The Fourth Currency: Gold

By Eric Janszen

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"Gold still represents the ultimate form of payment in the world.
Fiat money *in extremis* is accepted by nobody.
Gold is always accepted."

Alan Greenspan - Congressional Testimony, May 20, 1999

The British pound (£), the US dollar ($), and the Japanese yen (¥) comprise the three currencies used in international trade today.

The relative value of these currencies is influenced by global foreign exchange markets, the supply and demand for bonds and other securities denominated in them, and demand for currency used to settle trade in goods and services between countries. Currency values are also influenced by the monetary policies of governments.

A global financial crisis that started in 2007 in the US and evolved into an economic crisis in 2008 will develop into a currency crisis over the coming years. A fourth currency, one that is not so politically vulnerable as the three primary currencies in use today, survives as a reserve asset in the central banks of every country: **gold**. Gold is available to act as a fall-back currency for international trade should the floating exchange rate and government bond-backed currency system fail. This site is devoted to the discussion of this possible development and how it will impact investors throughout the world.

A return to the Bretton Woods international gold standard created in 1944 is inevitable

Thirty-seven years ago the world's economies started on the circular track back to Bretton Woods. We will sooner or later be back where we started, with international transactions guided by a fixed gold price.

The official output of the November 2008 G-20 Summit is 3,366 words, including 61 instances of the word "should" as in "Financial institutions must also bear their responsibility for the turmoil and should do their part to overcome it including by recognizing losses" and "Incentives should be aligned to avoid excessive risk-taking" and "Regulators should enhance their coordination and cooperation across all segments of financial markets" to cite only the first three. The entire rambling tract says in sum, "We met. We talked. We agreed that serious challenges to the world economy and financial markets exist but are not so serious as to compel us to do anything about them. There is so little urgency that we decided not to meet again until the spring of 2009 to talk about the crisis more."

The only intriguing output that passel of pattering public servants managed to produce is a rumor that the topic of gold came up in the meeting. Judy Sheldon, writing for the Wall Street Journal on Friday, in her article *Stable Money Is the Key to Recovery: How the G-20 can rebuild the 'capitalism of the future* said:

"What can an exchange rate really mean," ***Paul Volker*** *wrote in "Changing Fortunes" (1992), "in terms of everything a textbook teaches about rational economic decision making, when it changes by 30% or more in the space of 12 months only to reverse itself? What kind of signals does that send about where a businessman should intelligently invest his capital for long-term profitability? In the grand scheme of economic life first described by Adam Smith, in which nations like individuals should concentrate on the things they do best, how can anyone decide which country produces what most efficiently when the prices change so fast? The answer, to me, must be that such large swings are symptoms of a system in disarray."*

If we are to "build together the capitalism of the future," as Mr. Sarkozy puts it, the world needs sound money. Does that mean going back to a gold standard, or gold-based international monetary system? Perhaps so: it's hard to imagine a more universally accepted standard of value.

Gold has occupied a primary place in the world's monetary history and continues to be widely held as a reserve asset. The central banks of the G-20 nations hold two-thirds of official world gold reserves; include the gold reserves of the International Monetary Fund, the European Central Bank and the Bank for International Settlements, and the figure goes to nearly 80%, representing about 15% of all the gold ever mined.

Ironically, it was French President Charles de Gaulle who best made the case in the 1960s. Worried that the U.S. would be tempted to abuse its role as key currency issuer by exporting domestic inflation, he called for the return to a classical international gold standard. "Gold," he observed, "has no nationality."

Alan Greenspan a year ago recommended the same, as we noted at the time.

We're glad a WSJ writer said this before we did. We'd be labeled gold bugs for asserting that, not only is a return to an international gold standard necessary to restore the global financial system, it is an eventuality. Greenspan and the WJS get away with it because they are the WSJ and Alan Greenspan. Who are we but a bunch of fruitcakes who backed up the truck and bought gold at $270 in 2001? What do we know?

Note: *An international gold standard does not require a return to national gold standards by participating nations. In an international gold standard gold is only relevant for international transactions between nations. Fiat currencies, such as the dollar, euro, and yen, remain in use for domestic transactions within countries.*

Still Questioning Fashionable Financial Advice

In our original August 2001 article Questioning Fashionable Financial Advice we made the case to readers to buy gold when it was trading at $270, we offered the following argument that was as offensive to gold bugs as to the gold phobic.

Do you know of any commodity that the world's central banks hold in such large amounts? The world's central banks have had over 30 years since gold was disconnected from currencies to sell their gold. But they haven't. According to the International Monetary Fund, "Total official holdings have been reduced by 3,000 tons, or less than 10%, over the past 30 years." (Source -- World Gold Council) The question is, if they don't think they need it, why haven't they sold it? The standard answer is that they have too much of it to sell without negatively impacting the price of the remaining gold they possess and hurting economically allied nations that produce gold. The problem with this argument is that the world's central banks have had 30 years since the demise of the Breton Woods system to sell their gold. Methods for selling gold without significantly impacting price or hurting gold producing countries are well documented (see "Can Government Gold Be Put to Better Use? Qualitative and Quantitative Effects of Alternative Policies"*). It's hard to imagine that sales of an average of 3.3% of holdings per year over 30 years, an amount that represents a small percentage of annual gold mining output, would have had a significant impact on the gold price.*

Part of our investment theses since then is that monetary gold, rather than natural or honest money, is an artifact of ancient government money protocol. Most histories of gold coinage begin with the factoid of King Croesus of Lydia introducing gold coins around 643-630 B.C. but without explaining why; to enable the collection of taxes not in pigs and grain but in coin that the servants of the king and state could not manufacture on their own. Kingdoms and governments liked this arrangement so much that from then until the last century gold coin grew to become the most widely accepted form of tax payment collection globally, and so became the coin of many realms for domestic and international commerce as well.

As economies and commerce grew more complex, fractional reserve banking based on gold reserves, the true risk-free reserve asset, evolved. The 30,000 tons of gold that central banks still hoard in their vaults 37 years after the end of the gold standard is an artifact of that ancient evolution. In our usual habit of asking the most obvious question, when we did our analysis in 2001 we pondered: Why do central banks own 30,000 tones of gold when the stuff has had no monetary purpose for decades? Why not sell it over that time and hold "risk-free" government bonds instead that earn interest? How many hundreds of billions of dollars in interest income have central banks lost by not holding “risk free” government bonds instead of gold all this time? How can central banks justify this apparent fiduciary delinquency and waste?

The answer is obvious once you have asked the question. *A central bank without gold reserves today is like a stunt pilot without a parachute.* The stunt since 1971 is maintaining stable international currency values in a system of fiat money and floating exchange rates, difficult but possible when the global economy and money supply are expanding, but impossible when massive debt, the hangover from a 27 year long credit bubble, is deflating worldwide.

We’ve been here before

In the 1930s, nations abandoned the gold standard one by one, then formed into three currency blocks that commenced a global monetary *“circular firing squad”*. The three groups in turns engaged in competitive currency devaluation in a desperate attempt to export deflation to each other by means of depreciating the value of their respective currencies. The Smoot-Hawley Tariff Act was America’s unimaginative defense. It famously made matters worse; in 1933, after the US money supply collapsed 40% and bank credit 50% since 1929, FDR initiated a unilateral deflation of the dollar against gold that created a near instantaneous 40% monetary inflation.

There can be little argument that WWII was rooted in the political fallout of the global depression. Populations made angry and destitute by the depression electing various flavors of dictator to bang heads together to set things right. After the war, the international monetary regime developed at Bretton Woods was designed to avoid a repeat scenario that follows the folly of credit inflation, should such a dangerous error be allowed by the ignorant and greedy to develop again: financial crash, economic contraction, debt deflation, economic depression, political instability, dictatorship, war.

The development of America’s first ever current account deficit under the Bretton Woods system appeared at $400 million in Q1 1971 and grew to $1.17 billion by Q4, *a tenth of one percent of GDP*. That was enough to send US trade partners scrambling for payment in US Treasury gold rather than soon-to-be devalued dollars. In response, Richard M. Nixon first "temporarily suspended" gold convertibility, then devalued the dollar twice two years later in 1973. Gold convertibility was never restored. In the intervening years, the US current account deficit has ballooned to $183 billion, by a factor of 158 while US GDP grew by a factor of only 12.

Central banks have not had to use their gold reserve parachutes, but the circumstances we face today are precisely what they are there for: to permit the simultaneous reflation of all currencies in the event that another 1930s style global deflation recurs.

To us, the question of a global reflation of currencies and deflation of debt against gold is a matter of when and how, not if. The cost will be born unequally, with debtors like the US gaining more benefit and creditors like Japan and China less. In a world where trillions in currencies swim the global currency markets sea daily, the re-institution of an international gold standard with some formula of fixed exchange rates, even if temporary, will be wildly disruptive and costly to the global economy, and more to some nations than others.

This is why we don't see this happening until global economic conditions resulting from debt deflation grow much more dire; the economic and political costs of the ongoing debt deflation must outweigh the costs of implementing a new international gold standard.

More daunting, as the costs and benefits of that solution are unequal, who will provide the necessary leadership? Imposing a new world monetary order in 1944 was a simple matter in the wake of WWII when only one nation, the US, stood economically and militarily strong enough to drive all nations to consensus. In a multi-polar world, how will consensus be gained, especially if economic hardship is once again motivating populations to demand expedient solutions, and autocratic government makes a comeback, never mind that one major party at the table, China, is autocratic now?

Will gold re-monetization make me rich if I own gold?

Is gold re-monetization good for gold owners? We've seen calculations of potential future post re-monetization prices such as those suggested by Larry Edelson over at Money and Markets ranging from $5,300 to $53,000 per ounce. *We have since 2001 forecast a $5,000 peak gold price,* **but**, that estimate is based on a set of metrics, such as the ratio of gold to the DOW that we anticipate at the top of a global currency crisis, not post re-monetization gold reserve ratios. Less important than the gold price to gold owners, however, is the ugly political and legal environment, not to mention the social atmosphere, that is likely to exist at the time that economic conditions drive international parties to the table to hammer out a new international gold standard.

The range of future popular opinion of private gold holders under those drastic circumstances ranges from villain or hero and everything in between. If gold owners are vilified, you can count on a less than friendly government policies on gold taxation and possession. The 1933 confiscation was strictly old school; the modern approach is more likely to take the form of a 90% capital gains tax on private gold sales with high penalties to encourage sales to the government at a fixed price and slow a popular rush to the metal, and of course create an enormous black market in the bargain. *If that sounds paranoid, you haven't been watching the news lately.*

To time a new international gold standard you have to think in terms of the G-20 time-line. A year into the debt deflation, global leaders have yet to acknowledge it is the root problem, let alone do anything but issue vague "should do this" and "should do that" official statements, let alone propose a radical solution like gold re-monetization to bring the devastating effects of debt deflation under control. Our forecast two years ago of a severe post housing bubble recession was strictly tin foil hat at the time, as was our call of a bottom in the price of gold 2001, as this latest forecast will appear to many.

Rounding the bend, back to Bretton Woods

Another year or two must pass before the collapse of global economies motivates bold policy moves to address the root of the problem, how to deflate all of the excessive debt. Even then the question remains: without dominant economic and political leadership, who can herd the cats–the US, the EU, Japan, China–who may be fighting like cats in a sack, to a mutually beneficial accommodation when the costs and benefits are unequal? Yet the alternatives are either a new circular firing squad of competitive currency devaluation or ongoing destruction of economies around the world by debt deflation.

We cannot say, of course, how the impending crash of the world's national and regional economies on the track back to the Bretton Woods international gold standard will turn out, but only a diehard optimist can imagine we all escape without a scratch.

Our position has not changed since 2001. Central banks own gold for good reason: the global monetary system is fatally flawed. *They don't trust each other, and so why should we trust them?* The only new issue we've raised here, now that events are developing more or less as expected, is this: when the time comes, will owning gold do us any good? Is there some other asset we should own either in addition or instead?

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