. The real problem will start when the majority of investors wake up to the scale of the impending crisis and everyone rushes for the door. As Volcker noted (see excerpt above), this awakening could be accelerated by a major international incident.

Stephen Roach of Morgan Stanley, whose pronouncements over the past year or two have been consistently negative, made the following statement on 15 August 2005 about the ability and willingness of the American consumer to keep on spending:

> "Over the years, I've learned to be wary of betting against the American consumer. But the history of energy shocks argues to the contrary. Moreover, today's saving-short, asset-dependent, overly-indebted consumer is far more vulnerable than in the past. After years of such warnings, investors, of course, have all but given up on that possibility. That's precisely the time to worry the most."

Conclusion

The global risk profile is even worse than it was this time last year. What is more the underlying trends show no signs of improving; so, even as the markets continue to 'prosper' for another 12 months, we can expect the situation this time next year to be much closer to meltdown.

15 August 2005

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Discussion paper for limited circulation

Eight Reasons why a Global Economic Shock is inevitable by end-2008

by Robert Pye, Greystones, Co Wicklow

> ...the present [US trade] deficit is excessive and dangerous. Left alone, it could end in a global recession, rampant protectionism, and even a disastrous financial crash.
>
> - *The Economist,* 24 September 2005

The world is on course for a major economic shock. There are eight reasons, all inter-related, which suggest that this is almost certain to occur before end-2008. In random order, they are:

1. The US budget deficit
2. The US trade deficit
3. The US federal debt
4. The instability of the world financial system
5. The rising price of oil
6. Pension fund deficits
7. Growing geopolitical tensions
8. A failure of leadership

Reason No.1: US Budget Deficit

The US budget deficit is slipping out of control. The existing situation, and the underlying trend, is even less acceptable in an economy that is meant to underpin the world reserve currency. The position from 2000 to 2009 (projected by the US Office of Management & Budget) is set out in **Table A**.

Table A

Year	Budget Deficit (Surplus +) US$ billion	% of GDP
2000	+236	2.4
2001	+127	1.3
2002	158	-1.5
2003	375	-3.5
2004	412	-3.4
2005	319 est	-2.6
2006	268 est	-2.1
2007	241 est	-1.8
2008	240 est	-1.7
2009	237 est	-1.6

Data source: US OMB [table compiled by author]

Some commentators do not place a great deal of credence in the projections from 2005 to 2009, which are very optimistic in light of the trend over recent years, the commitments made post-Katrina, the increasing cost of the war in the Middle East, and the cost of paying for additional retirements as the baby boomers leave the work force.

As stated in the last paper in this series (August 2005), the key concern is not the absolute amount of the budget deficit but the emerging trend. The swing of 5.8 per cent of GDP over the 5-year period 2000-2004 is without precedent over the last 60 years.

Compare this with the Sixties, when the federal government funded a major war in Vietnam, the NASA moon project, and the Great Society programme. The average budget deficit for the period 1966-1970 was 0.9 per cent, and yet it is commonly argued that the huge increase in federal spending during the Sixties forced the US to drop its commitment to Bretton Woods in 1971. If an average budgetary imbalance of 0.9 per cent could form the background to a major shift in policy, what reason have we to believe that the pressures exerted today will not have a corresponding effect?

Reason No.2: US Trade Deficit

The trade deficit is also getting worse – see **Table B**. At the start of 2000 it stood at \$300bn. By end-2004 it had jumped to \$668bn, while developments to date in 2005 are far from encouraging.

Table B

	Trade deficit \$bn	GDP \$000bn	%
1995	113670	7522	1.51
1996	124894	8000	1.56
1997	140906	8471	1.66
1998	214064	8953	2.39
1999	300060	9519	3.15
2000	415999	9953	4.18
2001	389456	10226	3.81
2002	475211	10591	4.49
2003	519679	11236	4.63
2004	668074	11995	5.57

Data source: US Bureau of Economic Analysis [table compiled by author]

The deficit in the first 8 months of 2004 was \$396bn, while in the first 8 months of this year it has already climbed to \$463bn, an increase of almost 17 per cent.

So, as with the budget deficit, it is not just the absolute figures that are a cause of concern but the underlying trend.

The currencies of many developing countries collapsed when their international transactions fell this far out of balance. The normal solution, a carefully managed devaluation of the currency, is not being pursued. Perhaps the authorities fear that a move in that direction could trigger a slide. Also, an orderly devaluation would require a co-ordinated international effort, which in turn would require the full co-operation of China, a major rival of the US on the world stage.

The Plaza Accord of 1985 achieved a 'successful' devaluation of the dollar, but many commentators believe it led to the stock market crash of October 1987. Also, the Plaza accord did not require the co-operation of an aggressive economic competitor. China is a major rival to the US on the world stage and, unlike Japan and the EU member states, would welcome a long-term weakening of the US economy.

The Plaza Accord was necessary in part because interest rates had been exceptionally high for several years and had caused the dollar to become overvalued. But it was also prompted by a 'high' trade deficit – 2.34 per cent in 1984 and 2.73 per cent in 1985!

The US is acting as world consumer of last resort, fuelled by a property bubble. Over the past 4 years, consumption and residential investment together accounted for over 90 per cent of the rise in America's GDP. Even more striking, 40 per cent of all new private-sector jobs have been in construction, mortgage-broking and other areas related to housing. Unless its economy switches form such a high concentration in non-tradables, it will be unable to produce the exports needed to correct its burgeoning trade deficit. It will be more difficult to do this given the contraction in its manufacturing base which in 1980 was about 40% greater than it is today.

A significant component of the risk posed by the trade deficit is protectionism. If US industry is unable to reverse the imbalance, and there is every indication this could take some time to correct without an orderly depreciation of the dollar, politicians and captains of industry will increasingly call for the introduction of protectionist measures such as quotas and tariffs. This will stop globalization in its tracks and give rise to a whole new batch of economic problems. Depending on how the Asian economies react, it could trigger the very financial crisis it was designed to avoid.

Reason No.3: US Federal Debt

By itself, the current level of US federal debt would not be a matter of major concern. However, when other indicators are faltering, the federal debt assumes a greater significance. The projected level for 2006 is $8726 billion or 69 per cent of GDP, the highest it's been since 1960. For example, during the Seventies, when the economy had to bear the brunt of the first oil crisis, it averaged only 35.6 per cent of GDP

Table C

	Federal Debt $bn	% of GDP
2000	5628	58.0
2001	5769	57.5
2002	6198	59.8
2003	6760	62.4
2004	7486 est	65.3
2005	8132 est	67.5
2006	8726 est	69.0

Data Source: US Bureau of the Public Debt [table compiled by author]

As with the twin deficits, the underlying trend is disquieting. The debt has grown from 57.5 per cent of GDP to 67.5 per cent in only 5 years, a very large increase for the world's most powerful economy and bastion of the world's reserve currency. This could really start to hurt when interest rates rise, either in response to inflationary pressures or to demands by foreign lenders for the greater risk they are taking on.

It has been argued that inflation is being kept down by globalisation, where low labour costs in Asian economies and the more competitive pricing of internationally traded goods and services have held back the general increase in prices that might otherwise have occurred. But this argument ignores the dampening effect of the housing bubble, where asset price inflation has helped to hide the effects of loose monetary policy. When the housing bubble bursts, one can expect the inflationary wave to work its way into consumer prices. This will require further interest rate rises which in turn will increase the relative burden of the federal debt.

Monetary policy under Greenspan has been incredibly loose – see **Table D**. The large increase in M3 in recent years has not yet found its way into core inflation but it is very difficult to see how this can be avoided over the next couple of years without a painful increase in interest rates.

Table D

[September]	M3 $bn	GDP $bn	%
1996	4885	8000	61.1
1997	5332	8471	62.9
1998	5882	8953	65.7
1999	6323	9519	66.4
2000	7003	9953	70.4
2001	7850	10226	76.8
2002	8334	10591	78.7
2003	8909	11236	79.3
2004	9359	11995	78.0
2005	9977		

Data Source: US Federal Reserve [table compiled by author]

At this juncture, it is worth comparing the US economy as it stands today, under each of the above indicators, with the corresponding figures for 1980 when the last oil crisis struck – see **Table E**

Table E

	Trade Balance as % of GDP	Budget Deficit as % of GDP	Federal Debt as % of GDP	M3 as % of GDP
1980	+ 0.79	- 2.7	33.4	66.4
2004	- 5.57	- 3.4	65.3	78.0

[table compiled by author]

It is clear from Table E that the US economy is far less equipped to deal with an economic shock than it was in 1980. When one considers the inflation caused by that shock and the level of interest rates required to bring it under control, we can get some idea of the problems that are building up. (The average Federal Funds interest rate over the period 1975-1978 was 6.01%, while for the period 1979-1982 it was 13.3%.)

<u>Reason No. 4: The instability of the world financial system</u>

Since the last paper in this series we have witnessed the use of a hedge fund to hide losses of $430m incurred by a NY futures brokerage (Refco). This does not appear to have had a serious impact on the financial markets but it serves as a chastening reminder that the opacity of hedge fund operations provides ample opportunity for crimes of this kind. While there are doubtless large numbers of honest brokers in the market, there are also bound to be a fair share of unethical players who will use whatever means they can to push for higher returns or to conceal losses. The problem with concealment is that a lot of damage can be done before the authorities can intervene to stabilise the market.

Refco was subjected to due diligence by Goldman Sachs before it was floated on the stock market – just two months before it collapsed! If a major financial institution, with access to business records, cannot spot a gaping hole in the accounts of such a company, what reason have we to believe that many other black holes are not already extant throughout the financial system?

The hedge fund market has grown rapidly. Funds under management in Europe alone have trebled in less than 3 years and now stand at $279bn. Worldwide there are over 8,000 funds managing more than a trillion dollars. Some of these funds are very large. About 250 in the US and Europe have assets of more than $1bn. While such funds represent about 5 per cent of assets under management worldwide, they are estimated to account for between a third and a half of all daily trading on the London and New York stock exchanges.

The Bank for International Settlements made some stinging remarks in its latest annual report (June 2005) about the increased instability in the world financial system, mainly due to the "explosive growth" in credit derivatives. Despite the limited fall-out from the collapse in value of credit notes issued by General Motors and Ford, the BIS believes that

> "the robustness of these new markets has not been fully tested...The strong credit conditions that have fostered the development of these markets may not continue into the future. One concern is the impact of highly leveraged positions on the balance sheets of financial institutions when markets turn. Another is the nature of the systemic role played by highly leveraged institutions such as hedge funds in affecting market liquidity; two-way markets could conceivably disappear as protection sellers exit at precisely those times when default insurance is needed most."

While it is unlikely that any hedge fund today would indulge in the level of borrowing that brought down Long Term Capital Management in 1998, there is a good chance that the risk identified by the BIS could result in many of them being caught out at the same time, with no counterparty to soften the blow. The impact on the world financial system could be very painful indeed.

The world financial system is underpinned by staggering levels of debt. Non-financial corporate-sector debt in the US comes to around $7 trillion, while accumulated household debt is in the region of $10 trillion. Mortgage and credit card debt in the UK recently passed the £1 trillion mark. The low interest rate policy pursued by the Federal Reserve since 2001 has caused overall indebtedness, not just in the US but around the world, to expand enormously.

The sophisticated use of credit derivatives has allowed this debt to be securitized in so many ways that it has infiltrated just about every type of investment portfolio. It is argued that this spreads the risk, but it also serves to hide it. The more securitized debt is taken on by counterparties, the greater the instability in the system.

Credit card debt has grown at an extremely fast rate in the past ten years. Since a large proportion of consumers depend on this form of credit, which attracts a punitive rate of interest, the continuing increase in interest rates will eventually have a sharply negative effect on consumer confidence. This is especially true of the US, the engine of the world economy, where the personal saving rate is close to zero.

Reason No.5: The rising price of oil

The first paper in this series (June 2004) predicted that the price of oil would jump from $40 a barrel (as it was then) to $60 by end-2005. However, it hit that figure by start-2005 and has since spiked to $70 or thereabouts. The current baseline price is still above $60 and is not expected to fall.

It can't be stressed strongly enough that oil is not just a major commodity. It is **the** commodity, the *sine qua non* of all economic activity. The slightest suggestion that supply could be interrupted or curtailed sends jitters through the markets. US foreign policy for the past sixty years or more has been based chiefly on ensuring that this never happens. The rise of Al Qaeda and increased demand, mainly from China, has added considerably to the problem. There are also real concerns that reserves are running down faster than expected and that infrastructure is not being upgraded. Taken together, these factors strongly suggest that the price of oil will continue to rise for many years to come. Given past experience, this will have major implications for consumer confidence, growth, inflation, interest rates and industrial policy.

Al Qaeda cannot defeat the US militarily, but they can do it considerable economic damage. With two-thirds of world oil reserves in just five Islamic countries (Saudi Arabia, Iraq, Iran, Kuwait and the UAE), they will have ample opportunity to pursue this agenda.

The US entered Iraq for just one reason – oil. And it is staying for the same reason. The Bush regime would appear to have decided, in line with stated Neoconservative policy, that Middle Eastern / Caspian oil is vital to America's long-term strategic interests and that it will do whatever is necessary to protect it. Al Qaeda on the other hand will do all it can to promote civil unrest across the entire region. Military equipment for the insurgency will not be in short supply since the enemies of the US – Iran, Russia, and China – will continue to ensure that the Islamic insurgency remains a bitter thorn in the side of US foreign policy.

China has been making overtures to all the world's major oil-producing countries and is known to be particularly interested in securing a reliable supply of oil from one or more middle eastern countries. To this end it has been supplying military technology and other inducements to regimes in various countries, including Iran, Kazakhstan and Saudi Arabia, to win favour and exercise a greater measure of strategic influence in the region.

In short, both the reigning world super-power and its main rival are competing in the same region for the same resource. What is more, even though Russia has ample oil and gas reserves, it cannot afford to be pushed aside as the US and China vie for resources in sensitive regions along its southern border.

According to one study, total world oil production would have to grow by 60 per cent between 1999 and 2020 to satisfy anticipated world consumption, while total US oil consumption is expected to increase by 44 per cent between 2001 and 2025. With reserves falling, demand rising, growing civil unrest in many oil-producing countries, and increasing terrorist activity designed to interrupt supply, the price of oil is bound to rise significantly in the coming years. $100 a barrel by end-2007 is not out of the question.

It should also be remembered that the US economy benefits significantly from the fact that world oil prices are denominated in US dollars. To buy oil you must first buy US dollars. Any threat to depart from this arrangement is a threat to the well-being of the US economy. For example, Chavez could well decide to land a blow against perceived American imperialism by denominating Venezuelan oil in euro rather than dollars. This means that, to buy Venezuelan oil, the US would have to sell dollars to buy euro! Even Putin reminded the US of this possibility when in October 2003, in response to a question at a news conference with Gerhard Schroeder about the possibility of denominating Russian oil in euro, he said, "We do not rule out that it is possible. That would be interesting for our European partners."

Reason No.6: Pension Deficits

A pensions crisis is brewing. Funds worldwide are in deficit, and they are falling further into deficit as longevity increases. The UK government actuary has recently stated that he will no longer adhere to the 'limit to life hypothesis', namely the assumption that there must be a limit to longevity increases. This policy revision has added a further 4 months to the life expectancy of a 65-year-old man, taking it to 19.4 years, and one month to the expectancy of a 65-year-old woman. This means that in just two years, the official estimates of life expectancy for 65-year-olds has jumped from 17.8 years to 19.4 years for men and from 20.6 years to 22.1 years for women.

The net of effect of this is to push pension funds further into deficit and to raise the prospect of further life expectancy adjustments in the coming years.

The impact of the pension crisis in the US has been receiving greater attention with the collapse of Delphi, the auto parts manufacturer, which was one of the biggest in US history. A large chunk of its pension deficit will be assumed by the Pension Benefit Guaranty Corporation (PBGC), a federal insurance agency which allows corporate entities to insure their pension liabilities by contributing regular premiums. The collapse of Delphi has helped to highlight just how rapidly the funding shortfall at the PBGC is growing. The total underfunding of US pension plans increased from less than $20bn in 2000 to over $350bn by September 2004, while the direct deficit at the PBGC stood at over $23bn on the same date.

Some of major airlines in the US, by filing for receivership under Chapter 11, have successfully passed their pension liabilities to the PBGC. The very existence of the PBGC is thus proving to be a moral hazard, providing an incentive to large corporations to offload their pension liabilities by filing under Chapter 11. The fact that the corporations pay premiums to the PBGC is not very comforting, for two reasons. Firstly, the scope for increasing the premiums to underwrite the shortfall is both very restricted and politically sensitive. Secondly, the PBGC invests the bulk of its assets in US Treasuries. This means that future taxpayers, and not a self-sustaining investment portfolio, will be paying for the future aggregate deficit across the entire pensions industry. Since future taxpayers will also be paying for social security pensions, medicare and medicaid, this is a very grim prospect indeed.

Even if more companies switch from defined benefits to defined contributions, where the individual carries the investment risk, adverse market conditions will still give rise to a significant fall in personal income and thus in domestic consumption.

Reason No.7: Growing geopolitical tensions

A major weakness with modern economic theory is that it does not incorporate a measure or an indicator of geopolitical tension (GPT). Given the increase in globalization over the past 20 years or so, this omission is surprising. Of course, an accurate measure could hardly be expected, but some method of recognising such tensions should figure in any global economic model. If such a yardstick existed, its historical data would almost certainly show that geopolitical tensions today are far greater than they were when Iran fell in 1979 or when oil prices quadrupled in 1973. The fall of the Soviet Union, the rise of Islamic insurgency and the proliferation of nuclear capability have caused GPT to escalate. It seems unrealistic to take world GDP at face value when GPT is being ignored.

It would be unthinkable 15 years ago that a nuclear device could be smuggled into Tel Aviv. But this is a real prospect today. Only a few years ago citizens of Delhi were faced with the possibility, during a very tense two-week period, that Pakistan would direct a nuclear device at their city. Former US Senator Sam Nunn has repeatedly warned that the threat of a nuclear device being exploded in a large American city is a very real one. Al Qaeda have stated that their main weapon against the US is economic. A major terrorist attack in a financial centre such as Wall Street or the Square Mile could have a catastrophic impact on the world financial system. It is clear from many expert commentaries – such as Clarke’s *Against All Enemies*, Scheuer’s *Imperial Hubris* or Johnson's *Blowback* – that outcomes of this magnitude can no longer be considered improbable.

Even if Ahmadinejad’s threat that Israel “should be wiped off the face of the earth” through the use of a nuclear weapon is largely rhetorical, it is similar to the rhetoric that Ayatollah Ruhollah Khomeini broadcast regularly from Paris in the 1970s, before he overthrew the Shah. The Israelis see the current Iranian regime as posing no less a threat to the security of their state than did Saddam Hussein in 1981 when they destroyed his nuclear reactor in Osirak near Baghdad. Iran sponsors two major terrorist organisations, Hamas and Hezbollah, whose main aim is to destroy Israel. Iraq did not have the same strategic commitment to the destruction of Israel in 1981, yet its nuclear capability was demolished anyway. A proper GPT analysis of the world economy should therefore be asking what kind of fall-out can be expected when, and not if, Israel carries out a similar strike inside Iran.

Too many historians and self-appointed experts have been gushing indiscriminately about the ‘end of history’, claiming that democratic, free-market capitalism has triumphed and that citizens of every nationality are bound to adopt the American model in the decades ahead. This kind of nonsense is blinding many world leaders and economic commentators to the fact that major tectonic plates are moving faster than they have for sixty years, with potentially disastrous consequences for the very system they revere if they do not act quickly.

This brings us to the last factor, the quality of world leadership.

Reason No.8: A failure of leadership

As *The Economist* recently stated in a detailed survey of the world economy, where it highlighted the growing dangers, “If the first step towards finding a solution is to agree on the problem, the world’s policymakers are still a long way from solving the global imbalances.”

US fiscal and monetary policy since 2001 has consistently made the problem worse, while the failure of the current administration to engage in meaningful dialogue with the leading economies and establish a co-ordinated response is deplorable. G8 summits without China are virtually meaningless. Apparently no attempt is being made to encourage the oil-rich countries to use the huge windfall garnered on foot of recent price increases to bolster the world economy.

Unless two or more world leaders draw public attention to the massive misallocation of capital across the world financial system and the need to adopt a concerted approach to correct it, there is little likelihood that existing consultative structures will have any effect. In fact, their continued silence will only reinforce the common assumption that the invisible hand of the market will keep everything on an even keel.

In *The Fog of War*, former US Defense Secretary Robert McNamara gave a candid account of the duplicity and arrogance that pervaded the US administration in the 1960s, when countless military mistakes were made and one strategic blunder led to another. Given that McNamara was a leading player in this appalling failure of leadership, and that neoconservative policies today mirror many of those pursued by McNamara and his cronies, the documentary holds many lessons for the 21st century.

The calibre of leadership on the world stage is abysmal. Bush and Blair waltzed into Iraq without proper regard to the consequences. Chirac is ill. Schroeder was weak and Merkel will be even weaker. Few people could name the President of the European Commission. The Japanese premier, Kozumi, has never been an influential voice on the world stage, while the governments of the main Asian economies will not say anything without the implicit approval of Beijing. Putin is heard only by those who covet Russian oil and gas. Both the IMF and the World Bank are in thrall to Washington, while the OECD is too lightweight to make any difference, even if it did have the temerity to speak out. Trichet has been trying to highlight some of the difficulties but seems reluctant to challenge the main players. Greenspan has been one of the main architects of the coming fiasco, while his successor, who blames a global savings glut for the existing imbalances, is unlikely to act decisively.

Conclusion

The risk table in the attached appendix speaks for itself.

6 November 2005

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6. **15 August 2005** 'Ask not for Whom the (Lutine) Bell Tolls'

Table of Global Risks

	static risk	synergised risk
US budget deficit	10	12
US trade deficit	10	12
US federal debt	7	9
Instability of financial system	10	12
Rising price of oil	15	17
Pension fund deficits	8	10
GPT	15	17
Leadership failure	5	7
TOTAL	**80**	**96**

[compiled by author]

This table sets out an estimate of the risk in question triggering a world economic crisis sometime in the next 3 years, where 1 is a 1% chance and 100 is 100%. The 'static risk' column ignores the estimated values attaching to the other risks, while the 'synergistic risk' column attempts to factor in the cumulative impact of the other risks listed above. While the table is entirely subjective, the values in each case are fairly conservative. For example, few economic commentators would contest the assertion that there is a 10% chance that the US budget deficit could trigger a world economic crisis sometime in the next 3 years.

Article written for The Irish Times (January 2007) but officially blocked by the Department of Finance

Why a Global Economic Shock is Now Looking Inevitable

by Robert Pye

The world economy is poised on the edge of a precipice, and yet, oddly enough, few international commentators are alerting the public to the turmoil that lies ahead.

Before examining the situation facing us today, let's look first at the global situation in July 1914. The world economy was poised on the edge of a precipice then also. Like today, few market commentators saw what lay ahead. The world had enjoyed over four decades of relative peace and increasing prosperity. Markets everywhere had expanded steadily, international investment had grown significantly, and globalization in the modern sense was well established. Communication and co-operation between the major economies was well developed, the world banking system was fairly robust, the gold standard gave stability to the major currencies, and the leading world economy – Britain – was a net exporter of capital. Living standards across Europe had improved dramatically and the middle class in most economies was growing substantially.

While tensions between the great powers were well recognised, it was generally accepted that everyone had too much to lose by embarking on a military adventure against a major rival, especially one that might escalate into a grand confrontation. Among those with the most to lose, and with the greatest investment in the status quo, were the major bond holders in the main economies. These institutions, as well as wealthy individuals, could have been expected to monitor their portfolio of risks on an ongoing basis and to be sensitive to adverse developments on the world stage. And yet they failed completely to detect the tsunami that was about to sweep away a large portion of their wealth. The assassination of Archduke Franz Ferdinand in Sarajevo on 28 June 1914 is generally viewed as the spark which ignited World War I, but the bond markets at the time did not react. As the weeks passed, there was no indication that the leading financial houses grasped the magnitude of what was happening. Their methods of risk assessment were neither broad enough nor sensitive enough to detect the seismic shift that was about to occur.

The same holds today. The world economy is extremely out of balance and geopolitical tensions have grown considerably in the past five years, yet the markets continue to operate as though nothing untoward was happening. Investors are assuming, just as their predecessors did in 1914, that the benefits accruing from the existing arrangement are so great, so transparently obvious, that no nation state or ethnic group would dare to destabilise it.

This perception is so sadly at odds with the underlying geopolitical reality that it is difficult to fathom, but it is consistent with the myopia shown by previous generations. Market analysts focus on fine detail. That's what they're paid to do. But in doing so they often fail to take account of the wider picture, the broad geopolitical environment in which their assumptions are embedded. Sudden changes in that environment can have unsettling consequences.

So just how stable is today's global economy and how well does it reflect the sharp rise in geopolitical tensions? A small number of leading investors and market analysts, including the sage of Omaha, Warren Buffett, are convinced that a major correction is on the way. The world economy as a whole is driven, for better or worse, by developments in the US economy, which comprises about one third of global output. That economy is very heavily indebted. As we noted earlier, the world's largest economy in 1914 – Britain – was a net exporter of capital, but the US economy today is dangerously dependent on a continuing supply of capital from the world at large. It requires an inflow of roughly $2bn a day just to stay afloat. Most of this is supplied by Asian central banks who continue to buy US treasury bills (federal debt) to prevent their own currencies from appreciating against the dollar. They thus possess a mountain of dollar-denominated assets that will collapse in value if the dollar starts to slide. For this reason it is argued that both the US authorities and the Asian banks have too much to gain from the existing arrangement to let it fall asunder. But this kind of optimism is no more sustainable today than it was in 1914.

For a start, the American consumer must continue to consume. Unless he or she continues to buy masses of Asian imports, the cycle will come to a halt. The buying spree of the past few years was fuelled in large part by the sharp increase in property prices. On foot of this perceived increase in wealth, property owners withdrew equity from their homes to finance their additional spending. Personal savings rates dropped close to zero and credit card debt rose prodigiously. As a result a large proportion of US consumers are living so far beyond their means that a sharp contraction in domestic consumption is bound to occur at some point.

Historically low interest rates also induced many firms to borrow more than they had planned and certainly more than would be prudent in a less benign environment. If interest rates rise and domestic consumption falls, these firms will be unable to contribute through further investment to an economic recovery. On top of this, state and federal indebtedness have been rising excessively. While the total US federal debt – $8.7 trillion – is lower than, say, that of Germany as a percentage of GDP, it is historically high for a currency that is meant to function as the world reserve currency.

Furthermore, this debt figure represents official federal debt only, not the huge unfunded liabilities generated by social assistance commitments (pensions, medical cover, etc) which are variously estimated to lie somewhere between $45 trillion and $57 trillion – more than 4 times US GDP! In other words, the burden of debt being passed from one generation to the next is incredible. The level of future taxation needed to fund it would be punitive – assuming the federal and state authorities do not default on their obligations.

There are two other major problems that make the situation a whole lot worse. The first is the fiat status of the US dollar. Up to 1971, the dollar was underwritten by a formal link to gold. This made it difficult to expand the money supply ("print money") without first meeting certain sound economic criteria. With the lapse of these criteria, the US authorities (like those of other countries) can print money at their discretion. The production of money in this way, known as fiat money, is only stable over the long term if the money supply expands in step with economic growth. If it is allowed to outstrip growth, it can for a while create the illusion of prosperity – but a day of reckoning must come as prices readjust to reflect the over-supply of money.

There are strong signs that the US money supply has been expanding too rapidly and that the authorities are not disposed, at least for the moment, to bring it under control. One indication of this was the termination by the Federal Reserve in March 2006 of the publication of M3 money supply figures for the US economy. Every developed economy publishes these as a matter of course. While the US money supply can be extrapolated from other published figures, the refusal to release a standard headline indicator like M3 is a matter of concern. It lends credence to the view expressed by many critics that the US government is allowing money supply to expand at an excessive rate in order to fund the ever-rising cost of the war in Iraq.

This has not as yet hit the value of the dollar, at least to a degree that could trigger international concern. One reason for this is that the dollar has been enjoying a kind of proxy gold standard over the past thirty years or so. Since oil is denominated in dollars, all major economies are obliged to buy dollars to pay for their oil imports. While this accounts for only a fraction of the dollars bought by foreigners, it has nevertheless played an important role in sustaining the centrality of the dollar in world trade. Significantly, it has also meant that oil exporting countries have a direct interest in maintaining the value of the dollar, primarily by recycling a large portion of their oil-generated earnings back into the US economy.

What if a major oil-exporting country threatened to denominate its oil in a currency other than dollars? Chavez of Venezuela has adverted to this possibility, as has Putin of Russia. Both know the harm this would do to the dollar. Interestingly, shortly after Saddam Hussein threatened to do so, Iraq was invaded.

The other major problem is the risk posed by the ever-growing – and unregulated – market in financial derivatives. These are debt instruments designed to pass the underlying risk to the party best equipped to take it on. Many are so complicated that only a handful of experts in the leading investment institutions understand them. They are a sensible way of diversifying risk, but only if the risks concerned are transparent. Their amazing proliferation in recent years has given rise to legitimate concerns that buyers are increasingly unable to evaluate the underlying risk effectively. As the volume and speed of transactions increase, and as financial derivatives become more complex, the chances that untenable risks will accumulate in certain sectors are bound to increase. The web of derivatives is so pervasive that a market failure in one sector could spread fairly rapidly into others and cause a major shock to the financial system. This came close to happening in 1998 when a large hedge fund, Long Term Capital Management, collapsed. Only the timely intervention by the US authorities prevented a calamity. The real concern today is that a large institution or hedge fund could collapse before the authorities had time to intervene and underwrite its liabilities.

To get a better idea of the systemic risk posed by the collapse of a single institution, picture a circle of one hundred institutions, each owing \$100m to the institution on its right. The net debt within the circle as a whole is zero. But consider the implications for the remaining 99 if one of them goes under. Each of them will forfeit \$100m, and the circle as a whole will show an accounting deficit of \$10bn. Not a happy scenario. This is why timely intervention is so critical. If the authorities can take on the liabilities of the institution that failed, and do so in good time, it can prevent the collapse of the other 99. However, there is no guarantee that the failure will come to light in time or that sufficient liquidity can be assembled to plug the hole before the others go under. One has only to look at the criminal accounting practices employed by fairly straightforward institutions like Enron to see how easily major losses can be disguised.

If these were the only problems facing the world economy, there might be reason to believe that concerted action by leading participants – assuming they could reach a consensus – would lead to a satisfactory solution. But this ignores the huge frictions that have arisen from the conflicting ambitions of four major powers, namely the US itself, Russia, China and the Islamic bloc. The latter three regard the US as, at best a rival and, at worst, an enemy. This has been exacerbated by the policy of unilateral intervention pursued by the current Bush administration.

As far as the Islamic insurgents are concerned, before the US can be defeated militarily, it must be weakened economically. Thus they have a major incentive to exploit the existing problems with the US economy by creating further terror along the lines of 9/11, possibly by deploying portable nuclear devices or other instruments of destruction. A high death toll, especially if achieved through a series of simultaneous strikes, would cause a collapse in the stock market and deliver a catastrophic blow to the world financial system.

Putin's Russia is fast turning into a modern fascist state, where habeas corpus and the rule of law have no meaning. A humbling blow to the US economy would suit it admirably, as would a further increase in tensions in the Middle East between Shia and Sunni factions. By providing aid to the Iranian nuclear programme, it is gradually stoking the fire that it hopes will cut off western access to Middle Eastern oil. Once this happens it will enjoy a geopolitical influence that the Tsars of old would have envied.

China must continue to expand economically if it is to remain internally stable. To do this it needs a reliable source of oil. It has been working hard in recent years to forge closer ties with oil-exporting countries like Venezuela, Sudan, Canada and...Iran. The latter is geographically close, an enemy of the US and anxious to retain the covert support of another major power.

In addition to these major sources of geopolitical tension, there are three wild cards in the pack: Israel, Saudi Arabia and Pakistan. The first two are alarmed by the prospect of a nuclear-armed Iran. Israel is unlikely to let Iran reach the stage where its nuclear capability becomes militarily viable. It would rather provoke a confrontation on its own terms than allow Iran to dictate the course of events. The best it can hope for is a change of regime in Tehran, though the scope for this seems rather slim.

Saudi Arabia, a Wahabi-led Sunni state, is known to be very unhappy with the destabilisation of Iraq and the threat posed to its regime by a resurgent Shia movement led by Iran.

Western commentators tend to forget that another unstable Islamic state, namely Pakistan, already has a healthy nuclear arsenal. Its northern province is a known Al Qaeda stronghold and Musharraf's grip on power is tenuous at best. Through the agency of Abdul Qadir Khan, a leading scientist, it has also supplied nuclear technology and know-how to North Korea, among others. It is very unlikely that this occurred without the approval of senior power brokers in Pakistani political circles.

Putting all these pieces together, the outlook is grim indeed. Taken as isolated phenomena, they are fairly forbidding, even from a global perspective. But considered as related phenomena, strung together and reinforced by some common themes – a reaction by the great powers to American supremacy, hostility to Western intervention in Islamic countries, both recently and historically, and systemic weaknesses in the world financial system – they present a far darker picture.

Why is such a disturbing matter not discussed more openly in the media? I think that this is due in part to the fact that, generally speaking, economists do not study history and historians do not study economics. A major confrontation seems far too improbable to a generation with little direct experience of the pain and tragedy of large scale war. Even the younger generation of Americans see the Vietnam War as a distant, rather oblique event. The 'end of history' brigade have also lulled many into believing that the main problems of social organisation have been solved, that a paradigm for unlimited economic growth has been developed, and that reason will always prevail. It is difficult for anyone accustomed to such comforting assumptions to see that the conditions for a third world war are well and truly in place and that all that is required is an incident of sufficient magnitude to set it in motion.

When the shock occurs, the price of oil will go through the roof and industrial output will decline markedly. Economic growth in the west will stall for decades, unemployment will rise significantly and standards of living will fall. The stock market crash and the slide in the dollar will destroy wealth on a grand scale, leaving tens of millions without adequate pensions or health care.

Most level-headed readers will argue that this scenario is far from inevitable, that the most pessimistic assumptions are being lumped together to produce a sensational outcome. Three years ago I would have said much the same, but once you see the pattern taking shape and weigh it against the lessons of history, it is not a question of whether this will happen but when. Three months or three years from now? Who knows. All I suggest is that you give the matter some thought and draw your own conclusions.

[Mr Pye is author of *An Overview of Civil Service Computerisation, 1960-1990* published by the ESRI in 1992. The views expressed herein are personal and do not purport to represent those of any other person, group or organisation.]