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COMMENT

Farewell to all the Emperors

Let's see. Markets (stocks and commodities) rally from horrible lows of March 2009. Most economists switch the party line from "end of the world" to "recovery." By year-end smugness has returned. There was even a consensus that interest rates will have to move higher. Almost nobody accepts our view that the rally represented a flight out of money. Rather it is/was seen as a harbinger of economic recovery.

And now, moving into February 2010, the music has changed. The economy, particularly the Western economy, doesn't look so hot. The weak credits look weaker and even the strong credits (a bit of an oxymoron) look dodgy. Stocks and commodities get hammered for a few days. Led by the Europeans, the concept of competitive devaluation is digging in. And, once again, we are being duped into the idea that US paper represents safety.

A lower Euro will, to a small degree, help bail out the Club Med countries and also help the Germans, who will have to do the serious bailing, to sell more cars. But the lower Euro doesn't help the US which, God knows, has its well-documented problems. And whither Canada? For months the investment community (not us) has seen Canada (and/or the loonie) as some sort of resource-driven wunderkind. But in reality Canada is a tired old country with no gold reserves, an overpriced currency, the first trade deficit in decades, and industry (such as remains) in distress. Now the bloom is off metals and budget deficits (provincial and federal) are collectively at Club Med levels. The strength in the loonie over the past six months has resulted strictly from currency speculation. The denouement will be dramatic because optimism has been so universal.

G7 Finance ministers recently met in Canada and concluded that they had better keep their collective foot on the gas. They really have no choice. It is absurd to think that Greece, Spain, the UK, Ontario, California, the US or anybody else is going to solve its problems through austerity. A lot of economists think governments should start to tighten, but under current circumstances that would only lead to civil unrest and African levels of unemployment throughout the Western world. The chickens are coming home to roost; there is only one way out. The G7 has become a colossal Enron.

OK. It is easy to criticize. Let's be constructive. Ideally, to solve our problems we must focus on creating, instead of consuming, wealth. To do that, it would be preferable to start with solid money, respected by all, with no special privileges for one currency (or big trading bloc) over another. Businesses should have a level, well-defined, playing field. Unfortunately, that's a dream at the moment.

To move forward we must first look back. For centuries money was metallic. People moved sacks of gold back and forth from Venice, Frankfurt, Amsterdam, London and so on. Caravans carried the stuff from Ashanti and treasure ships carried it from Cartagena. Marco Polo took gold east to China and spices west along the Silk Road. Much later Charles XII of Sweden crossed most of Russia with a good chunk of Sweden's treasury in his saddle bags. All very cumbersome. The Dutch and the English created what became modern banking in the late seventeenth century and this led to the gold standard in which paper money was issued with the condition that it could be converted into gold at the Central bank doing the issuing. There were many attempts to circumvent the rules and their inherent discipline, such as John Law's Banque Royale in 1720 and the Confederate states during the American Civil War, but these currencies all went to zero. Countries pretty well had to "pay as you go" and banks like Rothschild and Barings became well established by lending money to various kings for their wars.

World War I saw the beginning of the end of the gold standard. Crowned heads disappeared and countries learned to print to finance the war in expectation of juicy reparations to the winners. Europe self-destructed during WW I but America came of age. True believers in the gold standard, the US amassed more than half the world's gold and built Fort Knox in 1937 to hold it. If you owed America money, you coughed up gold. WW II was another catastrophe. Again all the players both borrowed and printed to finance it and the US acquired even more gold.

Emergence from WW II required another monetary system and the Americans and the British cooked up the Bretton Woods system in which most of the world's major currencies were convertible at set rates into the dollar and countries could convert surplus dollars into gold at $35. The gold standard became a gold/dollar

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exchange standard which conferred huge benefits on the US. The dollar became the world's reserve currency and the US could enjoy seigneurage – it could finance foreign aid, wars (Korea, Vietnam), a military/industrial complex, purchases of foreign companies and God knows what else by merely printing. However, this undermined the integrity (gold backing) of the dollar. Big European countries converted (while they could) surplus dollars into gold and, later, the US, Canada and many other countries sold over 100 million ounces into the market (at $35) to keep the price from moving up and thereby maintain the charade that the dollar was as good as gold. When Fort Knox holdings had fallen to 300 million ounces (half the peak) in the late 1960s and early 1970s, the system was blown up.*

This left us with a pure dollar standard, floating exchange rates and no discipline. The US and everybody else have spent the past forty years printing ever more, ever more. Trillions for Iraq, trillions for the banks, trillions for lower taxes, trillions for the good life for the chosen few, and who is left holding the bag? The bag, incidentally, is tens of trillions of dollars, Euros, Yen and so on convertible into nothing. And this situation has been brought upon us with the blessing of all the great minds of our era – they make John Law look like a pillar of financial sobriety. But markets are telling us that the dollar (and the Euro) era is over.

During the recent Davos conference an important European head of state suggested a need for another Bretton Woods. But does he mean conference or deal? We need a monetary system, but there is not a scrap of evidence that the major powers will submit to a scrap of discipline. The US will not, cannot, return to Bretton Woods. Nobody wants to have the responsibility, or to delegate the responsibility, for providing a cornerstone for a monetary system. And, as always, policy makers still resent gold (its re-emergence must drive them wild) since the discipline of gold eliminates all the privileges described above.

So the first prerequisite for bailing ourselves out of the current mess, sound money, is going to be elusive. Policy makers don't appear to be even thinking about it. The same tribe of mandarins, perhaps symbolized by Mr Volcker (who is still advising the White House), continue to call the shots. They have orchestrated the sale of well over 300 million ounces of gold since the demise of Bretton Woods, with the idea of somehow enhancing the dollar and other currencies, and it will take a few crises before these people face the music. Or are replaced.

The changes in 1970 caught markets entirely by surprise but then the US had far more clout than today. Then it set policy, today nobody sets policy. What can Mr Volcker do now except watch? Even Europe's Monsieur Trichet seems to have lost some of his "we know best" veneer.

Our best guess is that markets, not policy makers, will determine the next monetary system. And, as much for lack of alternatives as the traditional reasons, gold will be somehow involved. Meanwhile markets will be characterized by volatility, defaults, lots of uncertainty and a rush for the hard stuff. Before they get around to a monetary system, governments will wake up to the need for wealth creation and, since the quick fix for wealth creation is competitive devaluation, we expect governments to get at it with vigour. Shades of the 1930s.

In the 1930s the US could, and did, exhibit leadership and deal from strength, whereas today Fort Knox has been depleted, probably mortgaged, and the nation is broke and riven with divisions. Pretty chaotic conditions and a backdrop to pretty volatile markets that will have dramatic ups and scary downs.

* According to Treaster's "Paul Volcker: The Making of a Financial Legend," Volcker, as Treasury undersecretary for monetary affairs, "devised a strategy for breaking the linkage of the dollar to gold" in 1971. The strategy was simply "breaking the [Bretton Woods] deal." Walking away from the obligations. And telling the world that gold was demonetized.

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