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THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER

The Merits of Stable Currencies via Restoration of the Gold Standard (Part I)

Introduction

In our Economic Winter, '**All That Glitters Is Gold**' – October 19, 2009 – we wrote: 'Gold is the only financial asset that is not someone else's liability, as all paper money is simply debt.' When the economic and financial systems are collapsing, people turn to gold because it's the only financial asset which they can trust. They lose all trust in paper currencies; that is fiat money and all assets valued in paper money (stocks, bonds and real estate) except precious metals companies, since the underlying assets of these companies are the metals themselves. Most people only equate a rising gold price to an increase in inflation, but the price of gold also appreciates during a deflationary depression because investors turn to gold as the ultimate money. People did that during the Great Depression of the 1930s and they are doing it now. However, the real panic buying of gold lies ahead, since the banking system faces renewed pressures as the debt bubble, particularly in America, continues to grow. In point of fact, during a deflationary depression, gold is the most liquid asset. In addition to investors losing their faith in fiat currencies, there are other reasons why gold will perform well over the next several years and why investment risk in gold will be minimal during this time. So much of the world's gold supply has been mined within the last 50 years that the globe's richest deposits are fast being depleted in South Africa, Australia and the United States; while new discoveries are becoming rare. The world's largest mining companies are now aggressively pursuing gold on a global basis. Giant Newmont Mining now operates open pit gold mines on five continents – from the rainforests of eastern Indonesia to the mountain ranges of Peru and to the lowlands of Ghana. The challenge for large producing gold companies like Newmont is the replacement of their annual gold production. Newmont produces about 7 million ounces per annum. To replace these ounces, the company must discover approximately 8 million ounces every year, since production is never 100% of the gold mined. This is an impossible task. There have been very few discoveries of this size over the past several years. Further, the timeline from discovery to production is about 10 years. This means that such large producers should have a significant discovery in the pipeline every year.

In his book, *The New Gold Standard* published in 2011, author Paul Nathan also notes: 'The use of the terms gold standard and new reserve currency are being used more in the last couple of years than in the last few decades. Some commentators, writers and magazines are beginning to join the debate on the pros and cons of a return to the gold standard. Most laugh at the prospect, but the fact is that it is happening now. The new controversy over reverting to a gold standard is welcome. Many who comment, pro and con, on the possibility are new to the subject and as such, have not really thoroughly explored some of the implications ... Government has a monopoly on money. This goes to the heart of government power. It goes to the use of force. The government declares what can and cannot be legal tender. It controls the value of money through setting the supply and the price of credit through the setting of short-term administered interest rates. America has been on a fiat standard for a century. Fiat means decree and that is what government does, sometimes subtly and sometimes brutally. The force of a monopoly alone, however, is insufficient to prevent individuals from protecting their wealth. Therefore, government's best chance of preserving currency stability is through trust, confidence and credibility. Lose these things and government will eventually lose control. Today, we are witnessing this very scenario playing out before our eyes ... If governments fail to get their fiscal houses in order, there is no telling what the future will bring. Gold offers some semblance of security. Among other things, it is a hedge against stupidity. Given the almost criminally reckless fiscal policies of government, who in their right mind would not want to protect themselves? Moreover, if a breakdown of national currencies occurs, who would believe the promises of a new replacement paper currency in light of the broken promises of governments everywhere? Gold is not a promise that can be broken and therein lies its present appeal.'

Gold as an Ideal Standard

In his book, *The Economics of a Pure Gold Standard*, published in 1996, international economist Mark Skousen – author of sixteen financial books – prefaced: 'While a pure gold standard is not likely to support a stable price level, in fact, prices are likely to decline gradually over the long run if gold production does not match economic growth. Under the classic gold standard in England and the United States (1821 – 1914), the wholesale price index tended to be slightly deflationary. A gently falling price level should not present any difficulties, however, as long as prices remain flexible and free from government control. At the same time, wage rates may not fall in the face of gently declining prices if worker productivity rises. Interest rates, reflecting the relatively stable monetary growth pattern, are likely to remain low, thus providing a favourable climate for economic growth and long-term financing. Significantly, monetarists have recently begun to recognize the natural advantages of a genuine gold standard. Milton Friedman, in particular, has reversed his position that gold mining is an economic burden on society. He now acknowledges the argument, made originally by Professor Roger Garrison (Auburn), that the cost of mining and storing precious metals has not diminished since the world went off the gold standard. Friedman has suggested that there were no longer any economic arguments against gold as an ideal monetary system, only political deterrents. That represents a dramatic change from a generation ago when virtually all economists, including Ludwig Von Mises and Joseph Schumpeter, felt that the gold standard could only be justified on political, not economic grounds.

Once the government established a gold standard, commercial banks and other financial institutions could be granted the right to issue their own gold certificates which could compete with government currency. They could also compete with the U.S. Treasury in minting gold coins (one ounce, half ounce, quarter ounce, and tenth ounce), since gold coins would begin circulating alongside gold certificates (dollar bills). By establishing a fixed-exchange rate between gold and the dollar, gold coins and gold certificates could once again become popular mediums of exchange. Gold coins could once again circulate, as they did prior to 1933. If the United States pursued a gold standard, other nations would probably follow, thus establishing an international gold standard. Granted, this gold-certificate program is not a complete 100 per cent system, since demand deposits (chequing accounts) are not covered. However, I believe this gold-backed monetary standard would provide a much more stable (economic) environment than our current fiat currency system ... A resurgence of interest in the 100 per cent specie standard has recently developed in the midst of monetary crises and foreign exchange upheavals in the western world, during the past decade, which have been accompanied by a relatively rapid rise in the free market price of gold and other precious metals. Some ultra-metallist economic and financial observers have predicted that the present international dollar standard will eventually result in such high rates of currency debasement that a pure specie standard will, ipso facto, be reintroduced in to the monetary system by market forces. One of the strongest academic advocates favouring a strict 100 per cent specie program has been Murray N. Rothbard, professor of economics at the University of Nevada, Las Vegas, who wrote in favour of a pure gold standard as early as 1962. Rothbard contends that it is the only monetary system that is "compatible with the fullest preservation of the rights of property and ... assures the end of inflation and with it, the business cycle." An integral part of Rothbard's thesis is the Austrian theory of the business cycle, which is interwoven throughout the works of the 100 per cent advocates.

The Fundamental Principle

The underlying principle adopted by the Currency School and other hard money proponents throughout the gold standard tradition has been that money should consist wholly of a full-bodied commodity. Gold is conveniently portable, malleable, of uniform quality indestructible and universally appreciated. Gold is adopted as the appropriate unit of account because of its natural emergence as the most efficient money in the competitive marketplace, displacing all other commodities previously used over the centuries. Traditionally, gold has been the premier monetary unit of account, while other metals such as silver and copper have been useful for small transactions. Gold being the highest priced monetary unit per troy ounce since the beginning of a metallic standard, it was natural that eventually it became the monetary unit of account among Western nations. In fact, most national currencies on the gold standard eventually defined their currency in specified weights of gold bullion.

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The Case for Gold as Money

While the favoured *Privateer* ceased publication last April, publisher William Buckler left us a justifiable legacy of the case for gold as money. 'Money is not wealth, but a medium by which wealth can be exchanged between consenting adults. If an adult does not consent, then money cannot produce an exchange. Nothing can produce an exchange if the potential parties to it do not consent. However, an expropriation can be produced by a government with sufficient power. To obtain that power, money must be controlled by government. Today, it is and because the money you use is controlled by your government, so are you.

A free nation cannot be achieved or preserved without sound money. Gold – above all other possible media of exchange – has historically proven itself to be that sound money. Any analysis of any aspect of our current global financial system which ignores this fact is fundamentally flawed. That is particularly true when dealing with markets, since money is the bedrock of all financial markets. As such, it is also the bedrock of all economies. It is impossible to overstate the importance of sound money. Gold is the soundest money ever discovered.

The Function of Gold

Anything bought or sold in a financial marketplace is supposed to be an investment. Financial investments are supposed to have two attributes. Firstly, regardless of their price at any given time, they provide a yield in the form of a dividend and/or any interest payment. Secondly, being traded on a market and therefore being subject to price fluctuations, they provide an opportunity for capital gains or losses. All dividends, interest payments and capital gains are denominated in the currency of the nation in which a given market is located. The aim is to enjoy both an income stream and the possibility that the market value of the investment will appreciate. Both of these financial investments are paid for in terms of money – in all cases a fiat currency. In the advanced nations – those most steeped in modern economic and monetary theory – the precious metals and gold in particular are not seen as investments. We have long since become very tired of the mantra of Western investment analysts: 'Gold is not an investment because it pays neither dividends nor interest. This is perfectly true. No form of money pays dividends or interest – it is dividends and interest –and every other form of payment which exists in all markets. Money is used to buy and sell investments. It does not constitute the investment itself. A gram, troy ounce, or metric tonne of gold is merely a mass of inert metal. When used as money, it is not a promise to pay, rather it is a medium of exchange and therefore a form of final payment. It cannot be created by law (fiat), so its quantity cannot be increased by law (fiat). It is not a promissory note (like a Federal Reserve note); it is a means of transferring property between participants in a market. It represents final payment. Its utility as a medium of exchange does not depend upon the future confiscation of wealth. It is the medium by which the ownership of wealth is voluntarily transferred between the owners of that wealth. Gold is the best means ever discovered to underpin a market economy – and by doing that – a free and civilized society.

The Market for Gold

The reason there is a market for gold today is because gold has been legally barred from its historic role as money. Since gold in the form of money is no longer the common denominator in all prices, it has a price in terms of the currencies which have usurped this role. There are two markets for gold. In one, money is used to price paper claims to gold and in the other, money is used to price physical gold itself. The headline price of gold is determined in the paper markets, most notably in the futures markets of the U.S. and other developed nations. Physical gold plays next to no role in these markets. Almost all contracts are bought, sold and settled in terms of paper. The holder of a futures contract can request settlement in the physical metal upon the expiry of that contract, but he or she cannot demand it. All contracts can be and almost always are settled in paper terms.

Gold investors will be well aware of the price volatility which has recently hit the futures market for precious metals. The most notable feature of the recent dive in the price of gold on the global futures markets is that the lower the paper price traded, the higher demand grew for the physical metal. Even more notable is the fact that this physical demand was not confined to those parts of the world where gold is seen as insurance against central bank monetary creation. The demand was global and the cleaning out of physical inventories took place everywhere. Moreover, the premium on physical metal – the markup of the spot physical price over the futures paper price – blew out all over the world to an unprecedented degree. This is the most dangerous event to have hit the overseers of the financial system since the credit freeze of 2008. Indeed, there is no cure for this one **because physical gold cannot be created out of thin air.**

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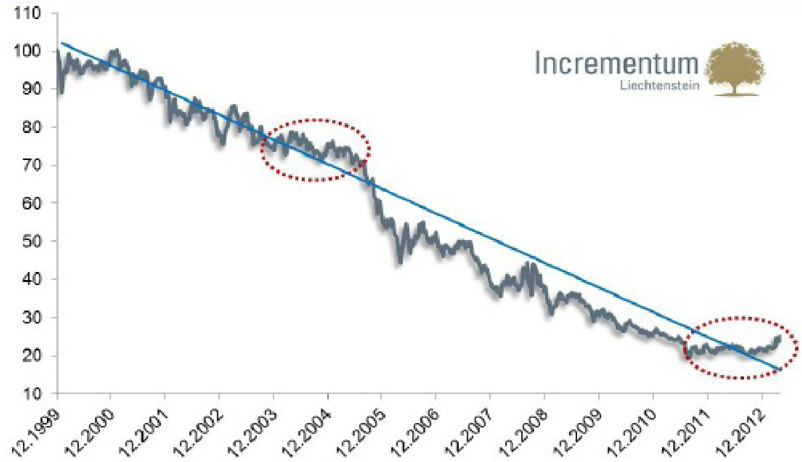
The chart below from Incrementum AG outlines the long term downtrend of a basket of fiat currencies relative to gold. The downtrend of the equal-weighted currency basket – consisting of the U.S. dollar, Euro, Swiss franc, Japanese yen, Renminbi, Indian rupee, British pound, Canadian dollar and Australian dollar – has however recently flattened and moved away from its trendline. A similar phase was already in evidence in 2003 and 2004. So, one must definitely keep an eye on the relative weakness of gold versus the basket. The second chart shows that the price of gold is suffering from the temporary return of confidence in the euro zone.



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"Those who cannot remember the past are condemned to repeat it." Santayana