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SPECIAL REPORT

Dark Vision for the World Economy

by Bernard Connolly

The new Four Horsemen of the Apocalypse are the financial collapse of the G3, political instability and unrest, debt repudiation and default, and worldwide inflation. Gold may be the best defense.

Editor's Note: Every once in awhile an article comes along by a commentator/analyst who has found the key to a clearer understanding of the forces at work in the world economy. This article by AIG's chief global strategist, Bernard Connolly, offers that degree of insight. The picture he paints is an interesting one. Far from a world moving toward global government and co-operation precisely orchestrated by the G-3 (Japan, Europe and the United States), Connolly describes a world perilously at odds with itself, fracturing along old pre-World War II fault lines, and heading toward a catastrophic inflation -- a circumstance brought on by their own inability to reconcile long-standing differences coupled with the failure to come to grips with their own internal problems. In a world of three structurally weak currencies, gold, he says, will be the primary beneficiary because it is the one asset which stands apart from this governmental and central bank currency destruction. Mr. Connolly provides some very convincing reasons for gold ownership on the part of citizens in all of the three G-3 nations. Written almost a decade ago, we leave Connolly's article in our Gilded Opinion Index because it outlines so well the forces still at work in the global economy.

- Michael Kosares, 2002

GOLD'S DEPRESSING BULL MARKET

The first half of 2002 has seen a strong rally in gold. There have been previous, always short-lived, rallies in the past twenty years or so. Is this one different? Has it got more staying power? Sentiment has certainly

changed. Nothing illustrates that more clearly than the gold market's absence of reaction, beyond a few hours, to the comments four months ago by Ernst Welteke that the Bundesbank would consider selling gold under a new Washington Agreement. A year ago, those remarks could easily have knocked twenty dollars off the gold price -- and on a permanent basis. What has changed?

One can adopt a bottom-up approach to this question, looking at it in terms of producer hedging behaviour, the attitudes of the banks to the financing of forward sales, the impact of the Washington agreement and the increase in retail demand in Japan. And one can supplement such an approach by noting the increase in political [unrest] in the world: the Middle East, the war against terrorism, the India-Pakistan dispute over Kashmir. Of course, many of those factors could swing around again: the renewal of the Washington Agreement might allow for bigger central bank sales; new production could come on stream and some of it might be hedged. The current period of relative calm about the financial system in Japan might continue for little while longer, perhaps reducing retail demand for gold. One prays that India and Pakistan will step back from the brink. There might be some miracle that brings peace to the Middle East. But even if all that happened -- and if it did the current rally would be knocked back in the short term -- a top-down approach would continue to suggest that the longer-term prospects for gold are good. Sadly, the reason for that are rather depressing: the world is getting worse, in political terms and in financial terms.

If one looks just at the economic factors, one sees a world in which three currencies predominate. Of those three, one -- the euro -- was created in the knowledge, and perhaps with the intention, that it would provoke financial, economic and political crisis in at last some of the countries trapped in its embrace; it is quite simply a congenitally bad currency. A second, the yen, is plagued by an intractable financial system and public debt problems; it will at some point become a highly inflationary currency. The third, the dollar, is backed by a strong, well-rooted polity and the best economic system, among major countries a least, in the world; but is overvalued, at risk from financial system vulnerabilities and tarnished by worries both corporate governance and about terrorism. In such an environment, gold can be seen as the least bad currency.

THINGS CHANGING FOR THE WORSE

Linked to the problems of the major currencies, and in part an explanation of those problems, is the unmistakable fact that the factors of geopolitics and political sociology affecting financial markets are changing for the worse and will continue to deteriorate. What will be the longer-term impact of September 11 on financial markets? No-one can say with confidence how the global war against terrorism will develop. But one thing should already be clear: the key assumption that did most to sustain and encourage the world financial system over the past decade or so -- an assumption about the pre-eminence of economics versus politics -- was an illusion. It would have been an illusion even if the events of September 11 had not happened, or had not yet happened. What those events did was to make it clear just how illusory the assumption had been. With enlightenment, unfortunately, will come a realization that the brief Golden Age of free-market international capitalism is ending.

The period from around 1982 until about a year or two ago was marked by great secular trends in financial markets: a bull market in stocks; a bull market in bonds; and a bear market in gold. Underlying all these trends was more or less continuous world disinflation, a falling equity premium related to perceptions of increased economic and political stability in the world, an improvement in public finances (except in Japan, which was of course, from the beginning of the 1990s onwards, the great outlier in terms of world equity market movements), reduced levels of taxation, a greater role for the private sector, reduced government regulation and intervention in the economy and, perhaps most important of all, a remarkable move away from

government control of international capital movements and of financial markets in general. One can summarize these trends by saying that what underpinned the bull market in stocks and bonds and the bear market in gold was a bear market in government -- the most desirable bear market one could wish for.

No market trend ever lasts forever. There has been a global bear market in stocks which, except in parts of non-Japan Asia, is intensifying again; and any projection of a revival would have to depend on assumptions that either are untenable or would imply a recrudescence of world inflation. The bull market in bonds may have come to an end, despite what has been a dramatically weak period for world growth. The bear market in gold has, on some readings, come to an end. And, sadly, the bear market in government is definitely over.

It is this last development that is now destroying the assumption that underpinned the Golden Age: the assumption that 1989 and the fall of Communism marked the end of history and, along with history, of politics. At a seemingly trivial level, the assumption meant that the media of countries such as the US and Britain was dominated, in the years before September 11, by the so-called celebrity culture. In fact, this phenomenon was not trivial at all: it was part of the illusion of "One World", a uniform anti-culture whose tawdry attractions were supposedly so great that all political, religious, social and economic divides in the world would melt away before it. At a seemingly less trivial level, the assumption implied that governments would take decisions essentially on the basis of economic rationality and subject to financial market disciplines: economics ruled, not politics. In financial and economic terms, "One World" meant the dominance of what Eisuke Sakakibara described as the Anglo-Saxon-dominated free-market international finance system. In the terms of the triumphalist book by Daniel Yergin and Joseph Stanislaw, "The Commanding Heights" of the world economy had been captured for free-market capitalism. But such conclusions were naive and premature.

The illusion of the visceral attractiveness of the "Anglo-Saxon" model should, perhaps, have been obvious in respect of Islamic countries. It wasn't. That error betrayed a lack of cultural understanding. But the illusion was just as complete in respect of continental Europe. Here, the error of understanding on the part of US strategists, of market analysts and of respected media commentators was much more culpable: it was a deliberate averting of the eyes from evident truths. Nowhere was the error more egregious than in the view taken, in the US and by the more naïve -- or cynical -- interests in Britain, of the drive towards economic and monetary union (EMU) in Europe.

TROUBLING IMPLICATIONS OF ONE WORLD VIEW

In the US, that drive was seen as a prime instance of the triumph of economics over politics, as representing the sincerest form of flattery of the US model and as signalling further near-inevitable moves towards a "One World" of effective economic union and world government. The first two elements of this view were simply wrong: the third pointed to paradox in the notion of "globalization", one with far-reaching and very troubling implications. Let us look at them in turn.

On the face of it, EMU might seem to have involved member governments' accepting a sacrifice of some supposedly empty concept of "national sovereignty" in return for the economic benefits, in terms of transparency, elimination of conversion costs, reduction of exchange-rate uncertainty and the impetus given to the development of integrated capital markets, supposedly flowing from the establishment of a continental-sized currency area. And that trade-off -- of political independence versus economic benefit -- was seen as inevitable in an increasingly-integrated world. Nothing could be farther from the truth. The structure of EMU flies in the face of all economic rationality. The project was politically-motivated from the beginning.

It meant, in short, the creation of a rival to, and a defence against, the importation of the "Anglo-Saxon" socioeconomic and political model. European politicians were quite explicit about that: just a few years ago the then-Finance Minister of Belgium (now the president of the European Investment Bank) said outright that, "The purpose of the [European] single currency is to prevent the encroachment of Anglo-Saxon values in Europe". In the face of such comments, it is very, very hard to understand how Americans could delude themselves about the nature and purpose of EMU. But they did.

In the event, every EU country whose government was not politically bound by a commitment to a popular referendum on the issue ended up being part of monetary union. This is proving disastrous. Why? To answer that, we have to turn for a while from geopolitics to economics -- while never forgetting that geopolitics has dictated why the economic disaster of a wide monetary union was accepted by its progenitors.

THE ROOTS OF THE EU IMMIGRATION PROBLEM: WHY IT MAY BE HERE TO STAY

The greatest advantage of the present world of internationally-integrated financial markets is that it has restored divergences in the rate of return on capital to their rightful position as prime driver of economic developments. Such divergences may be sector-specific, firm-specific or even person-specific in their origin, but what is important to recognize is that their macroeconomic impacts tend to be country-specific: that is, they affect some countries more than others. The probability of country-specific disturbances to the rate of return on capital is greater the initial differences in the economic, political, social, cultural and financial structure, differences which are often, though not invariably, summarized by differences in levels of productivity and incomes among countries. Such differences may exist within countries, too, of course. But they tend to be diminished by common political and economic structures and by mechanisms such as internal labour force mobility and by inter-regional government transfers within countries.

Within the EMU, inter-country income differentials are substantial and will become even greater as before the end of the decade EMU will expand to include countries such as Poland, Bulgaria, Romania, even Montenegro -- countries with vastly greater income disparities compared with the EU average. Now, either the poor countries make significant progress in catching up with the average or they do not. Either outcome spells massive economic and political instability within the present structure of EMU.

Suppose there is no "catch up". Then, given the freedom of labour movements within the EU, there will either be massive migration from poorer to richer countries or massive transfers from richer to poorer countries to induce people to stay at home. In the present political climate in Europe, massive migration is just not going to be politically acceptable in the richer countries. But, with budgetary constraints weighing heavy, neither will massive, ongoing transfers. EMU, indeed the EU, will not be able to stand the incorporation of poor countries who just do not catch up in terms of productivity and domestic income levels.

But how does "catch up" come about? What we have seen throughout the world over the past twenty years or so -- the period of the new Golden Age -- is that involves structural reforms that increase the anticipated rate of return on capital in the poorer countries. The experience of the past twenty years has confirmed what Wicksell and the Austrian economists had deduced theoretically during the previous period of more-or-less free capital movements in the world: macroeconomic stability requires the ex ante real rate of interest to move in step with the anticipated rate of return on capital. But in internationally-integrated financial markets, ex ante real interest rates in a particular country can rise above the "world" real rate of interest only if the currency of the country concerned is expected to depreciate in real terms. In turn, generating that expectation in

circumstances of, by construction, strong confidence about domestic economic prospects must involve an initial spot appreciation of the real value of domestic currency to a level above its long-run equilibrium value.

If these movements can be accomplished through movements in the nominal exchange, there is a chance that all will be well and good. Of course, monetary policy can get things wrong even in a floating exchange rate regime; but while a floating rate is not a sufficient condition for overall stability, it is certainly a necessary one. If the nominal exchange rate is abolished and national monetary policy eliminated through membership of a monetary union that is not also a political union, disaster is almost bound to strike. In the boom phase, when strong rate-of-return expectations are producing a simultaneous boom in investment and consumption, interest rates cannot rise and the nominal exchange rate cannot appreciate. Instead, asset prices are forced up, further stimulating both investment -- as the cost of capital is reduced and consumption as perceived household wealth increases. The economy overheats, and eventually inflation sets in.

But as capital accumulation proceeds, the rate of return on capital gradually subsides back towards its starting point, even if the process takes several years. As it does, business investment does not just decelerate -- it falls in absolute terms. A similar story can be told about consumer investment -- residential construction and purchases of consumer durables. As domestic demand falls back, net exports need to rise to fill the gap, a gap made bigger by the increase in capacity produced by the preceding years of strong investment. But, by definition, the exchange rate cannot adjust to aid this process. Instead, the lagged effects of past overheating, showing up in inflation, actually worsen international competitiveness. With domestic demand falling and competitiveness worsening simultaneously, the economy goes into a tailspin. Unemployment rises; inflation begins to fall back, even though for some time it remains above levels in competitor countries. Since nominal interest rates are set outside the domestic economy, falling inflation pushes real interest rates up while the rate of return on capital is coming down -- this combination produces falling asset prices, worsening the decline in domestic demand. To re-balance the economy, domestic inflation has to fall below that in other countries under the influence of recession and rising unemployment. But the process of disinflation (perhaps even deflation) constantly pushes real interest rates up. Worse, asset deflation weakens balance sheets, including the government's. Bankruptcy and default, including government default, become real possibilities. Credit spreads widen, exacerbating the problem of excessively high real interest rates. Asset markets weaken further. The circle is vicious indeed. If nothing is done to break into it, the outcome will be not just economic and financial collapse but social and political chaos.

THE UNPLEASANT FINANCIAL IMPLICATIONS OF A SINGLE CURRENCY

This story is a sadly familiar one. In the past, it described the experience of many countries subjected to Gold Standard constraints. Default, and political revolution, usually preceded "going off gold". It also describes the experience of Britain, Scandinavia and Iberia in the late 1980's and early 1990's. In the countries concerned, government default and political regime change were avoided by breaking free from the exchange-rate constraint -- whether ERM membership or pegging to the ECU -- that had caused the problem. Within EMU, there is no political, legal or financial mechanism for leaving the single currency short of leaving the EU altogether. So what happens to countries that get themselves into a cycle of this sort?

In Europe the advocates of monetary union have always been quite clear about the unpleasant financial implication of a single currency. For them, the crisis that will be created by the euro represents the route to establishing colonial administration in the smaller EMU countries. As the chairman of the European Commission, Romano Prodi, put it earlier this year, the euro will oblige the EU to provide itself with a whole new set of centrally-administered powers, powers it is now politically unacceptable to claim, but powers which

will be grabbed after the crisis created by the euro has come to pass. One should be prepared to take him at his word. But what crisis? What powers?

Within EMU, Ireland, Portugal and Finland have all gone through the up phase of a cycle generated by a discrepancy between the anticipated rate of return on capital and the ex ante real rate of interest. They are now clearly in the down phase of that cycle. In Ireland's case, the boom was so fierce that cock-eyed optimists can contemplate a sharp fall in the growth rate as perfectly absorbable. But in none of these countries -- with Greece to follow rather soon -- will the process end with a nice, smooth return to a "sustainable" long-run growth rate. All of them will face depression, deflation and potential default. Public sector financial positions in all of them will deteriorate with amazing speed (in the "peripheral Europe" boom-bust cycle a decade ago, for instance, government borrowing as a percentage of GDP increased in several countries by more than a dozen percentage points of GDP in just three or four years), yet all of them begin with public sector debt ratios higher than was Argentina's at the beginning of its recession. And the accession countries will assuredly follow a similar path when they join EMU.

Can the EU stand idly by and watch this happen? At first, yes. The ECB will claim that individual country developments are not its concern. And the EU as whole may argue that the countries concerned knew the rules, including the budgetary rules of the so-called Stability Pact: they have made their own beds, now they must lie on them. But that attitude cannot possibly persist. For however small these countries may be, financial markets will be aghast once the full horror of the slump, and it sociopolitical implications, becomes apparent. Ultimately, the ECB will be forced to behave as if it were the central bank of the small countries, easing monetary conditions massively depreciating the euro to keep the small countries afloat -- at the expense of inflation elsewhere in the area -- until a "political" solution can be arranged. What the politicians will decide will be to change the rules that currently prohibit EU bailouts of individual member countries. Bailouts will be instituted in return for the forced signature of the smaller countries on a new treaty which will extinguish what remains of national political independence in Europe. The progenitors of EMU knew exactly what they were doing. Thus Jacques Delors, for instance, said in 1995 that, "Monetary union means [our emphasis] that the Union acknowledges the debts of the member states of the monetary union". The syntax is contorted, but the logic is clear: the "no bailout" provisions in the original EMU setup were a sham, designed merely to reassure the German public, which had always intuitively tended to believe that a monetary union without a political union must become a debt union.

What would a European political union, necessary though not sufficient for superpower status, look like? It would certainly be plagued, as was the Austro-Hungarian empire, by a resurgence of nationalism. But things would be worse than that. For Europe is now multi-ethnic and multi-cultural. Such features have not been a problem-free even for the United States. But the United States has, at least in terms of its national myth, been a melting-pot in which races, languages, ethnic origins are fused in the pure flame of patriotism, a patriotism which is defined by allegiance to the constitution, to political institutions and political traditions. The American nation, that is, is a politically-defined nation. In Europe, it beggars belief to imagine that a politically-defined nation could be forged (although one should note, with horror, the recent press reports that five years ago the EU Commission wrote a secret paper arguing that political union would not come about without the perception of an external threat and that a terrorist outrage could contribute to producing such a perception). No, a political union in Europe would be created out of the deliberate destruction of existing politically-defined nations. And in that vacuum, populations would search for other sources of identity. It is all too clear that they would convince themselves, or be convinced by demagogues, that they had found their identity in terms of race, ethnic origin, language or religion. Europe would become a powder-keg of prejudices and hatreds. That is a horrifying prospect.

What of the third element of the American illusion about EMU, that EMU was a milepost on the way to some marvellous form of "global governance"? Well, it is certainly the intention of the EMU proponents to use the putative superpower status of "Europe" to take the US "hyperpower" down a few pegs and force America to engage in negotiations across a wide range of issues. But that desire is not flowering of a global "solidarity": it is a quite explicit attempt to subjugate the US and to move the world away from the dominance of market forces and towards a more bureaucratic mode of international decision-making.

A former member of the Monetary Policy Council, as it then was, of the Banque de France put it very clearly a few years ago: monetary union in Europe, he wrote, would increase the attractiveness of the euro to international investors. That would, it was hoped, suck capital out of the US, drive up American interest rates, create unemployment in the US and force the a weakened and chastened US to the negotiating table with "Europe". One can argue about the economic reasoning he employed, and things have certainly not worked out as he intended, but the intention was perfectly clear.

The economic analysis above certainly points to problem in the concept of economic "globalization" and international capital market integration. There is definitely an inconsistent triad. Global financial market integration, national political independence and imperfectly flexible exchange rates cannot all exist together. One of the three has to go. In the Bretton Woods era, it was capital market integration that was sacrificed, a sacrifice that kept most of the non-OECD world in poverty. Under the Classical Gold Standard, fixed exchange rates in peripheral countries were abandoned from time to time, even though the social and political acceptability of the safety valve of mass migration was much greater then than now. One can, it is to hoped, remain confident that the US will not, despite the ominous utterances of the "world governance" advocates, ever willingly give up its political independence.

But if the US neither wishes to nor is capable of enforcing a global empire as away of producing world political union, and if Europe is willing to do so but is incapable of doing so, which of the two other elements of the inconsistent triad will be abandoned? Europe has never abandoned a preference for fixed exchange rates and has no intention of doing so: leaving the exchange rate to be determined by the private sector has always been anathema to many European, particularly French, minds. There is undoubtedly a current of opinion even within the United Sates that would like to see a return to fixed rates, preferably via a system of pegs to the dollar or even widespread dollarization.

'THIRD WAY' COULD INCLUDE WORLDWIDE CAPITAL, FINANCIAL CONTROLS

The outcome is far from clear. But it does seem likely that we shall go through a "mixed" period, a kind of "Third Way" if you like, in which there are more and more attempts to restrict the ability of the private sector to move exchange rates around and that this restriction takes the from not only of government-imposed pegs, target ranges and the like (and a collapse of the yen under the strain of Japan's unsustainable public finances could well provide an excuse for such G-3 target ranges this year) but also from capital controls, whether explicit or, more likely, implicit.

Measures against money laundering, however necessary and justified in current circumstances, will, one has to fear, be used for all sorts of purposes other than fighting terrorism, including that of imposing implicit exchange controls. The Market Abuse Directive currently going through the EU legislative mill, which allows the authorities almost unlimited discretion in deciding, ex post, what constitutes a criminal offence of abuse, will be a weapon of ex ante intimidation in their hands. The ominous and sinister article 59 of the EU treaty permits the imposition of capital controls between the EU and the rest of the world. Like every other article of

the treaty it is there for a purpose -- it is intended to be used. It can be activated by a qualified majority vote of the member states -- a financial nuclear weapon aimed at London above all. All in all, there are just too many straws in the wind to be ignored.

This, too, is an aspect of the bull market in government which has now begun. It is by no means the only one. Fiscal policy is back in vogue everywhere. Budget deficits will rise and, soon after, so will taxes. Government subsidies to firms are back in a big way, everywhere. In Europe, just in one three-week period in the autumn of 2001 one saw: the effective nationalization, socialization, corporatization, or whatever, of Swissair; the effective re-nationalization by the Swedish government of the forestry interests of the firm, Assidomän; and the expropriation by the British government of Railtrack. It is possible that telecommunications companies in Europe, only recently de-nationalized, will face some from of re-nationalization in the next few years. The airline sector will be "rationalized", "restructured" or "consolidated" not by market forces but by Brussels fiat. In Japan, further bailouts of the banking system so extensive as to amount to de facto nationalization appear close to inevitable. Former Communists are now in power in Poland, and former Communists have made stunning gains in local elections in Berlin.

Free trade is coming under strain: the US government has imposed import duties on steel and the EU is likely to retaliate. The recriminations begun by the Merrills suit and the Tyco and similar affairs will be carried further, bringing the possibility of re-regulation both of financial markets and of corporate America.

The problems afflicting the dollar and the yen are not so nakedly political in origin: certainly, they are not deliberately pre-programmed in the way the manifold disasters that will engulf Europe have been, at least in part, deliberately pre-programmed. But they still pose serious risks for world financial markets.

JAPAN: MASSIVE INFLATIONARY DEBT REPUDATION POSSIBLE

The problems of Japan are wholly intractable. The public debt catastrophe alone is enough to justify that conclusion. A crisis, although its precise timing cannot be predicted, cannot be avoided for very much longer. With a debt-to-GDP ratio of around 250% and a true budget deficit in double figures as a percentage of GDP, there is no feasible alternative to a choice between outright default, government expropriation of private sector assets and a massive inflationary repudiation of government debt. Default or expropriation would bankrupt the life insurance sector, with potentially alarming social and political consequences. Inflation is the more likely outcome. The route to very rapid inflation will be through a massively-depreciating yen. What would that involve? Once the process began, no-one in the private sector would willingly hold any government debt except at massively-increased yields. So the BoJ would have to acquire the whole government debt stock. That would involve something like a twenty-fold increase in the monetary base.

All economists, whether monetarists or not, would accept that such an increase would mean hyperinflation and a dollar/yen level of at least 1000 if there were no attempt by other countries to restrain yen depreciation. In response, even though yen depreciation on such a scale would soon create Japanese inflation and claw back some of the initial real depreciation, other countries would panic and intervene to attempt to support the yen, implying excessive liquidity creation and inflation at home (if foreign governments bought up the Japanese debt stock and were ultimately forced to leave interventions unsterilized, the world monetary base would about double). An attempt to institute exchange rate target zones would be very likely. And in the changing political environment in the world, governments would be much more likely than in recent years to attempt to buttress their exchange-rate policies with capital controls, whether implicit or explicit.

In the United States, the late-80's boom got out of hand, involving over-investment, over-consumption, a stock-market boom and generalized financial excess, largely because the Fed did not raise interest rates aggressively enough and soon enough. As a result, the downturn, when it came, was violent as far as the business sector was concerned. A similar adjustment has not yet taken place in the household sector. That is largely because the Fed's very substantial rate cuts last year provided households with ample incentives -- via increased housing market wealth; equity release made possible by mortgage refinancing; and zero-rate financing offered by car firms -- not to adjust their balance sheets. Just last week Greenspan was implicitly encouraging households to carry on spending by assuring them that their balance sheets were sound, especially if, he claimed, they owned their own homes.

To an extent, the Fed's hand has been forced by the ongoing appreciation of the dollar last year, an appreciation that has only recently begun to reverse. Unless the dollar's depreciation is much bigger than we have seen so far -- which is possible but not assured -- and, importantly, a weaker dollar is maintained for several years -- unlikely given the problems of Japan and euroland -- the Fed will have to maintain interest rates below "neutral" levels for a long time to come, in an attempt to keep the consumer spending. But such a strategy will only delay, not avoid, the necessary balance sheet adjustment and lay the ground for a crisis, in two or three years' time, that will involve a choice between liquidation and inflation. The choice will dictated by whether or not it has to be made just before or just after the next presidential election, but on balance inflation is likelier to be chosen.

WORLDWIDE RETURN TO INFLATIONARY 1970s, GOLD TO SHINE

In short, there are many politico-economic trends in place or clearly in prospect that suggest a return to the world of the 1970's: inflation (probably triggered first in Japan, but with euroland and the US also prone to inflation); deficits; taxes; subsidies; regulation; government intervention and control; reduced freedom of financial markets and perhaps of international capital movements in particular; political instability and social unrest. All of these trends will be aggravated by the efforts of the European imperialists to achieve their ends through an economic and financial disaster deliberately created by EMU.

With a bull market in government in place, the prospect of prolonged period of a high rate of return on capital looks remote. Given that, the recent bear market in stocks will be reversed -- as the Fed is currently unsuccessfully trying to reverse it in the US -- only through deliberate action by central banks to sustain stock prices at overvalued levels, a policy that ultimately must lead either to general inflation or a crash in stocks. The inflation route -- more likely to be chosen -- would mean a bear market in bonds. So what about gold?

In the absence of a return to the Gold Standard, a return that is neither likely nor desirable (though it would be less bad than inevitably-politicized world monetary "co-ordination"), three things are necessary for the secular bear market in gold to be replaced by a bull market. First, there must be inflation or expectations of inflation. Second, investors must seek an inflation-proof asset that is an "outside" asset -- that is, an asset that is not the corresponding liability of someone else. Third, the palate of available financial assets must be restricted. Sadly, these preconditions are likely to be met within the next few years.

Inflation is likely for the reasons analysed above. And all the factors that will lead to inflation will operate through first weakening balance sheets, whether of the private sector or of the government or both. Credit worries will mushroom, increasing the attractiveness of "outside" assets such as gold.

Finally, the accelerating trend in the world towards the restriction of free capital movements and towards a contraction in the financial services industry in general will reduce the available alternatives to gold.

There are many dark clouds in the sky. If they have a bright lining, it is perhaps, if not gilt-edged, at least gold-coloured.

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