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Led by donkeys

"How can we have this idea that Scots are thrifty and good with financial management ?"

- Comment on The Daily Telegraph's website following news that Gordon Brown has been ordered to release information about his controversial decision to sell Britain's gold reserves when Chancellor. The writer may also have been thinking about the collapse of the Royal Bank of Scotland and Halifax Bank of Scotland and Sir Fred Goodwin..

Writing in the Financial Times, Martin Wolf suggests that the financial and economic crisis has inflicted huge damage on the reputations of Britain's two most significant recent political leaders, Margaret Thatcher and Tony Blair. That rather presupposes that the latter has any positive reputation left to defend. Not just within the confines of the UK but internationally, the reputation of politicians has probably never been lower. Forget the tawdry British expenses scandal, though that is bad enough; there is a more fundamental problem with our polity, and it is not just an alarming and justified lack of trust. Governments throughout the West have proven themselves functionally unable to steward their nations' finances. Labour had already made the forced redistribution of wealth from rich to "poor" a core component of its policy since election in 1997 (the net income gain for the poorest decile in the UK has been 12%; the net income loss for the most affluent decile has been 15%. But poverty has now become an entirely relative rather than an absolute concept, defined as a level of household income below 60% of the median income, thus ensuring that within a socialist culture, the poor will *always* be with us, at least statistically if not in fact, no matter how affluent our society becomes as a whole. That culture bears the seeds of its own ultimate collapse; as Margaret Thatcher is rumoured to have said, the problem with socialism is that eventually you run out of other people's money.) The more recent redistribution of the nation's resources from taxpayers to banking interests, while comparably involuntary, revealed just how much government was in thrall to the banking lobby, but it was hardly restricted to the UK alone. The problem may be rooted in the structure of the modern democratic system, in which the electorate increasingly and inevitably votes for putative self-enrichment (call it bread and circuses, if you will) as opposed to sustainable and productive national investment. In the words of Hans-Hermann Hoppe's book, democracy is the god that failed.

But then we are living through a period extraordinary for the failure of so many previously unchallenged wisdoms and almost religious beliefs. Faith in the free market has taken a severe if not fatal beating. That may be unfair: because the circumscribed circus in which today's investors perform, and in which yesterday's banks took the global financial system to the brink, was and is pretty far from being a free market. Now the price of money itself is essentially dictated by government fiat (at roughly zero, which would logically, ultimately, lead to some form of wealth-destroying inflationary inferno); money as a medium of exchange and unit of account is backed by nothing other than fast-depreciating political promises (whether it even qualifies as any form of store of value is up to the reader, if not to the market in gold); half of the West's banks are government owned, if not government directed; there are ominous and growing signs of further overly intrusive regulation of any private entities not supportive of whatever it is that Europe's crisis-afflicted governments think they are doing with their creaking balance sheets.

It feels, in short, like something akin to a phoney war. Just as with the slow deterioration in the health of the Western banking systems in 2007 and 2008, we are seeing isolated pockets of collapse or near-collapse (Iceland; Dubai; Greece..) punctuated by official statements from the likes of the EU that all is well and that the storm will soon blow over. The essential difference is that this time round, the problem is set in at a sovereign as opposed to private sector level. Unless we come to quickly colonise the solar system, there is no greater stage for the credit rot to migrate toward. We are already close to some kind of end-game. Awkwardly for our political "leaders", they are running out of ammunition. Short term interest rates rest at rock bottom. They cannot go any lower. Government finances are already hopelessly strained; they cannot be extended indefinitely. Future taxpayers have already been dreadfully mugged; all that remains is for them to wake up to the fact. Needless to say, few political parties or politicians are willing to make the extent of the pain to come remotely obvious or transparent. This past week's UK Budget was a masterpiece of sleight-of-hand. No real hint of the heaviness of the axe to come. And the grotesque indebtedness of the government was portrayed as a glowing improvement in deficit finance. *The budget deficit was £11 billion better than expected*. What about the absolute level of that deficit, a figure amounting to some £167 billion ? We may or may not be lions, but we are certainly being led by donkeys.

And yet still the debate goes on: are we and our portfolios to be chilled by deflationary ice, or uncomfortably overheated by inflationary fire ? Or do we get both ? The conventional economic response has it that deflationary forces win out in the short term. But that takes no real account of the fast collapse of faith in either the stability of the government bond market (just about everywhere in the G8 economies) or in the sanctity and stability of exchange rates (ditto). Politicians may be overly reliant on an outdated perception of national boundaries and interests. In a globalised world, nationality is moot (and in a world of competitive currency devaluations, or calculated depreciations, everyone is selling their currency – but who and where are the buyers ?) In a globalised world, national boundaries are also porous, so if you lean too heavily on the rich, you run the risk of sending them off to seek protection from your depredations within another, largely arbitrary, national border. (But the globalised world can also be switched off, if those nations most in denial about the gravity of their mauled government finances insist on igniting a trade war they cannot possibly win.)

Never slow to identify a scapegoat, the political classes have been making hay from the reversal of fortunes incurred by the banks and their employees. Other than through the venal accomplishments of the banking lobby, however, bankers do not dictate government policy – politicians do. We will not see a credible platform on which to rebuild our sovereign and individual fortunes until our politicians start displaying a little more honesty about the fiscal reality and, in truth, a greater willingness to abandon narrowly partisan leanings in favour of the national interest. This is not a uniquely British problem. As Oaktree Capital Management's Howard Marks recently wrote, citing Jackie Calmes in The New York Times:

"..rarely has the political system seemed more polarized and less able to solve big problems that involve trust, tough choices and little or no short-term gain. The main urgency for both parties [in the US] seems to be about pinning blame on the other, before November's elections, for budget deficits now averaging $1 trillion a year, the largest since World War II relative to the size of the economy."

Marks also cited former Republican Senate leader Alan Simpson:

"There isn't a single sitting member of Congress – not one – that doesn't know exactly where we're headed. And to use the politics of fear and division and hate on each other – we are at a point right now where it doesn't make a damn whether you're a Democrat or a Republican if you've forgotten you're an American."

Change in the political system is always possible. But we're not holding our breath. Until we see evidence of tangible improvement in the transparency, maturity and integrity of our politicians, not least those responsible for the exchequer we will, as far as possible and practicable, be moving capital away from their malign influence to appropriate, distort or devalue it. Inasmuch as bonds of any form make sense in light of the monstrous government debt mountain that politicians will be naturally keen to inflate away, they should comprise solely bonds from those countries best placed to repay their debts. (The shortlist includes neither the UK nor the US, but it does include the path less travelled of those countries that do actually maintain a surplus of foreign assets relative to GDP.) More to the point, the go-to asset that is beholden to no politician or counterparty and that offers a plausible protection against both inflation and – conceivably – deflation is, of course, gold. When the sceptics warn you of an incipient or even late stage bubble in the price of gold, ask them what they think their dollars, pounds sterling or euros are really worth, and what they can possibly protect you against.

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