

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE
ECONOMIC WINTER



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

The Folly of Elastic Money

In our Part I introduction we stated: ‘When the economic and financial systems are collapsing, people turn to gold because it’s the only financial asset which they can trust.’ In his book [Paper Money Collapse](#) published in 2011, author and Austrian School economist Detlev Schlichter concurs: Like all previous paper money systems, America’s present system is unsustainable. It will lead to ever-higher indebtedness, in particular that of the federal government, plus increasingly economic instability. In fact, the present U.S. system has already progressed a long way on the road to inevitable demise ... Fiat money is, has always been and always will be state money. Unlike other elementary social institutions like private property, market exchange and commodity money; paper money cannot claim to be the result of voluntary interaction. It was not adopted because its benefits were obvious to the mass of money users who then voluntarily chose to use it. Since it has been introduced by political means and for political purposes, the specific doctrines that support it require close attention. Various reasons are cited today for the alleged advantages of fiat money, however, none of them survives critical inspection. Historically, the reason why paper money was introduced has – consistently, very straightforwardly and often by official admission – been this one: to fund state expenditures, predominantly to finance war.

All governments enjoy the privilege of funding themselves via taxation, meaning the expropriation of resources from private wealth owners and market income earners. All other people and entities in society must obtain the goods and services of others by contributing to the production of goods and services themselves and then engaging in voluntary exchange. While the state can conscript through legislation, openly taxing wealth and income of the private sector is usually unpopular and comes with natural limitations. Thus, the printing of money created an additional avenue for funding the state. Without exception, this was the reason for all experiments with paper money in the history of mankind. In every case, the supply of paper money was constantly expanded and the purchasing power of the monetary unit eroded. The system always led to high inflation; ending either in the total collapse of the financial system with catastrophic effect for the economy and society, or in the timely abandonment of paper money and the return to commodity money ... The approaching breakdown of America’s present fiat money system – as dramatic and inconceivable as this may appear to today’s mainstream – will constitute nothing unusual or unique. Based upon any calm analysis of history and economic theory, it is simply what the rational observer must expect.

A Brief History of Fiat Money

In 1690, the Commonwealth of Massachusetts, at the time a British colony, started issuing paper money to pay its soldiers for military expeditions against French Quebec. The trend became popular in other North American colonies until all of them issued paper money. In all cases, the result was a steep decline in the purchasing power of the monetary unit. So, the British Parliament put an end to this experiment with paper money in 1764. The Bank of

England – often colloquialized as ‘The Old Lady of Threadneedle Street’ – was established in 1694 for the specific purpose of lending to the state. A multitude of legal privileges was bestowed upon the bank, which gave it an exalted status from the beginning. Anticipating the policy of all modern central banks, the Bank of England issued bank notes against liabilities of the Crown, which meant it monetized government debt. On several occasions during the first hundred years of its existence, the Bank was permitted to default on its promise to repay notes in physical gold and still continue as a going concern.

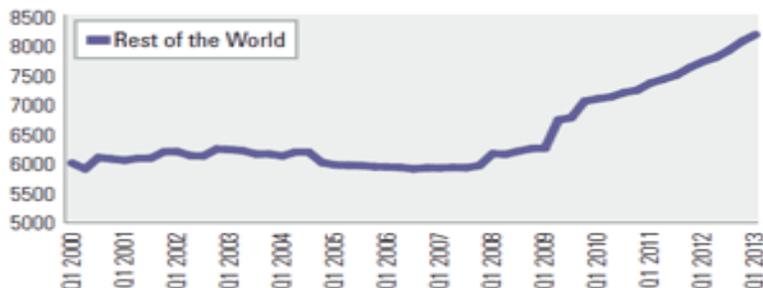
France issued paper money under the famous scheme of the Scottish gambler and monetary theorist John Law between 1716 and 1720 in order to bolster public finances. Saddled with enormous public debt as a result of the wars of Louis XIV, the government was on the brink of its third bankruptcy in less than a century. The issuance of paper money led to a speculative stock market boom termed the Mississippi Bubble. The inevitable crash and the decline in the value of bank notes brought turmoil to the French economy, as well as failed to ease France’s fiscal predicament. In 1775, the North American colonies resumed the issuance of paper money in the form of continentals, named after the Continental Congress; this time to fund the Revolutionary War. By 1781, continentals were practically worthless. France’s next paper currency was the assignats, issued during the revolution to fund another bankrupt government. They lasted from 1790 to 1803 and ended in complete worthlessness. The paper money collapse of the assignats is the first recorded inflation that created the modern statistical definition of hyperinflation, that is, an increase in prices exceeding 50% in a single month. In 1803, Emperor Napoleon introduced the franc. The period from 1793 to 1821 witnessed international conflicts on an unprecedented scale, involving much of Europe and at times America, in what were called the Napoleonic Wars. In Britain, the government of William Pitt increasingly used the Bank of England to fund the war with France. Excessive credit creation led to the outflow of gold and in 1797, the Bank was asked to suspend redemption in specie. Britain remained off gold for 24 years and experienced unprecedented price inflation, but in 1821, returned to the gold standard.

To fund the War of 1812 between the United States and the British Empire, the American government issued substantial amounts of Treasury notes, borrowed heavily from the growing banking sector and in 1814, allowed the banks to suspend specie payment. While resumption of specie payment took place in 1817, it was suspended again in 1819. The next major experiment with paper money was initiated by the U.S. Civil War. The northern Union was taken off gold in December 1861, when specie payment was suspended. This was followed over the next three years by substantial issuance of new paper money; new United States notes that were known as ‘greenbacks.’ Not surprisingly, greenbacks quickly began to lose their purchasing power and declined sharply versus gold. Greenbacks were declared legal tender and in 1863 and 1864, various measures were taken to disrupt the gold market. The goal of these policies was to suppress the price of gold and to discourage the use of gold as a basis for contractual exchange. The Resumption Act was passed in January, 1875, but the full resumption of specie payment did not occur until 1879. In that year, the United States joined the Classical Gold Standard, a global monetary arrangement that, while not perfect, saw an unprecedented period of fast economic growth, free trade and harmonious monetary relations that was ended by the First World War. Germany, Holland and the Scandinavian countries had already joined Britain on the gold standard in the 1870s. Switzerland, Belgium and France all followed in 1878. After the United States joined in 1879, Austria followed in 1892, Japan in 1897, Russia in 1899 and Italy in 1900.

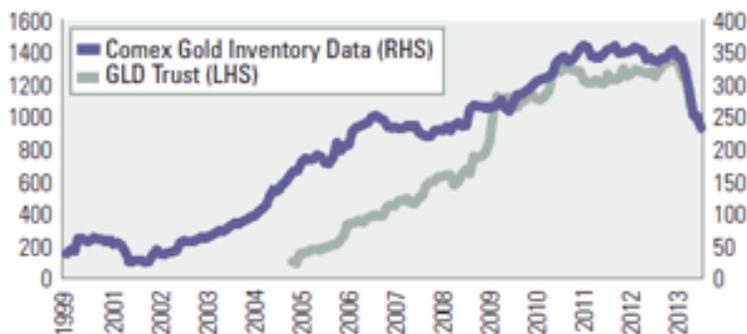
Why the Gold Bull Market Isn’t Over

In a recent ‘Markets at a Glance’ research report by Sprott Asset Management – excerpted by the Globe and Mail – Eric Sprott argues that Western central bank gold holdings are dwindling, causing physical gold market supplies to tighten markedly. ‘Recent dramatic declines in gold prices and strong redemptions from physical Exchange Traded Funds (ETFs) – such as GLD – have been interpreted by the financial press as indicating the end of the gold bull market. Conversely, our analysis of the supply and demand dynamics underlying the gold market does not support this interpretation. Many major buyers of gold are adding to their stocks, while simultaneously, supply is flat or even declining, compounding an already vast imbalance. For example, central banks from the rest of the world (non-Western central banks) have been increasing their holdings of gold at a very rapid pace; going from 6,300 tonnes in the first quarter of 2009 to more than 8,200 tonnes in the comparable quarter of 2013. At the same time, physical inventories of gold have declined rapidly since the beginning of 2013, while physical demand from large and small scale buyers remains solid. As we have shown in previous articles, the past decade has seen a large discrepancy between the available gold supply and gold sales. The conclusion we have reached is this gold has been supplied by central banks, who have replaced their holdings of physical gold with claims on paper gold.’

Central Banks Reported Gold Holdings (Tonnes)



Physical Gold Inventories are Declining (Tonnes)



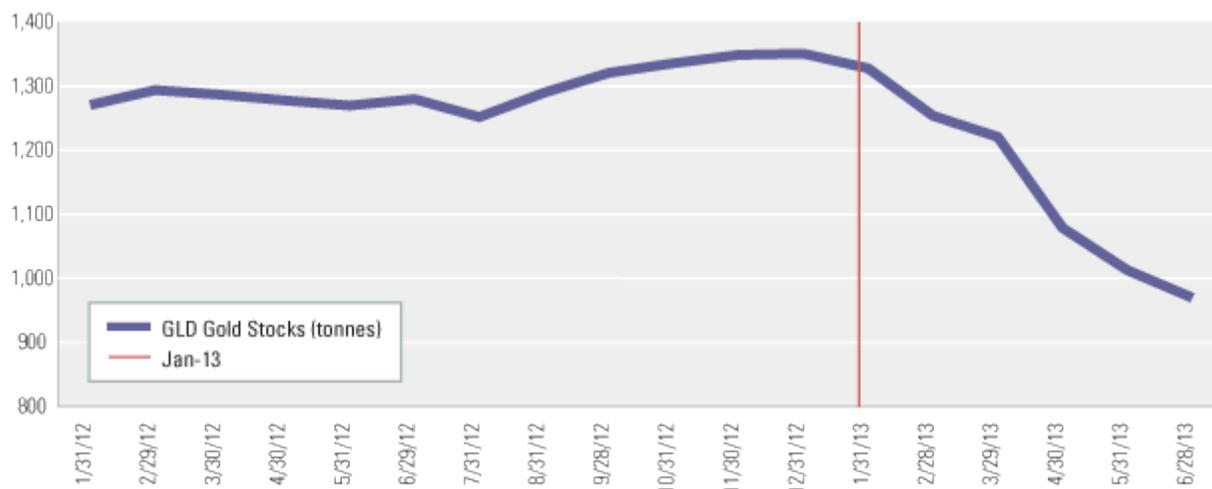
Source: World Gold Council, Bloomberg, Hong Kong Census and Statistics Dept.

Firstly, in January, the German Bundesbank – the second largest gold reserve in the world according to the International Monetary Fund (IMF) announced that they would repatriate their gold from the New York Federal Reserve’s vaults. In total, 300 tonnes out of the 6,200 tonnes the New York Fed claims to hold should be relatively easy to transfer. However, the Bundesbank also announced that it would take about seven years to complete. If the gold is really there, it should not take much time to transfer a paltry 4.8% of the New York Fed’s vault holdings. Then in March, there was a leaked letter from ABN Amro (a large Dutch bank) advising its bullion customers that redemption of physical gold from their allocated accounts would now be impossible. In April, we heard reports that UBS and Scotiabank were experiencing a depositor bullion run, where customers were lining up to withdraw their gold. Finally, a few days later, we heard from Jim Sinclair that allocated gold deposits held in Swiss banks could not be withdrawn on the basis of directives from the central bank. Indeed, why would a bank do that if it had its customer’s gold in its vaults? Finally, on July 1st. we learned that delivery times at the London Metals Exchange were as long as 100 days. All these events strongly support the thesis that the strong physical demand we have seen over the past few years, is putting ever increasing strains on the Central and bullion banks.

Against all odds, the price of gold has experienced a large decline over the past few months, only slightly recovering over the past few weeks or so. Given the strong physical demand and the lack of available supply, we think that this price decline was engineered by central and bullion banks to increase available (physical) supply and decrease demand. They flooded the COMEX (paper market), only to then uncover physical gold from the various available sources at depressed prices. This has been manifested in the GLD trust and the COMEX inventories. Since the beginning of the year and well before the April gold price crash, one of the largest repositories of physical gold – the GLD trust –

has seen redemptions of more than 300 tonnes of gold; while world mine production – excluding Russia and China – is approximately 2,300 tonnes a year. If our thesis is correct, the Central Banks are running out of gold. This cannot be allowed, so the only option left for central planners is to attempt to tame the demand for gold.'

The GLD Is One of the Last Reserves of Gold Bullion



The Most Effective Means of Creating a Currency of Stable Value

In his 2007 publication, *Gold: The Once and Future Money*, author Nathan Lewis purports: 'The gold standard, in its most rudimentary form, literally dates back to the beginnings of recorded history ... The use of gold as the benchmark of monetary value is based upon the premise and observation that the value of gold is more stable than any other commodity or any statistical concoction or any string of guesses by a policy board. The purpose of a gold standard is therefore, to produce the most stable currency value possible over both the short and long term. A gold standard is a value peg, not a quantity peg. A gold standard is not – and never has been – a system by which the amount of base money is determined by the amount of gold held by the monetary authorities. From this it can be seen that importing or exporting gold, or other such actions, are generally of little concern, since transporting gold from place to place does not change its value. In essence, a gold standard among multiple countries is a world currency. It needs no central governing bodies; it is not dependent upon any sort of fiscal rules and restrictions; and any country that chooses to participate, may do so unilaterally. It is the citizens' world currency.

Under a gold standard, the gold market is an open market free of government manipulation. The managing body does not intervene in the gold market to support or suppress prices ... The gold standard reinforces democracy; fiat money erodes it. Without the gold standard, the trillions of monetary agreements of the citizenry are made subject to the whims of a secretive, unelected, politically insulated policy board. The evolution of money has been toward a system which is not subject to political decision making. The bimetallic gold and silver standard had to be abandoned in the late nineteenth century because the questions of profit and loss, success and failure, solvency and bankruptcy were subject to a political decision of whether payment was allowed in gold or silver. Seemingly trivial, it was a major source of contention for decades.

In the longest term, gold's record is impeccable. Commodity prices were roughly the same in 1717 – when Britain began the gold standard – as they were in 1931, when Britain left it. The same held true in the United States between 1800 and 1930. The volatility of the gold market since 1971 is almost completely due to the volatility of the currencies in which gold is valued, primarily the U.S. dollar. Sales of gold by central banks or variability in annual production are very modest compared to the world supply of gold, and have little effect on the price. Predictions that gold would become a commodity after 1971 and trade below \$7 (U.S.) per ounce did not pan out. Gold is the world citizenry's standard of value, and as Von Mises predicted, no government action can undo that fact, just as governments were not responsible for its creation.

There is no ultimate authority by which gold's value itself can be measured. If there were, humans would have adopted it as a standard of value and abandoned gold long ago. Yet, it can be observed today that when a currency declines in value compared to gold, inflationary phenomena appear. When a currency rises in relation to gold, deflationary phenomena appear. This is true of whatever currency is measured against the golden benchmark. Gold has been adopted as money because it works. It has defeated every challenger. Although it has been spurned by governments many times, this has never been to a fault of gold to serve its duty as a standard of value, but because governments had other plans for their currencies beyond maintaining their stability. There is no reason to believe the great monetary successes of the past four centuries – indeed, the past four millennia – could not be recreated in the next four centuries.'

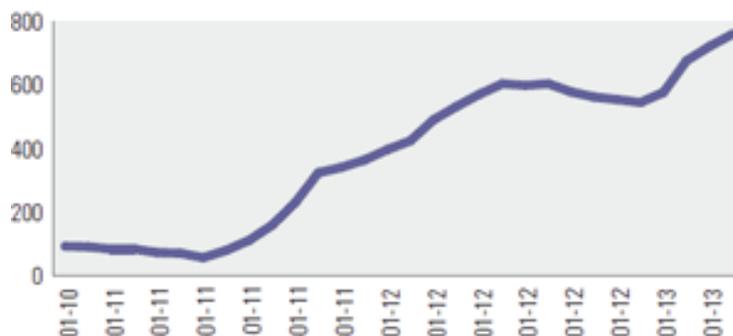
Summation

In our theme for the restoration of the gold standard on a global basis, we have referred to the writings of certain knowledgeable authors, such as Paul Nathan, who notes that there is no Utopia – not in economies, not in politics and not in investing. However, gold is what it is: a rare and precious metal with particular qualities that make it an effective medium of exchange. Today, due to the sovereign debt problems and challenges in the United States, Japan, Great Britain and several European Union countries (Greece, France, Italy, Portugal and Spain to name a few), gold is also a good investment vehicle. While there is no absolute guarantee that a gold standard will prevent future financial crises, the closer the world comes to embracing such a monetary system, the greater will be the security of money, hence the stability of the global economy. Without free market capitalism, free international trade and objective laws which protect individual rights and property rights, a gold standard monetary system cannot survive. Indeed, this can only be achieved through fiscal discipline and limited government.

While today the U.S. dollar remains the world's reserve currency, global confidence in America is gradually eroding on several fronts. Political gridlock in Washington is crippling the proper functioning of the federal government and is preventing the country from dealing with problems and challenges ranging from decaying infrastructure (roads, dams and bridges) to the statutory debt ceiling – rapidly approaching \$17 trillion (U.S.). In Washington, leaders of the House and Senate have degenerated from being political adversaries to being political enemies. The traditional process of compromise for the good of the nation has become a blasphemy. The American public's approval rating for Congress has nosedived to an all-time low of 18%. The U.S. also suffers from military overreach on a global basis, while domestically, over 47 million citizens are reliant upon food stamps. Economic growth remains low and the official unemployment rate remains high.

Accordingly, several countries are avoiding the U.S. dollar for international trade purposes and have established mutual currency agreements instead: citing Australia and China; Russia and China; as well as Japan and China. Moreover, China continues to stockpile gold bullion on a regular basis. Not only, does any domestic gold production never leave China, but Chinese gold demand on many levels remains very strong. (See chart below).

12-Month Cumulative Net Gold Exports to China (Tonnes)



Source: World Gold Council, Bloomberg, Hong Kong Census and Statistics Dept.

In the long history of global monetary systems, reserve currency status has always been afforded to the world's greatest creditor nation. Today, that country is China, not America. Accordingly, we believe that China is harbouring a very long-term plan to orchestrate the replacement of the U.S. dollar reserve currency status with the renminbi, or initiate a global campaign for a return to the gold standard.

Written by: Christopher Funston

Ian A. Gordon, The Long Wave Analyst www.longwavegroup.com

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