A View from the Trenches Toronto, Tuesday, September 22nd, 2009

Good morning,

A week ago, we went on record with our neutral call on equities (see www.sibileau.com/martin/2009/09/22). The three points we made played out as anticipated: Lack of clarity on exit strategies, dispersion in (global) monetary answers and political instability increasing. By now, both the first and last points should be self-explanatory (see: www.sibileau.com/2009/09/23). The second point, the dispersion in the monetary policy answers is the one that worries me the most. There will be an exit strategy and regardless of how difficult it may be to get clarity on it, eventually that clarity will come. There will be political instability, but it will only (for now at least) indirectly touch the markets. On Friday, for instance, the joint statement made by the US, UK and France at the G20 meeting on Iran lifted the price of crude from $65+ to $67 (statement released at 8:53am ET, the strength was sold with violence…). However, the dispersion in monetary policies is an open-ended question. We don't know how many countries may decide to abandon the coordination ship. We ignore what they will do if they abandon it, and we have no knowledge of the time when all this will happen.

But the process has started. It started with the United Kingdom. Last year, one thought it would be triggered by Iceland, or the Baltic nations dragging Sweden along, or Poland dragging Austria or Latin America dragging Spain. Today is the United Kingdom, and it is not hypothetical. It is a fact. The housing and banking problems have been rather serious there and although the UK has so far been in my opinion the most proactive and ingenious country in this crisis, the fact is that its currency is undergoing a speculative run. Moreover, it can get worse, because the market has heard from the Bank of England's Governor Marvin King himself that interest rates there are likely to stay low for longer than anticipated. The Pound Sterling is therefore on its own. Perhaps that is a good thing, as it will prevent the growth of further imbalances. Ultimately, the answer relies on the side of fiscal policy. The situation with the Pound Sterling worries me not because the currency has depreciated against other currencies, but against gold, along a clear definite path. *If gold becomes a visible refuge, the technical damage will have been done and the temptation to run against other currencies will grow exponentially.*

In the late '20s, the situation with the UK was very similar. I dug into a few documents I had and found an interview The Economist held with Jacques Rueff (http://en.wikipedia.org/wiki/Jacques_Rueff). It was published on June 1965, and entitled "The Role and the Rule of Gold." The entire interview was reprinted in Jacques Rueff's book "The Monetary Sin of the West", MacMillan Co., New York, 1971, Part III. Its online version can be found at (www.mises.org/books/monetarysin.pdf). I show below, a critical part of that interview, which I find contemporaneous:

The Economist: One of the countries that saw the biggest constriction imposed by the gold standard was, of course, Britain—which held no foreign exchange in its reserves. And, as we have always recognized, Britain at this time suffered precisely because of the harsh and inflexible disciplines of the gold standard, which you now want to restore

Jacques Rueff: Let me tell you that you touch a point on which I have quite a few personal recollections. In 1930, I was financial attaché in the French Embassy in London, and in that capacity, I was responsible for the deposits of the French Treasury with British banks. They were the direct result of eight years of the gold-exchange standard, because we had kept the pounds sterling in London, as my colleagues in New York had kept in the American market the dollars that had been pouring into the French Treasury from 1927 onward. Then, in 1931, the failure of the Austrian Creditanstalt caused successive waves of repatriations; and it was this collapse of the gold-exchange standard that, without any possible doubt, transformed the depression of 1929 into the Great Depression of 1931.

The Economist: While you are on this historical episode, what would your comments be on the very widespread view that it was to a substantial extent French pressure on London at that time, through the withdrawal of sterling balances that was in part responsible for the general collapse later on?

J.R. Let me tell you that, unhappily for the world, the French pressure did not exist, or was so mild that it had no effect. There is a very interesting document from this period, a letter from Sir Austen Chamberlain, who was then Foreign Secretary in London, to M. Poincaré, who was Prime Minister and Finance Minister in France; it must be of 1928. Sir Austen said, "We know that you are entitled to ask gold for your sterling, but in the frame of the close friendship between Britain and France we ask you, so as to avoid trouble for the City of London, not to do that." And we were, I must say, weak enough to comply with this request and not ask for gold. The fact that I had such important sterling deposits in London shows that we did not use this right to ask for gold. The adjustment, which would hardly have been felt if carried out on a day-to-day basis, was not made, and we had the fantastic boom of 1927, 1928, and 1929. This explains the depth of the collapse and of the depression, because the adjustment was so long delayed.

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