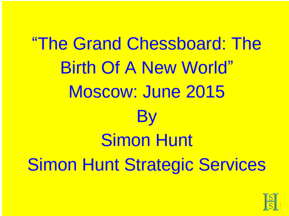
# "THE GRAND CHESSBOARD: THE BIRTH OF A NEW WORLD"

BY **SIMON HUNT**, SIMON HUNT STRATEGIC SERVICES

**Slide 1:**




I feel humbled and honoured to be invited to address you today and to pose the question *"Where is the World Heading?"* Will it be in peaceful accord with itself or are we entering an era of mounting tension?

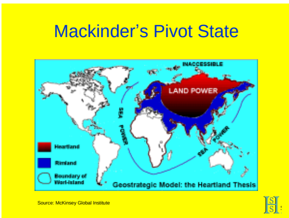
Whilst the question is not easy to answer, it is central to what the future holds for us all. The difficulty in answering the question lies in two specific areas.

The first reason is simple; global debt cannot keep rising faster than global GDP as it has been doing since the final demise of Bretton Woods in 1971. At some point, probably quite soon, the system will face its high noon, succumbing to failures in the derivative markets and resulting in a crash of epic proportions. It is only then that the Bank for International Settlements will have the crisis necessary to completely restructure the global financial system. But more on that later.

Secondly, the deep – and deepening – geopolitical tensions evident in so many corners of the world place us all at risk to the emergence of either a new Cold War, or, worse still, war itself. What then has evolved is a dangerous fusion between geopolitics and economics making that which the future holds an even bigger unknown.

**Slide 2:**

**Mackinder's Pivot State**




Our story starts in 1904 when Halford Mackinder, the father of geopolitics, coined the dictum:-

"He who controls Eastern Europe commands the Heartland

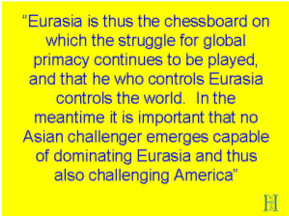
Who controls the Heartland commands the World Island

Who controls the World Island commands the World."

Mackinder posited that it would be geography that would define the nature of future struggles. The "pivot state'' or what he defined as 'Eurasia' represented the world's most critical area. Whoever controlled this vast landlocked region and its resources would effectively rule the world. He foresaw that any state dominating this 'World Island' would ultimately become the natural opponent to North America.

Zbigniew Brzezinski, an influential policy advisor to President Obama, many of whose colleagues hold senior positions within the current Administration, holds similar views to Mackinder as evidenced from "The Grand Chessboard", which he published in 1997.

**Slide 3**:




The Grand Chessboard, 1997

"For America", Brzezinski wrote later in his book, "the chief geopolitical prize is Eurasia. For half a millennium, world affairs were dominated by Eurasian powers and peoples who fought with one another for regional domination and reached out for global power. Now a non-Eurasian power is pre-eminent in Eurasia - and America's global primacy is directly dependent on how long and how effectively its preponderance on the Eurasian continent is sustained."

This is why the first part of the title for my address is The Grand Chessboard because the strategy laid out in that book appears to have become the cornerstone of Barack Obama's foreign policy.

It was in a CNN interview in February 2013 that Henry Kissinger revealed the truth behind Washington's involvement in Ukraine. When asked the question ''you know President Putin better than any other Westerner, what must be going through his mind now?''. Kissinger replied in his distinctive, gravelly voice that Putin believed Ukraine was ''...a dress rehearsal for what America wants to do in Moscow: regime change.''

**Slide 4:**

**World Continents and Regions**


The rise of China, the abundant resources possessed by Russia, the ever-strengthening ties between the two countries, the development of the BRICS own Development Bank, followed by China's announcement of the One Belt One Road project and finally the announcement of the Asian Infrastructure Investment Bank has fully alerted Washington to the risk that the formation of a powerful group of countries largely based in Asia could emerge as a serious competitor to America's global hegemony. Mackinder's dictum may well become reality unless America can find a way to stop it.

**Slide 5:**

**China's New Silk Road: Overland and on The Sea**

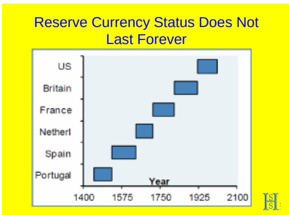

Picture the riches contained within the huge landmass that stretches from the eastern coast of China through central Asia enveloping India, Pakistan, Iran and even perhaps Greece and ends on the doorstep of Western Europe. If that group of countries can coalesce step-by-step into a united trade and financial unit it would emerge as a powerful competitor to America's global hegemony.

Today it accounts for almost 30% of global GDP, 45% of its population and holds almost half of the world's foreign exchange reserves.

Moreover, the group's GDP has grown by an average of close to 7% a year since 2009 whilst OECD countries have grown by just 2%. This group's growth is on course to surpass that of the western world in the not-too-distant future and should surpass the total combined GDP of the USA, Germany, France, Italy and Canada by 2020 according to a UN report.

**Slide 6:**

**Reserve Currency Status Does Not Last Forever**




Empires like reserve currencies don't last forever. Economic power, innovation and strong governments backed with military might form the backbone of empires. Nations move inexorably from The Age of Conquest to the Age of Affluence, when the soft underbelly of an empire overstretched and riddled with greed, laziness, corruption and rising debt becomes its fatal weakness. It has been true of every empire from the Persians to Portugal and Britain but these declines are not sudden and rarely happen overnight. It seems to us that America is fast reaching that point if it has not already done so.

**Slide 7:**

**Currency Debasement**


The first sign of a fading empire is a government consistently spending more than it earns – a process which begins the debasement of its currency. The debasement of the dollar by the United States bears a remarkable resemblance to how the Romans debased the silver content of their coins.

Since 2006, based on Federal Reserve Flow of Funds data, US government outlays have been $6.7 trillion more than the revenue it has generated. Its on-balance sheet debt is $21.7 trillion but when the government's unfunded liabilities are added, the total reaches a staggering $68 trillion compared with a GDP of 'just' $17.4 trillion.

**Slide 8:**

**The Petro-dollar is Being Decimated**


One of Kissinger's most brilliant moves was the creation of the Petro-dollar in 1973 which he achieved by persuading Saudi Arabia and the other Gulf producers to sell oil only for US dollars. This enabled the USA to finance its deficits through oil revenues being forced to be recycled through the US system. It also gave America 40 years of global financial domination. This was the real driving force behind America's conflicts with Iraq, Iran and Libya as all three countries had threatened to sell oil for other currencies.

Now, of course Iran, Russia, Syria, Nigeria and others are so doing. Others, including Saudi Arabia, are likely to follow suit. China will have an oil platform in the Shanghai Free Trade Zone which will start trading by year-end and the commodity will be priced in both dollars and Yuan. They will also establish a gold trading platform in the Zone with quotes available in both currencies. Crucially, this development will establish a globally-accepted quote for both oil and gold in Yuan – a precursor to the Yuan assuming the key pricing role for many commodities currently priced in dollars. Trial runs have, we believe, already taken place. China is the largest producer and consumer of a number of these commodities, but has limited pricing power: that is about to change.

The ramifications of the demise of the Petro-dollar cannot be overstated. America's influence in the Middle East will wane; America will no longer be able to depend on a steady inflow of dollars to finance its deficits; and its ability to dominate the global financial system will be weakened irreparably in the years ahead.

On the other side of the coin, China is internationalising its currency with more than thirty countries having negotiated Yuan swap agreements. Moreover China is establishing its own CHIPS payment system which will bypass America's which should be operational by year-end. Zurich, so we understand, has been made a major Yuan payment centre from where Saudi Arabia's oil sales to China will be made in due course but, importantly, these transactions will not be conducted in US dollars.

In fact, it is likely that one of the key reasons the Swiss National Bank broke its peg to the euro was to begin the process of turning its back on the Fiat currency world and shifting its focus eastward.

Indeed, I hear that Russia is considering issuing Russian state debt in Chinese Yuan, a move which would signify a further shift away from the US sphere of influence and towards an even closer alliance with China.

Ten years ago 90% of world reserves consisted of dollar-denominated securities. That figure has already shrunk to 60% and the pace of that decline is set to accelerate rapidly. China is opening up its capital account and will make its currency, at least partially convertible by the end of this year.

The deputy director of the Shanghai branch of the People's Bank of China is on record as having said that he expects the Yuan to be freely convertible soon in their Free Trade Zone.

The result of these moves will be a huge increase in trade payments being made in Yuan as well as vastly inflating both inflows and outflows of RMB. At the same time China is reforming its financial system and, in the process, deepening its bond market.

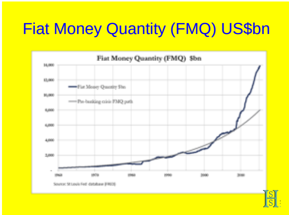
**Slide 9:**

**Shanghai Cooperation Organisation**


Our group of countries built around the BRICS and SCO no longer wants a world which has Washington as its axis, but, rather, a multipolar one. They don't want a reserve currency that favours only the USA, leaving the rest of the world carrying the burden of a declining asset. Because it lives far beyond its means – and has probably sold or leased most of its gold reserves – the United States has been forced to embrace a purely 'Fiat' currency system – a system in which currencies are nothing more than an entry on a computer and, as such, are not backed with anything of real value. In so doing they have dragged the rest of the world along with them.

**Slide 10:**

**Fiat Money Quantity (FMQ) US$bn**




Fiat currency excesses have been measured by Alasdair Macleod of Gold Money in compiling his FMQ, or Fiat Money Quantity, which is the sum of True Money Supply (TMS), as defined by adherents of the Austrian school of economics, plus total reserves less vault cash plus reverse repos.

The FMQ gives us a far better understanding of the risks to which a currency may be exposed from a loss of confidence. In the case of the US dollar this risk is accelerating. Should there be a loss of confidence in the dollar it would spread rapidly to other Fiat currencies. The FMQ now stands at almost $14bn - roughly $6bn above the pre-Lehman crisis level of 2007.

This development brings us to another factor in the growing division between the world led by the USA and that of the Sino-Russian axis centred on the BRICS and the SCO. This block does not want its monetary policies dominated by a fiat currency model but rather one based on sound money. As Alan Greenspan said last October '' Gold is a currency. It is still by all evidence the premier currency where no fiat currency including the dollar can match it''. This is one of the key reasons why both your country and China, amongst others, are active buyers of gold.

**Slide 11:**

**Simplified Gold Supply 1983-2002**

Simplified Gold Supply 1983-2002

| | |
|---|---|
| Official sales by central banks | 4,856 |
| Estimated leasing in addition (Median est. Veneroso 2002) | 14,000 |
| Mine Production | 41,994 |
| Net western divestment: bullion, jewellery and scrap (est.) | 15,000 |
| **TOTAL** | **75,850** |
| | |
| Possibly bought by: | |
| Middle East governments and individuals | 30,000 |
| India | 7,000 |
| Turkey | 4,000 |
| SE Asia | 5,000 |
| China | 25,000 |
| Others | 4,850 |
| **TOTAL** | **75,850** |

Source: Alasdair Macleod

Alasdair also prepared an interesting paper on the quantity of gold which was likely accumulated by Asian and Middle Eastern countries in the years between 1983 and 2002.

The most striking revelation from this report is Alasdair's estimate as to the true amount of gold acquired by the Chinese during this period. From what we know China's central bank holds only a fraction of the total, the bulk being held by different ministries and the PLA with most warehoused in the State Reserve Warehouses and within the PLA system.

A story told to me by a senior Japanese industrialist whose company has several factories in China illustrates that China's gold reserves are very much higher than they admit:

As he told me ''I have to know a lot of very senior people one being a senior general''.

My friend was invited to PLA headquarters one afternoon for cocktails which began at 4pm. At 6pm the general tapped my friend on the shoulder saying 'Let's go for a walk'. They walked across the compound to a large warehouse. The doors were opened. There stacked from floor to ceiling were bars of gold.

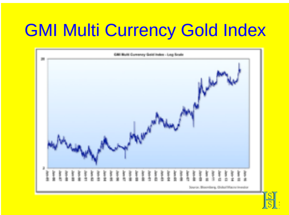
According to Alasdair's estimate, rather than the official figure of 1,054 tonnes, China's actual gold holdings are possibly in excess of 30,000 tonnes and were initially bought as a hedge against their dollar-based US Treasury holdings.

All other SCO members and prospective members have a similar preference for gold as opposed to fiat currencies and THIS is the line along which the world will be divided; the fiat money block and the group of countries whose currencies will be backed by gold.

Sometime within the next five years China will link its currency to gold. One way this might happen is that Gold Trade Notes will be introduced. These will be nothing more than Letters of Credit and, to speculate could potentially be interchangeable with the Yuan. It is possible also that the BRICS Development Bank one day will issue its own gold-backed currency. Meanwhile we hear that China is also offering gold-backed bonds to a few countries.

**Slide 12:**

**GMI Multi Currency Gold Index**




My friend Raoul Pal, author of The Global Macro Investor, was the co-manager of the GLG Global Macro Fund in London prior to starting his research service in 2004. A couple of months ago, Raoul created a gold index price versus an equally weighted basket of 25 currencies. He felt it was important to know the real value of gold not just in US dollar terms but in the event that gold would be viewed as a global currency.

The results astounded if not shocked him. Since 1990 gold has outperformed the basket of 25 currencies by 640%. This proves that gold is doing its job of maintaining its real value by offsetting global inflation.

More recently China has announced the establishment of a $16bn gold fund – a fund whose aims do not stop at buying purely physical gold, but also gold in the ground. In other words, gold deposits will be bought which will deliver an ongoing stream of physical gold to countries along the One Belt One Road highway.

What does this mean? First, we need to look at what China is trying to do by insisting that its currency be introduced into the IMF Special Drawing Rights (SDR) and that the BRICS members be given a larger share of the voting rights. This key proposal was first introduced in 2010 and was accepted by all member countries on the IMF Board – all, that is, with the notable exception of the United States. Eventually, China and the others gave America a deadline of January 2015 to approve the resolution. Perhaps unsurprisingly, given the wider implications I have laid out for you today, America dug in its heels and refused to cooperate.

The resolution will once more come before the IMF board at its autumn meeting this year. America and Japan have 23.3% of the votes between them but the Chinese are playing hardball– essentially warning the other voting nations that if they fail to vote with China, that decision will be taken into consideration going forward.

**Slide 13:**

**US Dollar Index**

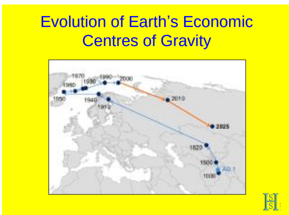

In spite of American objections the resolution is likely to be passed. In that event central banks and financial institutions will have to sell dollars to make way for the Yuan in their portfolios.

If the resolution does not get passed due to America's allies banding together to block the proposal, then both trust in, and support for the US dollar will be diminished. Either way, this suggests that the second half of 2015 will be characterized by the selling of the US dollar by multiple central banks around the world.

Our technical associate WaveTrack International has been very accurate on the US dollar index. The chart above tells its own story.

**Slide 14:**

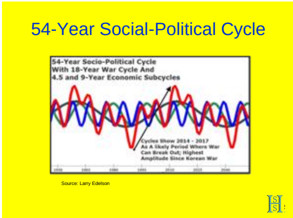
**Evolution of Earth's Economic Centres of Gravity**




The tensions between those wanting to retain a fiat currency system and those wanting a monetary system built on sound monetary foundations are just one part of a world being torn into two structures. History shows clearly that America's global hegemony is drawing to a close. But empires seldom fail without a fight or without a crisis.

**Slide 15:**

**54-Year Social-Political Cycle**




Our hope is that this transition can be managed with the minimum of conflict, though history shows that such a benign outcome is sadly unlikely. Based on a thousand year war cycle, the world currently finds itself at the highest amplitude for conflict since the Korean War over 50 years ago.

America sees clearly that its domination of the world is at risk. Like most empires before it – with Great Britain being the exception as its government negotiated its exit with India and other Commonwealth countries relatively peacefully– military force was used to maintain the empire. Notably, all failed.

**Slide 16:**

**US Military Presence Overseas**


The American empire encompasses more than 700 military bases in over 120 foreign countries. ''We cannot talk about fiscal responsibility while spending trillions on occupying and bullying the rest of the world and we cannot talk about a budget deficit and spiralling domestic spending without looking at the costs of maintaining an American empire...'' wrote Senator Ron Paul.

**Slide 17:**

**NATO Expansion**


NATO has broken its agreement with Russia by expanding its membership into Eastern Europe and deploying missile sites. Russia feels hemmed in and so does China.

**Slide 18:**

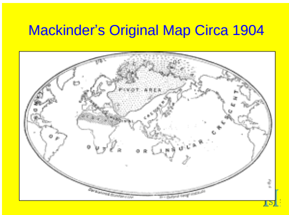
**US Strategic Encirclement of China in Eurasia**


China fears that America is attempting to encircle and thus contain its growth and expansion. Dai Xu, a well known military strategist wrote, ‘’China is in a cement shaped ring of encirclement. The ring begins in Japan, stretches through nations in the South China Sea to India and ends in Afghanistan. Washington’s deployment of anti-missile systems around China’s periphery forms a crescent shaped encirclement.”

Is it any wonder that China is retaliating by constructing runways and support infrastructure on reefs in the South China Sea or that Russia is rebuilding its military forces? Both countries would be foolish if they were not adopting contingency plans given America’s intransigence.

**Slide 19:**

**Mackinder’s Original Map Circa 1904**




So far our story sets out how the world risks being torn into two camps but there is another twist that one day - perhaps within five years - may emerge.

To understand this, we return to Mackinder’s original thesis.

Just outside the Heartland itself he placed Germany, Austria, Turkey, India, China, the Middle East and Southeast Asia as the countries most crucial to the Heartland.

India and China are already part of our group of countries and, given the fact that Saudi Arabia’s new king considers America to have broken two important strategic agreements between them and that America is negotiating with Iran, it is highly likely that the Kingdom will fall into our group of countries quite soon.

Let’s not forget that Saudi’s future oil sales will be eastwards.

The interesting question is what will happen to the two European countries on that list.

Both Germany and Austria are under the American umbrella but both have had substantial trade links with Russia and China. As their governments look to the future, it is abundantly clear that, from a business standpoint, their future lies eastwards. Germany's exports to Russia and China accounted for over 9% of its total compared with 8.5% to the USA last year. Guess where the growth will be fastest in future years.

However, politically-speaking, both are bound under the American umbrella. Exiting the umbrella will be tempestuous. Our sense is that the countries' ties with America are weakening. Within some of the EU's political elite there is a growing frustration that America is drawing the EU into a crusade against Russia which is not in the best interests of the EU. If continued there are bound to be unintended consequences which would have a compounding negative impact on the EU's trade and finance. Already companies such as Siemens and Alsthom have lost contracts in Russia.

If our scenario unfolds correctly then, very quietly Germany, followed by France and Italy, will move into the Sino-Russian axis.

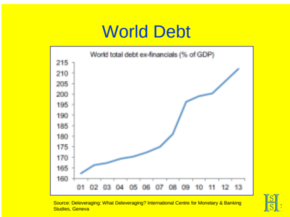
At that point, the Eurasian world which Mackinder envisioned as far back as 1904 will have finally materialized.

Rest assured, however, that America will do its utmost to prevent this goal from being achieved.

Within the geopolitical imbalances of the world lies the huge problem of the creaking global financial system.

**Slide 20:**

**World Debt**




Global debt is three times that of global GDP and continuing to rise faster than world output. Under the auspices of the Bank for International Settlements (BIS) central banks have been creating serial bubbles across most asset classes with the commodity complex the last likely to be so influenced. The rationale behind this is that governments are incapable of cutting back on the promises they have made to their electorates over the intervening years. Thus, it has been left to the monetary authorities to create a crisis environment out of which a restructuring of the financial system can be achieved.

That crisis is likely to start this autumn, around the time of the crucial annual meetings of the IMF and World Bank.

Let's now look at a few of the key developments that may well evolve over the coming two years.

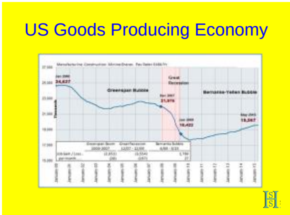
Slide 21:

**US Labour Participation Rate**


First the US economy is not nearly as robust as many of the government statistics would have you believe. In fact it is decidedly weak. Many of the government statisticians have used sleight-of-hand and dubious methodology to show them in the best possible light. Furthermore Wall Street wants the bull market to continue so many analysts wear rose-tinted glasses when writing their research reports. The labour statistics are just one example.

Slide 22:

**US Goods Producing Economy**




In the most recent reported data for May the entire goods producing sector – construction, mining and energy – saw a reported gain of just 2%. Employment in this productive sector has been shrinking for 15 years and is 11% below its pre-recession level. Instead, growth is being experienced in the part-time sector where pay is well under $25,000 a year – hardly enough to survive on.

Slide 23:

**Full Time Employment to Population Ratio**


The proof is in the pudding: as of May this year the ratio of full-time jobs to the adult working-age population remains lower than it was at the bottom of the 1990-1991 recession.

**Slide 24:**

**ISM vs US GDP**


This slide is once again courtesy of Raoul Pal and it shows that the US economy finds itself at the start of a downtrend which we believe will accelerate in the second half of 2015.

By the autumn we could well hear chatter about QE4.

One reason why the US economy will continue to weaken, along with those of Europe and Japan, is that China's real economy is likely to soften even more.

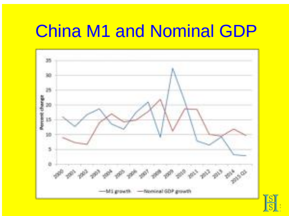
China's leadership is putting the country onto a long-term more sustainable growth path. This means the introduction of significant financial reforms and the restructuring of industry where surplus capacity is endemic in every sector and sub-sector. This surplus capacity results in there being no pricing power and thus an inability to earn real profits. The process of restructuring has begun but will accelerate in the second half implying that exports into China from Europe, America, S Korea, Japan and so on will slow.

The recently announced May import data so far confirms our observation.

Foreign banks have an exposure to corporate China of around $800bn. As bankruptcies multiply stress will be experienced within these banks.

**Slide 25:**

**China M1 and Nominal GDP**

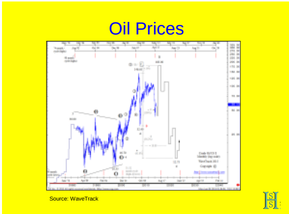



Under normal circumstances, M1 ought to correlate tightly with nominal GDP – as it did from 2003 to 2008. Since then, however, the two have diverged remarkably. M1 rose by 5.4% last year close to our estimate of China's GDP of 5% and in the first four months of this year M1 rose by around 3.5%. We expect China's real GDP to be no higher this year than last.

Third, as we have discussed, the dollar will be falling. The Fed will be unable to raise interest rates and with the chatter of QE4 starting to circulate, along with the BOJ likely being forced to introduce yet more monetary stimulus together with the ECB pursuing its own loose monetary tactics, investors will be looking for places to hide. After a summer sell-off in equity markets investors will go back into stocks and into the unloved commodity complex.

**Slide 26:**

**Oil Prices**




A falling dollar will first support the commodity complex. Moreover, as part of its dollar diversification policy, China is likely to import key commodities not only for current consumption but for inventory also.

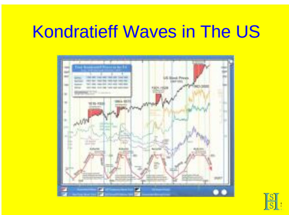
In recent weeks Treasury yields have risen to new recovery highs and Treasury bond prices versus commodities are on the verge of breaking down. This is highly significant and has not been seen since 2009. The move could be heralding a significant and important shift in capital flows from deflation models to inflation ones.

Finally, and rather ominously, perhaps, we expect the situation in the Middle East to deteriorate significantly. With Saudi Arabia's indiscriminate bombing of the Houtis in Yemen, we are very likely to see retaliation which has the potential to put their oil fields at risk. Should our forecast be correct, the outcome will shock Washington and the oil bears.

Rising oil prices will be the tipping point, erasing fears of deflation and focusing investors' minds on the dangers of inflation. Investors will start desiring physical assets in order to diversify away from purely paper assets. Some large institutions will begin buying metals like copper, warehousing the stocks outside the reporting system. Prices will then repeat the experiences of 2009-2012 years.

**Slide 27:**

**Kondratieff Wave**




But this will only be a short-term upward move. The inflation pop will be the last throw of the dice before the system collapses probably originating in the derivative complex.

By the second half of 2016 global financial markets and the world economy will be falling rapidly. Real deflation of assets will be experienced as Kondratieff's deep winter sets in.

Sometime in the period 2018-2020 spring will begin to arrive, offering the potential of a generation or more of sustainable debt-free growth as spring moves into summer. The path between now and then, however, will be fraught.

The outcome depends largely on political decisions taken in Washington. Neither China nor Russia want conflict but both want a multipolar world order in our view. If the US administration continues to demonstrate its desire to retain its global hegemony despite the rising financial and economic power of other countries then tensions will multiply.

If reason and common sense prevail through continuous inter-governmental discussions, as occurred during the Cold War, the result will be a multipolar world bringing peace and goodwill.

**Slide 28:**

**Thank you**


In conclusion I apologise for ending on such a dismal note but what I have set out is a snapshot of the real world not that dreamed up by the financial wizards of Wall Street or the City of London.

So I thank you for your patience in hearing me out and I will be happy to try and answer any questions.