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A PERSONAL VIEW FROM PETER BENNETT

STRATEGY 2013 – PART III

In thrall to some defunct economic theory ...
Keynes, or words to that effect (taking up from last bulletin)

Keynes referred to each new generation of financial thinking as being typically in thrall to some previous investment wisdom. In the military we called it planning to fight the last war.

By the way, anyone remember Gordon Pepper? Briefly master of the UK financial analytical universe. Quite early in the Thatcher regime his every utterance – as a religiously certain anti-Keynsian monetarist through and through – was awaited with bated breath in the financial community, as if the Pope or a deity had spoken. This resulted from the complete discrediting of faux Keynesianism by the end of the 1970s. Jim Callaghan was PM and leader of the Labour Party, in whose genes runs – per all left-wing outfits – the addiction to spending other people's money or borrowing so to spend (well, heck, you buy yourself a few 'client' votes. That hasn't changed.)

Even he stated that borrow and spend, by governments, beyond modest levels, was counter-productive. It is hard to exaggerate the degree of contempt in which faux Keynesianism was then held. I was in fact 'brought up' on Keynes in Economics Part 1 at Cambridge – so many years ago I can barely count them. He was the hero who overrode so-called sterile then conventional economic theory which stated that left alone the economy sorted itself out from a downturn. 'Demand' would automatically rise. (Actually, given the attitude of the modern consumer, that theory may in fact be valid in today's culture.)

Indeed, Lord Keynes did recommend borrowing by the government in certain circumstances, per recent bulletin. But he made those comments in an era where, bar during wars, the government was a tiny part of the economy, unencumbered by the pre-existing mountains of debt that the modern politico-economy has brought about. I agreed with him then. And I agree with him now – where he was quite clear that adding to a mountainously high existing level of government borrowing would end up producing inflation – not the desired economic rebalancing.

His theory is currently completely traduced by well-known commentators who should know better.

This time, we have mountainous total economy debt in the debtor nations. There is no historically approved theory as to how to deal with such a situation. It has never previously existed. It is both irrelevant and wrong to drag Keynes' 'borrowing' theory into the current debate.

Keynes was suggesting relevant and correct policy for the 1930s. But note – a reminder from my bulletin (of several years ago) on the Great Depression – contrary to folklore, Roosevelt's fiscal intervention in the US economy was no miracle cure. Henry Morgenthau, his Treasury Secretary, suggested all his fiscal tinkering actually produced no net benefit. Folklore is just that. The US did not, in fact, put Keynes' fiscal ideas to the test. Devaluing against gold certainly did help. Inter alia it ramped up inflation for a while – which hugely helped debtors. These things are not as simple as they seem to those who rely on folklore.

By Mrs Thatcher's time, the then existing financial gospel had been stood on its head. The pre-war deflation problem had metamorphosed into an inflation one. Step forward Milton Friedman. His line: fiscal manipulation has proved a disaster. Inflation is everywhere and every time a monetary phenomenon. If we get the inflation right all will be well. The UK flag-carrying acolyte of Mr Friedman was Gordon Pepper (of then stockbroker Greenwells. This was a fine firm that, like most others, disappeared after 'Big Bang', courtesy of the American invasion and subsequent cultural carnage. This ensured the root and branch destruction of businesses that had been conducted reasonably successfully for a grillion years. Oh, and thanks for the replacements, fellas! Look where those prats have got us.).

This 'monetarism' soon became an exercise in counting angels on the head of a pin. In the event, consumer inflation was reined in – but the clever, clever boys forgot that controlling consumer inflation does not prevent dangerous asset inflation. I pointed this out at the time. Of course, no-one listens to a Cassandra in such matters. For it is surely a pleasurable feeling for many to sit on their backsides whilst portfolio / house values rocket – and you can borrow to the nth degree to consume. Aren't you a genius? Inflation was the demon and monetarism had slain it. This was the new gospel, according to St Milton. It was the answer to our problems. But, like faux Keynesianism, it was not and is not. The problem has metamorphosed into how to get rid of the debt. Not inflation (yet). What narrow monetarism did help achieve was the destructive volcanic asset inflation. Acolytes forgot – as I also pointed out at the time – that asset inflation is more pernicious and harder to deal with than bog standard consumer inflation. This is dealt with via a brief 'squeeze'. In fact, as in reality practised, this monetarism was as 'faux' as the previous Keynesianism. (I won't bore you explaining that line of argument.) And I have no idea what happened to the good Mr Pepper.

So now we have two 'defuncts' battling it out – faux Keynesianism and faux monetarism. There are also austeritists – trying directly to address government debt, without at the same time undermining economic activity in such a way that the welfare budget goes up; the tax take down and, hey presto, the rapacious jaws of the deficit remain open like a hungry crocodile seeking insatiable gobbling.

We can see in peripheral Europe what a catastrophe relying on austerity more or less alone has caused. The authorities are truly mad. But as the peripherals apparently still regard staying in the euro as religion, there is little to be done. As I have said, taking 'Europe' as a whole there is no deficit with the world. There is accumulated debt as well as intra-Europe imbalance. The external deficits of the peripherals are improving sharply as 'costs' come down e.g. the economies are massacred by the euro-fetish. Imports have collapsed. As Wolfgang Munchau, who writes a superb column in the FT on Mondays, suggests, - the attempted fiscal pact (deficit control) is a solution in search of a problem. There is no overall "deficit".

Impasse

So we are stuck with entrenched positions, based on economic theories which became part of financial folklore, because they had appeared (note "appeared") to solve a specific set of problems at the time. That they arguably, in any satisfactory sense, didn't, doesn't bother their proponents.

Debt – Again

I have bored for England, nay, the world on this. But the fact is that debt remains the problem. (Absent a good dose of inflation, which would rob one section of society to bail out another. But you can say that's happening already.)

I show yet another example of a country with such a problem that bit the bullet. Terry Smith, writing in the Daily Mail, pointed out Estonia. It had run up private sector debt of 100 % of GDP by 2007 and ran a current account deficit of 18 % of GDP. Public spending was cut by 8 %; state payments to pensions were frozen; taxes were raised.

Sure, GDP fell 4.2 % in 2008; 14.1 % in 2009. No debtor nation political leader is likely voluntarily to accept this. But involuntarily? (Estonia more or less had no choice.) And now? The deficit is under 3 % of GDP. In 2010 the economy grew by 3.3 %. In 2011, by 8.3 %. An internationally well known economist and fully paid up member of the borrow, borrow, borrow, spend, spend, spend brigade has just pointed out that Estonia's GDP is still below its previous peak. This delusional fantasist (oops, economist) clearly thinks the 'peak' was for real instead of a chimera borrowed from future generations.

Remember too, Scandinavia, early 1990s. Banking crisis. The main banks were nationalized. The rubbish lending was put in one pot and dealt with by itself. 'Good' banks with cleaned up balance sheets were able to resume lending. What's wrong with that? Here the banks are paralysed. Ditto much of Europe. I know, they know, businessmen know, everyone knows, that they are not coming clean. They are up to their necks in ordure lending, 'amend and pretend' dodgy loans. Estimated 156,000 UK insolvent or near it businesses propped up, per a recent bulletin. The 'propping up' achieves exactly the opposite to what it seeks. The banks cannot in these circumstances do their normal job of lending for growth. (If they can't also do the casino stuff as well that's fine by me.)

Repeating, I have no clue how this will all work out – but mountains of likely insolvent European and UK banks, propped up by smoke and mirrors financial manipulation and stealing from the prudent to give to the profligate is not a good start. Nor a good message for the future.

Markets

All this dire stuff need not affect markets short-term. Indeed, the recognised complacency barometer (the VIX Index of option costs in the US) has fallen right back. Complacency again is rife despite the endless talk about the fiscal cliff. And, indeed, in the actual performance of markets bulls are running. The near future of the economies is near irrelevant to what happens in markets. Most people find this very hard to accept and deal with. But we must.

Good luck.

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