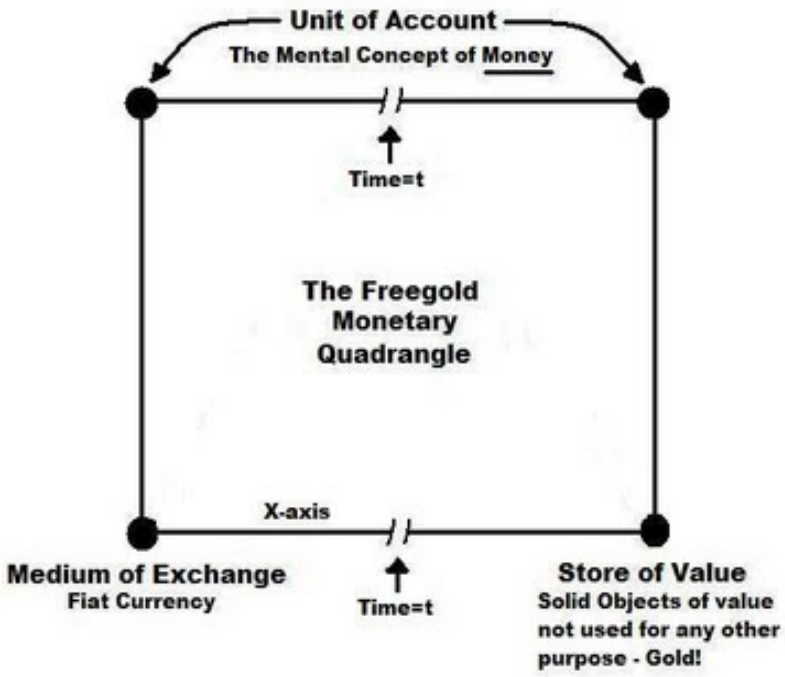
Aquilus & Matrix Freegold 101: An Introduction



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Saturday, October 17, 2009

Gold is Money - Part 1

Does this strike you as a curious title for an FOFOA blog post? I'll bet some of you are saying yes while others are thinking "huh? What kind of a stupid question is that?" Onward...

One of the greatest compliments I receive is when people say that I write in a way that anyone can understand. But one of the reasons my posts come across this way is that I really try to avoid stereotypical and dogmatic words. I especially try to avoid words deeply embedded in our elite academia. The problem is that these words carry so much baggage. They carry a standardized mental picture that is often wrong. In fact, some words carry multiple images specific to different factions of belief.

This "word problem" creates confusion and often stirs misguided debate founded on different definitions. "Inflation" versus "deflation" is a perfect example. So to avoid misunderstandings, I try to explain my Thoughts through descriptions rather than dogmatic words.

Hyperinflation, however, is one word I do use, because I think it portrays the best visualization I can deliver as to how the dollar's collapse will unfold. At the same time, I am careful to explain that I believe gold's price explosion is a totally separate event that is coming. It is not DEPENDENT on hyperinflation. In fact, hyperinflation could theoretically be avoided while gold's price explosion cannot.

Along these same lines, explaining myself descriptively, I state that my position is "deflation in *real* terms"... in terms of gold! What makes it so difficult for traditional "deflationists" to grasp this concept is that deflation (my description of deflation) will end in hyperinflation! "Hyperinflation", as I have shown, has much more in common with their understanding of "deflation" than it does with the

common understanding of "*in*flation". As I like to say, the only thing hyperinflation and inflation have in common is nine letters. And I also like to say that in the end we will have hyper-DE-flation in all things measured against gold, and hyper-IN-flation in all things measured against dollars.

I am opening with this long prelude only to demonstrate my "descriptive" intentions as I now tackle the most dogmatic and divisive word of all... **MONEY!** What is money? Answer this question honestly and I think a lot of what I write may suddenly come into clearer focus.

Gold is Money

This is *the* dogma among most in our crowd, is it not? Gold is money! Who on earth can dispute this (practically) divine statement? Well, I'm not here to stir up trouble, so I will leave this one alone for the moment. But I hope we can all agree on at least one thing for the moment. How about this one?... "Gold is a form of wealth!" Hopefully we can at least agree on this statement as we proceed. Gold is a form of wealth.

Functions of Money

"Money", as it is understood today, has three main roles. The late Dr. Willem F. Duisenberg, former President of the ECB, in his famous acceptance speech for the International Charlemagne Prize in 2002 stated it well...

> What is money? Economists know that money is defined by the functions it performs, as a means of exchange, a unit of account and a store of value.

Our modern understanding of money is that it has three roles or functions: 1) A medium of exchange, our TRANSACTIONAL currency, 2) a unit of account, a "number" used for comparing relative values, held in each person's memory AND on paper for bookkeeping (and legerdemain), and 3) a store of value, or wealth.

What I would like to do now is to take a broader view of money. A thought experiment that will transcend the last 38 years of our monetary experience. I hope to transcend even the last century, the last 233 years of our United States, perhaps even the last millennium. Let us think about money in terms of the last 2,500 years. And perhaps then we can gain a new perspective that yields a fresh understanding of what the heck is going on right now!

Etymology

Etymology is the study of the history of words. Now I am no expert, but I would like to point out what the dictionary says about 'money' and 'currency'. From my post, On Hyperinflation:

> Two definitions are important in this discussion. These are from Webster's Dictionary:
>
> Currency (1699) 1 a: circulation as a medium of exchange b: general use, acceptance, or prevalence 2 a: something (as coins, government notes, and bank notes) that is in circulation as a medium of exchange b: paper money in circulation c: a common article for bartering d: a medium of verbal or intellectual expression

> Money (13c) 1 : something generally accepted as a medium of exchange, a measure of value, or a means of payment
>
> Note that the first known use of the word Money in the English language was in the 13th century. The word Currency didn't make it into the English language until more than 400 years later.

Note also that the appearance of the word 'money' in the English language came 800 years *after* the fall of the Roman Empire.

Thought Experiment

Now on to our Thought experiment. This comes to us courtesy of FOA on The Gold Trail. I have edited the length of FOA's presentation for the purpose of this post, but will keep it in blue to differentiate the source. The entire post can be found at the link above.

Owning wealth aside from official money units is nothing new. Building up one's storehouse of a wealth of things is the way societies have advanced their kind from the beginning. What is new is that this is the first time we have used a non wealth fiat for so long without destroying it through price inflation. Again, a process of using an unbacked fiat to function as money and building up real assets on the side. Almost as if two forms of wealth were circulating next to each other; one in the concept of money and the other in the concept of real wealth.

This trend is intact today and I doubt mankind will ever pull back from fiat use again. Fiat used solely in the function of a money concept that I will explain in a moment.

Understanding all of this money evolution, in its correct context, is vital to grasping gold's eventual place in the world. A place where it once proudly stood long ago.

All of this transition is killing off our Gold Bug dream of official governments declaring gold to be money again and reinstitution some arbitrary gold price. Most of the death, on that hand, is in the form of leveraged bets on gold's price as the evolution of gold from official money to a wealth holding bleeds away any credible currency pricing of gold's value in the short run.

To understand gold we must understand money in its purest form; apart from its manmade convoluted function of being something you save. Money in its purest form is a mental association of values in trade; a concept in memory, *not* a real item. In proper vernacular; a 1930's style US gold coin was stamped in the act of applying the money concept to a real piece of tradable wealth. Not the best way to use gold, considering our human nature.

By accepting and using dollars today that have no inherent value, we are reverting to simple barter by value association. Assigning value to dollar units that can only have worth in what we can complete a trade for. In effect, refining modern man's sophisticated money thoughts back into the plain money concept as it first began; a value stored in your head!

So you think we have come a long way from the ancient barter system? Where uneducated peoples simply traded different items of value for what they thought they were worth? Crude, slow and demanding, these forms of commerce would never work today because we are just too busy, right? Think again!

Lean back and think of all the items you can remember the dollar price for. Quite a few, yes? Now, run through your mind every item in your house; wall pictures, clothes, pots and pans, furniture, TVs, etc... Mechanics can think about all the things in the garage, tools, oil, mowers. If one thinks hard enough they can remember quite well what they paid for each of these. Even think of things you used at work. Now try harder; think of every item you can remember and try to guess the dollar value of it within, say, 30%. Wow, that is a bunch to remember, but we all do it!

I have seen studies where, on average, a person can associate the value of over 1,000 items between unlike kinds by simply equating the dollar price per unit. Some people can even do two or three thousand items. The very best were some construction cost estimators that could reach 10,000 or more price associations!

Still think we have come a long way from trading a gallon of milk for two loves of bread? In function, yes; in thought no! Aside from the saving/investing aspects of money, our process of buying and selling daily use items hasn't changed all that much. You use the currency as a unit to value associate the worth of everything. Not far from rating everything between a value of one to ten; only our currency numbers are infinite! Now, those numbers between one and ten have no value, do they? That's right, the value is in your association abilities. This is the money concept, my friends.

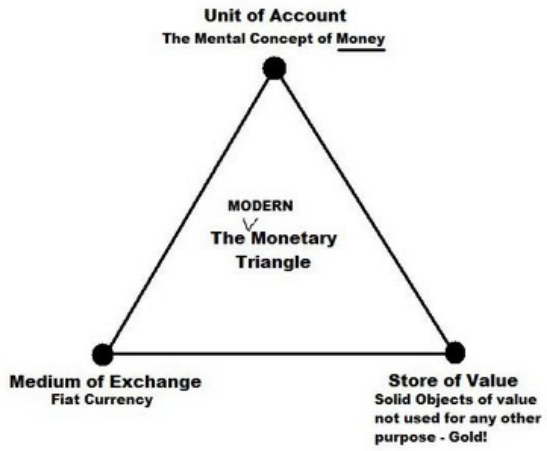
Unlike the efficient market theory that was jammed down our throats in school, we all still use *value associations* to grasp what things are worth to us. Yes, the market may dictate a different price, but we use our own associations to judge whether something is trading too high or too low for our terms. We then choose to buy or sell at market anyway, if we want to.

In this, we have moved little from basic barter. In this, we are understanding that an unbacked fiat works because we are returning to mostly bartering with one another. A fiat trading unit works today because we make it take on the associated value of what we trade it for; it becomes the very money concept that always resided in our brains from the beginnings of time.

In this, a controlled fiat unit works as a trading medium; even as it fails miserably as the retainer of wealth the bankers and lenders so want it to be.

So how did your Thought experiment go? Did you come to the conclusion that the concept of "money" in its most pure and primal form is the mental association of values in trade? That it is the actual thought process inside of our minds that we use to associate the relative value of real things? "Money is just a book keeping accounting of real wealth!" "Why do we need to save this stuff anyway?"

So, to assign this concept to one of the three "functions" of modern money, the *pure money concept* fits best within the unit of account function.



Modern fiat currency, our modern physical transactional medium fits best in the means of exchange function. And real wealth, with gold as the most liquid, durable and portable example par excellence, fits best in the store of value function.

History

Now let us take our Thought experiment back in time, before the words money and currency entered the lexicon. In those times, gold was just another form of wealth that was traded in simple barter. But gold had certain qualities that made it especially convenient to trade. And it also had qualities that made it especially good to hold as wealth! For one thing, it was not needed for other functions, so one could hold as much as possible without infringing on anyone else!

A hat was also wealth. So was a pig. A hat could be traded for a pig just as easily as a piece of gold. But pigs were for eating and hats were for wearing. And if one man became wealthy enough to hoard all the hats, there might have been an outbreak of sunburned heads! :)

The point is that gold was not "the pure concept of money" any more than hats were, or any more than paper dollars are "the pure concept of wealth"! When the ancients stamped gold into coins, they were simply making a true barter item, a wealth item more recognizable and easier to use. Even without any legal tender laws, this barter item, coined or not, still carried its value in its weight.

But as "the pure money concept" (the unit of account function) crept in and attached itself to the numbers stamped on gold coins, the door was opened to the debasing of wealth and public theft through the clipping and diluting the metal content of the coins. Enter the appearance of Gresham's Law!

Even still, was gold really what we think of as "money" back then? According to FOA, the answer may well be no:

We were first alerted to the "gold is money" flaw years ago. When considering the many references to gold being money in ancient texts, several things stood out. We began to suspect that those translations were somewhat slanted. I saw many areas in old texts where gold was actually referenced more in a context of; "his money was in account <u>of</u> gold", or; "the money account <u>was</u> gold", or; "traded his

money in gold". The more one searches the more one finds that in ancient times gold was simply *one item* that could account for your money values. To expand the reality of this thought; *everything we trade* is in account of associated money values; nothing we trade is money!

Well, I put it off at the beginning of this post, but I'll ask it again now... Gold is money! Who on earth can dispute this (practically) divine statement?

I ask this again only as a rhetorical question. Because as I pointed out in my long prelude, this post is all about confusing and misleading dogma presented through the use of stereotyped words. Money being the worst of all!

Are we using Wim Duisenberg's definition of money, consisting of three roles? Or are we using our own newly discovered "pure concept of money" definition, consisting of only one of those roles? Or are we suggesting, when we say "gold is money", some NEW definition based on a hybrid role assignment? What is "honest money"? And what does someone mean when they say "gold is money"?

Can you see how common words that different people define differently can cause great confusion and disagreement, even when it is not really warranted?

And can we now agree on these three statements at least? 1) Gold is a form of wealth. 2) The *pure* concept of money fits best within the unit of account function. 3) The word currency best describes what we currently use in the medium of exchange role.

Okay, with this newfound partial agreement in place, let us take a look at where we are heading. And let's see if we have gained any new understanding. Here is a little more from FOA:

Today's talk is, once again, a more detailed continuation of our theme: the evolving message of gold. I'll begin now.

Our modern gold market price illusion is little more than a product of the fiat dollar system; a design that denominates gold credits in a contract form. Is it a free market? Why yes, very free. But... TOO free, in the sense that contract supply is totally unlimited. Investors bought into this market even though they fully well knew 90% of the volume was represented by only cash equity on the other side. Knowing that, they somehow expected that those contracts were limited in creation by the fixed amount of gold in the world. Their mistake, not the market's.

Clearly, anyone schooled in classic hard money Thought should have known that this was just another gold inflation; a *transitory* era between money systems. This was a time to gather gold over the years, not invest in the leveraged aspects of gold's new fiat versions. Nor, to buy into the gold industry that owed its life and cash profits to the maintenance of such a system; transitory as it was. The expanding fiat universe was best used to gather real wealth each time the transactional fiat currency cycled through your domain.

Anyone that understood this knew that this is how you handle an evolving process. For myself and others, knowing that gold's inherent value could not change much and was historically undervalued in its comparative value to all things, we bought gold in quantity. We tossed aside Western concerns about shifting currency prices of gold.

This entire paper-gold trading realm represents the conclusion of a convoluted, decades long attempt by mankind to tie his fiat money concepts to physical gold. These centuries of gold/money tie-ins will end in a colossal breakup of the entire fiat money-plus-gold concept; leaving gold and fiat to trade independently of each other.

Unfortunately, it's on the dollar's watch this will all end as this gold failure is running in parallel to the dollar ending its position as a world reserve currency.

The above is a good summary of FOA's message. I am sure that some of you have read The Gold Trail, but I'm curious if you felt a slightly deeper meaning in it now that we have discussed the pure concept of money. And if so, you should try reading the whole of A/FOA again! It can be found at the top of my favorite links to the right.

You know, I often visit websites and forums that proclaim, "Gold is Money!" I have no argument with them. Obviously they are talking about the store of value function in Wim Duisenberg's definition of money. I mean, clearly gold is not our currency nor unit of account. And sometimes I visit sites that proclaim "We must return to honest money!" And again I have no argument. I understand that they are simply fed up with the built-in inflation in our modern medium of exchange that infringes on their store of value concept. I couldn't agree more.

Yet here I am to tell you that gold is now becoming completely demonetized! That the odds of us going back on the old gold standard are right around zero! That the inflating paper gold contract market has kept gold in a monetized state, even though we left the gold standard. But that is now coming to an abrupt end. I am here to tell you that even if we get some sort of new super sovereign global reserve currency with a certain "portion" held in gold, this will not mean the remonetization of gold!

Look no further than the political stylings of the Euro to see how this new super sovereign currency would work. Gold may be a portion of its reserves, just like the Euro. But also, just like the Euro, that gold will be marked to market! (See: Your Own, Personal, Freegold)

Indeed, Duisenberg also had this to say in his famous speech:

> [The Euro] is the first currency that has not only severed its link to gold, but also its link to the nation-state. It is not backed by the durability of the metal or by the authority of the state.

Yet somehow its required 15% gold reserves have risen to 55.6% in ten years! And for some reason its gold reserves are still on LINE 1 of its financial statement! Hmm...

But current global confidence is too shaken for a new reserve currency to work just yet. Gold may end up being the single object that restores confidence enough for a new reserve system shared by many nations, but not at today's gold price. Not anywhere even close to it!

The human concept of money is changing whether we like it or not. It is being torn apart. Gold, as a wealth reserve and wealth asset, will exist and trade parallel to the world of fiat, the world of credit and debt. Producers and savers will finally have the option to switch tracks so to speak. To get on a parallel track that avoids the inevitable collision with the debt-hungry collective their savings have always faced.

And as we pass through this phase transition, as gold switches from the transactional track to the wealth-reserve track, it will take on a whole new meaning... and a whole new value! The non-dollar part of the world already knows this. This is why they are buying gold now! You see, as a truly demonetized wealth asset, gold has a much much higher value to mankind than it does as a transactional money. To get an idea of the difference, just compare the basic transactional money supply with the vast quantity of so-called "paper wealth dollar derivatives". This should give you an idea of what is coming!

Sincerely,
FOFOA

Wednesday, October 21, 2009

Gold is Money - Part 2

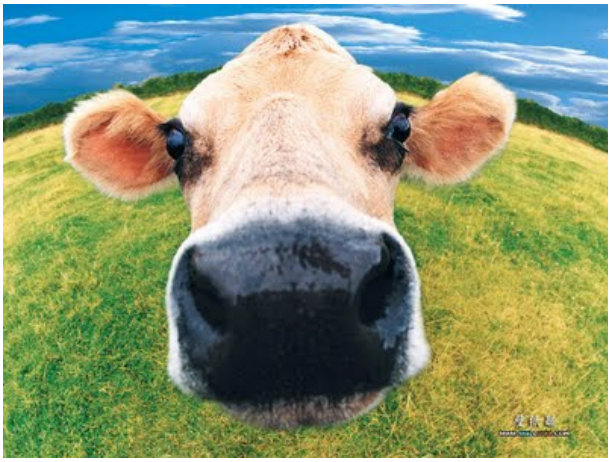
In our last discussion we distilled the pure concept of money down to the innate human ability to mentally associate relative values. Today we will expand this thought in order to apply it to some very different functions we associate with our modern, common understanding of money. Hopefully this exercise will help to reveal a deeper understanding of where we are heading.

Confusing the Human Instinct of Value Association

Taking the pure concept of money further, we can say that money is the range of numbers that we hold in our memory, or numbers that we write on paper in a bookkeeping account, for the purpose of value association.

Imagine an ancient barter system, where one cow trades for two goats. And one goat is worth five chickens. In our mental association of values we might use the chickens as the primary basis and attach a value of 1 to a chicken, to make trading a little easier. So a chicken is 1, a goat is 5, and a cow is 10. We now have a simple monetary system of 1 through 10 in which the numbers themselves are our money, and an object of wealth, the chicken, is our unit of account.

So if I have two cows, three goats, and 25 chickens to trade, I might calculate in my head that I have a total trading value of 60 monetary units with which to trade. That number 60 is my primitive concept of money. But I wouldn't say that my money account was only in chickens. I would have to say that I have a total value of 60, but my money account is in chickens, goats and cows.



Over time it was discovered by early man that gold was the most accepted tradable wealth of all, and soon almost everyone was accounting for their wealth using gold as the basis for the mental unit of account. Gold was better than chickens for many reasons, not the least of which that sometimes chickens died. Also, gold could be divided into smaller and smaller pieces. When you did this with chickens, again, they died. This was certainly acceptable at meal time, but not out on the road, traveling the trade routes.

So the pure concept of money was the account, the rating system for value, the worth association in your head. Physical gold became the main wealth object used in that bookkeeping practice. This is how it was for at least a thousand years. But as all things evolve, man eventually became accustomed to speaking of gold in the context of money accounting. Even as languages evolved the concept of money accounting and the physical wealth holding of gold became mingled as one and the same.

This transition was subtle and unnoticed, an evolution transcending generations and even civilizations. But it has led to what has become a major conflict in the money affairs of our modern world. As gold receipts took over as the concept of money accounting (the mental value association role), man became confused as he now had to value his cows and goats against chickens that were never there in the first place. Receipts for chickens that far exceeded the actual chicken count. And how to value real chickens in this case? One imaginary chicken receipt = 1 real chicken??

You see, man has not changed as much as we might think since his barter association days. We freely exercise our skill at the value associations of all real things. Real things must remain free to float up and down as the reality of supply and demand dictates in order for our innate skill to be most efficient. Our inherent need to constantly change valuations as we see fit is what is driving physical gold to break free from its modern monetary attachment.

We inherently want to use gold as a wealth item par excellence. We want to trade *its* changing value within the same universe of floating values that all other tangibles trade. But for the benefit of the bankers and the US Govt, in the pursuit of stable credit and debt values, we have tried to fix gold's value to our "pure concept of money" so that banks can lend THE MONEY CONCEPT ITSELF, in lieu of lending real things, or real gold. Gold cannot be rigidly fixed to any money concept that must constantly inflate in order to survive, as any lendable and borrowable fiat currency must do, because physical gold is in finite supply.

Lending a Mere Concept

Today's dollar is a purely symbolic currency. It is not officially attached to anything. Our modern money system, like those in the past (even ones attached to gold), is built upon the notion that a mere CONCEPT can be lent in lieu of actually having to lend (temporarily part with) something of real value. The banking system wants to lend us 'the number 10', and have us pay it back, with interest, in chickens, goats and cows. They literally want to have their cake and eat it too.

This system of lending a purely symbolic monetary CONCEPT instead of lending real wealth requires the perceived value of that CONCEPT to remain relatively stable or else the entire banking system will collapse. It is to this end that bankers, governments, politicians and economists always try to entangle (think: forced quantum entanglement) gold into the money system and control its value in order to keep their CIRCULATING DEBT CONCEPT viable and valuable.

This is the problem with the architecture of the dollar, versus how all non-reserve fiat currencies will work in a free gold environment. The dollar must cheat in order to retain any illusion of stability. There are other ways for a fiat to remain stable. Responsible currency management is one. And in a system where the value of all real things (including gold) float freely against the parallel universe of fiat currencies, this will be how they will work.

When the dollar became a mere concept in 1971, so did all fiat currencies in the world. Their only value lies in the tradable value associations we give them, based on what can be purchased in the parallel universe of real things. But because we have been encouraged to save these symbolic debt concept units in lieu of anything with real value, a mismatch has grown to epic proportions whereby not even a fraction of these debt units can be traded back into the real economy at anywhere near today's prices.

We have lent, borrowed, saved, sliced, diced, sold, resold and insured so many units of a mere CONCEPT while neglecting to pay attention to the comparative size of the real economy with which the CONCEPT must run in parallel.

Our political drive, our collective spirit, and our American lifestyle has encouraged the near-exponential growth of this system so that we could buy real goods from others without sending them real wealth in return. So that we could grow and expand our great nation on a CONCEPT alone! We have proclaimed a strong dollar for the past 15 years, promoted it to be "as good as gold" and not only a perfect substitute, but a *much better substitute* for real wealth holdings... "because you must earn a YIELD". The dollar is even held as a "hard money" wealth reserve behind other currencies!

And over this period of the last 38 years, while our dollar perfected its role as a medium of exchange, it also left in its wake a world chock full of worthless CONCEPT-denominated paper wealth that people and nations bought and held in lieu of anything real. Today we are in a transition that will take us out of this jumbled mess and, in the process, will destroy much of our wealth illusion as it appears to simply evaporate away. But the truth is that it was never there to begin with!

Saving the System - Not its Value

It was said, many years before Paulson, Bernanke and TARP, that the financial system will be saved at any cost! Apparently this statement has proven to be true. But at what cost?

You see they are now faced with a dilemma they will not discuss publicly. On one side is their product, the conceptual unit of credit account, their currency. And on the other side is their offspring, the financial system, Wall Street. What saves one will kill the other. They can save the present value of their product and kill their offspring through starvation. Or they can save their offspring by delivering what it desperately needs to survive... a constant expansion of credit (aka monetary inflation). But this will, of course, kill the value of their product, the currency.

They can save one or the other, but not both. And it was always known, but has now been proven, that the system will be saved at ANY cost. (Unfortunately for them, they did not think it through far enough to realized that the cost of saving their offspring will also kill it and a whole lot more. But that line of Thought is straying a little too far from the topic of this post.)

In order to survive, the system, the financial industry, Wall Street NEEDS a constantly increasing supply of CREDIT! If the population won't give their own blood to save this dying Frankenstein monster, then the CB's and governments WILL! It is happening now. Right under our noses. For more than a year now!

This is why it is SO important that we hold only physical gold in our own personal possession in order to escape this tangled mess. Only touchable, graspable physical gold metal under full ownership conveys ALL of the properties that have come to be attributed to this kingly wealth asset. By contrast, financial contracts denominated in gold as facilitated by bullion banks, gold derivatives, gold loans, gold depositories, gold pool accounts, gold ETF's, or known by any other name, are all at their core pure and simple... (wait for it)... CREDIT. And what feeds the monster?? All together now... CREDIT EXPANSION!!

And because the underlying potential for depositors to exercise their claim on the gold metal within the system poses a constant threat (to pull the rug out from under the confidence in this particular variety of credit) which grows as the credit expands, a limit is eventually reached where the participants will tolerate no further expansion. And guess what? We may have just reached that limit!

The bottom line is that the banking system *will* be "saved" at the expense of sacrificing the market value of every last credit instrument they have created. Anyone and everyone with their savings *inside* the system will take a serious purchasing power haircut. The only people that will enjoy the full value of their wealth (and more) are the ones who hold it outside of the imploding system. Inside the system, credit of any color, green OR yellow, is only credit.

Long versus Short

Today's paper currencies are not just a medium of exchange, but they are still a pretty good store of value in the short term. The greater the rate of price inflation, the shorter the term that you will want to be holding the actual currency. Wealth assets, on the other hand, are the store of value for the long term. This differentiation is understood by almost everyone today. And it is so close to the concept of Freegold that it will not be "a giant leap for mankind" to get there.

The only difference is that right now, most of the public has come to believe that wealth is simply paper ownership of wealth producing industries and paper claims on real assets that can never be recovered at today's values. This is true for most all items, not just gold. And as we hold these paper documents for the long term, understanding them to be better than holding the actual currency because they provide a "yield", the recoverability of the underlying real asset is being constantly eroded away. In other words, we are unknowingly losing principle at the same time as we think we are gaining a yield!

From 1980 to 2001, the expansion of the financial industry far beyond the means of its parallel real world counterpart was a signal that our human instinct to buy *things*, or assets (even if only paper debt assets), rather than to hold the actual currency, was still intact. But the fact of the matter was that the dollar currency itself was expanding during this time period at a furious pace to meet its global usage demand WITHOUT causing the price inflation that should have accompanied such an expansion.

This strange "pseudo-deflationary" signal (versus gold) during a time of high currency inflation might have told the people that it was okay to hold the currency itself during this period. That something odd

was afoot. As the currency was expanding with such ease, but at the same time gaining purchasing power especially against gold and oil. But the people only *spent* their currency, which demonstrated their natural inclination. To spend currency, and to buy real wealth assets for the long term (even if those assets were little more than a value illusion).

But today a totally different signal is being broadcast loud and clear, and being equally ignored. That gold is now about to resume its historic role and value as a wealth asset, long suppressed by its troubled association with inflating transactional currencies.

Ever since our dollar became a mere concept in 1971 it has required the illusion of a stable gold price in order to remain viable in its various roles. And a stable gold price it has had! Yes, even with the spike in 1980 and the quadrupling in price of the last 8 years, gold has remained relatively stable and locked into its confusing association with inflating currencies, mainly with the help of the inflating paper gold market, but also through anti-gold propaganda.

If gold had truly abandoned its currency role in the 1970's, and taken on the unfettered role of wealth reserve par excellence, we would have seen prices in the many thousands even before the 1980 price spike. The dollar and its insidious wealth-derivative offspring had multiplied *that* much even before the official link with gold was finally broken.

Half versus Whole

Our ancient instincts have not gone away. We have not "advanced" as much as we think. Our use of "the pure concept of money" has not changed since the days when we engaged in direct barter trade. We still want to accumulate wealth item along side and separate from our transactional "pure concept of money" which is really just a number in our mind, or marked down on paper. We know that this "number" is not something to be saved, except perhaps for as long as it takes to arrive at the next transaction. (See: Fekete's A ‘fairy’ tale)

You see our modern money concept has been surreptitiously eroded into only one half of our ancient barter understanding of the money concept, and one half does not equal a whole. Most of today's money, other than the monetary base, is borrowed into existence. It represents a debt, and a debt is an incomplete transaction. It is only one half of what our instincts require as a wealth reserve, which is a fully completed transaction resulting in an *accumulation* of hard value. And yet we still buy these "wealth assets" denominated in only "half a concept", *half* of the monetary concept that our mind

intuitively understands.

This is a flaw! It is a big one, especially now as "the other half" is waving the white flag of surrender and default. Some very smart analysts see this as deflationary. They truly believe that the waving of the white flag will make this "half a concept" actually *rise* in value against its parallel real world economic counterpart. But that is not what will happen.

Paradigm Shift

What *will* happen is a paradigm shift. The paradigm shift will be the sudden planetary recognition that the global debt(concept)-based paper investment pyramid is collapsing from its own weight and size. And that the best safe haven retreat is physical possession of the one and only hard asset that is globally recognized as an official monetary wealth reserve, an officially recognized hard collateral asset, a true national treasure, and an historic denominator of wealth with a history longer than recorded history itself!

As I see it, we are running out of time... fast! All it takes is for one event to destroy global confidence. One event. Maybe the current rumors will turn out to be just that, rumors. I hope so, because the dominoes that would fall will stretch all the way to empty shelves at your local grocery store. But even *if* the current rumors are a dud, how many other explosive probabilities are lurking in the murky swamp of banking, finance, money, and paper gold?

Clear anecdotal and circumstantial evidence is emerging that some sort of a squeeze is underway against institutions that might be short gold. A PR battle royale is also underway in the media to counter the effects. It is amazing to me that we can still walk into our local coin dealer and buy gold at a small premium to the paper price. But this, too, is probably part of the confidence battle that is being waged. Someone may be going to great lengths to ensure that the shortage at the top is not visible at the bottom.

The mint has already canceled certain gold coins because of too high of a demand. We have gold hitting all time record highs. Yet the mainstream media think it is most important that you understand the solid fundamentals behind each down-tick in gold.

I hope you can see what is happening. The giants are battling it out like Greek Titans while the masses are being subjected to an anti-gold propaganda machine of unthinkable proportions. All I can say is don't delay if you are still planning to move your savings out of the Frankenstein feeding tube and into the safety of gold. If you are waiting for a dip or a correction, you may just miss the greatest transfer of wealth the world has ever seen. Any price within $2,000 of today's gold price is a steal. Forget about corrections, even if they come. It is only a matter of time until physical gold runs dry, the paper markets suffer "an event", and the value of physical gaps up higher than ANY of the analysts have predicted. Don't miss this one time event!

Sincerely,
FOFOA

THOUGHT, concept and some writing credit goes out to Randy (@ The Tower) circa 2001, and of course to my Trail Guide! Thank you for your priceless guidance!

Monday, October 26, 2009

Gold is Money - Part 3

Allow me to start by beating a dead horse. There is a vital difference between what may in fact be the ideal, perfect monetary system and what are the real monetary changes we are heading straight into today. My purpose for writing this blog is to share with you, and in return to receive your feedback on my own discovery and understanding of the latter. There are plenty of other sites that discuss the former.

If we can discover together where we are heading financially, economically and monetarily, and why we are heading there, then perhaps we can know, in advance, how the understanding of the global consciousness will evolve and unfold in the coming weeks, months and years. And, with this understanding, hopefully we can gain a certain peace of mind with regard to our own financial decisions, positions and future as we head into very stormy waters.

I know from my own experience that a little peace of mind is a priceless asset. It is one worth sharing, and one worth growing. Sharing and growing this asset together with you is my goal. Onward...

Our Understanding of Money

Let us quickly run through an assortment of common understandings of the term 'money'. The most common, mainstream understanding of money is that of a device bearing three functions. The three functions are 1) medium of exchange, 2) unit of account and 3) store of value.

A more purist understanding states that money is only a medium of exchange. And that the usability of money in other roles flows from its declared form. For example, if our common medium of exchange is physical gold only, then it is also an excellent store of value.

In fact, as a medium of exchange, money is only one half of a full barter exchange. The other half is when you change your money into that item you desire. But when physical gold is the common medium of exchange, then it is possible that the concept of a "medium" (or middleman) is incorrectly applied, because if gold was what you were after (for its store of value function), then the exchange is completed in only one step! Direct barter!

Finally, there is our new understanding of "the pure concept of money" which is our innate human ability to associate relative values. And within this understanding of 'money', it became clear that in order for our ability to function properly and efficiently in the way it has evolved over millennia, gold must be free for each of us to impute value to it.

Gold Exchange Standard

Our most recent experiment with gold as the conceptual medium of exchange ended badly. The purist understanding of money, the common medium of exchange, longs for it to be a real commodity, or at least linked to a commodity so that the actual medium can have a relatively stable value and double as a store of wealth. But when we lock a finite commodity into a parity relationship with an inflating paper currency, we only drag down that commodity's relative value compared to the rest of the real world as the related currency is inflated.

Over time, pressure builds up in this relationship set at par, the same as pressure builds between two business partners where one is lazy and unproductive and the other must carry the business through hard work. Sooner or later some of that pressure must be released and parity must be broken. Perhaps the lazy partner's equity position in the business is cut or reduced to reflect his lack of contribution, buying the ill fated relationship a little more time. This is what Roosevelt did with the dollar/gold relationship in 1933. But eventually these mismatched partners will have to part company once and for all. Just as gold and the dollar did in 1971.

In 1971 official parity was broken, but not forgotten. In the years since, an unofficial parity of sorts has been maintained through the paper gold market. Paper gold, like dollars, can be expanded and inflated while being locked at a par with the real thing. This is still going on today. But the pressure has been building for a long time now. This pressure held in the parity relationship between paper and physical gold is about to blow.

Gold Coin Standard

Even the gold coin standard we had leading up to the creation of the Federal Reserve System ended badly. You see, people put their gold coins into the banks and the banks lent them out. And then when confidence suffered a shock and the banks faced a run on gold, the system collapsed, many banks failed, and people lost their gold.

Human people want to be able to borrow money in the present that they plan to earn in the future. Not all people want to do this, but enough to influence the system certainly do. And this practice, by its very

nature, expands the money supply beyond its physical commodity limits, even in a pure gold coin standard.

During the late nineteenth century, all the major nations of the world moved toward a gold coin standard, wherein the gold coin itself was the common currency and medium of exchange. Between 1873 and 1912 some forty nations used it. [Answers.com]

The following is a post by Randy (@ The Tower) describing the end of the gold coin standard and the dawn of the Federal Reserve System (in blue).

Continuing our investigation into the meaning/essence of "money"... In 1907 America was on the Gold standard and WITHOUT any central bank. Many modern goldbugs might be inclined to yearn for those "good ol' days" when "money was money and banking was as it should be!"

However, that year is best known by the Panic of 1907 in which the people's economy was plagued by runs on trust companies, banking panics, and a bear market in stocks. Across the nation, banks were unable (and refused) to deliver gold coins and currency to satisfy the requests of depositors for withdrawals of money from their own accounts -- and 246 banks collapsed. It is not difficult to see how the frustration of depositors unable to obtain currency from banks (even solvent ones!) holding their deposits would lead to pressure for political intervention and change.

For a quick exercise in perspective, imagine what you would do today if faced with the same situation in which your bank could not give you any currency ($1s, $5s, $10s, $20s $50 or $100s) to carry away with you as a representation of the money residing in your bank account. No problem. You would simply write a personal check to meet your spending needs, or perhaps ask for a bank draft, or wire the money wherever it needed to go. Amazing! What IS money??? How did you get yours; where did it come from? How do you know what its value is?? Ponder that, and now we return to our glimpse at history...

In the wake of this banking panic, a National Monetary Commission was formed to undertake a scholarly look at the failings of America's financial system. Of these, the four major flaws cited were that the banks were decentralized, clearing methods were inefficient, the huge cash holdings of the federal government were not distributed where most needed, and the currency supply was inelastic. (Please ponder for a moment how or why the CURRENCY supply would ever be an issue if the amount of MONEY found in banks were at a one-to-one ratio with the currency (gold) that represented it. Surely, in this absence of a central bank there couldn't be more money than gold coin! That's impossible!!) By 1911, the Commission had recommended a plan for a "Reserve Association of America" as the solution to these defects, giving rise two years later to what became our central bank -- The Federal Reserve System. However, that's another story for another time.

Through the coordinated stabilizing actions of three prominent NY bankers to arrest the banking panic [J.P. Morgan, George F. Baker (First National Bank), and James Stillman (National City Bank / Citibank)], their wealth and power was perhaps made more conspicuous in the eyes of the nation than perhaps it would otherwise have been. A prominent Wall Street lawyer named Samuel Untermyer suggested that there was a "Money Trust", and The Wall Street Journal also took notice of affairs and wrote, "So long as Congress will not give us what every other civilized country possesses, a central bank, it forces Wall Street to improvise something of the kind itself."

The House Banking and Currency Committee formed an investigative subcommittee to determine whether a Money Trust existed in NY. The chief counsel was Sam Untermyer, and I think you might gain some insights about the true nature of money from the testimony delivered by Morgan and Baker before the committee in Washington DC at the beginning of 1913.

In questioning Baker about the proposal for banking reform regarding expanded disclosure of bank assets and investments, Untermyer probed, "Why should not the assets, and the detailed assets, be a matter of public knowledge?"

Baker replied, "Business would come to rather a standstill."

Untermyer demanded, "I want you to explain to the committee why."

Baker declined, "I can not explain it."

Untermyer pressed further, "You mean you can give us no reason?"

Baker admitted, "It would be exposing all the details of that business to the whole world."

After following a sidetrack in questioning, Untermyer returned to this issue, asking, "Why should the public do business on confidence when it can get the facts?"

To which Baker proclaimed, "Mr. Untermyer, THE FUNDAMENTAL PRINCIPLE OF BANKING, perhaps more than some others, is CREDIT." [emphasis added]

It seems that George Baker sensed (rightly?) that the public, familiar with their Currency being a tangible asset (gold coin), would NOT be readily comfortable with the truth about Money. That is to say, that they might struggle to accept the reality that their Money Supply, as represented on the books of the bank, was created by credit, and existed through the grace of confidence. In effect, the tangible Currency had become a mere symbol for the Money (credit) it represented while circulating outside of bank account ledgers.

If you don't care to believe my assessment, I have another point for you. When Untermyer had J.P. Morgan on the witness stand, he asked him, "Is not commercial credit based primarily upon money or property?" [In this exchange, it appears that Untermyer ignorantly used the word "money" as equivalent to gold coin, a usage which Morgan plays similarly until his concluding point about granting CREDIT.]

Morgan responded, "No, sir, the first thing is CHARACTER." [emphasis added]

Untermyer, shocked, reiterated, "Before money or property?"

Morgan reassured, "Before money or anything else. Money cannot buy it. [credit]"

Untermyer remained obstinate against this notion, as though there were communication difficulties, and pressed again on this point.

Morgan then conclusively stated his conviction on the point that commercial CREDIT is based on character: "Because a man I do not trust could not get MONEY from me on all the bonds in Christendom."

From two eminent bankers who surely knew their business, you now have it that the creation or granting of Money (the extension of Credit) has more to do with the creditworthiness of the borrowers than the collateral that secures against possible default. And recall, these comments occurred while on a gold standard AND in total absence of a government-sponsored central bank -- which was authorized (against Baker's preference) a year later.

As you come to understand how Money and Credit are interrelated, the more you will understand the separate Wealth of gold and why you need it now more than ever.

The point here is that our modern understanding of money, or any money concept for that matter, combined with our modern taste for borrowing, lending and trading of credit and debt, may not NECESSARILY be a perfect fit with a pure gold standard. Even a gold standard, with gold as the actual currency, is manipulated by the banks through confidence-based lending schemes. Sure, a gold standard somewhat limits the collective in its more nefarious pursuits, but it also has flaws that always seem to lead to the same conclusion... failure.

Perhaps it is time for us to consider another alternative, even a natural one that is happening whether we like it or not. How about a new, de facto, free market-driven stasis instead of the old de jure (rigged) false parity relationship... how about Freegold?

The Fourth Dimension: Time

At any given moment, a snapshot of our world appears to be only three dimensions; left/right, backwards/forwards, up/down. But with the passage of each and every moment, the world changes. Values change! People change. Everything changes. And all of these changes happen as we move through the fourth dimension, time.

This fourth dimension is very important as we consider the pure concept of money. For it is in this fourth dimension that our pure concept of money resides!

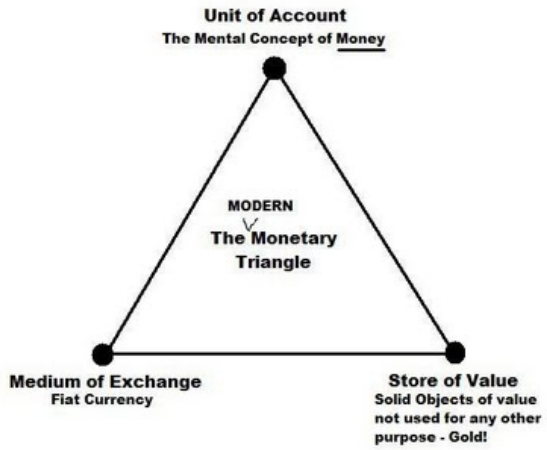
If time was not a factor, then anything accepted as a generic medium of exchange could perfectly

perform *all* the functions commonly linked to the term 'money'. You do your work (somehow without the passage of time) and get paid, and then spend your money on anything within that same moment in which your work's value was judged against the entire universe of real things. A perfect stasis of values would exist everywhere, all at once.

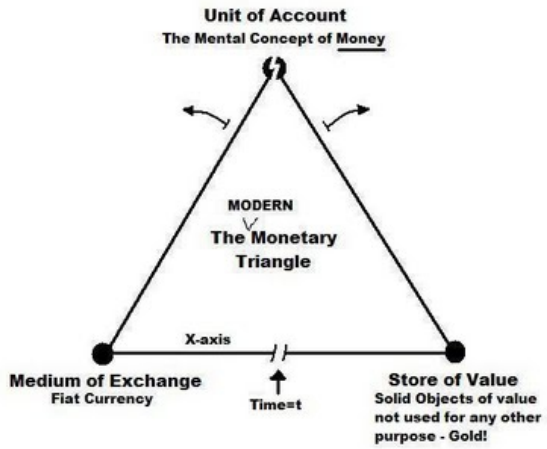
But here in the real world we must be concerned about how far we carry our money through the fourth dimension. Without this vital consideration, we stand to lose everything!

Breaking the Triangle

In part 1 of this series I used a diagram I created called The Modern Money Triangle. The three corners of the triangle represented the three primary functions of our modern understanding of money.



But as we pass through the coming phase transition in which the parity between paper gold and physical gold will be broken, cracks will start to form in certain parts of the triangle.

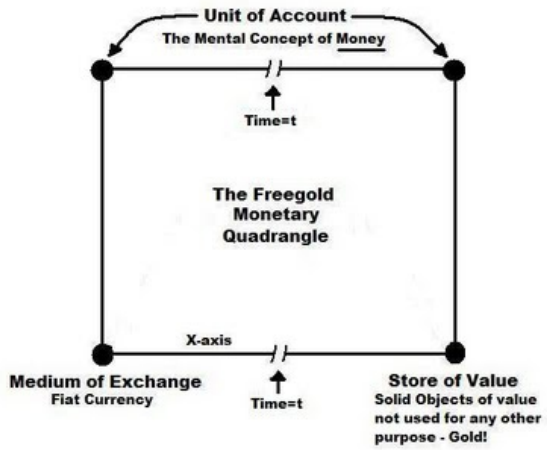


The fractures you see in this diagram are time related. On a short timeline [length of time is the key variable: "t"] fiat currencies will perform our necessary monetary functions, medium of exchange and unit of account. But at some point on the x-axis, 'length of time', we will switch to a different medium,

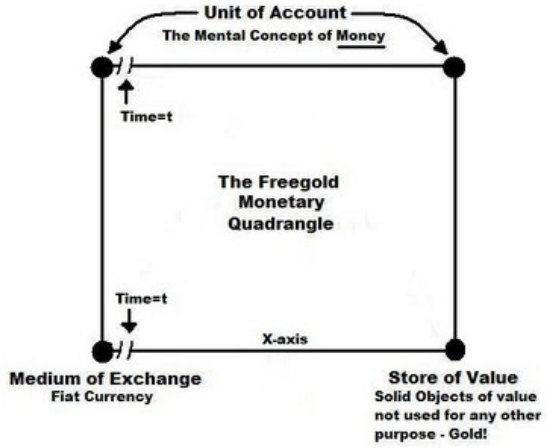
gold.

On a long timeline, gold will perform our necessary monetary functions perfectly, store of value and long term unit of account. By the way, there is no upper limit on the x-axis of 'length of time' when it comes to gold. If plotted out it runs to infinity!

The outcome will be my new Freegold Quadrangle!



The "x-axis" represents the amount of time you are willing to hang onto the fiat currency you either earn or receive in payment. If the monetary authority is printing money, "t" will be shorter and shorter. In a hyperinflationary situation "t" will slide all the way to the left with a value close to zero. [1]



As the new Freegold system of natural, pristine balance emerges, the fiat monetary authority will find its wisest move is to keep the money supply under control. And with a "wise" CB, gradually the "t" value will shift back to the right, little by little.

The further "t" moves to the right, meaning the longer people are willing to hang on to their fiat, the more investment will flow into new businesses in that currency zone, and the more tax the greedy collective can grab. This is how it will work.

But even MORE interesting to us physical gold advocates is how we will get there!

In part 2 of this series I explained that "they" will save *the system* at any cost. And that this stance presented them with a dilemma. You see, if they don't save the system then "all paper will burn" and gold will "shoot the moon" as the wealth reserve par excellence. But if they DO save the system, "the cost" will be the devaluation of the dollar along with all fiat currencies... and gold will "shoot the moon" as the wealth reserve par excellence.

Q.E.D. [quod erat demonstrandum].

The Catch-22 of Modern Paper Wealth

The phrase "Catch-22" is common idiomatic usage meaning "a no-win situation" or "a double bind" of any type. [Wikipedia] "The catch" in our modern concept of paper wealth is that on one side it is collapsing from its own unsustainable debt service making it, in fact, a non-wealth. But on the other side, if we rescue it from its own un sustainability by guaranteeing or propping up the debt service, we collapse the very denominator of the wealth itself, the currency, and make it a non-wealth. It is a lose-lose situation... a Catch-22!

Do you remember the 1985 movie Wall Street? In it Gordon Gekko liked to buy whole companies through the stock market, shut them down, break them up, and then sell off the pieces. He had figured out that the pieces were more valuable than the whole. Remember in the end of the movie he went after Blue Star Airlines? My, how things have changed in 24 years.

On Friday we learned that Japan Airlines is now completely worthless. Its net worth is now NEGATIVE $8.8 billion!

> JAL faces $8.8 billion excess debt if liquidated: source
>
> TOKYO (Reuters) - Liabilities at Japan Airlines Corp (Tokyo:9205.T - News) would exceed its assets by as much as $8.8 billion if Asia's largest airline by revenues were liquidated, a source with direct knowledge of the matter said on Friday.
>
> The estimate of JAL's negative net worth, calculated by a government-led task force in charge of its restructuring, underscores the depth of the problems facing the airline as it seeks aid from banks and the state to avoid bankruptcy.

Did you know that on Friday people were *still buying* JAL at a market capitalization price of $3.4 billion even though it was worth [NEGATIVE] -$8.8 billion? One thing I know for sure; Gordon Gekko would NOT have been interested in this one.

Which begs the question, how is the rest of the (publicly traded) economy doing after 24 years of debt accumulation?

This is where the $-debt regime has left us. With empty, hollow shells of corporate entities enslaved to produce revenue only to service their unsustainable debt. What if the owners of JAL decide to leave their vacuous corporate shell behind like a hermit crab abandoning his home, for the greener pastures of a fresh start? That debt hole, the $8.8 billion, is what we hold today as wealth!... inside the financial system! It is gone, not there, if they walk away. Just like an underwater homeowner walking away from his home. <u>If the debt-slave quits, the value illusion is gone!</u>

The entire financial industry today is marked to model, myth, illusion, whatever... just not reality. It is amazing that we even got a story like this, exposing a small portion of the gap between reality and "high finance". JAL is a dead man walking.

At least we are getting some honesty with regard to the real value of JAL. How about the rest of them? How about the banks? Who's debt do YOU hold as wealth? How is THEIR balance sheet doing? Do you have any idea?

Gold is pure equity... no one's debt. No one to walk away. No one to default in bankruptcy. Nothing to liquidate in an attempt to recapture 10 cents on the dollar.

The entire US banking system today is built upon the idea that debt-slaves will continue servicing their debt on millions of underwater houses marked to mythical values at which the loans were established. If you hold your wealth within this freakish system... all I can say is good luck!

The knowledge of the difference between principle and interest must be dead. Everyone is chasing an imaginary yield from entities with negative equity today... with their hard earned principle savings. Can you believe it?

But don't worry about JAL. It won't be quitting. It has been deemed too big to fail! This means that the

printing press will guarantee not only its debt-slave service, but its executive bonuses as well (to keep the slaves in the field)!

Next up, the idiotic concept of too big to fail is set to bring down all the imaginary currencies, and with them, the system itself. And once again, gold is not only immune but highly levered in the OPPOSITE direction.

Consider this: You may not fully understand where we are heading. You may be figuring it out at your own pace. But the millions of ungodly fortunes in the world (yes, there are millions of fortunes) don't have that luxury. They must figure it out FAST... or die.

Survival of the Fittest

Try to imagine each and every fortune that exists today as a distinct animal. These "fortunes" can be held by individuals, organizations, by funds, or even by sovereign collectives. They can also be held in any number of vessels at this current time. For instance, the Saudis' fortune is largely held underground in oil deposits. Other fortunes are in paper financial products, like your pension fund, and others are already in gold.

As we move forward, the law of nature, the survival of the fittest will come more and more to the forefront. The wholesale creation of new digits is one way that some of the more inbred fortunes are trying to survive. Will it work? Others, with a deeper gene pool, are fleeing to the safety of gold.

Imagine this world of TOO MANY "fortunes" vying for survival in the limited landscape of the real world which is actually too small for them all to survive. The fortunes that have moved entirely into physical gold have already staked out their claim to a specific volume of real estate that is needed to survive in this brutal world. They now own their own territory, a true slice of the real world pie, on which to live and thrive.

Those that are still trying to increase their claim size by inflating paper digits may miss out because the

landscape of reality is quickly being bought up by the more clever and observant animals. Survival of the fittest! Those fortunes that make the right moves in these trying times will be the ones to survive and thrive. The rest will die.

These "fortunes" are the giants. Their titanic battle for survival in the limited real world is what will take us where we are going. They need to figure things out quickly if they want to survive. Natural selection will pick the winners and kill off the losers. Today this epic battle nears its climax.

Stake out your own claim today before this final act unfolds. Then spread the word to as many people as possible. This is the best we can do, Lilliputians that we are.

Sincerely,
FOFOA

[1] No, the y-axis is nothing but a perpendicular connecting line to a parallel function. I am making a point with the help of visual aids and common understanding. I am not making a mathematical proof. Sorry if I offended any mathematicians with my terminology. :)

Friday, December 17, 2010

Focal Point: Gold

In game theory, a focal point (also called Schelling point) is a solution that people will tend to use in the absence of communication, because it seems natural, special or relevant to them. The concept was introduced by the Nobel Prize winning American economist Thomas Schelling in his book The Strategy of Conflict (1960). In this book (at p. 57), Schelling describes "focal point[s] for each person's expectation of what the other expects him to expect to be expected to do." This type of focal point later was named after Schelling.

Consider a simple example: two people unable to communicate with each other are each shown a panel of four squares and asked to select one; if and only if they both select the same one, they will each receive a prize. Three of the squares are blue and one is red. Assuming they each know nothing about the other player, but that they each do want to win the prize, then they will, reasonably, both choose the red square. Of course, the red square is not in a sense a better square; they could win by both choosing any square. And it is the "right" square to select only if a player can be sure that the other player has selected it; but by hypothesis neither can. It is the most salient, the most notable square, though, and lacking any other one most people will choose it, and this will in fact (often) work.

Schelling himself illustrated this concept with the following problem: Tomorrow you have to meet a stranger in NYC. Where and when do you meet them? This is a Coordination game, where any place in time in the city could be an equilibrium solution. Schelling asked a group of students this question, and found the most common answer was "noon at (the information booth at) Grand Central Station." There is nothing that makes "Grand Central Station" a location with a higher payoff (you could just as easily meet someone at a bar, or the public library reading room), but its tradition as a meeting place raises its salience, and therefore makes it a natural "focal point." [1]

Salience: the state or quality of an item that stands out relative to neighboring items.

Sesame Street - One Of These Things - Letters and numbers

There are two simple, but seemingly, apparently impossible-to-comprehend concepts. The first concept is why money not only *can* be split into separate units for separate roles, one as the store of value and the other to be used as a medium of exchange and unit of account, but why it absolutely *must* and WILL split at this point in the long evolution of the money concept. This means no fixed gold standard, or any system that attempts to combine these units/roles into one, making easy money "less easy" and hard money "less hard." And by "must" I do not mean that we must do this, I mean that it is happening today whether we recognize it or not.

And the second concept, once the first is understood, is how and why gold and only gold will fill the monetary store of value role. Not gold and silver. Not precious metals. Just gold. People often ask why I don't mention silver. They assume that when I say gold I really must mean gold and silver, or precious metals. So let me be clear. When I say gold, I mean gold and only gold.

Money's most vital function in our modern world is lubricating commerce, or more specifically, keeping the essential supply lines flowing – supply lines that bring goods and services to where they are needed. Without it we would be reduced to a barter economy, eternally facing the intractable "double coincidence of wants." This is the problem whereby you must coincidentally find someone that not only wants what you have to trade, but also, coincidentally, has what you want in return. And in the modern world of near-infinite division of labor, this would be a disaster. [2]

So we need money, and lots of it. In fact, we need money in unrestricted amounts! (I'll bet you are surprised to see me write this!) Yes, I said it, we need unrestricted money in order to fulfill this most vital function in our modern society – lubrication! But here's the catch: we need the **right** money in order to perform this seemingly impossible task. Let me try to explain.

Money is debt, by its very nature, whether it is gold, paper, sea shells, tally sticks or lines drawn in the sand. (Another shocking statement?) Yes, even gold used as money represents debt. More on this in a moment.

For this reason, the money used as a store of value must be something completely separate and different from the medium of exchange. It must be so, so that the store of value unit can expand <u>in value</u> while the medium of exchange unit expands in quantity and/or velocity. You may be starting to encounter my thrust. Expand… and expand. Unrestricted by artificial constraints.

Compare this concept to a gold standard in which you fix the value of gold to the dollar at, say, $5,000 per ounce. The assumption is that this is where the price of gold will stay for a long time, if you manage the system properly. So what is the result? You artificially constrain the expansion of the medium of exchange fiat currency while also restricting the value expansion of the store of value. You are locking the two together. Do you think this works and makes sense?

I said we need unrestricted money in order to ensure the lubrication of the vital supply lines in our modern world. This is it. This is what really matters. If we have a major monetary and financial breakdown, what do you think will be the worst consequence? Do you grow all of your own food? Do you make – or know someone who does – all of your own stuff? How long could you survive without any stores? Do you trust your government to be sufficiently prepared to take care of you with no supply lines flowing?

Have you ever stretched a rubber band until it breaks? You can feel the resistance grow gradually and observe the smooth thinning of the band until finally it loses its continuity and the two parts snap back stinging your fingers. A tiny observer of this exercise, perhaps a flea resting on your thumb (or an economist), one who doesn't really understand rubber bands, might swear that it could be stretched forever. The smooth change in the stretching rubber gives little warning of the abrupt (sometimes painful) deformation that is coming.

This is where we are today. The dollar standard is like a stretched rubber band. It has been stretched and stretched, but it cannot provide the unrestricted money that we need today. They think it can. And that's why they are spewing it out in quantitative easy money boatloads. But it's not the right money. As I said above, we need the **right** money in order to perform this seemingly impossible task.

That resistance you feel is the artificial restraint built into the dollar system. It appears to be infinitely expandable, but it is not. It is just like the rubber band. Oh sure, you can print all the dollars you can imagine, to infinity and beyond! But it won't work. It won't do the most vital job, beyond a certain point. And yes, we are beyond that point.

I want you to imagine a tiny micro economy. Just two guys stranded on a tiny island. Let's call the guys Ben and Chen. They have divided the island in half and each owns his half. They each have a tree which bears fruit and three tools for fishing, a spear, a net and a fishing pole. For a while they both fished often. Fish were the main trade item between Ben and Chen. Sometimes Ben would take a vacation from fishing and Chen would provide him with fish to eat. Other times Chen would take a break.

But after a while Ben got lazy, and Chen got tired of giving Ben free fish to eat. At first they used sea shells as money to keep track of how many fish Ben owed Chen. Then they switched to leaves from the tree. Finally they just broke a stick off the tree and drew little lines in the sand. If Chen gave Ben a fish, Ben drew (issued) a line in the sand on Chen's side of the island. There were only two of them, so it was easy to avoid cheating.

These lines sort of became Chen's bank account. Each one represented the debt of one fish that Ben owed to Chen. But after a while they started adding up, and Chen worried that he would never get that many fish back from Lazy Ben. So Chen cut a deal with Ben. Chen said he would keep accepting lines drawn in the sand for fish, but he wanted to be able to use them to purchase some of Ben's other stuff (since Ben didn't like to fish).

At first he used them to purchase fruit from Ben's tree. But after a while the pile of fruit just rotted on Chen's beach. Next he started purchasing Ben's tools. First the spear, then the net and lastly the fishing pole. But at this point Chen realized that Ben would NEVER be able to repay those fish without his fishing tools. So Chen rented them back to Lazy Ben.

Of course Ben was still lazy, and now he owed rent on top of the fish he already owed. The lines in the sand grew even more rapidly as lines were added to pay for rent even when Chen hadn't given Ben a fish. Then Ben had a great idea. Why even go through the charade of selling the fishing pole and then renting it? Ben could just sell Chen some "special lines" which had a "yield." For ten one-fish lines, Chen could buy a special "bond" that would mature into 11 lines in a year's time. They tried this for a

while, but all that happened were more lines in the sand. So many lines! Nowhere to walk. Chen's "bank account" was taking up all of his real estate!

Finally Chen had had enough. He called Ben over and said, "Okay, since you refuse to fish for yourself, let alone to pay me back, I want to use these lines to buy some of your gold coins." Oh, did I mention that Ben had a treasure chest of gold coins that had washed ashore? Of course these gold coins were the last thing that Chen wanted, because what good are gold coins on a tiny island with only two inhabitants?

But actually, they turned out to be an excellent record of the debt Lazy Ben owed to Chen the fisherman. You see, at first, Chen bought half of Ben's gold with the lines he had already accumulated, transferring his "bank account" over to Ben's side of the island and consolidating his "wealth" into gold. It worked out to 100 lines for one gold coin, or 100 fish per ounce.

But after a while, Ben realized that he was running out of gold. He knew it would only be a short matter of time until he ran out, so he closed the gold window. And once again, Chen started accumulating lines and special yielding "bond" lines. Finally, they agreed that the value of the gold coins had to be raised higher than 100 fish per ounce. Ben suggested 500/oz., but Chen saw the short-sighted flaw in his thinking. So Chen said that the value of ounces should float against the number of lines issued by Ben. This way, Ben would never run out of gold, and his lines would always and forever be exchangeable for gold coins. Finally, a sustainable accounting system!

Now I do realize the glaring flaws in this analogy I cobbled together. So spare me the critique. It is far, FAR from perfect. But it does help with a few good observations.

First, the lines in the sand and the gold coins are both money on this island. One is the medium of exchange/unit of account and the other is the store of value. The store of value is quoted at any given time in units of lines, but its value **floats**, it is not fixed, so it never runs out. This method of accounting forces Lazy Ben to part with something more substantial than simply issuing more lines via line-yielding "special bond lines."

In this case it was the accounting of transactions between a consumer and a producer. But it works just as well between any two actors with unequal levels of production and consumption. Some people just produce more while others can't stop consuming. I'm sure you know a few of each type.

Also, notice that gold coins and lines in the sand both represent the debt owed from Ben to Chen. And with gold, Chen can wait forever to be paid back (which, on this island, is quite likely). The gold doesn't spoil, and Chen's possession of it doesn't interfere with Ben's ability to fish or eat fruit. But notice also that the more lines in the sand that Ben issues, the more the value of the gold (representing a debt of fish) rises. So the longer Ben runs his trade deficit, the more debt he owes for each ounce of gold that Chen holds.

This is not so dissimilar to the special bond lines, with a few notable differences. The bond values are not only quoted in lines, they are also denominated in lines. So the principle amount paid for the bonds drops in value as more lines are issued to lubricate the vital trade. To counteract this "inflation," interest is paid by drawing more lines without the reciprocal delivery of fresh fish. But these additional "free" lines also dilute the value of lines, which leads ultimately to infinity (or zero value) in a loop that feeds

back on itself.

The more fish Chen supplies to Ben, the more lines he receives, the more bonds he buys, and the more lines he receives in service to interest. Eventually Chen will be receiving two lines for each fish, one for the fish and one for the interest. And then three, and then four. And so on. Wouldn't you rather just have one gold coin that floats in value? I know Chen would.

Another observation is that the medium of exchange on our island devolved into the most insignificant and easy to produce item. A simple notation in Chen's "account." Is that so different from what we have today? And Ben could issue them with ease as long as Chen let him. Once Chen had so many lines, he wasn't about to just abandon the system, was he? Wipe the (beach) slate clean? No, Chen wanted to get something for his lines. Something compact that didn't interfere with Ben's ability to work off his debt should he ever decide to do so. Something durable. Something physical from Ben's side of the island. Something… *anything* other than those damn-stupid lines!

I hope that this little analogy helps you visualize the separation of monetary roles, because those talking about a new gold standard are not talking about this. I understand that sometimes you have to speak in terms familiar to your audience in order to not be tuned out, but I also hope that my readers come to understand how and why a new gold standard with a fixed price of gold, no matter how high, will simply not work anymore.

The full explanation of why it will not work is quite involved, and I'm not going to do it here. But the short answer is that the very act of defending a fixed price of gold in your currency ensures the failure of your currency. And it won't take 30 or 40 years this time. It'll happen fast. It wouldn't matter if Ben decided to defend a price of $5,000 per ounce, $50,000 per ounce or $5 million per ounce. It is the act of defending your currency <u>against gold</u> that kills your currency.

You can defend your currency against other currencies… **using** gold! Yes! This is the very essence of Freegold. But you cannot defend it against gold. You will fail. Your currency will fail. Slowly in the past, quickly today. If you set the price too high you will first hyperinflate your currency buying gold, but you won't get much real gold in exchange for collapsing the global confidence in your currency, and then you will have to empty your gold vaults selling gold (to defend your price) as your currency heads to zero. And do you think the world trusts the US to ever empty its vaults? Nope. Fool me once…

If you set the price too low, like, say, $5,000/ounce, you will first expose your own currency folly with such an act and have little opportunity to buy *any* of the real stuff as the world quickly understands what has gone wrong and empties your gold vaults with all those easy dollars floating around. You will sell, sell, sell trying to defend your price, but in the end, the price will be higher and you'll be out of gold. Either that, or you'll close the gold window (once again), sigh, and finally admit that Freegold it is.

Yes, the gold price must… WILL go much higher. The world needs MONEY! And by that, I mean recapitalization. Unfortunately the dollar is not the right money. And printing boatloads of it will no longer recapitalize anything. Today we are getting a negative real return on every dollar printed. That means, the more you print, the more you DEcapitalize the very system you are trying to save. Less printing, decapitalized. More printing, decapitalized. Freegold… RECAPITALIZED. Yes, it's a Catch-

22, until you understand Freegold.

There Can Only Be One

A "focal point" is the obvious, salient champion. But for many reasons, some things are not as obvious as we would think they should be. Mish ended his recent post, Still More Hype Regarding Silver; Just the Math Maam, with the following disclosure:

> As a deflationist who believes Gold is Money (see Misconceptions about Gold for a discussion), I am long both silver and gold and have been for years.

Now is it just me, or did he say that because gold is money, he is long both silver and gold?

Here's another one from a recent article on Zero Hedge:

> Part 3. People lie…..
>
> "…I want to make it equally clear that this nation will maintain the dollar as good as **gold**, freely interchangeable with gold at $35 an ounce, the foundation-stone of the free world's trade and payments system."
> -John F. Kennedy, July 18, 1963
>
> "That we stand ready to use our **gold** to meet our international obligations–down to the last bar of **gold**, if that be necessary–should be crystal clear to all."
> -William McChesney Martin, Jr. (Federal Reserve Chairman) December 9, 1963
>
> Lesson: When someone says you can exchange paper for precious metals – make the swap before they change the rules.

Whoa. Wait. Did he just take two quotes about monetary gold and extend the lesson to all precious metals? Is this right? Should we all be assuming that "gold" always means "precious metals?"

According to Wikipedia:

A precious metal is a rare, naturally occurring metallic chemical element of high economic value, which is not radioactive… Historically, precious metals were important as currency, but are now regarded mainly as investment and industrial commodities…

The best-known precious metals are the coinage metals gold and silver. While both have industrial uses, they are better known for their uses in art, jewellery and coinage. Other precious metals include the platinum group metals: ruthenium, rhodium, palladium, osmium, iridium, and platinum, of which platinum is the most widely traded.

The demand for precious metals is driven not only by their practical use, but also by their role as investments and a store of value. Historically, precious metals have commanded much higher prices than common industrial metals.

Here's how I read the above description. Precious metals have a high **economic** value. But because of investment demand, they also tend to have a price higher than it would be on its industrial merits alone. Gold and silver carry some additional sentimentality for their past coinage. In other words, precious metals are industrial commodities with an elevated price due to levitation from investment demand. Fair enough?

Now to understand Freegold, I think there are two issues that need to be addressed. The first is the difference between money, or a monetary store of value, and an industrial commodity levitated by investment demand. And the second, once the first is understood, is whether silver belongs in category with gold as money, or with platinum as an elevated commodity. You see, the very key to understanding Freegold may actually lie in understanding the difference between gold and silver with regard to their commodity versus monetary wealth reserve functions.

So from here, I will explore the valuation fundamentals of money versus levitated commodities. And then I will explore the history of silver as money and ask the question: Is silver money today?

First, money. Money is always an overvalued something. Usually a commodity of some sort. But it can be as simple as an overvalued line in the sand, or a digital entry in a computer database. But the key is, it is always overvalued relative to its industrial uses! That's what makes it money! If it was undervalued as money, it would go into hiding, just like Gresham's law says, be melted down, and sold for whatever use valued it higher than its monetary use.

It is fair to also say that commodities levitated by investment demand are overvalued in a similar way. But there are a couple of important differences. First is that all of our experience with commodity markets during currency turmoil happened while the two naturally-divergent monetary functions (the spur and the brake) were rolled into one unit, namely the dollar. This left only the commodity markets as an escape. Second is that monetary overvaluation usually has official support while commodity overvaluation often has government disdain.

There is this idea out there that if you have a paper investment market for a commodity that is larger than the physical units backing it (fractionally reserved, so to speak), that the commodity's price must automatically be suppressed by the market. This is simply not true unless we are talking about money masquerading as a commodity.

A paper market brings in investment demand and leverage (borrowed money), two levitating factors that would simply not be present if the paper market disappeared. And these two factors, "the speculators," can take a commodity's price well into overvalued territory. Just look at oil for an example. Even the sellers of the physical stuff say they prefer a lower price than right now, not to mention during the all-time high in 2008.

You'd think the sellers of a physical commodity would love a higher price driven by speculators. But they don't, because it is only a real price if all the investment participants have a real use for, and ability to take possession of, your physical commodity. Otherwise it's just a casino.

Back to the Zero Hedge piece:

> At today's prices, a million dollars in gold weighs less than fifty pounds, but a million dollars in silver weighs more than 2,300 pounds! So ask yourself, how many rich people are storing their own silver? How many hedge funds hold physical silver in their own storage facility?

Cool! So a million in gold only weighs 50 lbs.? Sounds like low storage fees and easy delivery! 2,300 lbs. for silver? Wow, that sucks. How many rich people are taking possession of their silver? Not many, I'd guess.

To be honest, I really don't know if silver is overvalued or undervalued today at $30/ounce. But if you are counting on the industrial fundamentals of silver for your moonshot like the Zero Hedge article is, or on a busted paper market like the "vigilantes," you may be in for an unpleasant surprise. The same fundamental arguments that are used today were also used back in 1982. [3] In gold, at least, we know that jewelry demand rises and falls opposite the price of gold. [4] But then again, gold is money, right? So, is silver still money?

Easy Money

Silver was certainly used as money in the past. So why not again today? Maybe the people will rise up and demand silver money! Maybe China, or somebody else, will remonetize silver and start a new silver standard, right? After all, China *was* the last to use a silver standard.

I don't mean to pick a fight with silver. In fact, I write this post with a heavy heart. But there is so much silver hype right now that I feel I owe it to my readers to at least try to spell out Another perspective. And China is certainly on the minds of the silverbugs these days. How often have we heard about China encouraging its citizens to buy gold and silver lately? (There's that "gold and silver" again.)

But did you know that China was practically dumping its silver a decade ago? And to this day it is still a large exporter of silver. Not gold. Just silver. In 2009 China exported 3,500 tonnes of silver. That amount will probably be cut in half for 2010. The drop is due to increases in both industrial and investor demand, but also due to China's recent move to stem the shipment of all natural resources leaving its shores.

I'm sure many of you know that China was the last country on Earth to end its silver standard back in 1935, in the middle of the Great Depression. But do you know why? And would China ever want to start a *new* silver standard? Does it make any sense now that they've sold most of their silver? And what has changed since 1935 that would make them want to go back?

Something very interesting happened after Jan. 30, 1934 when Roosevelt devalued the dollar against gold. The price of gold went up 70%. What do you think happened to silver? Did it go up more than gold? Did it shoot the moon? Was it leveraged to gold? No, it dropped like an unwanted rock.

In response to the falling price of silver, on June 19, 1934 (four and a half months later) the U.S. Congress approved the Silver Purchase Act of 1934 which authorized President Roosevelt to nationalize silver holdings (to buy silver). This decision resulted in an increase in the world price of silver, which forced China to abandon the silver standard in November 1935.

The US Silver Purchase Act created an intolerable demand on China's silver coins, and so in the end the silver standard was officially abandoned in 1935 in favor of the four Chinese national banks "legal note" issues.

Remember what Mundell wrote (See Mundell in The Value of Gold). The use of a commodity as money is the overvaluing of that commodity for profit by the monetary authority. When the US started buying commodity silver on the open market (to prop up the price artificially) the Chinese people found it was better to sell their silver coins for melt value than to use them in commerce for face value (which was lower than melt).

This effect to China's base money (silver) in 1934 was similar to what the US felt in 1933 and 1971 with gold. The main difference being that the demand for silver in 1934 was artificial (from one single entity, the US govt.) while the demand for gold has always been real, global and market-driven. This price supporting move (not unlike the Agriculture Adjustment Act and other destructive price control measures) by the US caused the "Shanghai Financial Crisis" which lasted from June 1934 until November 1935, finally ending in Currency Reform on Nov. 4, 1935.

So, in 1934, the US govt. wanted to devalue (set the price of) the dollar against gold and silver. In order to do so, it had to influence the market of each. For gold, it had to inflict capital controls internally and sell gold externally at the new higher price. For silver, it had to BUY silver at the new higher price. Sell gold, buy silver. The same exact thing that happened 45 years earlier with the Sherman Silver Purchase act of 1890.

Pushed by the Silverites, the Sherman Silver Purchase act of 1890 increased the amount of silver the government was required to purchase every month. It was passed in response to the growing complaints of farmers and mining interests. Farmers had immense debts that could not be paid off due to deflation caused by overproduction, and they urged the government to pass the Sherman Silver Purchase Act in order to boost the economy and cause inflation, allowing them to pay their debts with cheaper dollars. Mining companies, meanwhile, had extracted vast quantities of silver from western mines; the resulting oversupply drove down the price of their product, often to below the point where it was profitable to mine it. They hoped to enlist the government to artificially increase demand for, and thus the price of, silver.

Under the Act, the federal government purchased millions of ounces of silver, with issues of paper currency; it became the second-largest buyer in the world. In addition to the $2 million to $4 million that had been required by the Bland-Allison Act of 1878, the U.S. government was now required to purchase an additional 4.5 million ounces of silver bullion every month. The law required the Treasury to buy the silver with a special issue of Treasury Notes that could be redeemed for either silver or gold.

That plan backfired, as people turned in the new coin notes for gold dollars, thus depleting the government's gold reserves. After the Panic of 1893 broke, President Grover Cleveland repealed the Act in 1893 to prevent the depletion of the country's gold reserves. [5]

To "set the price" of anything, you must either buy or sell that thing. Governments cannot just "set" prices. Whenever they try, the items just disappear or go into hiding. If the price you set is lower than the value, then you will have to sell. If the price is too high, you will have to buy. More from Mundell:

> "[In the 1870s] France pondered the idea of returning to a bimetallic monetary standard, but with American production of silver going up and Germany dumping silver as the new German Empire shifted to gold, France realized it would have to buy up all the excess silver in the world on its own."

So... if your standard is going to overvalue something, you must buy it. If you undervalue something, you must sell it. And what was the US doing with gold throughout the entire Bretton Woods system? That's right, it was SELLING gold through the gold window. So it wasn't the gold that the US monetary authority was overvaluing for profit. It was the cotton-pulp paper in the FRNs! Cotton pulp! That's the overvalued commodity today!

Remember what Another wrote? "Any nation/state can put its economy/currency on a gold standard. They only have two requirements. Own a stockpile of gold and raise the price very high!"

Why do you think you need a stockpile of gold to start a gold standard? In the case of France in 1870 above, they realized they would have to *buy* all the excess silver in the world to keep a silver monetary standard. You don't need a stockpile to do that! Yet you don't need to worry about buying all the gold to have a gold standard. You need to be prepared to SELL! That's why you need a stockpile. So what's the difference?

Could it be that silver is only a commodity today (and for the last 150 years at least) and because of this, any monetary use is not backed by the free market? Any silver standard is an unnatural levitation requiring BUYING of silver by the monetary authority. While a gold standard gives the free market what it really wants, gold, requiring SELLING of gold by the monetary authority.

Can you find an example where the opposite occurred? Can you show me where a government ever had to buy gold and sell silver (at whatever price or ratio) in order to maintain its system?

The US quit bimetallism during the Civil War, prior to the Silverite movement. [6] This ended the government's "overvaluing" of all silver for use in money. After the Civil War, there was a difference between commodity silver (what the miners dug up) and monetary silver (overvalued silver in US coins) because in order for the US to sustain bimetallism (or a silver standard) it would have had to value (buy) ALL the excess silver in the world at the overvalued price of the coins.

This meant it would have to BUY any and all commodity silver that was offered for sale (to prop up the price). You see, silver needs its price propped up (huh? why?) while gold appears to need its price suppressed (see: The London Gold Pool). So rather than actually "valuing" silver, the government compromised with the Silverites and agreed to buy a specified quota of commodity silver. At least it did until it ran out of gold in 1893. Something must have been wrong with that 16:1 ratio in the 1800s, huh?

70 years later, when the price of commodity silver *finally* overran the value of the coins in 1964, it was because of cotton-pulp printing (inflation) only, not global monetary demand! This is exactly how commodities act. They respond directly to monetary inflation until the commodity value overruns the face value.

So it seems that the free market wants to exchange its "money" for gold. But "the people" (at least in the late 1800s) wanted silver to be money. They wanted to SELL their silver to the government while the government SOLD its gold to the market. This is a one-way flow that tends to end in a vault full of silver with no gold. So why did the US Government intervene in the silver market and support this folly?

The government caved primarily because of politics (pressure from the Silverites – the farmers and miners out west), and tradition secondarily (past use of silver as money, the US Constitution, etc.). Politically, "the people" will always want easy money. And silver was their easy money of the day.

Price deflation in the late 1800s was hurting the farmers. The farmer business cycle is seasonal. Borrow money for equipment and seeds to plant in the spring. Then grow your product. Then harvest and sell in the fall and pay off your debt with the proceeds.

The effect of causing an inflationary environment through "easy money" means that it is A) easier to pay off your debt in the fall than it was in the spring (or the year before), and B) you get more money for your crop than you did last year. The effect of a deflationary environment is the opposite. Your debt gets harder to pay and you get less money for your crop. It's the same for all businesses actually. But farmers were a big political group in the 1800s that were all roughly on the same business cycle.

This bears repeating: "The people" wanted silver back then (late 1800s) because it was the "easy money" of the time. "The people" NEVER want harder money. Today silver would be harder money, so it will never have the support of "the people" (other than the silverbugs). 16:1 was quite obviously an artificial monetary ratio, because whenever they maintained it, there was a run on the gold. The market wanted to push the ratio much wider, and the government, in service to "the people," fought that market force.

Today silver would be "harder" money than cotton-pulp. This is why there will NEVER be a big enough political movement *of the people* that will bring back a silver standard. We have now discovered easier money than silver!!!

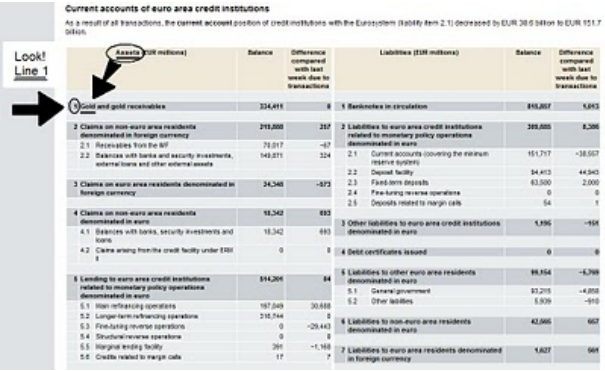
If you want harder money, it's gold. If you want easier money, it's cotton-pulp. So where does silver fit in? Well, it's just another industrial commodity with a lingering sentimental mystique as the old "easy money."

And where does gold fit in? Freegold of course! The monetary wealth reserve as demonstrated by the Central Banks of the world!

So what if gold really is the wealth reserve of choice for the giants that A/FOA said it was? That means silver is nothing but an industrial commodity today, being somewhat levitated by the lingering hype. What if silver is just a commodity, like copper or oil?

Monetary value is a self-supporting, self-sustaining levitation. Money is the bubble that doesn't pop. The price of money is arbitrary. Not so with commodities.

So... is silver really money today? I know gold is. Here's the evidence:



Current accounts of euro area credit institutions

As a result of all transactions, the current account position of credit institutions with the Eurosystem (liability item 2.1) decreased by EUR 38.6 billion to EUR 151.7 billion.

Look! Line 1

Assets (EUR millions)	Balance	Difference compared with last week due to transactions
1 Gold and gold receivables	334,411	0
2 Claims on non-euro area residents denominated in foreign currency	219,000	257
2.1 Receivables from the IMF	70,017	-67
2.2 Balances with banks and security investments, external loans and other external assets	149,071	324
3 Claims on euro area residents denominated in foreign currency	24,340	-573
4 Claims on non-euro area residents denominated in euro	18,342	693
4.1 Balances with banks, security investments and loans	18,342	693
4.2 Claims arising from the credit facility under ERM II	0	0
5 Lending to euro area credit institutions related to monetary policy operations denominated in euro	514,205	84
5.1 Main refinancing operations	187,049	30,688
5.2 Longer-term refinancing operations	218,744	0
5.3 Fine-tuning reverse operations	0	-29,443
5.4 Structural reverse operations	0	0
5.5 Marginal lending facility	261	-1,168
5.6 Credits related to margin calls	17	7

Liabilities (EUR millions)	Balance	Difference compared with last week due to transactions
1 Banknotes in circulation	845,857	1,013
2 Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	289,605	8,206
2.1 Current accounts (covering the minimum reserve system)	151,717	-38,557
2.2 Deposit facility	94,413	44,343
2.3 Fixed-term deposits	63,500	2,000
2.4 Fine-tuning reverse operations	0	0
2.5 Deposits related to margin calls	54	1
3 Other liabilities to euro area credit institutions denominated in euro	1,196	-154
4 Debt certificates issued	0	0
5 Liabilities to other euro area residents denominated in euro	99,154	-6,769
5.1 General government	93,215	-4,858
5.2 Other liabilities	5,939	-910
6 Liabilities to non-euro area residents denominated in euro	42,066	667
7 Liabilities to euro area residents denominated in foreign currency	1,627	561

Does anyone have any evidence that silver is still money today?

Yes, I am aware that the stock of silver is disappearing into our landfills. These "properties" of silver have been with the metal since the early 80s, through decades of single-digit prices. [3] So, is jacking the raw materials from industry and holding them hostage for ransom at a higher price the real play today? (Hint: this tactic often ends badly for the speculator.) Or is the real play front running the new global monetary wealth reserve during a transition in our international monetary system?

Here's one silverbug who is starting to put two and two together! I think he might also be reading FOFOA. ;) (Hi Joe. I think you are confusing me with FOA in your video. But that's okay, it's a wonderful compliment to me! Tip to others: If you mention me in a video include a link in the description and I might just find your video.)

Did you hear him at 6:35? "Only one metal in the world that fits the bill for money, and that's gold!" That's right Joe! Good job from the "Silverfuturist". There can be only one! Did you see my subheading? And please read the description of a "Focal Point" again. It's the first thing in this post. Can you put two and two together like Joe?

I don't write about silver very much. Just like I don't write about copper or pork bellies. But, in fact, I have addressed many of the standard arguments for silver over gold in various comments on this blog and others. I'm sure someone will dig them out again and post links as people pose these arguments once again in the comments. But here's a new one.

One of the argument for silver that we hear often is that it is "the poor man's gold." So I guess gold is "the rich man's gold." Well, what is the main difference between rich men and poor men? Is it that the rich have an excess of wealth beyond their daily expenses? In fact, the really rich have "inter-generational wealth," that is, wealth that lies very still through generations. The poor do not have this.

So what do you think is going to come of all that "poor man's gold" that the silverbugs have hoarded up? Is it going to lie very still for generations? Or will it circulate, to meet daily needs? Note that circulation velocity is the market's way of controlling the value of any currency. Faster circulation = lower value. Lying still for generations = very slow circulation.

So as you contemplate which commodity will be the monetary focal point of the future, I'll leave you, as I often do, with a little music.

Sincerely,

Wednesday, December 1, 2010

The Value of Gold

The concept of value can be a bit tricky. Value is one of those words that is tossed around as if there were universal agreement on its meaning. There is not. Often in such cases I simply use a different word, just to be sure we are on the same page. Years ago Town Crier did this with "value", substituting in the word "dearness":

TownCrier (8/24/2000; 18:08:49MT - usagold.com msg#: 35476)
Nice table, Sir Mitchell:

Column 1 = Year
Column 2 = Avg. annual nominal price of gold
Column 3 = Avg. annual price of gold in 1999 US dollars
Column 4 = Avg. annual price of gold in 1970 US dollars

1970 35.94 158.75 35.94
1971 40.80 170.18 38.53
1972 58.16 232.59 52.66
1973 97.32 376.76 85.29
1974 159.26 580.57 131.44
1975 161.02 528.81 119.72
1976 124.84 375.79 85.08
1977 147.71 420.26 95.14
1978 193.22 516.19 116.86
1979 306.68 761.43 172.38
1980 612.56 1,364.05 308.79
1981 460.03 902.53 204.30
1982 375.67 668.20 151.28
1983 424.35 710.70 160.91
1984 360.48 585.02 132.44
1985 317.26 493.66 111.77
1986 367.66 552.19 125.00
1987 446.46 658.04 148.98

1988	436.94	621.63	140.74
1989	381.44	521.31	118.02
1990	383.51	500.14	113.21
1991	362.11	448.04	101.43
1992	343.82	408.25	92.42
1993	359.77	414.74	93.90
1994	384.00	429.77	97.31
1995	384.17	419.09	94.89
1996	387.77	412.70	93.41
1997	330.98	342.00	77.42
1998	294.24	298.95	67.68
1999	278.88	278.88	63.14

The third column (representing prices based on the purchasing power of 1999 dollars) clearly shows that gold is currently at the best bargain for buyers since way back in 1972.

Meanwhile, the fourth column (representing the equivalent prices in terms of the 1970 dollar which was itself officially defined as one-thirtyfifth ounce of gold) clearly shows that despite the massive mining effort and flood of derivatives since that time, the "dearness" of gold has still managed to almost double; otherwise, we must all admit, the price of an ounce today as represented in "1970 dollars" would still be $35. It isn't. One ounce as of 1999 is as dear as 63.14 of those "gold-backed" dollars, or put another way, despite production and derivatives, one ounce today is as dear as 1.8 ounces then. All things considered, that's not bad performance for an item that many are content to view as a neutral "insurance" asset.

Now just imagine how much dearer an ounce might become in the event of a derivatives bust...

(I have used the term "dear" in deference to the recent disputes on the meaning of "price" and of "value". To say "dearness" is my attempt at splitting the middle so that the message reaches both sides of this debate.)

Quite clever that was. But value is a vital concept to understand. So here we will explore some misconceptions associated with this most dear and valuable word.

Probably the most common misconception is that price and value are the same thing. They are not. They are related but different. Price can be precisely known, but true value can only be estimated or guessed. And because price changes, price is always wrong while true value is always right, even though it is unknown. So price and value are always different. Value is always either higher or lower than price.

There is a little trick to knowing whether value is higher or lower than price. This trick will reveal the direction of value, but not the magnitude of the disparity. The trick is to look at which direction the government wants to influence any price. If the government is attempting to manage a price upward, then it is a safe bet that the value is lower than the price. And if the government would like to keep a price down, then you can be pretty sure the value is higher than the price.

It is certainly fair play to place your bets on the ability of government to overpower the gravitational

pull of value. But when you do, you should be aware that you have just purchased the opposite of real value. And to understand why this may be detrimental to our financial wellbeing, we must first understand the concept of value.

A Brief History of Value Theory

The concept of value is primary and central to the study of all human society. Economics is just one branch of study that uses this concept. And value theory is fundamental to all schools of economic thought.

At the most basic level value theory reveals the concept of "the good." This concept can refer to either people or objects. When referring to people (or the conduct of people) we talk about "the moral good." And when referring to an object we call it "a natural good." Value Theory could also be called "Goodness Theory," and it covers two branches of study: Ethics, which deals mostly with "moral goods," and Economics, which focuses primarily on "natural goods."

Plato

Plato wrote about value 2,400 years ago in "The Republic" where he distinguished "instrumental value" and "intrinsic value." Something with "instrumental value" is worth having only as a means to get something else. It is not an ends-in-itself but merely a means to an end, a medium. An object with "intrinsic value" is regarded as an end or end-in-itself. It is a thing worth having for itself, not as a means to something else. COMEX gold futures versus physical gold is an example of instrumental versus intrinsic value. In fact, the dollar itself (or any medium of exchange for that matter) is a good example of something with instrumental value.

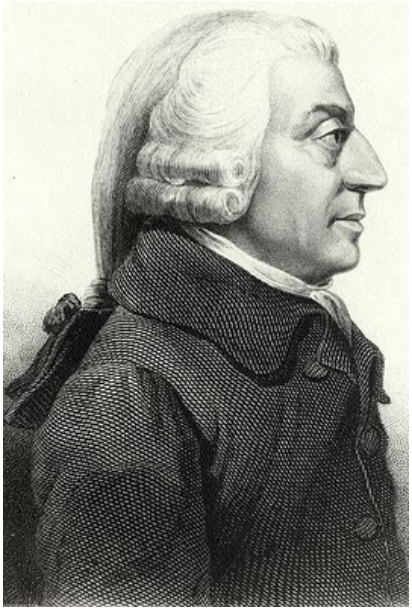
The Modern Era

Because this is a "brief" (and extremely generalized) history of value, we will now leap forward through time 2,251 years from 380 BC to 1871 AD when the economics branch of value theory itself branched off in two directions. We are now traveling down the economics branch, so we are dealing

with "natural goods" which are non-moral goods (and services), like houses, cars, hamburgers and gold.

The study of economics grew throughout the Renaissance period of transition from the Middle Ages into the Modern Era. Notable figures during this transitional period are Sir Thomas Gresham (1519–1579), John Locke (1632–1704) and John Law (1671–1729). And the era of Modern Economics (also called Classical Economics) began in 1776 with Adam Smith's (1723–1790) "The Wealth of Nations."

Adam Smith



95 years later a new branch, sometimes called Neo-Classical Economics, emerged from the old school of Classical Economics branch. Classical Economics held that value should be donor-derived or determined by the cost to supply a good to market rather than the demand for the good *from* the market. This is generally called the Labor Theory of Value. Neo-Classical Economics grew out of the realization that it is the utility of a good that matters more to its value than how much labor it took to produce.

Karl or Carl?

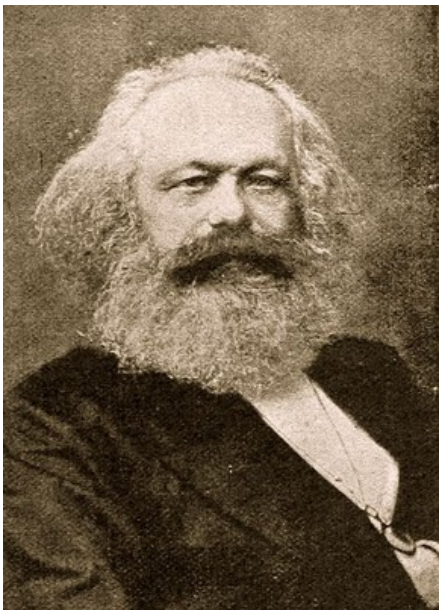
The Labor Theory of Value (LTV) was the mainstream and widely accepted value theory prior to the 1870's, culminating in the controversial economic theories of Karl Marx (1818–1883). Then, in 1867, a young journalist named Carl Menger (1840–1921) noticed a discrepancy between what the classical economics he had been taught in school said about price determination, and what real world market participants were paying for goods. Stirred by this observation, Menger left journalism to spend the next four years studying "political economy" which, at the time, was basically the study of capitalism, or the relationship between markets and government.

Carl Menger

In 1871 Menger published "Principles of Economics" (Grundsätze der Volkswirtschaftslehre), thus becoming the father of the Austrian School of economic thought. It was in this work that Menger challenged the classical cost-based theories of value with his own marginal utility theory of value.

From what I can tell, the basic difference between the approach of Marx versus Menger is that of activist versus observer. The Marxian Labor Theory of Value tells you what something's value *should* be, while marginal utility observes what it actually *is*, and then attempts to explain the observation.

Karl Marx



Someone here recently asked, How can an ounce of gold ever be more valuable than a new BMW since the BMW embodies a vast amount of energy, human capital expenditure and significant utility in the real world?

I found this question to be quite valuable, embodying significant utility for this blog. The implication in

the question is that an ounce of gold *cannot* be more valuable than a new BMW for two stated reasons:

1. The Marxian LTV tells us that the cost to produce a BMW is much higher than the cost to produce an ounce of gold, and,
2. The BMW is "significantly" more useful to mankind than an ounce of gold.

These two "value fallacies" cover almost all of the arguments against the sustainability of the unfolding Freegold revaluation. So let's take a look at them one at a time.

1. Marx's LTV view suggests that market actors pay more attention to what an item cost the seller of that item in determining the price they, the buyer, are willing to pay, rather than to how useful the item will be to them, the buyer. It goes even further, though, in suggesting the supplier's cost is the true value and therefore *should* be reflected in the price. Any price above that cost or "labor value" is considered to be exploitation, super profit, or unjust benefit as far as the Marxist activist is concerned, and therefore should be controlled through communal enforcement.

But clearly, commodities do not follow this labor value theory in a free market. Especially in globally fungible commodities, where price is the same all over the world yet production costs vary vastly from region to region. Oil is a good example. In fact, the production of oil is impossible in many regions lacking viable reserves. Menger writes in "Principles of Economics":

"There is no necessary and direct connection between the value of a good and whether, or in what quantities, labor and other goods of higher order were applied to its production. A non-economic good (a quantity of timber in a virgin forest, for example) does not attain value for men since large quantities of labor or other economic goods were not applied to its production. Whether a diamond was found accidentally or was obtained from a diamond pit with the employment of a thousand days of labor is completely irrelevant for its value. In general, no one in practical life asks for the history of the origin of a good in estimating its value, but considers solely the services that the good will render him and which he would have to forgo if he did not have it at his command...The quantities of labor or of other means of production applied to its production cannot, therefore, be the determining factor in the value of a good. Comparison of the value of a good with the value of the means of production employed in its production does, of course, show whether and to what extent its production, an act of past human activity, was appropriate or economic. But the quantities of goods employed in the production of a good have neither a necessary nor a directly determining influence on its value." (Menger)

Timber in a virgin forest has some value separate from labor, just like gold known to be deep in the

hillside of your property has value, even though it has never been touched by mankind. So even in a Marxian view of value, applying the value of the raw material (the land with gold underground) to the labor involved to dig it up, we could easily put an ounce of gold higher than the value of a new BMW.

Imagine that physical gold is trading for $55,000 per ounce. If you own a hill with 100 ounces of gold underground, that hill must have a value somewhere south of $5.5 million, assuming you are legally allowed to remove the gold. Now imagine the labor and production cost of removing that gold from your hill and having it refined into tradable ingots comes to $300,000. For your small lot, that works out to a cost of $3,000 per ounce (not economically viable until recently), and it puts the value of your virgin hill somewhere under $5.2 million.

So in our exercise here, your input costs would be <$5.2 million plus $300,000 and your output would be $5.5 million. In fact, it doesn't matter if you bought the hill last week for $5.2 million or if your great grandfather bought it in 1920 for $1,500. All that matters is the present value of that hill. So in this scenario, your total energy and human capital expenditure for each ounce of gold dug up from your hill is equal to $55,000, or more than a new BMW (some models excluded). The Marxist, however, would say that the gold in your hill is the property of the collective (common ownership of the means of production). He might still let you dig it out at a cost of $3,000 per ounce, but then he would tax you $50,000 per ounce for the privileged of digging on communal land and removing (privatizing) communal gold. And of course this government action would do nothing to either the $55,000 price of an ounce of gold or to the >1:1 BMW:gold value ratio.

Gold in the ground would be the raw material or the "means of production" for producing gold, the global (private) commodity. The former is communally owned while the latter is privately owned, which transfers value from the latter to the former and its owner, the commune at large.

So as we can see, the free market does not follow the LTV rules that Marx proposed, and even Marxist communal enforcement and elimination of the "exploitation, super profit and unjust benefit" of producing new gold will have no effect on the price or value of private, physical, above-ground gold. It may, however, have a deleterious effect on the price and value of gold mines. But that's a subject for another day.

2. Part 1 of my look at the question above focused on how and why the Labor Theory of Value will not prevent a high value for gold. But it did little to explain how the price will get from here to there. That's what part 2 is about. The marginal utility of physical gold.

What is the utility of a BMW? According to the above question is it "significantly" greater than gold "in the real world." So what is this significant, real world utility?

Well, you can drive a BMW around. Can't do that with gold! It will even get you to work. Gold won't get you to work and back home. And a BMW will do these things in comfort, style and safety! In fact, a BMW may even improve the image of your status in society. I suppose gold could be useful in this regard if you are Mr. T. But then someone might steal it from you. A BMW is harder to steal than loose gold because it has redundant locking mechanisms and carries a visible registration number that can be tracked by a vast police force. Gold in your pocket or around your neck doesn't have these "real world" features.

And what is the utility of gold? Well, it used to be a medium of exchange and a unit of account. But today it is neither of those things. And yes, it does have a few industrial uses, but not many, and certainly not very many when compared to other industrial commodities. So what is gold's utility?

Gold's utility is that for thousands of years it has held its value relatively well. And because it is not used for many things other than mere hoarding, the act of hoarding gold is not an infringement on the natural rights of others to enjoy the utility value of "real world" things like BMW's and oil and wheat and pork bellies. If one were to corner, say, the copper market or the chocolate market, there would likely be repercussions as those industries fought back through the power of the collective that likes to consume chocolate and copper. But with gold there is no such worry.

Can you imagine if central banks hoarded 20% of the world's wheat in giant CB silos while millions of people went hungry? Or how about if the old money aristocrats accumulated and hoarded 20% of the lumber produced every year, preventing it from being used to build shelter? Do you think there might be cries of outrage and a wholly justified uprising against the CB's and the rich?

Thankfully we have a commodity that is mostly used for hoarding, and little else. Like Warren Buffet said, we dig it up and then bury it again in a vault. And all it does is one little thing: it maintains its value over thousands of years. That's gold's utility.

So now that we have looked at the utility of BMW's and gold, let's look at the *marginal* utility of each, that which gives value to an item. But first, what *is* "marginal" utility?

In this use, the term marginal refers to the effects of small changes in the consumption of any commodity we possess or are considering buying. It is a measurement of relative values because in order to increase our consumption of one commodity, it is thought that we must forgo another. Or perhaps we must work more hours, forgoing an equal amount of leisure time.

For example, if you didn't have a refrigerator you might be willing to forgo something quite significant in order to obtain your first fridge. But once you have one refrigerator, the second one you buy has less use value to you, because most people only have room specifically designated for one fridge. And someone who already has an extra fridge in the garage and a small beer fridge in the laundry room is unlikely to give up anything else for another refrigerator. It has no use to him. With each subsequent fridge he bought, the utility dropped. This is the law of diminishing marginal utility, or diminishing returns on expanded consumption.

Think about the bare necessities of life: Food, water, shelter and air to breathe. If you didn't have one of these things, you would pay any price to obtain your first unit of it. But once you have what you need to survive, the marginal utility of additional units drops off a cliff. So the bare necessities of life actually have very low marginal utility, or very high diminishing marginal utility. For this reason, their prices stand right near where Marx's LTV would put them.

A BMW also has low marginal utility. After you have bought so many BMW's, how many more can you possibly need? Imagine a man with a "disposable" $1.5 million. He may buy a $50,000 BMW. He may even buy two! If he buys one, the utility of that BMW could be said to be 30 days of "speed, comfort, style and safety" use per month. If he buys two and uses them equally, then the utility of his marginal (most recent) purchase could be said to be half that of his first purchase, or 15 days of use per

month.

Now imagine that he disposed of his whole $1.5 million into $50,000 BMW's. He would have one for every day of the month! And if we include his newfound need for a very large garage, it could be said that the marginal utility of additional BMW purchases, for him, had diminished to well below 1/30th of the first BMW he bought. So while the price of another BMW would still be $50,000, the value, to him, might be less than a thousand bucks.

This concept of diminishing marginal utility can even be found as far back as the fourth century BC, in Aristotle's "Politics", in which he wrote, *"external goods have a limit, like any other instrument, and all things useful are of such a nature that where there is too much of them they must either do harm, or at any rate be of no use."*

There is more to this story, but before we proceed, let's take a quick look at the marginal utility of gold as a store of value. Take the man above with $1.5 million in disposable cash. Say he buys himself one $50,000 BMW and one $55,000 gold eagle coin. He has just obtained the full utility of a fine automobile as well as the value preservation of that same purchasing power, for up to thousands of years if he should so choose.

Now say he buys one more $55,000 gold eagle coin, and then another, and another, and so on until all his cash is gone. In the end he will have 26 gold coins. And here's the question: Will that 26th gold coin purchase provide the same utility or diminished (less) utility than the first? Remember, the only utility of gold coins is that they retain their value for thousands of years. That's all they do. And hoarding them doesn't interfere with any other economic activity, at least not when they are *not* "official money."

The answer is "the same utility," because unlike ANYTHING else, (yes, even silver), gold has INFINITE marginal utility in this particular role.

Sidebar:

Back when gold *was* "official money," the hoarding of gold to store value actually *did* interfere with economic activity as it put a deflationary squeeze on the global monetary system. Here is a paper that discusses this subject:

Did France cause the Great Depression?

Abstract:

The gold standard was a key factor behind the Great Depression, but why did it produce such an intense worldwide deflation and associated economic contraction? While the tightening of U.S. monetary policy in 1928 is often blamed for having initiated the downturn, France increased its share of world gold reserves from 7 percent to 27 percent between 1927 and 1932 and effectively sterilized most of this accumulation. This "gold hoarding" created an artificial shortage of reserves and put other countries under enormous deflationary pressure. Counterfactual simulations indicate that world prices would have increased slightly between 1929 and 1933, instead of declining calamitously, if the historical relationship between world gold reserves and world prices had continued. The results indicate that France was somewhat more to blame than the United States for the worldwide deflation

of 1929-33. The deflation could have been avoided if central banks had simply maintained their 1928 cover ratios.

The introduction of the concept of "marginal utility" to the study of economics in the 1870's created a revolution in economics, called The Marginal Revolution.[1] All modern schools of economic thought (except for Marxism and those related to Marxism) grew out of this Marginal Revolution. As I said earlier, the theory of value is fundamental to the study of economics, and all human society for that matter, making any shift in this theory a "revolution."

In modern economics, the idea of marginal utility has led to "marginal rates of substitution" and "indifference curves" which are used in "consumer preference theory" in modern applications. The focus today is on choice and substitution. And this sets gold apart from not only BMW's, but from everything else in the physical world today.

In 1918, Silvio Gesell, a "free money" (easy money) economist with many radical ideas, wrote:

"And it is clear that money cannot be simultaneously the medium of exchange and the medium of saving - simultaneously spur and brake."

"I therefore propose a complete separation of the medium of exchange from the medium of saving. All the commodities of the world are at the disposal of those who wish to save, so why should they make their savings in the form of money? Money was not made to be saved!"

Silvio Gesell

While Gesell's "free money, free land, social equality for all, full employment, shorter work weeks for all and economic growth on demand" ideas appear quite impossible and dangerously utopian to this blogger, he was certainly on to SOMETHING of value in the above quotes. But while those selected quotes sound an awful lot like Freegold, can you spot the one problem in them?

That's right, he suggested that "all commodities of the world" could serve relatively equally as stores of value outside the monetary plane. This suggestion ignores the difference in marginal utility between the one commodity used ONLY as a store of value and all the rest that rely on their other uses for value.

Substitution, indifference and preference do not apply *only* to consumer products and food. They also apply to industrial commodities.

In applications of marginal utility, it is often assumed that commodities are continuously divisible. And as you divide a commodity (which you might do as the price rises) you reduce its consumption and increase the likelihood of substitution. For example, a consumer who previously enjoyed 1 lb. steaks may face a substitution dilemma if the price of steak doubles. He may have to choose between a ½ lb. steak and 2 lbs. of ground beef. Steak is divisible but dividing that steak reduces its utility.

This is true for all commodities on Earth in their "real world" uses… except gold!

Say gold doubles in price just like the steak. It is also divisible, just like the steak. Prior to doubling you could have gotten an ounce of gold for $25,000. After the doubling, you can only get ½ ounce for $25,000. Like the steak, you are only getting half as much. Or are you?

Unlike the steak, the utility of the ½ ounce of gold has not diminished. If anything, it actually INCREASED! How? Well, this ½ ounce will protect your present purchasing power of $25,000 for thousands of years just as well as a full ounce, but it will only require half the storage space and expense! (Keep in mind that the utility of gold is **protecting** your purchasing power, not increasing it. The fact that the price and value of gold have an extremely wide disparity right now is a separate issue.)

As any other commodity used in industry or consumption rises in price, the necessary division reduces its utility and encourages substitution. So all other commodities have this value-limiting characteristic. But not gold. Gold becomes MORE useful at higher prices while industrial commodities become less useful and subsequently get swapped out.

Now let's take a closer look at gold's highest and best (most valuable) use and compare to gold's present utility. But first, we must get one fallacy out of the way. Is gold's value derived from its industrial uses? Of course not. There, I'm glad that's out of the way. Gold is not just another commodity like all others.

Got it?

So what is gold's highest and best (most valuable) use? I'm sure a lot of you said "money!" And by "money," I'm sure you meant currency, or at least base money as it was during the gold standard. As the mysterious blogger Mencius Moldbug (one of my favs btw) and his even more mysterious alter-ego John Law points out:

"Money is always fundamentally overvalued. Its purchasing power is independent of its direct physical usefulness to anyone. This is obvious for paper money, but true even for gold and silver."

And he goes on to show that "precious metals" will at some point be spontaneously remonetized (overvalued), which is why you should buy gold and silver today.

He is right about official money being overvalued. Even Karl Marx agrees with that statement:

"The function of gold as coin becomes completely independent of the metallic value of that gold. Therefore things that are relatively without value, such as paper notes, can serve as coins in its place." (Das Kapital, Vol 1, Part 1, Section 2)

And Robert Mundell, Nobel laureate economist and "father of the euro" tells us how ancient rulers profited by overvaluing gold and stamping it into coins:

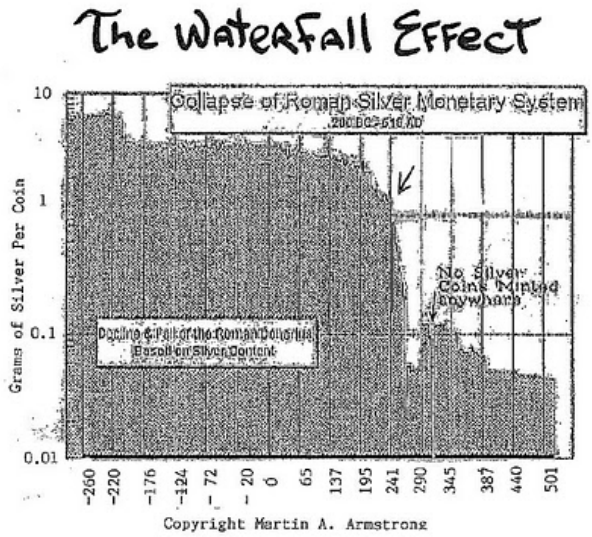
"The introduction of overvalued coinage provided a strong economic motive for the cultivation of a mystique. From its very beginning, probably in Lydia in the 7th century B.C., coinage was overvalued; one could say that was its very purpose.

"The earliest function of coinage was therefore profit. Coinage not only helped to market the [gold and silver] found in the Patroclus but the markup on them generated a substantial profit, helping these kings to achieve their dynasty's ambition of extending the Lydian Empire throughout Asia Minor. Accepted at face value as if they had a high gold content, the Lydian staters started out with a high proportion of gold but got progressively smaller, increasing the markup and the revenue for the fiscal authorities."

Robert Mundell

But then he goes on to tell us what ultimately happens:

"Coins cannot of course remain overvalued in a free market. Gyges and his successors were no libertarians. Overvalued coinage implies artificial scarcity, a monopoly and government control."



So the face (fiat) value stamped onto the coins ultimately falls from *above* the value of the metal to *below* the value of the metal, without fail. It did in the 600's BC Lydia, the 200's AD Rome, and again in the 1960's AD United States. Prior to 1964, the silver metal minted into a quarter was worth less than 25 cents. The quarter was overvalued, "inked" silver metal.

After 1964 they had to eliminate silver from the coins because people were starting to hoard that particular form of money for its greater melt value, putting a certain "squeeze" on the money supply and inverting the profit or "seigniorage" the government derives from making coins. Today a 1964 U.S. quarter is valued at $5 while the metal content of a 2010 quarter is only worth five cents!

So is money (currency) the best and highest (most valuable) use for gold? I think not. Is it the *likely* "next" use of gold in our near future? Not a chance! Another, FOA, FOFOA and the computer literate reincarnation of Aristotle all agree. And as a bonus, we can see clearly that the best, highest and most valuable use for gold is ALSO the most likely use of gold in our future!

Please read the following post carefully as Aristotle describes a pendulum with "gold money idealists" on one side and "easy money idealists" on the other. Notice that while he calls Freegold the "perfect bottom," he also points out that it is the most pragmatic and realistic point in an arc between two opposing idealisms:

Aristotle (8/25/2000; 4:02:42MT - usagold.com msg#: 35502)
The evolution and confessions of an unrepentant Gold advocate

There was a time I gave very little thought to the nature of the money I earned and spent and saved. But as certain thoughts drew me years ago to investigate Gold, as a result of my reckless nature I listened too attentively to the standard Goldbug rhetoric of others and was not well-served regarding the influence it had on my pursuit of clearer monetary understanding or on my discussions with others on this subject. Fortunately I had no investment commitments during that period of tainted perspective, so

only my perception of monetary affairs was temporarily damaged, not my meager savings at the time.

Fortunately, my mother raised me right, and I still possessed the capacity to think for myself despite the heavy influences of the Goldbug dogma I had eagerly absorbed with gusto. As I came to realize how many pieces of their puzzle didn't fit, I came to see that the explanation was owing to the well-intentioned reason that much of the "standard Goldbug rhetoric" was based on idealism. Well, that's fine and all, and something worthy to strive for, but in the end, we all must live in a pragmatic world. Happily for the buggiest Goldbugs, this same pragmatism also renders equally null and void the successful implementations of any notions of an idealistic paper-only world as seen in the wildest dreams of Keynesians, governments, and many bankers. As things are, Gold has a very important role squarely in the middle of a pragmatic world, yet too few people give much "theoretical thought" to this middle ground. Arguments are always made from the merits of the lofty points on opposite ends of a pendulum's arc. Pointless for making meaningful progress, to be sure, but God bless the idealists, anyway. (For the record, the Goldbug (Goldheart!) idealism--however unworkable it happens to be--is at least noble in the "eyes" of the individual human spirit, whereas the paper idealism is not.)

After a period of slower talking and deeper thinking, I arrived at a position with a realistic eye on the middle ground giving me clearer monetary understanding as it works in the real world, and also how it COULD in fact (and should) be made to work immeasurably better. Simply put, my thoughts had evolved from their starting point, and I became comfortable with my own concepts of a unique kind of monetary idealism that existed at the nadir--the bottom of the pendulum's arc. Despite reservations about beginning to share such radical monetary thoughts at this Goldbug-infested forum, in truth, it happens to be the finest economics discussion forum to be found anywhere on the web, and the credit goes to the good hosts (MK and TC) along with the high quality of those individuals who "infest" it. And to my delight, there are in fact some here, past and present, (I won't name them because it is obvious to them who they are) who also have grappled this monetary pendulum at the "perfect bottom" at the risk of receiving slings and arrows from those feeling ill-tempered on any given day who occupy the "perfect top" on either side--although given the Golden nature of this forum, our position at the bottom center surely looks like the opposite paper side due to the complete absence of those folks making their case here. In their presence, I have been further nurtured and heartened in my convictions that the international monetary system could and seemingly **IS** evolving toward this position.

Such has been my evolution toward monetary "enlightenment," and such is my position here--as a pilgrim, not a teacher--at the very bottom and on the fringe of the admirable and idealistic gentlemen who gather here to share their thoughts and visions of a better world and a better monetary system. I certainly didn't come here as perhaps some of the traders have--after having gotten themselves into an investment hole, hoping to argue, defend, and justify their way out of it. I don't feel stressed or defensive in any degree because my investment strategy has not put me on the ropes as others perhaps are. I have maintained a savings/investment position that is consistent with my understanding of how the world works, and to that end, I hold physical Gold at this time in such a large percentage of my net worth that most Gold bugs would tarnish green with envy, or else think ME to be the idealistic one.

Believe it or not, Gold within the system I endeavor to describe during my time here, though my views are unpopular, <u>will be far more valuable</u> (yes, and priced accordingly) than Gold ever could be in the more popular Gold-standard system. Such a radical vision? It promises vast wealth (for current Gold owners) AND international monetary stability (for everyone), whereas the Gold-standard vision won't propel your physical Gold near as high in value and has already shown

itself in the past to fail under natural worldly pressures. Which system (and outcome) would YOU rather wish upon yourself and also leave to your children?

Keynes didn't call Gold itself a "barbarous relic," but he rightly called the Gold STANDARD a "barbarous relic," **which is also precisely what the system of Gold derivatives and bullion banking of today has become--a relic of a clever scheme originally to offer life-support to a failing dollar-based international system at a time when the world had no other option. This patchwork scheme is no longer needed. On the other hand, freemarket physical Gold, as the pure and essential reserve/savings asset (unlent with no derivatives) is desperately needed in the modern world to indiscriminately bolster each of us alongside modern currencies which are now a permanent feature in the financial landscape. Simply put, Freemarket Gold is the only way for a man to safely coexist with his currency.**

Gold. Get you some. ---Aristotle

Somewhere above I said that while the present price of something can be known with precision and certainty, value can only be estimated or guessed at until it is finally revealed. I have explained how paper gold and dollars have "instrumental value" while physical gold has "intrinsic value." I have described how value flows from the use of, or the marginal utility of any commodity rather than from its cost.

I have often alluded to the separation of the monetary functions of medium of exchange and store of value unfolding within our global monetary system today. And I have frequently inferred that gold will not only be most valuable in the monetary role of store of value par excellence, but that once it is, as Aristotle stated, even our purely symbolic medium of exchange will reveal a new stability not seen in decades. I have also touched on the importance of choice, preference and substitution in determining value. And with a little thought about some of the paper alternative stores of value in competition with gold today, you may just discover for yourself a little A-HA moment. (Those are always fun!)

Now I will estimate and guess at gold's value in different roles. The present price, as you know, is $1,390 per ounce. But that price is not gold's value. That price does not reflect any particular use or role for gold. What it reflects is today's position in the journey along the Gold Trail, because gold's use is in the process of transition right now. Gold's use is changing, and so is its value, tugging like gravity (or Jim Sinclair's magnetic angels) on its price.

If gold was only an industrial commodity its true value would be relatively close to its LTV price because of the limited industrial uses for gold, or somewhere around $500 per ounce. (Think of central banks and "giants" as the REAL commercial users of gold.) If gold were returning to its past role as base money in a fractionally reserved dollar-gold standard, its value would probably be around Jim Rickard's low estimate of $5,000. If gold were to take a more prominent role, as say an international currency, it would probably be closer to Rickard's high estimate of $11,000.

And as the international CB reserve *asset* (NOT currency) standard designed into the Eurosystem quarterly MTM reserve concept, gold's value is probably around $55,000 per ounce. And lastly, if all fiat money caves in like a house of cards and oil is forced to bid directly for gold, we're looking at a value closer to $100,000 per ounce. But that scenario would be relatively short until a new super sovereign currency was resourced. Aristotle wrote, "I discovered that we absolutely NEEDED fiat

currency in order to set Gold free." And this includes an international trade currency like the SDR or the euro.

Of course these values are mere guesses on my part. But I'll tell you that the Eurosystem MTM Freegold concept looks to be most probable by a longshot. And perhaps somewhat imminent as well.

If you still cannot see how a wealth reserve ASSET can be more valuable than a currency, look no further than the $IMFS. Look at the total value of currency versus the total value of wealth reserve assets denominated in currency. It is something like 10 to 1. Not dissimilar to my 55,000:5,000 ratio above! And for more on this train of thought, as you read FOA's post below, think about how a PHYSICAL wealth reserve asset in FINITE supply will hold REAL value differently than the currency-denominated paper assets of today.

Now here's the FOA comment that seeded this post. The above is just my long-winded intro. ;) It is a comment about value (obviously) and a checklist for the unfolding of Freegold. FOA had wanted to post this on the Gold Trail, but it never made it due to technical difficulties. It only appeared as a link a week later. So some of you may never have read this before. A few final words by me are at the bottom. Enjoy!

Trail Guide (8/26/2000; 19:16:31MT - usagold.com msg#: 35569)
Couldn't post this on the Gold Trail? Something Wrong?

Hello Cavan Man!

In your post of ---- Cavan Man (08/21/00; 19:49:05MT - usagold.com msg#: 35278)---- you asked for more detail. Something like a grocery list to check off as events move along (smile). The exact question came as: ----"What are some of the impediments to moving ahead with your "freegold" scenario?"----

Well, Cavan Man, one of the toughest problems investors have with following the Gold Trail stems from their perception of how our modern dollar money values things in the market place. I, we, all of us have discussed this extensively. Often from a somewhat different view than mine.

From my interaction with people of various far reaching world backgrounds, one thing is clear: Investors and regular workers with a Western slant do not grasp what wealth is. Overwhelmingly they see their currency and paper investment portfolios on an equal footing in value with the same "real things" that raise our living standards. Yet, in real life, they cannot be equal because these paper assets are only an exercisable future claim on our "real things in life".

Take my debate "Against" Goldhunter as an explanation example. His perception is typical in that the ---"prices bid for futures contracts are the market value of gold"---- (see msg#: 35427). These future contracts serve no more purpose in setting pricing function than do all modern paper assets we today hold as wealth.

In this larger sense, after rereading my post to him,,,,, one can see where the entire dollar world itself has become a "futures pricing arena" that "undervalues" almost every real usable item we function with in daily life. The dollar asset system, as we know it today is used as a value setting tool even though it,,,, like gold futures,,,, does not entail the removal of real goods from circulation.

But wait, you say,,, of course it does,,,, we buy and sell for our life's needs every day using dollars! Yes, this is true, Cavan Man but in that process we as an economic society only use a tiny fraction of this paper asset wealth to do that physical trading. As an example:

Look at the daily trading of gold futures and gold future "look-alikes" in London as they trade in a huge volume multiple of the actual physical market. As this lopsided trading is a comparison valuation that understates the value of gold,,,,, so too does the collective acceptance that dollar assets are held as equal to life's physical needs,,,,,, also understates the real value of all things in our lives.

You see, a futures system that functions as our currency or currency contracts, values physical assets without taking these assets into our lives and by extension taking the assets out of the market. This is the current money world we live in. The dollar in your pocket is part of a much larger paper wealth system that has evolved into today's money system. A reserve system that is not tested against real "supply and demand" values. With these money futures we may leverage our perceived wealth by thinking we actually control "real assets" just by holding contracts or dollar denominated paper assets. In reality we only own claims on each other's ability to produce,,,,, just as a futures contract holder only holds a claim on another to produce physical. Expand this function to a level where today's dollar world is and we can grasp what others see in the real value of gold.

This is the reality of perception that Another speaks of when he said -----"your wealth, it not what your currency say it is"-----.

Truly, this statement was larger than life to anyone that could understand its implications then and correctly act on it today! Unfortunately, most readers just went out and brought more paper denominated dollar gold assets. Many have lost a bundle thinking they were hedging when they were just playing the same dollar game.

This takes us back to your initial question:

Western society and Western influenced investors cannot grasp gold's value because they mentally must denominate it into currency first. To do this they turn to the "market place" as the undisputed tester of values. But, as shown above, our market place uses a currency system that is entering the end of its timeline and therefore can no longer measure "things" on a simple supply and demand value basis.

Some of the things on our "grocery list" are being checked off as we walk this Golden Trail.

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This currency systems and the evolving nature of our current society that created this system is in the process of radically changing its paper wealth structure. **The government, as an extension of that society begins to support and maintain the asset value of almost everything. This is the engine that drives an eventual hyperinflation. Not a typical business expansion inflation we are used to, rather an all-consuming, ending inflation that does not stop. At this point the concept of sound money takes a back seat to maintaining majority asset holdings on a permanent plateau. By extension, the official stance is moved to promote all paper assets as "national money". Stocks, bonds, business function and even general welfare is elevated to an equal footing with the need for a good sound money in your pocket. The mood becomes one of "what good is a sound dollar if**

we are deflating"? Check that one off your list because we are well on that road.

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The international value of major currencies become more a function of "who can manipulate them the best" rather than their soundness. Forget the trade deficits, asset price bubbles, debt overflows or interest rates,,,,, it's who is best at controlling currency derivative function. Traders buy using "official control" as their determining value fundamentals. Truly, at this stage the prospects of a price deflation and its opposing currency hardness are a distant joke. The US has now moved to using measures once reserved for third world systems when it comes to playing the money game. Example: "our national debt is being paid off"! Or the CPI rising .01%! **Check this one off your list**, it's happening now.

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Those with power outside this game are seen making long term preparations for the day when the US dollar inflates away. They see where the dollar value is only a function of trade flow manipulations. Not real economic progress. They see where throwing ones entire economic system wide open to "bubble expansion" policy in a "come and get it while you can" experience,,,,, can only end one way. So they play the game while there is time and they play to win with gold! As USAGOLD poster Henri put it today in msg#: 35547:

---- " If one considers wealth to be the accumulation of unencumbered assets of enduring value, then the pursuit of fiat profit to be converted to real wealth makes sense.-----

(nice post Henri)

The unanswered question that "no one" could ever understand was "outside the other CBs, who has been buying all this gold over these years?" **Check this one off your list** my friend.

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The Washington Agreement has placed us "on the road" to one of the most exciting changes for our current physical gold market in its short 25 year history. This part of the world reserve currency system was about to radically evolve with respect to the world dollar gold values. To date, the ongoing dramatic fall off of LBMA trading from its (also) short public life is leading to an eventual official evaporation of dollar based paper gold banking.

Someone in Another's group pointed to that spike in paper trading long before most had ever heard of LBMA,,,, and did so by saying that a drop below $360 would cause it. That ensuing round of massive paper playing was but a backstop to maintain the dollar reputation with low paper prices prior to Euro presentation.

I point this out because many new watchers of our gold wars have no knowledge of this important play on the political currency chess board.

This paper game got out of hand before the Euro was born and the BIS was ready to hold the gold line at $280 if needed. But, the Euro was born and is now a functioning currency. Today our paper gold game has come full circle and most of the players that know anything are shaking at the prospect of a pure physical market that will stand next to the Euro.

Forget the gross volumes of derivatives on the books of majors, they don't mean a thing. They can keep writing contracts all they want but with trading volume falling away, eventually there will be no market to value these assets.

If this process is allowed to mature fully, major pain is coming to paper hard money investors worldwide. They have hitched their wagon to assets that require an operating paper system to sell into. Outside the private markets for existing and circulating bullion and coins, the entire industry will shutter to a halt as the mess is worked out. Investors will be kicking themselves as bullion soars while an extended workout phase brings their asset values to almost zero. Sure, something will give,,,, maybe? Maybe we are at the paper price lows now?

But most "regular" hard money people that read these Thoughts are in the game for asset preservation during a world currency crisis and or inflation. Ten ounces of French gold coins and $60,000 in mining stocks and derivatives will make them sick during such a paper work out. Other proud hard paper asset holders proclaim they have millions in the industry and are not the least worried. They also said the Euro would never happen, oil will never see $30 without $600 gold and $280 gold would mean a major US depression! Well,,,, Don't check this one off yet. It's still playing out.

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Then there is oil. I will repost my recent and now "edited" post to oldgold:

Trail Guide (8/25/2000; 8:55:32MT - usagold.com msg#: 35512) Comment

oldgold (8/25/2000; 8:12:54MT - usagold.com msg#: 35510)
Energy and Gold

Hello Oldgold,

I know you have held a forceful opinion for some time that the US can and is still controlling oil producers. Your thinking was no doubt rightfully influenced by our last ten to twenty years of experience with the political world of oil.

What has been changing for the last number of years was our realization that a new currency would be available to the world. True, this Euro is nothing to write home about now but we as a Western thinking group tend to underweight its strategic importance as an "available alternative" to the dollar if needed. This subtle fact has shifted the playing field considerably when viewing the US ability to control oil flow.

Edited note: this next item is where we should watch for the dollar to be impacted by an increase in oil prices. For oil prices to be this high after all the political favors we are owed,,,, something must be countering that leverage. The US must be endorsing the move?

---------- Today, oil flow has moved from playing a fundamental game of pricing "use value" with supply and demand to pricing its "monetary value" in supporting any major currency block. Concessions are now there for the taking by oil producers. Dollar prices for oil can rise considerably higher with the US giving behind the scene support for this action. In addition, the world paper gold markets can and are being dismantled as a further concession to retain dollar settlement of oil.

Strangely, the coming surge in physical prices are now a 180 degree shift from keeping them low in support of oil flow.

Edited note: This next was the purpose for the short history of the LBMA high volume. Its use is now behind us.

In the future, rising physical bullion stores (and dollar prices) will play an important role in playing a failing inflationary dollar against an ever likely increasing shift towards Euro oil settlement. No matter how this eventually plays, our dollar paper gold markets will dissolve as free priced bullion supports the EBS / Euro system.

Oldgold, Your posted article goes a long way to seeing the mental shift some Western thinkers are only just now grasping. It seems even Goldman has printed a paper calling for 50 oil! It will be very interesting to see how their stock price is valued as they try to ride the middle ground between a short gold position vs. long oil. In the end their much vaulted paper gold game should make them a ton of money, but without a market available to realize those gains? The more GATA talks, the more the paper world sweats. Not from a short squeeze, but from their market being officially evaporated. I know you, oldgold must also (smile) as I do at that thought!

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Cavan Man, check off rising oil prices.

We are on the road to "Freegold"!

thanks
Trail Guide

A Final Word

Many have asked about an eventual exit from gold after the Freegold (physical gold market) one-time revaluation is complete. Aside from the obvious answer of using your wealth in ways that will rebuild a broken economy, this is a complicated question about value storage to which I will now give a grossly simple answer, only because it pertains to the subject of this post. And it's probably not what you'd

expect.

It is an extremely small group of people that followed ANOTHER's advice 13 years ago and sunk their retirement nest egg entirely into physical gold. And the following is my personal opinion only as it pertains to this extremely small group.

The whole point of an over-sized position in physical gold now, like Aristotle described above, and as explained by ANOTHER, is to let your wealth ride out this inevitable earthquake in the one asset that will benefit the most. Once the earthquake has passed, such a large position will not be as necessary.

Giants don't go "all in" to gold. And they won't exit their positions for reasons I have explained in other posts. CB's are different, they don't collect non-monetary assets. They also won't exit their gold positions. And most average gold investors will be lucky to retain their present purchasing power. They won't exit their gold positions until they need the money for expenses.

So the "exit" of this extremely small group I am talking about will be inconsequential to the Freegold price of gold. In fact, there will still be a rush INTO physical gold while ANOTHER's followers quietly exit a portion of their over-sized position in favor of other wealth assets that can be a little more enjoyable in everyday life than gold hidden away in a vault.

During normal times there are many valuable, non-essential, non-industrial, non-economic physical assets other than gold that protect your purchasing power just as well as gold. And they can also be enjoyed more openly in your home and your life. These are what Richard Maybury calls "endurables". They include: Real estate, fine art, antique furniture, rare collectibles, ancient artifacts, fine gemstones, fine jewelry and rare classic cars. None of these items will do well in the brief gold revaluation as ANOTHER explained. But other than that one, historic, brief burst in time, they do quite well.

Sincerely,
FOFOA

[1] While Carl Menger is considered the father of Austrian economics, he was not the only "father" of marginalism. Per Wikipedia there were three: Jevons in England, Menger in Austria, and Walras in Switzerland, followed by many more in "the second generation."

Monday, September 12, 2011

Once Upon a Time

The story I am about to relate to you was first told in a lecture hall at the School of Political Sciences in Paris (L'École des Sciences Politiques) on March 17, 1932, from the depths of the Great Depression. It is, perhaps, more relevant today than it was on the day Jacques Rueff delivered it. Rueff began with this:

"The story I am going to relate covers a long period. It is the life story of the gold standard, now afflicted with so grave an ailment that only time will tell if the victim will succumb or be left, at the very least, in a state of virtual paralysis." [1]

He said "only time will tell"… well, some time has passed, and it did "tell".

So what grave ailment was he talking about in 1932? What did time reveal since then? And how has this important story been misread over the years? I will try to answer these questions and to retell Rueff's story the way I think it should be told today. And my hope is that this will, in your mind, bring together many dissonant concepts, as it did in mine, into a grand, unified, long-line view of Freegold.

Jacques Rueff told the story of two different monetary conferences, two "committees of experts" that both met in Genoa, and changed the course of monetary history. The first committee gathered in October, 1445, and the second one began in April, 1922, so Rueff's lecture had ten years on this second conference. The two committees gathered under similar circumstances, to respond to monetary disorder in the aftermath of a protracted war, yet they came to opposite conclusions.

The first committee declared gold the new, sole monetary reserve, unleashing its 500-year reign as the governor of supply and demand that would act as the natural counter-balance to international trade for the next half a millennium. The second committee, under the guise of improving this system, destroyed it, laying the groundwork for the unchecked growth of global imbalance, perpetual malinvestment and the series of periodic monetary crises we have experienced for the last 90 years.

The 1922 Genoa Conference. The British Prime Minister Lloyd George on front row, left.

Prior to 1922, gold was a vibrant, fertile member of the global economic ecosystem — what I like to call the Superorganism that governs naturally, far above the ability of mere mortals. Rueff put it this way:

"Gold… governs all the components of our international transactions with faultless effectiveness… it is a forceful but unobtrusive master, who governs unseen and yet is never disobeyed. Nevertheless, it is too wise to oppose the inclinations of men. It never, for example, prohibits the purchase of foreign securities; taking all their actions into account, it guides the conduct of men in order to prevent the upsetting of the balance it is supposed to maintain. We should also point out that while guiding men's actions it respects their freedom of choice. They are always at liberty to buy according to their preferences, but the monetary mechanism, in its omnipotence, will raise the price of those items whose purchase is contrary to the general interest, until such time as consumers decide of their own free will to stop buying them. The gold standard thus resembles an absolute but enlightened monarch; he does not destroy man's freedom, but employs it for his own ends."

The sustainability (and, indeed, the very survival) of the global economic ecosystem is predicated not on balance in the monetary realm, but on the delicate balance between **real production** and **real consumption**. It is the *flow* of actual physical gold that, at least prior to 1922, moderates and regulates this complex balance because gold, like real production and consumption, exists in the physical realm and is therefore not subject to the politics of easy money. But following the economic destruction of Europe in WWI (1914-1918), the US experienced high inflation accompanied by a dramatic **inflow** of gold. So in the early 20s, along with raising interest rates and federal budget cuts, the US began a policy of gold "sterilization" to resist the natural price mechanism—inflation—that would have otherwise acted not only as a brake on the inflow of gold all through the 20s, but also as a spur on the struggling European economy:

> **Federal Reserve Sterilization of Gold Flows**
>
> When a country imported gold, its central bank could sterilize the effect of the gold inflow on the monetary base by selling securities on the open market…
>
> Sterilization of gold flows shifted the burden of the adjustment of international prices to other gold standard countries. When a country sterilized gold imports, it precluded the gold flow from increasing the domestic price level and from mitigating the deflationary tendency

> in the rest of the world. Under the international gold standard, no country had absolute control over its domestic price level in the long run; but a large country could influence whether its price level converged toward the world price level or world prices converged toward the domestic price level…
>
> Traditionally, economists and politicians have criticized the Federal Reserve for not playing by the strict rules of the gold standard during the 1920s.
>
> …Federal Reserve sterilization in the early 1920s probably served the best interests of the United States.
>
> -Leland Crabbe, Washington, D.C., 1988
> Board of Governors of the Federal Reserve System [2]

The price mechanism is the Superorganism's governor in the delicate balance between production and consumption. It is what keeps the economy in a sustainable balance somewhere between starving shortages and ruinous waste. And the flow of unambiguous real gold has always been a key international transmitter of the price mechanism because gold is *the* physical-monetary proxy for economic goods and services, subject to the same physical limitations as goods and services. Modern currency, on the other hand, even though it flows and trades like a commodity, is subject only to political limitations, not physical ones, and is therefore qualitatively different (an inferior, infertile transmission medium) from the perspective of the Superorganism.

The flow of gold is the flow of real capital, even if today it is obscured by an electronic matrix of imaginary capital (infertile media). Today's debt (the bond market) is imaginary capital in that it cannot perform in real terms; with "real terms" defined as economic goods and services (under current economic conditions) plus gold—and this part is important—**at today's prices**. It is all nominal debt, but the price of goods and services—as well as the price of gold—is what connects it to reality. And at today's prices of each, bonds are imaginary capital. It is our obsessive compulsion to centrally control the price mechanism that sterilizes the vital signals that would otherwise be transmitted to billions of individual market participants keeping the monetary and physical planes connected.

The outflow of *real* capital from any zone signals the need to produce more and consume less. The inflow of real capital signals the need to consume more and produce less. The price mechanism transmits this signal to individual actors in the economy. The inflow of real capital will raise prices vis-à-vis real capital, which makes exports more expensive abroad, lowering exports and raising imports. The country with an inflow of real capital will have to start consuming more of its own production or else it will just pile up and rot.

Likewise, the country with an outflow of real capital will have to start producing more than it consumes. Again, this signal is transmitted to individual actors via the price mechanism. With less real capital upon which credit flourishes, credit will contract, general price levels vis-à-vis real capital will drop, the purchasing power of real capital will rise, and real capital will become more expensive in terms of goods and services. Exports will rise because exportable goods will fetch a higher price abroad, imports will slow because local prices have fallen versus the vanishing real capital, and people will have to begin producing more than they consume in order to survive.

The monetary plane, that electronic matrix of imaginary capital, obscures the simplicity of what is actually happening today, and it does so by design. But it's really simple, and hopefully I can help you see through all the noise. Everyone knows that the sovereign debt in Europe is a problem today. But all we hear are complex solutions proposed within the monetary realm. Consolidate this paper, roll over that paper, haircuts, pay cuts, job cuts, interest rate cuts, print, sell, buy, repo, reverse repo, reverse-reverse repo, rescue funds, POMO, SOMA, EFSF, SMP, EMP, ETA, ESPN; it can make your head spin after a while.

The lesson from the monetary changes made in the post-war 20s is that if you want the debtors to ever be able to repay their debts in real terms, you do not sterilize the vital spur and brake function of gold by locking its purchasing power. It is the price mechanism—price changes in goods and services—that transmits the arbitrage signal that causes gold to physically flow to where it has the greatest purchasing power. For a struggling economy to grow and expand to a point at which it can repay its debts, the gold not only needs to flow, but it must be a fertile member of the economic ecosystem so that it can perform its vital function.

I know this is difficult to see, so I want you to try a little thought experiment with me for a moment. I want you to imagine that the complex and confusing monetary plane doesn't exist. You can still imagine the debt existing, but imagine that the debt is denominated in physical goods and services. So there's only real goods and services… and gold—gold being the proxy for goods and services that floats in value *against* those goods and services.

(We can eliminate currency from the equation in our thought experiment because we know that we want a relatively stable currency—not too much inflation, not too much deflation—for the purpose of contracts and debt if we want a vibrant economy.)

Now imagine you have one country with debts denominated in goods and services. Let's call it Greece. Greece owes Germany X goods and services. Meanwhile Germany is still exporting goods and services while Greece is still importing. This leaves Germany with a structural surplus in its Balance of Payments and Greece with a deficit. But gold can reverse this flow in an instant on the BOP at a high enough price. And once it does, it will begin to exert the brake and spur forces on the two countries until the flow of actual goods and services finally corrects and reverses. Once that flow corrects, the gold flow (which is opposite the flow of goods and services) will reverse and subsequently the brake and spur forces will also reverse.

Gold flows in the opposite direction of goods and services. Remember when ANOTHER said, "gold and oil can never flow in the same direction"? Well it's the same thing with other goods and services. Germany and Greece may both be exporting *and* importing, but Germany is exporting more, which shows up on the BOP as a Trade Surplus and a Capital Account Deficit. At a high enough price, a small amount of gold can (and will) flow in the other direction, from Greece into Germany, and if its value exceeds the (net) trade difference between Germany and Greece, it will turn Germany's Trade Surplus into a Trade Deficit and a Capital Account Surplus.

Now jump back to post-WWI. Europe was the debtor with debts denominated in goods and services owed to America. But Europe's economy was struggling to get back on its feet, making it difficult to pay its debt in actual economic goods and services. So the proxy—gold—flowed from Europe to

America in unprecedented amounts. This flow should have acted as an incremental brake on the American economy and a spur on the struggling European economy. But instead, the US sterilized the effects of this gold flow in 1920 and '21 while implementing "intelligent and courageous deflation" (President Harding's words), and then in 1922, the Genoa Conference sterilized gold's natural mechanism globally.

Once sterilized, gold flowed uncontrolled into the US right up until the whole system collapsed and beyond. This would be similar to Greece selling gold at today's prices to pay off its debt. The gold would quickly be gone and then the economy would collapse. The sterilization of gold may be at least partly responsible for the roaring 20s, the Great Depression, the rise of Hitler and the Second World War.

You can't squeeze blood from a turnip. That's an old saying. It means that you cannot get something from someone that they don't have. In order to pay its debt in real terms, Greece needs to ultimately get back to producing more than it consumes. And as counterintuitive as this may sound, they will *first* need to run a BOP surplus in order to get there. You do that by exporting more value than you import.

I realize how backward this sounds, but that's only because we haven't seen gold function properly in more than 90 years—beyond living memory. And this is why the limited stock of physical gold is ***far*** more valuable than the paper gold promises of New York and London would have you believe. This is why Greece will never part with its gold at today's prices. It is far more valuable. Greece ultimately needs to get back to *importing* gold which is what happens when you produce more than you consume. But you can't get back to that place by spewing your real capital at imaginary capital prices.

At the true value of physical gold set by the Superorganism, Greece will automatically start running a Trade Surplus on its BOP and Germany will automatically run a Deficit with Greece. The high price of gold is the only factor that can achieve this goal. At that point Greece will be paying its debt in **real terms** and gold will be flowing. This will spur the Greek economy until that flow of gold is reversed and it starts flowing back into Greece. At that point Greece will have a vibrant economy. And then, as the gold flows in, it will start to act as an incremental brake, a natural governor that prevents the overheating of the new Greek economy. This will occur naturally. This is the future in real terms, regardless of all the monetary floundering. And this future cannot be managed by a committee of experts no matter what economic school of thought they practice. This is Freegold.

The elegance of this natural regulator is that, as long as it is free from systemic counterfeits, it functions regardless of the shenanigans of monetary "experts". That's because the Superorganism's price mechanism is a function of the purchasing power and flow of *real* capital, not the purchasing power and flow of imaginary capital (paper promises). To wrest control away from this "forceful but unobtrusive master" one must render its purchasing power and flow infertile in the global economic ecosystem.

What the 1922 Genoa Conference did was to institutionalize the "sterilization" of gold for the rest of the world through the reserve structure of the international banking system. And this bit of genius was decided by a "committee of experts" from 34 different countries. They did this by introducing paper gold—or paper promises of gold—into the international banking system as reserves equal to the gold itself. This wasn't the first paper gold, but it was the first time that specific paper gold (that from New York and London) was used as an equal reserve upon which credit can be expanded. What is acceptable

as international reserves is critical because trade settlement is a function of the reserves. This conference was the birth of the $IMFS.

In 1922, they officially changed the old gold standard into the new "gold *exchange* standard", which Rueff said was "a conception so peculiarly Anglo-Saxon that there still is no French expression for it." The stated purpose was "the stabilization of the general price level" which you can feel free to read as code for sterilizing the price mechanism and its elegant governance of an extremely delicate and complex balance. This, of course, gave birth to the arrogance of the ***managed economy*** and its attendant science, Keynesian Economics (est. 1936) and its step-daughter Monetarism (est.~1956).

With the gold mostly staying put in London and New York, and paper promises of gold flowing as equal base money elsewhere, the monetary base was effectively duplicated. Credit could now expand without ever having to contract, at least not because of the *unwanted* flow of gold. But of course that's not how it actually works in practice. The "unwanted" flow of gold is not the cause, but the effect of real imbalances (physical, not monetary ones) between international production and consumption. So, obstructing the adjustment mechanism of real gold settlement set the world up for periodic busts, economically destructive punctuations and regular currency devaluations.

To use a modern buzz word, they expanded the 500 year-old international monetary base into a more flexible "basket" that included US dollars, British pound sterling, and gold. As dollars began to accumulate abroad, they would be deposited back in the New York banks in exchange for a book entry reserve on the foreign country's balance sheet. In this way, the unbalanced flow of trade acted only as an occasional spur, and never as a brake. The only brake would now come in the form of destructive crises and abrupt monetary resets.

Here's a comment I wrote back in May, 2010:

The US exorbitant privilege began at the International Monetary Conference of 1922 when for the first time international banks were allowed to accept not only physical gold, but also US dollars (paper gold) as reserves. But all US dollars held by foreign banks were put on deposit back in New York City banks. And there they were counted as local US deposits, the same as if you and I put our gold into the bank, in addition to being counted abroad.

These deposits were used as the basis for credit expansion in both the US and in the foreign countries claiming them as reserves. This process doubled the money supply paid out through the US balance-of-payments deficit for the last 88 years (except that money which France demanded in gold). US deficits never contracted the aggregate purchasing power of the US after 1922, the way deficit settlement is supposed to. It also exported US inflation outward. And it continues today.

The only solution to this problem is the explosive expansion of the gold base (volume x price). Volume can be expanded through mining, but not fast enough to suffice in a crisis. Therefore price will take the brunt of this reset. The price of gold will explode.

1971 was the first step toward Freegold. The final step is today.

1445

Now let's look back at the first monetary committee that deliberated in Genoa from October, 1445 until June, 1447. The Hundred Years' War was already more than a hundred years old at that time, as was the economic and monetary havoc that protracted war brings. By 1420, the French currency, the livre, was under severe market pressure to devalue. The King valued his livres at .78 grams of gold each, relative to the gold mark, the contemporary unit of weight for gold. But the marketplace was trading livres at only about 11% of that official value, or .09 grams of gold. The market had already devalued the livre by 90%.

Jacques Rueff describes the French King's response: In 1421 Charles VII "resorted to a series of measures bearing a remarkable likeness to those which were to be adopted in France five centuries later: the prohibition of exchange transactions by unlicensed dealers and the fixing of a scale of fees for such transactions; a ban on the export of gold and silver specie; the imposition of fines on notaries who stipulated payments in gold and silver marks, that is, in bullion rather than in livres, the intensive exploitation of France's silver mines; and an attempt to achieve a balanced budget by rigorous and methodical management… But all these efforts did not succeed in alleviating the financial distress. A variety of monetary adjustments—which might be termed devaluations—were devised, as usually happens in such troubled times."

Genoa spent 15 years under French domination during the war, but by 1445 it was its own city-state, a maritime republic and an important trading center and port for international commerce. It was also home to the Bank of St. George (1407-1805), one of the oldest chartered banks in the world. In 1444, the Bank was chartered to manage the public debt and make loans to the government, not unlike a modern CB or Treasury. "Niccolò Machiavelli maintained that the Bank's dominion over Genoa made possible the creation of a 'republic more worthy of memory than the Venetian.'" [3]

The Bank of Saint George

So when the fluctuations, weakness and debasement of the local and foreign exchange currencies "gravely unsettled" its marketplace in 1445, the Genoese government convened a "committee of experts" consisting of mint officials and Bank of St. George trustees to figure out a solution to all the monetary turmoil. The committee labored for almost two years, but could not come to an agreement. So instead, it issued a report in which the majority and minority set forth their views.

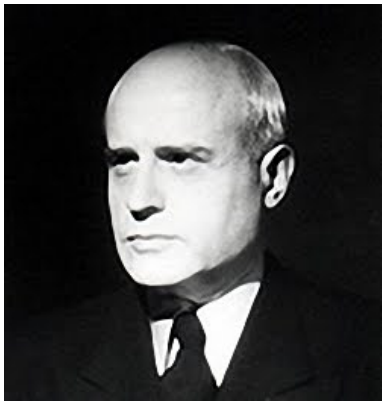
The minority report, which was rejected, recommended a "basket" monetary standard (although they didn't use the word "basket") consisting of 1/3 gold, 1/3 silver and 1/3 in the depreciating currencies of the countries involved in any transaction. The majority report on the other hand, signed by 15th century "Trail Guide" Benedetto Centurione of the house of Centurione and trustee of the Bank of St. George, recommended the adoption of the gold standard pure and simple.

Benedetto Centurione appears to have been the head of the house of Centurione, one of the wealthiest influential houses of international commerce. It had many foreign branches, each run by one or more of the Centurione brothers. As Rueff told it, "Nicolo and Giovannie were in Majorca, Raffaelo was at Bruges, and Paolo at Lisbon." They later opened branches in Antwerp and in the Indies, "and Christopher Columbus [a Genoese native] was undoubtedly one of their traveling salesmen."

But in 1445, as Rueff tells it, Benedetto "was quite aware of the fact that for half a century a large number of trading countries had adopted the gold standard. One after the other, Egypt, Syria, Yemen, Hedjaz, and some parts of the Greek world had adopted… gold." (Reminds me of a more recent Trail Guide who noted a certain *Eastern* taste for gold.)

In his majority report, Centurione wrote, "The banks will be obliged to pay in [gold] florins, exchange will take place in [gold] florins; in this way gold will not leave the country and, in time, by driving out bad money, it will constitute the wealth of the people." This was the opinion that prevailed in 1447. Soon the banks were required to settle credit imbalances in gold, the new banking system reserve, and to deposit one hundred gold pieces as security for fines in case they broke the rules. And all bank drafts drawn on Genoa abroad had to also be denominated in gold, thus making it the new international bank reserve, in the modern sense of the term.

As Jacques Rueff described it in 1932, this "plain and simple" recommendation would "endow the world with the most marvelous instrument of international co-operation in its history… The system was to function perfectly well until it was shattered—also at Genoa—by the second committee of experts, which in April and May, 1922, contrived to demolish the work of the house of Centurione."



Jacques Rueff

Like Centurione, Rueff also turned out to be a bit of a monetary architect himself in his later years. During the Great Depression, Rueff was a major figure in the management of the French economy. In 1941 he was dismissed from his office as the deputy governor of the Bank of France as a result of the Vichy regime's new anti-semitic laws. After the war he served in political office as the Minister of the State of Monaco, as a judge on the European High Court of Justice, and later as a key economic advisor

to French President Charles de Gaulle. The 1958 "Rueff Plan" balanced the French budget and secured the convertibility of the French currency.

Rueff was highly critical of the use of the dollar as a unit of reserve, which he warned would cause a worldwide inflation. He was strongly in favor of European integration, and always remained a firm opponent of Lord Keynes' ideas. In 1947, Rueff critiqued Keynes' magnum opus, *The General Theory of Employment, Interest and Money*. After his critique of Keynes, Rueff's main critic became James Tobin, a Keynesian economist who would later serve as an advisor to both the Federal Reserve and the US Treasury where he would help design the American Keynesian economic policy during the Kennedy administration. It is somehow fitting that Rueff's archnemesis, Tobin, would be best remembered for his 1972 suggestion of the "Tobin Tax", a tax on the exchange of foreign currencies in response to Nixon ending Bretton Woods. [4]

The London Gold Pool

Jacques Rueff's advice led Charles de Gaulle to begin withdrawing physical gold from the US Treasury during the later years (1965-1967) of the London Gold Pool, and then to withdraw altogether from the Pool in 1968 which ultimately led to the closing of the US gold window in 1971. Here is de Gaulle speaking in 1965:

DE GAULLE predicted the US monetary crisis in 1965

And here is a description of the subsequent failure of the London Gold Pool that I wrote for my 2010 post Living in a Powder Keg and Giving Off Sparks:

The London Gold Pool was a covert consortium of Western central banks, a 'gentleman's club' of sorts, that agreed to pool its physical gold resources at predetermined ratios in order to manipulate the London gold market. Their goal was to keep the London price of gold in a tight range between $35.00 and $35.20US.

London had become the world's marketplace for gold. For more than a half century nearly 80% of the world's gold production flowed through London. The "London Gold Fix" daily price fixing began in 1919 and only happened once a day until the London Gold Pool collapsed in 1968 and an "afternoon fix" was added to coincide with opening of the New York markets.

In 1944 the Bretton Woods accord pegged foreign currencies to the US dollar and the dollar to gold at the exchange rate of $35.20 per ounce. At that time gold was not traded inside the US, but in London it continued to trade between $35 and $35.20, rarely moving more than a penny or two in a day.

Through the first decade of the Bretton Woods system there was generally a shortage of US dollars overseas which lent automatic support to the fixed gold peg. But the US was running a large trade deficit with the rest of the world and by the late 1950's there was a glut of dollars on the international market which began draining the US Treasury of its gold.

Then, in one day in October 1960, the London gold price, which would normally have made

headlines with only a 2 cent rise, rose from $35 to over $40 per ounce! The Kennedy election was just around the corner and in Europe it was believed that Kennedy would likely increase the US trade deficit and dollar printing.

That October night, in an emergency phone call between the Fed and the Bank of England, it was agreed that England would use its official gold to satiate the markets and bring the price back under control. Then, during Kennedy's first year in office the US Treasury Secretary, the Fed and the BOE organized the London Gold Pool consisting of the above plus Germany, France, Switzerland, Italy, Belgium, the Netherlands, and Luxembourg.

The goal of the pool was to hold the price of gold in the range of $35 - $35.20 per ounce so that it would be cheaper for the world to purchase gold through London from non-official sources than to take it out of the US Treasury. At an exchange rate of $35.20, it would cost around $35.40 per ounce to ship it from the US to Europe. So the target range on the London markets acted as a shield against the US official gold which had dwindled substantially over several years.

The way the pool was to work was that the Bank of England would supply physical gold as needed into the public marketplace whenever the price started to rise. The BOE would then be reimbursed its gold from the pool according to each countries agreed percentage. If the price of gold fell below $35 an ounce, the pool would buy gold, increasing the size of the pool and each member's stake accordingly. The stakes and contributions were:

50% - United States of America with $135 million, or 120 metric tons
11% - Germany with $30 million, or 27 metric tons
9% - England with $25 million, or 22 metric tons
9% - Italy with $25 million, or 22 metric tons
9% - France with $25 million, or 22 metric tons
4% - Switzerland with $10 million, or 9 metric tons
4% - Netherlands with $10 million, or 9 metric tons
4% - Belgium with $10 million, or 9 metric tons

And since they, as a group, were doing this in secret, it turned out that they were able to make a substantial profit in the first few years of the pool. Since they were buying low and selling high within a fixed trading range that only they knew was fixed, they reaped substantial profits and even increased their reserves as much as FIVE-FOLD by 1965!

But with the cost of US involvement in Vietnam rising substantially from 1965 through 1968, this trend reversed and the dollar came under extreme pressure. From 1965 through late 1967 the gold pool was expending more and more of its own gold just to keep the price in its range. Seeing this, France (who was one of the insiders and knew of the price fixing operation) began demanding more and more gold from the US Treasury for its dollars.

And as this trend progressed, the world was flooded with more and more dollars that were backed by less and less gold, creating an extremely volatile situation. Public demand for gold was rising, the war was escalating, the pound was devalued, France backed out of the gold pool, and in one day, Friday March 8, 1968, 100 tonnes of gold were sold in London, twenty times the normal 5 tonne day.

The following Sunday the US Fed chairman announced that the US would defend the $35 per ounce gold price "down to the last ingot"! Immediately, the US airlifted several planeloads of its gold to London to meet demand. On Wednesday of that week London sold 175 tonnes of gold. Then on Thursday, public demand reached 225 tonnes! That night they declared Friday a "bank holiday" and closed the gold market for two weeks, "upon the request of the United States". (So much for "the last ingot", eh?)

That was the end of the London Gold Pool. The public price of gold quickly rose to $44 an ounce and a new "two tiered" gold price was unveiled; one price for central banks, and a different price for the rest of us. Even today official US gold is still marked to only $42.22 per ounce, $2 LESS than the market price in 1968!

The Architects

In my opinion, there are two things we learned from ANOTHER via his mouthpiece FOA that outweighed all the other great insights they shared. Those two things are:

1. The true purpose behind the euro and its architecture, and
2. The effect the approaching euro launch would have on gold.

Following ANOTHER's revelations, Jacques Rueff was the first name I put on my own personal list of early ideological euro architects a couple years ago. The ECB itself pegs the beginning of "The Road to the Single Currency, The Euro" at 1962 with the "Marjolin-Memorandum". [5][6]

The Marjolin-Memorandum was the European Commission's first proposal for an economic and monetary union. Robert Marjolin (1911-1986) was a French economist and politician involved in the formation of the European Economic Community (EEC). He was 15 years Jacques Rueff's (1896-1978) junior and, like Rueff, he was an economic advisor to Charles de Gaulle. I mention this only to further the connection between the modern euro and Charles de Gaulle of the 1960s who complained publicly about the exorbitant privilege afforded the US by the use of dollars as international CB reserves, demanded physical gold from the US Treasury, and pulled out of the London Gold Pool which led to the end of Bretton Woods three years later.

What we learned from ANOTHER thirty years later was:

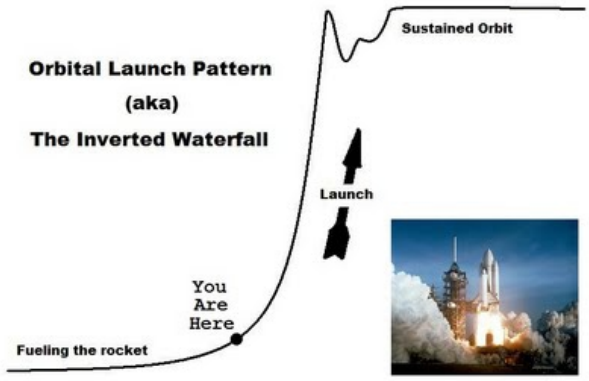
1. The purpose of the euro was to provide an international transactional alternative to the dollar.
2. The consequence of the launch of the euro would be that gold would undergo "the most visible transformation since it was first used as money."

Quote - Monday, August 6, 2001 - GOLD @ $267.20 - FOA: "The result will be a massive dollar price rise in gold that performs over several years."

Tuesday, January 1, 2002 - Launch of euro notes and coins
Friday, February 8, 2002 - GOLD ABOVE $300
Monday, December 1, 2003 - GOLD ABOVE $400
Thursday December 1, 2005 - GOLD ABOVE $500

Monday, April 17, 2006 - GOLD ABOVE $600
Tuesday, May 9, 2006 - GOLD ABOVE $700
Friday, November 2, 2007 - GOLD ABOVE $800
Monday, January 14, 2008 - GOLD ABOVE $900
Monday, March 17, 2008 - GOLD ABOVE $1000
Monday, November 9, 2009 - GOLD ABOVE $1100
Tuesday, December 1, 2009 - GOLD ABOVE $1200
Tuesday, September 28, 2010 - GOLD ABOVE $1300
Wednesday, November 9, 2010 - GOLD ABOVE $1400
Wednesday, April 20, 2011 - GOLD ABOVE $1500
Monday, July 18, 2011 - GOLD ABOVE $1600
Monday, August 8, 2011 - GOLD ABOVE $1700
Thursday, August 18, 2011 - GOLD ABOVE $1800

What I can tell you with full confidence is that this is only the very beginning of gold's functional transformation.



Here are a few more quotes from A/FOA:

It's important to understand that most of the world wanted to at least see another currency that could share some of the dollar's function. It didn't have to replace it. To this end, most every country gave some philosophical and political support in its creation.

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Within this change, gold would undergo one of the most visible transformations since it was first used as money.

++++++++++++

We are, today, at the very conclusion of a fiat architecture that is straining to cope with our changing world. Neither the American currency dollar, its world reserve monetary system or the native US structural economy it all currently represents will, in the near future, look anything as it presently does. Trained from birth, as all Western thinkers are, to read everything economic in dollar system terms; we, too, are all straining to understand the seemingly unexplainable dynamics that

surround us today.

Western governments, the public and several schools of economic thought are attempting to define and explain what extent these changes will have within our financial and economic world.

++++++++++++

Asking more; what if the architects of a competing currency system and the major players that helped guide its internal construction, all took a hand in promoting the dollar's extended life, its overvaluation and its use; so as to buy time for this great transition in our money world?

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The actual debt machine that built much of America's lifestyle is now going into reverse as it destroys its own currency; one built upon a stable debt system with locked down gold prices.

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To compete in the new architecture of a Euro System currency, unrestrained trading of gold will advance its dollar and Euro price significantly.

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This not only has "everything to do with a gold bull market", it has everything to do with a changing world financial architecture. And I have to admit: if you hated our last one, you will no doubt hate this new one, too. However, everyone that is positioned in physical gold will carry this storm in fantastic shape. This is because the ECB has no intentions of backing their currency with gold and every intention of using gold as a "free trading" financial reserve. None of the other metals will play a part in this.

Here's something interesting. In Indonesia, CPI includes gold! This is very $IMFesque.

Inflation up, exports down
Esther Samboh, The Jakarta Post, Jakarta | Tue, 09/06/2011

SNIPS:

An uncertain global economy has put pressure on Indonesia's economy, as the yearly inflation rate grew in August for the first time since January over surging gold prices, while export growth slowed due to sliding global demand.

Core inflation — the primary measurement of the country's inflation rate, which includes gold but excludes volatile food and government-controlled prices — accelerated faster than headline inflation to 5.15 percent, well above Bank Indonesia's 5 percent threshold.

"The increase in core inflation is not across the board. The impact of the gold prices increase is small, as gold is not a primary or secondary need for the people," Eric Sugandi,

> an economist at Standard Chartered Bank Indonesia, told The Jakarta Post over the phone.
>
> "In August, there was no help from lower import prices to offset the surge in gold prices," Destry told the Post in a telephone interview.
>
> Rusman announced that the surplus in the nation's trade balance fell to $1.36 billion in July, its lowest level so far this year, halving June's surplus of more than $3 billion. "The trade surplus narrows as exports slide and imports surge," he added.
>
> Exports slowed 5.23 percent in July as compared to June, reaching $17.43 billion, while imports grew 6.57 percent to $16.06 billion.
>
> BI governor Darmin Nasution said increasing fuel imports and a slight slowdown in global demand may continue to pressure the nation's current account — which includes trade balance — to book deficits starting in the fourth quarter of this year. "The fluctuation in the current account will be greater."
>
> "If the current account books a deficit, we will need capital inflows" to maintain a surplus in the nation's balance of payment to build up the central bank's foreign exchange reserves, he added.

This is a very interesting news article because it not only demonstrates how 90 years of the $IMFS has distorted foreign government benchmarks at the highest levels, but also how ass-backward this view actually is. Indonesia's Consumer Price Index should include food and ***exclude*** gold, not the other way around! In a fiat regime, you want your fiat to be relatively stable against the goods that make the economy healthy. But in this case, what they are registering as inflation (rising price of gold) is actually **deflation in real terms** because the purchasing power of gold in Indonesia is rising against things like food.

In Freegold, this rising purchasing power of gold against food would have the effect of an inflow of physical gold and a spur on the economy as exports rise due to being cheaper in gold elsewhere. But here's the catch: the signals are all messed up by the $IMFS! Indonesia is already running a trade surplus. And gold is rising versus food ***everywhere***. It doesn't matter if you're producing or consuming more in your country today, gold is still rising. In this way we can know for certain that today's price of gold is not really the true ***value*** of gold (gold priced in goods).

And that's because the price of gold today still does not reflect the physical flow of gold that would normally be a function of arbitrage, with speculators transporting gold to where its purchasing power is highest. The flow of gold today is still sterilized by the paper gold trade within the LBMA bullion banking system that, by a recent LBMA survey, was around 250 times larger than the flow of new gold from the mines. That's a total turnover in the LBMA (sales plus purchases) of 5,400 tonnes every single day. That's the equivalent of every ounce of gold that has ever been mined in all of history changing hands in just the first three months of 2011. That's what the LBMA members, themselves, voluntarily reported. And *that's* a lot of paper gold that is still sterilizing the economically beneficial price mechanism that physical gold would otherwise be transmitting.

Yet things are changing, even today. That's what the rising price of gold since 2002 tells me. This is about much more than just a rising price. It's not just about a gold or even a commodity bull market. As FOA said, "it has everything to do with a changing world financial architecture." Gold's ***function*** in the monetary system is changing. And as FOA also said, "None of the other metals will play a part in this."

Gold will return to its pre-1922 function, but that does not mean we will return to a pre-1922 gold standard. This post is not about the merits of the gold standard. It is not about praising the hard money camp's decision in 1445 over the easy money camp's decision in 1922. It is about the choice of the Superorganism over the management of men. The pre-22 gold standard, although it allowed gold to function, still carried the same flaw I point to so often; that using the same medium for exchange and savings leads to regular recurring conflicts between the two camps.

This is an important distinction to understand. Gold's true function is relative to the real, physical balance of trade, not man's flawed, political-overvaluation of debt and other monetary schemes. In 1971, the entire planet switched to using a pure token money as its medium of exchange. These symbolic tokens do fail miserably and regularly as a store of value, but they work remarkably well as a medium of exchange. They are not going away.

The whole ECB/Euro architecture was built to turn Genoa 1922 on its head, to reverse the damage done and to restore the function of gold which Jacques Rueff knew all too well. The ECB has one plain and simple mandate, to act with regard to a target CPI that is statistically harmonized across different economies dealing with different economic factors. In other words, the job of the ECB is to maintain stability in the purchasing power of a common currency against the general price level in many different countries.

This simple architecture is designed to work best in Freegold, where the ***price*** and ***flow*** of physical gold will automatically regulate and relieve the pressure of economic differences between member states. If the ECB had been designed to assist the European economies, it would likely have been given the second mandate, same as the US Fed. The Fed has two mandated targets: CPI and full employment. These dual mandates are like fair weather friends, because when the heat is on—like it is today—they actually become ***dueling*** mandates. The ECB, on the other hand, is not mandated to assist the economy like the Fed is. In fact, FOA wrote back in 2000:

"Basically, this is the direction the Euro group is taking us. This concept was born ***with little regard for the economic health of Europe****. In the future, any countries money or economy can totally fail and the world currency operation will continue. What is being built is a new currency system, built on a world market price for gold."*

Like I said earlier, the monetary plane, which includes all that nominal sovereign debt in Europe, is only connected to the physical plane by two things, the price of goods and services (CPI or the general price level, on which the ECB has a mandate) and the price of gold (which the ECB happily floats). I think we can all agree that the aggregate debt is doomed at today's prices. It is fictional, imaginary capital. But those of you predicting the imminent collapse of the euro as a medium of exchange need to explain how nominal euro debt is more likely to break its connection with goods and services than its imaginary connection to gold at today's prices.

I'll give you a few hints. Unlike the US, where the expenses of the same government that calculates

CPI rise along with CPI, and where the CB has conflicting mandates that benefit from a statistically-lowered CPI, the ECB has not only met its mandate, but done so credibly. And unlike Indonesia, the ECB does not count gold in its CPI (HICP). Instead, the ECB *floats* its gold publicly and without worry. So while you're wondering in which of the two choices the disconnect will happen in Europe, consider this: Over the last decade, the general price level has performed more or less as expected while the gold price in euro broke off in 2005 and rose 325% in six years:

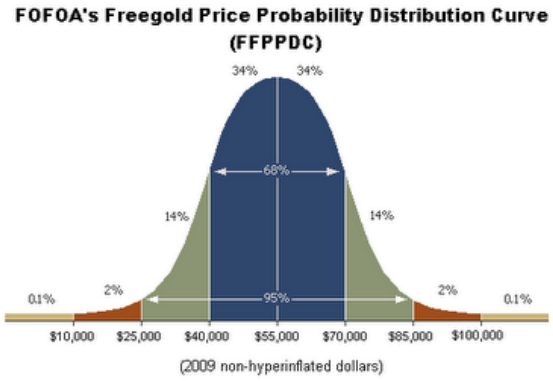
January 1, 2002 – GOLD @ €310.50
Tuesday, November 15, 2005 - GOLD ABOVE €400
Tuesday, April 18, 2006 - GOLD ABOVE €500
Thursday, January 10, 2008 - GOLD ABOVE €600
Friday, January 30, 2009 - GOLD ABOVE €700
Wednesday, December 2, 2009 - GOLD ABOVE €800
Tuesday, May 4, 2010 - GOLD ABOVE €900
Monday, May 17, 2010 - GOLD ABOVE €1000
Monday, July 11, 2011 - GOLD ABOVE €1100
Tuesday, August 9, 2011 - GOLD ABOVE €1200
Monday, August 22, 2011 - GOLD ABOVE €1300

And those of you that incessantly argue that gold is just one of many commodities—an asset like any other that, when push comes to shove, will ultimately be liquidated in favor of symbolic token currency units—need to explain how the monetary plane, insolvent at today's low prices, will maintain ***any*** grip on reality at even lower prices. The fact is it can't. And that's why you can only maintain your arguments with fantastic stories of modern day all-powerful overlords enslaving the serfs to their graves. But unfortunately, that's not how a diverse global economic ecosystem actually works.

Our money is credit. “The people’s” money has always been credit. Credit expands and contracts based on the availability of actual money, the monetary base. 1922 was the first time they included a form of credit as the base itself. A Pandora’s box if ever there was one!

But don't assume there is coercion involved when I say credit is our money. It is the best possible money for a vibrant economy. It is how the pure concept of money emerged in the very beginning. When gold first became money, it was as the mental unit of account. I'll give you five ounces of gold worth of cattle and you'll owe me five ounces worth of milk and other goods and services. When we participate in a vibrant economy, we deal in credit denominated in money. When we withdraw from a mismanaged economy, we withdraw into the monetary base, we hoard the reserves. Holding credit is our vote for vibrancy. Hoarding reserves is our vote against the current economy.

Gold is in the process of changing functions in the global economy. And in this transition, "the most visible transformation since it was first used as money," it will plateau at a new, mind-blowing level before it resumes its proper function. This is happening. It must happen, because bullion bank paper promises cannot function like gold. So be careful what kind of gold you're holding (physical is what you want), or you might just miss out on the revaluation of the millennium. Gaining a deeper understanding of what is happening, as you can here, here and here, should help those of you that worry about buying gold now because a few analysts, who have no idea what they're talking about, keep saying this is the top. This is the "top range" prediction I made two years ago:



Here's the main thing, gold will work the same way as a reserve asset in Freegold as it did before 1922, even without going back to being the sole monetary base. Gold is superior to even the entire monetary plane in this regard. It is the sole monetary member of the physical realm. Whether it is part of the transactional currency system or not doesn't matter to its balance-governing role. It can fulfill that role even in Freegold. That's what the architects figured out! That was their Grand Induction. That's how the euro architects are comparable to the Genoa Conference of 1445. And that's how Jacques Rueff is comparable to Benedetto Centurione. Probably far superior!

Sincerely,
FOFOA

[1] The Age of Inflation, Chapter 2, Jacques Rueff
[2] http://fraser.stlouisfed.org/docs/meltzer/craint89.pdf
[3] http://en.wikipedia.org/wiki/Bank_of_Saint_George
[4] http://en.wikipedia.org/wiki/Jacques_Rueff
[5] http://www.ecb.eu/pub/pdf/other/whypricestability_en.pdf p. 51
[6] http://www.ecb.int/pub/pdf/other/ecbhistoryrolefunctions2004en.pdf pp. 15 - 17

"It's worked so far, but we're not out yet." -Leonard "Bones" McCoy

Friday, February 12, 2010

Greece is the Word

We take the pressure and we throw away
Conventionality belongs to yesterday
There is a chance that we can make it so far
We start believing now that we can be who we are

Greece is the word
Greece is the word, is the word that you heard
It's got groove it's got meaning
Greece is the time, is the place is the motion
Greece is the way we are feeling

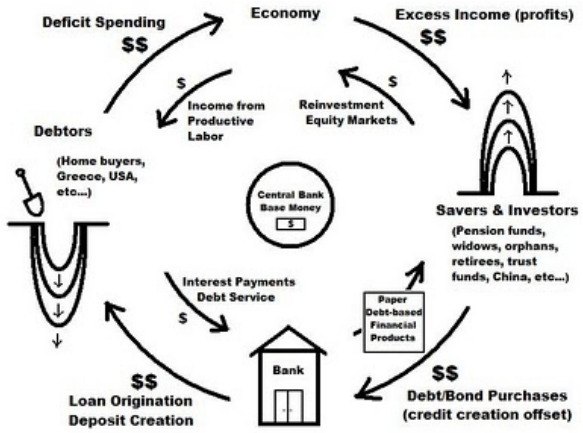
This is the life of illusion
Wrapped up in trouble laced with confusion
What are we doing here?

We take the pressure and we throw away
Conventionality belongs to yesterday
There is a chance that we can make it so far
We start believing now that we can be who we are
Greece is the word

The situation with Greece and the euro presents us with a fresh opportunity to explore what is really wrong within the system from a macro perspective. And I am not talking about the euro system. I am talking about our global system of savings that are value-fixed directly to a transactional currency unit whose value doesn't even matter in the context of its primary function.

This problem is what we call a Catch-22, or a no-win situation for the system as a whole. This means that because of its fatal flaw and current precarious position, the global financial system faces threats from too many fronts, any one of which can bring it down like a house of cards. And attempts to shore up the system on one side are kneecapping the legs supporting it on the other. Our global monetary/financial/economic system today lies in a "critical state", barely surviving on a "knife-edge of instability".

In order to understand the greater systemic problem that is presenting today as a boiling pustule in Greece, we must first understand the flow of capital and the growth of debt. With debt growth as the deadly tumor in the cycle, it is easiest to visualize the flow of money as a circular feedback loop, where the debt cycle feeds back on itself in a sustained growth pattern.



The denouement or final shakeout of this systemic crisis will include two separate events, no matter what decisions are made along the way. In this statement I have full confidence. For semantic simplicity I call these two events freegold and hyperinflation. But these terms seem to cause consternation and confusion in many readers, so you can think of them simply as the dramatic devaluation of paper gold and the catastrophic devaluation of the dollar. Two inevitable devaluations. Two unavoidable outcomes.

In order to understand how we get there, we must think about the three main forces at work in today's systemic crisis. The three forces are nature (you can call it "math" or "physics"), politics (call it socialism or "the collective will"), and self preservation (of the giants and the savers). These three forces are interacting in ways that appear chaotic here on Earth, but that form a clear, emergent pattern when viewed from outer space.

Further, we must understand the dynamics that brought us to where we are today. And those are the dynamics of debt, the global dollar system and the roles of money in the collective mind. Imagine that I am the debtor in the above diagram and you are the saver. I am going to keep living off credit as long as you keep buying my debt repackaged by the banks as a bond. The more you buy, the more the banks are going to offer me credit cheaper and on easier terms. Can you really blame me? Who should know better? Little ol' negative-net-worth me or super-producer giant you?

You see, by buying my debt from the banks you have become my enabler. You are feeding the dynamic

that will bury me in debt until I hit the mathematical limit of my ability to pay. Eventually it will become clear that life is simply not long enough for me to pay back the principle I have borrowed. And ultimately it will be impossible for me to even pay the monthly interest. But can you really blame me? I have always had an out. Have you? I have always had the option to default and declare bankruptcy! I know this, and even though I am not the sharpest tool in the drawer, at least I know where my escape route lies. Do you know where yours is?

Credit Money

The first thing we must understand is that almost no one holds actual dollars as their savings. When I talk about the problem of transactional currency being used as a wealth reserve, I am talking about the paper assets that are denominated in dollars, fixed to a specific number/flow of dollars, and therefore whose value is directly fixed to the value of an actual dollar.

And when I talk about dollars, I am talking about the actual physical bills, cash, monetary base and bank reserves (which are all basically the same thing). So the only people who hold actual dollars as savings are those who employ a shoe box or a mattress at home. Even if you keep your entire savings in a checking account earning no interest, I am not calling those dollars. Those are credits to you from a corporate counterparty authorized to call its units dollars.

So all the money circulating through the economy without physical Federal Reserve notes passing from hand to hand I am going to call "credit money", not dollars. We do think of them as dollars when they come from special institutions that are authorized to call them dollars (banks). But they are really just credits from an institution.

Think of it this way: You have two credit cards, one from Citibank and one from Macy's. Citibank is an authorized institution so its credits can be called dollars and spent anywhere just like dollars. They can even be used to pay the IRS. Macy's is *not* an authorized institution so its credits can only be spent at Macy's. They are truly just credits. Try paying your taxes with your Macy's card if you don't believe me.

Now think about the cash you just deposited at the bank. Did the bank put that stack of cash in a safety deposit box with your name on it? Nope, it went right into the general reserve pool with all the other cash at the bank and they issued you an equal number of their institutional credits! Got it?

Now, think about money circulation in terms of the above diagram. Imagine the rotation as a small hurricane inside of a large hurricane, each spinning in opposite directions. 99% of the flow of money never moves a single dollar. It is just the balancing and shuffling of institutional credits. Bank A credits 100 to bank B and vice versa. At the end of the day they just cancel out for the most part.

Furthermore, we think of new credit money as being created out of thin air every time a loan is originated. It is true, but that new credit money is offset within the system as a whole by two things. The first is the sale of a new financial product by the bank to the savers, a financial product that represents the claim on that new debt. And the second is that inner circle on the diagram above. Investment, income and debt service all work against credit creation in the systematic accumulation of credit money.

That's not to say there is no growth within the system. On the contrary, there is constant and infinite growth and almost never any contraction in the aggregation of debt-related assets. This pile on the right side of the diagram grows uncontrolled like an undiagnosed tumor until it ultimately kills the host. But for "the money supply" that generally affects our inflation expectations, there is very little real movement. And likewise, there is very little visible inflation within the dollar's spending zone.

The base money or cash around which this system swirls is rarely needed or even touched. Yet it is each unit of that base which determines the ultimate value of that mountain of savings growing to the right, a mountain that is more than two orders of magnitude larger than the unit on which its value is fixed.

I realize this is new and probably contradictory to what you have learned about money and the banking system, but this is the way it really works. 99% of the economic activity that swirls in these circles has no effect on the number of actual dollars in existence. But what it *does* have an effect on is the growth of paper assets held as savings by the entire world, paper tied directly to the value of a single physical dollar. With each rotation the pile of "paper wealth" on the right side grows larger and the hole of debt on the left side is dug deeper. There is no balancing mechanism in this system of debt, only an ever-increasing imbalance.

Religious tradition teaches of a Jubilee, or a debt-forgiveness cycle. Such a theoretical policy would periodically reset the balance between the left and right back to its starting point. And what the awareness and anticipation of an event like this would cause is that debt would be structured in a way to be paid off by the time Jubilee rolls around. If it wasn't paid off, then the savers would lose their savings. So the debt would grow for roughly half the cycle and then shrink for the remaining half and at Jubilee, any debt that remained would have to be forgiven. An imperfect system to be sure, because it does not have a dynamic balancing function, but one that would at least be sustainable through periodic resets.

But considering this hypothetical solution begs the question of where the savings would flow during the debt contraction period of the Jubilee cycle. They would have to flow into either physical goods or reinvestments into the economy, equity positions similar to our stock market today. As the debtors paid down their debt during this latter portion of the cycle the savers would have to choose between equity reinvestment or physical wealth storage. And it would be the collective's job to encourage the former as that would grow the economy and create a larger tax base to feed the collective hunger. But for the latter, the physical wealth storage vehicle par excellence has always been gold.

What we are about to experience today is a natural Jubilee of sorts, a hundred-year reset, only this one will happen at the point when the debt mountain is at its all-time peak, and right when nobody expects it to happen. A grand surprise. An ultimate shock. This will be catastrophic for the savers of debt and will be so traumatic to the system that total systemic entropy will be achieved. And a new system will have no choice but to emerge naturally from an absolute void of confidence.

But I am getting ahead of myself. Let's go back to Greece and my diagram.

If you have been following the news lately you have seen plenty of criticism directed at Greece, "the PIIGS", the euro and the ECB. But what you probably haven't seen in the news is what you get here, and what you get in the archives of Another and FOA, a more historic and proper perspective on the

euro and what it means, why it was formed, and how it was designed like an iron bunker to weather just this sort of a systemic collapse. How, in fact, the architects saw this coming decades ago and planned accordingly.

Many pundits and analysts have been speculating that this "Greek debt crisis" could mean the end of the euro, the end of a broad-based euro, the break-up of the Eurozone, or something along those lines. But this analysis flows from the shallow and short-sighted thinking that has become the very hallmark of Wall Street and Washington. The euro was and is a political movement (remember I said that politics is one of the three key forces to watch) that spans decades if not centuries, and encompasses much more than just a transactional currency. It is comical to watch some of these Wall Street hot shots criticizing what is really quite an impressive accomplishment in the euro.

Jim Rickards explains some of the history behind the euro and its relation to the Greek debt crisis in a recent interview on King World News:

Eric King: I want to ask you about Greece. Because the Greek situation seems over-hyped as a way to talk down the euro. What are your thoughts on that, Jim? Because I know in another interview you pointed out that the Greeks have a lot of gold and could just sell some if they had to.

Jim Rickards: Yeah, the Greek gold position is not the whole story and it's not the whole answer, but it is significant. What's interesting is that people talk about the PIIGS, you know, with two I's. And of course that stands for Portugal, Ireland, Italy, Greece and Spain. And these are considered to be the weak members, if you will, of the euro system... of the Eurozone. And they all have different fiscal problems in various ways. But the amount of gold they have varies widely from a high which is Italy which has over 2,000 tonnes. Actually about 2,400 tonnes according to the World Gold Council.

Greece is less than that but still has a significant amount at over 100 tonnes, and then you have Ireland which only has 5 tonnes. So the amount of gold they have to back up their reserve positions, to, in effect, back up their central banks varies widely. And I've actually read the S&P and the Moody's, the ratings agency reports on these countries and they don't even mention gold!

[FOFOA: The PIIGS combined gold hoard is 3,233.8 tonnes, more than three times that of China. And their combined population is only 133 million. So the PIIGS actually have about the same amount of gold per capita as the US. And they have 34 times as much gold per citizen as China. In fact, Greece alone has 14 times as much gold per capita as China. China has 0.7 tonnes per million citizens. Greece has 10 tonnes per million and the PIIGS as a whole have 24 tonnes per million!]

I'm not saying it's the whole story. It isn't. And they don't have enough gold [at today's price] to retire their national debt. And I'm not saying that. I'm just saying that it's more dry powder. And it's another foundation for your monetary system. And to completely ignore it or disregard it, which the rating agencies do, is a little bit of a mistake.

So Greece does have a little backstop there and what you could do, for example, is that the Greek central bank could, with a phone call and a couple book entries, swap out their gold for euros and again, it wouldn't be enough to retire their debt, but it would be 3 or 4 billion euros at current market rates and that's not an insignificant amount of money. So it does give them a little bit of a lifeline.

But it's impossible to think about Greece without thinking about the euro system as a whole, because, of course, Greece is a member of that. I mean, does it have its fiscal house in order? No, not completely, but its debt to GDP ratio is only about one half of Japan's. Its deficit to GDP ratio is not that much worse than the United States. So they look bad compared to Germany, but they don't look that bad compared to other members of the G7 for that matter! So it's not as if they've been reckless, or it's not as if they're that different from all these other countries, but they have become the eye of the storm. For a while the Greek stock market was going down. Their interest rates were going up. Credit default swaps spreads were widening out. You know, maybe that was a good opportunity for day traders, but I wasn't really worried about Greece defaulting. I'm quite sure Greece will not default at the end of the day. They seem to be moving in the right direction.

But because their debts are denominated in euro, and because they're a member of the euro system, at the end of the day they are going to be backstopped by the ECB which ultimately is controlled by Germany. And the reason I say that is if you're Germany, and you're the ECB, and you're Trichet, and you start throwing members under the bus, where does that end? I mean if you allow Greece to default and, in effect, impugn the value of sovereign bonds denominated in euros, who's next? I mean it probably will be Ireland, and it will be Spain, and then it will be Portugal. And if you start losing four or five members, there goes the whole euro system. The whole thing falls apart and there's a flight from that currency.

Now the history of this is very significant. The euro system, and Greece in particular, those are not Wall Street piñata. I know traders like to bang them around, you know the spreads widen and then the spreads come in. There are trading opportunities there. But this is taken much more seriously by the Europeans. I mean you go all the way back to the Counter-Reformation in the late 16th century which was extremely bloody. And then the Thirty Years' War which was devastating. And then the Seven Years' War and the Napoleonic Wars, the Franco-Prussian War, World War One, World War Two... this is one catastrophe after another! And Europe literally destroyed itself and exhausted itself in fighting all these wars. And finally after WWII they said enough! We're going to pursue unification. It's the only way to keep from fighting each other.

Now, political unification has had modest success. Military and foreign policy unification has really had no success at all. But the crown jewel of European unification is their monetary system, the euro and the European Central Bank. So that's the pinnacle of their world historical efforts to unify the continent. They're not going to give that away lightly. I mean, they view it in a much broader historical context than Wall Street and Americans. And so it's of the utmost importance to them. And they're going to do everything they can to preserve it. And that's one reason, along with the gold, why I have confidence that Greece will not default.

And then following WWII and joining with the dollar in the new Bretton Woods system for stability, Europe stumbled through the shock of the London Gold Pool in 1968 and the end of Bretton Woods in 1971. And then in 1979, at the height of the dollar crisis, they formed the European Currency Unit (ECU) with an eye toward eventually introducing a unified currency. The ECU ultimately became the EMU with the introduction of the euro.

As I said in my Dead End post, *"They came to the realization that the path the dollar (and the entire international monetary and financial system) was on was essentially a DEAD END. It was not sustainable! At some point in the future this system, and its MONETARY FOUNDATION, would*

(MUST) collapse. This was not a plot to collapse the dollar. It was, instead, a RECOGNITION of the inevitable!"

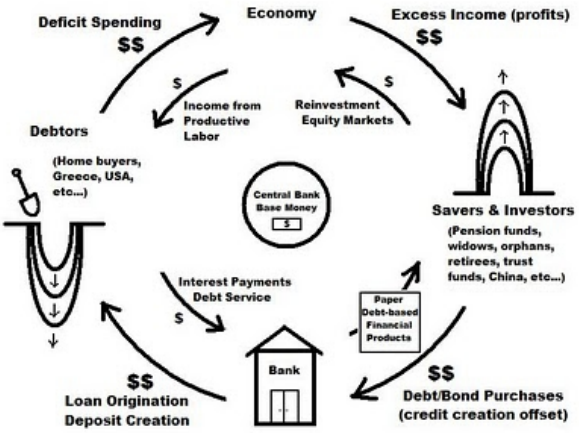
But I'm getting ahead of myself again. Let's get back to the money...

The current system of infinite debt accumulation is unsustainable and has been destined for collapse from the very beginning. There is no device in place for a periodic reset, and there is no automatic counterweight to balance ongoing trade deficits, correct imbalances and hold profligacy accountable. If it weren't for the hard fixed currency zone of the euro, Greece would be headed toward currency collapse and hyperinflation right now, just like in 1944, and just like Iceland, Argentina, Brazil, Zimbabwe, Weimar Germany, Bulgaria, Hungary, Peru, Bolivia, Ukraine, Yugoslavia and so many more.

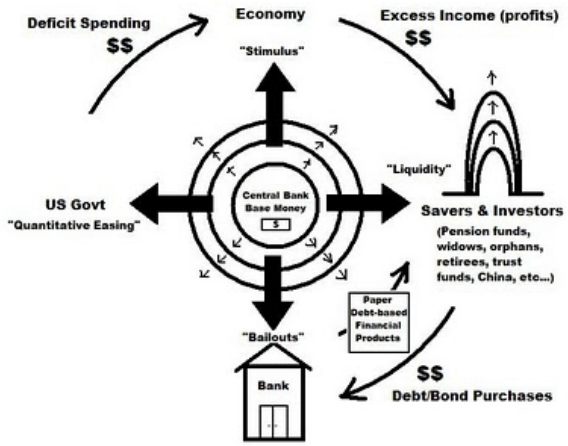
The euro did not cause Greece's troubles. It has actually spared Greece the worst of it. The problem is the dollar system of debt accumulation that simply continues unabated until finally someone can no longer pay.

Jumping around a bit, what do you think gold, the stock market, fine art and houses all have in common? Their value is *inversely* related to the value of a dollar. If the dollar tumbles in value all of the above rise in their dollar price in response. This is the *opposite* of the relation between debt/bond instruments and the dollar. And this **THIS** is the concept we must all assimilate into the core of our being. On one side there is the transactional currency and the debt markets, and on the other side is everything else. And the transactional currency does not depend on a high valuation to perform its primary function. It can do its job as a medium of exchange with literally ANY valuation. So why is the global debt market, which is tied inseparably to this symbolic unit so damn big?

Why? Because of this...

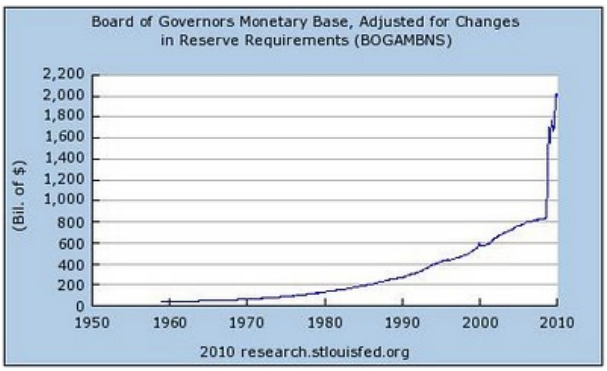


Unfortunately ^_THIS_^ is about to collapse. The mountain has grown too large and the debt hole has been dug too deep. The ability to pay has come to its mathematical limit and now threatens the value of an entire planet-full of savings. First the US consumer and homeowner dropped off from the left side. Then Iceland and now Greece. Here is roughly what it looks like right now...



It is now a broken system where credit money is not circulating with sufficient steam to keep it viable. It is now reliant on A) the one debtor that can print its own debt service and B) the expansion of the monetary base at the center in order to replace the outlying losses.

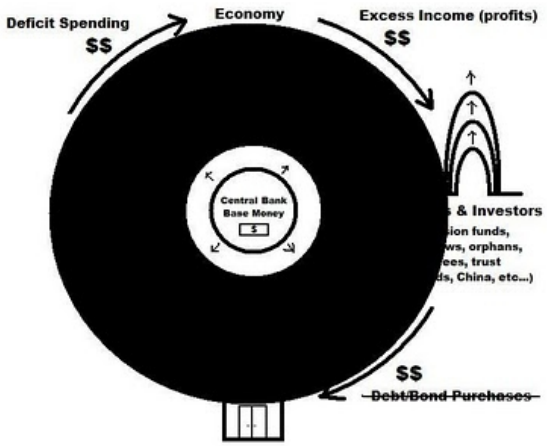
Notice the growing concentric circles around the central bank and the cash. Here is what that looks like in an official graph...



All the other monetary aggregates contain credit money and debt assets that are generally very liquid and directly tied to the value of a physical dollar. These assets that we are taught are the same as dollars are the direct debt of certain approved corporate institutions. They are mere credits while the institutions engage in a murky game of financial smoke and mirrors with your real money. These credits may be the most dangerous of all during a systemic collapse as they are cloaked in a morass of legalese small print.

And as I have shown to some degree in this post, and in greater depth in past writings, these wider aggregates have little effect on the consumer price index we all watch so closely. The big secret of the central bankers is that it is the monetary base, the cash, that has the most effect from a quantity theory perspective. And it is systemic confidence (YOUR confidence in the system) that has an *equal* effect from a velocity perspective.

To demonstrate my point, I have adapted the above diagram to show what it looked like in Zimbabwe last year...



The important thing to remember is that the pile of debt on the right side of the diagram is fixed to the value of each individual physical dollar. So as the physical stuff is diluted to fill the void left by the failing credit/debt system, it directly impacts the real value of the debt market.

This is exactly where we are heading. So you have to ask yourself: With a whole planet-full of paper debt wealth, how long are the savers going to sit there waiting for their value to disappear? But the fact is that it doesn't matter how long they sit there. The only difference that will make is how much value they are going to lose. You see the system can no longer support their value on its own. This is clear from the housing crisis, Iceland and now Greece. But the system must go on so the very unit their value is fixed to must be diluted to infinity just to keep the circle spinning.

And infinity is truly the limit. Don't expect austerity or a deflationary collapse. Don't expect them "to do the right thing" and let the bad debt fail. There is simply too much of it out there. **It is our entire global monetary system**, not just the bond investors. There is no political will anywhere in the world to let the people's wealth simply vanish in order to maintain the value of a silly little physical dollar. This **THIS** is the big Catch-22!

In order to save the people's "money" it will be destroyed!

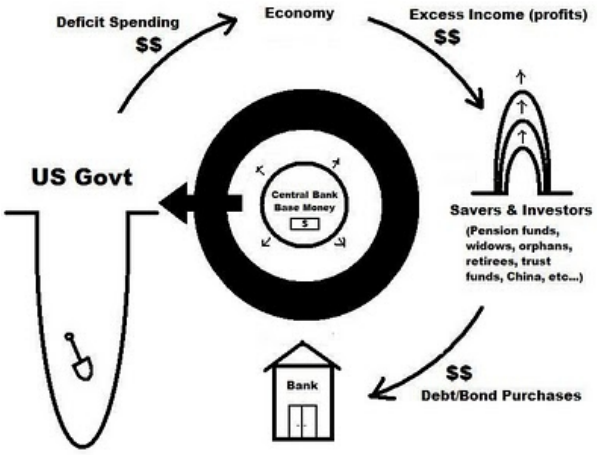
And the first thing to go will be the low price of gold. The depressed price of gold did many things for this failing debt system. It kept the savers, that didn't feel like braving the equity markets, going to the debt markets instead of physical items... "for a yield". It kept the heat on the debtors of the world, forcing them to pay off their debt in real, difficult terms, even though the same system made it ironically easy to get *into* debt. It made the dollar appear strong, as the numéraire of the debt markets. And it allowed the central banks a certain *ease* in shuffling reality around while maintaining a myth.

But most importantly, it provided an escape route for those savers who noticed the finite timeline of this system and sought safety. We can see that this group now includes the Saudis, the Chinese, the Russians, the Indians and the euro architects, among many others.

Probably the biggest and most visible (and visibility is one of the keys to collapse) problem with our system, reliant as it is on infinite debt accumulation, is that with the majority of the world at its mathematical limit, ***only one entity remains*** that is both willing and able to dig itself the infinite debt

hole required to keep the system churning.

The problem is that this entity also controls the printing press of the numéraire of its own debt, so no one, or certainly not enough people with real credit money on the periphery, are willing to feed this black hole of moral hazard. So the only one left to fund this debt hole to the extent that is required is the Fed itself. And that means that the fuel needed to churn the credit money system is now fresh base money. And as this fuel flows out from the center of our diagram into the formerly credit-driven periphery, the center base swells like a red giant about to consume its own solar system.



This dilution of the base diminishes the real value of each unit with each unit of fuel that flows. And like an advanced alien civilization fleeing its dying sun, the savers will flee as they see this visible threat swell. Either that or their savings will be swallowed whole by that which was meant to protect them from the default of the "deadbeat" borrowers.

Default or devaluation. Only two ways to go. Catch-22. Math. Inevitable. Unavoidable.

Politics will force devaluation over default, inevitably, presently.

Self preservation will choose the only escape route not subject to economic health nor subject to credit-driven bubble deflation.

Freegold, then hyperinflation.

You see, the system, because it is made up of billions of humans, is like a living organism itself. It will seek out and find what it needs, which is an automatic mechanism to deal with imbalances and bring them back into sustainable equilibrium. That mechanism is extremely high-value gold. And the only way that can be achieved is the destruction of the paper gold-promise market.

The Nuclear Option

The ECB and the BIS have a secret weapon. They don't want to have to use it because they don't want to be seen as the instigators of the dollar's collapse. They would prefer the market to take care of it for them. But don't doubt for a second that they won't use it before sitting back and watching permanent

damage come to the euro system.

Just imagine how Greece could deal with its problems if its gold were valued at $55,000 usd per ounce. In terms of current exchange rates that would raise Greece's liquid assets to 50% of its public debt. In other words, instead of being a "sub-prime" borrower, Greece would instantly become a PRIME borrower.

Let's say you owe $200,000 on your home which has fallen in value to $200,000. You aren't exactly underwater yet but your loan to value is 100% now, a precarious situation for someone with income and asset problems. Now let's say you also have $100,000 worth of gold. You could still walk away from your home if you chose to, but you are certainly not a foreclosure candidate anymore. And your future needs would be backed by your new asset base. Of course this would also give you a newfound incentive to get your fiscal house in order, lest you have to part with your gold!

This is freegold. And this is the secret weapon. Although it is not so much of a weapon as it is a *defense*... against the inevitable.

Rumors have been circulating for a few months now about some large physical buyers on the public LBMA being cashed out with a 25% premium and being sent to the private cash market to get their gold where such a purchase at a premium would not move the official price. This rumor suggests a relative shortage to demand for physical on the official price-setting markets. And this tightness is confirmed by the low GOFO or Gold Forward Offered rate reported by the LBMA which is currently languishing at lows only seen twice before. Both times in close proximity to backwardation events that both times signaled that the system was teetering on the edge of collapse, only to be rescued by some entity supplying physical gold to market at an intentional loss.

COMEX being in the US and the LBMA being in London leaves the ECB and the BIS with "the nuclear option" if things ever get desperate enough to use it. This nuclear option is A) for the BIS to begin operation of a public "physical only" market for gold to be used by the really giant participants, primarily sovereign entities and billionaires, and B) for the ECB to use the price discovered by the BIS in its quarterly reserve asset "marked to market" adjustments.

Such a move would put Greece, and all the PIIGS for that matter, in a much better position almost overnight. Of course it would have devastating effects on the value of the dollar and the rest of the paper gold market. You see, in order for the BIS to supply actual physical gold to each and every giant that was ready to buy, the price would have to rise high enough that someone else with an equally huge amount of gold was willing to become a seller. And right now, at today's prices, we know that the central banks of the world have become net buyers! So the question is, just how high would the price have to rise in order to balance out the demand of the world with the supply, in a physical-only official price discovery market?

Chances are that what would be revealed by such a market would have an eye-opening and breathtaking effect on the rest of the world and demand would skyrocket. What passes today for enough demand to *almost* break the paper markets would quickly shift all players from paper to physical and add new savers that hadn't even considered gold before. Literally, the entire world would shift its view to gold.

And because this would be a physical-only market in the presence of a credit money contraction it would have no way to bubble in price beyond actual demand. Instead it will finally plateau once the Thoughts of all the giants and savers of the world reach their Nash equilibrium. And the price will be high enough that it becomes a coin toss as to whether you'd rather be in cash or gold. What it will come down to is your own time preference and your appetite for investing back into an economy that must be rebuilt.

The euro architects knew the difference between the monetary functions. They knew that the infinite growth, store of value function was the dollar's Achilles' heel. So they designed the euro to be a stable transactional and accounting currency even if the world chose non-euro physical assets as a store of value. The dollar does not have this design.

This is not to say that the euro will not devalue against gold right along with the dollar. All infinite, symbolic, transactional currencies will, which is to say *all currencies* will. And to a lesser extent, all currencies will have to devalue against the rest of the finite real world as well. But they will not all hyperinflate to infinity in the aftermath as the dollar will be forced to. Some will. Others will not. The euro probably will not.

This is freegold. It is coming whether or not the euro uses its secret weapon. Like I said, they would prefer not to be seen destroying the paper gold market proactively. They would rather just wait until it destroy itself (which, by the way, it is doing pretty well).

But the unfortunate effect of this transition will be the panic that will ensue within the dollar camp. What has already started through QE, bailouts, stimulus and liquidity operations (base money creators all) will have no option but to accelerate to infinity. When I say no option, I mean that there will be absolutely *no* political will to do anything else.

So as we can see, we have math, political will and self preservation all coming together in a perfect storm as our entire system of infinite debt accumulation teeters on a knife-edge of instability. What could possibly go wrong?

Well, there's Greece I suppose. It usually only takes one little shock to bring down a house of cards. And this is why I say you cannot be prepared too early. There is no such thing when the stakes are so high. Preparation must happen early and completely. Because once this thing starts to unravel it will be too late to prepare and to even prosper from the foresight of an inevitable event. Once it all starts unraveling you will be completely preoccupied just trying to limit your losses.

Gold

This is where physical gold comes in. I have shown you what is wrong with the system when viewed from outer space. And I have shown you what is missing, and what will be found. And I have shown you how the really big money with really big foresight has prepared.

Notice that Greece and the ECB do not have palladium in their reserves. Just sayin'.

Of course you should also make other preparations to ensure that your bare necessities of food, clothing and shelter are taken care of. Some silver and even some dollar currency makes sense in this regard.

This whole "gold thing" is really just for those people that have more money than they will need to live on for about a year. And it is for those that would like to store that excess wealth in the most universally liquid vehicle since they don't know exactly what they will be needing a year from now.

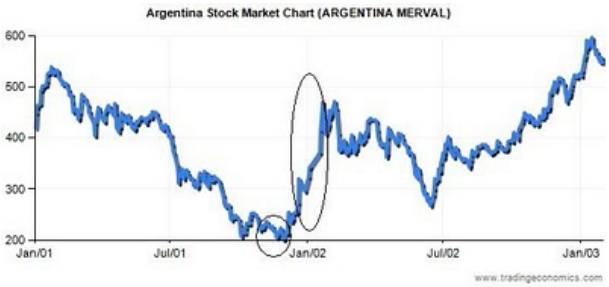
Perhaps they will need a generator. Or maybe a cow. Or maybe a gun. Maybe a new Ford F150. This is where gold comes in handy. You can store your wealth securely now in a universal package that should be convertible into the most needed things later. It can cost a pretty penny to be totally prepared now for every possible eventuality. Instead, it is best to prepare for the most probable events and keep a universal reserve for the unexpected!

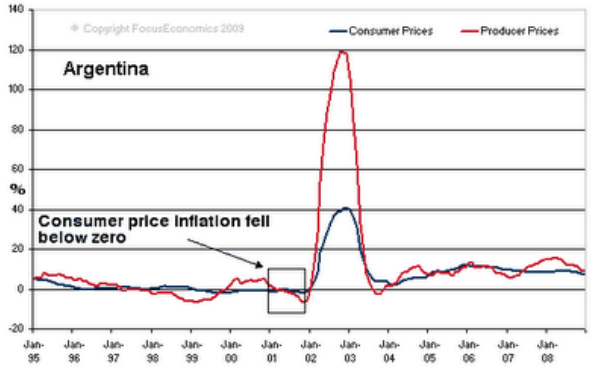
But as a practical matter, because of the explosive potential in gold and because of the proximity of a likely event, many smaller investors are now piling in with their "six-months-out" money and then some. And to be honest, I can't really argue with their reasoning.

But what about the stock market? Someone emailed me saying,
"During a currency crisis in the western world, we may see a very powerful stock market rally as equities are a form of real asset. Better to own a piece of Procter and Gamble than a unit of currency that can devalue quickly. Look to the Argentina general equity market MERVAL index during the peso crisis. It shot up – although not as much as the 3:1 currency devaluation."

The writer answered his own point. The stock market shot up LESS than the currency devalued. So while the stock market in Argentina performed MUCH better than debt fixed to the value of the currency, it only chased - and lagged - actual inflation. (Actually, short term hyperinflation.)This is partly because the economy is usually in shambles at the time of a currency devaluation. So while you would expect real things like real companies to compensate for a falling currency, you must also weigh in any previous bubbling that might deflate and any economic factors that might reduce company profits.

But Argentina is still a good example for us to look at. In January of 2002 the currency devalued 3:1. At the same time the stock market rose in response to the devaluation and then stayed up (because the currency stayed down). But what is interesting about Argentina is that just prior to the devaluation, in December of 2001, inflation dipped into negative territory (deflation?) and the stock market dipped as well. Then they almost immediately exploded out of this head-fake in an unexpected devaluation. See the charts. The first is the MERVAL and the second is CPI:





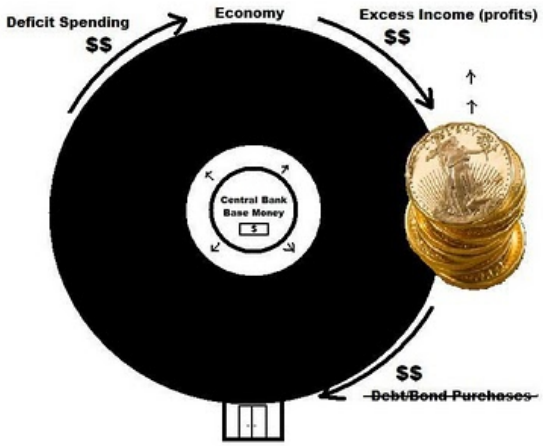
Hmm... look familiar?

Bottom line: The stock market, because it represents equity not debt, will fare much better than the rest of the paper world. But the stock market does suffer from dilution, manipulation and bubbles. Expect the stock market to languish in economic chaos as it chases real inflation only to fall a little short.

But gold is different. The system desperately needs a counterweight, and gold is it. The counter is already in place, only the weight is yet to come. And once we have seen the reset in gold as it performs its phase transition from commodity to wealth reserve, it will then chase (hyper)inflation along with the rest of the "non-dollar" world, only it will be the ONE AND ONLY THING that will be immune to the economic mess that will still need to be worked out.

Got any gold yet?

Greece does.



Sincerely,
FOFOA

Monday, July 11, 2011

Euro Gold

(Photo: REUTERS)
A gold bar carrying the Euro sign is seen during the European Central Bank's Euro Exhibition organised by the Romania's Central Bank in Bucharest March 10, 2011.

A little over a week ago on "Snapshot Day" (Thurs., June 30), the Eurosystem MTM party began with the CB rendition of "Whoop, There It Is" –-> Gold: EUR 1,043.382 per fine oz. – promptly followed by a dip down to EUR 1,022. Of course it has now recovered and is up at the all-time high in the EUR 1,100s. And even though this wasn't the all-time high quarterly snapshot in EUR terms, it was only 1% under the previous ATH and it *was* the first ever quarterly close over $1,500.

Then on Wednesday the ECB released its quarterly ConFinStat (Consolidated financial statement) for the Eurosystem. Here are the top two lines from that statement (my emphasis):

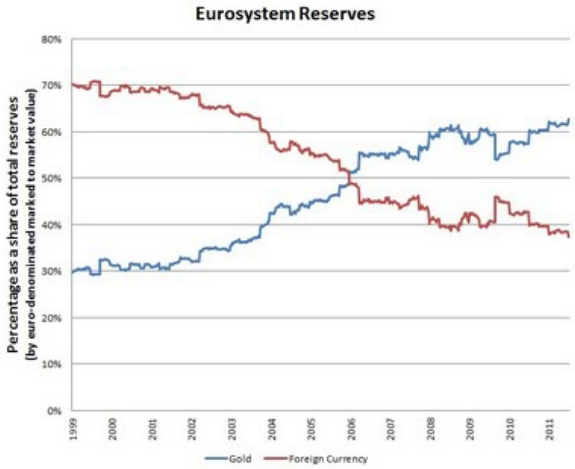
In the week ending 1 July 2011 ***the increase*** *of EUR 12.6 billion* ***in gold*** *and gold receivables (asset item 1)* ***reflected quarterly revaluation adjustments****.*

The net position of the Eurosystem in ***foreign currency*** *(asset items 2 and 3 minus liability items 7, 8 and 9)* ***decreased*** *by EUR 0.6 billion to EUR 176.6 billion.*

In other words, the decade-long trend continues, with the Line #1 asset gold floating upward while the Line #2 asset, foreign currency, sinks downward.

Value and Volume

Now, the ECB puts out a ConFinStat every single week, 52 weeks out of the year. And every week it makes quantitative **volume** adjustments, like net increases or decreases in both gold and foreign currency reserves. But it only makes qualitative or **value** adjustments on four of those 52 statements. This is when the ECB marks its reserves to what the market says they're worth. The MTM party! And for the last 12 ½ years the trend has been that, proportionally, the Eurosystem's gold reserves have been rising while their foreign currency reserves (mostly dollars) have been falling. Here's the chart:



Yet if we look at those reserves only quantitatively by volume, the opposite is true. Foreign currency reserves (again, mostly dollars) have grown over 12 ½ years in volume, from roughly $260 billion to $310 billion from a dollar-denominated perspective. Meanwhile the Eurosystem's gold reserves have fallen, again, only quantitatively, from 402 million ounces to 347 million ounces in volume.

This view, the volume-only view, is the fundamental modus operandi of the $IMFS that praises quantitative (voluminous) expansion and "growth" while ignoring qualitative (value) degradation. The reason is that governments and central banks can only print volume, not value. Think about this for a moment.

A clear example, of which I'm sure you are all aware, is that the official US monetary gold stockpile is still held on the books at $42.22 per ounce. But would you believe that this arcane (some would say moronic or worse) treatment of national reserves is actually codified in the official guidelines governing global central bankers operating under the $IMFS?

It's true! Since 1993, the last word in international reserves has largely gone to the IMF as set forth in the Fifth Edition of its Balance of Payments Manual which can be found on the IMF website here. Under 'Structure and Classification' you'll find chapter XXI: Reserve Assets, paragraph 444 on Valuation (my emphasis):

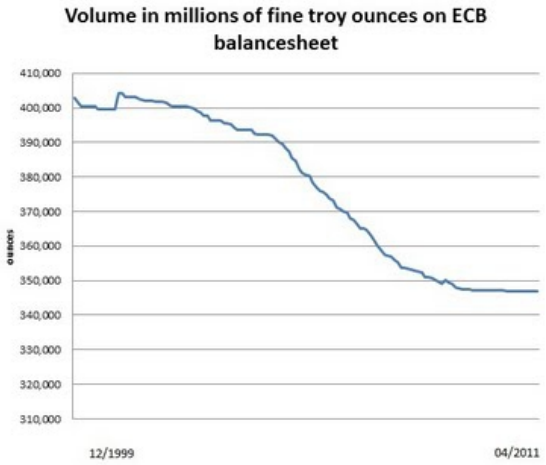
Valuation

444. ***In principle, all transactions in reserve assets are recorded at market prices—that is, market exchange rates in effect <u>at the times of transactions</u>****, market prices for claims such as securities, and SDR market rates as determined by the Fund.* ***Monetary gold transactions are valued <u>at the market prices underlying the transactions</u>****. For valuation of stocks of reserve assets in the international investment position, market prices in effect at the ends of appropriate periods are used.*

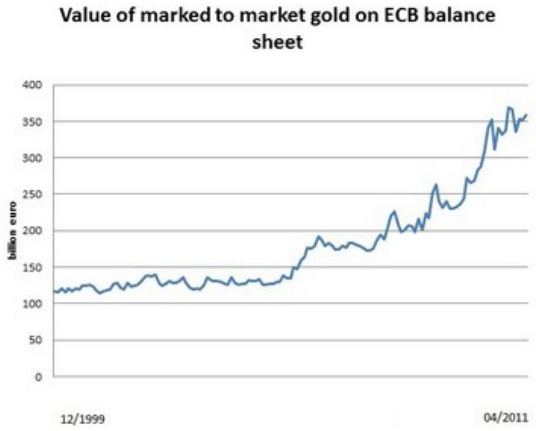
In other words, the IMF guidelines are out of step with modern best practices insofar as they lamely prescribe that reserve assets be recorded at the market price in effect at the time of the transaction that acquired them. Hence, there is no provision for periodic MTM adjustments to provide a rational reassessment of the evolving market-health of the balance sheet.

Recognizing this particular valuation/accounting shortcoming (along with "a few" others), the ECB has been at the institutional forefront implementing useful deviations. Essentially acknowledging the IMF's own admissions of ambiguity within the manual, the ECB tactfully says, *"the definition of reserve assets included in the 5th edition of the IMF Balance of Payments Manual leaves some room for interpretation,"* setting the stage for its own definitive refinements as put forth in its "Statistical Treatment of the Eurosystem's International Reserves" formally published October 2000 and found on the ECB website here.

So, from this volume-only view loved by the $IMFS, here's what a chart of the Eurosystem's gold would look like:



But from the volume ***times*** value view (which ldo makes tonnes more sense and also assists the little guy deciphering the monetary mess), here's the **true** picture:



A different view, wouldn't you say? Do you remember this quote from ANOTHER?

"Know this, "the printers of paper do never tell the owner that the money has less value…"

The funny thing is that writing this post made me want to go look up that quote. It was written on

5/26/98, six months before the euro launched as a unit of account and 42 months before the ECB launched its euro medium of exchange. Now yes, of course, at that time (1998) no printers of paper currency told you their product was losing value. The dollar was still showing gold on its books at $42.22. But here's what I started to think about: Today, the printer of the euro, the ECB, tells all the owners that the money it prints has less value in gold… **once every quarter!** And not only that, but it encourages people to save in gold through system-wide mandates. Dang, now that's quite a 'something different' when you really stop to think about it!

You see, there are two fundamental differences between the euro and the dollar that most Westerners simply can't grasp, no matter how many times you try to explain their significance. Wim Duisenberg, the first ECB president, stated them pretty clearly in this 2002 speech:

"The euro, probably more than any other currency, represents the mutual confidence at the heart of our community. ***It is the first currency that has not only severed its link to gold, but also its link to the nation-state.*** *It is not backed by the durability of the metal or by the authority of the state. Indeed, what Sir Thomas More said of gold five hundred years ago – that it was made for men and that it had its value by them – applies very well to the euro."*

There's a lot in that one paragraph, but the two fundamental differences with the dollar are the severed links to gold and the nation-state. Hopefully I have sufficiently addressed the former above. I will now try to explain the significance of the latter.

Choices

Homo sapiens generally tend to focus on the minutiae of any situation, or else on what everyone else is saying about it. And in the case of the euro, that would be "the debt" or "Greece". Somehow most people always seem to miss the giant big-picture elephant tromping about the room. And in this case, that elephant is the euro's severed link to the nation-state. When Duisenberg said this was a *"first"*, he meant it. And Milton Friedman also said it in 2001 (my emphasis):

"The one really new development is the euro, a transnational central bank issuing a common currency for its members. ***There is no historical precedent for such an arrangement****."* [1]

In the world of currencies, there are many varieties. The way a nation chooses to manage its currency relative to the world outside its boundaries can have a wide range of effects and consequences, ranging from long-term stability to periodic hyperinflation. If you want a hard currency, then, ideally, you want it managed by someone else—a disinterested third party. Here's Milton Friedman again:

"A hard fixed rate is a very different thing. My own view has long been that for a small country, to quote from a lecture that I gave in 1972, "the best policy would be to eschew the revenue from money creation, to unify its currency with the currency of a large, relatively stable developed country with which it has close economic relations, and to impose no barriers to the movement of money or prices, wages, and interest rates. Such a policy requires not having a central bank." [Milton Friedman, Money and Economic Development, (Praeger,1973), p.59] Panama exemplifies this policy, which has since come to be called 'dollarization.'"

Currency instability is a common problem for smaller nations. The hard fixed exchange rate described

above is one way a small country can share the same currency stability enjoyed by larger nation-states. This is in contrast to the (dirty) floating exchange rate among most large, modern economies or the pegged rate of countries like China today, where a central bank uses brute force to try and overpower the normal market adjustment mechanism in order to maintain its desired valuation peg.

Bretton Woods was a pegged system, and one of the characteristics of pegging seems to be the buildup of market pressure that must be periodically released through a currency crisis like we saw in 1933, 1971 and again in the 90s with Mexico and East Asia. The market wants what the market wants, and trying to fight a force as powerful as that always ends in tears for someone. But sometimes the market simply bypasses the choices of the currency manager by using secondary media of exchange.

There are many examples over the last century where the dollar was used by the marketplace as a hard currency in conjunction with a local, unstable currency. Even today it is a common practice in small nation-states for the dollar to be the market's longer term store of value circulating in concert with the local medium of exchange, which you only want to hold for the short term. And this is an example of how the market force, or the demand side of the currency equation, fights back against profligate nation-state printers.

As I explained in Big Gap in Understanding Weakens Deflationist Argument, the value of any currency is determined by a kind of tug-of-war between supply and demand. The demand side is the marketplace and the supply side is the printer. This was true even when gold was the currency. If the market demand for gold was rising faster than it could be pulled out of the ground, the value would rise and the circulation velocity would slow, often causing a slow-down in the economy sometimes resulting in recession or even depression. This tends to lead to monetary revolt and the re-emergence of easy money.

The point is, all the market wants is a stable currency, not too hot, not too cold. It is like a sleeping giant. Give it a stable currency and it will keep sleeping. Wake it and you (the printer) will lose control of the value of your currency and everything else you try to control. The market is the demand side of the equation. And the market is by far the more powerful of the two sides in this tug-of-war. If this isn't making sense, please read my post linked in the paragraph above because I'm not going to explain it all here.

To summarize, there is a whole menu of options for the aspiring money printer to choose from when stepping into the supply side shoes of the monetary game. And as a supply sider, his job is providing a service to the demand side, the market, which wants one thing and one thing only, a stable currency. And if he wants to keep his job, he'd better give his clients what they want, because if they wake up to an unstable currency, they can easily take the reins of control away from him. So if his mandate is—***or evolves into***—anything other than a stable currency, he will not be long for this monetary world. And one last thing; instability means quick changes both up and down. The client doesn't want drastic inflation *or* deflation.

The Debt

Most of you already know this quote from FOA:

"My friend, debt is the very essence of fiat. As debt defaults, fiat is destroyed. This is where all these

deflationists get their direction."

Now that's not the whole quote, of course. But that's enough to warrant some extra thought. Just think about it for an extra few seconds before continuing onward. And then next I want to jump from that to this; chapter 82 from The Triumph of Gold by Dr. Franz Pick, written in 1985:

"82. How currencies die

As currencies become more and more devoid of substance, they perpetuate their existence through their multiples. The milreis replaced 1,000 reis, and the bilpengoe tried to substitute for a billion pengoe. The conto was worth 1,000 escudos. The Greek talent was equal to 6,000 drachmae or 36,000 obols. In Java, the bahar was good for 100 million candareens. In India, the nil replaced one hundred billion rupees...

Some coins were flattened to the point where they were as thin as a sheet of paper, or actually chopped up into strips, or cut into bits of all sizes and shapes. Some were punctured and the holes then plugged with inferior metal.

These strategems did not and will not save currencies, which are all doomed by the passage of time."

He's talking about debasement. Debasement is not monetary expansion through credit expansion. De**base**ment is the **base** money behind the credit being expanded in volume by the supply side as its only possible response to value degradation coming from the demand side. Note in particular the last line: "doomed by the passage of time." And here is some more FOA from 2000 which I reposted in Freegold in the Proper Perspective:

"...Our dollar has had a usage period that corresponds with the society that interacts with it. Yes, just like people, currencies travel through seasons of life. Even gold currencies, in both metal and paper form have their "time of use". Search the history books and we find that all "OFFICIAL" moneys have at one time come and gone with the human society that created them. Fortunately, raw gold has the ability to be melted so it may flow into the next nation's accounts as "their new money".

This ebb and flow of all currencies can be described as their "timeline". We could argue and debate the finer points, but it seems that all currencies age mostly from their debt build up. In a very simple way of seeing it, once a currency must be forcefully manipulated to maintain its value, it is entering the winter of its years. At this stage the quality of manipulation and debt service become the foremost determinant of how markets value said money. Suddenly, the entire society values their currency wealth on the strength and power of the state's ability to control, not on the actual value of the money itself. Even today our dollar moves more on Mr. Greenspan's directions than from the horrendous value dilution it is receiving in the hands of the US treasury.

This is where the dollar has drifted into dangerous waters these last ten or twenty years. If you have read most of Another's and my posts, it comes apparent that preparation has been underway for some time to engineer a new currency system. A system that will evolve into the dollars slot once it dies.

Out here, in deep water, we can feel what the Euro makers are after. No one is looking for another gold standard, or even something that will match the long life and success of the dollar. We only know that

the dollar's timeline is ending and a new young currency must replace it. No great ideals, nor can we save the world! But a reserve currency void is not acceptable.

Now look back to shore and watch the world traders kick ankle deep water in each other's faces over the daily movements of Euros. From here, up to our necks in blue water, you ask "What the hell are they doing?" I'll tell you. They are trying to make $.50 on a million dollar play! Mostly because they are seeing the chess game one move at a time. (smile) Truly, their real wealth is in long term jeopardy.

Our dollar has already entered a massive hyperinflation. Its timeline is ending and there will be no deflation to save it..."

And a little more from Franz Pick:

"85: Few people understand the concept of currency debasement

This process of debasing the currency to pay for government deficit spending has been going on for centuries. The Egyptians did it, the Greeks and Romans did it. Countless other nations have done it. Now it's going on all over the world. The process of monetary inflation – and its result, soaring prices – is a simple concept. Adam Smith understood it, as did John Stuart Mills, David Ricardo, and other classical economists.

But, alas, today few people understand the concept. Instead, thanks in large part to the writings of John Maynard Keynes, higher prices are laid at the feet of excessive labor wage demands, greedy corporations, Arab oil sheihs, and the disappearance of anchovies off the coast of Peru. Mon Dieu! The media – woefully ignorant of currency theory – propagandize these stupid explanations, and the public is left totally in the dark as to the real cause."

And to complete FOA's quote at the top of this section:

"My friend, debt is the very essence of fiat. As debt defaults, fiat is destroyed. This is where all these deflationists get their direction. Not seeing that hyperinflation is the process of saving debt at all costs, even buying it outright for cash. Deflation is impossible in today's dollar terms because policy will allow the printing of cash, if necessary, to cover every last bit of debt and dumping it on your front lawn! (smile) Worthless dollars, of course, but no deflation in dollar terms! (bigger smile)"

Saving the Debt

Now I want to talk about "the process of saving debt at all costs, even buying it outright for cash" because this is something they are doing in Europe as well, and, therefore, is one of the arguments the euro critics use to claim that the euro is no different—or even worse—than the dollar. Should we be surprised or shocked that they are doing this in Europe having read A/FOA all those years ago? Well, no. Unless, like many, you didn't really understand what you read.

In my 2009 post Gold is Money – Part 2, I wrote, *"And it was always known, but has now been proven, that the system will be saved at ANY cost."* When I wrote that I was discussing the dollar and the dollar system, aka the $IMFS, aka Wall Street. But this applies to any monetary and financial system. The system always takes political precedence over the currency. The currency will always be debased if that

is needed to keep the system functioning nominally. This is nothing new and it should not be surprising, yet it's apparently very surprising to 99.9% of all financial analysts.

Politicians and central bankers can only expand the monetary base in volume. They cannot expand its value. And at the first sign of systemic trouble, this is what they do. They do this because to not do it would make them redundant. A void, a vacuum of empty space with no politicians or CBs would do nothing which would allow our money, credit, to collapse down to its base, so the politicians and CBs have to do something to distinguish their fine selves from nothingness. Sure, they talk the hard money talk during normal times, but at the first sign of systemic trouble they print. Here's one more chapter from Franz Pick, 1985:

"83. The pious pronouncements to hold the money supply in check will not be kept

The fellows in the central bank make pious pronouncements about fighting inflation and holding the money supply in check. But they panic immediately when they see signs of distress-borrowing in the banking system, as debtors, many of whom are corporations having interest payments larger than their pre-tax profits, try to keep their enterprises from going under.

Although the Federal Reserve system makes a lot of noise about controlling the money supply and reaching monetary targets, it is at times difficult to understand just what exactly they are controlling. Be that as it may, they will in time revert to form and resume the process of what is coyly referred to as "reliquifying the economy."

This will lay the groundwork for another cycle of currency destruction, which could assume unprecedented dimensions. Though "to deflate or not to deflate" may be the question, ***the only answer to America's growing financial and economic malaise is to debase****."*

The point is that the Eurosystem's response (volume expansion) to its current systemic threat (the debt crisis) is not surprising. Does this mean the euro will collapse (experience hyperinflation)? No. Because, for one reason, it has severed the link to the nation-state. The euro is behaving perfectly predictably in maintaining the nominal performance of its system through expansion, **but it cannot be forced to fund the future government profligacy of the PIIGS through volume-only expansion. That link is severed.**

But the dollar, on the other hand, is nominally on the hook not only for the debt mistakes of the past, but for all *future* dollar-denominated liabilities, obligations, entitlements and promises of the biggest debtor in all of history, on top of a debt mountain that is probably another $100T in size depending on your measurement criteria. **That's a big difference.** The dollar is an old currency in the winter of its life, linked to **the greatest profligate debtor the world has ever known.** The euro is a young currency that has severed its link to the nation-state. The ECB can save its own system, but the member states cannot force it to fund perpetual profligacy.

Here are a few simple principles that will save you the hassle and embarrassment of constantly being surprised by the actions of politicians and central bankers. They will never sacrifice the system to preserve the value of the currency. But they will always sacrifice the currency to save the system. And there is a very simple formula for how they do it.

There are four players to keep in mind; the debtors, the savers, the banks and the printer. They never print and give the money directly to the debtors to pay off their debt. Instead they print and give the money to either the creditors (banks) or the savers (e.g. pension funds) in exchange for the older bad debt which they then put on the public balance sheet to socialize the lost value.

So they "bail out" the banks and the savers nominally, which in turn (through currency debasement) actually bails out the debtors and screws the savers. The banks come out even because they only require nominal performance. But the retirees and pensioners that require real performance at the supermarket get screwed.

It is important to understand the difference between nominal and real. Nominal means you get the number you expected. Real means you get the purchasing power you expected. Nominal expansion is volume-only expansion which is all the politicians and central bankers can do. Real degradation is the value degradation that goes along with nominal expansion or debasement. The banks don't mind this because they only require nominal performance and their CEO's are comfortably seated at the business end of the printing press where they can turn their personal share of the bailout into real returns.

So now that you know what is, and always has been, perfectly predicable and expected, perhaps you will not be so surprised at the news coming out of Europe. Instead, far more interesting is the news coming out of Washington DC.

A Fairy Tale Expanded

Now I'm going to share with you an analogy that I think will help as we compare and contrast the EU and the USA from a currency perspective. As I have discussed on several occasions, the pure concept of money which maintains continuity from thousands of years ago when it first emerged until today, is the common knowledge of the relative values between real goods and services conceptualized and symbolized by a shared and agreed upon unit. And currency, in the context of the pure concept of money, is nothing more than the clearing system for the trade of real goods and services.

As a foundation for this analogy, please read A.E. Fekete's "A 'fairy' tale" from a speech he gave in 2008 (pdf) which I have used on a few occasions:

A 'fairy' tale

Let us look at another historical instance of clearing that was vitally important in the Middle Ages: the institution of city fairs. The most notable ones were the annual fairs of Lyon in France, and Seville in Spain. They lasted up to a month and attracted fair-goers from places as far as 500 miles away. People brought their merchandise to sell, and a shopping list of merchandise to buy. One thing they did not bring was gold coins. They hoped to pay for their purchases with the proceeds of their sales.

This presented the problem that one had to sell before one could buy, but the amount of gold coins available at the fair was far smaller than the amount of merchandise to sell. Fairs would have been a total failure but for the institution of clearing. Buying one merchandise while, or even before, selling another could be consummated perfectly well without the physical mediation of the gold coin.

Naturally, gold was needed to finalize the deals at the end of the fair, but only to the extent of the

difference between the amount of purchases and sales. In the meantime, purchases and sales were made through the use of scrip money issued by the clearing house to fair-goers when they registered their merchandise upon arrival.

Those who would call scrip money "credit created out of nothing" were utterly blind to the true nature of the transaction. Fairgoers did not need a loan. What they needed, and got, was an instrument of clearing: the scrip, representing self-liquidating credit.

The Modern European Fair

Now imagine if you will a giant fair with dozens of E-Z Up tented booths and tables full of merchandise, kind of like a swap meet at your county fairgrounds. As Fekete says, you show up at the fair with your goods and services for sale, your E-Z Up tent, your table and your shopping list. But when you arrive you must first check in with the fair operator to pick up your scrip money. I imagine the husband then works the booth while the wife goes shopping.

At this particular fair we are imagining, let's call it the Eurosystem, when you register with the fair operator you pay a small fee, deposit your gold for safekeeping during the fair and also for publication of your amount of gold to the other fair participants, and you are issued your scrip money for trade at the fair. But your scrip money is not a receipt for your gold. It is simply the clearing system for trade at the fair, so you are issued an amount consistent with the goods and services you brought to market.

There are a wide variety of booths at this fair. To give you a bit of a mental image, there's a large booth called Germany where you can buy fast cars and good beer! (I know, a strange combination.) There's another one with a fancy custom tent called France. There you can buy funny hats and cheese. And then there are smaller booths, one is called Greece. At Greece you'll find a table loaded with stacks of colorful vacation brochures.

Our fair, however, is a little different than Fekete's fair above. What we've seen over time at our fair is that some of the smaller booth operators like Greece took home more goods and services than they brought to market. And they did so on credit. Large operators like Germany, it turns out, gave Greece some extra goods in return for promises to pay later, and those promises were denominated in units of scrip money from the fair.

After some time, it became apparent that Greece could never pay back the debt at full value. This realization actually threatened the system, I mean the fair. So what the fair operator decided to do was to buy those promises to pay from Germany at face value, with newly printed scrip. This kept Germany in the game although it did devalue the scrip since now there was more of it than there were goods at the fair. But this was fine because the fair operator published a ConFinStat in which he told all the fair participants that the fair's scrip money was now worth less.

Those, like Germany, that had actually saved some income in promises to pay denominated in scrip, and then found those promises severely devalued by the recognition they would never be paid back at full value, received a nominal gift of the same number loaned to Greece, even though it was now devalued. Those that had not saved in scrip, but instead had cleared with gold at the end of each fair, simply carried on trading at the new, lower value of the scrip. You see, the fair operator, we'll call him the ECB, did not participate in the fair itself, primarily because he had severed his link to any specific

booth operator. His only job was providing scrip, announcing its value, and maintaining the system, I mean the fair, even if it came at the cost of debasing the scrip money.

Back Across the Pond

Now in your mind's eye I want you to take a bird's eye view of this fair, looking down on all the colorful tents, and then zoom way out as if you were using Google Earth, spin the globe and zoom back in on a different fair "across the pond." We'll call this fair the USA.

On the surface, this new imaginary fair looks very similar to the other one. There are many different tents, tables, goods and services, buyers, sellers, debtors, creditors and, of course, a fair operator who we'll call the Fed/USG. And that's the first difference you'll probably notice, probably because I will point it out. The Fed/USG is not only the fair operator, but also a participant, just like Sy Sperling. At this fair, the link is ***not*** severed.

Here are a few more differences. The fair operator is not only a participant, but he is also the biggest debtor this fair or any other throughout all of human history has ever seen. He is literally printing up scrip to buy things from the fair. He is not only funding his ongoing (perpetual) trade deficit by printing and spending scrip, but he is also paying the interest on his past debt by printing scrip. And whenever his creditors start to worry about him paying his debts, he simply prints more scrip to buy back the promises to pay at face value. And he does all this without *ever* telling the fair participants that his scrip now has less value.

But it gets worse. This fair operator is truly cashing in on the reputation of his forebears. He's emptying his bank of credibility like there was no tomorrow. You see, for a long time his scrip has been used as the inter-fair clearing system instead of gold. So he is not only able to purchase goods and services with his freshly printed scrip within his own fair, he is also able to shop at far away fairs with his printed scrip, simply on the basis of squandering past credibility. And don't think this isn't getting noticed. Ooh baby, you better believe it is getting noticed!

But it gets even worse! The other participants at this fair include a wide variety just like the Eurosystem, including a large surplus vendor called Texas where you can buy ten gallon hats and concealed carry permits. There's also a large deficit/debtor vendor booth called California where you can pose on a fake wave while someone takes your picture. But these participants don't have to deposit any gold when registering, mainly because the fair operator confiscated the gold from their economies 78 years ago and hid it away out of sight. (Note: gold does not have to be in the hands of the state itself to benefit the economy in its stabilizing role in clearing.) So, unfortunately, they don't have any gold unlike the participants at the Eurosystem fair.

Some of the participants in the USA fair, like California, have lots of debt just like Greece. But unlike the ECB, the Fed/USG can't really deal with that right now because it has its own debt problems it is dealing with (printing away). Here's a thought… The USA states are republics not unlike the Eurosystem participants, and certainly as large. What would happen if the Fed/USG just gave that gold it confiscated 78 years ago to the states? Then the District of Columbia, with its modest population of gentlemen busily trying to distinguish themselves from nothingness, could just default on its ridiculous debt and unfunded liabilities. I, for one, would call that move "distinguished!"

Believe me, I **know** I'm fantasizing here. Remember? This is an imaginary world of fairs and E-Z Ups. But just think about it. We could still have the scrip (common currency) we are all used to (see: Mises' Regression Theorem here), the US dollar. The Fed's mandate could be modified to "only a stable currency" giving the marketplace the one and only thing it wants. Instead of "End the Fed" we could "End the Fed/USG". Doesn't that sound nice?

And in such a fanciful utopia as I am imagining right now for the dollar fairgrounds, one could rightfully proclaim that the dollar had joined the euro in severing its links to both gold and the nation-state. But, of course, this is just fantasy. Such a thing could never happen by choice of the printer, the supply side, because the USG is so large today that it literally forms its own giant parasitic organism, fighting for survival. In the EU, however, there is no such thing.

Quarterly Reflection

Over the latest quarterly cycle we have witnessed several curious advances in Europe. To name just a few, on May 24th the European Parliament's Committee on Economic and Monetary Affairs agreed unanimously to allow gold to be used as collateral in clearinghouses. [2] And then on June 7th the ECB encouraged investors to buy new Greek bonds to replace maturing securities with two separate unnamed European officials saying investors may be given collateral as one possible incentive to roll over the debt when it matures. [3] And finally, on "Snapshot's Eve", June 29th, we learned that China's SAFE (State Administration of Foreign Exchange) is actively doing all it can to transfer billions of its dollar-denominated holdings into euros. [4][5]

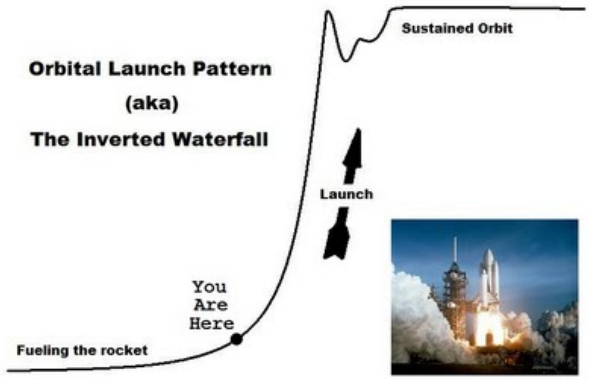
The monetary plane is changing. The signs are everywhere. Euro gold just broke EUR 1,100 today. Here's what it looks like in dollars:

Tuesday, January 1, 2002 - Launch of euro transactional currency
Friday, February 8, 2002 - GOLD ABOVE $300
Monday, December 1, 2003 - GOLD ABOVE $400
Thursday December 1, 2005 - GOLD ABOVE $500
Monday, April 17, 2006 - GOLD ABOVE $600
Tuesday, May 9, 2006 - GOLD ABOVE $700
Friday, November 2, 2007 - GOLD ABOVE $800
Monday, January 14, 2008 - GOLD ABOVE $900
Monday, March 17, 2008 - GOLD ABOVE $1000
Monday, November 9, 2009 - GOLD ABOVE $1100
Tuesday, December 1, 2009 - GOLD ABOVE $1200
Tuesday, September 28, 2010 - GOLD ABOVE $1300
Wednesday, November 9, 2010 - GOLD ABOVE $1400
Wednesday, April 20, 2011 - GOLD ABOVE $1500

Do you think this is the top? Do you think gold is expensive at $1,550? Do you think gold is just another commodity and will therefore collapse back to its 2002-2005 range if the economy tanks? Think again.

On timing, look up. It's already begun. But here is, I think, *the* question you should be asking yourself. It comes from John Rubino with a couple of Freegold edits from me [in brackets]: *"Do you wait until it [the rapid RPG-Freegold revaluation] is underway at the risk of missing the discontinuity [gap up, punctuation, phase transition, etc.] that growing imbalances make likely, or do you load up on precious metals [sic—only physical gold IMO] and short Treasury bonds now, and just accept the fact that the coming year might be dominated by delusion?"* [6]

Do you remember my "Orbital Launch Pattern" from Gold: The Ultimate Un-Bubble? *"For all you technical analysts out there plotting and planning your eventual exit from gold before the blow off phase, I have a new pattern to introduce to you. I call it the Orbital Launch Pattern, or the Inverted Waterfall. In this pattern there is no blow off! It looks something like this..."*



Feel free to reflect on this while you enjoy the music below!

Sincerely,
FOFOA

[1] One World, One Money?
Robert Mundell and Milton Friedman debate the virtues—or not—of fixed exchange rates, gold, and a world currency.
[2] Bid to Use Gold as Collateral Advances (WSJ)
[3] Trichet Gives First Signal Endorsing Greece Bond Rollover (Bloomberg)
[4] It's Official: China Is The "Mystery" Daily Buyer Of Billions Of Euros (ZH)(WSJ)
[5] I also discussed these stories in this comment under the last post.
[6] Bondholders Should Be Under No Illusions (Rubino)

FOA

FOA (2/26/2000; 11:13:56MT - usagold.com msg#7)

Foundation: A Day Walk

If I had a nickel for every time we thought the dollar was finished, I would have a bunch of nickels! Remember back in the early 80s or even further back into the 70s. All we heard was how the dollar was finished and going to crash and burn. Books about hyperinflation and the need for gold / Swiss francs were all over the place.

I read all of them to gain perspective and also acted on some of their advice. Made some money on it too. But even then, something just didn't completely ring true about the whole scenario. Indeed, in hindsight, gold never did return above $800, the dollar didn't hyper inflate and most of the world kept using the dollar as a reserve.

Today, we can more fully understand why so much of that early insight failed to deliver.

True, the dollar was seen as a basket case back then. It had just been pulled from its gold bond and prices were going up all around us. However, because the world had been on a simi dollar / gold standard, all nations that had previously signed onto using the US buck as their currency reserve now did so with even more resolve. More important, it seemed than using gold itself was out of the question as every country's Central Bank brought dollars as fast as we printed them. The dollar still settled most all trade accounts while dollar reserve buying made an obvious show of support for this world system. No matter how much bad press

was offered, they were staying on track and they have continued to do so right up into the 90s!

But all of this flew into the face of what every economist was saying, back then. The common understanding of the era was: if the US didn't stop over printing its money, we would all experience a major price inflation, and no one could stop it! Again, "major" inflation didn't happen and to ask a further question: if the dollar system was so bad, why didn't the world just dump the reserve system and refrain from using it further? In other words, let the dollar be "the US dollar" but don't use it as a backing for your own money system.

Thick Brush Now

Going against the logic of "sound money": throughout all the currency turbulence of the 70s and 80s era (including today), the US never did reign in the over printing of its currency. It continued almost nonstop money supply expansion for its local economy and in addition sent a good portion of its cash all over the world. On and on the US trade deficit continued to do its work of feeding ever more US cash into foreign economic systems. We printed paper currency by borrowing it into existence, used it to purchase real goods overseas , while foreign governments actively soaked up this dollar flood by expanding their own money supply.

Like this: When you buy an item externally, a dollar is sent overseas to pay for it. Usually, through the world currency trading arena, that dollar is converted into the local currency of the nation which the goods came from. But more often than not, as we print that dollar out of thin air, the foreign government takes the dollar into its reserve account and prints one of their units for deposit in the local economic system. They do this because: if the foreign CB didn't save the dollar as

a currency reserve , and sent it back into the world currency markets to "buy" an existing unit of their money supply, this action would drive up their currency value vs the dollar and make the price their goods non-competitive in world markets. In other words, a US citizen couldn't use a printed (borrowed) dollar to buy an item for $10.00 that outside the "dirty float" of exchange intervention would cost $15.00.

This is how the "dollar reserve process" inflates the money supply worldwide as we (USA) run a trade deficit for our benefit. It keeps the dollar exchange rate higher than it would naturally be thus allowing a US citizen to buy goods at a cheaper price than our expanding money supply and implied currency value would normally dictate. A process in and of itself that invites still more dollars to flow out and purchase still more external goods. Had foreign CBs not taken so many dollars, the ever expanding US money supply would have long ago impacted currency exchange rates and forced a major price inflation internally (in the US). Yes, the major inflation so many saw coming, back then, would have arrived, then.

So why did these other CBs do it? The standard explanation was that this created a market for their goods here in the US. Yes that's true, but it begs the question; did no one in their land want to buy goods manufactured locally, and pay for them with the same printed money supply? Why is it the US could inflate its money supply to buy cheaper goods externally for no more than the price of printed paper? But, in the same country our paper was sent to, they couldn't print their own currency to buy their own goods? Why couldn't they raise their real standard of living somewhat using the same process like the US, and doing so without the burden of inflation or importing foreign currencies?

Again, why would our printed, inflated money movements not create price inflation for us (USA) in goods purchased externally? What if they (foreign goods

producing countries) printed an amount of their money equal to the inflow of dollars, but, without holding paper dollars as reserves to back it, brought the exact same goods from themselves. Common prevalent economic theory says price inflation would result? Or would it? Or better said: why them and not us?

Into the deep woods again

Again, and as above, In the 70s, it was widely held that the dollar reserve system forced other countries to inflate their local currencies, thereby importing dollar price inflation. But, as time went by, indeed a decade or two now, the same process continued nonstop, with no change. It seemed that some "other" countries had found a "new way" to somewhat circumvent the dilemma. Or was this "new way" something sold to them in order to extend the dollar system's timeline?

Many of the lesser third world countries experienced a combination of sporadic hyper inflation and deflation as we forced the dollar reserve system down the throats of their citizens. Their people's living standard constantly fell as they worked ever harder to produce more goods in return for more of our printed dollars. But, instead of using the extra inflow of dollars (positive trade balance) to buy their own currencies in the local system, thereby keeping their currency strong, they used that dollar flow as collateral to borrow (from IMF and international banks) more dollars from the world dollar float (mostly called Eurodollars). The lure (or the hard sell) was that they could build up their infrastructure, increasing their production efficiencies (human productivity's), thereby raising the national standard of living. Further, they were sold the unneeded idea that even if they didn't completely use the dollar surplus to borrow more, they should hold those dollars in reserve (buy and hold US treasuries) and print more of their own money!

Again, it seemed they had no advocate to push for their own best interest. No one told them that their people already worked cheaply enough to more than offset the competitive loss of a stronger local currency. No one told them that with a strong local currency structure,(that using the dollar surplus to buy their own currency would create), would allow them to borrow in their own capital markets. A more go slow approach that builds long term benefits. This process would free them from the entanglements of making international debt payments in another money. Indeed, the costs of those involvement's later proved overwhelming!

Now the trail becomes more open

For third world countries their international dollar debt exposure eventually locked them into a servitude to the dollar reserve system. Despite all their natural and human resources, currency involvement had taken a lion share of any productivity increases and increased lifestyle this modern world offered.

However, it did help the cause for the dollar reserve system. By creating an ever growing international debt in dollars, eventual dollar demand to service this debt would only increase. Thereby keeping its value artificially high. In addition, any leftover floating dollars quickly took the form of US treasury debt held in these small countries treasuries. There they were used to further hyper inflate their own currency supply.

For the more developed gold owning countries of the G-7, they had a different question in mind. Again, if taking in inflated dollar reserves was the act of importing US dollar inflation into ones local economy, and in the process creating a market for your goods overseas, why not just print your own currency without

taking in dollars, and in doing so give the same buying power the US citizens have in your market, to your own people?

If it's not price inflationary to take in part of a world "inflated dollar supply" and create jobs for your people locally, why would it be any more inflationary to print your own currency outright? Indeed, why does one need a dollar inflow to legitimize the same money inflation process? That being currency inflation to create jobs?

Why should we (as dollar asset holders) think about this question? Because someone else is and doing something about it today!

Back to a marked trail

Today, and after all of this, the dollar never did crash from price inflation. At least nothing like what was expected earlier in the last two decades.

The dollar reserve system was never going to fail then because the major world economic powers were willing to use (waste) all the productive efforts of the world's people to keep it running. Looking back we now understand the thinking behind this. Without the dollar acting as a reserve, we would have had to go back to a gold system. There was no other currency structure strong enough or deep enough to carry the load.

But, gold had been proven to be much too easy to circumvent as a national or world currency. It seemed human dynamics would never allow an economic

system that operated on a pay as you go process without gold debt. If history had proven anything it was that if we have a money, fiat or gold, we are going to lend it, borrow it and in the process create

debt. Yes, even using gold!

Even if we have a pure gold system, human nature will find a way to turn it into securities. In doing so we will, come hell or high water, lend more gold than we have and borrow more than we can pay back. One has but to return to the history books to see it all in plain print. Over and over again, we start with a solid gold foundation and soon degrade it into trash. It's not just the American way, it's the world's way.

Because the modern world had progressed into the efficiencies of using high speed digital fiat currencies, no one at that time or today, was willing to crash the whole system by returning to gold. I suspect that the world's richest would have lost a lot, but so to would "us regular" people. Even with our savings in the form of a "digital illusion", at least we had a job to go to and a dream in our bank account. Removing the dollar and returning to gold would have erased the illusion and temporarily shut down the jobs.

So, dollar hyperinflation never arrived and gold did not make its run because world CBs bet your productive efforts on supporting the dollar reserve. In the process, the US standard of living was raised tremendously on the backs of most of the world's working poor. But this is not about to last!

A broad view from the ridge

Not long after the US defaulted on its gold loans, dollars held as gold certificates, major thinkers began the long process of forming another world currency. One

that would not maintain the fiction of a gold standard with the somewhat fixed gold prices inherent in such a system. The creation was distorted, to say the least. Just as the River in my first post was often seen in distortion, so too was this currency issue. It began with the European Currency Unit (ECU) and has later progressed to its present state of the Euro.

After operating on a fiat system for 20+ years people are starting to realize that the only thing that backs a currency is the real productive efforts of their people. Yes, over time we always borrow more than our productive efforts can pay back and proceed to crash the money system.

But what else is new? (smile)

We call this a money's "timeline" and it's as new an idea as life, death and taxes! Time and debt age any money system until it dies. The world moves on. Only this time gold is going to play a different part in the drama. We will all watch it unfold.

It seems people saw something else that would make the Euro unique. Paid-up assets also stand behind circulating money. Indeed, if someone owns a $100,000 dollar piece of land , has a good producing job and borrows $50,000 against his land, the world is likely to circulate that debt note as a fiat land backed currency. But, if his gold (the land) is worth $1 million in a free physical market, AND RISES FURTHER IF CURRENCY SUPPLY OUTPACES REAL PRODUCTION, and his other debts are relatively low , the same note would circulate just as effectively if the $50,000 was borrowed against his name alone.

In essence, the jump into the Euro is more based on a new currency that is more honest in dealing with our historic human dynamics. Let's try not lying to ourselves and admitting that gold alone in a currency will not remove our will to

borrow and lend and therefore eventually defraud each other! Would it not be better to at least not shackle the money to gold? Indeed, a real physical freegold market will constantly be devaluating any

fiat currency over a long term. While removing the need for CBs to maintain fixed exchange structure through a dirty float against gold.

But, the most important aspect is in the escape valve gold would provide to developing countries with positive trade flows. Those that wish to settle their debts outside the currency arena using gold as a settlement. Or, if they wish, to buy gold in the open market with their trade reserves.

The secret to all of this is in the "Legal Tender laws". Allowing gold to be used as a Legal Tender, "for the settlement of all debts public and private", but changing international law such that no form of debt can force its payment in gold! This opens a one way street for gold and a two way street in fiat currencies. No one will lend gold because they cannot force its return in the courts, thereby making gold a physical only international currency. Yet, on the other hand, we all must borrow in this modern world and currencies will be the only avenue for this. Creating a demand (and added value) for them [fiat currencies] in addition to general use demand.

The first thought many will have is that everyone will just buy gold to make debt payments, driving out fiat currencies. But remember, if you have debts they will be [enforced] in currency settlement only. One will weigh the cheapest form for repayment! Gold in this atmosphere will be completely free to trade, become extremely expensive and stay that way.

We rest now.

Aristotle

Aristotle (02/07/00; 10:52:39MDT - Msg ID:24602)

Part Three: A Test of Your Monetary Maturity

The vagaries of the economic process in the real world make it infeasible to give this matter a comprehensive treatment in this format (nor would I be mentally capable!) so of necessity I will only build upon the most fundamental core principles throughout this commentary. With that caveat out of the way, let's tackle this fiat currency issue right now so that we may sooner breathe a sigh of relief that the bitter pill has been swallowed and that recovery is at hand. How often have we all rallied at one time or another around the Goldhearts' battle cries: "The Fed (or banks in general, or government) simply makes this fiat currency from thin air!" "Fiat money is worthless!" "Fiat currency is the Fed's (or banks', or government's) tool to keep the poor man down." Well, a cold hard reality is that contrary to this line of thinking, while I do indeed fit the description, I certainly have not been kept "down." Have you? Further, and directly to the point, fiat currency isn't "worthless." Have you ever tried to buy anything with it? Did you succeed? I'm sure that you did, so what does that lesson tell you? As a general rule, a person rarely gets "something for nothing." Therefore, the fiat currency must certainly be "something," and that "something" can't BE worthless.

There is a subtle but important distinction here between being "nothing of value" versus being no *thing* of value. A dollar (or any other fiat currency) is certainly no longer a *thing* although it once was (back in those days of yore when it was defined as a certain weight of Gold.) But it does in fact have value--a value it finds in measure of the success with which it retains the original Concept of

value it represented at the time of its origination...at loan creation. This "Concept" is built on a unit foundation of arbitrary size, to be sure; and there can be no doubt that this remains a fundamental weakness for it to serve properly as money (medium of exchange, store of value, and unit of account.)

Nonetheless, the value in any given currency-unit originates in the terms of the loan contract in which the borrower has promised to repay these units of currency to the lender. And while it seems that these currency units are indiscriminately created out of thin air, each of the many trillions in existence today were created through the joint cooperation of a lender AND a borrower. It takes two to tango. Want to find value in a dollar? Simply track down a new homeowner who toils each workday to pay off his mortgage. (Is he *evil* for borrowing money from "thin air"? More on this later.) It's easy to convince yourself that people will provide goods or services in return for dollars--either because they themselves are in debt and in need of the currency to repay their outstanding debts, or else because they believe with near certainty that these same dollars will be useful to them as a medium of exchange when they encounter somebody else who is burdened with outstanding debts.

A Commonly-stated Problem With Fiat Currency

All in all, the system works about as well as any other manmade thing. Unfortunately, taken as a whole, dollars retain their original value only as reliably as wage-earners and price-setters remain content with past pricing levels. And that is influenced in large part by the perceived ease with which additional dollars may be obtained or loans defaulted on. If a significant number of borrowers will not validate the dollars they borrowed through some manner of equivalent production, then the foundation of its value is eroded. Our own Federal government for example, in its consistent failure to balance its operating budget, has effectively become a significant collective of borrowers that refuse to service their debt--they don't pay back their loans. The government is thereby failing to validate its many trillions of borrowed dollars; and the currency system suffers. The dollar value falls and prices generally rise.

The flip side of the coin regarding money supply is where loans are being paid back more rapidly than new loans are written to keep the outstanding money supply expanding with the prevailing growth rate of the real economy. In this circumstance, increased competition for dollars during this relative contraction in the money supply generally results in an increase to the dollar's value; prices would generally fall. The problem with these expansions and contractions, these inflations and deflations of the currency supply, is that in business and in private life both, people tend to enter into long-term contracts. Because earning power, prices, and wages are subject to this variability over time due to changes based on business cycles and money supply, the act of entering into long-term contracts becomes a mixture of faith and gambling.

As I've stated in an earlier post, people have generally been more comfortable to see monetary supply inflation erode the purchasing power over time. The coping mechanism is to renegotiate for pay-raises--and to face paying higher prices. They are less willing and less happy to renegotiate lower rents and wages and lower prices received for goods resulting from a currency that gains value over time. Due to the prevailing inability of people and businesses to accommodate a currency that gains purchasing power over time, the fallout is harsh. Instead of adjusting the price of contracts downward, the reaction is typically to reduce production and cut back on labor when business profits yield fewer currency units. Economic recessions/depressions are frequently the undesired effect of currency supply that either fails to grow as fast as the economy demands; or worse, a currency supply that actually contracts. This has traditionally been the impetus for a well-intentioned government to attempt various degrees of monetary interventions to bring about more desired economic conditions.

A Solution?

No doubt you are familiar with these problems, and tend to agree with our intrepid forefathers whose anti-banking, anti-fiat currency pronouncements are legendary. In all frankness, these were a handful of exceptional men living at an exceptional time and who accomplished an exceptional feat -- the birth of a new Republic. It should not, therefore, come as a surprise to anyone that the opinions and desires so expressed by the likes of Thomas Jefferson and John Adams raised the bar for performance so high that practical performance by their multitudes of mortal descendants could not do but fall woefully short of their lofty vision. (In light of their exceptional life and times they desired perfection -- and why not? -- they thought they had set the world itself into a state of perfection!) I am not saying that perfection is not a worthwhile goal, but I am saying we must at least be rational about what can and can't be done in a real world populated by...well, just look around you.

Please for give my haste when I don't look up the exact quote here, but I seem to recall the great Thomas Jefferson once voiced his conviction which after all these years still has appeal and finds ample support among Gold advocates: "If banks are allowed to control the money supply first through inflation, then deflation, our children will wake up homeless on the continent their fathers conquered." The implication is that banks will issue their credit from "thin air" in return for a pledge of collateral against the return of that credit, drawing in everybody such that currency values fall, prices rise, and people seek ever more loans in their desire to buy before prices rise further, with the added benefit of paying off the loan with devalued currency. But then, in their nefarious desire to rule the world, the bankers would cause the money supply to deflate, making it difficult for everyone to successfully obtain the cash needed to repay their loans. The bankers then walk away with the collateral, leaving the borrower with nothing but a bad credit rating to show for the experience. On the face of it, this seems to be a noble enough assessment, and gives rise to the equally noble suggestion that our problems would be solved if banks could simply be done away with...these institutions that were once said to be "more dangerous than standing armies." So there you have the perfect inspiration for the monetary system of your dreams,

worthy of any true patriot....you suggest we eliminate banks--and with them goes the inflation-threat from the paper money they create--leaving us with only Gold coins as currency.

Not So Fast, Sport Shoes...(you'd better rethink your advice)

Ok, for the sake of indulging this off-the-cuff "perfect" solution, let's be optimistic and assume that we could indeed suddenly find ourselves in a system in which banks are non-existent, and only physical Gold coin is currency. In our euphoric pursuit of perfection, we need only to roll the clock forward from this "perfect" starting point to see that we've rashly and incorrectly assumed that our modern problems could be avoided. First come the banks out of necessity, and then the fractional-reserve lending phenomenon naturally evolves into existence-- whether or not it was deliberately intended from the outset. Are you skeptical? Consider this: it would be a mistake to give thought to monetary matters without due consideration of the weave of our social fabric--examined through the magnifying lens of history.

In the real world, banks are necessary. We need only to look at the circumstances surrounding the appearance of the first significant public bank as documented nearly two centuries after-the-fact by Adam Smith in his "Wealth of Nations," written as America was just a newborn pup. The setting was Amsterdam, a bustling international trading center as the 1500's gave way to the next century. As Adam Smith describes it, the bank was formed and thrived by filling a specific market niche: addressing the corruption of the currency. In settlement of trade, Gold and silver coins from many countries and many mints (public, private, and some disreputable) were in circulation, and as is ever the case, the coins of

inferior alloy or those clipped of proper weight were always the first to be offered to the merchants. In addition to the money-changing manuals that served to document the metal (money) content of the coins from the various known mints,

the merchants had scales to verify the sum of coins offered as payment. However, the good quality and reputation of these scales was seen as suspect in the eyes of the shopper even as the coins were seen in the eyes of the merchants. Smith wrote: "In order to remedy inconveniences, a bank was established in 1609 under the guarantee of the City. This bank received both foreign coin, and the light worn [and other debased] coin of the country at its real intrinsic value in the good standard money of the country, deducting only so much as was necessary for defraying the expense of coinage, and other necessary expense of management. For the value which remained, after this small deduction was made, it gave a credit on its books." Here you see the coins naturally coming out of circulation in favor of "mathematically certain" bank accounting.

In this way, much of the effort and cunning that went into adulterating the coinage by men of low integrity was thereby rendered unprofitable. This system worked well for all parties involved in trade, and the popularity gave rise to similar banks in the nearby trading centers of Delft, Middlebourg, and Rotterdam, and then to other countries. (I've got to work Rotterdam into every long post...have you noticed?) History also records that "banks" have also come into being for the purpose of the security against theft. Early metal smiths also became early bankers by virtue of the security offered by their strongboxes. What practical-minded person would deny the modern need for a similar service in the event of a return to a strictly Gold-based currency system...for safekeeping and for quality assurance?

Yesterday's Performance is no Guarantee on Tomorrow in the 'Business World'

The Bank of Amsterdam was said to work well for a full century, with a man's deposits remaining his on actual deposit until such time as he transferred the money in payment to another man's account. The money (Gold) was not lent out, and so when Louis XIV's French army approached Amsterdam in 1672, causing the

depositors to rush to the Bank in fear for the safety of their money, those panicky depositors all discovered that their money was indeed on hand for immediate withdrawal. The fear-induced bank run gave evidence of yet another universal truth about the nature of mankind--that when satisfied as to the apparent safety and availability of their deposits, they no longer desire to follow-through with the actual withdrawal of their funds, remaining content to let the bank serve as the guardian. And so we have the seeds of the eventual fall of the Bank of Amsterdam, and many thousands of its successors. The Bank's ownership by the City of Amsterdam gave rise to close associations with the Dutch East India Company by virtue of the same men often involved in the governing or management of both operations. Due to the nature of their business, when literally waiting for their ship to come in, even while still a solid company with solid profits, the East India Company would from time to time need a short term provision of credit. In a precursor of what modern banks would come to call their bread-and-butter business, the Bank began to provide these loans to the Company out of depositors' accounts. When business profits turned south for the East India Company in the late 1700's as many ships and cargo were lost in the war, the loans increased; the City government itself also came to rely on the bank for loans.

During the first century of operation, merchants preferred to receive payment in bank deposits instead of the uncertain quality of the coin of the day. But as the loans of the Bank increased, and as the Bank began to put limits on withdrawals or transfers to accounts at other banks, merchants began to cast a wary eye upon payment made in bank deposits, and they raised their prices to reflect this growing

uncertainty, discounting the value of the bank money. As you might expect, when a bank can't be counted on to reliably provide your money on demand, its days are numbered. And so it was for the Bank of Amsterdam--the doors were closed in 1819. It should also come as no surprise that similar scenes were played out many times on a smaller scale by the metal smiths mentioned earlier. After being sought out for the security of their strongboxes, and after a period of reliable service, many smiths would observe the willingness of their

depositors and citizens in general to leave the Gold under lock and key, opting to circulate the receipts of ownership instead. The more unscrupulous among them would come to grant loans to others for profit, or else grant loans to themselves through the issue of receipts for more Gold than they held. When rumor brought about sufficient alarm to bring in an abundance of receipts for redemption all at once, the game was up and justice was swift--though to be sure, this righting of the wrong on the inevitable day of reckoning was COMPLETELY unsatisfactory to the good citizens left holding worthless Gold-receipts from the bank after the Gold ran out.

Aristotle (02/07/00; 13:14:18MDT - Msg ID:24610)

Part Four: Outright Bank Fraud IS Black and White, but this gets Very Gray Very Quickly...

You have likely identified the problem in both of these examples: the entity providing the banking service began issuing loans using their customers' deposits without the consent and cooperation of the depositor. Let's consider an example in which the bank is of the most noble character and management, simply offering safe storage and quality assurance of the Gold currency. It is human nature that those with wealth--such as we might find among those having deposits in our hypothetical Noble Bank--might seek to generate some income with their wealth. They might play an active role in this attempt as a venture capitalist, offering their money directly to entrepreneurs in return for some profits after personal negotiations convince them of the viability of the prospect.

But not all would-be-lenders and borrowers are well suited to negotiate and organize such arrangements themselves, particularly the smaller would-be lenders seeking an income, and the smaller would-be borrowers seeking funds for such things as small business expenses. The Noble Bank easily develops the in-

house expertise in evaluating those borrowers that represent a good credit risk, and can organize the formal loan arrangements on behalf of their depositors. And rather than matching up a depositor/lender with a borrower on a personal, individual basis, the Noble Bank would come to pool the depositors' funds into an anonymous operation in which the profits from the lending of capital are then provided to the depositors (minus the Bank's own profit for providing this service) according to the amount of funds the depositor put into account with the bank. This provides the flexibility demanded by the banking depositor to generally be able to access his funds as needed.

It's like this. Assume that you, me, and someone else have all put $10 in Gold coin on deposit with the Noble Bank for safe keeping, with the added hope to earn a return on the Bank's ability to lend it at a profit in the meanwhile. Let's say a shoe cobbler needs to buy leather and a new sewing machine in

order to make new shoes, so the bank lends him $18 of the $30 available. The cobbler takes his borrowed Gold, makes his purchases, and sets to work in order to repay the bank $19 from his anticipated profits within the coming months. In the meantime, you incur unanticipated expenses, and need to obtain your $10 deposit back from the Bank. Because this Bank wants to keep you happy, and to retain your future business, it doesn't tell you that $6 of your account is currently unavailable (out on loan) as per your wishes for the bank to earn you an income, and that the cobbler will be returning it (along with the profit you sought) in regular installments over a period of time. Instead, the Noble Bank gives you $10 of its remaining $12, and hopes that neither me or that third depositor will want to reclaim our own deposits anytime soon.

Here you can see that no money was created out of thin air. But the size of the Noble Bank grows as a good track-record of management attracts ever more deposits in which withdrawals don't threaten the remaining funds on reserve, and the depositors all come to perceive through their good experience that the entirety of their account is available to them should they need it. The bank would

accommodate this concept of reality by shuffling the credit distribution among accounts to provide the depositor's money on demand. This creates the illusion of money being in more than one pocket at the same time through no *fault* or evil intent of the Noble Bank. This is what the users of the System wanted, and this is what we got. And as the cobbler's leather supplier deposits the cobbler's Gold payment into the neighboring Honest Bank in order to earn a return, the process may continue yet further. The economy seems to experience an abundant money supply, and the purchasing power of all funds are thereby diminished by rising prices as the actual goods offered for sale are then held more dearly than the money which has suddenly become so easy to come by.

Please note that in this example, I didn't once use the term interest in connection with the lending of money. A great many of the over-zealous Gold advocates try to equate the lending of money at interest with the evils of usury, so I purposely avoided that trap which has become a mental stumbling block in their thinking. While they might be inclined to say rightly or wrongly that lending at interest should be banned in order to eliminate the "sin" of usury, they certainly can't make that claim against the form of venture capitalism that I laid out above. And if the banks come to define the terms of providing venture capital from their available pool of deposits as a standard low interest rate rather than higher claims on profits that vary from borrower to borrower, what's the harm?

Too Much of a Good Thing

A quick historical note is in order here on the position of famed economist David Ricardo, who was a strong supporter of the Bullion Committee and its position in favor of the Gold Standard in monetary discussions hosted by the Bank of England in the early 1800's. The purpose of the discussions was to get to the root of the problem regarding rising prices, including [the price of] uncoined Gold bullion. The center of the debate was whether bank notes--which by that time had

formed the bulk of circulating money supply--were losing value, or was Gold simply rising in price? Given the observation that other prices (such as bread) were rising, the verdict was against the bank notes, just as it was in the latter years of the Bank of Amsterdam when the merchants had diminished faith that the bank could successfully redeem its credits for Gold coins. In the course of the debates, Ricardo described in his works "it was most justly contended that a currency, to be perfect, should be absolutely invariable in value." While conceding that precious metals couldn't be held to the desired level of perfect invariability, they remain the best-suited item we have discovered. And yet while holding this position, Ricardo was not completely opposed to bank notes, finding them to be economical and convenient, so long as they were always fully exchangeable for metal upon demand.

I'll say again, if the Noble Bank could legitimately tell a rational depositor that a portion of his deposit wasn't immediately available for withdrawal, then things would likely be closer to OK, with the bank notes in circulation representing the Gold allocated to the borrower and properly held aside for redemption of the note as Ricardo would have it. While this sounds good initially, there would still be some perception of an abundant Gold supply due to the borrowed funds hitting the marketplace, and there would still tend to be the resulting diminution of the currency's purchasing power. And further, the banks would always try to accommodate the depositor's desire to withdraw funds by reallocating their available resources, leading to a false (and eventually fatal) sense of security in the general nature and supply of money.

As you can see from everything above, it begins innocently enough. The depositors' money is physically distributed (unlike the ledger creation of credit- money used today,) but it would not be long before the depositors who had thus risked their deposits for a return came to have faith that their full deposit would be returned with interest, and acted on faith as though the Gold was actually still at their immediate disposal. But inevitably, the day always comes when

confidence is in short supply, and depositors rush en masse to reclaim their deposits, feeling that money in-hand is more desired than the prospects of any returns that the bank may have to offer, or perhaps fearing for the viability of the bank itself and its ability to provide Gold for the quantity of funds in account.

And as it begins innocently enough, it ends innocently enough, too. The availability for the common man to get a loan serves as an undeniably equalizing force in society. It allows a poor person with time and energy to participate in the economy on par with a man who has his own capital. Through the credit obtained from the banks' pool of deposits, a borrower is able to gain possession of land, buildings, tools, raw materials, or other goods and facilities with which to become a farmer, manufacturer, or merchant--using the profits from his time, energy and know-how to earn a living for himself and to compensate his lenders for their extension of credit. The poorer and more wretched a man might be, the more he might wish for the presence of a bank of low standards willing to extend credit to the likes of him.

The Same Old Arguments have Always Been With Us...

But despite this common desire for banks, even from the very beginning there has always been an element of society that for one reason or another saw banks as fraudulent means of transferring the wealth of honest workers to an elite group (the lenders) with agendas to rule the world. In a letter to John Adams about his own fear and loathing over the proliferation of banks and their issuance of paper credit, Thomas Jefferson wrote in 1814: "I have ever been the enemy of banks; not of those discounting for cash; but of those foisting their own paper into circulation, and thus banishing our cash. ...these are to ruin both republic and individuals. This cannot be done. The Mania [of borrowing and lending] is too strong. It has seized by its delusions and corruptions all the members of our governments, general, special, and individual." But in contrast to Jefferson, in a

little-publicized footnote of history, Benjamin Franklin was a strong supporter of paper money. He saw that a national paper money provided a "general benefit" of facilitating alternatives for a government against the dual "horrors" to its citizenry of taxation and deflation. And as mentioned in the preceding paragraph, very "specific benefits" were seen on an individual basis by those who sought loans of any form of bank money (Gold, paper, credit, whatever) in order to improve their position in life.

Because the "little guy" clamors for loans just as the "big guy" who pursues bigger projects, and because the banks (which were naturally established to help the marketplace maintain the safety and

quality of its original Gold currency) come to naturally play the middleman between the population with money to lend to the population seeking to borrow, the blame for all that follows is hard to pin on anyone specifically. Almost everyone in modern society comes to rely on the continuing and smooth operation of the banking system. As outlined throughout this commentary, you can see that as civilization advances and as the economy expands and the population grows, the general trend is for the apparent money supply to expand, even if the banks themselves do nothing more than efficiently reallocate deposits as needed to keep everybody happy. The threat of a bank run grows with the growing disconnect between what is perceived as the fair value contained in the underlying Gold contained in the coin that originally defined the currency unit, versus the witnessed purchasing power of the same currency units as dictated by the apparently swollen supply as borrowed and efficiently allocated by banks. Due to the unacceptably disruptive nature of bank runs on society, and the hurt inflicted on those who were late to the doors and therefore left holding worthless receipts of a newly failed bank, the inevitable outcome (generally tolerated by most) is two-fold. First, for the officially-sanctioned (government) regulation or development of a national central bank to bring more order to the hodgepodge of wayward private banks, and second, for the eventual officially- sanctioned termination of Gold convertibility for the abundance of circulating bank notes and bank deposits on account.

Aristotle (2/10/2000; 3:37:44MDT - Msg ID:24877)

Part Five: "Building the Perfect System by Capitalizing on Gresham's Law"

Who's to Blame When the System Fails?

Perhaps it would be clearer if I rephrased that question. "The System" as I've defined it is the ever-changing monetary principles, policies, and practices seen in the course of satisfying the real demands of conducting business and commerce among real people. At any given moment, the System is undergoing change from one form to another, generally smooth and gradual, but occasionally abrupt and painful. But never in the largest sense can the System itself be said to "fail," although parts of it certainly prove troublesome and are altered from time to time as economic efficiency dictates. Did the old Gold Standard era System "fail" when there was a bank run at one institution or another? Well, if you were a depositor who didn't get your deposits out before that particular bank closed its doors, you might indeed be inclined to say that the System failed. But more specifically, it failed YOU. Meanwhile, your contemporaries who lived half a continent away might say that the bank closure was a healthy adjustment to the system, weeding out a weak bank. As such, System "failure" might be viewed as any time YOU were legitimately dissatisfied with its performance. Therefore, it would probably be more appropriate to ask this question instead: "Who is to blame when the System disappoints you?" An important thought to consider in this regard is whether any conceivable System could please all of the people all of the time.

Let's briefly examine the dissatisfaction of the typical Goldheart. In his mind the System has failed because he is dissatisfied all the time--so long as Gold is not the circulating currency, apparently. How irrational is that? Romantic, to be sure, but

completely irrational. This superficial desire will never be the impetus for a change to the System as we

know it. Even in the "good ol' days" the coins quickly gave way to bank notes as the circulating equivalent. There simply must be more at stake than the whimsical preferences of an individual in order to inspire change.

Something to rally around...

Here's the key factor as detailed earlier in this commentary which ultimately argues forcefully for the proper role of Gold in the monetary system's architecture. In what has been revealed as a misplaced goal, with Gold as the circulating currency, artificial inflation of the Gold supply is the unavoidable consequence because money will always be lent by somebody to somebody else who wants to borrow. As a result, under any past System architecture, there has never been a truly satisfactory means to safely and reliably escape the ravages of inflation and deflation. Having Gold attached either directly or indirectly to the circulating currency (or Gold itself subject to being lent independently as we see today), the proper valuation of Gold is always understated by the market due to the perception of of an increased (artificial) supply. Truth be told, it is this element that gives rise to my own dissatisfaction--that Gold is not at all points in time held near to its honest physical-based monetary valuation as it should be. This is true at nearly all points in time except for those brief and historic moments when the adjustment inevitably comes and Gold reaches an entirely new price plateau. This proves unacceptable for those who live in the interim periods as they strive to protect their personal wealth...those holding Gold during these past 20 years, for example. (Although make no mistake, the extent of currency depreciation in various non-OECD nations would paint a more normal looking picture for citizens holding Gold within those countries.)

As the number of people increases who are dissatisfied with the System's performance at any given moment in time, the greater the pressure mounts to effect some degree of change. Similarly, the greater the level of dissatisfaction, the greater the impetus to effect some rectifying change. For those who are yet clinging to the notion that we need a Gold Standard with fixed convertibility of the currency, please forgive me as I verbally try once again to shake you out of your mental stupor. Under a Gold Currency-based system, any time someone borrowed money they would in essence be participating in a Gold loan (much as we see happening today--an act that is ill-tolerated by those who can rightly recognize its depressing effect on the value of that same Gold/Money.) For the hundredth time, because people will always have a desire to borrow money to meet their business or personal needs at one point or another, you would always be dissatisfied by any Gold Standard that allowed these (Gold-) loans to occur. Meanwhile, everyone else would be dissatisfied by such a Gold Standard System that specifically pleased you in which money (which would be Gold) could not be borrowed as needed.

Accepting the constraints of the real world...

Any properly functioning monetary system in the real world must accommodate those seeking to borrow funds. And if I've made no other point but one, we should all see from the extensive commentary (bludgeoning) presented earlier that such a system cannot sustainably coexist with a Gold Standard which has a fixed convertibility. Inflation is always a consequence, and then so are bank runs, a phenomenon unique to any such Standard of fixed convertibility. There can be little denying that those bank runs are the ultimate monetary catastrophe experienced on an individual basis. Think about it. If you were among the depositors left with unhonored deposits of metal on account at a failed bank, you might just as well be located in a modern-day Third World nation when its currency loses value...your life's savings have been wiped out through no fault of your own.

Examining this case of a bank run, everything was working fine for you and your currency-units yesterday, but then suddenly your world fell apart today. In truth, to witness that a bank run was

"justified" by the bank's obvious (after the fact) shortfall of Gold necessary to honor all of the deposits reveals with abundant clarity that a goodly portion of the system's funds were actually "unbacked" currency. And since these same unbacked currencies were seen to be functioning well prior to the pain of the bank run, it makes little sense to those left holding the bag in a bank run. And as hard as it is for these unfortunate citizens to fathom fundamentally why these currencies could work yesterday but not today, it is even harder for them to grasp why the same currency could function properly at the front of the bank line, but not for those in the back end of the line. It is this kind of pain, especially when bank runs become an epidemic, that compel significant changes to be made to the System architecture. History reveals that a natural starting point to ease this pain is national regulation of the scattered and various independent private banks.

This leads to a united-we-stand, divided-we-fall solution in which resources are managed among the banks so that individual hemorrhages can be addressed without leading to domino-style bank failures. But ultimately, the whole system is put at unacceptable risk from bank runs inspired by the realization that the bank- money inflation has rendered a currency value that is less than the metal value in the system's few coins. Again, the institutional thinking goes, "Since all this unbacked paper worked yesterday, let's just get rid of the inspiration for bank runs--the Gold coins." Those finding themselves in the back of the lines certainly would welcome this. Their currency would not only remain just as good as the currency held by those in the front of the line, but it would also be not significantly different than it was yesterday.

OK, so who IS to be blamed for our disappointment with the System as it is?

The lesson to be learned is not to blame the push for fiat currency upon "the few and powerful" men of wealth of the world. While inflation can be bad even under a Gold Standard (along with the pain of bank runs for those who fail to rescue their deposits), inflation has the distinct opportunity and track-record to be much worse within a system built upon a fiat currency. The truth is, inflation hurts those with money (it erodes their purchasing power), and helps those with debts (it makes loan repayment easier.) David Ricardo said it eloquently: "The depreciation of the circulating medium has been more injurious to monied men...It may be laid down as a principle of universal application that every man is injured or benefited by the variation of the value of the circulating medium in proportion as his property consists of money, or as the fixed demands on him in money exceed those fixed demands which he may have on others." He said further that the farmer "more than any other class of the community is benefited by the depreciation of money, and injured by the increase of its value." This is likely for the dual reason that farmers as a general rule were often in debt to begin with, and because their annual creation of crops (from thin air!) could then be sold for more currency units in each subsequent year, even if the net real-world value of the product being offered remained entirely unchanged.

Don't waste energy on laying blame...

And so we can see, with more people in society having common wealth than uncommon fortune, it is distinctly the case that democracy proves to be the greater threat to a convertible Gold Standard than does even the unmanageable expense of war. I faintly recalled some historical figure who made the astute observation that in a democratic society, when the people come to realize that they can vote "largess" for themselves from the public treasury, they will do so, and hence bring about their system's collapse. And in researching this matter further (thanks Journeyman, ji, and RossL for your help) it seems that there

actually have been a number of figures echoing this same sentiment through time. But regardless of the

precise citation of this quotation, one look at the growing national debt in America (serving as the substitute for the taxes that would otherwise be necessary to fund our chosen social programs) gives credence to this assertion. Simply put: the people (the masses) get what the people want-- and the people apparently want easy money. Even outside of a democracy, over time, the forces of the population always win out over the forces of the few men of power. And in the end it matters not which group is on the side of good, and which is destructive--the many prevail over the few.

So, what is the proper role of Gold in the monetary system architecture?

At this point, the staunchest Gold supporters are likely gnashing their teeth and forming a posse to hunt me down for a proper lynching, I'm sure. After all, I have made no bones about the need to cut Gold out of any ties whatsoever with the various national currencies. Due to inflation and deflation that naturally arise through variations in the rates of borrowing, payback, and growth of the economy, currency fluctuations lead to bank runs which are frankly too disruptive and are not to be tolerated. Fortunately, they are rendered completely meaningless under a fiat currency regime. National fiat currencies allow governments to manage their own national economies to the extent that that are able, and to take whatever efforts needed to avoid falling into those most destructive currency deflations that wreak havoc on economies.

Gold must be removed from these currencies so that governments are not tempted to manipulate its perceived value in order to give a boost to their own currency. The goal would be that sudden value shocks will be avoided because at all points in time the currencies will be fairly valued against Gold--there won't be an inevitable and recurring "day of reckoning" in which the pent-up false perceptions are unwound amid calamity and crisis of confidence. Gold must also

be removed from any element of the monetary system that would seek to make loans using Gold because, as we've seen, these confound Gold's ability to reach its true physical-based fair market value. Gold derivatives must also be done away with for the same reason. Gold must remain a pure monetary asset, bought and sold and owned outright--nothing else would be allowable. National fiat currencies will ably serve the market's various needs to borrow funds...after all, that's how fiat currency is born in the first place.

Although I've seemingly cut Gold out of the monetary system, that is not the case at all. Gold qualifies as the only true money; being able to function as a unit of account, as a medium of exchange, and as a store of value. A fiat currency only meets the first two elements, but they fail as a store of value. Therefore, Gold will be be the money of savings, while national currencies will be the currency of commerce. They will all float relative to each other, and constantly seek out their proper value. Kept with special status as an independent and unlendable currency, Gold will be the ever-rising North Star of the monetary system. Central banks would be inclined to hold only Gold in reserves of any significant size-- because Gold is not the liability of any other nation, and its real-world value would continue to grow over time. As said before, quantities held in other national currencies would be done only to the extent that they facilitate trade between active partners. Individuals across the Earth would also choose to hold Gold as their savings; their life's productivity forever protected from inflation and deflation, and from reliance upon another person's (or nation's) liability.

The beauty of reserving Gold as an unmanipulated monetary asset is that individual local currencies can still be "managed" by the government in whatever manner is seen befitting that specific country, without having an adverse effect on the meaningful wealth held in reserves (in the form of Gold savings) among other nations and local citizens alike. No single national currency need ever be held by another nation as a reserve currency (which "unfairly" allows the nation that issues the reserve currency

to export its inflation.) However, a nation might

choose to hold another's currency in a quantity simply because it makes for expedient trade.

The reassurance of Gresham's Law...

Perhaps a short lesson is in order for those new to this realm of thought. In 1558, Sir Thomas Gresham made his observation that whenever there was latitude in tendering payment (as could be seen in the major medieval cities where coins from many lands came together in the course of trade--as we covered in the case of Amsterdam,) inevitably the money of poorest quality was offered while the better money was retained. In describing the circulation of currency, Gresham's law says that bad money drives out good. (The inferior money circulates, while money of superior quality is held.) In our new system herein described, paper currency will circulate while Gold money will be saved.

Pause for a moment to fully consider this practical notion of saving Gold on one hand, while on the other, borrowing and spending paper just as we always have in our lifetimes (and know of no other reality from personal experience.) This is in perfect tune with Gresham's law. Given our own limited history, this accord with Gresham's law provides a very comforting reassurance for predicting the success of this system. Why? Because Gresham's law is arguably the only economic law that survives beyond challenge--an echo of the universal and enduring truth that given a choice, people will choose the option that serves their own needs best. Gresham's law predicts that the world's supreme currency, Gold, would not actually circulate in a conventional sense, though it would move from the hand of one saver to another as individual circumstances might require. Sure, you could use it outright as money if you insisted, but nodding to Gresham's law, wouldn't you rather keep your Gold for the rainy day and spend your paper instead? This system will enhance the transparency of national economics and financial positions, rewarding those with good fiscal policy and balanced budgets, and

giving none an exorbitant privilege over another through reserve currency status. It will allow the citizens a natural avenue to protect themselves against depreciation of the national currencies (which will inevitably inflate until the end of time,) and to actually gain a no-risk real "return" by simply holding the metal without the self-defeating aspect of lending it out for interest.

Gold. Get you some. ---Aristotle

Friday, September 24, 2010

The Shoeshine Boy

To set up this post I will share with you two brief predictions I recently received by email. These were both in email blind copied to large groups of recipients that included me. The two senders do not know each other. In fact, their only connection is that they are both supporters of my blog on the highest order, I know what they each do for a living (very respectable), and I therefore hold them both in high regard:

> **Email 1:**
> This is a very orderly secular bull market. The bubble, that WILL come, is still about 2 or 3 inches to the right of the margin on the right side of this chart...
>
> **Email 2:**
> Perhaps we are talking about the first general realization among the investing public that the Fed cannot/will not rescue us with their magic wands and QEs… This may be it, the beginning of Stage 2 of gold's rally, where the smart money starts moving in. Stage 3 is next when the shoeshine boy tells you: Buy gold!

For those of you that don't know the meaning of the shoeshine boy reference, JFK's father, Joe Kennedy claimed that he knew it was time to get out of stocks in 1929 when he received investing tips from a shoeshine boy. Ever since, the shoeshine boy has been the metaphor for "time to get out"; for the end of the mania phase in which everyone, even the shoeshine boy, wants in.

Joe Kennedy

Joe Kennedy's credibility on this "bubble top calling" issue is bolstered by the fact that from 1929 to 1935 his fortune went from $50 million to $2.85 Billion in today's purchasing power. And the take-home lesson in this story is that it is time to sell ANYTHING once the shoeshine boy is recommending it. Because the next phase is the blow off phase where the item in question comes crashing back down.

Bubble Phases

And the fact that two of my favorite readers are now calling for an eventual bubble in gold reminded me that it has been 9 ½ months since I wrote Gold: The Ultimate Un-Bubble. Perhaps it is time for an update.

Now I'll grant that the point in both of the quotes above was that we are nowhere near the bubble top. And they were addressed to people that are very jumpy when it comes to bubbles because they have been burned by a couple bubbles in recent history. But even so, I think they expose a fundamental misunderstanding of what is actually happening today.

How Gold will handle even the Shoeshine Boy

Before I get into what is actually happening with gold today, I want to show you WHY it is happening to gold. And WHY gold is different. There's a unique thing that happens with gold. ANOTHER said it pretty clearly (even if still a bit cryptic) in his very first post:

"Gold has always been funny in that way. So many people worldwide think of it as money, it tends to dry up as the price rises."

In a future post I'll explain the context in which ANOTHER made this statement because it portends vast changes in the international monetary system directly in front of us. (Remind me of this. I was going to include it here but the post grew too long even without it. :) But for now, we need to look at why this statement is true. For this I turn to John Law. Well, not the real John Law, but another pseudonymous blogger like me using his name back in 2006:

An illustration

Let's start by comparing two hypothetical cases.

In case A, a million Americans decide right now to move all their savings into Dell stock, buying at the current market price no matter how high.

In case B, a million Americans decide right now to move all their savings into gold, buying at the current market price no matter how high.

In both cases, let's say each of these test investors has an average of $10,000 in savings. So we are moving $10 billion.

Neither gold nor Dell can instantly absorb $10 billion without considerable short-term increases in price. Because it would require us to predict precisely how other investors would react, we have no way to precisely compute the effects. But we can describe them in general terms.

In case A, the conventional wisdom is right. Our test investors should expect to lose a lot of money.

This is because Dell has a stable equilibrium price which is set by the market's estimate of the future earning power (price-to-earnings ratio) of this fine corporation. Because it is not the result of any new information about Dell's business, the short-term surge should not affect this long-term equilibrium.

Since there will almost certainly be a short-term price spike, many of the test investors will be buying at prices well above the stable equilibrium. In fact, the more investors we add to the test, the more each one should expect to lose. Doh!

But there is no way to apply this analysis to case B.

Precious metals have no price-to-earnings ratio. With gold formally demonetized (that is, with no formal link between gold prices and currencies such as the dollar, as there was until 1971), there is no stable way to price it. There is no obvious equilibrium to which the gold price must converge.

It is true that gold has industrial uses. It can be priced on the basis of industrial supply and demand. The conventional wisdom is that it is.

Thus we can say that gold, for example, is overvalued if gold miners are selling more gold than jewelry makers and other industrial users want to buy. At present (with gold near $700), they probably are. So if you follow this reasoning, the right investing decision is not to buy gold, but to sell it short.

But this just assumes that there is no investment demand for gold. On the basis of this assumption, it

shows that gold is a bad investment. Therefore there should be no demand for it.

Therefore, when our case B investors put $10 billion into gold, that money has to be used to bid gold away from its current owners, many of whom already believe that the price of gold in dollars should be much higher than it is now.

So the result of case B is that the gold price will, as in case A, rise immediately. But it has no reason to fall back.

In fact, quite the opposite. Because the gold price is largely determined by investment demand, any increase in price is evidence of increasing investment demand. Mining production, noninvestment jewelry demand, and industrial use are relatively stable. Investment demand is a consequence of investors' opinion about the future price of gold - which is, as we've just noted, largely determined by investment demand.

This is not a circularity. It is a feedback loop. Austrian economists might call it a Misesian regression spiral.

Suppose you believe this. It's all well and good. But what does it really prove? Couldn't gold still be just another bubble?

And why should gold be a better investment because it has no earnings to price it by? This makes zero sense.

To answer these sensible objections, we need a few more tools.

Nash equilibrium analysis

The Nash equilibrium is one of the simplest and oldest concepts in game theory. (Nash is John Nash of A Beautiful Mind fame.)

In game theory jargon, a "game" is any activity in which players can win or lose - such as, of course, financial markets. And a "strategy" is just the player's process for making decisions.

A strategy for any game is a "Nash equilibrium" if, when every player in the game follows the same strategy, no player can get better results by switching to a different strategy.

If you think about it for a moment, it should be fairly obvious that any market will tend to stabilize at a Nash equilibrium.

For example, pricing stocks and bonds by their expected future return (the standard Wall Street strategy of value investing) is a Nash equilibrium. No market is infallible, and it's possible that one can make money by intentionally mispricing securities. But this is only possible because other players make mistakes.

(Nash equilibrium analysis of financial markets is not some great new idea. It is standard economics. The only reason you are reading a Nash equilibrium analysis of the interaction between precious metals

and official currency now on the Web, not 30 years ago in the New York Times, is that the Times gets its economics from real economists, not random bloggers, and the profession of economics today is deeply tied to the institutions that manage the global economy. Real economists do not, as a rule, spend time thinking up clever new reasons why the global financial system will inevitably collapse. They're too busy trying to prevent it from doing so.)

What Nash equilibrium analysis tells us is that the "case B" approach is interesting, but inadequate. To look for Nash equilibria in the precious metals markets, we need to look at strategies which everyone in the economy can follow.

Let's focus for a moment on everyone's favorite, gold. One obvious strategy - let's call it strategy G - is to treat only gold as savings, and to value any other good either in terms of its direct personal value to you, or how much gold it is worth.

For example, if you followed strategy G, you would not think of the dollar as worthless. You would think of it as worth 45 milligrams, because that's how much gold you can trade one for.

What would happen if everyone in the world woke up tomorrow morning, got a cup of coffee, and decided to follow strategy G?

They would probably notice that at 45mg per dollar, the broad US money supply M3, at about $10 trillion, is worth about 450,000 metric tons of gold; that all the gold mined in human history is about 150,000 tons; and that official US gold reserves are 8136 tons.

They would therefore conclude that, if everyone else is following strategy G, it will be difficult for everyone to obtain 45mg of gold in exchange for each dollar they own.

Fortunately, there is no need to follow the experiment further. Of course it's not realistic that everyone in the world would switch to strategy G on the same day.

The important question is just whether strategy G is stable. In other words, is it a realistic possibility that everyone in the world could price all their savings in gold? Is strategy G in fact a Nash equilibrium?

There are no market forces that would tend to destabilize it. Or are there? Actually, it turns out that we've skipped a step in our little analysis.

Levitating collectibles

The problem is that the exact same analysis works just as well for any standardized and widely available asset.

For example, let's try it with condoms. Our benchmark of all value will be the standard white latex condom. We can have a "strategy C" in which everyone measures the worth of all their assets in terms of the number of condoms they exchange for. Cash payments will be made in secure electronic claims to allocated boxes of condoms, held in high-security condom vaults in the condom district of Zurich. And so on.

This is obviously ridiculous. But why? Why does the same analysis seem to make sense for gold, but no sense for condoms?

It's because we've ignored one factor: new production.

Let's step back for a moment and look at why people "invest" in gold in the first place. Obviously they expect its price to go up - in other words, they are speculating. But as we've seen, in the absence of investment the gold price would be determined only by industrial supply and demand, a fairly stable market. So why does the investment get started in the first place? Does it just somehow generate itself?

What's happening is that the word "investment" is concealing two separate motivations for buying gold.

One is speculation - a word that has negative associations in English, but is really just the normal entrepreneurial process that stabilizes any market by pushing it toward equilibrium.

The other is saving. We can define saving as the intertemporal transfer of wealth. A person saves when she owns valuable goods now, but wishes to enjoy their value later.

The saver has to decide what good to hold for whatever time she is saving across. Of course, the duration of saving may be, and generally is, unknown.

And of course, every saver has no choice but to be a speculator. The saver always wants to maximize her savings' value, as defined by the goods she actually intends to consume when she uses the savings. For example, if our saver is an American retiree living in Argentina, and intends to spend her savings on local products, her strategy will be to maximize the number of Argentine pesos she can trade her savings for.

Here are five points to understand about saving.

One is that since people will always want to shift value across time, there will always be saving. The level of pure entrepreneurial speculation in the world can vary arbitrarily. But saving is a human absolute.

Two is that savers need not be concerned at all with the direct personal utility of a medium of saving. Our example saver has little use for a big hunk of gold. Her plan is to exchange it for tango lessons and huge, delicious steaks.

Three is that from the saver's perspective, there is no artificial line between "money" and "non-money." Anything she can buy now and sell later can be used as a medium of saving. She may have to make two trades to spend her savings - for example, if our saver's medium of saving is a house, she has to trade the house for pesos, then the pesos for goods. If she saves directly in pesos, she only has to make one trade. And clearly trading costs, as in the case of a house, may be nontrivial. But she just factors this into her model of investment performance. There is no categorical distinction.

Four is that if any asset happens to work well as a medium of saving, it may attract a flow of savings that will distort the "natural" market valuation of that asset.

Five is that since there will always be saving, there will always be at least one asset whose price it distorts.

Let's see what happens when that asset is condoms. Suppose everyone in the world does adopt strategy C, just as in our earlier example they adopted strategy G. What will happen?

Just as we predicted with gold, there will be massive condom buying. Since condom manufacturers were not expecting their product to be used as a store of wealth, demand will vastly exceed supply. The price of condoms will skyrocket.

Strategy C looks like a self-fulfilling prophecy. Condoms will indeed become a costly and prized asset. And the first savers whose condom trades executed will see the purchasing power of their condom portfolios soar. This is a true condom boom.

Let's call this effect - the increase in price of a good because of its use as a medium of saving - "levitation."

Sadly, condom levitation is unsustainable. The price surge will stimulate manufacturers to action. Since there is no condom cartel - anyone can open a factory and start making condoms - the manufacturers have no hope of maintaining the levitated condom price. They will produce as many condoms as they can, as fast as possible, to cash in on the levitation premium.

Levitation, in other words, triggers inventory growth. Let's call the inventory growth of a levitated good "debasement." In a free condom market, debasement will counteract levitation completely. It will return the price of a condom to its cost of production (including risk-adjusted capital cost, aka profit). In the long run, there is no reason why anyone who wants condoms cannot have as many as he or she wants at production cost.

Of course, condom holders will realize quickly that their condoms are being debased. They will pull their savings out, probably well before debasement returns the price of a condom to the cost of producing one.

We can call the decrease in price of an asset due to the flow of savings out of it "delevitation." In our example, debasement causes delevitation, but it is not the only possible cause - savings can move between assets for any number of reasons. If savers sell their condoms to buy Google stock, the effect on the condom price is exactly the same.

Because condom debasement is inevitable, and will inevitably trigger delevitation, savers have a strong incentive to abandon strategy C. This means it is not a Nash equilibrium.

The whole sad story will end in a condom glut and a condom bust. The episode will be remembered as a condom bubble. In fact, if we replace condoms with tulips, this exact sequence of events happened in Holland in 1637.

So why won't it happen with gold?

The obvious difference is that gold is an element. Absent significant transmutation or extraterrestrial trade, the number of gold atoms on Earth is fixed. All humans can do is move them around for our own convenience - in other words, collect them. So we can call gold a "collectible."

Because it cannot be produced, the price of a collectible is arbitrary. It is just a consequence of the prices that people who want to own it assign to it. Obviously, the collectible will end up in the hands of those who value it highest.

Since the global bullion inventory is 150,000 tons, and 2500 tons are mined every year, it is easy to do a little division and calculate a current "debasement rate" of 1.66% for gold.

But this is wrong. Gold mining is not debasement in the same sense as condom production, which does not deplete any fixed supply of potential condoms. In fact, it only takes a mild idealization of reality to eliminate gold mining entirely.

Gold is mined from specific deposits, whose extent and extraction cost geologists can estimate in advance. In financial terms, gold "in the ground" can be modeled as a call option. Ownership of X ounces of unmined gold which will cost $Y per ounce to extract is equivalent to a right to buy X ounces of bullion at $Y per ounce.

Since this ownership right can be bought and sold, just as the ownership of bullion can, why bother to actually dig the gold up? In theory, it is just as valuable sitting where it is.

In the form of stock in mining companies which own the extraction rights, unmined gold competes with bullion for savings. Because a rising gold price makes previously uneconomic deposits profitable to mine - like options becoming "in the money" - the total value of all gold on earth does increase at a faster rate than the gold price. But the effect is not extreme. 2006 USGS figures show 30,000 tons of global gold reserves. This number would certainly increase with a much higher gold price - USGS reports 90,000 tons of currently uneconomic "reserve base" - but the gold inventory increase would be nowhere near proportional to the increase in price.

In practice, modeling unmined gold as options is too simple. Gold discovery and mining is a complex and political business. The important point is that rises in the gold price, even dramatic rises, propagate freely into the price of unmined gold and do not generate substantial surges of new gold. For example, the price of gold has more than doubled since 2001, but world gold production peaked in that year.

The result is that gold can still levitate stably. Even if new savings flow into gold stops entirely, debasement will be mild. The cyclic response typical of noncollectible commodities such as sugar (or condoms), or theoretical collectibles whose sources are not in practice scarce (such as aluminum) is unlikely.

Of course, if savings flow out of gold for their own reasons, it can trigger a self-reinforcing panic. Delevitation is not to be confused with debasement. Again, it is important to remember that debasement is not the only cause of delevitation.

What we have still not explained is why gold, which is clearly already levitated, should spontaneously tend to levitate more, rather than either staying in the same place or delevitating. Just because gold can

levitate doesn't mean it will.

Money in the real world

In case it's not obvious, what we've just done is to put together a logical explanation of money, using gold as an example, and using only made-up terms like "collectible" and "levitation" to avoid the trap of defining money in terms of itself.

Now let's apply this theory to the money we use today - dollars, euros, and so on.

Today's official money is an "artificial collectible." Money production is limited by legal violence, not natural rarity. If in our condom example, the condom market was patrolled by a global condom mafia which got medieval with any unauthorized condom producers, it would resemble the market for official currency. No one can print Icelandic kronor in the Ukraine, Australian dollars in Pakistan, or Mexican pesos in Algeria.

It may be distasteful to hardcore libertarians, but this method of controlling the money supply is effective. There is minimal unlicensed production of new money - also known as counterfeiting.

It should also be clear from our discussion of gold that there is nothing, in principle, wrong with artificial paper money. The whole point of money is that its "real value" is irrelevant. In principle, an artificial money supply can be much more stable than a naturally restricted resource such as gold.

In practice, unfortunately, it has not worked out that way.

Artificial money is a political product. Its problems are political problems. It does no one any good to separate economic theory from political reality.

Governments have always had a bad habit of debasing their own monetary systems. Historically, every monetary system in which money creation was a state prerogative has seen debasement. Of course, no one in government is unaware that debasement causes problems, or that it does not create any real value. But it often trades off short-term solutions for long-term problems. The result is an addictive cycle that's hard to escape.

Most governments have figured out that it's a bad idea to just print new money and spend it. Adding new money directly to the government budget spreads it widely across the economy and drives rapid increases in consumer prices. Since government always rests on popular consent, all governments (democratic or not) are concerned with their own popularity. High consumer prices are rarely popular.

There is an English word that used to mean "debasement," whose meaning somehow changed, during a generally unpleasant period in history, to mean "increase in consumer prices," and has since come to mean "increase in consumer prices as measured, through a process whose opacity makes chocolate look transparent, by a nonpartisan agency whose objectivity is above any conceivable question, so of course we won't waste our time questioning it." The word begins with "i" and ends with "n." Because of its interesting political history, I prefer to avoid it.

It should be clear that what determines the value of money, for a completely artificial collectible with

no industrial utility, is the levitation rate: the ratio of savings demand to monetary inventory. Increasing the monetary inventory has a predictable effect on this calculation. Consumer price increases are a symptom; debasement is the problem.

Debasement is always objectively equivalent to taxation. There is no objective difference between confiscating 10% of existing dollar inventory and giving it to X, and printing 11% of existing dollar inventory and giving it to X. The only subjective difference is the inertial psychological attachment to today's dollar prices, and this can easily be reset by renaming and redenominating the currency. Redenomination is generally used to remove embarrassing zeroes - for example, Turkey recently replaced each million old lira with one new lira - but there is no obstacle in principle to a 10% redenomination.

The advantage of debasement over confiscation is entirely in the public relations department. Debasement is the closest thing to the philosopher's stone of government, an invisible tax. In the 20th century, governments made impressive progress toward this old dream. It is no accident that their size and power grew so dramatically as well. If we imagine John F. Kennedy having to raise taxes to fund the space program, or George W. Bush doing the same to occupy Iraq, we imagine a different world.

The immediate political problem with debasement is that it shows up in rising consumer prices, as whoever has received the new money spends it. If we think of all markets as auction markets, like EBay, it should be clear how this happens.

Debasement and investment

We haven't even seen the most pernicious effect of debasement.

Debasement violates the whole point of money: storage of value. As such, it gives savers an incentive to find other assets to store their savings in.

In other words, debasement drives real investment. In a debasing monetary system, savers recognize that holding money is a loser. They look for other assets to buy.

The consensus among Americans today is that monetary savings instruments like passbook accounts, money market funds, or CDs are lame. The real returns are in stocks and housing. [Written in 2006]

When we debasement-adjust for M3, we see the reasons for this. Real non-monetary assets like stocks and housing are the only investments that have a chance of preserving wealth. Purely monetary savings are just losing value.

The financial and real estate industries, of course, love this. But that doesn't mean it's good for the rest of us.

The problem is that stocks and housing are more like condoms than they are like gold. When official currency is not a good store of store value, savings look for another outlet. Stocks and housing become slightly monetized. But the free market, though it cannot create new official currency or new gold, can create new stocks and new housing.

The result is a wave of bubbles with an unfortunate resemblance to our condom example. When stocks are extremely overvalued, as they were in 2000, one sign is a wave of dubious IPOs. When housing is overvalued, we see a rash of new condos. All this is just our old friend, debasement.

This debasement pressure answers one question we asked earlier: why should gold tend to levitate, rather than delevitate? Why is the feedback loop biased in the upward direction?

The answer is just that the same force is acting on gold as on stocks and housing. The market is searching for a new money. It will tend to increase the price of any asset that can store savings.

The difference between precious metals and stocks or housing is just our original thesis. Stocks and housing do not succeed as money. Holding all savings as stocks or housing is not a Nash equilibrium strategy. Holding savings as precious metals, as we've seen, is.

Presumably the market will eventually discover this. In fact, it brings us to our most interesting question: why hasn't it already? Why are precious metals still considered an unusual, fringe investment?

The politics of money

What I'm essentially claiming is that there's no such thing as a gold bubble.

This assertion may surprise people who remember 1980. But markets do not, in general, think. Most investors, even pros who control large pools of money, have a very weak understanding of economics. The version of economics taught in universities has been heavily influenced by political developments over the last century. And your average financial journalist understands finance about the way a cat understands astrophysics.

The result is that historically, the market has had no particular way to distinguish a managed delevitation from an inevitable bubble. Because of Volcker's victory, and the defeat of millions of investors who bet on a dollar collapse, the financial world spent the next twenty years assuming that there was some kind of fundamental cap on the gold price, despite the lack of any logical chain of reasoning that would predict any such thing.

Even now, there is no shortage of pro-gold writers who predict gold at $1000, $2000 or $3000 an ounce, as though they had some formula, like the P/E ratio for stocks, that computed a stable equilibrium at this level. Of course, they do not. They are only expressing their intuitive feeling that gold is very, very cheap right now, and tempering it with the desire to be taken seriously.

Gold's main weapon is one we alluded to already: a sudden, self-reinforcing, and complete collapse of the dollar. In a nutshell, the problem with the dollar is that it's brittle. When Volcker did his thing, the US was a net creditor nation with a balance-of-payments surplus. Its financial system was relatively small and stable. And it had much more control over the economic policies of its trading partners - the political relationship between the US and China is very different from the old US/Japanese tension.

For the Fed, what is really frightening is not a high gold price, but a rapid increase in the gold price. Momentum in gold is the logical precursor to a self-sustaining gold panic. If the US federal

government was a perfectly executed and utterly malevolent conspiracy to dominate the world, let's face it. The world wouldn't stand a chance. In reality, it's neither. So a lot of things happen in the world that Washington doesn't want to see happen, and that it could easily prevent. Anticipating surprises is not its strength. [1]

Holy Cannoli, Batman! I think this is the longest "snip" I've ever used in a post. Nine pages in Word, just for that quote. And I even edited several pages out of it, "to tighten it up!" I hope you enjoyed it.

To recap, a rising gold price is evidence of increasing investment demand, which confirms the belief of those that already invested in gold that it was a good investment. And because investment demand is over and above the relatively stable industrial supply and demand dynamic, any new investment dollars must bid gold away from its current owners. And because saving in gold is a Nash Equilibrium, the price will rise very high. And because gold is THE monetary metal with the highest monetary to industrial use ratio, it will have no reason to fall back when it reaches its top.

And, as ANOTHER said, "So many people worldwide think of it as money, it tends to dry up as the price rises."

Stock, Flow, Supply and Demand

Let's try a little thought experiment and see where it leads us. This might be a bit of a mind bender and a challenge for me to articulate, but what the heck, we're already 11 pages into this thing. Why stop now?

Let's think of all the physical gold in the world in the same terms as our price discovery markets classify the gold they hold secure for private parties. (You do know that the gold for sale does not belong to the exchanges, don't you?) There is that gold which is "eligible" for delivery. And in our experiment this would be all the physical gold in the world. It is ALL "eligible" to be handed to someone else in exchange for something else. (The only requirement for eligibility in our thought experiment being that it is a physical object made of gold.) And then there is the gold that is actually "registered" for delivery. In our case this would be the gold that is up for sale or expected to go up soon.

So "eligible" is the "stock" and "registered" (for delivery) is the "flow," sort of. (Yes, I know that flow would mean the gold coming out of the ground and then being used up in jewelry and electronics if gold was like other commodities, but it's not, so get over it.)

Now what I just wrote is not entirely correct. You cannot simply compare stock to flow like that because they have different measuring units. Flow is measured in units/time and stock is just units. They do not and cannot compare. The only meaningful relationship they have is a ratio. Stock:Flow, or units/(units/time), which = time. This yields us a time value in which the flow will deplete the stock. So "our flow" is the amount of "registered" gold that actually gets delivered in exchange for something over a given time unit.

In the world as a whole, gold has the largest stock to flow ratio of any commodity, which is why it is unique. This means a very high time value for the depletion of gold stocks. In fact, it is an infinite time

value since gold is not consumed, it is merely shuffled around until it ends up with those who value it most. So in our case we'll think of flow as delivery demands actually being met with "registered" stock over a period of time. And in this view, "stock to flow" is a dynamic system that is complicated by many factors.

One complication is that, today, physical and paper gold exist as "stock" at par with each other inside the system. And the flow of paper happens prior to the flow of physical stock (on the price discovery exchanges). In other words, price is discovered in paper and then delivery comes later. Price is not discovered at the physical delivery window. In fact, whether there is any physical at that window when you finally show up with your paper depends on dynamic changes that happened earlier.

As the paper flow precedes the physical flow, the supply and demand dynamics can change very fast, perhaps even so fast as to give the impression that they traveled faster than the speed of light like a tachyon, went back in time, and originated in the past! (Making them impossible to get out in front of!) As demand increases while registered gold is depleted and/or deregistered one of two things must happen. Either the price must skyrocket or the supply of paper must explode to take up the slack.

And as either of these things happen – or they both happen together – we end up with John Law's self-sustaining Misesian regression spiral. Where today's demand is determined by yesterday's performance. (We can call it "the tachyon effect" if you'd like.) This applies to both physical gold and paper gold, and the feedback loop will have separate effects on these separate elements of the market. It will be the cause of the separation and the result will be a flood of paper and no registered gold to service the delivery demand portion of it.

Ultimately the stock to flow ratio of physical gold will go inverse to that of paper gold. Infinite flow demand against zero registered stock. Zero time until physical depletion, concurrent with infinite time until paper depletion. At this point the price will have to go infinite and paper supply will separate because parity will no longer exist.

And in case you haven't noticed, we are now, apparently, at a novel stage in the game. The stage when it is becoming obvious to almost everyone that the Fed can do nothing but print more money (QE), and that it plans to do just that. I draw your attention to gold trading at $1,301 today as evidence! And regarding the Fed, what does a monkey with a hammer do? That's right. It hurts itself.

Being at this stage in the game right now, when clarity is spreading like wildfire, we can expect a further run up in the price of paper gold. Of course the price discovery market buys and sells paper gold so a move in either direction is possible in the short run, but the general trend in gold should now be obvious, even to monkeys. And don't forget that delivery of physical in this market is secondary, and only comes after price discovery occurs in paper.

So with this dynamic situation we find ourselves in, we should expect conflicting signals and responses in the gold market. The flow of gold should increase as demand from dollars pulls on the market. And the supply of gold bullion should be withdrawn or "deregistered" as the people holding it realize their investment belief has been confirmed.

From a demand perspective, flow should increase per the economic law of demand. And from a supply perspective, it should decrease. But how is this possible? Well, this is where price factors into the

dynamics of the situation. In most commodities (and all other markets for that matter) flow would be measured in the weight of the good. "How many ounces are flowing?" But gold is a little different.

Because gold is behaving in this case primarily as a savings instrument, flow can be measured in the amount of savings being exchanged. Just like exchanging dollars for euros. In other words, to properly judge the flow we should look at the aggregate amount of wealth flowing "into" gold rather than the weight of gold changing hands. And in this view, the flow can increase with demand even as the stock is withdrawn. Price takes up the slack. It can even accommodate the shoeshine boy without threatening a top.

But there's another element in this dynamic situation that must be considered. And that is paper gold. As I said, price discovery occurs in paper only, and delivery comes after the fact. So paper supply creation can easily absorb the pressure of increasing demand while relieving price of its "taking up the slack" burden.

However, unless the ratio of physical stock "registered" to become flow rises along with the creation of new paper gold, well, "Houston, we've got a problem." And I'm talking about registered physical stock measured in weight, not value! Which is QUITE a problem!

Fortunately, to quote John Law (not the real one), there is no need to follow this challenging scenario further. Instead, we can just repeat ANOTHER's line once again:

"Gold has always been funny in that way. So many people worldwide think of it as money, it tends to dry up as the price rises."

In economic terms, ANOTHER was referring to gold's price inelasticity of supply here. In other words, gold seems to violate the economic law of supply. As the price rises, the supply dries up.

But another funny thing also happens when gold "tends to dry up as the price rises." Even more people join the "many people worldwide that think of it as money." And this means that gold violates the economic law of demand as well, delivering a positive price elasticity of demand. In other words, gold is a Veblen good. But unlike a Rolls or the Mona Lisa, gold is divisible and fungible making it the Veblen good that puts the common man on equal footing with the Giants!

This is what FOA meant:

In this world we all need much; blessings from above,,,,, family,,,, home,,, friends and good health. But after all that, one must have currency and an enduring, tradable wealth asset that places our footing in life on equal ground with the giants around us,,,,,, gold!

And this is how and why gold WILL accommodate even the shoeshine boy without collapsing!

There is no such thing as a physical gold bubble.

So, to wrap this beleaguered post up, let's just say that we have the distinct makings of a parity break between paper and physical gold in the works. The supply of paper gold must rise while the supply of physical is withdrawing (deregistering). The flow must also rise, at least in nominal terms, so the price

will skyrocket to take up the slack. And as expanding paper competes with a rising price for the "slack taking-up" role, who do you think will win?

Could they each have their way? Could the price rise to take up the extra demand while supply contracts at the same time as easy paper dilution wins itself a lower price? Confused yet?

Well, this situation leaves us with an uncomfortable question. If the only price of gold we know today is the price of paper gold, what is going to happen to "the price of gold?" Will it skyrocket? Or will it plummet?

And if we apply the principles learned in John Law's amazingly long piece in a logical way to this uncomfortable predicament, we'll find ourselves at the conclusion that the true Nash Equilibrium is to take possession of physical gold. And, if you already have some, not to sell it while the price is rising OR falling (this time).

And with the supply of paper gold rising to meet demand while physical is being withdrawn, the only conclusion we can come to is that the gold buyers **IN SIZE** will have to stop buying from the price discovery marketplace because, if they do their due diligence, they'll clearly see that subsequent physical delivery has become impossible at the present price.

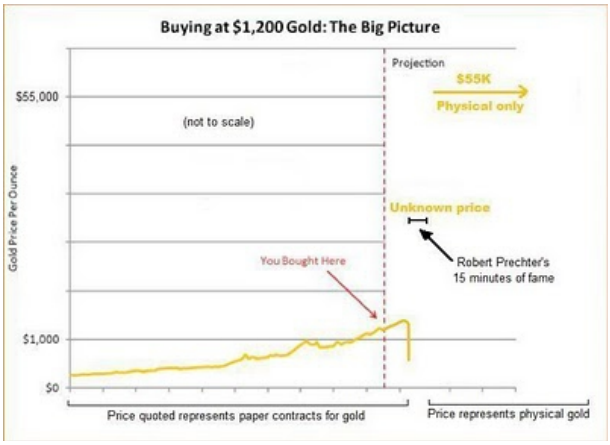
So, in conclusion, the price of gold will plummet!

That's right. At some point in the future, after the price of gold rockets upward, it will fall like a box of rocks! And right about that time you'll see more of Robert Prechter on CNBC than you ever thought was possible.

But here's the challenge. When the price of gold falls to $200 per ounce, try and get some physical. I'm sure that Kitco will sell you some from their pooled account. And GLD will be standing ready to sell you a share at $20. But just try to take delivery. I think you'll find it will be impossible at that point.

And that's why you've got to take delivery NOW, at the current "high" price of $1,300. Don't wait for the dip. Oh, yeah, the big dip is definitely coming. A **BIG** "correction." But will there be any physical available? Perhaps at $1,200 if you're really lucky. At $200? No way.

When I look into MY crystal ball, here is how I see a future gold price chart developing (roughly, of course):



And with that, I'll leave you with my replies to the email at the top:

My reply to email 1:
Is this an orderly bull market in paper gold or physical gold?

The bubble that "WILL come"... will it be in paper gold or physical gold?

Is there a difference between paper gold and physical gold?

Is your chart showing paper gold or physical gold?

My reply to email 2:
*You may be right on stage 2. But my gut says that stage 3 is when it's obvious everyone's flooding into gold and the real physical **IN SIZE** decides its best move is to withdraw from delivery registration. At that point the paper market won't be able to handle the flood.*

*My bet, when the shoeshine boy tells you to buy gold he'll be talking about small gold coins **only**. GLD probably won't even exist anymore. And in this unique historical case, the shoeshine boy will not be the bad omen of a bubble top mania phase, but he will instead be the amazing bell-ringer of a new era. One in which even shoeshine boys can save their surplus wealth in gold. One I like to call Freegold. Because a physical-only gold market can actually handle everyone PLUS the shoeshine boy, unlike <u>any</u> other market.*

Sincerely,
FOFOA

[1] From Why the Global Financial System is About to Collapse
by John Law
Edited by me for length and content.

Wednesday, August 25, 2010

Credibility Inflation

Here's a neat little concept that FOA introduced briefly in 1999. I think it explains a lot about the inflation, deflation, hyperinflation debate when it finally sinks in that this is where all the money went for the past 30 years: into inflating the credibility of the $IMFS far beyond the underlying reality. And yes, it has a direct impact on the Freegold revaluation as well. So here I will try to expound on this enlightening concept just a bit.

The Setup

Part of the reason the rest of the world did not abandon the dollar in 1971 was that the rate of economic expansion flowing from Middle Eastern oil cheaply priced in U.S. dollars was already exceeding the expansion rate of the money supply. So the switch from a semi-gold-(con)strained monetary system to a much more expandable "balance sheet money system" as I like to call it — or another name I like is "purely symbolic monetary system" — allowed for the non-deflationary addition of many new "quality of life" gadgets, widgets and shipping lanes that the world had never before imagined.

For the next three or four decades we would be able to comfortably afford the new introduction of Betamax VCR's, microwave ovens in every home, personal computers, DynaTAC cell phones, camcorders, digital cameras, LaserDiscs, Compact Discs, DVD's, MP3's, and on and on. Eventually, all of these wonderful products would be built cheaper by someone else on the other side of the world and shipped to us cheaply using the oil purchased from the Middle East with easily available U.S. dollars.

Sony BetaMax®

The reason I like the term "balance sheet money" is that whenever there is a need for more dollars they can be easily gotten from any bank's balance sheet. The dollars don't have to be there in the bank. You simply jot down the "need" for them on one side of the balance sheet and the dollars magically appear on the other side. Presto!

Of course once that "need" (demand) is supplied, the balance sheet must then be serviced with interest. But the thing about easy money is that you can always borrow new to service the old. In the previous system (con)strained by its parity fixation to the U.S. Treasury's limited supply of gold all these wonderful life-enhancing advances would have put a deflationary pressure on the dollar.

What this means is that when all these new products came to market, the dollars we needed to purchase them would have become more and more precious with each new widget that came to market. The cost to borrow dollars to buy a new BMC-100P or DynaTAC-8000 would have been prohibitive. And even if you did borrow the money, the service of that debt would have grown more and more burdensome over the life of the loan as dollars became ever more precious.

This deflationary dynamic would have stifled the global economic growth rate and confined it to only reasonable risk-taking. Which is part of the reason the foreign central banks, represented by the BIS, did not lobby the U.S. to officially devalue the dollar against its Treasury gold in 1971.

Rather than closing the gold window, the U.S. could have, for example, raised the price of gold to $200 and kept the system going for another 30 or 40 years. A move like this would have been the mathematical equivalent of increasing the Treasury's physical stockpile 5X to double what it was at the height of the Bretton Woods experiment.

But while that would have satiated the monetary transgressions of the past, it would have done little for the future. It would not have substantially changed the system to one of easy money. It would only have extended the old system of hard money.

BMC-100P - The first camcorder

It was reasoned at that time that more than just the ridiculous price of gold being broken, the *system itself* was broken, and needed a global finance structural change. So the international consensus was to let the U.S. default outright on its gold obligations rather than lobbying for a revaluation of its gold at a new fixed rate. But then continue using the dollar anyway, as long as relatively cheap oil could be gotten for dollars.

And with this decision, the stage was set for a renewed global (Western?) economic growth spurt, much like after the end of WWII. Only this time, the value lost through the non-delivery of U.S. Treasury gold would be more than replaced by the value oil brought to the new world economy, especially with first-of-a-kind products like Pong, released for the Christmas season in 1975.

Pong™ - The first video game

Even at the higher oil prices of the 1970's, the economic demand for oil proved to be a far superior "backing" to the dollar than the depleting Treasury gold had been. And in a certain (limited) sense, the world got its first small taste of Freegold in the 1970's.

But as gold's price began freely rising in the global marketplace, the old alarm bells went off in the dollar's management office. The dollar, which had always been viewed at par with gold, was now seen

to be falling as gold soared. So during the mid to late 70's the U.S. Treasury and the IMF held a series of gold auctions to flood the market and quell the perceived danger. But by 1979 the demand for gold was so overwhelming that the auctions had to be stopped.

Through '78 and '79 the dollar *plunged* against foreign currencies, and in July of 1979 a desperate Jimmy Carter appointed the tough New York Fed President Paul Volker to head the "deeply divided, inexperienced, soft and indecisive" Federal Reserve Board. Then in early October of that year, while attending an IMF meeting in Belgrade, Yugoslavia, Volcker received "stern recommendations" from his European counterparts that something big had to be done immediately to stop the dollar's fall. The general fear at that meeting was that the global financial system was on the verge of collapse.

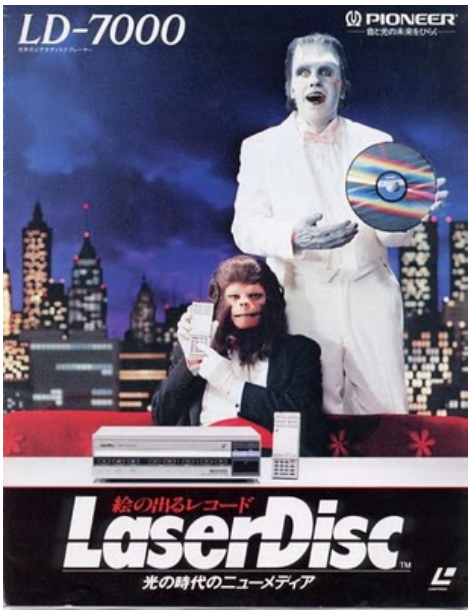
TRS80 (Pronounced "Trash Eighty")

Returning to the U.S. on October 6, Volcker called a secret emergency meeting in which he announced a major change in Fed monetary policy. The Fed would switch from controlling interest rates through the Fed Funds rate to directly controlling the money supply through bank reserves. One of the side effects of this sharp policy change was that interest rates would now be governed by the marketplace rather than the Fed. The Fed did still raise its discount rate from 11% to 12%, but then the market took the Prime Rate up to 20% within 6 months where it mostly stayed for the next year and a half.

It was later observed that Volcker's 1979 policy change was the most significant change in Fed policy since 1932, when in the middle of the Great Depression the Fed abandoned its "real bills doctrine" and started massive open market purchases of government bonds.

In early 1980, Volcker's new Fed policy began to bite. As interest rates rose, the Dollar first slowed its descent, then stopped falling, and then began to rise. Both the public and the investment community which had stampeded into Gold were lured back into paper by this huge rise in interest rates – and by the prospect of a higher U.S. Dollar.

LaserDisc™



Many facets went into this change in investment attitude, but one concrete change in the U.S. financial system was the most telling. Way back in March 1971, four months before Nixon closed the Gold window, the "permanent" U.S. debt ceiling had been frozen at $400 Billion. By late 1982, U.S. funded debt had tripled to about $1.25 TRILLION. But the "permanent" debt ceiling still stood at $400 Billion. All the debt ceiling rises since 1971 had been officially designated as "temporary!" In late 1982, realizing that this charade could not be continued, The U.S. Treasury eliminated the "difference" between the "temporary" and the "permanent" debt ceiling.

The way was cleared for the subsequent explosion in U.S. debt. With the U.S. being the world's "reserve currency," the way was in fact cleared for a debt explosion right around the world. It was also cleared for five of the biggest bull markets in history.

The global stock market boom of 1982-87
The Japanese stock market/real estate boom of 1988-90
The Dow (and then Nasdaq) led boom - late 1994 to March/April 2000
The great global real estate boom of 2002-06
The global stock market revival of 2006-07 [1]

DynaTAC-8000

And thus, in 1980, began the modern era of Credibility Inflation.

Salting the Mine

Most simply stated, credibility inflation is the expanding confidence in the fiat financial system to always deliver a higher payoff tomorrow than today. And through credibility inflation we ultimately destroy the currency structure by believing it can somehow deliver more than reality will allow.

Credibility inflation is the exact antithesis of price inflations like the 1970's. It is why we saw low consumer price inflation for the last 30 years relative to the massive monetary and financial product inflation. It is partly why we saw gold stagnant or falling for 20 years. Yet it is just as much a product of monetary inflation as regular price inflation is (more on this in a moment). And it is much more catastrophic in the end.

Periods of high credibility inflation are generally *not* followed by smooth cycles of credibility DEflation. Instead, they tend to SNAP BACK into sudden **real price inflation** when confidence abates. What happens in the most extreme cases is real price HYPERinflation.

This is one of the main concepts deflationists and mainstream economists completely miss; the SNAP-BACK of credibility inflation that can instantly take down their precious fiat currency. And it is their intentional avoidance of this obvious concept that delivers aid and comfort to masterprinters like Gideon Gono and Ben Bernanke.

When people try to protect their assets against the effects of fiat money, what are they really fighting against? The first inclination is to say "rising prices." Yet it's much more than that! Most everyone agrees that the interest rate paid by the banks never covers the loss of buying power brought on by price inflation. Especially the "after tax" return. It's the same old story, played out decade after decade. We must "invest our savings" (or become a day trader?) because the money will erode in value! Even at 3%, price inflation can eat away at any cash equivalents.

But, price inflation isn't the only story that impacts us. Rising prices come and go, but money inflation continues to affect us without fail. So why do people feel better when price increases slow or stop, even as money inflation runs ever upward? The good feelings usually evolve from the effects that money inflation (increases in the money supply) has on financial instruments. These assets take on the very

same characteristic that the rising prices of goods once exhibited. They run up in currency price.

During these periods of "less goods inflation" another sinister form of mindset lurks in the shadows. Credibility inflation! Yes, it has been here many times before as every fiat currency alternates its effects upon the feelings of the populace.

Fiat currencies must, by definition, always expand in quantity. Their continued usage and acceptance is always obtained with the bribe of "more wealth to come!" Without that bribe, humans would never fall for holding a debt to receive the same goods in the future if they could get the real thing today. Human nature has always dictated that we buy what we need now instead of holding someone's IOU to receive it later. That nature is only changed through the "greed to obtain more." Like this: "I'll hold my wealth in dollars as long as my assets are going up. Later those increased assets will buy me a better lifestyle as I purchase more goods and services than I could buy now."

This is the hidden dynamic we see today. Just as destructive as "goods price increases," "credibility inflation" impacts our emotions to "hold on for the future, more is coming!" In every way, "credibility inflation" is just as much a product of an increase in the money stock as "regular price inflation" is. As cash money streams out to cover any and all financial failures, we begin to attach an ever higher credibility to the continued function of the fiat system. In effect, the more money that is printed, the higher we price the credibility factor. [2]

Selling the Salted Mine

Is this not where we are today? Interest rates – and with them, bond valuations – have run their 30 year course from 20% down to 0%. The credibility of paper assets has taken at least three severe beatings in the last decade. And now, to simply slow the acceleration of credibility DEflation, every manner of bailout and market rigging is being employed, practically in broad daylight. And this on the assumption that the global flock of sheep will only watch the numbers, not the men making them or the underlying economy from which they spring.

GDP is one of the great deceivers in the fiat money world. During the last century (??) or so, some form of GDP has always been used to measure the great mass of human endeavors. Yet, throughout this time, some form of fiat currency has always been in effect. Even during the Gold standard, fractional reserve banking expanded "gold note money" more so than the "gold money" in existence. Prior to 1929 this effect, if not creating outright "price inflation" during a time of Gold standard policy, was creating "credibility inflation" in the minds of investors. Using the backdrop of a growing GDP, people bought into inflating financial assets and ignored these signals as evidence that the fractional currency system was failing. Even though the dollar contained a policy statement to supply gold, back then a gold loan was still only good until everyone asked for gold.

The same thing is happening today. People destroy the currency structure by thinking it can deliver more than reality will allow. Instead of all debt failing slowly with each upward march of price inflation, prolonged "credibility inflation" snaps all at once as investors try to suddenly revert to a "buy now mentality." The inability of government authorities to contain the fiction of "good debt" is usually the feature behind the investor mood change. The "snap back" into a sudden "real price inflation situation" caused during this stage by a currency failure always breaks the whole structure. We approach this end today!

The GDP has been the relative gauge to mark all other measurements against. Even so, its numbers reflect little more than the result of an "expanding fiat money supply." Yes, there have been recorded downturns in GDP, but these contractions would have been worse if measured in real (gold) money. In opposite fashion, expansions paint a much brighter picture as all financial liabilities seem less a threat if held against a rising GDP. I submit that the GDP figures offer little more than a way to entice investors to increase their "credibility image" of our monetary system. Fiat moneys are always on a long term upward expansion, and they can hardly do less than bloat the picture.

Someone I know once said; "your wealth is not what your money say it is!"

A great historical example of credibility inflation with parallels to our present financial and monetary system was the system in France under the direction of the esteemed Scottish economist, John Law. In 1716 Law established the first French central bank, the Banque Générale, which was later nationalized and renamed the Banque Royale. Law used the Banque to introduce paper money in France.

Simultaneously, Law aggregated the trading companies in the French colony of Louisiana into a singular monopoly under the name "Company of the Indies" and sold shares of this company back in France. Law exaggerated the prospects of the company so well that he was actually appointed Controller General of Finances (essentially the first French Central Banker) by Philippe d'Orléans and given the official job of pumping this stock. In a way, John Law was kind of like the "Jim Cramer meets Larry Summers" of his time.

Wild speculation on the shares of the Company of the Indies led to the Banque Royale issuing more and more paper money to fund the monetary demands of the buying frenzy. And the "company profits" owed to the shareholders were also paid in fresh paper money. John Law's credibility was being entirely financed by his printing press.

Then, in late 1720, opponents of John Law's paper money attempted en masse to exchange their paper notes for gold. This forced the Banque Royale to cease physical gold "delivery," declare the essence of "force majeure" (which incidentally is a French term from French law), and admit it had issued much more paper than it had in gold. Both the Company stock value and the paper money itself plunged, ultimately to worthlessness. The monetary system in France was revamped six years later, but by the end of 1720 John Law had been disgraced, relieved of his official job, and had to flee France a poor man. He died in poverty nine years later.

Trading Salted Mines

One observation we can make is that in the long-line cycles of monetary history, technical (momentum) trading emerges in the very late stages of cycles in its most frenetic fashion. This is when it draws the most people into the unproductive activity of trading for trading's sake. And this is when it draws in the greatest profits, right before it delivers a catastrophic total loss.

In the early stages of these long-line cycles the greatest profits in society come from productive enterprises like building large companies from the ground up. But in the very late stages the greatest profits seem to come from paper churning and speculation in things that were previously traded mostly on fundamentals, based on actual, physical use.

We can see this in the famous bubbles like the tulip bubble, the Mississippi bubble, the South Seas bubble, the dot com bubble and the housing bubble. But it also occurs at the end of currency cycles. History is full of stories of traders frantically trying to trade out of their positions at the end of long-line cycles, while the currency burns around them. Look at any list of historic hyperinflations to find examples.

The modern version of this late-stage trading fad is most prevalent in the West, because that is where modern currency flows into financial assets at the highest rate relative to their real world, physical counterparts. For example, Western paper gold traders look to the seasonal preferences of Eastern physical gold users to plan their buys and sells. The Asian harvest season, after which farmers invest some of their year's surplus income in gold is closely watched by Western traders. As is the Indian wedding season where every year Indian brides are adorned with physical gold.

Western paper gold traders love front-running these Eastern gold-buying seasons. Recall ANOTHER's comment on this from my last post:

Everyone knows that western minds don't like or want gold, but if they think you like it they will trade it up in price for the sake of "sticking it to you." Enter the world of "paper gold."

This paper trading mentality works really well right up until the moment it doesn't. And that's when it can deliver a total loss. I sometimes wonder if it should even be considered a profitable activity when a split second of fundamental phase transition can take away a decade of technical trading profits. Or the inverse, when the price of a fundamental misjudgment can be the opportunity cost of generations' worth of wealth. In a way, this is the hard question Freegold poses.

Getting Out Before the Collapse

Above I mentioned that the snap-back effect when a fiat currency loses its credibility (hyperinflation) is one of the obvious concepts intentionally ignored by deflationists and mainstream economists alike. Another obvious concept they remain oblivious to is that the two primary functions of money are in no way necessarily tied together. Those two functions being: "medium of exchange" and "store of value." Just because we have suffered their apparent fixation for centuries, they are most definitely not fixed by nature.

As long as you have the freedom to spend your money – the freedom to spend the fruits of your labor, which exists everywhere outside of outright whips-and-chains slavery – you have the choice of how to save your money. If you can spend your money then you can save your wealth in something other than money.

This is the essence of Freegold.

A medium of exchange need only have value in its usage (trade clearing) function. It can quickly lose all value when it is no longer used. This long-forgotten principle can be easily comprehended in Antal E. Fekete's "A 'fairy' tale" which I used in The 100 Year Clearing:

> A 'fairy' tale

> Let us look at another historical instance of clearing that was vitally important in the Middle Ages: the institution of city fairs. The most notable ones were the annual fairs of Lyon in France, and Seville in Spain. They lasted up to a month and attracted fair-goers from places as far as 500 miles away. People brought their merchandise to sell, and a shopping list of merchandise to buy. One thing they did not bring was gold coins. They hoped to pay for their purchases with the proceeds of their sales. This presented the problem that one had to sell before one could buy, but the amount of gold coins available at the fair was far smaller than the amount of merchandise to sell. Fairs would have been a total failure but for the institution of clearing. Buying one merchandise while, or even before, selling another could be consummated perfectly well without the physical mediation of the gold coin. Naturally, gold was needed to finalize the deals at the end of the fair, but only to the extent of the difference between the amount of purchases and sales. In the meantime, purchases and sales were made through the use of scrip money issued by the clearing house to fair-goers when they registered their merchandise upon arrival.
>
> Those who would call scrip money "credit created out of nothing" were utterly blind to the true nature of the transaction. Fairgoers did not need a loan. What they needed, and got, was an instrument of clearing: the scrip, representing self-liquidating credit.

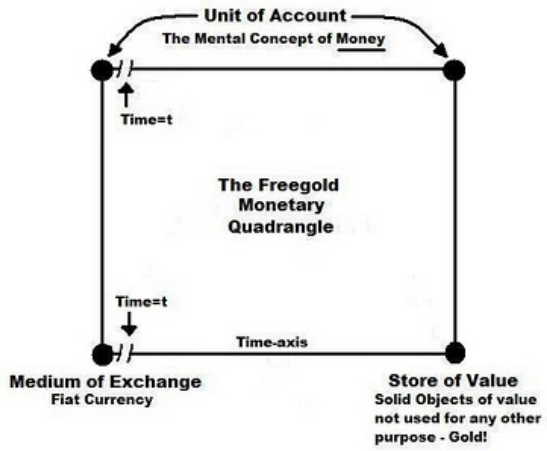
In this example the scrip money at the fair had value only through its use at the fair, not intrinsic in itself. After the fair, if you ended up with a trade surplus (extra scrip money), you turned in your medium of exchange for gold coins, the tradable store of value at the time. Can you imagine how this concept could work in a fair that's open for business 24/7/365?

So how can we possibly have one thing as a medium of exchange and something else as the store of value in our modern world? Has this ever been tried before in recent times? Of course it has! We have been doing it all along!! But the problems that ultimately come arise from those stores of value that are denominated in, and tied to, the durability of the scrip money, the medium of exchange.

Once upon a time, when the medium of exchange was physical gold coin, it was very durable. And stores of value denominated in that durable medium of exchange, denominated in gold, were quite durable for a time. But through the gold standards of the past century that "paper denominated in gold" became the medium of exchange. And now gold will once again become the store of value.

You see, these two monetary functions play off each other in a see-saw fashion. As "assets" (claims really) denominated in the medium of exchange fail and collapse, true physical "store of value" assets alternately rise to the occasion. It is only our ingrained misconception that both monetary functions must be somehow fixed at parity with each other that leads us to foolish ends. And understand also that the Giants of this world know better.

The Freegold Monetary Quadrangle – Explained in Gold is Money - Part 3



Today all governments of the world hold only two assets in reserve, meaning "for a rainy day." They hold claims against counterparties denominated in the medium of exchange and they hold gold, the store of value. And some of the more forward-thinking governments are already floating their gold reserves on the books, for all to see.

Now, the claims held in reserve have two vulnerabilities; the solvency of the counterparties and the durability of the scrip they are denominated in. Of course new scrip can be easily conjured on the national balance sheet to keep the counterparties technically solvent so most assuredly it will be the scrip itself that fails. The gold in reserve, on the other hand, has no counterparty and plenty of durability. So what monetary asset do you think will rise to fill the global monetary reserve void when the scrip finally fails? Palladium?

Bear in mind too that these Giant balance sheets can move the price (value) of gold more in a split second than all of us could in a lifetime of buying. And with any such tectonic shift in the importance of gold on international balance sheets, you can say goodbye to the fractionally reserved commodity (paper) gold trading arena and anything remotely associated with it.

The Collapse of the Salted Mine – Hyperinflation

First of all I would like to clear up probably the most common misconception about hyperinflation. What most people believe is that massive printing of base money (new cash) leads to hyperinflation. No, it's the other way around. Hyperinflation leads to the massive printing of base money (new cash).

Hyperinflation, in most people minds, conjures images of trillion dollar Zimbabwe notes. But this image is simply the government's reflexive response to the onset of hyperinflation, which is actually the loss of confidence in the currency. First comes the loss of confidence (hyperinflation), then, and only then, comes the massive printing to keep the government and its obligations afloat.

And what sets the stage for hyperinflation is a period of high credibility inflation followed by the loss of credibility. During our period of high credibility inflation the dollar was invisibly hyperinflated in a near-monetary sense. This has already happened. We are already there.

When I say the dollar has already hyperinflated in a near-monetary sense, I am talking about the number of dollars people, entities and even foreign nations *think* they have in reserve. Not in a shoebox, but in contractual promises of dollars to be delivered more or less on demand by somebody else. Claims denominated in dollars. This is how the vast majority of "dollars" are held; as promises to deliver more dollars. And this is *why* they are held this way. Because of the *more* in "more dollars." "Let me spend your dollars today and I will give you *more* dollars tomorrow!"

The Credibility Waterfall

I think it is fair to say that we have finished our 30-year run of high credibility inflation and we are now in the early stages of credibility deflation. The real question now is, can the credibility of the financial system deflate without tripping a breaker, without causing a credibility waterfall in the currency in which it is denominated?

The difference between today and a few years ago is that a few years ago credibility inflation was being fed by private credit (debt) expansion. Asset values, like homes, were being sustained and driven higher with the arrival of new marks. But today the Ponzi cycle of credibility inflation has peaked, there are no more new marks, and its decline is being managed centrally with the government expansion of new base money to conceal the failures one at a time.

And as in any Ponzi scheme there comes a point when redemptions can no longer be financed by new marks. I think the tipping point of credibility must come once it is clear that Bernie Madoff, I mean Uncle Sam is writing redemption checks that can never be cashed. The point is, **we are already past the tipping point.** So timing isn't really a question anymore. The credibility waterfall has already happened. But somehow we still have early marks continuing to stockpile rubber checks as if they are

worth something. Does this mean credibility still exists? I think not.

I suppose this begs the question, is all that dollar debt out there in the world really worth anything anymore? If you answer yes simply because you cashed some of it in today for new underwear, then I say you didn't answer the question. The question is, is all that dollar debt out there in the world really worth anything anymore? The answer is no, it is not. Only at the margin, where you reside, can it still be cashed in for new underwear. But in aggregate, it is worthless, even today.

And then the next logical question should be, what is gold really worth today? If you answered $1,240 per ounce simply because you bought a gold Eagle today for $1,240, then I say you didn't answer the question. The question is, what is gold REALLY worth today? And the answer is it is priceless, but probably could be had in extremely large volumes for somewhere between $10,000 and $50,000 per ounce. (How much physical gold could China realistically get today if it tried to cash in $2T in debt paper for gold? At today's price it could get more than 50,000 tonnes, but only if that's the real value of gold.)

Only at the margin, where you reside, can physical gold still be had for $1,240 per ounce. But in aggregate, in the vaults of the world's central banks as the only reserve asset not tied to the medium of exchange, it is priceless, in the truest sense of the word.

My advice: Get as much of this priceless reserve asset as you can while it's still going for $1,240 at the margin. Seems like a bargain to me.

Sincerely,
FOFOA

[1] Brown text from The Early Gold Wars by Bill Buckler, The Privateer
[2] Blue text written by FOA in 1999

The story of oil, gold and money: More Than Meets the Eye

By “Aristotle” Written in 1999

Part 1 --- Storm clouds gather...

The estimable economist Milton Friedman stated his forgettable opinion in 1974 that OPEC would collapse and oil would never get up to $10 per barrel. In all fairness to Professor Friedman, we must recognize his position as coming from a staunch monetarist, emphasizing money supply as the "true religion" for the Federal Reserve to keep the US Dollar as good as gold. At times, he half-seriously argued for the abolition of the Federal Reserve in light of the simple monetary policy guidelines that could serve in its stead, with the economy returning to a state of self-regulation. (In the past sound-money days, economic hardships were far from unnatural, and they were not necessarily attributable to acts of government. However, modern attempts to centrally manage the economy ensure that any blame for systemic difficulties today may be clearly laid at government's feet.)

Milton's mistake was two-fold. First was his knowledge that Arabian oil could be produced for one dime of real money, and that inevitable competition among OPEC members would surely keep the price close to cost of production. Second, and most importantly, Milton failed to account for the possibility that the government would abandon such reasonable monetary management to keep the dollar nearly as good as Gold. This fact was NOT lost, however, on the oil producing countries. Ask yourself, what would YOU do if your business or trading partners suddenly started offering you payment with Monopoly money instead of "real" money? Would you shun real money as though it were the plague, and embrace Monopoly money as the greatest thing since sliced bread? If you would, then I have got a job for you!! Bring your shovel and some work-clothes; you have been hired for life...

Upon the 1971 declaration by the United States that redemption of dollars for Gold would be terminated, the entities in receipt of dollars for balance of trade settlements had no difficulty recognizing this as an outright default on payment contracts. The scramble was on to make sense of this new payment system in which the dollar was no longer a THING of value (a small amount of Gold), but was now reduced to a CONCEPT of value; an undefined unit with which the world would denominate the amount of value in contracts for goods and services. The problem ever since has been in coming to terms with the meaning of value for this shifting and undefined unit, and its vulnerability for mismanagement and abuse.

Jelle Zijlstra, who became head of the Bank for International Settlements, said while with the Bank of the Netherlands in regard to the 1971 severing of Gold from the dollar, "When *we left the pound, we could go to the dollar. But where could we go from the dollar? To the moon?"*

As I continue this tale, I hope it becomes clear that not only have we gone to the moon, but that Gold is going there also.

Part 2 --- A Transition: Things Are what they Are...

Do you see the world as it is? Or, do you see the world as you are? A tough obstacle, to be sure, as our experiences weigh heavily on our perceptions, and many people have no practical earthly experience with real money. There is hope..."the Truth is out there!" as a popular show is quick to proclaim. Albert Einstein puts an interesting slant on this theme: "My religion consists of a humble admiration of the illimitable superior spirit who reveals himself in the slight details we are able to perceive with our frail and feeble mind."

So with a ready admission our minds are frail and feeble, let's prepare to tackle something so

ponderous it must hopelessly remain an abstraction to us mere mortals. I refer to the U.S. national debt, expressed in dollars, that stands at 5.6 trillion. Wow! What does that really mean? To put it in some perspective, we will revisit the 1970's, and try to get our arms (and feeble minds) around some much smaller numbers, and yet numbers that themselves are large enough to be abstractions. Let's examine the incredible and overwhelming wealth and economics of oil.

Imagine having claim to a sandy and barren land that reaches 120 degrees Fahrenheit in summer, making your living through the ages on goats, dates and Pilgrims to Mecca. Not a posh existence when compared to America in the Roaring 1920's, but the passage of time reveals the fortunate few that were in the right place at the right time. When the Standard Oil Company of California was granted an exploration concession for Saudi Arabia in 1928, the 35,000 Gold sovereigns paid by SoCal were reportedly counted by Sheik Abdullah Sulaiman himself. Wispy shades of things to come! This can be thought of similarly to how you might view a collection of skinny stock investors who found themselves heavily invested in penny internet stocks when the technology market exploded in the 1990, making them all millionaires. Except this: Oil is much, much bigger! We will soon examine what it means to be in the right place at the right time.

I will talk about pricing and balance of trade in the next part...stay tuned for the biggest transfer of wealth the world has ever seen. The key-currency gets debased in 1971, and Gresham's Law rules the land.

Part 3 --- It's Only (a mountain of) "Money"...

Having purchased this Saudi Arabian concession, in subsequent drilling Socal's Damman Number 7 struck oil in 1937 (I believe old Number Seven is still flowing.) SoCal partnered with Exxon, Mobil, and Texaco to form the Arabian- American Oil Company. Over a thirty year period, Aramco discovered petroleum reserves in Saudi Arabia in excess of 180 billion barrels...a quarter of the known reserves of the planet at that time. And as the world aged and changed, the amount of oil consumed daily in world trade climbed dramatically, from 3.7 million barrels per day (mbpd) in 1950, to 9.0 mbpd in 1960, to 25.6 mbpd in 1970, to 34.2 million barrels per day in 1973 during the first Oil Crisis.

Consider this for better perspective: the average yield per well at the end of the 70's in the United States was 17 barrels per day per well, in Venezuela (one of the co- founders of OPEC) it was 186 barrels per day per well, and in Saudi Arabia (the other OPEC co-founder) it was 12,405 barrels each day per well. Wow! Just imagine if the internet companies today issued new, additional shares each day at this same rate as oil consumption...the stock price would plummet! But unlike internet stocks, because this oil is consumed, it must be replaced (and paid for) every single day.

But before I can move into the fascinating region of this miniseries that sheds light on how and why the Gold market is as it is today, this background is vital, so please bear with me, and I shall thank you for your patience. Oftentimes, understanding is its own reward, but in this case it may well prove essential for wealth preservation at a minimum. To begin, we must look at life in these United States (and in the process we will see a compelling reason that import barriers must be fought tooth and nail)...

What does the Texas Railroad Commission have to do with this story? Plenty. So much oil was being produced in Texas in the 1930's that engineers were concerned about depletion and wastage, and the owners would fret over the effects of oversupply that would at times bring the price per barrel down to ten cents. Tiny independent producers were often drilling side by side with the majors, but when the price slumped their profitability suffered more because they didn't have income

from the downstream processes like the majors did. Because some of the individuals operating these

independent companies happened to be multimillionaires, their complaining voices were heard thanks to their political contributions.

The state government responded by giving the Texas Railroad commission the power to regulate drilling. And while they didn't have the authority to set prices, they could regulate production levels. By setting an appropriate rate of production, oil would be conserved and this restricted supply would achieve price levels high enough to keep the independents in gravy. This Texas price became the American price, and also the world price (in the 1950's the U.S. was producing half of the world's oil.) This meant pure profit for the major companies with overseas production that cost only ten cents per barrel. To keep the price of oil up, what started as a gentlemen's agreement among the American oil companies to limit the imports of cheaper oil later became enforced by the U.S. government--known as the "invisible dike" against the outside world of cheap oil. Throughout the 1960's, the Persian Gulf offered the world oil at $1.80, while inside the "invisible dike" oil was being sold to the nation at the Texas price of $3.45 per barrel by the end of the decade.

The great irony is that a Venezuelan lawyer (and oil minister) named Juan Pablo Perez Alfonso studied and used the Texas Railroad Commission as his model for OPEC, which he co-founded with the Saudi Arabian director of the Office of Petroleum Affairs, Abdullah Tariki, in 1960. OPEC from the beginning maintained that oil was a depleting asset, and it had to be replaced by other assets to balance national budgets and fund developments.

Now that we know a bit about the producers and the price and cost of oil during the era of "real money," let us take a look at the dollar itself. The dollar and the world was pegged to Gold via the post-WWII Bretton Woods agreement in which $35 was convertible to one ounce--but for foreigners only, not U.S. citizens. The rate for international currency exchange was coordinated through the International Monetary Fund (IMF), with each currency pegged to each other through the dollar and Gold. The U.S. economy steamed along nicely in the 1950's, producing half of the world's oil as I've already stated, and half of the cars that burned up this oil. By the arrival of the 1960's, American industry was buying foreign factories, equipment and raw materials. In addition, the government was spending for its foreign bases and troops, and Vietnam was funded largely in the red.

An overhang of dollars was developing overseas--and while at first the foreigners

were reassured that the Gold guarantee of the dollar was solid, as ever more dollars piled up, ever more of them cashed in the dollars for Gold. General de Gaulle summed up the sentiment, saying that America had "an exorbitant privilege" in ownership of the key-currency. By that he meant that the dollars America was able to issue via simple printing carried the same value in trade as the dollars that had to be earned by other nations through meaningful productivity. It quickly became clear that too many claims had been issued on the limited Gold, and President Nixon was prompted to close the Gold exchange window in the face of a certain run on the Treasury.

In a quick repeat from Part 1: " Upon the 1971 declaration by the United States that redemption of dollars for Gold would be terminated, the entities in receipt of dollars for balance of trade settlements had no difficulty recognizing this as an outright default on payment contracts. The scramble was on to make sense of this new payment system in which the dollar was no longer a THING of value (a small amount of Gold), but was now reduced to a CONCEPT of value; an undefined unit with which the world would denominate the amount of value in contracts for goods and services. The problem ever since has been in coming to terms with the meaning of value for this shifting and undefined unit, and its vulnerability for mismanagement and abuse."

With OPEC in place, and the dollar now rendered meaningless by traditional standards, the stage is

adequately set to describe what followed. With OPEC now united and able to conserve, and threaten to cut back in the grand tradition of the Texas Railroad Commission, they were able to name their terms of payment, and decide essentially what value the dollar would have in oil terms. That is important enough to repeat: **They were able to name their terms of payment, and decide essentially what value the dollar would have in oil terms.** The increased world demand for oil ensured that the price would be met (Texas was pumping around the clock and still coming up short), and the printing presses essentially ensured that there would be no lack of dollars, so to speak.

It is important here to realize the attitude of OPEC, and notably the Middle East. In the mid 1970's, the finance ministers of both Kuwait and Saudi Arabia stressed that their needs were only to provide for the welfare of their citizens, and that oil in the ground is better than paper money. Who from the West can argue with that? They called our money's bluff, fair and square. So in 1971, while the Texas price of oil was $3.45, OPEC re-priced their Middle Eastern oil up from $1.80 to $2.20 (such audacity, don't you think?) only to see the market price due to demand in 1973 overtake the official posted price, at which point OPEC saw the writing on the

wall, and in October raised the price per barrel to $5.12 while curbing production. By December, the Shah of Iran called a press conference to announce the official price would now be $11.65. Well, why not? It's only paper to you if you are not in NEED of this currency through a debt to someone else. And so began the First Oil Crisis of the 1970's.

Just as America had been issuing claim checks on the national Gold throughout the 1960's, its spending habits didn't change with the advent of the all-paper dollar. As a consequence, the world's greatest transfer of wealth was underway. Watching the rising cost of real estate became a national pastime in the 1970's--an odd distraction from the gas lines and cost of fuel. By raising the price of oil $10, from $1.80 to $11.65, at those current production levels OPEC raised its annual revenues by approximately 100 billion dollars. Now recall from Part 2 where I promised you we would tackle some large numbers, though nowhere near as incomprehensible as the $5.6 trillion U.S. debt. Here we go...

How much IS 100 billion dollars per year? It can't be much, because we all know the Middle East is heavily in debt with struggling economies even now at the end of the 1990's. Right? Well, I invite you to follow along, and judge for yourself. Let's try to spend that $100 billion, and remember...it is 1974. And let's not waste time on small stuff; we'll go right for the big ticket toys.

How about some F-14's? Fully equipped (minus missiles because we are a peaceful bunch) they are ours for $9 million each. Grumman on Long Island assembles 80 each year. Hell, let's take 'em all for $720 million. How about some F-15's too? At $12 million each, we conclude our visit to McDonnell Douglas with 100 under our arm for a cool $1.2 billion. Let's take home the biggest brute the U.S. has to offer-- a top of the line nuclear-powered aircraft carrier for $1.4 billion. Better yet, make that two carriers. Throw in some destroyers, some submarines...let's see... We've spent a total of $2 billion on a kicking air force and a little more than that on a fine little navy. How much money is left in round figures? About $100 billion!

And this amount comes in not only this year, but the next, and the next, and the next... [a side thanks to Mr. Goodman for these historical prices.] $100 billion is a large annual paycheck, and we haven't even touched the $30 and $40 dollar prices brought about in the Second Oil Crisis. Now consider again that America has written future claims on $5.6 trillion dollars. Can you imagine how such a figure might be settled? Ouch.

Where did all of this money come from? It would seem that America found an

efficient means to issue claims on the country in exchange for something that goes up in smoke. Would OPEC own America lock, stock, and barrel? What would OPEC do with all of that cash? And would there be any end to it? How are the poorer countries that must EARN their dollars, as General de Gaulle indicated, going to fund their own oil needs? Banks are the answer. Buy banks, fill banks, and recycle the petrodollars. Oh, and let's not forget Gold. Straight from two ministers of finance, "We would rather keep the oil than have the paper money." We thank you for that insight.

Now that I have properly set the stage, in the next part I shall relate the really good stuff of the tale, suggesting where this money went, and how the system survived 20 years after the end was nigh, bringing cheap Gold crumbs for anyone mindful enough to pick them up. To quote that good knight, "With a payday reaching that magnitude, the question of destiny begs no answer. You set your own, and hope for nice weather."

Part 4 --- A 1970's History Lesson (without the disco)

One Oil Crisis down, one to go. We looked at some pretty incredible figures in Part 3. Where did this money go, and maybe more importantly, where does it come from? For the sake of brevity I will assume the reader is well acquainted with the process of money creation via modern banking. If not, then you have some important questions to ask and research to do. For now, accept on faith that new money is created (as a simple ledger entry at a bank) through the process of borrowing. A loan creates new money, and banks collectively may create money far in excess of what they hold on deposit. As a contract, the loan is quite real, but the dollar is not. A dollar is an undefined concept--an undefined unit of measurement for value, so to speak. You can see how such an arrangement favors those in a position to name their price.

As you can well imagine, for a country such as Saudi Arabia that had been subsisting on simple agriculture and the business of Pilgrims, a sudden infusion of such a magnitude of money can be seen as pure profit, and a fine opportunity for capital improvements to national infrastructure. Much of this money flowed back to the rest of the world to pay for international contractors and materials. But clearly, much more money was coming in than could possibly be spent. Vast sums of it found its way into the world's largest international banks--the five largest American, three largest Swiss, three biggest German, two biggest British, and then on to the next tier... Suddenly there were over one hundred banks that set up shop in tiny Bahrain: Citicorp, Chase Manhattan, Barclays, and Bank of Tokyo among

them; all competing for surplus oil profit deposits. Paris suddenly found itself host to over 30 new Arab banks.

So much money flowed in, and so much was lent in turn to the poor countries that could scarcely afford to buy oil with their meager exports, that the financial system became a large game of musical chairs, and the biggest risk was that the music might stop. There were no chairs to sit on!

To protect themselves from the unthinkable--that the Arabs might pull their deposits out of an individual bank--the banks developed a system. This system provided for the relatively smooth inter-lending of funds. Because even though a bank can create new money "out of thin air," they have to have deposits in the bank as a starting point. If these funds were to be withdrawn, the bank must locate other deposits to cover their outstanding loans. If the money were pulled, say from a British bank, it had to go somewhere; the amount of money was too great to "hide" for long. This British bank could call around, and arrange to borrow the funds back from a Swiss bank, or German bank, by paying a nominal interest rate on this inter- bank loan. The important concept to grasp here is this: as long as the petrodollars stayed in the banking system, the banking system would survive.

In fact, that is how the world weathered the storm of the First Oil Crisis. Such a grand scheme of inter-reliance was formalized by several central banks in a meeting in Switzerland to handle any event should money come up short in one area or another--the Basel Concordat.

Have you ever heard of the LIBOR in any of your financial reading? Some credit card issuers make use of the LIBOR instead of the US. prime rate in their contracts. It is the London Inter-bank Offered Rate, and functions as the international bank borrowing rate, and it is the tie that binds the group together into a nearly seamless global financial system.

When the First Oil Crisis caused a global tightening of belts, only America, as the issuer of the key-currency, could shamelessly create new money with ease to pay its bills. Other countries had to balance their own books with productive output, or else turn to the banks to borrow the needed funds. And borrow they did! Let there be no doubt that these petrodollars were recycled through the banking system. Throughout the Oil Crisis and the distractions of the Nixon Watergate scandal, the former Secretary of Defense under the Johnson administration, and then president of the World Bank, Robert McNamara, was focused on one thing only-- maintaining the good graces of OPEC. McNamara had to ensure continued access

to OPEC's funds. During 1974, the World Bank had drawn on OPEC for $2.2 billion, for a total at the time of $3 billion--one quarter of all World Bank debt. For Euroland banks, business was booming because lending was their business. And the IMF had its hands full trying to hold together the international currency exchange system.

Some of the countries that quickly found themselves behind the eight-ball: Brazil, Korea, Yugoslavia, the Philippines, Thailand, Kenya. (You can easily imagine that there aren't enough coffee drinkers in Saudi Arabia to achieve a meaningful balance of trade of coffee beans for oil for a country like Kenya.) So in a move driven more by politics than banking to ease the financial squeeze upon a nation's citizens and industry, the governments would turn to their central banks and to the international and multinational banks to secure the needed money. And the banks couldn't stop lending, because many countries relied on new loans to pay off the old loans in addition to their continued need for oil. Loans in default were simply rescheduled. There were no chairs, and the music could not be allowed to stop.

If a bank were to fail, what would the Arabs do with their remaining deposits, now clearly in jeopardy? Further, the inflationary impact of all of this borrowing was also a fact not lost on the OPEC nations. Many of the OPEC members' advisors and ministers held Ph.D.'s from prominent American colleges. They did not have their heads in the sand. The inflation would lead to a new price of oil just to recapture the value that was lost, and the cycle would intensify in the next round. OPEC knew the western currencies were depreciating faster they were compensating with price hikes. They were getting less "real" money as a result.

Hopeless!!

Remember Jelle Zijlstra with the "moon" comment earlier? As head of the BIS in 1980, he confidently predicted that the Second Oil Crisis could be worked through, slowly, but that the System (international financial system) could not survive a Third Oil Crisis--the inflation would make it impossible to recycle the petrodollars to the oil importing countries with any hope of repayment, trade would crumble, and the System would be brought to its knees. On that grim note, we need to take a quick look at how the world reacted to the Second Oil Crisis. It opens the door to everything that follows.

By now you are patiently awaiting mention of Gold. There it is. Now back to the story... No, seriously, pay attention here, and things will start to fall into place. I hope you have noticed the few references to

oil prices throughout this series. In

most cases, the oil was made available at a posted price. In the 1960's, OPEC's posted price was $1.80 (though sometimes the producers would undercut that to gain an advantage through additional volume), then it was $2.20, then $5.12, and within weeks it had been changed again to $11.65 (in late 1973). By May 14 of 1979 the posted OPEC price was $13.34 per barrel, but life was about to change. The key element to keep in mind is that oil was not priced directly by the market. It was mostly sold under long-term contracts at posted prices that were set by the producers after careful analysis of what the market could bear under self- determined production levels.

When the Ayatollah Khomeini's revolution deposed the Shah, Iran's 6 million barrel per day production fell off dramatically, and the resulting shortage sent the downstream processes scrambling for sources of oil anywhere to feed their refineries. Many turned to Rotterdam for oil, to fill their empty tanks. The deepwater port at Rotterdam was the main harbor where huge tankers could be found to deliver oil on the spot, and hence the spot market for oil was often referred to as the Rotterdam market--but in truth, the spot market was available worldwide. This spot market was never meant to determine the price for oil, but was only supposed to supply day-to-day purchases.

Due to the stresses of low supply, the Rotterdam price sailed above the $13.34 posted OPEC price on Tuesday, May 15,1979 to $28, and two days later it reached $34. Iran immediately took what little production remained and sold on the Rotterdam market. OPEC then set a ceiling price for oil at $23.50 per barrel, but that was soon broken by Libya and Algeria. Obviously, Rotterdam was the place to sell oil at the best price, so many tankers with long-term contracts for oil stood empty waiting for delivery while ever more of OPEC-member production was diverted through Rotterdam. Countries and many companies looked at the low levels in their storage tanks, and soon they were rushing to support the Rotterdam market with their business. The "spot" price reached $40 per barrel as uncertainty about the future brought forth every empty tank or dilapidated tanker out of retirement to be filled.

Gresham's law can help explain this phenomenon-- bad money is spent and good money is saved. Oil was being bought and saved as a store of value, while paper money was spent. The flames of this Rotterdam inferno were eventually cooled as the last available storage tank was filled to capacity. This display of the spot value for oil reinforced OPEC's concept of value, and they had no qualms about raising the posted price to the spot value. Please recall, "We would rather keep the oil than have the paper money." Any student of history will also recall that the explosion in

Gold prices also occurred in 1979 to early 1980, showing us Gold priced at $850 per ounce.

So what exactly has changed in the world since 1980? There haven't been any similar blowups in the pricing of important assets...so how was this wild tiger tamed? Is the money better than it once was? Or are the OPEC nations now suddenly and truly beggars upon the West's doorstep? What happened? Are the multinational banks (once scrambling to hold together the System) now calling the shots with nary a care in the world?

In Part 5, I put an end to this tale, and answer the biggest mysteries about Gold in the easiest of terms. The road will seem so straight and fair to travel, you will kick yourself for struggling through the brambles for so long, and wonder at your neighbors who STILL can't see the path, though it is truly a freeway.

Part 5 --- Gold, Money, and the Free Market

Before I conclude this commentary, let me first express my gratitude to USAGOLD for hosting this illuminating site, and for the tolerance I've been extended by so many here for my four long posts that

up until this moment probably didn't seem germane to the topic of Gold.

On any journey, the first few steps are the most important, and in this case they were also the most difficult--to include enough for context without drifting off- topic. This last part is easy. The task at hand is to provide an explanation of Gold's pre-eminence as a monetary asset. Gold is, in fact, Money, while the dollar and others are merely currencies--an importance difference!

I am not claiming to be offering new findings of my own. The inspiration for this tale originated from many sources. I have been challenged to render this tale into the clearest of terms suitable even for those not acquainted with Gold and worldly economics. If I have succeeded in my challenge, at the conclusion of this final part you will fully grasp how the free market has managed to provide a sophisticated asset (Gold) at a laughably minute fraction of its relative value. You will know that Gold is Money, and will gain new respect for its "price." Although this information isn't new, it might be new to you, and hopefully this explanation of financial operations with Gold, together with the background information of the 1970's Oil Crises, will help you anticipate and conclude for yourself an outlook for events ahead. Knowledge is power, and with it your destiny shall be yours to decide.

To start, I'm going to paraphrase some specific remarks that some people need to hear and think about, though most of the Forum posters are already in tune with this.

'The falling price of Gold has had various effects on people. The common person says, "Of course it is falling, because Gold has been demonetized."

The Goldheart knows better, so the falling price has a more remarkable effect, bringing out insecurities and irrationalities of some. Though these people don't question that Gold is money, their insecurities start to question *whether the world really needs money at all...that* somehow this greatest device of mankind has been antiquated. Simply preposterous!

If they knew the truth they would confidently buy today at triple the price and call it a bargain of a lifetime. People ask, "Why waste effort to dig up Gold from the ground, only to rebury it in vaults?" I say, "For the same reason the central banks toil to print millions of fancy notes that nobody reads. If you've read one, you've read them all."

The effort is needed to prevent cheating, though we easily see the fancy cash does not stem the abusive tide of money from nothing.

People also say, "Gold is a dead asset. It does not earn interest." What is the point of such a comment, to demonstrate their naiveté? Did banks not pay interest when coins were stamped from Gold?

You see, it is not the nature of money itself to earn interest, but rather, it is the investment risk that maybe earns a reward. A modern dollar in a shoebox is as a Gold coin beside it. No interest for either. You should know the interest paid by a bank savings account is not a product of the money itself, but instead it is the rewards on the risk the bank takes with the money you have provided for their investment use. Sometimes these banks choose poorly, and in those cases even the modern dollar earns no interest, and does not come back at all--lost with the closing of the bank doors.

Money must be risked (invested) to expect a yield, and in this regard, the big players in the world risk Gold money as they do paper money (though often not as aggressively), while the small players are content with the shoebox yield. You are forced to be more aggressive (more risky) with paper because its value dies quickly, unlike Gold that stands forever even in a shoebox of no risk.'

With that, I will now conclude this tale that shows Gold functioning in its role as Money. And because preconceived notions of words often cloud a person's ability to see the case before them, I shall try to

deliver this message with the slightest use of such terms as Gold loans, leases, shorts, etc. In fact, I will be so bold as to simply refer to Gold as Money (I will write it as "Money (Gold)" to ensure you know my meaning, but as you read, simply pronounce it as money). As far as what you might think is money (dollars, yen, pesos, etc.), I shall from this point forward not call them money, but refer to them by their given name (dollars, yen, pesos, etc.) or else will call them "fiat currency," or just "currency" for short. Fiat means "by decree, and fiat currency is currency because the government tells us it is.

Enough of the preamble.

Let's pick up where we left off from Part 4. In days past, the oil exporters had been poor to modest countries scraping by when two things occurred. They discovered that they owned lots and lots of oil, and they also found that the rest of the world had developed a voracious appetite for oil. Think how different the world situation would be today if this supply of oil had simply never existed. We are certainly lucky to have its availability, and it is a reasonable expectation to pay fairly for all that we take. As bold as that statement is, it is necessary because some people have suggested (as Kissinger did in the 1970's) that warfare is a possible alternative to obtain what isn't ours. Such a world!

We've already discussed much of the turmoil that resulted from consumption that outpaced ability to pay. Payment in Money (Gold) was terminated, and many payment scenarios were developed in addition to the ever rising prices in paper currency. While it can be suggested that currency is a reasonable means in which to track balance of trade accounts (equating oil exports with similar value of imports such as infrastructure improvements), it should be readily admitted that paper currency is an unacceptable means in which to pocket one's profits. Book the trade balances with paper currency, but pocket the profits (savings) with Money (Gold). That's what I do every month, too!

Paper currency was falling fast in value when it was no longer tied to Money

(Gold), and this was causing international settlement difficulties on many fronts in addition to oil. It is instructive to investigate some of the tools of the international financial System, because what worked for Money (Gold) and currency back then, certainly works for Money (Gold) today.

Back in the 1960's when dollars were still tied to Money (Gold) under the Bretton Woods agreement, the American penchant to spend for goods abroad led Kennedy's Undersecretary for Monetary Affairs, Robert Roosa, to fear a mass "cashing in" of these dollars in international hands for Money (Gold)--a run on the Treasury. Roosa created a new financial device, referred to as a "Roosa bond," which was a special issue of Treasury bonds that were denominated in Swiss francs. As the bonds were sold to the world, they would sop up excess U.S. dollars with the terms that repayment at a future date would be in a given quantity of Swiss francs. (Notice I said quantity, and not value.) While these Roosa bonds stemmed the tide of a possible run on the Treasury, they ended up costing America more because the Swiss currency appreciated versus the dollar during the life of the bond.

In 1978, the U.S. issued 10 billion dollars' worth of bonds denominated in foreign currencies (marks or yen) to milk extra life out of a dying dollar system, and the fix lasted until the 1979 Oil Crisis made mincemeat of it. It was an acknowledgment that some foreign investors wouldn't hold U.S. government obligations that would be repaid in dollars' worth less than originally spent on the bond. Further, it was at this time that the U.S. promised to sell Money (Gold) from the Fort Knox stockpile to foreign central banks unwilling to hold dollars. (On his last day of office, March 31, 1978, Federal Reserve chairman Arthur Burns suggested that the entire $50 billion of the nation's Gold stock be sold for foreign currency in defense of the dollar, at which time the foreign reserves could be used to buy up the collapsed dollar in international markets. While this plan was originally rejected, within three weeks the Treasury Department was forced to announce it would auction Money (Gold) on a regular basis.)

Treasury Secretary Michael Blumenthal pledged in a meeting two days later with top-level Arab businessmen that the integrity of the dollar would be defended vigorously, and asked them to do their part to stabilize the global economy by

keeping a price freeze on oil in place at least through 1978. (You should have no questions now about where the dollar found its value after the 1971 delinking with Money (Gold). The asking price by oil--influenced by many factors--is what established the dollar's value.)

It is also important to realize that not all international arrangements are conducted on the open market. For example, to avoid the German mark from being bid up in strength with a result of ever more people bringing them dollars for an exchange, Germany's BundesBank issued bonds directly to the Middle Eastern buyers, avoiding the marketplace impact altogether. This was at the time Saudi Arabia was swimming in cash and spreading the excess among the world's largest banks (as mentioned in Part 4). My point is this (which I shall expand on soon): don't be surprised that banks are far more creative in their operations than revealed in your common experience through savings and checking accounts and home loans.

Eliyahu Kanovsky, an oil economist, won renown by many for accurately forecasting long-term oil production and pricing trends by OPEC where all others had gotten it wrong. In the 1970's he maintained that economics, not politics, were the determining forces behind the decisions of OPEC. In 1986 he wrote in response to the prevailing notion that OPEC would eventually own the world as a result of its oil wealth: "It is, by now, abundantly clear that these forecasters committed gross errors not only in terms of magnitude of change, but, far more important, in terms of direction of change. Instead of increased dependence on OPEC and especially Middle East oil, there has been a very sharp diminution. ... Oil prices have been weakening almost steadily since 1981 and there has been a collapse since the end of 1985. Instead of rising 'petrodollar' surpluses, most OPEC countries, and Saudi Arabia in particular, are incurring large current account deficits in their balances of payments, and are rapidly drawing down their financial reserves."

In the 1990's, Kanovsky maintains that OPEC has lost its ability to raise income through raising prices, and that oil below $20 is virtually assured. (This should remind you of Milton Friedman's poor prognostication from Part 1.) Kanovsky claims competition among producers ensures an end to price fixing. They can only pump it and sell it for whatever the market will provide. He contends (rightfully

so) that Iraq can be counted on to "pump like mad" upon lifting of UN sanctions. He also contends that with the current account deficits of many OPEC members, notably the Saudis, they have no option themselves but to add to the oil glut with overproduction to raise revenue.

Since it has been brought to our attention by Kanovsky, let's take a look at the Saudi budget, and the toll taken on it in the aftermath of the Gulf War. IMF data reveals that the Saudi deficit climbed from $4.3 billion in 1990 to $25.7 billion in 1991. Oil had been selling at around $14 per barrel until June 1990 when Saddam Hussein pressured OPEC to raise the price to about $20 to help repair Iraq's national budget (which had been wiped out and sent into the red by their 1980-88 war on Iran). Iraq's subsequent invasion of Kuwait in August 1990 temporarily spiked the price higher.

Here I must ask you to pause for a moment to reflect on those huge oil trade surplus figures we toyed with in Part 3, and recall that they were from early 1970's oil demand at a price of $11.65 which caused the First Oil Crisis. What happened to the vast amounts of petrodollar revenue that was being pumped into international banks, and recycled as fast as the loans could be written to borrowers throughout the 1970's? Further, what happened to the earnings that were surely being generated on these deposits through the activities of the lending institutions? As I noted at the end of Part 4, the System

miraculously survived the Second Oil Crisis of 1979, and concurrently the skyrocketing price of Gold promptly abated in 1980. Further, Kanovsky points out that oil prices started weakening in 1981, and then plunged in 1985. Force yourself to make the connections. You will be one step ahead of Kanovsky, who has identified the effect, but no doubt has missed the cause entirely. Let us now tie together everything we know, and fill in the remaining pieces.

Historically, the price of oil had been simply posted by the producers for contracted delivery until it was unleashed to respond to daily supply/demand forces on the "spot" Rotterdam market, at which time the price exploded in 1979-80. Although the dollar had been historically fixed to Money (Gold), after it was unpegged in 1971, the currency price of Money (Gold) was determined by the daily supply and demand, similar to Rotterdam. Gold auctions began in May of

1978 because the U.S. had trouble getting international entities to accept its dollar currency. After "booking" their trade balances with dollars, the House of Saud, among others, wanted to "pocket" their profits with Money (Gold), and therefore competed with everyone in the world for Gold on the spot market. As the price shot right through $700 it was clear that every ounce purchased made it that much more difficult to purchase the next ounce. There was little trouble raising the price of oil as needed, except the financial structure of the world was coming apart at the seams. Each dollar withdrawn from international banks to buy Money (Gold) made life ever more difficult for the banks to square their books against outstanding loans or to write new loans. There had to be a better way...the return of Money!

The high price of Gold brought mining companies out of the woodwork. The Earth was suddenly crawling with geologists looking for the next jackpot Gold deposit. The mining companies needed capital to finance the construction of these numerous new mines. It's not strange to you to accept that banks can lend currency. It should not be difficult for you to accept that banks can lend Money (Gold) also. Struggling with that thought? Don't. They lent Money (Gold) in the days prior to Roosevelt's 1933 confiscation of Money (Gold) in exchange for currency, and they can lend Money (Gold) today. In fact, they can even create Money (Gold) out of thin air, in a manner of speaking, and I'll walk you through it.

Sometimes a parallel familiarity assists comprehension. Consider the existence of Government-Sponsored Enterprises (G-SE's) such as the Federal National Mortgage Association (commonly known as Fannie Mae). Fannie Mae is in the business of creating financing for people to acquire a house. The government's involvement in this affair is that they underwrite the risk of a default on the repayment of the loan. Dollars are borrowed, dollars are lent, and dollars are repaid. It doesn't matter what happens to the exchange rate of the dollars versus other currencies. A certain amount of dollars are owed, plain and simple, under the terms of the loan contract. If a home mortgage loan is sold on the secondary market, the purchaser of the loan is effectively buying not the house that was financed by this loan, but rather the rights to receive the borrower's scheduled repayments over a span of time.

Think of a loan to a mining company in a similar fashion. Interest rates on Money

(Gold) loans are often much less than on currency loans because the Money (Gold) holds its inherent value over time (despite its "price,) whereas the paper currency fails so fast you must return more for the lender to at least break even, not to mention show a profit for the risk. Because miners will be pulling Money (Gold) out of the ground, it makes the most sense to them to seek a loan of Money (Gold) rather than currency in order to finance their new mine construction. But because Caterpillar has its head in the sand, it requests dollar currency for the purchase of its mining equipment, so an exchange must be made for paper currency as an integral part of this Money (Gold) loan. These arrangements can take place in every conceivable fashion, but this following example will be

representative.

As 1980 arrived, the Saudis naturally still wanted Money (Gold) for their oil, and the rest of the world was struggling with liquidity. Much currency "wealth had already been transferred to OPEC, leaving many countries toiling to service their own debts--much of their credit existing as recycled petrodollars. Let the lending continue! Bullion banks would facilitate these deals, **and central banks (CB's) would act in the same capacity as with the G-SE Fannie Mae, guaranteeing ultimate repayment in the event of a borrower's default.** In this simple example, the House of Saud could be looked at as the principal lender (although the borrower doesn't see this)...providing the currency equivalent of the Money (Gold) borrowed by the mining company to pay for Caterpillar's equipment to build the mine. Because this is contracted as a Money (Gold) loan, Money (Gold) must be repaid over time. In a sense, from the Saudis' viewpoint it is similar to the Roosa bonds where U.S. dollars are paid for the bond, with a fixed amount of another currency (in this case, Money (Gold)) expected to be returned upon maturity.

With the simple but vital central bank guarantee against the default of these Money (Gold) loans, the House of Saud, for example, would have no qualms about supplying the cash side, **effectively buying not the Gold metal immediately, but rather the rights to receive the borrower's Gold repayments over a span of time.** Just like buying a home loan on the secondary market. And the Money (Gold) of the central bank need not ever move or change ownership unless the borrower defaults on the loan, and the CB is obligated to deliver on its guarantee for the full repayment in Money(Gold).

There is nothing sinister in all of this. The price of Gold has fallen simply because anti-gold sentiment has been fostered throughout the common investment markets while the main buyer at the Golden "Rotterdam market" had found another avenue in which to obtain the Money (Gold) desired in exchange for oil profits. This is very much like the off-market BundesBank offerings that I mentioned about earlier. Please appreciate the patience in this approach, and the commitment it shows to Money (Gold), knowing full well that for many years it might be getting ever cheaper, while they would appear the fool for buying it from the top prices all the way down to the lowest. But the big payoff is in the end--which is near--and I'll get to that.

Now that you grasp the basics, let's take things up one level. So many Money (Gold) loans were written, that the House of Saud in our example spent down their past petrodollar surpluses. What now? It is time for banks to do what banks do best...create new money. This is the typical example I promised you earlier:

The miner approaches a bullion bank for a Money (Gold) loan. Let's assume the current dollar price of Money (Gold) is $400 per ounce, and the miner needs $20 million to pay Caterpillar for equipment. The bullion bank (such as can be found operating in the network of the London Bullion Market Association--LBMA) writes the Money (Gold) loan contract specifying the term of repayment of 50,000 ounces of Money (Gold) plus interest at 1% - 2%. The borrowing miner collateralizes this Money (Gold) loan with company stock, the deed to the mine, etc., and is sent down the road with $20 million in currency for Cat. Where did this cash come from? The bullion bank turned to the House of Saud, which is currently out of currency. However, using their oil in the ground as collateral, the bullion bank is able to write them a currency loan out of thin air (just like banks can do) with which the Saudis purchase the repayment rights on the Money (Gold) loan. They will be receiving future Gold for their future oil! As they sell oil, they will use their dollar revenue to repay their currency loans, and in the meanwhile, the miner's Gold loan repayments will be directed to the Saudis' account.

What does the bullion bank get for all this trouble? First, the central bank gets 1% - 2% for

underwriting or guaranteeing the loan. (Just like the underwriting done with

Fannie Mae.) The bullion bank had added on top of this low interest rate an applicable margin for its cost of funds to establish the final interest rate for the miner that borrowed the Money (Gold). This rate might run 3% - 5% (while currency loans would demand much more.) Each year the miner produces Gold, and after paying the required installment of Money (Gold) for the Loan, the remainder of his annual production can be sold on the spot market for currency used to meet business expenses.

There's one hitch. Because the biggest Gold buyer is no longer shopping on the spot market, the pricing pressure has come off, and prices could very well be expected to fall. To protect against this leading to the possible bankruptcy of the miner, and hence his default on the repayment of Gold, the terms of the Loan might also require that the miner lock-in a certain amount of future production at the current Gold prices at the hedging counter. (Economists first scrutinize the mining plan to ensure that it will in fact be viable at current prices before granting the Loan.)

As described so far, it should come as no surprise that the House of Saud would also step right up to purchase the delivery side of this hedged production. Enough must be hedged to ensure the mine will remain viable (even at lower prices) at least long enough to repay the Loan. Let’s assume this mine is operating today with Money (Gold) at $260 per ounce, while their cost of production is actually $320. The current price of Money (Gold) is not a factor on the Loan repayment...they owe 50,000 (plus interest) ounces, regardless. Any additional production would be sold under the terms of their hedge, at $400 per ounce, and they can pay their bills comfortably and stay in business. Is the House of Saud a fool for paying $400 long ago for the Loaned ounces, and for paying $400 today to honor such hedged ounce agreements? You or I could pay $260 today for that same ounce on the spot market. Have you started to develop a new opinion of your currency, or at least a new opinion of Money(Gold)?

OK, so what else does the bullion bank get out of this, other than the applicable margin on the Money(Gold) loan mentioned above? It also collects the interest on the currency loan that was written to the Saudis using their oil as collateral. You can see how the mechanism that has brought us temporarily cheap Money (Gold)

over the years has also given us cheap oil not subject to the same shocks witnessed in the Seventies. You can also see why the economists can look at the Saudi balance books and see tremendous currency debts and budget deficits where once there were surpluses that threatened to buy up the world. They have in fact bought up a significant portion of the Gold mined well into the future...through Loans and Hedges bought all the way down from the top. So who are we to question whether to exchange our currency for Gold now or tomorrow, and to gripe over a missed opportunity of $10? The equation is simple. If you have cash, buy Gold immediately, because the downward trend has become terribly unstable. Here's why...

The various financial Hedge Funds saw how easy it was for miners to raise low interest capital, and further appreciated the fact that even if they were not themselves a producer of Gold, the Gold itself needed for repayment could be purchased on the spot market at ever lower prices. The Hedge Funds could meanwhile invest the capital received through taking out this Loan and expect to have a double profit potential in the end. (The infamous Gold Carry Trade would invest the currency received through the 1-2% Gold Loan into U.S. bonds that yield over 5%.) And of course, with the proper central bank guarantees, the House of Saud would be there to buy up the repayment contracts expected on these Money (Gold) loans also.

The problem is that these speculating Hedge Funds have cumulatively driven the price so low (well beyond where mines would have long ago stopped seeking this type of Loan) that some un-hedged

mines are shutting down or going bankrupt. This aggravates the spot market with thin supplies of real metal reaching it (due to so much production already having delivery obligations) such that it becomes hypersensitive to any real effort to make substantial purchases there.

As a result, the Hedge Funds will be in for a rude awakening in their efforts to purchase the Gold needed to repay their Loans. And the bullion banks are sweating, because they stand next in line having facilitated the Money(Gold) loans and pledged to the CB's that they were credit worthy of the CB Gold guarantees. And the important Oil Producer sees that the big bucks paid long ago for future Gold delivery has actually purchased only uncertain arrival. And further, some

miners, despite their hedges, have played fast and loose liquidating them for cash, and through general mismanagement have not been able to stay so viable as to ensure future operation and delivery of the repayment terms.

The CB's are fretting because their guarantees were used over and over again, and they are on the hook for a lot of Money (Gold) when the speculating Hedge Funds and bullion banks find it impossible to cover their Loan repayment obligations on the spot market as the price races away from them due to the hypersensitivity that low supply has caused. Shades of Rotterdam. Currently aggravating this spot market problem is the massive demand by individuals brought about by the low prices and concerns for Y2K. I hope this give you new perspective on the push lately by some CB's to free up some Money (Gold) from the vaults, whether it is Bank of England, IMF, or maybe even Swiss. It should also give you perspective on the anti-gold propaganda delivered regularly by the media. Consider that a skyrocketing price of Gold would not only be viewed by the masses as a viable investment avenue, it would also tend to shake the confidence in paper currencies, and threaten the banking system and Wall Street in general.

It is this same currency, borrowed against oil collateral for the purchase of Gold, which has added the massive liquidity to the world over the past decade and a half that many people have used in turn to fan the flames of the stock markets here and overseas. That's a lot of cash born unto Gold; and were it not for the prospects of receiving the real wealth of Gold metal, this supply of currency would have been stillborn, and oil would likely only come forth by way of brute force rather than by civil, economic means. I realize that I have left a lot out, but this should get you started along the clear road traveled by smart currency.

Now, knowing what you know, what would you do with your dimes?

I'll leave you once again with perhaps my favorite statement made one evening last month among old friends. "If I were given a dime for every time I cursed the market for providing easier (cheaper) gold, I'd have a dime...and that one was found on my way over here.

"*Gold. Heading to the moon at a world near you"* ---"Aristotle"

Wednesday, July 7, 2010

The Debtors and the Savers

Ever hear the one about the little old lady living in an old but paid-off house, with a shoe box full of gold coins in the basement? Across the street lived a big guy, in a big McMansion. It had a special garage for the RV, and another four-car garage for the other four cars. He had a boat at the side and a trailer with two jet skis in front of the boat. Then one day little old lady noticed big guy was gone. The bank had taken back his house.

Most people thought big guy was rich and little old lady was poor. How wrong most people were.

Tiger's Tail

I watched a pretty forgettable movie the other night on TV. It was just so-so from a film-maker's perspective, but it had at least one redeeming quality from my blog-maker's perspective. It highlighted a point I had been thinking about.

The film is called "The Tiger's Tail", and the basic back story is identical twin brothers that were separated at birth when one was given up for adoption. The adopted brother is destitute when he discovers he has a twin who is a very public multi-millionaire businessman. So, filled with envy and anger over being given up as an infant, he hatches a plan to "steal" his brother's identity and life for just long enough to liquidate his assets and make off with the cash.

He is successful supplanting himself into his brother's life only to find that the vast wealth is built completely on debt. What filled him with envy on the surface is nothing but a giant, net-negative hole once he looks behind the curtain.

Here is an eight minute version of the movie that contains all the relevant scenes. We pick it up right at the point where the adopted twin first arrives at his brother's office, pretending to be him, ready to liquidate a few assets...

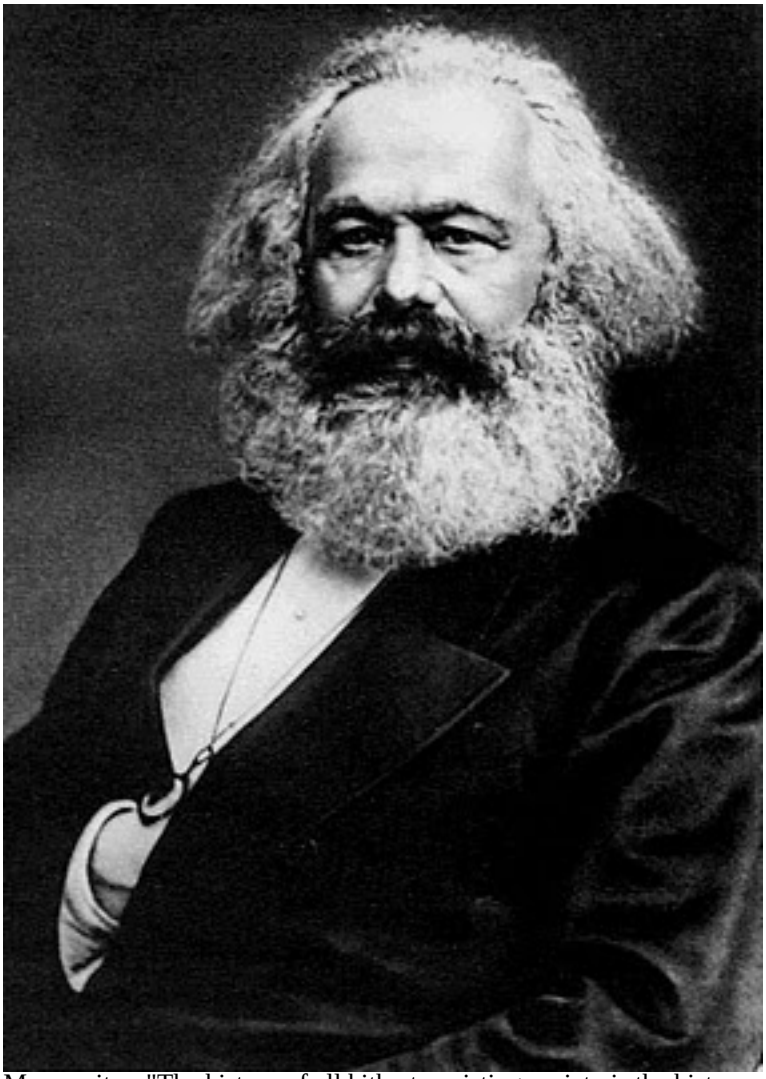
My apologies to John Boorman. I'm really looking forward to your remakes of The Wizard of Oz and Excalibur, and I loved Deliverance and Exorcist II: The Heretic. ;)

Marx Had It Backwards

Karl Marx predicted the breakdown of capitalism as a result of class struggle, followed by the establishment of a grand commune in which all the means of production would become publicly owned and used only for the public good. Sounds pretty nice, huh? *"Imagine no possessions, I wonder if you can. No need for greed or hunger, A brotherhood of man. Imagine all the people, Sharing all the world..."* ... and all that peace and harmony stuff.

Today we have many fine, intelligent and exacting analysts all looking at the same economic data and coming up with vastly different analyses of the present global financial crisis. What sets them all apart from each other is not intelligence, or math skills, or even popularity. What sets them apart is the foundational premises on which they operate.

And a false premise can skew a brilliant analysis 180 degrees in the wrong direction. Few analysts fully disclose their premises. But Karl Marx did, and in this we can find the one, key flaw that sent his analysis off in a disastrous direction.



Marx writes, "The history of all hitherto existing society is the history of class struggle." He got this part right! What he got wrong was his delineation of the classes.

Marx's classes were:

1. Labour (the proletariat or workers) - anyone who earns their livelihood by selling their labor and being paid a wage for their labor time. They have little choice but to work for capital, since they typically have no independent way to survive.

2. Capital (the bourgeoisie or capitalists) - anyone who gets their income not from labor as much as from the surplus value they appropriate from the workers who create wealth. The income of the capitalists, therefore, is based on their exploitation of the workers.

Simply put, Marx says it's the rich versus the poor. According to Marx the rich exploit the poor to get themselves a "labor-free income", which spawns a class struggle.

This is an attractive perspective because it requires only a cursory, superficial judgment to place someone into one of the two camps, the rich or the poor. If someone is driving a Bentley we immediately know which group they are in, right?

But within this simple, foundational premise lies an error so serious that within 130 years of Marx's death it caused somewhere between 85 million and 150 million deaths, depending on how you count them. That's an oddly large number of dead people for a commun-ity in which class struggle had been eliminated, isn't it? Peace and harmony my ar$e.

Inscription reads: "Workers Of All Lands Unite"

As I said, Marx got one thing right. History does bear out the dramatic story of centuries of class struggle. But if we eliminate his one small flawed premise, we can see it all much more clearly.

The two classes are not the Labour and the Capital, the rich and the poor, the proletariat and the bourgeoisie, or the workers and the elite. The two classes are the Debtors and the Savers. "The easy money camp" and "the hard money camp". History reveals the story of these two groups, over and over and over again. Always one is in power, and always the other one desires the power.

1. Debtors - "The easy money camp" likes to spend (and redistribute) money it did not earn, either by borrowing it, taxing the savers for it, or printing it. They like easy money because it is always and everywhere constantly inflating, easing the repayment of their debts.

2. Savers - "The hard money camp" likes to live within their means and save any excess for the future. They prefer hard money (or in some cases "harder" money) because it protects their savings and forces the debtors to work off their debts.

1789, the French Revolution, "the hard money camp" had been in power since 1720 when John Law's easy money collapsed, and starting in 1789 "the easy money camp" killed "the hard money camp" and took back the power. This is the way "the easy money camp", the Debtors, usually take power... by revolting against the hard repayment of their spending habits.

Only nine years later, 1797, easy money collapsed once again (as it had just done in 1720) and a new French monetary system based upon gold was again reinstated. This is the way "the hard money camp", the Savers, almost always regain control: when the easy money collapses. On very rare occasions and only under highly favorable circumstances (like moving to a new continent!), "the hard money crowd" takes control by physically separating from "easy money" and declaring independence from the Debtors.

The American Revolution. Yes, the Constitution mandates hard money.

So just to repeat for clarity: Hard money regimes almost always end in bloodshed, when the easy money camp slaughters the hard money camp to avoid hard repayment terms. And easy money regimes almost always end in financial suffering when the easy money collapses. Here are a few more examples of "easy money collapses"...

Angola (1991-1999)
Argentina (1975-1991, 2001)
Austria (1921-1922)
Belarus (1994-2002)
Bolivia (1984-1986)
Brazil (1986-1994)
Bosnia-Herzegovina (1993)
Bulgaria (1991-1997)
Chile (1971-1973)
China (1939-1950)
Free City of Danzig (1923)
Ecuador (2000)
England (1560)
Greece (1944-1953)
Georgia (1995)
Germany (1923-1924, 1945-1948)
Greece (1944-1953)
Hungary (1922-1927, 1944-1946)
Israel (1979-1985)
Japan (1944-1948)
Krajina (1993)

Madagascar (2004)
Mexico (1993)
Mongolian Empire (13th and 14th Century AD)
Nicaragua (1987-1990)
Persian Empire (1294)
Peru (1984-1990)
Poland (1922-1924, 1990-1993)
Romania (2000-2005)
Ancient Rome (~270AD)
Russia (1921-1922, 1992-1994)
Taiwan (late-1940's)
Turkey (1990's)
Ukraine (1993-1995)
United States (1812-1814, 1861-1865)
Vietnam (1981-1988)
Yap (late 1800's)
Yugoslavia (1989-1994)
Zaire (1989-1996)
Zimbabwe (1999 - present)
Source

You see, Marx had it almost completely backwards when he said the rich exploit the poor for free income. Once we shuffle and re deal the two camps correctly we see that it is actually "the easy money camp" (the Debtors) that always exploit "the hard money camp" (the Savers), taxing them, destroying their savings, destroying capital, borrowing money only to repay it on easier terms, and sometimes even killing them. So are "the Debtors" the rich and "the Savers" the poor? Of course not! Is this clear enough?

What does all this have to do with Freegold today? Well, with history, ANOTHER and FOA as our guides, we can see clearly what is coming. And with a correct view and a wide enough perspective, we can also see how some fine analysts operating under false premises are inducing the wrong conclusions.

Today we are living the end of the longest stretch of time in which "the easy money camp" has been in power both politically and monetarily. For a century now they have been easing our money more and more. And for those of you obsessed with the "emerging" NWO and One-World Currency... surprise! You've been living with it for 66 years now.

This latest push for central control and massive deficit spending by the "easy money camp" is simply the blow-off phase right before the long awaited collapse. And when easy money collapses, the transition is always financially painful but not necessarily bloody like the French Revolution, which was the end of the "hard money camp".

Now, what happens during ALL periods in history, whether "the hard money camp" is in charge or "the easy money camp" are running things... is a transfer of wealth. This is important! Because when the easy money guys are in power the transfer of wealth happens slowly and gradually, and wealth flows **from the Savers to the Debtors**. But when "easy money" collapses - and it ALWAYS collapses - there is a very RAPID transfer of wealth in the other direction, **from the Debtors back to the Savers**.

And this is where you need to take some action today. Because we have been living in a "easy money regime" for so long now, the delineation of the two camps is somewhat obscured. There are many many people who consider themselves Savers who are still sitting in the wrong camp, and will be on the WRONG side of the coming
- extremely rapid - transfer of wealth.

Today you need to be proactive if you want to get on the receiving end of this "blow back" transfer of wealth. You need to actively choose which camp you are in. And to do that, you need to recognize the two camps, or classes. Remember, this is a

"class struggle".

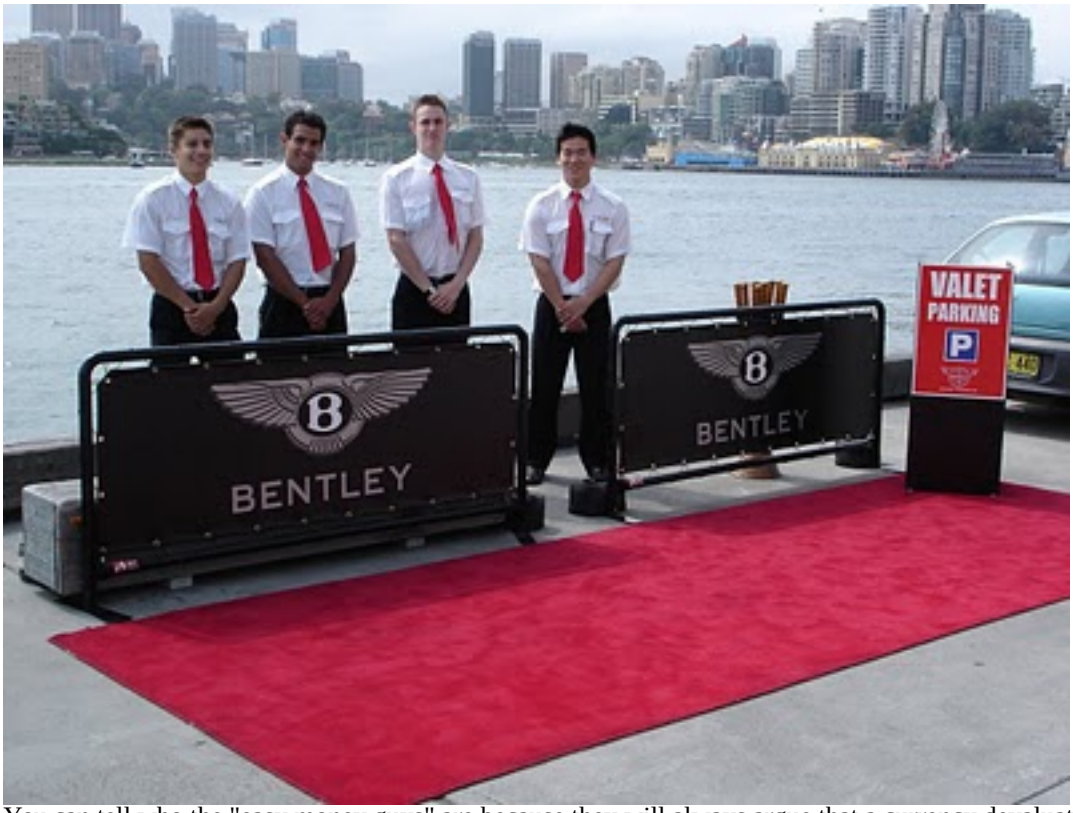
So let's put a few modern groups and people into these two camps. I think it is fairly obvious that almost all modern "socialistic" governments and their politicians addicted to sovereign debt and deficit spending are in the debtor class. These are the easy money guys. And the bankers as a class are generally there too. As I said in a recent post:

The banker makes his largest profits during times in history when the liberal easy money crowd is in power both politically and monetarily. And he makes his most absurd profits when the debtor class allows its debt to go too far... to the very mathematical limit. But don't worry. This unstoppable avalanche will reduce banking and central banking to what it should be; a utility for the public good.

And this is because easy money debt must flow THROUGH the banking class as it is passed between the savers and the debtors.

But as individuals, not "banks", but individual bankers, we could say that some of them are Debtors while others are Savers. For example, would you agree that the Rothschild family, as a family unit, is in the "saver class" while their industry or profession (banking) as a whole falls in the "debtor class"? Or perhaps we could say that the banking institutions, as the hollow corporate shells that they are, are *closely aligned* with the debtor class.

But on the other side of the coin, we can broadly say that most of the young "hot shot bankers" and investment bankers probably fall firmly in the "debtor class". When you look at the lavish lifestyle of a lot of these young guys, you don't see the debt it is built upon. Just like our character, Liam O'Leary, in The Tiger's Tail. You could watch a Rothschild and a Goldman VP pull up to an event in identical Bentleys, not seeing that one is leased while the other is owned outright. Are you catching my drift?



You can tell who the "easy money guys" are because they will always argue that a currency devaluation is preferable to forced austerity. They will say, "the euro got it wrong because it doesn't allow for Greece to devalue." And in saying this, they put themselves firmly in the Debtor camp. They are saying that the "Argentine/Brazilian /Soviet/Zimbabwe workout" is preferable to what is happening in Greece today.

How *about* that Soviet "easy money collapse" in 1992? Who came out ahead? Most average people that thought they were savers lost everything. So did the Russian banks take over Russia? Or did a handful of "Oligarchs" emerge as multi-billionaires through the process and buy up anything in sight for pennies on the dollar? And which camp do you think these Oligarchs were in? The Debtors or the Savers? Curiously, one of them just bought the New Jersey Nets.

Russian Oligarch Mikhail Prokhorov
(Age: 45 - Born: Poor - Starting Industry: Precious Metals)

As I said earlier, almost all modern governments are in camp with the Debtors. And this includes the Russian government. So are the Oligarchs in the opposing camp as their beloved comrades in the corrupt government? Here is an interesting article:
Here's The Real Reason The Russian Oligarchs Are Buying Up Professional Sports Teams
By Henry Blodget
Business Insider

SNIP:
...we hear that some Russian oligarchs feel that, if they become highly visible owners of beloved sports franchises, the Kremlin will be less likely to take them out.

Yes, as in that kind of out.

Remember Alexander Litvinenko, the ex-Russian spy who got poisoned in London...

Russian Oligarch Roman Abramovich
(Age: 43 - Born: Poor - Starting Industry: Entrepreneur)

So here's the important thing in today's dangerous world. We must each understand the difference between choices and inevitabilities. What is coming at us is inevitable. It is unavoidable. How we personally prepare for it is a choice we each must actively make.

The coming "blow back" hyper-rapid transfer of wealth is not something that necessarily requires moral judgments of good and evil. It is simply a fact of life today. Pick which side you want to be on in THIS particular transfer of wealth. By selling your debt-financed paper savings and buying physical gold today you are making the conscious CHOICE to join the camp of the true Savers.

Many people that consider themselves "savers" are precariously positioned right now. These people need to take active measures to get on the receiving end of this transfer of wealth to survive. Many, many, many average citizens amazingly still have this option, yet they don't even realize it. They need to get up and move over into the same camp as the Rothschilds and the Russian Oligarchs, and prepare to own the future. It's not a matter of good versus evil at this point, it is a matter of survival!

The easy money crowd has had a really, really long run in the sun this time. There's no need to feel bad for them. And all the last-ditch central control efforts we see today are simply the culmination of that run. But their influential position is completely dependent on the power afforded by the easy money debt machine that is now crumbling. Their "power generator" is out of gas. And it's not the kind of gas you can legislate or print.

But don't take my word for it. And certainly don't take financial advice from me! For that matter, don't take financial advice from ANYONE. Think it through yourself, quietly. Use your own head. This is the only path to peace of mind. You and only you will lose your wealth if you take the wrong advice. And this time, it doesn't take an MBA and a JD to understand the choices.

It is easy to watch the dollar losing its reserve privilege today. And it is also easy to see who will come out ahead when it happens. All else is noise. Choose your camp wisely.

Sincerely,
FOFOA

The Debtors and the Savers 2012

Like Dust in the Wind

There are 31,530,000 seconds in a year. A thousand milliseconds in a second. A million microseconds. A billion nanoseconds. And the one constant, connecting nanoseconds to years, is change. The universe, from atom to galaxy, is in a perpetual state of flux. But we humans don't like change. We fight it; it scares us. So we create the illusion of stasis.

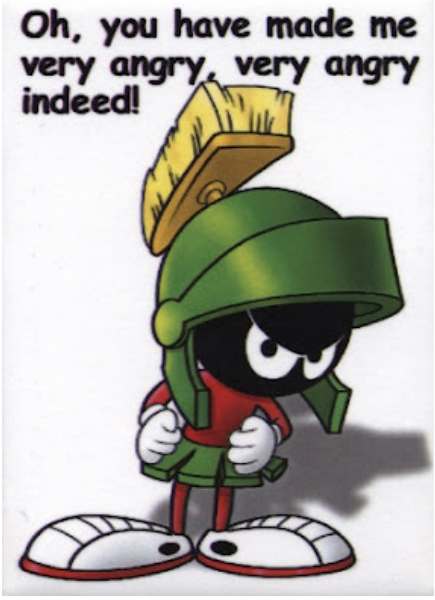
We want to believe in a world at rest—the world of right now. Yet our great paradox remains the same. The moment we grasp the now, that now is gone. We cling to snapshots, but life is moving pictures, each nanosecond different than the last. Time forces us to grow, to adapt, because every time we blink our eyes, the world shifts beneath our feet.

Change isn't easy. More often, it's wrenching and difficult. But maybe that's a good thing. Because it's change that makes us strong, keeps us resilient, and teaches us to evolve. –Tim Kring

Prices change. Don't they? Yes, of course they do! We don't always like it when prices change, but they do nonetheless. And why do prices change? Because values change! That's right, I'm talking about the way humans value things relative to other things. Relative values change constantly, and because relative value is a subjective choice made by each individual, what actually changes is demand.

I remember back in 2008 BlackBerries were all the rage. First generation iPhones were a little buggy and RIM (the maker of the BlackBerry) was rocketing toward $150. Both RIM and Apple were around $140 at about the same time. Today iPhones are cool, RIM is $10 and Apple is $577. Demand changes, relative values change, prices change. We don't always like it when things change, but they do nonetheless.

So why are some people so stuck on that old objective cost theory of value? One thing I have learned through writing this blog is that these people in particular, when they come across my blog, seem to be the most obsessive about "debunking" me. Yes, I'm talking about our old Marxist frenemy Ash. In the first draft of this post I had links to a couple of others as well, one who wrote something like *Debunking FOFOA* and another who devoted no less than six posts to the cause. But there's really no need to look any further than everyone's favorite Marxian with his ten posts and counting. He has an ongoing series over at "The Automatic Earth" devoted to debunking Freegold!



The Marxian View

Ashvin Pandurangi: *"This series was a comprehensive attempt to debunk the [Freegold] theory by attacking its foundations, which range from Hegelian idealism to the (more concrete) marginal utility theory of value, and by replacing those foundations with what I believe to be more solid ones. Among these were Marx's theory of capitalism, spanning his concepts of surplus value, rate of exploitation, over-production and realization of value…"*

In my 2010 post, The Debtors and the Savers, I explained the "Marxian" view of class struggle like this: *"Simply put, Marx says it's the rich versus the poor. According to Marx the rich exploit the poor to get themselves a "labor-free income", which spawns a class struggle."* This flawed perspective makes it impossible to understand Freegold, which is perhaps why they are so driven to debunk it.

Hegelian Idealism

With the correct delineation being the debtors and the savers (aka the easy money camp and the hard money camp), Freegold simply explains how, with the termination of the $IMFS, what remains is a system in which these two camps will no longer be in a perpetual state of monetary conflict. This is what Ashvin dubs Hegelian idealism; the idea that mutually beneficial coexistence between those whose innate tendency is to net-produce (produce more than they consume) and those who prefer easy money through borrowing, taxing and printing is even possible. His argument that it is not possible boils down to "they" (the evil ruling elite) will never let it happen.

Marginal Utility Theory of Value

Simply stated, the Marginal Utility Theory of Value which Marxists object to is really just the subjective view of value which I described at the top. They prefer Marx's objective view of value which says that value flows up through the costs embedded in the supply side rather than down from the subjective choice of the end user. And while Marx has been thoroughly discredited in economics, this

objective view of value persists because it fits the "exploitation of the workers" theme that is so popular among impressionable young minds and scary doomers with batshit-crazy worldviews.

Which brings us to Ashvin's "more solid" foundations of Marxian "surplus value, rate of exploitation, over-production and realization of value."

Surplus Value

In this view, surplus value comes only from the Capitalist's exploitation of workers, be it from selling goods back to the workers for a price higher than the value (value being the *cost* of production paid to the workers), or from lending to the workers for interest or rent (labor-free income).

Rate of Exploitation

The rate of exploitation, as you can imagine, is simply the rate of surplus value accumulated by the Capitalists at the workers' expense. So if surplus value is the stock, the rate of exploitation is the flow.

Over-production

Here's a quick excerpt from Marxists.org on over-production:

> The real problem when goods lie on the shelves is that no-one can afford to buy the commodities; in other words “over-production” should really be called “under-consumption”.
>
> In another sense however, the term “overproduction” is valid; but it is not goods and services which have been over-produced, but capital.
>
> During a boom period – the rising phase of a capitalist crisis – profits run high and a mountain of fictitious capital is built-up by speculation and borrowing for unwarranted

> future expansion. All this fictitious capital has to be fed by the surplus extracted from workers and this grows to be more and more of a burden on the backs of the workers until profitability can no longer be maintained, and slump takes over.

Realization of Value

Again from Marxists.org:

> Realisation is the transformation of something from an ideal or potential form to an actual or material form. Realisation of value is the conversion of a profit or payment in the form of a surplus product or credit into money form.
>
> Commodity production is based on the production of a product which the producer themself does not need, on the basis that their own need can be met by exchange or sale of the surplus product. In particular capitalist production can only complete the cycle of capitalist reproduction when the labour power is used, the product sold and paid for.
>
> The beginnings of crisis often lie not so much in the failure to produce a surplus as in the failure to realise surplus production.

Are you starting to get the picture? These guys don't like the concept that value is in the eye of the beholder. They need value to be an objective metric in order to explain how the Capitalist exploits the worker. How the rich exploit the poor. How the bourgeoisie exploit the proletariat. From my 2010 post, here are Marx's classes in his version of the class struggle:

Marx's classes were:

1. Labour (the proletariat or workers) - anyone who earns their livelihood by selling their labor and being paid a wage for their labor time. They have little choice but to work for capital, since they typically have no independent way to survive.

2. Capital (the bourgeoisie or capitalists) - anyone who gets their income not from labor as much as from the surplus value they appropriate from the workers who create wealth. The income of the capitalists, therefore, is based on their exploitation of the workers.

And here is my corrected delineation:

The two classes are not the Labour and the Capital, the rich and the poor, the proletariat and the bourgeoisie, or the workers and the elite. The two classes are the Debtors and the Savers. "The easy money camp" and "the hard money camp". History reveals the story of these two groups, over and over and over again. Always one is in power, and always the other one desires the power.

1. Debtors - "The easy money camp" likes to spend (and redistribute) money it did not earn, either by borrowing it, taxing the savers for it, or printing it. They like easy money because it is always and everywhere constantly inflating, easing the repayment of their debts.

2. Savers - "The hard money camp" likes to live within their means and save any excess for the future. They prefer hard money (or in some cases "harder" money) because it protects their savings and forces the debtors to work off their debts.

Some of my readers thought this was my most profound post. Others picked up on my theme and wrote their own articles about "the debtors and the creditors" thinking they had corrected my obvious error. It wasn't an error. It was intentional. The Debtors and the Savers are the two inherent camps. They are not, and should not be, direct counterparties! More on this in a moment.

In Time

In The Debtors and the Savers I posted a very short version of a forgettable movie which helped make the point that individual members of the two camps are not as obvious as the superficially rich and poor. In fact, many in the West who are living like kings are actually up to their eyeballs in debt.

For this post I'd like to direct your attention to the movie In Time starring Justin Timberlake and Amanda Seyfried. It's a much less forgettable movie than Tiger's Tail, so check it out. Here's a two-minute trailer:

In Time Trailer (Justin Timberlake)

The premise of the movie is that time is the currency. And since time passes automatically, that's like inflation. If you just sit on your currency doing nothing, it will leak away with time. In the movie, when you run out of currency, you run out of time and you drop dead on the spot. Most of the people live in the ghetto and they never have more than a day or two at a time, so they have to keep working just to stay alive.

Then there are the rich people who have eons of time. You can literally live forever in this world if you accumulate enough currency which is also real time. And the rich get richer not by producing lots of good stuff, but by loaning their surplus time to the poor at usurious rates.

The story is told from the perspective of the poor, but from another perspective it really drives home the point that wealth is best kept *not* mixed in with the transactional currency by relying on debtors' servitude. In the movie the rich could only live forever as long as the poor lived hand to mouth, always working, producing, and never getting ahead to the point where becoming a consumer was an option. So the wealthy relied on the production output of poor debtors for their wealth which, in this world, was an endless life of luxurious consumption.

But as a net-producer (one who produces more than you consume) that's not the best way to store your purchasing power. If you could pick a counterparty for your future, would it be a debtor who lives hand to mouth always on the precipice of bankruptcy, or a fellow net-producer? How about if you could choose between either *all* of the debtors as your counterparty, aggregated by a government which has every incentive to debase your savings, or *all* of the net-producers/savers with a 5,000 year track record of their innate drive to net-produce and save for the future? Which would you choose if such a choice existed?

This film is a classic illustration of the popular "Marxian" view of perpetual class struggle: exploitation of the workers. The wealthy live the good life consuming as much as they want on the backs of the indebted poor who must slave away producing just enough to stay alive, plus some surplus for the wealthy to consume.

But is this reality?

With the proper perspective and a little quiet contemplation it becomes obvious that, today, we highly indebted Westerners have a much higher living standard and luxurious rate of consumption than the net-producers of the world. Those supporting our lifestyle are not indebted to us—it's the other way around. And other things become clear as well. Like that credit (debt) is *demanded* by the debtors (remember, human demand drives everything), not forced upon them. And that banks, whose job it is to extend credit (aka easy money), are actually in the easy money camp along with the debtors. More on this in a moment.

The Mungerian View

Over on the other side of the coin we have Mungerian paperbug Capitalist and fair-weather friend to the "goldbugs" (a term with which I cannot identify), Izabella Kaminska [1], who, after "enduring" a few tweets from Freegolds among others, thought she schooled her buggy friends with a two-part series creatively titled, Debunking goldbugs.

I say she's the other side of the coin because Izabella thinks the savers owe it to the debtors to be their direct counterparty and earn some labor-free income via interest which the Marxians call exploitation. And I called her a Mungerian paperbug in honor of Charlie Munger because she sounds just like Munger and the Dingbat from my post A Winner Takes the Gold. Remember that Charlie thinks you're a jerk if you hoard gold? Well Izabella says you're a selfish, anti-social cheat.

She even tries channeling John Locke's reasoning into an argument against hoarding gold with this clever quote from the conveniently titled RealitySandwich.com:

> Suppose I have twelve loaves of bread, and you are hungry. I cannot eat so much bread before it goes stale, so I am happy to lend some of it to you. "Here, take these six loaves," I say, "and when you have bread in the future, you can give me six loaves back again." I give you six fresh loaves now, and you give me six fresh loaves sometime in the future.
>
> In a world where the things we need and use go bad, sharing comes naturally. The hoarder ends up sitting alone atop a pile of stale bread, rusty tools, and spoiled fruit, and no one wants to help him, for he has helped no one.

Here's some John Locke from my post dealing with Munger and the Dingbat:

> Furthermore, gold is the most socially responsible valuable good to "hoard" (save), which is another reason it is the focal point. John Locke wrote way back in 1690 that it is "foolish and dishonest" for men to hoard up things of short duration, things that are consumed in the support of life, or any more than one can personally use from the common stock of perishables and truly useful supports of life. This, Locke wrote, is how man came to value

> durable things of no industrial worth, that "he might heap up as much of these durable things as he pleased… and keep those by him all his life," because "he invaded not the right of others."

Of course you don't want to hoard perishable goods like loaves of bread! That's just silly. But it is an important concept to understand. So why hold someone else in debt rather than simply hoarding a durable thing of no industrial worth, as the real John Locke recommends? Well, Izabella's argument is that you are better off if you lend your surplus to someone so that you can later ask for it back. She calls this the "favour system" and she says that if you hoard gold then you are "opting out" of this "collaborative process".

But how does holding someone else in your debt make it more likely that you'll be able to redeem your six loaves than if you simply sold them and bought a durable thing that is extremely likely to be considered valuable by other savers in the future? In fact, it doesn't! And Izabella addresses this issue.

She says that you're better off not holding a specific person in debt because he might die, but rather holding your government's debt! She says the "sovereign lord" provides the vital service of credit aggregation and central clearing (which is true for the transactional currency) and thereby creates "fungible" and "non-perishable" debts for saving! (At least she didn't go so far as to call government debt infinitely divisible, discreet, transportable and pretty.)

But even though government debt may be relatively fungible and (nominally) non-perishable, you're still at the mercy of the government should it decide to debase your savings. Izabella says this is not only a good thing, but it is your social duty:

> Luckily for the system, the sovereign can expand or contract the number of debts that circulate within its community to match the current production/wealth profile of the nation and keep the system in check.
>
> […]
>
> You could say, the sovereign borrowed from the rich (those with surplus wealth which will otherwise perish) and redistributed the wealth according to the needs of the community. Since everybody received something, including the 'rich', a tax (cancellation of debts outstanding) kept the system in balance. Very MMT.

What she's saying here is that too much savings is a burden on the system and the government provides the valuable service of debasing burdensome levels of savings down to a socially healthy level. How does that make you feel? And yeah, Izabella is apparently quite fond of MMT, which is why this part reminded me of someone else who once said that savings above "a certain level" are a "burden". I'm talking about our very own MMT Greg:

> I don't disagree with your idea of saving but it cannot be done to much of a degree on a macrolevel. There must be someone to consume your oversupply after a certain level. **Savings is a burden when excessive**. How to predetermine the "right" amount ? Dont know. How to know it when you see it..... right now. We have OVER produced a lot of

things.

As Mosler is fond of saying, economics is the opposite of religion, in economics it's better to receive than to give. If you produce extra and **[loan]** it to me so I don't have to produce it myself .....THANKS is the proper response.

In part 2 of her bug schooling affectionately titled Gold's Anti-Social Behaviour Order, here is Izabella expressing the same sentiment as MMT Greg regarding excessive savings being a burden on the system (my emphasis):

> …there's no denying a promissory note is a much more practical unit of exchange and store of value than a bar of gold.
>
> The problem with promissory notes from a goldbug's point of view, however, is that a sovereign always has the means to "manipulate" supply ***so as to regulate the system's excesses and deficits for the benefit of the group: bringing their purchasing power of the notes down*** when there is an abundance of goods to notes "by printing more", and bringing their purchasing power up when there is a deficit of goods to notes.
>
> This puts the interests of the group above those of the individual, because — in the words of goldbugs — it "steals" wealth from individuals.
>
> ***These regulative processes of course are necessary.*** They're a correcting mechanism that ensure efficiency and curb wasteful production. And, as we've stated before, it is anticipated that promissory notes are eventually extinguished via the payment of taxes. ***In a perfect system the sovereign should provide for you, once you're no longer productive anyway***.

In other words, it is good that the government can reduce "excessive savings" through debasement. In fact it is the government's job to do that, just like it is the government's job to take care of you when you get old according to Izabella. And here is "gold's anti-social behavior" in a nutshell:

> What gold thus represents, we would argue, is an opt out, and a cheat, from participation in the group correctional process. Its existence undermines the sovereign's ability to regulate the supply of debt to match the needs of the system. In a situation where there are too many goods, and too little monetary sovereign debt, the sovereign clearly needs to create more sovereign 'debt money' — and debase the store of value — to encourage more of this overproduction to be used and efficiently allocated.
>
> Since gold can't be "debased", it begins to attract investment from those who would rather not consume today's overproduction (and via that sharing wealth and 'favours') but continue to hoard these for the purpose of individual wealth accumulation.
>
> In the opposite scenario, when there aren't enough goods to satisfy sovereign debt claims and the sovereign intervenes by contracting the money supply — by making it extremely expensive to borrow but extremely attractive to invest in the production of goods — gold

> attracts investment from those who would rather not delay consumption until tomorrow for the benefit of the community.
>
> Gold in this way symbolises humanity's selfish streak.
>
> […]
>
> So while gold may be a workable underlier for a redemption option, this doesn't change the fact that at the heart of the system it is faith and faith alone which holds everything together. Whether that faith is reflected in a sovereign's ability to manage the economy on behalf of the group, in the sovereign's guarantee to honour a gold option, or faith in the gold god himself… faith is the constant. Not gold.
>
> What's more, while gold encourages anti-social behaviour and hoarding in individuals, a fiat-based system encourages the very opposite: sharing, distribution, collaboration and cooperation.

And then she concludes with two options:

> Which leaves two possible plans out of the crisis:
>
> 1) The goldbug plan: based on encouraging everyone to hoard ever greater amounts of natural wealth for themselves and themselves in what is ultimately a commodity you might never be able to eat.
>
> 2) The fiat plan: based on encouraging society to trust each other again, and via that storing, redeeming and returning favours until the system's ails are eliminated.

This is obviously someone with both feet firmly planted in one camp telling the other camp what they should do. Almost reminds me of that famous quote about sharing and unselfishness by… hmm, I forget, was it Jesus? ***"From each [producer] according to his ability, to each [consumer] according to his needs."*** Funnily enough, here's what Wikipedia says about that quote:

> In the Marxist view, such an arrangement will be made possible by the abundance of goods and services that a developed communist society will produce; the idea is that there will be enough to satisfy everyone's needs.

Now compare that idea with Izabella's post one week later titled The end of artificial scarcity:

> It's an environment that we have argued requires a new paradigm for the world. A transition towards a steady-state where money has no choice but to depreciate because its role as a store of value has been made redundant due to the general abundance of goods in society, brought about by technological innovation and efficiency. In a post-scarcity environment there is no need to delay or hurry purchases, or to even have a store of value. You use only what you need.

[…]

And when that happens money itself will die, because who needs to save for their old age, if over the time the system is going to provide ever more “stuff” you need for free or almost for free.

Not convinced?

We’d argue the signs that this is happening are already appearing.

Отъ Военно-Революціоннаго Комитета при Петроградскомъ Совѣтѣ Рабочихъ и Солдатскихъ Депутатовъ.

Къ Гражданамъ Россіи.

Временное Правительство низложено. Государственная власть перешла въ руки органа Петроградскаго Совѣта Рабочихъ и Солдатскихъ Депутатовъ Военно-Революціоннаго Комитета, стоящаго во главѣ Петроградскаго пролетаріата и гарнизона.

Дѣло, за которое боролся народъ: немедленное предложеніе демократическаго мира, отмѣна помѣщичьей собственности на землю, рабочій контроль надъ производствомъ, созданіе Совѣтскаго Правительства — это дѣло обезпечено.

ДА ЗДРАВСТВУЕТЪ РЕВОЛЮЦІЯ РАБОЧИХЪ, СОЛДАТЪ И КРЕСТЬЯНЪ!

Военно-Революціонный Комитетъ при Петроградскомъ Совѣтѣ Рабочихъ и Солдатскихъ Депутатовъ.

25 октября 1917 г. 10 ч. утра.

Да здравствует революция indeed!

In truth, Izabella's whole argument in the two goldbug posts was based on a flawed premise considering that they were spawned by her frustration at interaction with "Freegolds" and a few of my other "regulars" on Twitter rather than with true goldbugs. That premise was her assumption that they (we) have, in her words, an "utter and complete hatred of the so-called paper money system."

The truth is that we view the primary and secondary functions of a monetary system separately. Paper money (and electronic currency) is, in fact, the best thing since sliced bread in the transactional role. Here's a quote from our very own Aristotle describing his personal journey and discovery that paper money is not only good, but necessary, back in 2000:

"Going in, I was a charter member of the Goldhearts club [aka a goldbug], and I emerged even more excited about the prospects of Gold than before. The future for Gold is bright, and it is rapidly approaching in the manner I laid out, if I'm reading the signs correctly.

In working on this project, **I was personally shocked when I discovered that we absolutely NEEDED paper currency in order to set Gold free**."

Freegold is not about making easy money a little bit harder. On the contrary, it is about the debtors and

the savers coexisting without the perpetual monetary conflict embedded in all prior systems. (See The Debtors and the Savers 2010 for more about this perpetual conflict.)

Izabella has probably never heard of FOFOA's dilemma. Here it is, from The Return to Honest Money:

FOFOA's dilemma: When a single medium is used as both store of value and medium of exchange it leads to a conflict between debtors and savers. FOFOA's dilemma holds true for both gold and fiat, the solution being Freegold, which incidentally also resolves Triffin's dilemma.

And from that same post, here's my definition of Honest Money: "My definition is that honest money is simply money that does not purport to be something it is not." As I explained in that post, money's two main functions, medium of exchange and store of value, are actually fulfilled by two different media, even today: a primary and a secondary medium of exchange. Today (and in Izabella's ideal world) that secondary medium of exchange is debt denominated in the primary medium.

The quote at the top of my blog reads: *"Everyone knows where we have been. Let's see where we are going!"* Well, everyone knows we have been where debt is the systemic store of value, its "tier 1" reserves, and Izabella doesn't seem to be arguing the inevitability that this is also our future. Instead she seems to be arguing that it is simply the better of two choices—the socially responsible and unselfish thing to do with your savings. But is she correct? Is debt really better than gold for the overall society?

In order to answer this question I think we need to look carefully at which one is better from two different perspectives; from the perspective of the savers and from the perspective of society at large. I'm attributing the perspective of society at large to that of the debtors as well. As I pointed out earlier, Izabella is clearly in the debtor camp. This doesn't necessarily mean that she's in debt. It simply means that she's in the easy money camp as opposed to being in the hard money camp—what she thinks of as "the goldbugs".

She may in fact have savings, but as she says, she "puts the interests of the group above those of the individual" and she's happy to do her civic duty of letting the government debase her savings when necessary. This puts her firmly in the debtor camp. And being in the debtor camp, she is obviously arguing for the benefit of the overall society or economy. So that's why I say I'm attributing the perspective of society at large to that of the debtors as well, because they are apparently one and the same.

Now would probably be a good time to restate that "the debtors and the savers" is a dichotomy, not a moral judgment. It is a way of viewing the world in two camps that corrects Karl Marx's most enduring (and harmful) legacy. Neither camp is better than the other any more than women are better than men. It is simply a model for understanding how two groups with apparently different innate tendencies have always been placed in conflict with each other throughout history due to the emergence of monetary systems. If you haven't read The Debtors and the Savers yet, now would be as good a time as any! ;)

From the Viewpoint of the Savers

Is money positive or negative equity? Izabella correctly implies money to be fungible claims on each other's goods. And she goes on to explain that these claims can sometimes be too numerous "when there aren't enough goods to satisfy" all of the claims. This, she explains, is when the government steps

in and makes adjustments to keep the number of claims roughly in line with the number of goods.

So when we look at money (or claims against the physical plane of goods and services) in aggregate, we can clearly see that hypothetically doubling or tripling the number of claims actually reduces the specific amount of equity in the physical plane each fungible claim represents. It is for this reason that I like to think of money in aggregate as negative equity, and also why I like to delineate between the monetary and physical planes.

Being a claim, it is merely one half of a physical plane barter transaction. You sold a good or provided a service in the physical plane and received a claim in the monetary plane. Once you redeem that claim for a good or service in the physical plane you will have completed a full transaction. But until that time, while you are holding money, you are only halfway there. And for as long as you remain in this barter purgatory, you are exposed to the effects of your claim being negative equity which I just described.

(I used the term "money" above because if, hypothetically, the gold stock could be doubled or tripled quickly enough, the same principle would apply to gold.)

Clearly it is the well-known exchange rate between monetary claims and the physical plane—as opposed to some intrinsic or cost-derived value—which gives these claims their value. It is the observed completion of other transactions today, yesterday and last week, which informs us of what we can expect to get for the claims *we* are holding. But as savers, we intend to hold these claims for a long time, perhaps even decades, so we want some sort of additional reasoning as to why they will hold this present known value for such long periods of time.

Of course very few savers hold the primary medium of exchange for long periods of time. We hold what Mises called secondary media of exchange. And the world is full of things other than "the common stock of perishables and truly useful supports of life" which we can hold (hoard) for this purpose, from stocks to bonds to antiques, classic cars or even baseball cards. Here is Mises from his book Human Action explaining the concept of secondary media:

> A first-class bond is more marketable than a house in a city's main street, and an old fur coat is more marketable than an autograph of an eighteenth-century statesman. One no longer compares the marketability of the various vendible goods with the perfect marketability of money. One merely compares the degree of marketability of the various commodities. One may speak of the secondary marketability of the vendible goods.
>
> He who owns a stock of goods of a high degree of secondary marketability is in a position to restrict his cash holding. He can expect that when one day it is necessary for him to increase his cash holding he will be in a position to sell these goods of a high degree of secondary marketability without delay at the highest price attainable at the market.
>
> […]
>
> Consequently there emerges a specific demand for such goods on the part of people eager to keep them in order to reduce the costs of cash holding. The prices of these goods are partly determined by this specific demand; they would be lower in its absence. These goods

> are secondary media of exchange, as it were, and their exchange value is the resultant of two kinds of demand: the demand related to their services as secondary media of exchange, and the demand related to the other services they render.
>
> […]
>
> One must not confuse secondary media of exchange with money-substitutes. Money-substitutes are in the settlement of payments given away and received like money. But the secondary media of exchange must first be exchanged against money or money-substitutes if one wants to use them—in a roundabout way—for paying or for increasing cash holdings.
>
> Claims employed as secondary media of exchange have, because of this employment, a broader market and a higher price. The outcome of this is that they yield lower interest than claims of the same kind which are not fit to serve as secondary media of exchange. Government bonds and treasury bills which can be used as secondary media of exchange can be floated on conditions more favorable to the debtor than loans not suitable for this purpose. The debtors concerned are therefore eager to organize the market for their certificates of indebtedness in such a way as to make them attractive for those in search of secondary media of exchange. They are intent upon making it possible for every holder of such securities to sell them or to use them as collateral in borrowing under the most reasonable terms. In advertising their bond issues to the public they stress these opportunities as a special boon.

I included all of that long excerpt so that you could see how he explained, in his own words, the concept of a focal point in this secondary media role. Many items will suffice as a secondary medium of exchange, but the more an item is used in this function, the more value it derives *from* this particular function, over and above the value from other uses: *"…their exchange value is the resultant of* ***two kinds of demand****: the demand related to [1] their services as secondary media of exchange, and the demand related to [2] the other services they render."*

And then you probably noticed that his search for the focal point led him to government bonds. I figured this would make Izabella smile if she's still with us. So why do you think he didn't mention gold as one of the secondary media of exchange? Perhaps it was because, when he wrote the book in 1940, gold was the *primary* medium of exchange.

I think I'm now at the point where I can narrow the focus of the discussion substantially. Izabella and I are both talking about government debt versus gold as the two main competitors to becoming the focal point store of value (aka secondary media) of the future. So let's just stipulate that and move on. Also, I think we can both agree that government debt *has been* the official (and focal point) secondary medium of the recent past. Furthermore, Izabella says that between government debt and gold, gold is the more ***selfish*** choice. I'll stipulate to that as well.

In a moment we'll investigate whether the "selfish" choice is the better one for the economy as a whole, but in this section we are looking at it from the "selfish" viewpoint of the savers. Izabella admits that the government debases its own debt, which, taken along with her labeling of gold as the "selfish"

choice, leads me to believe that she would be okay stipulating that, at least on the surface, gold *appears* to be the better choice from a "selfish" saver's perspective. So then the only question remaining is whether or not gold actually *is* better as it appears to be. Izabella says no.

Izabella warns "us" via Twitter: *"The problem with gold (imho) is that it isn't a scarce commodity. You have to physically make it scarce by hoarding it."*

The only problem with her tweet is the word "problem". Other than that, she's absolutely right! There are 170,000 tonnes of gold out there somewhere, 60 times annual production—that's a 60 year "supply overhang" in commodity terms—and yet the flow today is barely more than what's coming out of the ground. That's not a problem. That's absolute ***proof*** that gold is far more valuable than its commodity price today!

Gold's value really comes from intergenerational Giants who have no need to ever sell it. They really just net-produce and net-produce and they do it willingly for more and more gold, and then just sit on that gold until they die and pass it on to the next generation. And they will keep doing this no matter what the $PoG does. They're not buying it for its weight, but for proven long run currency exchange value! But if there's no flow for them to get some, then they have to buy things like extra castles and cars and stuff that drives up prices and drives down everyone else's purchasing power.

So it's better for everyone if there's a steady flow of gold. Remember how Another said they justified the "gold as a commodity" (strong dollar) trade because they thought it would induce the mining industry to produce greater and greater quantities of gold?

Date: Mon Feb 16 1998 14:40
ANOTHER (THOUGHTS!) ID#60253:

Now, back to gold. The deal: you may stand your army for us, in return, "oil will back the dollar if the dollar is made strong by gold" "in as much as our people may replace the lost value of oil with gold" "in as much as we will produce oil in amounts to equate a gold/oil/dollar ratio close to that which existed at our previous agreement in the 70's" And, pray tell, how does the USA make the dollar strong in gold ? The BIS leads the creation of a paper gold market that will lower the world price of gold to the extent that it remains above "production costs".

Guess what, it worked! Contrary to all expectations of oil shortages, inflation, debt collapse and what have you, It Worked! But, there is one small problem?

The BIS and other various governments that developed this trade (notice I didn't use conspiracy as it was good business, as the world gained a lot), **thought that the paper gold forward market would have allowed the gold industry to expand production some five times over! Don't ask where they got this, as they are the same people that bring us government finance and such.** But, without a major increase in gold supply, the paper created by this "gold control operation" will either be paid by, 1. new supply. 2. the central banks. 3. rollover existing. 4. cash? or 5. total default! As the Asians started buying up everything last year (97) , numbers 5 and 5 started looking like the answer! When the CBs started selling into this black hole of demand, the discussion of #5 started in their rooms also.

So it's good for everyone if there's a steady flow of gold and a stable price for the Giants. These Giant

super-producers (including oil producers) will produce the most stuff and leave it on the economic table for us without running up the prices of things we need to buy as long as gold is flowing unrestricted. And also, when CBs and nation-states start valuing gold the way these Giants do, we won't have the mines running at full steam trying to add more to the supply. First of all they'll want the price to stay steady for the economic benefit net-producers bring to the table, and second of all they'll want their own treasure to hold its value. And to the nation-state, gold in the ground is a treasured reserve as well as gold in the vault.

It may seem counterintuitive, but the flow of gold from the mines will eventually be controlled or regulated by the government and, in most cases, will be just enough to keep the miners economically viable. This is why I view mining shares as a terrible Freegold play. Today the flow of physical gold is mostly from the mines to the savers. In Freegold, the flow will be almost entirely from the above-ground stock, from one saver to another.

As I wrote about in Glimpsing the Hereafter, gold is like a closed circuit for the savers, isolated from the transactional currency system which is used by everyone, debtors and savers alike. Some might call it selfish. I can live with that. Here's a taste from that post:

> I think that if we look closely at how the debtors use the fiat money system with and without the assistance of the savers, it will become clear that we will all be better off with a bifurcated monetary system. And it will certainly be clear that the savers have no business taking debtors on as the counterparty to their savings.
>
> […]
>
> So gold has kind of a double float. It floats with the inflation/deflation of everything else. And then it also floats in a closed circuit consisting only of savers (and their "hoard/dishoard" choices), of whom the majority (measured by value stored) are intergenerational giants.

The way the gold market works today is a little different. It is kind of a flow within a flow. On the surface, anyone can very easily buy exposure to the price of gold. In fact, this "exposure" is all that most Westerners want, including traders, speculators, goldbugs, hedgefunds, anykindafunds, banks, you name it. And most of this group is firmly in the debtors (easy money) camp. But underneath this superficial flow is the physical flow from the miners and physical gold pukers in the West to the true savers like the Giants in the oil-rich Middle East and net-producing Asia.

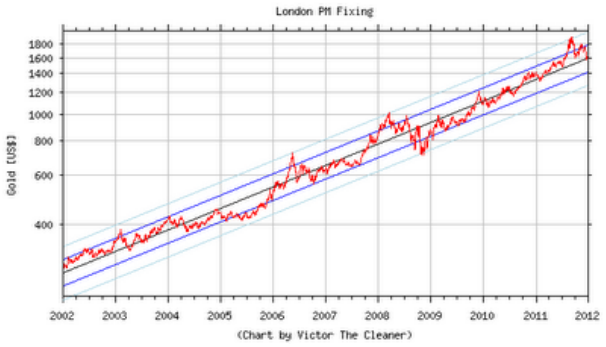
The key to keeping this gold market humming along, however, is that anyone who asks for physical in any size has to get it. But those who can afford real size also know that hogging the flow and stressing the system is not the best way to get what they want. So here's what we know. In 1997 the LBMA leaked to the Financial Times a paper gold clearing volume far greater than anyone imagined. This was the same time that Another said "the Asians started buying up everything" and that "the CBs started selling into this black hole of demand."

About two years later we heard from the European CBs through the WAG (the Washington Agreement on Gold) also known as the CBGA (the Central Bank Gold Agreement). The agreement came on the

heels of the euro launch and, even though it was announced in Washington DC during an IMF meeting with Larry Summers and Alan Greenspan present, it was only between the European central banks. It stated very simply the following:

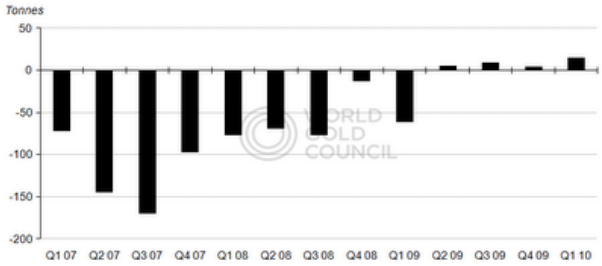
> In the interest of clarifying their intentions with respect to their gold holdings, the undersigned institutions make the following statement:
>
> 1. Gold will remain an important element of global monetary reserves.
>
> 2. The undersigned institutions will not enter the market as sellers, with the exception of already decided sales.
>
> 3. The gold sales already decided will be achieved through a concerted programme of sales over the next five years. Annual sales will not exceed approximately 400 tons and total sales over this period will not exceed 2,000 tons.
>
> 4. The signatories to this agreement have agreed not to expand their gold leasings and their use of gold futures and options over this period.
>
> 5. This agreement will be reviewed after five years.

Two years later, in 2001, gold began a relentless climb in dollar-denominated price of about 18% per year which continues today:



And then, in 2009, the CBs in aggregate became net-buyers of shiny rocks:

Change in official gold holdings (tonnes)



Source: GFMS

In 2011 the LBMA released a survey revealing not just the clearing volume it began reporting in 1997, but the *total daily turnover* in LBMA bullion bank gold credits. From my post Once Upon a Time:

And that's because the price of gold today still does not reflect the physical flow of gold that would normally be a function of arbitrage, with speculators transporting gold to where its purchasing power is highest. The flow of gold today is still sterilized by the paper gold trade within the LBMA bullion banking system that, by a recent LBMA survey, was around 250 times larger than the flow of new gold from the mines. That's a total turnover in the LBMA (sales plus purchases) of 5,400 tonnes every single day. That's the equivalent of every ounce of gold that has ever been mined in all of history changing hands in just the first three months of 2011. That's what the LBMA members, themselves, voluntarily reported. And *that's* a lot of paper gold that is still sterilizing the economically beneficial price mechanism that physical gold would otherwise be transmitting.

Yet things are changing, even today. That's what the rising price of gold since 2002 tells me. This is about much more than just a rising price. It's not just about a gold or even a commodity bull market. As FOA said, "it has everything to do with a changing world financial architecture." Gold's ***function*** in the monetary system is changing. And as FOA also said, "None of the other metals will play a part in this."

Gold will return to its pre-1922 function, but that does not mean we will return to a pre-1922 gold standard. This post is not about the merits of the gold standard. It is not about praising the hard money camp's decision in 1445 over the easy money camp's decision in 1922. It is about the choice of the Superorganism over the management of men. The pre-22 gold standard, although it allowed gold to function, still carried the same flaw I point to so often; that using the same medium for exchange and savings leads to regular recurring conflicts between the two camps.

Then in 2012 (just a couple of days ago actually), the US FDIC announced that gold bullion is up for consideration as an equal to government debt with a zero risk weighting. And just yesterday Ben Bernanke signaled his subconscious support for this measure by choosing to wear a gold tie. ;)

I'm sure this is all very insignificant information to a Mungerian paperbug like Izabella Kaminska, but let's just think about this for a second as it compares to *her* racehorse: government debt.

From a saver's perspective—one who wants to hold claims for a long but unknown, unspecified amount of time—debt is attractive in a *falling* interest rate environment. This is because debt usually has a specific maturity date and yet savers can't know precisely when they'll need their money. So debt is appealing as long as there is a liquid secondary market with plenty of upside to run.

This is most obviously true when interest rates are allowed to be set as high as necessary by the unfettered marketplace and then they begin to fall for one reason or another. As interest rates fall, old promissory notes signed when rates were higher become more dear. Debtors seek refinancing while savers can easily unload their saving without losing purchasing power.

This was the case from 1981 to present. Interest rates fell (for one reason or another) from around 20% down to 0%. Today there's not a whole lot of room for them to fall any further except for maybe going negative, and then you're just losing principle. So there's not much upside for debt today like there was in 1981, but with ZIRP there is a whole lotta potential downside.

Not only that, but in this case we're talking specifically about *government* debt. And what are our choices today? We can choose between almost no interest (actually negative real interest) from a government which is openly debasing its currency and diluting its bond market, or a slightly higher interest rate from a government with serious budget problems and some non-zero likelihood of default. That's quite a choice for a secondary medium with limited upside and unlimited downside!

Then there's gold, with limited downside and lots of upside potential. It's a tough sell to savers who have been swimming in a sea of Mungerian paperbuggerdom their whole lives, but not to the true Giants who already hold 170,000 tonnes and aren't letting it go at today's paper gold prices. As I have already pointed out, the intergenerational Giants who hold a great deal of this physical gold have no ***need*** to ever sell it. This is a key concept you might want to stop and ponder.

Lastly, I want to mention the nominal savings argument. Government debt, especially a government like the USG which can print its own currency, is at least nominally safe. If you save a million dollars you'll get a million back at the end of the day. The only question is what will be the purchasing power of those dollars when you need them. Well the same nominal argument applies to gold when applied properly. If you buy 500 ounces of gold you will still have 500 ounces of gold at the end of the day. The only question is what will be the purchasing power of those ounces when you need them. See?

So, not that I think I have convinced Izabella of anything, but just so that we can move on, let's agree that from the viewpoint of the savers—perhaps even a selfish viewpoint if that helps—who want to hold fungible "claims" on goods and services for a long but unknown/unspecified amount of time, gold beats government debt today hands down. If you don't agree then please return to the top of this section and read it again. If you agree, let's move on to the viewpoint of the debtors, aka the viewpoint of the economy as a whole.

From the Viewpoint of the Economy as a Whole

In the simplest terms, I like to refer to the savers as net-producers. All this means is that a saver consumes less than she produces. It's really the simplest way to differentiate the debtors and the savers. In general, the debtors either consume as much or more than they produce by borrowing, taxing or printing money. Of course everyone consumes, and everyone produces to one extent or another. But at the margin, debtors consume and savers produce.

My delineation does go a little deeper than this, though, to include monetary preference. That's why I use "the easy money camp" interchangeably with "the debtors". The easy money camp prefers easy money for various reasons including not just the ease of repaying debts but also that easy money may be how they make a living. And this is why I put the banking industry, including Wall Street, in the easy money camp along with the debtors.

Banks, of course, are often the creditors to the debtors. And that's why it's the debtors and the *savers* rather than the debtors and the creditors. The debtors and the creditors are in the same camp together! As I said earlier, it's not a good idea for the savers to be counterparty to the debtors. But, of course, Izabella Kaminska disagrees. She thinks it's the savers' civic *duty* to be the debtors' counterparty.

In thinking through which is best for the economy as a whole, it is important to understand that the excess money earned from net-producing does not disappear no matter how it is saved. It is always passed along to someone. The money remains in the economy. Hoarding gold does not deprive the economy of your excess earnings any more than buying government debt does.

If you choose to save in debt, your money is passed on to a debtor. A debtor's natural inclination is to net-consume (consume at the margin) rather than net-produce (produce at the margin) if at all possible. So by saving in debt you actually encourage a natural predilection to produce *less* since you enable specifically those people with the tendency to borrow rather than produce. In the long run you end up with high unemployment.

But in Freegold, the money that comes from net-producing is passed on to other net-producers who choose to sell their gold for one reason or another. These "dishoarding" net-producers (savers) are either going to use that money for consumption or they will use it for productive purposes like starting or expanding a business. All of these uses tend to employ someone. And if the easy money camp is managing the currency prudently, some may even sell their gold for money just so they can lend it for productive purposes, or invest it in promising ventures.

Debt-financed consumption only expands the total amount of debt and the ranks of the unemployed. The idea that debtors borrowing to consume can sustainably raise employment levels is pure hogwash.

So in no uncertain terms, Freegold *is* the key to true full employment! Debt as an alternative to gold ultimately leads to high unemployment! Izabella, Munger and the Dingbat are all dead wrong!

The Winds of Change

Are you enjoying high unemployment yet? The $IMFS is, even though its leaders will never admit it. One of the Fed's (quote-unquote)
"mandates" is full employment and Obama touts (quote-unquote) softening unemployment while the number of PhDs on food stamps has tripled.

Everyone would enjoy full employment, right? The debtors, the savers, the economy as a whole? Well, maybe everyone except the welfare junkies. And who's the biggest welfare junkie of them all? The only hint I'm gonna give you is look at the picture at the top of this post. See? Welfare junkies don't always look like this:

It's Free Swipe Yo EBT

The flight plan to global unemployment was filed in 1922 when they came up with the brilliantly circular idea of using credit as the store of value foundation for credit. Of course global unemployment is a fantasy island destination, so here we have had an emergency hard landing on the island of reality with a brief layover before heading toward our new destination, change.

Banks can provide all the credit the debtors need beyond their ordinary income (and that includes governments). There is no fundamental economic need for the savers to contribute their surplus earnings through debt securitization as a store of value. All that does is encourage unemployment.

The savers have no business being counterparty to the debtors. A German economist, uber-easy money camper and social justice activist who wrote the book on easy money a century ago even said as much.

From his book cleverly titled 'Free Money' on which John Maynard Keynes showered fulsome praise, here's Silvio Gesell:

"And it is clear that money cannot be simultaneously the medium of exchange and the medium of saving - simultaneously spur and brake.

[...]

I therefore propose a complete separation of the medium of exchange from the medium of saving. All the commodities of the world are at the disposal of those who wish to save, so why should they make their savings in the form of money? Money was not made to be saved!"

And a fun quote from Keynes:

> "I believe that the future will learn more from Gesell's than from Marx's spirit."

The Debtors and the Savers is simply a common sense adjustment to the prevailing dichotomy of the Capitalists and the Laborers, or the bosses and the workers. It is a slightly altered lens with which to view the history of the world. The old lens has a bloody history of leading to dangerous and deadly confrontations. It will also prevent you, personally, from understanding Freegold early enough to profit from that understanding.

Of course all present goods and services get used in the present, but that doesn't mean that surplus value is only an illusion based on exploitation. Surplus value is very real, and savable through any length of time and in theoretically limitless amount. But not if you're using debt as the medium. Using debt, too much "savings" becomes a burden which is then dealt with one way or another.

Everyone will understand this eventually, although it may not specifically be called "Freegold" in the end. Thinking for yourself pays. Seeking reassurance feels good, but it doesn't pay. Waiting for official confirmation is also rewarding, but the reward isn't money.

"Change isn't easy. More often, it's wrenching and difficult. But maybe that's a good thing. Because it's change that makes us strong, keeps us resilient, and teaches us to evolve."

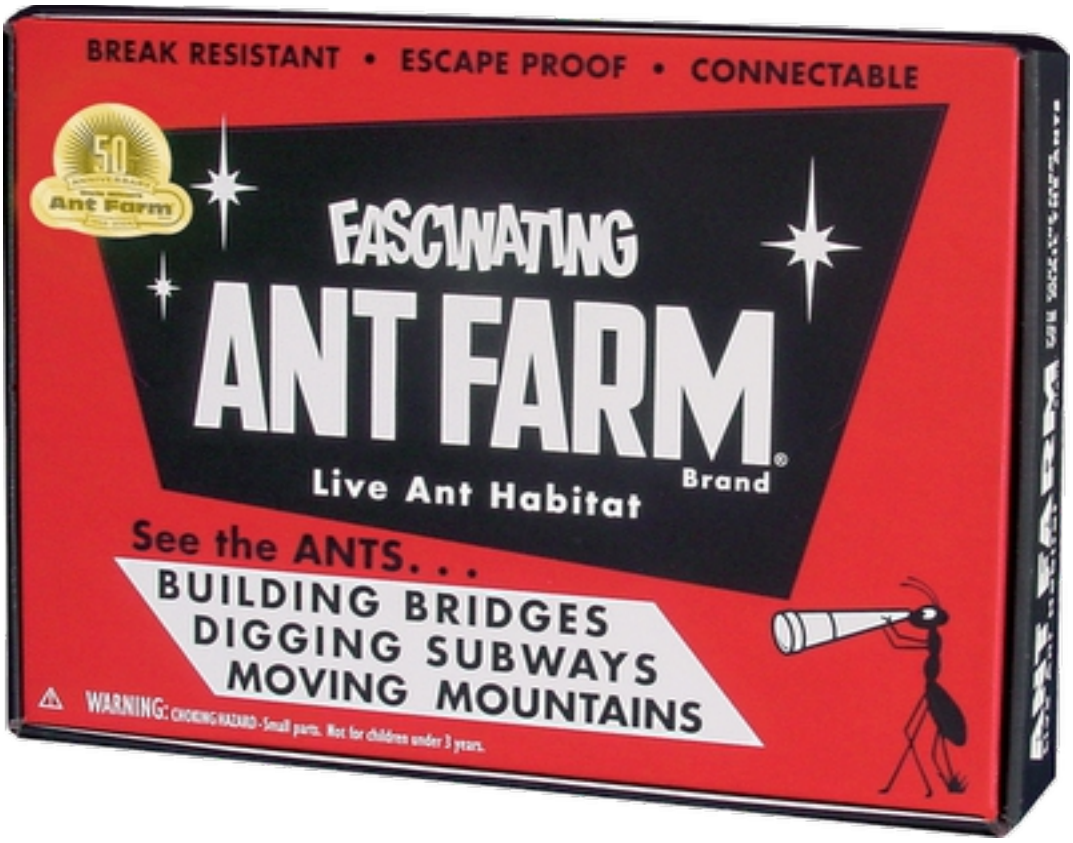
FOA: "It has everything to do with a changing world financial architecture. And I have to admit: if you hated our last one, you will no doubt hate this new one, too. However, [and here's the all-important caveat] everyone that is positioned in physical gold will carry this storm in fantastic shape."

Sincerely,
FOFOA

[1] Note to Izabella: When I use you in a post like this you shouldn't take it personally. I never expect to change a fixed mind. You were simply used as a literary device, so please don't take it personally. Or do… that could be fun!

Sunday, April 18, 2010

Life in the Ant Farm



Dear reader, is all of this Goldman Sachs securitization and interest rate swap business making your head spin? SPVs, SIVs, SPEs, PPPs, PPIs, PFIs, SPCs, CDOs, CDSs, ABSs, MBSs... whew! I know it's making me dizzy. And I find that when my head starts to spin it is useful to fire up the old hooch still and cook it down into something more easily consumable.

We all like animal analogies, right? I probably should have gone with rats in a rat race or hamsters on a treadmill, but instead I chose ants in an ant farm. Not very glamorous, I know, but let me explain why selected these robust yet delicate creatures.

Did you ever have an ant farm when you were little? An ant farm makes the ants' behavior easily visible and controllable. They are imprisoned in a two-dimensional world in which their decisions are limited and their needs are met by you! They can only go side to side and up and down. And up usually leads them to the leaf you dropped into the ant farm for their lunch! But in the wild...

Ants form highly organized colonies which may occupy large territories and consist of millions of individuals. These large colonies consist mostly of sterile wingless females forming castes of "workers", "soldiers", or other specialized groups. Nearly all ant colonies also have some fertile males called "drones" and one or more fertile females called "queens". The colonies are sometimes described as superorganisms because the ants appear to operate as a unified entity, collectively working together to support the colony. (Wikipedia: Ant)

A superorganism is an organism consisting of many organisms. This is usually meant to be a social unit of eusocial animals, where division of labor is highly specialized and where individuals are not able to survive by themselves for extended periods of time. Ants are the best-known example. The technical definition of a superorganism is "a collection of agents which can act in concert to produce phenomena governed by the collective," phenomena being any activity "the hive wants" such as ants collecting food or bees choosing a new nest site.


Superorganisms exhibit a form of "distributed intelligence," a system in which many individual agents with limited intelligence and information are able to pool resources to accomplish a goal beyond the capabilities of the individuals.

Nineteenth century thinker Herbert Spencer coined the term super-organic to focus on social organization... Similarly, economist Carl Menger expanded upon the evolutionary nature of much social growth, but without ever abandoning methodological individualism. Many social institutions arose, Menger argued, not as "the result of socially teleological causes, but the unintended result of innumerable efforts of economic subjects pursuing 'individual' interests." (Wikipedia: Superorganism)

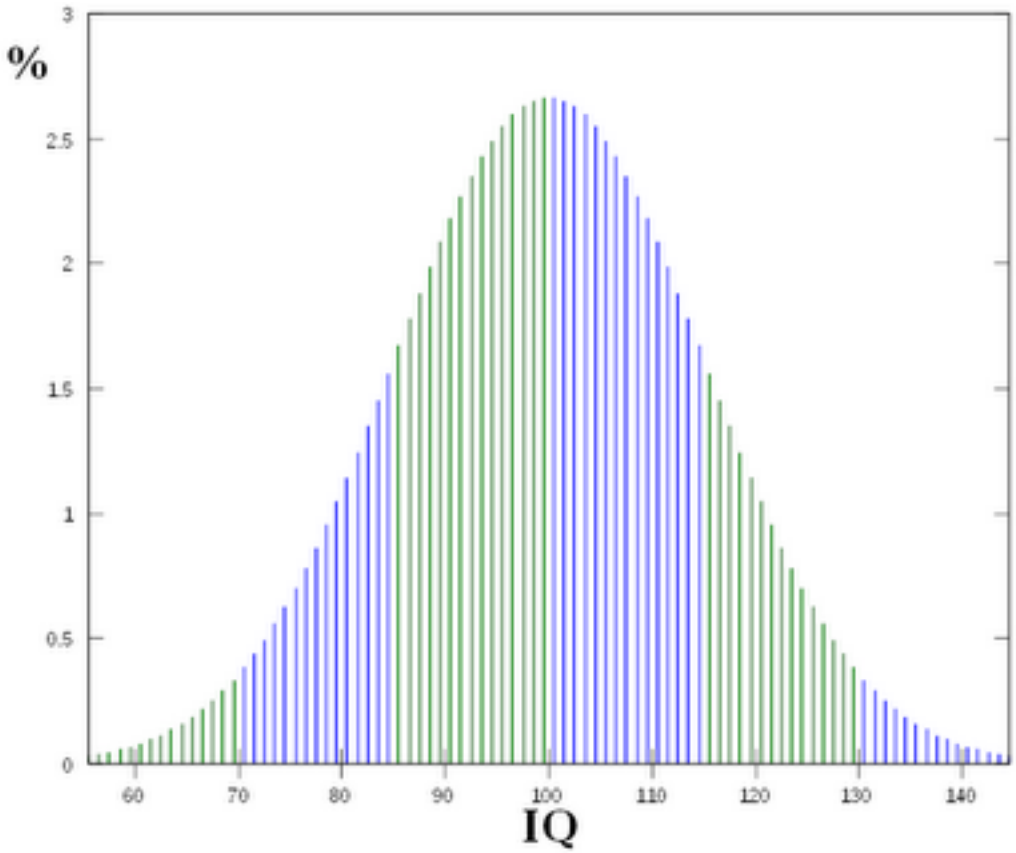
Methodological individualism does not imply political individualism, although methodological individualists like Friedrich Hayek and Karl Popper were opponents of collectivism. Detaching methodological individualism from political individualism... if a properly-functioning communist regime were to arise, it too would have to be sociologically understood on methodological individualist principles. (Wikipedia: Methodological Individualism)

Hopefully I didn't lose you yet. I know, I'm supposed to be distilling not mixing, but I needed to draw the connection between ants and economics. Did you get it? Ants are dumb little creatures by

themselves. But even as dumb as they are, some are more skilled at smelling and finding food while others are better at fighting, and some others are really strong, for carrying food back to the colony for lunch.

And in a wild colony of ants these individuals end up specializing in what they do best which leads to a collective intelligence far greater than the intelligence of any individual ant.

In this way, humans are similar to ants! A normal IQ distribution among humans ranges from 60 to 140. To me as an average human this seems like a very wide distribution. The dumb seem very dumb, and the smart seem really smart. But in the big scheme of things the human intelligence distribution is not so far off from the ant "intelligence" distribution. In other words, the smartest ant in existence doesn't even come close to the "distributed intelligence" of a wild colony. And the same goes for humans!



But when we put ants into a two-dimensional, controlled environment, the distributed intelligence of the superorganism is stifled and nearly snuffed out. As a confined group they end up no smarter than an individual ant.

Throughout human history the division of labor, or economic specialization, has brought fantastic growth in total human output and led to the astonishing complexity of modern computers and industrialization. These vast leaps were truly the accomplishment of the distributed intelligence of the human superorganism, with a relative IQ perhaps in the thousands.

And behind each great leap of mankind was a string of important decisions made by methodological individuals. This is true capitalism. In order for the human superorganism to display its "IQ in the thousands", certain specialized individuals must be free to make the most important decision. The individuals I'm talking about are the savers, or as I sometimes call them, the "super-producers".

They are the people whose contribution to society exceeds their own daily needs, creating an excess of wealth. And the most important decision for the human superorganism is the savers' choice between hoarding their wealth, or deploying it into the economy!

It is this decision process, made millions of times at the *individual level*, that lends the superorganism its superior IQ. There is no single human that possesses an intelligence high enough to compete with the human superorganism, just as there is no single ant that is smart enough to make better decisions for the colony than the colony itself. In fact, there is not a single *human* that could do a better job running the ant colony, although man has written many complex algorithms trying to mimic and even

improve upon the collective intelligence of ants.

Debt and Specialization

As it turns out, the people that contribute the greatest leaps for mankind often don't have the wealth to realize their dreams on their own. They must engage other people with wealth, who on their own don't possess the knowledge and ability to make great leaps for mankind. It is this "working together" that made things like electricity possible.

I said earlier that the most important individual decision is between hoarding and deploying one's wealth. Modern socialist thinkers will all tell you that hoarding is always bad for the economy. That the key to a thriving economy is the free (read: forced) deployment of *all* wealth back into the economy immediately once it is saved. But the problem is that removing the decision process from the savers changes the behavior of both the savers (lenders) and the debtors.

Debt becomes cheap and easy to get, therefore debtors no longer need great ideas like "electricity" to get a loan. And for the savers, the choice becomes as simple as a multiple choice test for a government job. The lowest common denominator rules the collective as those with a 60 IQ face the same choices as those with a 140: low yield (supposedly safe) or high yield (more risky). What is missing is the option to hoard, without losing purchasing power, which forces lenders to look at debtor's "proposals" more closely.

The GFC

Debt is the most fundamental cause of this Global Financial Crisis (GFC). More specifically, it is the modern method of usury that compels large pools of savings into the service of new debt. Savers must have a way to hoard outside of the economy for the economy to be efficient. It is the selection process of when and how to deploy one's savings that keeps both debt in check, and the economy efficient and productive. And it is the coerced loaning of all savings, with the lenders and borrowers segregated by a "Chinese wall" of bankers interested only in fees and bonuses, that has led to the massive malinvestment and explosive debt of today.

This GFC is the final stretch in the long evolution of money, spanning centuries, that led to a global monetary system in 1944, a purely symbolic fiat system in 1971, an electronic computer-assisted system in the 80's and 90's and today's insurmountably complex system of derivatives. With each step adding new layers of complexity and distancing finance from reality, the savers and the debtors have now become so disconnected from each other that our human superorganism is now literally dumber than the lowest functioning human. The collective IQ is now probably well below 50, thanks in large part to the "geniuses" on Wall Street who created SPVs, SIVs, SPEs, PPPs, PPIs, PFIs, SPCs, CDOs, CDSs, ABSs, MBSs... We are truly ants in an ant farm!

As Paper Burns

In Sultans of Swap - Explaining $605 Trillion of Derivatives, Gordon Long writes "The cheaper money is, the more borrowing will occur. Everyone is happy except the unwitting lender."

This line really gets to *why* all these "genius" Wall Street creations are such an explosive problem today. "Everyone is happy except the unwitting lender." The "unwitting lender" is all the savers and "super-producers" of the world. It is everyone you know who has a pension or a pension fund. It is everyone you know who has a 401K or an IRA. The "unwitting lender" is anyone and everyone who relies on the $IMFS and its network of specially trained and licensed financial advisors with official titles like RIA, CFP, CFA, CPA, ChFC, CRPC, RFC, MSFS, all of whom are practically bound by law and fiduciary duty to NOT tell you the *true* nature of the risk you are facing.

On the other hand we have the writings of one with remarkable wisdom, relegated to pseudonymous postings on an Internet forum, warning us more than 12 years ago of things like this...

Much paper value will burn before this fire is done!

If you owned an oilwell in your back yard and no-one could take control of it, then oil is the best investment. But, most people use various forms of western paper to trade oil and that paper will burn in a currency fire.

Metals have not shown their true worth for many years as the world has done very well. This is very good. But, all things do change! As it is our time and place to live this change, our thoughts must view the future as it must be. Who can know the minds of men and countries as paper burns?

Remember, "when the currencies go to nuclear war, all paper and paper markets will burn"! Many hard

assets will lose in the public mind as confusion will rule. In the thoughts of many, gold will perform!

In that day, debts will burn and currencies will war, and you sir will, with honor, raise your standard of living with Gold!

Your profits from such trade, will, on the last day, in the heat of fire, burn as paper does! Sir, the world is going to change, and the rules of engagement will also change. Gold will be repriced, once! It will be enough for your time of life.

Sir, The history of "Hot" paper money does show it to "burn easily" from "much heat"! If you read my Thoughts in today's replies, we see much "fuel" in dollar derivatives trading in foreign markets.

During this result, all paper will burn and the world economy will start over. However, the BIS is buying gold for customer governments as they begin to lower the dollar. This action, began some months ago will bring gold up, perhaps to the middle $360 range. If the world paper markets do not destroy themselves, gold stocks may rise for a time. But, physical gold is the good hold for this time. Source

This kind of advice is all but *illegal* within the $IMFS! If it's ever even spoken, it is whispered and "off the record". But I guess that's why you're here, reading "voluminous posts" by a pseudonymous blogger, eh?

At the top of this section I mentioned Gordon Long. I recommend his recent articles for an in-depth yet digestible view of the head-spinning, mind-numbing world of "genius" Wall Street contributions to mankind, like SPVs, SIVs, SPEs, PPPs, PPIs, PFIs, SPCs, CDOs, CDSs, ABSs, MBSs...

Exponential Debt

One of the things Gordon writes about is probably the most catastrophic aspect of this mountain of debt: the maturity wall. This is the hurdle of old debt rollover that is facing us collectively right now, where all of the world's present saving must be compelled into the interest payments alone on the old debt. Talk about the unproductive and inefficient use of savings! What I can tell you is it ain't gonna happen. The system cannot be saved at this point.

I received an email from a reader, Lars Olsson, with a nice article he wrote about exponential growth and debt. Here is an excerpt from his piece with an exercise you can try at home to wrap your mind around what happens when savings are compelled into indiscriminate debt:

If you believe that 2+2=4, then you should believe the following. Compound interest at 2% is a miniscule interest charge measured by today's standards. Compounding the interest charged on a single unit of money can be written as follows: money-amount * 1.02 * 1.02 * 1.02 .... (adding another term for each year) .... and on and on. That is, if you can place your faith in mathematics and calculations and really "believe" that the calculator will return a correct result when you punch the buttons. We reckon our current time since the long ago birth of a civilization some 2000 years ago. History tells us they had money then. A functioning economy of sorts. Mediterranean trade. Payments for goods. Money of gold and silver. If any man would have placed only a fraction of his purse at interest, his descendants would be wealthy beyond imagination, and the world have been hollowed out.

Let me show you. Open the calculator function under Windows. If you run Apple you are smart enough to figure out a substitute on your own. You'll find the calculator under Accessories. Set the "View" to Scientific. Got that! If not, that's ok too, but you probably shouldn't be reading this. On the keypad, punch in 1.02, then hit the "x^y" button, then on the keypad punch in 2000, then hit "=". The display now shows you a large number. This is the multiplier for some amount placed at 2% interest for 2000 years compounded annually. On the keypad hit the "*", then punch in 0.01, then hit "=". Now the display shows you what one cent ($0.01) would have turned into. To make this a little easier to view, hit the "/" key, the on the keypad punch in "1","Exp","12","=" to get the answer in trillions of dollars. Yes. The calculator really does say that $0.01 placed at 2% interest for 2000 years turns in to $1,586 trillion, or $1.586 quadrillion, or a hundred year of US GDP. If you don't like 2%, change it. If you don't like 2000 years, change it.

What the previous exercise shows is that a purse of silver was certainly not placed at interest anywhere in the world 2000 years ago, and allowed to compound at 2% interest, since that numerical representation of wealth would today dwarf all known hoards of "money", electronic or otherwise. So compound interest is not a sustainable operation spanning millennia. Compound interest applied to any finite system will grow out of bounds, which is what we are experiencing today. The current "money" system, which is engineered with "debt/credit" as its foundation has breached its sustainable limit. Stimulating the economy without addressing the fundamentals of the "money system" decay will not restore economic prosperity. Money at interest, does not price risk in venture. A functional society requires an efficient "money system", but "money" can be made available through means other than extending fractional reserve privilege to the banking class and putting a price on the existence of money.

Lars' piece may seem simplistic, but I like it. I'll even take it a step further and say that a monetary and financial system that uses compounded interest **cannot afford** to compel all savings into the hands of debtors. It **must** have a means of hoarding wealth outside of the system in order to constrain the exponential growth function, or else the entire system will become retarded and then collapse. In return, this constraining function of "gold the wealth reserve" will restore intelligence to the human superorganism. Intelligence that has been sucked dry by Wall Street's systemic aggression against a free-floating physical gold price.

We are all like ants in an ant farm when we patronize Wall Street. Our contributions to society, should they exceed our day-to-day needs, are deployed by a system that does not care *how* they are deployed, just that they are deployed ASAP. If you would like to make a real contribution to the future of civilization then please buy physical gold and find a way to keep it close. Hoard your efforts outside of the system and watch as they receive a tremendous power boost just in time for deployment. You will be rewarded with the freedom to choose when and how your saved effort will be deployed and in so doing, you will help shape the future.

Sincerely,
FOFOA

Tuesday, April 3, 2012

Peak Exorbitant Privilege

*"**Importing more than you export means lots of empty containers**. That visual manifestation of our trade deficit is what drivers see as they pass the Port of New York and New Jersey on the New Jersey Turnpike. In the first eight months of 2010, the port saw the equivalent of 700,000 more full 20-foot containers enter than leave.*

***45% of containers exported** from port operator APM Terminals' Port Elizabeth facility (part of the Port of New York and New Jersey)*
***are empty**, a reflection of the trade imbalance."* Source

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In the wake of WWI (1914-1918) there was an international movement in Europe to return to the stability of fixed exchange rates between national currencies. But all of them had been inflated so much during the war that reestablishing the peg to gold at the pre-war price would have implied an overvaluation of currencies that would have led inevitably to a run on all the gold in the banking system, monetary deflation and economic depression (good thing they avoided that, eh?). At the same time, they feared that raising the gold price would raise questions about the credibility of the new post-war regime, and quite possibly cause a global scramble into gold.

This "problem" with gold was viewed at the time as a "shortage" of gold. And so one of the stated goals of the effort to solve this problem was *"some means of economizing the use of gold by maintaining reserves in the form of foreign balances."* (Resolution 9 at the Genoa Conference, 1922) To economize means to limit or reduce, often used in conjunction with "expense" or "waste". So to "economize the use of gold" meant to limit or reduce the use of gold.

Meanwhile, the United States had emerged from the war as the major creditor to the world and the only post-war economy healthy enough to lend the financial assistance needed for rebuilding Europe. And so even though the U.S. wasn't directly involved in the European monetary negotiations that took place in Brussels in 1920 and Genoa in 1922, it was acknowledged that any new monetary order was likely to be a U.S. centered system.

The Genoa negotiations were led by the English including British Prime Minister Lloyd George and Bank of England Governor Montagu Norman who proposed a "two-tier" system especially designed to circumvent "the gold shortage". The British proposal described a group of "center countries" who would hold their reserves entirely in gold and a second tier group of (unnamed) countries who would hold reserves partly in gold and partly in short-term claims on the center countries. [1]

The proposal was named the "gold-*exchange* standard" (as opposed to the previous gold standard). In 1932 French economist Jacques Rueff proclaimed the gold-exchange standard that had come out of the Genoa conference a decade earlier *"a conception so peculiarly Anglo-Saxon that there still is no French expression for it."* [2]

The gold-exchange standard that officially came into being around 1926 (and lasted only about six years in its planned form) worked like this: The U.S. dollar was backed by and redeemable in gold at any level, even down to small gold coins. The British pound was backed by gold *and* dollars and redeemable in both, but for gold, only in large, expensive bars (kind of like the minimum gold redemption in PHYS is 400 oz. bars but you can redeem in dollars at any level). Other European currencies were backed by and redeemable in British pound sterling, while both dollars and pounds served as official reserves equal to gold in the international banking system. [3]

Since only the U.S. dollar was fully redeemable in gold, you might expect that gold would have immediately flowed out of the U.S. and into Europe. But as I already explained, the U.S. emerged from WWI as the world's creditor and the U.S. Treasury in 1920 held 3,679 tonnes of gold. By the beginning of the gold-exchange standard in 1926 the U.S. was up to 5,998 tonnes and by 1935 was up to 8,998 tonnes. By 1940 the U.S. Treasury held 19,543 tonnes of gold. After WWII and the start of the new Bretton Woods monetary system, official U.S. gold peaked at 20,663 tonnes in 1952 where it began its long decline. [4]

In Once Upon a Time I wrote, "Once sterilized [at the 1922 Genoa Conference], gold flowed uncontrolled into the US right up until the whole system collapsed and beyond." My point was that before the introduction of "paper gold" as official reserves in the form of dollars and pounds, the flow of physical gold in international trade settlement governed as a natural adjustment mechanism for national currencies and exerted the spur and brake forces on their economies. But after 1922, this was no longer the case.

After 1922, the U.S. provided the majority of the reserves for the international banking system in the form of printed dollars. And as the world's creditor and reserve printer, dollar reserves flowed out and gold payments flowed in. From the start of the gold-exchange standard in the mid-1920s until 1952, about 26 years, the dollar's monetary base grew from $6B to $50B while the U.S. gold stockpile grew from 6,000 tonnes to more than 20,000 tonnes. [5]

The Roaring Twenties was not just a short-lived period of superficial prosperity in America, it was also a time when a great privilege was unwittingly granted to the United States that would last for the next 90 years. And I say "unwittingly granted" because the U.S. did not even participate in the negotiations that led to its privilege. As Jacques Rueff wrote in his 1972 book, The Monetary Sin of the West:

> *"The situation I am going to analyze was neither brought about nor specifically wanted by*

the United States. It was the outcome of an unbelievable collective mistake which, when people become aware of it, will be viewed by history as an object of astonishment and scandal." [6]

I should pause here to note that gold standard advocates and hard money campers will quickly point out that the post-1922 gold-exchange standard is not what they want. They want to return to the gold standard of the 19th century, the one before WWI. But that's not my position. And anyway, it's not gonna happen and even if it would/could happen, it would not fix the fundamental problem. Just like time, we move relentlessly forward and, luckily for us, the future is much brighter than the past.

Now, back to this privilege which, in the end, may turn out to be more of a curse. In order to really understand how the gold-exchange standard and its successor systems, the Bretton Woods system and the current dollar standard system translated into a privilege for the United States, we need to understand what actually changed in the mid-20s as it fundamentally relates to how we use money. I will explain it as briefly as possible but I want to caution you to resist the temptation to make judgments about what is wrong here as you read my description. As some of you already know, I think there is only one *fundamental* flaw in the system and it was present even before the gold-exchange standard and the U.S. exorbitant privilege, but that's not the subject of this post.

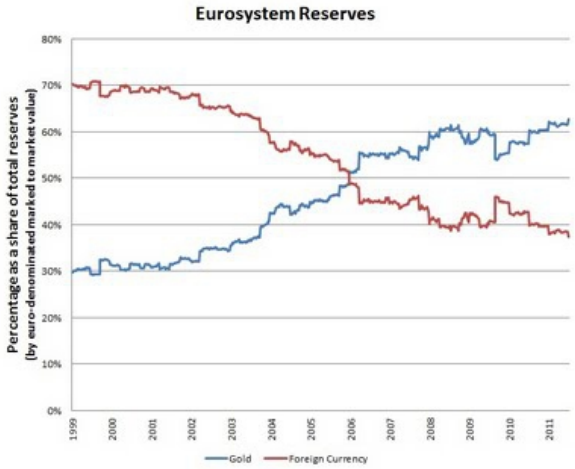
What changed?

People and economies trade with each other using money – mainly credit, denominated in a national currency – as their primary medium of exchange so as to avoid the intractable double coincidence of wants problem with direct barter. So we trade our stuff for their stuff using bank money (aka fungible currency-denominated credit) and the prices of that stuff are how we know if there is any inequity or imbalance in the overall trade. When we periodically net out the bank transactions using the prices of the stuff we traded, we inevitably come up short on one side or the other. And so that imbalance is then settled in the currency itself.

But because different countries use different currencies, we need another level of imbalance clearing. And that international level is cleared with what we call **reserves**. So, in essence, we really do have two tiers in the way we use money. We have the domestic tier where everyone uses the same currency and clearing is handled at the commercial bank level with currency. And then we have the international tier where everyone doesn't use the same currency and so trade imbalances tend to aggregate and then clear with what we call "reserves" (aka international liquidity) at the national or Central Bank level.

This is built right into the very money that we use, and have used, for a very long time. To see how, we will regress conceptually back to how our bank money is initially conceived. And because most of you have at least a basic understanding of the Eurosystem's balance sheet from my quarterly RPG posts, this should be a fairly easy exercise. If not, RPG #4 might be a good place to catch up quickly.

Recall this chart from Euro Gold:



It shows the change, over time, in relative value of the **two kinds of reserves** held by the Eurosystem: 1. gold reserves and 2. foreign currency reserves. And in RPG #4 I explained the difference between reserves and assets on the CB balance sheet. Assets are claims against residents of your currency zone denominated mostly in your own currency. Reserves are either gold or claims against non-residents denominated in a foreign currency.

In our regression exercise we'll see the fundamental difference between reserves and assets. Reserves are the fundamental basis on which the basic money supply of a bank is borne, while assets are the balance sheet representation of the bank's extension of credit. Changes in the ratio between reserves and assets exert opposing (enabling/disabling) influences on the ability of the system to expand.

So, now, looking back at the very genesis of our money, we've all heard the stories of the gold banker who issues receipts on the gold he has in his vault, right? Well, that's basically it. Money as we know it today ultimately begins with the monetization of some gold. The Central Bank has some amount of gold in the vault which it monetizes by printing cash.

CB
Assets-------Liabilities
Gold | Cash

For the sake of this exercise, let's say that the government deposits its official gold in its newly-created CB and the CB monetizes that gold by printing cash which is now a government deposit. So let's simplify the balance sheet even more. CB = Central Bank, R = reserves, A = assets and C = cash (or also CB liabilities which are electronic obligations of the CB to print cash if necessary, so they are essentially the same thing as cash within the banking system).

CB
R|C

That's reserves (gold) on the asset side of the balance sheet and cash (the G's deposit) on the liability side. Now the G can spend that cash into the economy where it will end up at a commercial bank. Let's say COMMBANK1 = commercial bank #1, C = cash (or CB liabilities) and D = deposit.

COMMBANK1
C|D

Now that the G spent money into the economy, our first commercial bank has its own reserves and its first deposit from a government stooge who received payment from G and deposited it in COMMBANK1. In the commercial bank, cash is the reserve on the asset side of the balance sheet whereas cash is on the opposite side, the liability side, of the Central Bank's balance sheet. Also, all the cash issued by the CB remains on its balance sheet even after it has left the building and is sitting in the commercial bank (or even in a shoebox under your bed).

At this point we have a fully reserved mini-monetary system. Both the CB's and the commercial bank's liabilities are balanced with reserves. The CB's reserves are gold and the commercial bank's reserves are cash or CB liabilities. That's fully reserved. But let's say that the economy is trying to grow and the demand for bank money (credit) is both strong and credible. So now our banks can expand their balance sheets.

As credit expands, the asset side will be balanced with assets (A) rather than reserves (reserves are gold in the case of the CB and cash in the case of COMMBANK1). Also, I'm going to put the CB *under* the commercial banks since it is essentially the base on which the commercial bank money stands.

COMMBANK1
ACC|DDD

CB
AR|CC

Here we see that our CB now has an asset and a reserve. The asset is a claim denominated in its own currency against a resident of its currency zone, and the reserve is the gold. Let's say that the CB lent (and therefore created) a new C to the government. Meanwhile, our commercial bank COMMBANK1 has had two transactions. It has received the deposit from a second government stooge and it has also made a loan to a worthy entrepreneur.

So on the COMMBANK1 (commercial bank) balance sheet, the A is a claim against our entrepreneur and the two Cs are cash reserves. The first C came in when our first stooge deposited his government paycheck and the second C came in when the second stooge deposited his payment which G had borrowed (into existence) from the CB. The three Ds (deposits) belong to our two stooges and the entrepreneur.

I'm not going to go much further with this model but eventually, as the economy and bank money expands, we'll end up with something that looks more like this:

COMMBANK1
AAACC|DDDDD

COMMBANK2
AAACC|DDDDD

COMMBANK3
AAACC|DDDDD

COMMBANK4
AAACC|DDDDD

COMMBANK5
AAACC|DDDDD

CB
AAAAAAAAAR|CCCCCCCCCC

And here we have a simple model of our monetary system within a single currency zone. There are two observations that I want to share with you through this little exercise. The first is the tiered nature of our monetary system even within a single currency zone. And the second is the *natural* makeup of a Central Bank's balance sheet.

You'll notice that one thing the Central Bank and the commercial banks have in common is that the asset side of their balance sheets consist of both reserves and assets. Remember that assets are claims denominated in your currency against someone else in your currency zone. But you'll also notice that the commercial bank reserves are the same thing as the Central Bank's liabilities. So the Central Bank issues the reserves upon which bank money is issued to the economy by the commercial banks.

The fundamental take-home point here is that reserves are the base on which all bank money expands. CB money rests on CB reserves and commercial bank money rests on commercial bank reserves which are, in fact, CB money which is resting on CB reserves. So you can see that the entire money system is built up from the CB reserves.

The deposits (D) in the commercial banks are both redeemable in reserves and cleared with reserves (reserves being cash or CB liabilities). Deposits are not redeemable or cleared (settled) with assets. If a commercial bank has a healthy level of reserves it can expand its credit. But if it expands credit without sufficient reserves for its clearing and redemption needs, it must then go find reserves which it can do in a number of ways.

Notice above that we have 25 deposits at 5 commercial banks based on 10 commercial bank reserves. Those commercial bank reserves are Central Bank liabilities which are based ultimately on the original gold deposit. Before 1933, gold coins were one component of the cash, and CB liabilities were also redeemable by the commercial banks in gold coin from the CB to cover redemption needs. So the commercial banks (as well as the Fed) had to worry about having sufficient reserves of two different kinds. As you can imagine, this created another level of difficulty in clearing and especially in redemption.

Clearing and Redemption

Very quickly I want to go over clearing and redemption and how they can move reserves around in the system. Here's our simple system once again:

COMMBANK1
AAACC|DDDDD

COMMBANK2
AAACC|DDDDD

COMMBANK3
AAACC|DDDDD

COMMBANK4
AAACC|DDDDD

COMMBANK5
AAACC|DDDDD

CB
AAAAAAAAAR|CCCCCCCCCC

Now let's say that one of our depositors at COMMBANK5 withdrew his deposit in cash. And let's also say that another depositor at the same bank spent his money and his deposit was therefore transferred to COMMBANK4 and that transaction cleared. Here's what it would look like:

COMMBANK1
AAACC|DDDDD

COMMBANK2
AAACC|DDDDD

COMMBANK3
AAACC|DDDDD

COMMBANK4
AAACCC|DDDDDD

COMMBANK5
AAA|DDD

CB
AAAAAAAAAR|CCCCCCCCCC

A few quick observations. There are now only 9 Cs in the commercial banking system even though there are still 10 Cs outstanding on the CB's balance sheet. That's because one of them is now outside of the banking system as on-the-go cash in the wallet.

Also, notice that COMMBANK4 received its sixth deposit which cleared and so COMMBANK4 received the cash (C) reserve from COMMBANK5. This transaction bumped COMMBANK4 up from being 40% reserved to 50% reserved. But because COMMBANK5 had to deal with two transactions, one redemption and one cleared deposit transfer, COMMBANK5 is now out of reserves.

In this little scenario, COMMBANK4 is now extra-capable of expanding its balance sheet, while

COMMBANK5 needs to forget about expanding and try to find some reserves. To obtain reserves, COMMBANK5 can call in a loan, sell an asset for cash, borrow cash temporarily while posting an asset as collateral, or simply hope that some deposits come his way very soon. But in any case, COMMBANK5's next action is, to some extent, influenced by its lack of reserve.

This is an important point: that as reserves move around, their movement exerts some influence on the activities of both the giver and the receiver of the reserves.

International Clearing

Now let's scale our model up and look at how it works in international trade. Commercial banks deal mostly in their own currency zone's currency. But in today's fast-paced and global world we have a constant flow of trade across borders, so various currencies are also flowing in all directions. Some international commercial banks handle these transactions, but as you can imagine, clearing and redemption becomes a bit more complicated.

You might have a deposit (D) at COMMBANK5 in the U.S. being spent in Europe somewhere and ending up at a European commercial bank where it is neither redeemable nor clearable as it stands (currently denominated in dollars). The U.S.-based COMMBANK5 will transfer both the C and the D to the European bank. The European deposit holder who sold his goods to the U.S. will want his bank to exchange those dollars for euros so he can pay his bills. So the European bank will look to either the foreign exchange market or to its CB to change the currency.

If trade between the two currency zones was perfectly equal at all times, there would be an equal amount of euros wanting to buy dollars and vice versa. But we don't live in a perfect world, so there's always more of one or the other which is why the exchange rates float. If, instead, we had fixed exchange rates, the CBs would be involved in equalizing the number of euros and dollars being exchanged, and then the CBs would settle up amongst themselves using *their* reserves, which was how it was before 1971.

But even today, with floating exchange rates, the CB's still do get involved in what we call the "dirty float" to manage the price of their currency on the international market. This is essentially the same process as during fixed exchange rates except that they don't maintain an exact peg, but instead they let it float within a range that they deem acceptable. And the way they do that is essentially the same way they did it back in the fixed exchange rate system of Bretton Woods and before. They buy up foreign currency from their commercial banks with newly printed cash.

Or, if there's a glut of their own currency in foreign lands trying to get home, then they have to buy back their own currency using up their CB reserves. Which brings us to the makeup of a CB's balance sheet, most pointedly its reserves. And the take-home point that I want to share with you here is the difference between finite and infinite from a CB's perspective.

From the perspective of a CB, its own currency is infinite while its reserves are finite. So if there's a glut of foreign currency in its zone, it has no problem buying up as much as it wants with printed cash. In fact, theoretically, a CB could buy up foreign currency that is accumulating in its zone until the cows come home. On the other hand, if there's a glut of its own currency abroad, its buy-back power is finite and limited to the amount of reserves it stockpiled earlier.

So why do it? Why does a CB spend its precious reserves buying its own currency back from foreign lands? What happens if it doesn't? Currency collapse is what happens. If there's a glut of your currency abroad and you don't buy it back, the market will take care of it for you by devaluing your currency until it becomes impossible for you to run a trade deficit. And this is a painful process when the marketplace handles it for you because it not only collapses your trade deficit to zero, it also tends to bring your domestic economy to a standstill at the same time, a double-whammy.

And this is how the monetary system above scales up to the international level. While the commercial bank reserves (Cash) are good for clearing, redemption and credit expansion within a currency zone, only the CB reserves work in a pinch on the international level. And if the CB runs out of reserves, the currency collapses due to market forces and, therefore, the commercial bank reserve (Cash) upon which commercial bank money is expanded devalues, and so bank money, too, devalues. It is all stacked upon the CB reserves from whence the first bank money was born.

And as you can see above, the natural makeup of a CB's reserves is gold. But that changed in 1922.

Now obviously there are a myriad of directions in which we could take this discussion right now. But the direction I want to keep you focused on so that I can eventually conclude this post is that when a Central Bank's finite reserves are ultimately exhausted in the international defense of its currency, its local commercial bank's reserves (Cash) are naturally devalued by the international market. And with the commercial bank reserves being what commercial bank deposits are redeemable in, so too is local money devalued.

But in 1922 they "solved" this "problem" with the introduction of theoretically infinite reserves.

As we move forward in this discussion, I want you to keep in mind my first fundamental take-home point which was that reserves are the base on which bank money expands. Commercial banks expand their bank money on a base of Central Bank-created reserves. And (as long as there is trade with the world outside of your currency zone) the Central Bank's reserves are the base on which the commercial banks' reserves stand. So the corollary I'd like to introduce here is that theoretically infinite reserves lead to theoretically infinite bank money expansion.

Of course it doesn't take a genius to figure out that infinite money expansion does not automatically translate into infinite real economic growth. And so we need to look at who, in particular, was the prime beneficiary of these newly infinite reserves.

In 1922 the Governor of the Bank of England which had around 1,000 tonnes of gold at the time (less than the Bank of France which had about 1,200 tonnes) proposed economizing the use of gold by declaring British pound sterling and U.S. dollars to be official and recognized reserves anywhere in the world. The "logic" was that dollars and pounds would be as good as gold because they would be redeemable in gold on their home turf.

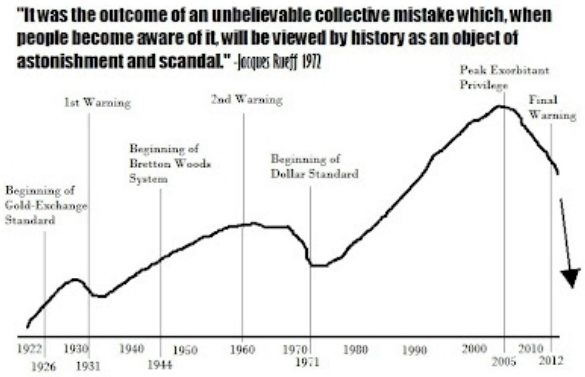
Three Fair Warnings

The reason I went through this somewhat-lengthy exercise explaining the significance of reserves in our monetary and banking system was to help you understand the words of Jacques Rueff who first

warned of the catastrophically dangerous flaw embedded in this new system—a flaw which continues today—way back in 1931. The term "exorbitant privilege" would not be used until 30 years later under a new system, but I hope to help you see, as I do, the common thread that ties all three systems together, the gold-exchange standard, Bretton Woods and the present dollar standard.

As we walk through this timeline together, you'll read three warnings at times of great peril to the system. The first was delivered by Rueff to the French Finance Minister in preparation for the French Prime Minister's meeting with President Hoover in Washington DC in 1931. The second was delivered to the U.S. Congress by a former Fed and IMF economist named Robert Triffin in 1960. And the third will be delivered later in this post.

To put it all in perspective, I drew this rough timeline to help you visualize my thought process while writing this post:



Those of you who have been reading my blog for a while should be aware that the U.S. has run a trade deficit every year since 1975. You should also know that, since 1971, the U.S. government has run its national debt up from $400B to $15,500B, and that foreign Central Banks buying this debt have been the primary support for both the relatively stable value of the dollar and the perpetual nature of the U.S. trade deficit.

But it wasn't always this way. Before 1971 the U.S. was running a trade surplus and the national debt level was relatively steady during both the gold-exchange standard and the Bretton Woods era. During the gold-exchange standard the national debt ranged from about $16B up to $43B. It increased a lot during WWII to about $250B, but then it remained below its $400B ceiling until 1971.

Another big difference during this timeline which I have already mentioned is the flow of gold. The U.S. experienced an uncontrolled inflow of gold from the beginning of the gold-exchange standard until 1952, and then a stunted outflow ensued until it was stopped altogether in 1971.

The point is that with such a wide array of vastly disparate circumstances, it is a bit tricky for me to explain the common thread that binds this timeline together. Very generally, let's call this common thread the monetary privilege that comes from the rest of the world voluntarily using that which comes only from your printing press as its monetary reserves. It started as a privilege, grew into an exorbitant privilege 35 years later, and then peaked 45 years later at something for which, perhaps, there is not an appropriately strong enough adjective.

Robert Triffin thought it had gone far enough to warrant warning Congress in 1960, but just wait till you see how much farther it went over the next four and a half decades. But first, let's go back to 1931.

First Warning

In his 1972 book [6], Jacques Rueff writes:

> *Between 1930 and 1934 I was Financial Attache in the French Embassy in London. In that capacity, I had noted day after day the dramatic sequence of events that turned the 1929 cyclical downturn into the Great Depression of 1931-1934. I knew that this tragedy was due to disruption of the international monetary system as a result of requests for reimbursement in gold of the dollar and sterling balances that had been so inconsiderately accumulated.*
>
> *On 1 October 1931 I wrote a note to the Finance Minister, in preparation for talks that were to take place between the French Prime Minister, whom I was to accompany to Washington, and the President of the United States. In it I called the Government's attention to the role played by the gold-exchange standard in the Great Depression, which was already causing havoc among Western nations, in the following terms:*
>
>> *"There is one innovation which has materially contributed to the difficulties that are besetting the world. That is the introduction by a great many European states, under the auspices of the Financial Committee of the League of Nations, of a monetary system called the gold-exchange standard. Under this system, central banks are authorized to include in their reserves not only gold and claims denominated in the national currency, but also foreign exchange. The latter, although entered as assets of the central bank which owns it, naturally remains deposited in the country of origin.*
>>
>> *The use of such a mechanism has the considerable drawback of damping the effects of international capital movements in the financial markets that they affect. For example, funds flowing out of the United States into a country that applies the gold-exchange standard increase by a corresponding amount the money supply in the receiving market, without reducing in any way the money supply in their market of origin. The bank of issue to which they accrue, and which enters them in its reserves, leaves them on deposit in the New York market. There they can, as previously, provide backing for the granting of credit.*
>>
>> *Thus the gold-exchange standard considerably reduces the sensitivity of spontaneous reactions that tend to limit or correct gold movements. For this reason, in the past the gold-exchange standard has been a source of serious monetary disturbances. It was probably one cause for the long duration of the substantial credit inflation that preceded the 1929 crisis in the United States."*

Then in 1932 he gave further warning in the speech at the School of Political Sciences in Paris which I wrote about in Once Upon a Time:

The gold-exchange standard is characterized by the fact that it enables the bank of issue to enter in its monetary reserves not only gold and paper in the national currency, but also claims denominated in foreign currencies, payable in gold and deposited in the country of origin. In other words, the central bank of a country that applies the gold-exchange standard can issue currency not only against gold and claims denominated in the national currency, but also against claims in dollars or sterling.

[...]

The application of the gold-exchange standard had the considerable advantage for Britain of masking its real position for many years. During the entire postwar period, Britain was able to loan to Central European countries funds that kept flowing back to Britain, since the moment they had entered the economy of the borrowing countries, they were deposited again in London. Thus, like soldiers marching across the stage in a musical comedy, they could reemerge indefinitely and enable their owners to continue making loans abroad, while in fact the inflow of foreign exchange which in the past had made such loans possible had dried up.

[...]

Funds flowing out of the United States into a gold-exchange-standard country, for instance, increase by a corresponding amount the money supply in the recipient market, while the money supply in the American market is not reduced. The bank of issue that receives the funds, while entering them directly or indirectly in its reserves, leaves them on deposit in the New York market. There they contribute, as before being transferred, to the credit base.

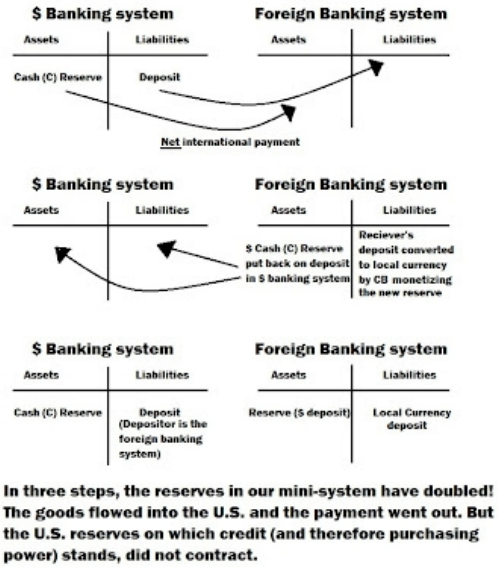
[...]

By the same token, the gold-exchange standard was a formidable inflation factor. Funds that flowed back to Europe remained available in the United States. They were purely and simply increased twofold, enabling the American market to buy in Europe without ceasing to do so in the United States. As a result, the gold-exchange standard was one of the major causes of the wave of speculation that culminated in the September 1929 crisis. It delayed the moment when the braking effect that would otherwise have been the result of the gold standard's coming into play would have been felt.

Are you starting to get a sense of the key issue yet? Reserves move from one bank to another to settle a transaction. When our depositor at COMMBANK5 spent his deposit and it was thereby transferred to COMMBANK4, the cash (C) reserve was also moved to COMMBANK4 to settle (or clear) the transaction. This put a certain strain on COMMBANK5 since it had also lost another reserve to redemption which forced COMMBANK5 into the action of seeking reserves.

Or when a Central Bank expends its reserves trying to remove a glut of its currency abroad so that the marketplace won't devalue (or collapse) it, that CB is generally limited to a finite amount of reserves which, once spent, are gone. So the movement of reserves serves two purposes. It is not only attained by the receiver but it is also forfeited by the giver. Both are vital to a properly functioning monetary system.

But with the system that began around 1926 and still exists today, we end up with a situation in which one currency's reserves are actually deposits in another currency zone:



Notice that I am avoiding the use of gold in my illustration. The warnings given in 1931 and 1960 were presented in the context of a gold exchange standard of one form or another, and therefore they (of course!) heavily reference the problems as they related to ongoing gold redemption. But the real problem, as I have said, transcends the specific issues with gold at that time.

The real problem was and is the common thread I mentioned earilier: the monetary privilege that comes from the rest of the world voluntarily using that which comes only from your printing press as its monetary reserves. It was and is, as Jacques Rueff put it, *"the outcome of an unbelievable collective mistake which, when people become aware of it, will be viewed by history as an object of astonishment and scandal."*

Another angle which was apparent from the very beginning—because Rueff mentioned it in 1932 (as quoted above)—was that of international lending. It basically worked in the same way as the three steps above except that the net international (trade) payment was an international loan. Remember that the U.S. was the prime creditor to the world following both wars. This may partly explain the inflow of gold payments that brought the U.S. stockpile up from 3,679 tonnes in 1920 to 20,663 tonnes in 1952. A dollar loan was the same as a gold loan and was payable in dollars or gold. But as Rueff pointed out above, the lent dollars came immediately back to New York just as the pounds came back to London:

> *"During the entire postwar period, Britain was able to loan to Central European countries funds that kept flowing back to Britain, since the moment they had entered the economy of the borrowing countries, they were deposited again in London. Thus, like soldiers marching across the stage in a musical comedy, they could reemerge indefinitely and enable their owners to continue making loans abroad."*

Now think about that for a moment. The same reserves (base money) getting lent out over and over

again like a revolving door. And let's jump forward to the present for a moment to see if we can start connecting some dots between 1932 and 2012. Here's a recent comment I wrote about the revolving door of dollars today:

> *Hello Victor,*
>
> *The point of JR's excerpts is that the real threat to the dollar lies in the physical plane (real price inflation) rather than the monetary plane (foreign exchange market). The source of the price inflation will be from abroad and it will be reflected in the exchange rate, but the price inflation, not the FX market, is the real threat.*
>
> *Imagine a toy model where the entire United States (govt. + private sector) imports $100,000 worth of stuff during a period of time (T). T repeats perpetually and, just to keep it real, let's say that t = 1 second, which is pretty close to reality. So the US imports the real stuff and exports the paper dollars. But the US also exports $79,000 worth of real stuff each second. So 79,000 of those dollars come right back into the US economy in exchange for the US stuff exports.*
>
> *Now, in our toy model, let's say that the US private sector is no longer expanding its aggregate level of debt. And so let's say, just for the sake of simplicity, that $79,000 worth of international trade over time period T represents the US private sector trading our stuff for their stuff. And let's say that the other $21,000 worth of imports each second is all going to the USG consumption monster.*
>
> *So the USG is borrowing $21,000 **from some entity** each second and spending it on stuff from abroad. This doesn't cover the entire per-second appetite of the USG consumption monster, only the stuff from abroad. The USG also consumes another $114,000 in domestic production each second, which is all the domestic economy can handle right now without imploding, but we aren't concerned with that part yet.*
>
> *Now, if the **from some entity** is our trading partner abroad, then there is no fear of real price inflation.* ***The USG is essentially borrowing $21,000 this second -- that our trading partner received last second -- and the USG will spend it again on more foreign stuff a second from now and then borrow it again. See? No inflation! The same dollars circulate in perpetuity, the real stuff piles up in DC, and the USG debt piles up in Beijing****.*
>
> *But what if that **from some entity** is mostly the Fed, and has been for two years now (and they are calling it QE only to make it sound like its purpose is to assist the US private sector)? If that's the case, then the fear of real price inflation is now a clear and present danger to "national security" (aka the USG consumption monster). Not so much for the private sector which is now trading our stuff for their stuff, but mostly for the public sector which trades only $21,000 in paper nothings, per second, for their stuff.*
>
> *Under this latter situation, you now have $21,000 per second piling up outside of US borders and it's not being lent back to either the USG or the US private sector (which has stopped expanding its debt). It's either going to bid for stuff outside or inside of US*

boundaries.

The USG budget approved by Congress does account for this $21,000 per second borrowing, but it also assumes reasonably stable prices. If the general price level starts to rise faster than Congress approves new budgets, this creates a problem for the USG. It's not as big of a problem for the US private sector, since we are trading mostly stuff for stuff. If the cost of a banana rises to $1T, it will still only cost half an apple. But if you're relying only on paper currency to pay for your monstrous needs, real price inflation is an imminent threat!

FX volatility has more to do with the changing preferences of the financial markets. It is a monetary plane phenomenon on most normal days. But it will also show up when the price of a banana starts to rise.

When the USG cuts a check, it is drafted on a Treasury account at the Fed. Sometimes those funds are all ready to go in the account. Sometimes they are pulled (momentarily) from a commercial bank into the Fed account for clearing purposes. And sometimes the Fed simply creates them, adding a Treasury IOU to its balance sheet.

This latest Executive Order paves the way for the Fed to start stacking not only Treasury IOUs, but also Commerce Dept. IOUs, Homeland Security IOUs, State Dept., Interior, Agriculture, Labor, Transportation, Energy, Housing and Urban Development, Health and Human Services, etc… IOUs. Whatever it takes to keep the real stuff flowing in! If you think the Fed's balance sheet looks like a gay rainbow now, just wait!

But from a financial perspective, if you are stuck in dollar assets when real price inflation takes hold, you are going to want out. And the quickest way out is through the currency itself. So we could see a spike (outside of the US) in the price of Realdollars *even as the dollar is collapsing against the physical plane and the USG is printing like crazy to defend its own largess! How confusing will that be to all the hot "experts" on CNBC?*

The financial markets can cause dramatic volatility in the FX market, and vice versa. But that's all monetary plane nonsense. A small change in the physical plane might not even register at first in the FX market, especially if a financial panic is overpowering it in the opposite direction. But even if the dollar doubles in financial product purchasing power terms (USDX to 150+), that's not going to lower the price of a banana in the physical plane while the USG is defending its consumption status quo with the printing press.

Sincerely,
FOFOA

I highlighted the part relevant to our revolving door discussion, but the whole comment is relevant to the whole of this post because I had this post in mind when I wrote the comment. Anyway, can you see any similarity between what Jacques Rueff wrote about the sterling in 1932 and what I wrote last week?

How about a difference? That's right, the U.S. is now the world's premier debtor while it was the

world's creditor back in the 30s. But in both cases the dollar currency is being continuously recycled while notations recording its passage pile up as reserves on which foreign bank money is expanded while the U.S. counterpart of reserves and bank money is not reduced as a consequence of the transfer.

If you print the currency that the rest of the world uses as a reserve behind *its* currency, that alone enables you to run a trade deficit without ever reducing your ability to run a future trade deficit. Deficit without tears it was called. For the rest of the world, running a trade deficit has the finite limitation of the amount of reserves stored previously and/or the amount of international liquidity (reserves) your trading partner is willing to lend you.

Another thing that happens is that, as the printer of the reserve, the rest of the world actually *requires* you to run a balance of payments deficit or else its (the rest of the world's) reserves will have to shrink, and its currency, credit and economy consequently contract. So to avoid monetary and economic contraction, the world not only puts up with, but *supports* your deficit without tears. Here's a little more from Jacques Rueff:

> ***The Secret of a Deficit Without Tears*** *[6]*
>
> *To verify that the same situation exists in 1960, mutatis mutandis, one has only to read President Kennedy's message of 6 February 1961 on the stability of the dollar.*
>
> *He indicates with admirable objectivity that from 1 January 1951 to 31 December 1960, the deficit of the balance of payments of the United States had attained a total of $18.1 billion.*
>
> *One could have expected that during this period the gold reserve would have declined by the same amount. Amounting to $22.8 billion on 31 December 1950, it was, against all expectations, $17.5 billion on 31 December 1960.*
>
> *The reason for this was simple. During this period the banks of issue of the creditor countries, while creating, as a counterpart to the dollars they acquired through the settlement of the American deficits, the national currency they remitted to the holders of claims on the United States, had reinvested about two-thirds of these same dollars in the American market. In doing so between 1951 and 1961 the banks of issue had increased by about $13 billion their foreign holdings in dollars.*
>
> *Thus, the United States did not have to settle that part of their balance-of-payments deficit with other countries. Everything took place on the monetary plane just as if the deficit had not existed.*
>
> *In this way, the gold-exchange standard brought about an immense revolution and produced the secret of a deficit without tears. It allowed the countries in possession of a currency benefiting from international prestige to give without taking, to lend without borrowing, and to acquire without paying.*
>
> *The discovery of this secret profoundly modified the psychology of nations. It allowed countries lucky enough to have a boomerang currency to disregard the internal*

consequences that would have resulted from a balance-of-payments deficit under the gold standard.

Second Warning

By the early 1960s, Jacques Rueff was not alone in speaking out against the American privilege embedded in the monetary system. Another Frenchman named Valéry Giscard d'Estaing, who was the French Finance Minister under Charles de Gaulle and would later become President himself, coined the term "exorbitant privilege". [7] Even Charles de Gaulle spoke out in 1965 and you can see a short video of that speech in my post The Long Road to Freegold.

But perhaps more significant than the obvious French disdain for the system was Robert Triffen, who stood before the U.S. Congress in 1960 and warned:

> *"A fundamental reform of the international monetary system has long been overdue. Its necessity and urgency are further highlighted today by the imminent threat to the once mighty U.S. dollar."*

To put Triffin in the context of our previous discussion, here's what Jacques Rueff had to say about him:

> *"Some will no doubt be surprised that in 1961, practically alone in the world, I had the audacity to call attention to the dangers inherent in the international monetary system as it existed then.*
>
> *I must, however, pay a tribute here to my friend Professor Robert Triffin of Yale University, who also diagnosed the threat of the gold-exchange standard to the stability of the Western world. But while we agreed on the diagnosis, we differed widely as to the remedy to be applied. On the other hand, the late Professor Michael Heilperin, of the Graduate Institute of International Studies in Geneva, held a position in every respect close to mine."*

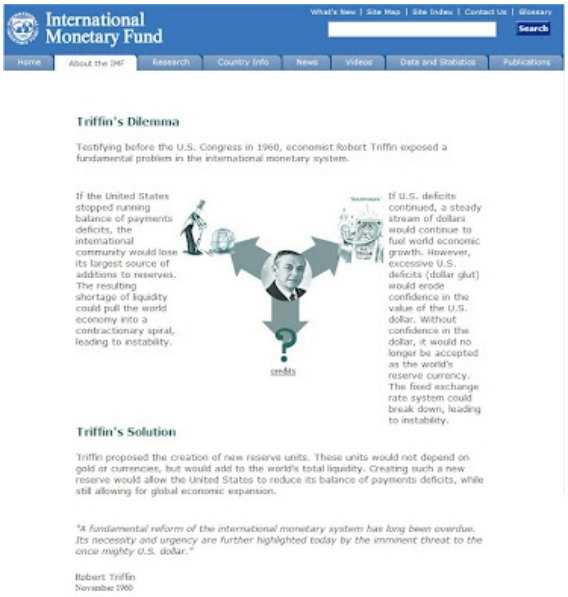
And here is what Wikipedia says about Robert Triffin's Congressional testimony:

> *"In 1960 Triffin testified before the United States Congress warning of serious flaws in the Bretton Woods system. His theory was based on observing the dollar glut, or the accumulation of the United States dollar outside of the US. Under the Bretton Woods agreement the US had pledged to convert dollars into gold, but by the early 1960s the glut had caused more dollars to be available outside the US than gold was in its Treasury. As a result the US had to run deficits on the current account of the balance of payments to supply the world with dollar reserves that kept liquidity for their increased wealth. However, running the deficit on the current account of the balance of payments in the long term would erode confidence in the dollar. He predicted the result that the system would not maintain both liquidity and confidence, a theory later to be known as the Triffin dilemma. It was largely ignored until 1971, when his hypothesis became reality, forcing US President Richard Nixon to halt convertibility of the United States dollar into gold, an event with consequences known as the Nixon Shock. It effectively ended the Bretton Woods System."* [8]

(For more on the Triffin dilemma, please see my posts Dilemma and Dilemma 2 – Homeless Dollars. And for a glimpse at what I view as an even *more* fundamental dilemma, you'll find "FOFOA's dilemma" in my post The Return to Honest Money.)

As noted above, Triffin's prescription in the 1960s was at odds with Rueff and the French contingent. In fact, even today, the IMF refers to "Triffin's solution" as a sort of advertisement for its own product, the almighty SDR. [9] From the IMF website:

> ***Triffin's Solution***
>
> *Triffin proposed the creation of new reserve units. These units would not depend on gold or currencies, but would add to the world's total liquidity. Creating such a new reserve would allow the United States to reduce its balance of payments deficits, while still allowing for global economic expansion.*



But even though Triffin proposed something like the SDR (a proposal the IMF loves on to this day), I think that actions speak louder than words.

Robert Triffin was a Belgian economist who became a U.S. citizen in 1942 after receiving his PhD from Harvard. He worked for the Federal Reserve from 1942 to 1946, the IMF from 1946 to 1948 and the precursor to the OECD from 1948 until 1951. He also taught economics at both Harvard and Yale. But in 1977 he reclaimed his Belgian citizenship, moved back to Europe, and helped develop the European Monetary System and the concept of a central bank for all of Europe which ultimately became the ECB five years after his death in 1993.

Final Warning

With the end of the Bretton Woods monetary system in 1971, three things (besides the obvious closing of the gold window) really took hold. The first was that the U.S. began running (and expanding) a blatant trade deficit. It went back and forth a couple of times before it really took hold, but starting in

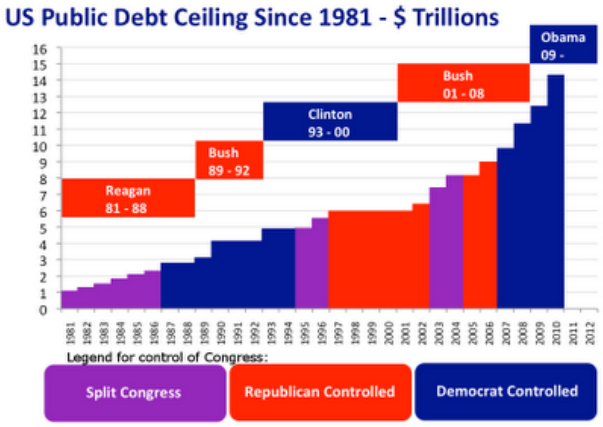
1976 we have run a deficit every year since. [10]

The second thing that took hold was something FOA called "credibility inflation". You can read more about it in my aptly-titled post, Credibility Inflation. This phenomenon, at least in part, helped grow the overall level of trade between the U.S. and the rest of the world in both nominal and real terms. In inflation adjusted terms, U.S. trade with the rest of the world is up almost eightfold since 1971. [11]

The third thing was that the U.S. federal government began expanding itself in both nominal and real terms by raising the federal debt ceiling and relying more heavily on U.S. Treasury debt sales. From Credibility Inflation (quoting Bill Buckler):

> *Way back in March 1971, four months before Nixon closed the Gold window, the "permanent" U.S. debt ceiling had been frozen at $400 Billion. By late 1982, U.S. funded debt had tripled to about $1.25 TRILLION. But the "permanent" debt ceiling still stood at $400 Billion. All the debt ceiling rises since 1971 had been officially designated as "temporary!" In late 1982, realizing that this charade could not be continued, The U.S. Treasury eliminated the "difference" between the "temporary" and the "permanent" debt ceiling. The way was cleared for the subsequent explosion in U.S. debt. With the U.S. being the world's "reserve currency," the way was in fact cleared for a debt explosion right around the world.*

Here are the debt ceilings through 2010 as found on Wikipedia:



That's all well and good, but to really see the U.S. exorbitant (is there a stronger word?) privilege of the last 40 years in stark relief, we must think about those empty containers we export from the picture at the top. Those containers come in full and leave empty, just to be refilled again overseas and brought back in. Those empty containers represent the real trade deficit, the portion of our imports that we do not pay for with exports. Those empty containers represent the portion of our imports that we pay for with nothing but book entries which are little more than lines in the sand. [12]

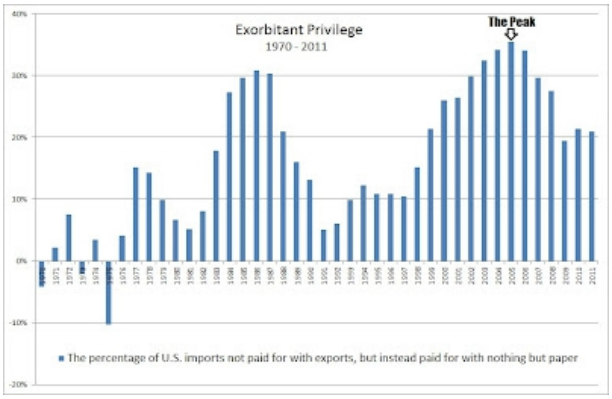
Here's my thesis: that the U.S. privilege which began in Genoa in 1922, and was so complicated that only one in a million could even fathom it in 1931 and 1960, became as clear as day for anyone with eyes to see after 1971. And so, to see it in real (not nominal) terms, we can very simply look at the *percentage* of our imports that is not paid for with exports. So simple, which might be why the government doesn't publish that number and the media doesn't talk about it. All you have to do is

compare the goods and services balance (which is a negative number or a deficit every year since 1975) with the total for all goods and service imports.

That's comparing apples with apples. For example, in 1971 total imports were $60,979,000,000 and total exports were $59,677,000,000 leaving us with a trade deficit of $1,302,000,000. It doesn't matter what the price of an apple was in 1971, because whatever it was, we still imported 2.14% more stuff than we exported. 1,302 ÷ 60,979 = 2.14%.

A trade discrepancy of 2.14% in any given year would be normal under normal circumstances. You'd expect to see it alternate back and forth from deficit to surplus and back again as it actually did from 1970 through 1976. But it becomes something else entirely when you go year after year (for 36 years straight) importing more than you export. And that's why I showed that little dip in the above timeline visualization of the U.S. exorbitant privilege at 1971.

And now here's what it looks like charted out from 1970 through 2011:



Here's the data from the chart:

1970	-4.14%
1971	2.14%
1972	7.49%
1973	-2.13%
1974	3.43%
1975	-10.32%
1976	4.09%
1977	15.17%
1978	14.30%
1979	9.88%
1980	6.66%
1981	5.21%

1984	27.26%
1985	29.66%
1986	30.88%
1987	30.31%
1988	20.99%
1989	16.05%
1990	13.13%
1991	5.11%
1992	5.98%
1993	9.86%
1994	12.28%
1995	10.82%

1998	15.11%
1999	21.39%
2000	25.99%
2001	26.42%
2002	29.85%
2003	32.42%
2004	34.23%
2005	35.50%
2006	34.04%
2007	29.63%
2008	27.48%
2009	19.49%

1982	8.07%
1983	17.84%

1996	10.89%
1997	10.38%

2010	21.39%
2011	20.97%

As you can see, the U.S. exorbitant privilege (essentially free imports) peaked in 2005 at an astounding 35.5%, or more than a third of all imports! Stop and think about that for a second. For every three containers coming in full, only two went out full. So how do we reconcile that number (35.5%) with the report at the top of this post that said 45% of containers are exported empty?

The answer is simple. The trade deficit includes both goods and services. But services are not imported in containers. In fact, the U.S. has been running a trade *surplus* on services every year since 1971. Imagine that! So if we look only at the portion of goods coming and going, we get an even higher percentage. So let's look at 2005 in particular.

In 2005 we imported $1.692T in goods but we exported only $911B for a goods balance of payments of negative $781B. That equates to 46% of all containers being exported empty in 2005. That goods deficit has since dropped down to around 33% for the last three years, so perhaps 45% empty containers in 2010 can be explained by the location of the Port Elizabeth facility being only 200 miles from Washington DC, consumption capital of the world.

But all of this is kind of beside the point. The point is that the U.S. exorbitant privilege peaked in 2005, for the last time, at its all-time high of a third of all imports, and soon it will go negative, where it hasn't been in a really long time.

I can say this with absolute confidence because the signs are everywhere, even if nobody is talking about them in precisely these terms. Here's one bloodhound who's at least onto the right scent (from Barrons):

> *But more recent Treasury data show China has been selling Treasuries outright. And while the markets have been complacent to the point of snarkiness, MacroMavens' Stephanie Pomboy thinks that's wrong. Unlike other Cassandras, she's been right in her warnings -- notably in the middle of the last decade that the U.S. financial system was dangerously exposed to a bubble in U.S. real estate. Hers was a lonely voice then because everybody knew, of course, house prices always rose.*
>
> *As for the present conundrum, there's an $800 billion gap between the $1.1 trillion the Treasury is borrowing to cover the budget gap and the roughly $300 billion overseas investors are buying, Pomboy calculates.*
>
> *[...]*
>
> *But Pomboy has little doubt that the Fed will step in to fill the gap left by others. In other words, debt monetization, a fancy term for printing money to cover the government's debts, which in polite circles these days is called "quantitative easing."*
>
> *"Having pushed interest rates to zero, launched QE1 and QE2, there's no reason to believe*

that the Fed is going to allow free-market forces to destroy the fragile recovery it has worked so hard to coax forth now. And make no mistake, at $800 billion, allowing the markets to resolve the shortfall in demand would send rates to levels that would absolutely quash this recovery…if not send the economy in a real depression."

But her real concern is a bigger one. "The Fed's 'need' to take on an even more active role as foreigners further slow the purchases of our paper is to put the pedal to the metal on the currency debasement race now being run in the developed world -- a race which is speeding us all toward the end of the present currency regime." That is, the dollar-centric, floating exchange-rate system of the past four decades since the end of Bretton Woods system, when the dollar's convertibility into gold was terminated.

[…]

That would leave the Federal Reserve as lender of last resort to the U.S. government to fill the gap left by its biggest creditor. Think this Zimbabwe style of central-bank monetization of an unsustainable government debt can't happen in one of the world's major industrialized democracies? [13]

That was from March 2nd. Here's another one from the same writer at Barrons just a few days ago:

Our friend, Stephanie Pomboy, who heads the MacroMavens advisory, offers some other inconvenient facts about the Treasury market: Uncle Sam is borrowing some $1.1 trillion a year, while our foreign creditors have been buying just $286 billion.

"I'm no mathematician, but that seems to leave $800 billion of 'slack' (of which the Fed graciously absorbed $650 billion last year.) Barring a desire to pay the government 1% after inflation, there is NO profit-oriented or even preservation-of-capital-oriented buyer for Treasuries," she writes in an email.

"For the life of me, I can't understand why NOBODY is talking about this???!!!"

Having known Stephanie for a few years, I can't recall her being this agitated since 2006, when she insisted the financial system's hugely leveraged exposure to residential real estate posed grave risks. She was called a Cassandra then, but both ladies' prophesies turned out to be right.

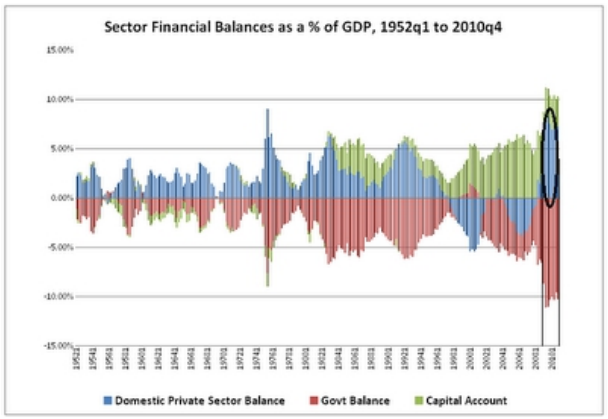
The U.S. fiscal situation hasn't mattered as long as the Treasury could readily finance its deficits at record-low interest rates. Even after the loss of America's triple-A credit rating from S&P, Treasuries rallied and yields slumped to record lows.

That's no longer happening. For what ever reason, assurances by the Fed Chairman aren't impressing the bond market. Neither is weakness in the commodity markets. Maybe Stephanie is on to something. [14]

Of course they are looking only at the monetary plane, the silly market for U.S. Treasury debt which the Fed can dominate with infinite demand. As I keep saying, the real threat to the dollar is in the

physical plane: the price of all those containers being unloaded and then exported empty.

The U.S. government has grown addicted to its exorbitant privilege over the years. It is a privilege that has been supported by foreign Central Banks buying U.S. debt for the better part of the last 30 years. But as I wrote in Moneyness, and as Ms. Pomboy has noticed above, that ended a few years ago. From Moneyness, the blue that I circled below shows the Fed defending our exports ****of empty containers**** with nothing more than the printing press and calling it QE:



I would like you all to give this some serious thought:

1. The U.S. exorbitant privilege peaked in 2005 **(before the financial crisis)** and is now on the decline, meaning it is no longer supported abroad.
2. The U.S. government (with the obvious assistance of the Fed) is now in defensive mode, defending that inflow of free stuff with the printing press.
3. The U.S. federal government budget deficit (DC's "needs" minus its normal revenue) ****eclipses**** the trade deficit by more than a 2 to 1 margin.

So what could possibly go wrong? The recession has already contracted the U.S. economy, all except the part that resides in Washington, DC. And just to maintain its own status quo (when has it ever been happy doing only that?) our federal government needs to insure our national business of exporting empty containers at its present level.

What could go wrong? Prices! If the price of an apple doubles, what do you think happens to the price of a full container? Those of you who think we are due for some more price deflation in the stuff that the USG needs to maintain its status quo should really have your heads examined. Even Obama is winding up to pitch the whole ball of twine at the problem. He just delegated his executive power to print until the cows come home to each of his department heads. I quote from Executive Order -- National Defense Resources Preparedness:

> *"To ensure the supply… from high cost sources… in light of a temporary increase in transportation cost… the head of each agency… is delegated the authority… to make subsidy payments"*

In case you're having difficulty connecting the dots I've laid out (not) so subtly, I'm talking about a

near-term dollar ***super***-hyperinflation that will make your hair curl and make Weimar and Zimbabwe seem like child's play in the rearview mirror. If you're new to this blog, you should know that the rate of hyperinflation does not follow the printing. An apple does not end up costing a trillion dollars because they printed enough dollars to price all apples that way. Hyperinflation comes from the margin, from the government defending its own needs, and there's never enough "money" for us mere mortals to pay the prices which are running away from everyone during hyperinflation.

Also, hyperinflation turns physical (as in physical cash) very quickly once it takes hold. So if you're expecting some sort of electronic currency hyperinflation, fuggedaboutit. If you think we're more technologically advanced than bass-ackward Zimbabwe or ancient Weimar, you are not understanding what really happens during currency hyperinflation. It cannot play out electronically all the way to the bitter end because, when prices are rising that fast, physical cash always brings a premium over electronic deposit transfers which require some amount of time (and thereby devaluation) to clear.

Here are a few of my recent posts in which I explore what little we can do to prepare for what is inevitably coming our way:

Deflation or Hyperinflation?
Big Gap in Understanding Weakens Deflationist Argument
Just Another Hyperinflation Post - Part 1
Just Another Hyperinflation Post - Part 2
Just Another Hyperinflation Post - Part 3

That's right, I saved the "crazy ***super***-hyperinflation talk" for the tail end of a really long post. Because A) people who think they have it all figured out already tend to abandon a post once they read the word "hyperinflation", and B) the stuff in this post really happened and is still happening so it's only fair to you, the reader, to give its inevitable denouement the appropriate weight of a bold conclusion. If I didn't do that, I would not have done my job, now would I? ;)

And in case you didn't figure it out yet, this third and final warning was only for the savers who are still saving in dollars. It's way too late to fix the $IMFS.

Sincerely,
FOFOA

PS. Thanks to reader FreegoldTube for the custom video below! He just happened to send me the link while I was considering songs for this post. The band is Muse and the song is Uprising from their album titled The Resistance.

[1] http://mauricio.econ.ubc.ca/pdfs/kirsten.pdf
[2] The Age of Inflation –Jacques Rueff
[3] http://mises.org/money/4s3.asp
[4] http://www.gold.org/download/pub_archive/pdf/Rs23.pdf
[5] research.stlouisfed.org/publications/review/03/09/0309ra.xls
[6] http://mises.org/books/monetarysin.pdf
[7] http://en.wikipedia.org/wiki/Exorbitant_privilege
[8] http://en.wikipedia.org/wiki/Robert_Triffin

[9] www.imf.org/external/np/exr/center/mm/eng/mm_sc_03.htm
[10] www.census.gov/foreign-trade/statistics/historical/gands.txt
[11] Using data from [10] and the BLS inflation calculator at
http://www.bls.gov/data/inflation_calculator.htm
[12] Lines in the sand is a reference to my Ben and Chen island analogy in Focal Point: Gold
[13] http://online.barrons.com/article/SB...5246.html
[14] http://online.barrons.com/article/SB...6544.html

Sunday, November 6, 2011

Moneyness

Have you ever wondered what money really is? You'll notice that everyone you read has a strong opinion about what money actually is, but who's right? Is money really just one single thing and then everything else has varying levels of moneyness relative to real money?

Is gold real money? Or is money whatever the government says it is? Or is it whatever the market says it is? Is silver money in any way today? Are US Treasury bonds money? Is real money just the monetary base? Or is it all the credit that refers back to that base for value? Is money supposed to be something tangible, or is it simply a common unit we use to express the relative value of things?

Is money really the actual medium of exchange we use in trade? Or is it the unit of account the various media of exchange (checks, credit cards, PayPal) reference for value? Should the reference point unit itself ever be the medium of exchange? Some of the time? All of the time? Never? Is money a store of value? And if so, for how long? Is money supposed to be the fixed reference point (the benchmark) for changes in the value of everything else? Or is it simply a shared language for expressing those changes?

So many questions, right? And how often have you seen these questions even asked, let alone answered? Is money something that changes over time? Or is money's true essence the same concept that first emerged thousands of years ago? And probably the most important question: Does the correct view of money produce answers that are vastly superior to the blind conjecture prescribed by all other views?

Answers

I wonder if it's even possible to answer all these questions in one post. It's a neat challenge in any case, isn't it? As I said at the top, everyone has a strong opinion about what money actually is. So "everyone" will probably disagree with what I write. But that doesn't mean they are right and I am wrong. I want to challenge you to use your own mind and see for yourself. Take what I say and then take what they say, compare, contrast, analyze and then decide for yourself. The prescription produced by my view is quite simple. And only you can decide if it is vastly superior to their blind conjecture.

The Pure Concept of Money

According to Webster's the word 'money' emerged in the English language sometime during the Medieval period in Europe, maybe around the late 1200s. Wikipedia suggests a possible etymology originating with the Greek word for 'unique' or 'unit'. The Western term for physical coins that emerged sometime around the late 1500s was 'specie' from the Latin phrase for "in kind" or "payment in kind," meaning "payment in the actual or real form." The word 'currency' came a little later from the Latin word for current or flow, and was married to the money concept in 1699 by the philosopher John Locke who described the "circulation of money" as a flow or current of monetary payments made in specie.

Etymology is important, because with money or "the moneyness of things" we are talking about a vital concept that predates the word by thousands of years. And it's only by understanding the pure concept that we can see the ways the word has been bastardized by the two camps over centuries. The meaning we commonly assign to words may change over time, but that never changes the original concept underlying the emergence of the word in the first place.

Case in point: Is 'money' equal to 'wealth'? Is "gathering wealth" the same as "gathering money?" In the 1950s a Seattle engineer named Howard Long was deeply distressed that his beloved King James Version of the Bible just didn't seem to connect with people when sharing the Word of God. Long felt he needed a new translation that captured the truths he loved in the language that his contemporaries spoke.

It took a couple of decades, but Long's passion became the New International Version (NIV), a completely original translation from Hebrew, Aramaic, and Greek texts that was finally released in 1978. The King James Version had been translated into English and released 367 years earlier, in 1611. Here is one verse as it appears in each version:

Proverbs 13:11 (KJV) **Wealth** gotten by vanity shall be diminished: but he that gathereth by labour shall increase.

Proverbs 13:11 (NIV) Dishonest **money** dwindles away, but whoever gathers **money** little by little makes it grow.

I use this only as an example of how we sometimes change words to fit our modern understanding, not as any kind of a criticism of the NIV. To be fair, there are many more verses where the NIV does *not* remove or replace the word 'wealth'. Here are a few other translations of the same verse, which I think will help to illustrate my point about words and concepts:

Proverbs 13:11 (English Standard Version **2001**) Wealth gained hastily [or *by fraud*] will dwindle, but whoever gathers little by little will increase it.

Proverbs 13:11 (Wycliffe Bible **1395**) Hasted chattel, that is, gotten hastily, shall be made less; but that which is gathered little and little with hand, shall be multiplied.

Proverbs 13:11 (Young's Literal Translation **1862**) Wealth from vanity becometh little, And whoso is gathering by the hand becometh great.

And, just for fun:

"Think now, if you are a person of "great worth" is it not better to acquire gold over years, at better prices? If you are one of "small worth", can you not follow in the footsteps of giants? I tell you, it is an easy path to follow!" --ANOTHER (THOUGHTS!) 1/10/98

The point is, your modern understanding of 'money', and the pure concept of money that emerged long before the word, may be substantially different things. I'll go even further to say that the modern understanding of money is so confused and disputed by the two opposing money camps that the only way we can hope to have a clear view of what is actually happening today is by reverting *our* understanding to the original concept, before it was corrupted by the two camps.

So now let's go back to the etymology at the top of this section because, while it does not set the pure concept, it does reflect it from a time more proximate and a meaning less corrupted than now. And I should note that etymology is a somewhat subjective and inexact science, kind of like interpreting what you find at an archeological site. So I'm using it only as a tool that helps me share with you a concept, not as proof of the correctness of my concept. There is no proof at this time. There is only the use of your own discerning mind.

If we look at the specific etymology I highlighted, we are pretty close to the pure concept which I will confirm from a couple different angles. 'Money' is a "unique unit" that we use as a kind of language for expressing the relative value of things other than money. The modern example would be "dollar". Not "*a* dollar," not a physical dollar, but the word "dollar" as it is used to say a can of peas costs a dollar, or my house is worth 100,000 dollars, or you owe me a hundred dollars. If you give me two grams of gold you won't owe me a hundred dollars anymore. You don't have to give me actual dollars. That's just the unit I used to express the amount of value you owed me. That's the pure concept of money.

This is where it gets a little tricky and mind-bending. The actual physical dollar, that physical item we call "a dollar," is not money in and of itself. In other words, it is not intrinsically "money". It is only money because we reference it when expressing the relative value of goods, services and credit. If we stopped referring to it, it would cease to be money even though it would still be a dollar. Can you see the difference? Like I said, it's tricky.

A dollar is just a thing, a tradable item. And it will continue being that same thing even if we stop referring to it when expressing relative values. It will still be a dollar, it just won't be money anymore. Therefore it is not money *in and of itself*. It is just a thing. Take the old German Reichsbank marks from 1923. Some of them still exist. They are still marks with lots of zeros. But they are no longer money. We can still trade them. I might trade you a few Zimbabwe notes for an original mark, but that obviously doesn't make them money. The same goes for gold. Gold is just a tradable item.

We could be using seashells as money. If we were, then all the seashells available for trade would be the monetary base. That's the base to which I would be referring when I said you owed me one hundred seashells. A single seashell would be the reference point, the unique unit, but the whole of all available seashells would be the base around which money flowed. You could pay your debt to me with either an item that I desired with a value expressed as 100 seashells, or with 100 actual seashells. So if the total amount of seashells available (the monetary base) suddenly doubled making them easier for you to

come by, I'd be kinda screwed. Of course I'd only be screwed if the doubling happened unexpectedly between the time I lent you the value of 100 seashells and the time you paid me back.

Getting back to our etymology, the concept behind the term 'specie' meant actual units of the monetary base. In the 1500s, that was the total of all metal coins-of-the-realm available for trade. That was the monetary base of the day and the term 'specie' arose as a way to express payment in the monetary unit itself rather than payment in bulls, or hats, or anything else. But original concept aside, the meaning of the word became married to coins and stuck to this day:

Specie: 1610s, "coin, money in the form of coins" (as opposed to paper money or bullion), from phrase in specie "in the real or actual form" (1550s), from L. in specie "in kind," ablative of species "kind, form, sort"

Notice it says "coins… as opposed to… bullion." That's because while gold *coins* were referenced in the use of money at the time the word 'specie' emerged, gold bullion was not. "Gold" was not money in and of itself. It was just a thing; a tradable, barterable item. Notice also that it says "money ***in the form of*** coins." The coins themselves were also not money *in and of themselves*. They were only called money because, in that coin form, they were the monetary base that was referenced when expressing the relative value of everything else *at that time*. Some of those gold coins from the 1500s and 1600s still exist today. Today they are not money, but they are still gold coins. Can you see the difference yet?

Now remember, there's no right or wrong at this point. There's only the usefulness of a perspective in delivering the correct analysis of what's actually happening today and the best prescription for your personal action. But you can't use a perspective until you get it. Then, and only then, you can use your own mind to decide if it is the correct perspective and then act upon it. Later it will be proved correct or incorrect, just as Another said: "time will prove all things."

But in support of this particular view of the money concept, I'd like to direct your attention to Gold Trail Three where FOA went to great length explaining the historical precedents for this view found in the archeological record. Some of this history has been rewritten in hard money text books to fit the modern meaning of words, while the actual historical record—and FOA—tell a different story about the underlying concepts.

Sidebar Post-within-a-post

FOA on the Concepts of Money and Wealth

Beginning on the third page of The Gold Trail, FOA presents a number of cases in which the hard money camp has corrupted the interpretation of money-related archeological finds in order to make them fit a modern agenda. By projecting modern biases on antiquity, this camp leaves us with estimates of the volume, value and role of ancient gold that may be entirely wrong.

FOA explains "his group's" contentions along with the archeology and sound logic that backs them. And in so doing, he leaves us with an alternative interpretation of the historical record that I think can only be properly viewed by letting go of some of our modern hard money dogma.

For example, the amount of gold that existed in, and made it out of antiquity is probably overestimated. So, if anything, there's likely *less* than the current estimates of all gold available today. And gold probably carried a *much* greater value in antiquity than Hard Money typically assumes. Less gold, circulating as a tradable good (not hoarded, not money) at a really high value relative to everything else. Gold's primary utility was that you could travel to far-away markets with a great amount of tradable wealth in a small package. It was essentially the trade good that was preferred "on the road," not at home in common everyday trade. It was too valuable for that.

The way gold was used, the way it was valued, the reason why we find more silver, copper, and bronze coins buried at the ancient sites, all this and more has been misinterpreted by our hard money teachers because they project modern thoughts onto the ancients in support of their modern policy prescriptions. FOA said "to understand the value of gold, we must remove ourselves from present time thought and think of gold as the Ancients did." Gaining FOA's ancient perspective is helpful in understanding the ultimate moneyness of gold in Freegold.

I went through GT3 again (for probably the fourth time) just to pull a few tastes and give you the flavor of this masterful piece of conceptual dissemination by FOA:

Gold, that wonderful metal that has all the unique qualities to function as our one and only wealth medium, and we just can't use it without altering its purpose. You know, the Lydians had it right, back around 430 BC. They didn't struggle with the concepts of money, like we do today. They just stamped whatever pieces of gold they found laying around and kept it for trade. There was no need to clarify for certain that their gold money needed properties of "utility", store of value, medium of exchange, etc. etc.. They didn't need to identify these qualities were in gold before they stopped questioning if it was safe to use gold as savings. Gold was owned and the knowledge that people owned it and carried it for

trade was alone enough to make it "worth its weight as wealth".

You see, back in antiquity there existed another property that could override our need for modern definitions of tradable wealth. That property was found in the one identifying mark of wealth that transcended all ages; real possession!(smile) This factor and this one factor alone had the ability to activate all the other modern attributes of money properties, even when the knowledge of these attributes was unknown in the ancient era. Come now, Alexander the Great didn't know about "utility" did he? (grin)

Wealth.

As a means of example; think about art work for a moment? That fine painting that graces your main prominent wall. It's tradable for something, isn't it? Perhaps that Renoir for the acreage down the street. That use would cover some of the medium angle, right? A little bulky, but the large value makes it no more or less cumbersome than five gold bricks.(smile) Utility? Just watch your friends stare at it for hours. Store of value? A Renoir? We don't even need to discuss this.

But, one more thing, is it wealth? Of course it is. You see, it is wealth because you possess it, and the very knowledge that you possess it is held by others.

These paintings command a value, a price, a demand, precisely because every one of them is possessed by an owner. In the world of wealth, worth is enhanced because the supply is lessened by this "possession attribute". And possession is how most people in antiquity understood wealth.

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Many hard money philosophers have pointed their finger at others for the fiat situation we use today. It was the bankers and governments, the kings and cohorts, big business and robber barons or some communist manifesto that forced us to use this type of money. Well, you may not like the process and consider yourself above or apart from it all. You may even declare all of them evil. But, in the end, one fact remains; society may govern itself in many ways over thousands of years, but it has never stopped the evolution that corrupts the use of real money as official money.

Over time and life spans gold has been brought into official use countless times. Only to be bastardized by forces, we as peoples can never control. After every failure and ruination of much wealth, the cries always return to bring gold back as money. Once again to begin the long hard road that leads to the same conclusion. Gold coins, then bank storage, then gold lending, then gold certificate use, then lending of certificates, then certificates are declared paper money, then overprinted, then gold backing removed, then price inflation, then,,,,,, we begin again. But this time it's different the hard money crowd say. Yes, it is. Only the time has changed.

For the better part of human existence, gold alone has served all of the best functions of tradable wealth. But as soon as we call it our money, human nature takes over. Yes, we can call it a stock or a bond, a piece of land or a painting, a car, boat or antique, but just don't label it as money.

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Going back over #56 "The Gold of Troy":

You noticed that I structured that discussion in a way that makes the independent mind wander about. Let's pull those thoughts together and move along.

We found that history had left us with some conclusions that were, it seems, never concluded. Archaeology had never been approached by someone like us, with a different hard money perspective. Yes, all the records were there, but most every paper written on the subject appeared carbon copy. They all projected our modern sense of money into the economic structures as they existed back then. "Of course, we are today more complicated", our history papers said,,,, so,,,,,, allowing for that difference "the ancients still operated back then the same as us now". How neat!

Yes, our teachers "called our perception of money, their money and our perception of goods, their goods" in the same context we can use now. They said "hey, they were using hard money to buy and sell from each other, just like we once did" Again,,,,, how neat"!

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For us, as hard money "Physical Gold Advocates", to understand the value of gold, we must remove ourselves from present time thought and think of gold as the Ancients did. Not as money but as little tradable hunks of metal. Gold for goods, straight up, as the citizens of Troy did!

It's the Physical Gold Advocate's "advantage", because while he is waiting for the real value to emerge, the real value that we know existed in antiquity has never gone away! It just doesn't have a marketplace to show it. It will.

I use the phrase; "our advantage of owning the metal", because buying physical gold for today's currency,,,,,,, is like buying a lifetime wealth option that never expires. The commission one pays for this gold coin position, in the form of what we call today's price,,,,,,, may one day go to almost zero as our paper market structure fails from the discovery of real price.

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So, with the Athens, Macedon, Tarentum and Antiochus to name a few, began the world's first coins. Gold coins? Yes they were, but money as we know it? Our view of how these people viewed and used this gold money is, we believe, far different from what gold scholars teach. And its impact on estimates of existing modern gold supply and use is enormous.

All throughout these early times, prior to BC and into some AD, people didn't see these gold coins as we think of money today. These various gold coins had tremendous value, but they were just gold pieces. They were wealth for trade like everything else was. That's simple logic, I know, but the vessel of oil, for instance was just as tradable as a gold coin. In fact, within most of the medium sized city states of that era, barter of like goods was just as good or better than gold coin. One's life was better if he owned wealth he used.

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More to the point, this logic made these guys spenders of gold, rather than savers! If you had gained gold in trade, for your services or goods supplied, you had no reason to save it. There was no other money that needed to be hedged against value loss.

It's becoming more and more apparent that average people of that time quickly traded (spent) their gold for something useful of value, for both them and their family. They didn't have the excess we know today. In modern nomenclature; this logic dictates that a much smaller amount of gold money circulated and circulated faster than many supposed.

For longer savings, even for those of above average means that had all they wanted, people tended to spend their most valuable gold coins first, while saving the least valuable (bronze, silver, iron) for emergencies and later use. To us, today this sounds strange, but place yourself in that time. It was better to build your most useful and needed store of things while times were good.

Therefore, you traded the gold, which brought the most equal trade, first. If things got so bad that one had to dig up the stash, you were trading for last ditch things anyway. Kind of like wrapping up and burying beef jerky to get you thru a pinch. This use of lower metal is supported. Remember, lots of things served as money objects then. Even much later, AD, it was common in Rome to trade big iron bricks that were forged as a bull. Its use was in trade for "one bull" or something of that animal's value.

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When evaluating lifestyle wealth, back then, many often find themselves comparing things in a relative mode with today's perspective. In this position we think the mark has been far missed for gold worth. It's possible that gold payment, in these early times amounted to a huge premium compared to today. The various goods and lifestyle conditions in existence indicate a much higher relative worth for their goods of daily life. Thereby giving gold a much greater relative worth within one's life also. If a one stater Darius of gold, from Cyrus of Persia was worth a very valuable vessel of oil, why utilize the effort to find gold just to trade for some oil. Better to skip the gold production and make the oil. This was the norm for thinking by people not trading on the road, living "within local" city states. Indeed, outside the need to pay armies, a much smaller amount of gold did the job much better than us modern thinkers thought was necessary. Further, the use of oversea warfare and trade perhaps lost more gold into the ocean than we will ever know.

Consider these possibilities well. In that gold today is in a much lesser existence, compared to modern goods supply and lifestyle enhancements, when comparing it to its value in life in the past. It's true worth as a wealth medium could be a 1,000 times higher! For it to return to its ancient position of true asset wealth, for trade outside the modern currency realm, we can see where its European benefactors have once again placed it "On The Road" to much higher fiat currency prices.

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Back then, there was no other currency. No paper moneys or banks. One had no need to save gold as a hedge or savings account. Your wealth was in the useful things contained in the world around you.

Those little hunks of metal were just that, little hunks of gold that everyone knew had trading value. They were not money, not the way we think of money today. They were just a beautiful metal, gold.

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The Lydians, Greeks and Romans all held gold. From Parthia through Rome and on to the Visgoths, Lombards, Normans and Franks, they all held gold as wealth. It was wealth first and traded as what we call money second. Possession identified that gold as real wealth, even if that ownership was for but the moment of a trade.

From the earliest times right into the Old World periods of Europe, gold served as the most valued wealth asset one could use in trade. It was by far the largest unit of tradable wealth in circulation that could be counted on to bring a premium in trade while shopping between cities. It moved, it flowed and it traveled. It was indeed, always "on the road"! Lesser metals and other tradable wealth assets always competed with gold for its trading function, but only gold made the best "on sight" trade. When given the choice of other "almost moneys", gold would always bring an extra slice of meat or fuller basket of cloth.

The irony of gold use over most of its earlier periods was that few average people kept it for long. Hence the seldom discovery of gold coinage where average people lived (see my earlier posts). To be sure, it represented wealth to these commoners, in good form and to the highest degree. Yet, their possession of this wealth usually constituted only a short time period. This short ownership occurred because gold did, would and could trade so much better for the needed things in life. For the worker, service wages paid in gold meant you just got a bonus or raise and the time had come to finally buy what you couldn't afford if paid in other means. If these people saved at all, it was usually in the form of the lesser metals (see my other posts).

If gold was so valuable back then, there must have been a bunch of it saved and transported into our modern time?

No, not really! We used to try and extrapolate all the gold that was mined and turned into jewelry, bullion or coin. If it was so good for coin and trade, civilizations must have saved every ounce, we thought! But something kept nagging at our conclusions. Something that kept turning up over and over at our digs.

Some of you have seen the Gold of Troy pieces or other fine examples of old gold craftsmanship at other museums. Ever notice how good they were at making gold so long ago? From intricate bracelets to rings, head dress items to fine cups, even the most thin of leaf. Some of it was so small we had to use magnifying glasses to see the work clearly.

This gold in jewelry and art work form was the other major form of traveling wealth. In many of our recent findings we now think that jewelry and coin traded places as easily as getting your check cashed today. Throughout the ancient land, gold centers occupied the trade routes. Any gold that rested for too long was quickly recruited into a form that worked for the next traveler. In fact, evidence now points to all forms of gold ownership, not just coins, being a short term proposition for the average man. Indeed, contrary to what we thought, the fingers of all mankind did, through the ages, touch gold!

Now place yourself in that time. You work for Rome in the army, a fighting man. Not all of you were paid in lesser metals, many of you were relatively better off. You did carry some of your wealth with you in the form of gold coin or jewelry. In the case of a Roman soldier, a gold ring was very probable. When you went into battle, did you leave your few gold items laying in the tent? Or did you wire them back to a Swiss bank for safekeeping until after the battle? (big grin)

What we are finding, in the form of molecular fragments at battle sites, leads us to believe that most wars were fought with most wealth possessions worn or in pockets. Gold included. To make a long story short, we now believe that a great deal of early gold was scattered on trails, in the sea and during every war. In fact, rubbed, scraped and powdered to the four winds.

Because gold was so valuable in long trade, extremely small creations were carried as jewelry. Much smaller and much more able to be lost than other larger units of the lesser metals. The nature of so much of this gold was that it was easy to be lost and dispersed. Especially considering the modes of travel back then. We as museum visitors see all the magnificent pieces displayed. What we don't see are the countless broken, partial and fragmented items that are never offered for viewing.

Knowing what we know now, we believe that a very large portion of gold was lost and scattered on a yearly basis. Add to this the fact that most gold mining brought almost the same return as making many of the goods it purchased and we can see how gold was and is over counted. Where it was once taken as fact that all gold was looted and remelted, we now think that gold stocks were lucky if replaced.

By the time of the great gold coinages in Europe, the gold that flowed into these major commerce centers was all there was left in the world!

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The real issue is our misunderstanding and misuse of the term "sound money". That thought has been bantered around for hundreds of years. Truly it does not exist except in the minds of men.

Money, the term, the idea, perhaps the ideal,,,,,,, is something we dreamed up to apply to one of our chosen units of tradable wealth. Usually gold. We could take almost every item in the world and use it in this same "money fashion". Still, this form of trading real for real is just exchanging wealth. It isn't exchanging money as we understand money.

Gold is no different than anything else you possess as your wealth, it just so happened to be the most perfect type of tradable wealth in the world. So it evolved to be used the most and eventually labeled in the same function of what we consider to be "sound money".

Now, consider that all wealth is represented in and of itself. You cannot reproduce wealth through substitution, like giving someone five pieces of copper for one piece of gold and then have them think they now have five pieces of gold! This is the process we try to perform within the realm of man's money ideals. We have always debased trading wealth by duplicating it into other forms and calling all of it, collectively, "our money".

This duplicating, this replicating, this debasement is the result of taking the concept of a credit / contract function (paying in the future) and combining it with the concept of completing a trade at the moment. Think about that for a moment?

As an example, I'll give you a paper contract to pay you later for some oranges and you give me the basket of oranges. Better said, I just gave you modern man's actual concept of money.

Or I trade you a basket of apples "or gold" for those same oranges and the deal is finished, done! We have been taught to think that this is also the concept of money trade.

The first uses what our currency system has evolved into, what is really money in our mind. Where the second uses no credit form at all and is more comparable to trading real wealth as the ancients traded using gold.

Contemporary thought has always blurred these two notions; saying that these two methods of trading are one in the same and both forms use the same idea of what we think money is.

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This is the road ahead. A fiat no different from the dollar in function, yet a universe away in management. A wealth asset that also stands beside this money, yet has no modern label or official connection as money. In this way modern society can circle the earth, to once again begin where we started. Having learned that **the concepts of wealth-money and man's money were never the same**.

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They are not trying to Un-money gold! They are going to un-Westernize gold so it performs its historic function of acting as a tradable wealth holding. No longer following the Gold Bugs' view that governments need to control gold so it acts like real money in the fiat sense. Truly, the BIS and ECB are today "Walking In The Footsteps Of Giants"!

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Gold will no longer be able to successfully carry the Western name of Money so as to allow for its political price fixing. A process that, it seems, has been with us for generations. Enslaving millions of hard workers by always officially classifying the terms and value of both their paper currency and their metal savings. Always inflating both items for the good of society's never ending political agenda.

Allowing FreeGold to circulate as a wealth asset would denominate its true worth through the much larger real demand of "Wealth Possession" instead of paper possession. Such a gold scale would measure our world reserve currencies against each other instead of against our Western concept of gold as official money. But, in addition, on a higher level, prevent any one country from subjugating other nation states through fiat dominance. To more fully grasp the impact of "Possession" and why ancient gold was worth so much more as FreeGold; hike again that part of our trail (FOA (04/18/01; 20:20:06MT - usagold.com msg#64) Lombards, Normans and Franks.)

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We were first alerted to the "gold is money" flaw years ago. When considering the many references to gold being money, in ancient texts, several things stood out. We began to suspect that those translations were somewhat slanted. I saw many areas, in old text, where gold was actually more in a context of; his money was in account of gold or; the money account was gold or; traded his money in gold. The more one searches the more one finds that in ancient times gold was simply one item that could account for your money values. To expand the reality of the thought; **everything we trade is in account of associated money values; nothing we trade is money!**

The original actual term of money was often in a different concept. In those times barter, and their crude accounts of the same, were marked down or remembered as so many pots, furs, corn, tools traded. Gold became the best accepted tradable wealth of the lot and soon many accountings used gold more than other items to denominate those trades. Still, **money was the account, the rating system for value, the worth association in your head. Gold, itself, became the main wealth object used in that bookkeeping.**

This all worked well for hundreds and perhaps thousands of years as fiat was never so well used or considered. Over time, society became accustomed to speaking of gold in the context of money accounting. Translations became all the more relaxed as gold and money accounting terms were mingled as one in the same. It was a subtle difference, then, but has become a major conflict in the money affairs of modern mankind; as gold receipts became fiat gold and bankers combined fiat money accounting with gold backing.

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To understand gold we must understand money in its purest form; apart from its manmade convoluted function of being something you save. **Money in its purest form is a mental association of values in trade; a concept in memory not a real item**. In proper vernacular; a 1930s style US gold coin was stamped in the act of applying the money concept to a real piece of tradable wealth. Not the best way to use gold, considering our human nature.

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By accepting and using dollars today, that have no inherent form of value, we are reverting to simple barter by value association. Assigning value to dollar units that can **only have a worth in what we can complete a trade for**. In effect, refining modern man's sophisticated money thoughts back into the plain money concept **as it first began; a value stored in your head!** Sound like something that's way over your head of understanding? I'll let you teach yourself.

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You use the currency as a unit to value associate the worth of everything. Not far from rating everything between a value of one to ten; only our currency numbers are infinite. Now, those numbers between one and ten have no value, do they? That's right, the value is in *your* association abilities. This is the money concept, my friends.

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A fiat trading unit works today because we make it take on the associated value of what we trade it for; it becomes the very money concept that always resided in our brains from the beginnings of time. In this, a controlled fiat unit works as a trading medium; even as it fails miserably as a retainer of wealth the bankers and lenders so want it to be.

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For thirty years fiat use evolved on its own to embrace the non-wealth trading aspects of "the money concept". Leaving in its wake a world of worthless dollar debt as people bought wealth outside the "money concept" anyway. We are, today, in a transition away from that dollar mess and much of our wealth illusion will be passing from our grasp in the process.

In every way, society is trading its way back to where it started. In the process, gold will find a new value from its history in the past:

"A wealth of ages savings for your future of today."

End Sidebar

Well, there you have it! The pure concept of money is our shared **use** of some *thing* as a reference point for expressing the relative value of all other things. Money is the *referencing* of the thing, not the thing itself. As FOA said, money is "a value stored in your head!" Money is not something you save. "Money

in its purest form is a mental association of values in trade; a concept in memory not a real item… the value is in your association abilities. This is the money concept, my friends."

But what does this have to do with me in 2011? I can almost hear you thinking this question now. Well, I'm going to share a secret with you. The big secret is that the people's money is simply credit. And by "the people's money," I mean *our* money, the real producing economy's money. The monetary base is only the banks' and governments' money, except for that little bit of cash you keep in your wallet for emergencies. Let me explain.

Today's monetary base is a clearly defined thing. It is all physical currency plus reserves held at the Fed. We the people cannot have electronic base money. We cannot open an account at the Fed. Only banks and the government can. We use commercial bank credit and private credit to keep the economy churning. The reference point of our credit is the base. We reference that base when we transact in "dollars".

Private and commercial bank credit appears and disappears spontaneously all the time, all throughout the real economy. This is what actually lubricates the economic engine; having a base of stable value to which we refer in monetary transactions. Private credit is generally cleared using bank credit. And bank credit is cleared using the monetary base. But all credit denominated in dollars refers to that base and relies on a stable unit value or price stability.

It is the banks' job (both commercial and central banks) to make sure that bank credit (the people's money) and base money (the banks' money) are fungible. That is, they are always freely and equally exchangeable. But of course they are two separate things, credit and base money, with two very different volumes. Under normal conditions, there's a lot more credit money floating around than there is base money. So keeping them fungible can be a juggling act on occasion. But for the most part, we the people *choose* to hold bank credit as our money rather than cash. And, in fact, it is the limited availability of cash in the system (its relative "hardness") that keeps *our* money stable in unit value.

Think about it this way: We are free to choose cash at any time. And when we go to the bank to exchange our credits for cash, we put that bank under pressure to come up with cash that is relatively "harder" to come up with (more limited in volume) than credit. Let's say, for example, that "demand deposits" (those that *can* demand cash on the spot) are ten times larger than the total volume of cash in the system. Is this good for our money? Yes, because it means that the reference point unit we use is in limited supply, which keeps a vital *tension* on the overall system. The operations the bank must do to come up with our cash (sell off some value) maintain value in our credits.

Say the base volume is one trillion dollars, which is about what it was in October of 2008. That means the base *unit reference point* for all dollar credit in the world is one one-trillionth of the base volume, all the available above-ground dollars ever mined throughout all of history. Then imagine you doubled that base to two trillion dollars. The unit reference point will have been ***cut in half***, from one one-trillionth to *one-half* of one one-trillionth of the base volume.

Like this: Remember the "reference kilo" in Reference Point Revolution?

Say you've got a contract or a credit for a kilo of gold. Now obviously the total volume of gold can't be doubled overnight like the dollar base was, so what would be the equivalent effect? Well, it would be like someone cutting that reference kilo in half. Your one kilo contract, since it is denominated in kilos, refers to this unit reference point that has just been cut in half. It has suddenly become twice as easy for your creditor to deliver on his obligation. And, by the way, the volume of the dollar base has more than doubled since Oct. 2008. It's now at 2.7 trillion, which means the unit reference point was actually given a 63% "haircut" in three years, from one one-trillionth to little more than one-third of one-trillionth of the total volume.

Now, before you start arguing your own favorite economic pet theory, let me remind you that there is no right or wrong at this point. There's only the usefulness of a perspective in delivering the correct analysis of what's actually happening today and the best prescription for your personal action. But you can't use a perspective until you get it. Then, and only then, you can use your own mind to decide if it is the correct perspective and then act upon it. Later it will be proved correct or incorrect, just as Another said: "time will prove all things."

Clearly the 63% destruction of the dollar unit reference point over the last three years did not immediately translate into a 170% rise in prices at the grocery store. And I wouldn't expect it to. It never works like that. Henry Hazlitt explained it like this: "The value of the monetary unit, at the beginning of an inflation, commonly does not fall by as much as the increase in the quantity of money, whereas, in the late stage of inflation, the value of the monetary unit falls much faster than the increase in the quantity of money."

If you have a large 401K, IRA or pension fund full of credits for dollars, you may be taking comfort in the fact that the 63% haircut in the very unit your retirement nest egg references has not yet shown up at the stores where you shop. But the fact remains that the dollar has been debased. That's why they call it debasement. The base is diluted by expanding its volume which reduces the value of the unit used for reference relative to the volume of available units.

There are, of course, plenty of economic theories out there that are wholly designed to distract your

attention away from this plain and obvious debasement and to tell you why it doesn't matter, and how the presently slow price inflation is proof that it doesn't matter if they debase your money and your life's savings. Some will tell you that the apparent fungibility of credit and cash means they are the same thing. And some will even try to tell you that the base unit reference point derives its value from the volume of *credit* rather than its own volume, and that the base volume is essentially meaningless. But I think that if you are keeping your wealth in the form of money, sheep being periodically sheared is an image worth keeping in mind.

The Pure Concept of Wealth

Another concept of concern today is that of 'wealth'. As FOA emphasized in the sidebar, the fundamental property of wealth is that of "possession." It is by this property that wealth is identified, and thereby it becomes 'wealth'. "In the world of wealth, worth is enhanced because the supply is lessened by this 'possession attribute'. And possession is how most people in antiquity understood wealth."

Have you ever noticed how the super-rich seem to stay super-rich no matter how much money they spend? Not only that, but they seem to get wealthier the *more* they spend! They buy amazing super-homes, expensive antique furniture to fill the homes, and priceless artwork to hang on every inch of their fancy walls, yet somehow they retain their wealth.

That's not to say that they don't also participate in the Western tradition of "the something for nothing game" we call the paper markets. They do, but that participation does not constitute their 'wealth'. Yet we, the commoners, are told constantly, by state-approved financial advisors, to put our entire nest egg at risk in this "something for nothing game."

We can't afford that nice furniture and art that the super-wealthy buy, so we buy low-priced crap from China that is worth half what we paid for it the minute we walk out of the store. What is going on? Is it possible to imagine a new monetary system that would put common people on equal footing with the super-rich when it comes to possessing our wealth?

FOA (05/06/01; 20:30:52MT - usagold.com msg#69)
A Tree in the Making

In this world we all need much; blessings from above,,,,, family,,,, home,,, friends and good health. But after all that, one must have currency ***and*** an enduring, tradable wealth asset that places our footing in life on equal ground with the giants around us,,,,,, gold! Understanding the events that got us here and how they will unfold before us is what this GoldTrail is all about.

I know I keep repeating myself, but this post is specifically designed to encourage independent thought; to let your mind wander about, freed from the confines of modern dogma. If you were able to wrap your mind around the pure concept of money, you may be starting to sense the danger, at least conceptually, in holding your lifetime's-worth of accumulated wealth as money. Because when they double the base, they are diluting all of “our” money by half, even if “our money” outnumbers the base by 10:1 (bank credit), 100:1 (all credit), 1,000:1 (credit derivatives) or whatever. It is credit's reference point they are abusing to ease their own discomfort, and our money they are debasing. And the more money you are holding when they do this, the greater your share of the loss.

To contrast these two important concepts, money and wealth, notice that, conceptually, money is not the item that is referenced, and the item (e.g., a dollar bill) is not money in and of itself. It only obtains moneyness by the fact that it is referenced in valuing other items. True wealth, on the other hand, is, in fact, the item itself. A wealth item *is* wealth, in and of itself, by the mere fact that it is possessed.

The easy money camp always wants the savers to store their wealth in money, so they can loot those savings by debasing the referenced unit which eases their discomfort. Meanwhile the hard money camp always wants the debtors' deficit spending to be denominated in real wealth. The problems with this approach are myriad.

So here's an interesting question: What do you call a monetary system where physical gold wealth (not credits denominated in ounces issued by a commercial bank, but the actual physical stuff) sits on Line 1 of the Eurosystem's monetary assets? There's no silver there on line 2, no copper, no oil, no GLD or PHYS, no mining shares, no antique furniture or Renoirs, just 400-ounce bars of physical gold bullion and a few minted gold coins. Official purchases and sales of gold (changes in the volume) are publicly reported every week, and its value is updated every quarter.

What do you call that system? And what do you call the gold in that system? How would you describe gold's moneyness in such a system? And why hasn't Greece sold its gold yet to end the discomfort? Why do we mainly hear politicians proclaiming "the euro will survive." Why do we rarely if ever see the central bankers sweating "the survival of the euro"? Aren't they worried about the survival of their reference unit? Or do they simply understand moneyness better than the rest of us?

MMT

If you read my whole sidebar like I hope you did, you saw where FOA described in the broadest terms how we arrived at our latest iteration of easy money. Here it is again:

Gold coins, then bank storage, then gold lending, then gold certificate use, then lending of certificates, then certificates are declared paper money, then overprinted, then gold backing removed…

How's *that* for covering a lot of years in one sentence?

Depending on which camp you're in, as long as you haven't grasped the pure concepts of 'money' and 'wealth', there's a whole spectrum of descriptions of how "modern money" works with varying degrees of uselessness in practical applicability, both macro and micro. On the hard money side, you'll find lots of criticism of "fractional reserve banking," "thin air money," "borrowed into existence," "credit money is a pyramid scheme" (it's not, the concept of money has always been a credit reference to a base unit), etc., etc… Hard money descriptions of modern money are overwhelmingly critical because, of course, the easy money camp has been in charge for a long time now.

Obviously I think the hard money camp misses the mark in its policy prescriptions, but you've got to understand that they can only address today's issues in the counterfactual subjunctive. In other words, "if A had been true, then B wouldn't have happened or the outcome would have been better." But A isn't true. A being "if only we had hard money today."

But it's over there in the far corners of the easy money camp where you'll find some truly repulsive arrogance by those who unfortunately have the luxury of using *true* antecedents in their modal logic. Like this: "If it is true today that USG deficit spending is not technically constrained by taxes and borrowing because it issues its own currency, then structural trade deficits are not only sustainable, good and loved by our trading partners, but necessary. 'Austerity', or producing more than we consume at times like these, on the other hand, is a total disaster." That's the logic. Here's the arrogance:

"As a current account deficit nation, the US government can appropriately be thought of as a net currency exporter. This means that we send pieces of paper over to the foreign nations in exchange for goods and services." (Cullen Roche)

"We don't need China to buy our bonds in order to spend. China gets pieces of paper with old dead white men on them in exchange for real goods and services." (Cullen Roche)

And why doesn't China just buy other American stuff?

"They have attempted to use their dollars to purchase other USD denominated assets, but the US government has squashed those efforts. So, instead of leaving these pieces of paper to collect dust in vaults, they open what is the equivalent of a savings account with the US government." (Cullen Roche)

"Anyone who uses the term [monetization] in the context of the Fed's contribution of government spending does not understand how the modern monetary system works." (Cullen Roche)

"This is basic macroeconomics and the debt-deficit-hyperinflation hyperventilating neo-liberal terrorists seem unable to grasp it." (Bill Mitchell)

"The Fed is not printing money. They are merely swapping treasuries for deposits." (Cullen Roche)

Someone should explain to these guys the meaning of the phrase, "never look a gift horse in the mouth." It means that when someone gives you a free horse, you shouldn't inspect it too closely in front of the giver.

Of course this is MMT, or Modern Monetary Theory I'm talking about. Even Paul Krugman noted the arrogance of these theorists in his latest blog post about MMT (my emphasis):

"First of all, yes, I have read various MMT manifestos — this one *is fairly clear as they go. I do dislike the style — the claims that fundamental principles of logic lead to a worldview* ***that only fools would fail to understand****..."*

I bring up MMT not because it is entertaining to make fun of their misguided (and often repulsive) arrogance, but because of the inauspicious rise of their extreme easy money theories right at the tail end of history's grandest easy money experiment. I find it to be a handy platform from which to explain how the ancient concepts of money and wealth are still more relevant to the near-term outcome than a few accounting identities that thrive solely in the monetary plane, and do so with reckless disregard for the real power of the physical plane.

One of the main tenets of MMT is the accounting identity that roughly states the amount the USG

deficit spends (government spending in excess of the taxes it takes in) is always equal to private sector net savings plus the trade deficit (exports minus imports, or stated another way, our trading partners' net dollar savings).

This is generally explained with the analogy that the USG spends money *into* existence and taxes money *out of* existence. So if the USG (God forbid) taxed as much as it spent (or spent as little as it taxed), there wouldn't be any extra USG money for us mere mortals to save. So by spending more than it takes in, the USG is graciously giving us money for savings. And then, the USG issues Treasuries in an amount equal to that deficit spending (extra money for us to save Woo hoo!) to give us an interest-bearing exchange for our net-production.

To be fair, MMT consistently reminds us it is only ***de***scribing and not *pre*scribing a monetary system. Fair enough. But the presence of the trade deficit and our trading partners' presumed need for dollar savings should probably set off your alarm bells. If so, MMT wants to calm your worry with these soothing words:

"In a world with global trade we are certain to have trade deficit and trade surplus nations." (Cullen Roche)

In other words, we are simply a trade deficit nation. That's just who we are. Get used to it, and then embrace it! After all, it's pretty cool to get free stuff:

"...the US government can appropriately be thought of as a net currency exporter. This means that we send pieces of paper over to the foreign nations in exchange for goods and services." (Cullen Roche)

It's pretty neat the way accounting identities work. They are always true because, by definition, they must be true. They are like saying, "the amount of widgets sold equals the amount of widgets bought." You can't really dispute them as they are framed. But it is in the static assumptions that go into the careful monetary plane framing that flaws can be found. The physical plane can be much more dynamic than they assume.

For example, what if all the private sector net-producers decided to save in gold instead of USG debt? Since the accounting identity we're talking about includes our foreign trading partners like China, I'm essentially asking what happens if they (and we) stop buying Treasuries. Remember that Cullen says it doesn't matter:

"We don't need China to buy our bonds in order to spend. China gets pieces of paper with old dead white men on them in exchange for real goods and services." (Cullen Roche)

In other words, if they don't buy our Treasuries (run a capital account deficit), then they'll just stack the Benjamins. In other words, that's just the way it is. See? It's an accounting identity.

But then a reasonable person might point out that the USG still issues Treasuries equal in amount to all its deficit spending. And if we and the Chinese aren't buying them, then the Fed has to, so it makes up a cool name like QE2 to disguise the real purpose of the purchases. Not so fast, MMT says. The Treasury does not need to issue debt in order fund its spending. When it spends, it simply credits private sector accounts with new credit money and the banks with new base money. There is no direct connection

between sales of Treasuries and money spent other than a myth in our confused minds.

In fact, during the debt ceiling debate in late 2009, MMT actually advised them to stop issuing Treasuries and just keep spending:

"The anti-deficit mania in Washington is getting crazier by the day. So here is what I propose: let's support Senator Bayh's proposal to 'just say no' to raising the debt ceiling. Once the federal debt reaches $12.1 trillion, the Treasury would be prohibited from selling any more bonds. Treasury would continue to spend by crediting bank accounts of recipients, and reserve accounts of their banks. Banks would offer excess reserves in overnight markets, but would find no takers—hence would have to be content holding reserves and earning whatever rate the Fed wants to pay. But as Chairman Bernanke told Congress, this is no problem because the Fed spends simply by crediting bank accounts.

This would allow Senator Bayh and other deficit warriors to stop worrying about Treasury debt and move on to something important like the loss of millions of jobs." (L. Randall Wray)

I want you to notice a small detail in the above quote that probably slips by most people. Wray writes (my emphasis): *"Treasury would continue to spend by crediting bank accounts of recipients,* ***and reserve accounts of their banks****."*

Out here in the real world of the productive economy, when we spend, only the account of the recipient gets credited. Not the reserve account of their bank. The "reserve account of their bank" is that commercial bank's account at the Federal Reserve Bank. Remember? You and I can't have accounts there. Only the banks and the government can. Our spending is netted out in the system each night and the imbalances between banks are cleared with those substantially smaller reserve accounts.

I imagine there's a good reason Randall Wray was careful to include this small technicality in his piece. That's because raw government-created money through deficit spending is fundamentally different from "our money." Government spending adds one unit of credit money (our money) to the system as well as one unit of base money (their money). The bank receiving the deposit gets a reference point unit asset to match the liability it takes on.

So the volume of the base is expanded when the government spends, and it is likewise contracted when the government taxes and/or sells Treasuries to the private sector (including our trade partners like China). But when the government spends in excess of those two operations (taxing and debt selling), the base volume is simply expanded. And MMT apparently sees no difference between the true concept of money (all that 100s of trillions of credit denominated in a single reference point unit) and the base which it references. Take QE2 for example.

Super easy money camper and activist Ellen Brown writes in IS QE2 THE ROAD TO ZIMBABWE-STYLE HYPERINFLATION? NOT LIKELY:

"Unlike Zimbabwe, which had to have U.S. dollars to pay its debt to the IMF, the U.S. can easily get the currency it needs without being beholden to anyone. It can print the dollars, or borrow from the Fed which prints them.

But wouldn't that dilute the value of the currency?

No, says Cullen Roche*, because swapping dollars for bonds does not change the size of the money supply. A dollar bill and a dollar bond are essentially the same thing."*

This is part of the flaw in MMT's view. Bonds are credit (the economy's money) denominated in (referencing) the base unit (the dollar). Swapping credit for base units dilutes and debases every single credit dollar in the world, all quadrillion of them if you included derivatives.

When the private sector (plus our foreign free stuff suppliers) buy bonds, the USG is essentially spending credit money rather than expanding the base because "the credit to the ***reserve account*** of their banks" that Randall Wray mentioned above is ***deleted*** when the private/foreign sector buys a Treasury bond. Spending credit money does not dilute the base and debase the reference unit. But when the people (or banks) that bought those bonds swap them with the Fed for cash, the base is diluted and the reference unit is debased. So Cullen is wrong. A dollar bill and a dollar bond are *not* essentially the same thing.

Back in June, talking about QE2, I wrote something very similar to what Cullen says. See if you can spot the subtle difference.

Cullen: *"There is not 'more firepower' in the market following QE. All that the Fed altered was the duration of the U.S. government's liabilities. The Fed took on an asset (treasurys) and also accounted for a new liability (the reserves). But this transaction did not change the net financial assets in the system. The point here is that from an operational perspective the Fed is not really altering the money supply."*

Me: *"The Fed has not created more money, it has simply* ***changed the nature of existing money****. Remember, FOA said that '...hyperinflation is the process of saving debt at all costs, even buying it outright for cash.'"*

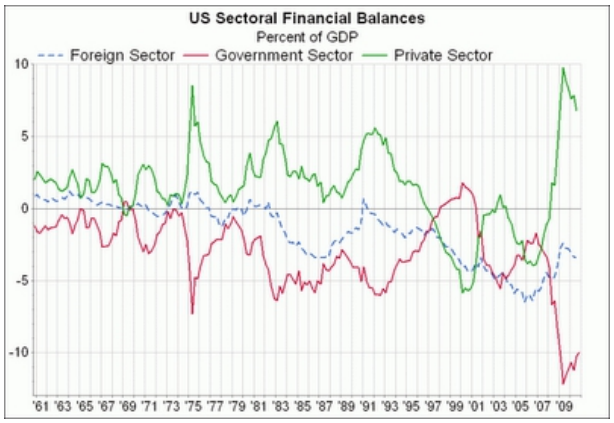
So, just to recap, MMT says that neither selling debt to the Chinese nor QE (selling it to the Fed) is actually necessary to fund government deficit spending. The government spending actually happens *first*, therefore it is independent of, and not reliant on, either of those financial operations. And to this point, I think we can all agree with MMT's description of the process as it exists in the monetary plane, although it is clearly not the *only* correct description, and certainly not the whole story.

Here's the thing, the act of government deficit spending *without* either counterbalancing taxes or Treasury sales to the private/foreign sector, and the act of Fed quantitative easing, both change the nature of the money supply in a way that all other "normal" activities do not. They debase "our money" by expanding "their money" in volume to ease their discomfort. And this kinda gets us to the driving thrust of MMT; that MMT sees little to no danger of this monetary plane debasement spilling out into the physical plane with deadly consequences for the dollar.

There is, however, one area in which the danger is at its all-time peak today. And that is the US trade deficit as viewed from the physical plane. But before we get into that, let's take a look at a couple neat charts that Cullen Roche uses to visualize the monetary plane accounting identity that underlies his theory. Cullen calls them "sectoral balances," meaning the monetary plane balance sheet of three different sectors: the government sector (USG), the domestic private sector, and the foreign sector.

What I'm going to try to do is to help you see the physical plane reality of these charts. They are so neat and balanced in the monetary plane, yet they represent an immense ***imbalance*** in the physical plane that, because of the credibility inflation of the last 40 years, leaves the dollar vulnerable to spontaneous hyperinflation. More on that in a moment.

In this first chart, I want you to pay special attention to the dashed blue line. In the monetary plane, that line represents the amount of US paper our foreign trading partners are taking in each year. When they take in dollars, those show up as a current account surplus on their sheet and a current account deficit on ours. Then when they trade them in for Treasuries they show up as a capital account deficit on their sheet and a capital account surplus on ours. But the easiest way to understand this blue line is in the physical plane. It represents the trade deficit; the amount of free stuff we got each year in exchange for nothing but paper. As Cullen says, "the US government can appropriately be thought of as a net currency exporter." So the blue line is our "currency exports."



Here's a link to our Balance of Payments (BOP) from 1960 through 2010:

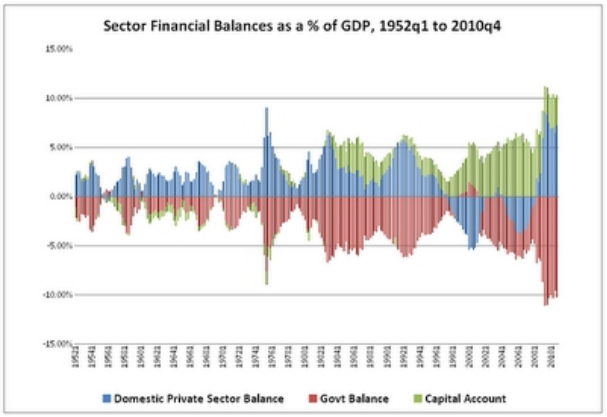
www.census.gov/foreign-trade/statistics/historical/gands.txt

The first column is our trade balance. A negative number means a trade deficit. I'm sure the MMT folks reading this are getting tired of me calling it "free stuff," but that's what it is, which I'll explain in more detail later. Foreign central banks were literally supporting our trade deficit for their own reasons for the last 30 years. You'll notice we went into deficit in 1971, with the only blips up into surplus since then occurring in '73 and '75.

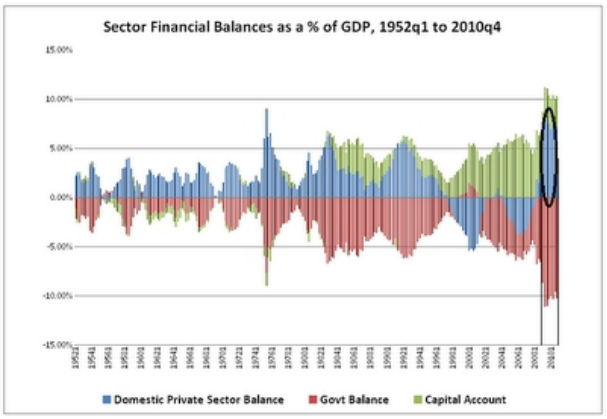
You've probably heard it said that the US has become a "service economy" as opposed to producing all the real stuff we used to produce. Well, if you look at the second and third columns, the goods column and the services column, you'll see the inflection point of that transition was also in 1971. So all those negative numbers in the first column really do represent real goods, the kind of stuff that gets packed into containers and physically shipped to the US.

In 2010 you'll see that our trade deficit was $500 billion. That number comes from a $645B deficit in goods, and a $145B surplus in services. In 2011 we are on track for a trade deficit of about $565B (monthly data). For the last decade, our trade deficit range has been $400B - $750B per year. The average for the decade is $581B per year, or $48.5B per month.

Now this second chart really shows the monetary plane symmetry that MMT loves. The whole point of the accounting identity is that the balances of the three sectors (government sector, domestic private sector and foreign sector) must net out to zero. One person's savings is another person's debt, or so the story goes. Remember what I said about widgets? "The amount of widgets sold equals the amount of widgets bought." Well the accounting identity behind this chart is essentially just as simple: "the amount of debt sold equals the amount of debt bought." If you're going to save, then I have to deficit spend (create debt notes) for you to hold as your savings. Neat, huh?



On this chart, the bottom is the amount of debt sold and the top is the amount of debt bought. All that red on the bottom is the government sector selling debt. The green on the top is the foreign sector buying that debt. The blue, which seems to jump around, is the domestic US private sector either buying (top) or selling (bottom) debt (think: MBS). What I want to draw your attention to is this last bit of blue at the end:



What this section, roughly encompassing the last three years, apparently shows is that 1. The debt sold by the USG jumped dramatically, 2. The debt purchased by the foreign sector decreased, and 3. The domestic US private sector apparently picked up the slack dropped by the foreign sector. I propose to you that "the domestic US private sector" in this case was mostly Ben Bernanke and the Federal Reserve. I do understand that MMT interprets QE as something other than money printing, but I would like you to read this paragraph from Wikipedia on the specific amounts of quantitative easing:

"The US Federal Reserve held between $700 billion and $800 billion of Treasury notes on its balance

sheet before the recession. In late November 2008, the Fed started buying $600 billion in Mortgage-backed securities (MBS). By March 2009, it held $1.75 trillion of bank debt, MBS, and Treasury notes, and reached a peak of $2.1 trillion in June 2010. Further purchases were halted as the economy had started to improve, but resumed in August 2010 when the Fed decided the economy wasn't growing robustly. After the halt in June holdings started falling naturally as debt matured and were projected to fall to $1.7 trillion by 2012. The Fed's revised goal became to keep holdings at the $2.054 trillion level. To maintain that level, the Fed bought $30 billion in 2–10 year Treasury notes a month. In November 2010, the Fed announced a second round of quantitative easing, or "QE2", buying $600 billion of Treasury securities by the end of the second quarter of 2011." (Wikipedia)

Now, before we move on, I want to draw your attention to three curiosities to which I will be referring:

1. Using the latest data for the last three years, the dollar monetary base expanded by **$1.7T** and the US trade deficit (free stuff inflow) was **$1.5T** over the same time period.

2. For fiscal year 2011, the trade deficit was **$540B** and "QE2" was **$600B** over the same time period.

3. For the last year, Chinese Treasury holdings are perfectly flat (same amount held in Aug. 2011 as in Aug. 2010) and Hong Kong holdings are down by $26B.

The Debtor and the Junkie

The USG may be a dealer in the monetary plane, but it is most definitely a sketchy junkie in the physical plane. The USG thinks (and truly believes) that the key to rejuvenating the US economy is trashing the dollar as a short cut to increasing exports (reducing the trade deficit). But what it can't see (nor anyone that focuses solely on the monetary plane for adjustment) is that the huge trade deficit the USG wants to quit is actually its own heroin fix. This is a deadly combo for the US dollar.

MMTers don't think very highly of "hyperinflationists". They call us "hyperventilators" and such, although I shouldn't really bunch myself in with the others. I think my description of hyperinflation is more in line with reality than others I've read. See here, here, here, here and here. But in this post I hope to show you where the MMTers go wrong on hyperinflation, and to show why—and how—dollar hyperinflation is the only possible outcome.

The "debtor" I had in mind for my section title was Weimar Germany in the early '20s, not the USG today. The USG is the junkie. Weimar Germany owed war reparations, a debt resulting from WWI that was essentially denominated in gold. This was a debt in a hard currency (hard as in difficult, not hard as in solid), unlike the USG who owes its debt to others in its own currency. MMT got that part right. The USG cannot be forced into involuntary default on its own currency debt. And because of this property, USG debt is a monetary plane illusion when viewed from the physical plane. It is a great store of nominal value, and a terrible store of real value.

Where MMT derails from the description track and goes careening off the *pre*scription cliff, the message is usually about the admirable goal of full employment. You know, the Fed's ***other*** mandate. Indeed, L. Randall Wray's book is titled Understanding Modern Money: The Key to Full Employment and Price Stability. But the bottom line is MMT's untested theory that the USG *could* pay for full employment (hire anyone who wants to work) through raw monetary base expansion while enjoying

the same relatively stable prices of the last 30 years. And their best defense of this shark jump proposition appears to be debunking the hyperventilators.

In Zimbabwe! Weimar Republic! How Modern Money Theory Replies to Hyperinflation Hyperventilators (Part 1) Randall Wray writes:

"MMTers are commonly accused of promoting policy that would recreate the experiences of Zimbabwe or Weimar Republic hyperinflations. These were supposedly caused by governments that resorted to "money printing" to finance burgeoning deficits—increasing the money supply at such a rapid pace that inflation accelerated to truly monumental rates." (Wray)

He goes on to explain how the hyperventilators have it all wrong. He shows how hyperinflation is more about an increase in money velocity than volume; that hyperinflation begins with a loss of confidence, not too much money. Any of this sound familiar? Then he beats a gold bug straw man or two before explaining to us how modern money *really* works. Here's the most important part to understand:

"You cannot print up Dollars in your basement. Government has to keystroke them into existence before you can pay your taxes or buy Treasuries." (Wray)

Notice he mentions taxes and Treasuries. This is important to understand. Government money, which is the monetary base the economy uses as its reference unit, is expanded when the USG spends, and only contracts when you either 1. pay taxes, or 2. buy Treasuries. He wasn't just throwing those out as two examples of how you might spend your money. Those are the *only* two checks on base money expansion. But the sneaky thing that MMT does is to marginalize the importance of those two methods of contracting the base. Like this, as if it's no big deal, a mere afterthought:

"Usually the treasury then sells bonds to let banks earn higher interest than they receive on reserves." (Wray)

The basis of MMT is that government spending (base money expansion) is not conditional on 1. taxing or 2. borrowing that money (base money contraction). Expansion is not conditional on contraction. This is obviously true because the base has been expanding. But armed with this epiphany, along with the "obvious fact" that the hyperinflationists don't understand how modern money works, they jump to the conclusion that contracting the monetary base after the government has expanded it is a fool's errand. And so they go to great lengths to marginalize the need for contraction, especially when unemployment is rising and the economy is in recession.

As it stands, our government still operates on the "antiquated" condition that taxes plus borrowing must equal spending. So we periodically raise the debt ceiling and we keep issuing Treasuries to match the entire budget deficit. But QE is the new way to reverse the base money contraction that happens when these Treasuries are sold. The Fed simply buys them from the banks and credits the banks with the base money that was deleted when they were purchased.

From an accounting perspective, this QE operation has the same effect as if the government had spent more than taxes and borrowing combined, or as if the government reduced taxes while keeping debt and spending constant. So armed with this epiphany, MMT is able to marginalize QE as a mere fiscal operation rather than the "helicopter drop" those silly hyperventilators like to talk about. "Fiscal

operation" sounds pretty innocuous, doesn't it? But it's not quite that tame.

What I'm going to show you is that there's something quite dangerous to the dollar that is already well underway. From an accounting perspective, there's not much difference between QE and the easy money prescriptions coming from some of the MMTers. And these seemingly innocuous "fiscal operations" are actually born of necessity arising, not in the monetary plane, but from the physical trade deficit.

Unfortunately, the USG/Fed believes that trashing the dollar will help the domestic US economy as a kind of short cut to growing exports and thereby increasing wages and consumption demand. In other words, if we could just make our products cheaper overseas through monetary plane operations, we could sell more real stuff and thereby we'll have more money and all will be peaches and cream.

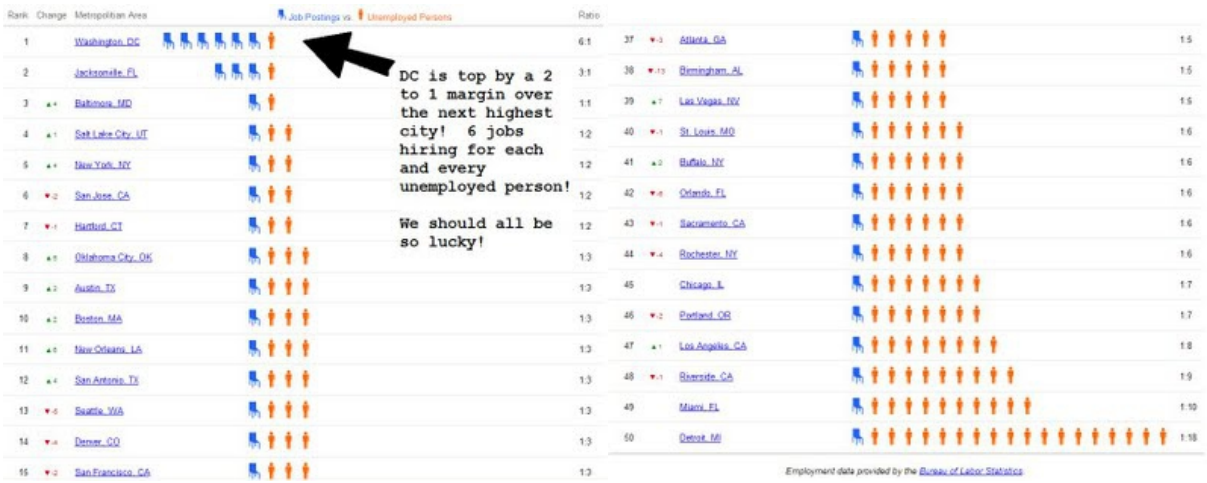
But the problem is that, net-net, the US consumes everything it produces and then some. This intractable problem cannot be solved in the monetary plane, except through dollar hyperinflation! Here's some more FOA:

"I point out that many, many other countries also have the same "enormous resources; physical, financial, and spiritual" that we have. But the degrading of our economic trading unit, the dollar, places the good use of these attributes in peril. Besides, the issue beyond these items is our current lifestyle. ***We buy far more than we sell, a trade deficit. Collectively, net / net, using our own attributes and requiring the use of other nation's as well.*** *Not unlike Black Blade's Kalifornians sucking up their neighbors energy supplies (smile). We cannot place [our tremendous resources] up as example of our worth to other nations* ***unless we crash our lifestyle to a level that will allow their export! Something our currency management policy will confront with dollar printing to avert.*** *Also:*

NO, "this country will not turn over and simply give in" as you state. But, we will give up on our currency! Come now, let's take reason in grasp. Our American society's worth is not its currency system. Around the world and over decades other fine people states have adopted dollars as their second money, only to see their society and economy improve. Even though we see only their failing first tier money. What changes is the recognition of what we do produce for ourselves and what we require from others to maintain our current standard of living. In the US this function will be a reverse example from these others. We will come to know just how "above" our capabilities we have been living. Receiving free support by way of an over-valued dollar that we spent without the pain of work." (FOA)

That was written a decade ago. In the month that was written, the US as a whole (Government sector plus domestic private sector) was living above its means to the tune of $31.3B. That year we were living above our means by $361B. In the decade since that was written, we have maintained an average "excess consumption" of $48.5B per month and $581B per year. But here's the thing—in the most recent third of that decade (2008-2011), the domestic US private sector actually *has* crashed its lifestyle more or less. The economy is in recession and unemployment is up over 9%. Yet the government sector expanded *its* "lifestyle" to take up the slack!

Remember these from my 2009 post No Free Lunch?



And for something a little more recent, here are two headlines I saw on Drudge just last month:

DC area tops US income list; average fed employee makes $126,000 a year...
Reid says government jobs must take priority over private-sector jobs...

No wonder we're maintaining that trade deficit!

So I thought I'd come up with my own "physical plane identity" (kinda like an accounting identity in the monetary plane) for "living above our means." Here's the legend:

USG=US Government sector
USP=US Private sector
BOP=Trade balance for both sectors combined

We know how much the USG is living above its means. That's the budget deficit. And we also know how much the USG+USP combined are living above their means. That's the BOP. So the "identity" looks something like this:

USG+USP=BOP

The annual USG budget deficit (how much the USG lives above its means, with means equaling taxes) is about $1.4T. And the BOP is about $565B. So we get this:

USG=$1.4T
BOP=$565B
$1.4T+USP=$565B

Or stated another way:

USP=(-$835B)

So the US private sector is actually living below its means by $835B if we isolate it from the government sector. The government sector, on the other hand, is living way above its means with 60% domestic support and 40% foreign support. Stated another way, the US private sector is providing the USG with $835B in goods and services in excess of taxes, or 60% of USG's "deficit consumption."

Viewed this way, there's only one way to reduce that trade deficit (inflow of free stuff): reduce the size of the USG monstrosity. Unfortunately, the USG is totally incapable of voluntarily shrinking itself, especially because it issues its own currency! The real problem, the heart of the matter, the reason why the dollar will and *must* hyperinflate, is that the US trade deficit, on the physical plane, is structural to the USG who issues its own currency. Simple as that.

Here's what we get whenever the USG pretends to crash its own lifestyle:

Obama Budget Cuts Visualization

Jack Daniels Explains the Deficit

I can almost hear the MMTers screaming at their computer screens, "he doesn't understand how modern money works!" ;)

Of course, MMTers don't think the USG should crash its "lifestyle" at all. They think the USG needs *more* deficit spending right now. Because deficit spending is not constrained by taxes and/or borrowing

and the hyperventilators don't understand how modern money works so currency collapse can be essentially ignored. Are you starting to catch on yet?

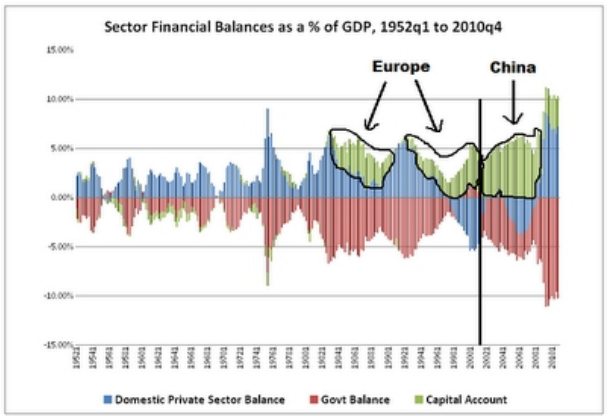
MMT is all about ***how*** it works from a monetary plane accounting perspective with reckless disregard for ***why*** it works and ***why*** the dollar monetary plane has stayed connected to the physical plane (no hyperinflation) as long as it has. That last part, of course, is what *this* blog is all about. MMTers, like most modern economists, think the physical plane services the monetary plane, not the other way around. They think you can fix problems in the real world by simply controlling the monetary world. Why? Because everyone wants money, of course!

But herein lies the problem of what money actually *is* to the real economy. Money is our shared **use** of some *thing* as a reference point for expressing the relative value of all other things. And by expanding the base you don't simply create money, you destroy the moneyness of it. As MMT explains, the base is expanded when the government deficit spends, and it is likewise contracted when the Treasury sells debt to anyone other than the Fed. Those of you who read FOFOA regularly know the story of ***why*** the dollar has not yet collapsed, but here's a very brief version for the rest of you.

The US has enjoyed a non-stop inflow of free stuff including oil (a trade deficit) ever since 1975, the last year we ran a trade surplus. In the 1970s, following the Nixon Shock and the OPEC Oil Crisis, the US dollar went into a tailspin. Because the US dollar was the global reserve currency, this was bad news for the global economy. If the dollar had failed then, without a viable replacement currency representing an economy at least as large as the US, international trade would have ground to a standstill.

Europe was already on the road to a single currency, but it still needed time, decades of time. So at the Belgrade IMF meeting in October of 1979, a group of European central bankers confronted the newly-appointed Paul Volcker with a "stern recommendation" that something big had to be done immediately to stop the dollar's fall. Returning to the US on October 6, Volcker called a secret emergency meeting in which he announced a major change in Fed monetary policy.

Meanwhile, the European central bankers made the tough decision to support the US dollar, at significant cost to their own economies, by supporting the US trade deficit by buying US Treasuries for as long as it took to launch the euro. As it turns out, it took 20 years. After the launch of the euro, the Europeans slowly backed off from supporting the dollar. But right about that same time, China stepped up to the plate and started buying Treasuries like they were hotcakes. This may have been related to China's admission into the WTO in 2001.



Then, sometime around 2007 or 2008, the dollar's Credibility Inflation peaked. The growth of the "economy's money" (credit denominated in dollars) hit some kind of a mathematical limit (expanding to the limit was wholly due to FOFOA's dilemma) and began to contract. Since then, China has slowly backed off from supporting the dollar. We now know that China is more interested in using its reserves to purchase technology and resource assets wherever they are for sale than bonds from the US Treasury. China is also expanding the economic zone that uses *its* monetary base as a reference point in trade settlement to the ASEAN countries.

Meanwhile, the junkie USG has kept the free stuff flowing in by expanding the monetary base. Sure, China still wants to sell her goods to the US, but she's no longer supporting the price stability of the last 30 years by recycling the dollar base expansion back into USG debt. Cullen says:

"We don't need China to buy our bonds in order to spend. China gets pieces of paper with old dead white men on them in exchange for real goods and services." (Cullen Roche)

While technically true, one has to wonder at the consequences of them ***not*** buying our bonds, no?

"They have attempted to use their dollars to purchase other USD denominated assets, but the US government has squashed those efforts. So, instead of leaving these pieces of paper to collect dust in vaults, they open what is the equivalent of a savings account with the US government." (Cullen Roche)

So does that mean they're just stackin' 'em up now to collect dust rather than going after real resources wherever they are for sale in the world?

Okay. So the USG doesn't owe a hard debt like Weimar Germany did in the early '20s. But perhaps she has developed a structural addiction; a need for something that's just as hard as foreign currency—real stuff from the physical plane. Here is L. Randall Wray describing Weimar:

"The typical story about Weimar Germany is that the government began to freely print a fiat money with no gold standing behind it, with no regard for the hyperinflationary consequences. The reality is more complex. First, we must understand that even in the early 20th century, most governments spent by issuing IOUs—albeit many were convertible on demand to sterling or gold. Germany had lost WWI and suffered under the burden of impossibly large reparations payments—that had to be made in gold. To make matters worse, much of its productive capacity had been destroyed or captured, and it had

little gold reserves. It was supposed to export to earn the gold needed to make the payments demanded by the victors. (Keynes wrote his first globally famous book arguing that Germany could not possibly pay the debts—note these were external debts denominated essentially in gold.)

The nation's productive capacity was not even sufficient to satisfy domestic demand, much less to export to pay reparations. Government knew that it was not only economically impossible but also politically impossible to impose taxes at a sufficient level to move resources to the public sector for exports to make the reparations payments. So instead it relied on spending. This meant government competed with domestic demand for a limited supply of output—driving prices up. At the same time, Germany's domestic producers had to borrow abroad (in foreign currency) to buy needed imports. Rising prices plus foreign borrowing caused depreciation of the domestic currency, which increased necessitous borrowing (since foreign imports cost more in terms of domestic currency) and at the same time increased the cost of the reparations in terms of domestic currency.

While it is often claimed that the central bank contributed to the inflation by purchasing debt from the treasury, actually it operated much like the Fed: it bought government debt from banks—offering them a higher earning asset in exchange for reserves. For the reasons discussed above, budget deficits resulted from the high and then hyper- inflation as tax revenue could not keep pace with rising prices. Finally in 1924 Germany adopted a new currency, and while it was not legal tender, it was designated acceptable for tax payment. The hyperinflation ended." (Wray)

Let's happily skip over the fact that Wray compares the German central bank during the Weimar hyperinflation to the Fed today when he writes: "actually it [the Reichsbank] operated much like the Fed: it bought government debt from banks." I have a better comparison I want to try. I want to try a little word replacement game with Wray's Weimar description. Let's replace Germany with the USG and the war reparations debt with a trade deficit addiction and see how it looks. Other than these few substitutions, I'll leave Wray's descriptive words alone:

"The USG had endured 30 years of foreign-supported trade deficit and developed an addiction to free stuff. To make matters worse, much of its productive capacity had been shipped overseas during this time period. The US private sector could not possibly support the USG's addiction to real goods.

The nation's productive capacity was not even sufficient to satisfy domestic demand, much less to support USG demand. Government knew that it was not only economically impossible but also politically impossible to impose taxes at a sufficient level to move resources to the public sector to satisfy the USG's insatiable addiction. So instead, it relied on deficit spending through raw base money creation. This meant government competed with global demand for a limited supply of importable goods—driving prices up. At the same time, the US private sector had to pay the same higher prices without the benefit of issuing its own currency to buy needed imports. Rising import prices forced the US economy to consume more of its own domestic goods, which increased USG's reliance on imports, and since foreign imports cost more in terms of the domestic currency, this increased the cost of the USG's addiction in terms of domestic currency." (Me)

Now I want you to think especially hard about that last line, "…this increased the cost of the USG's addiction in terms of domestic currency." This is the key to understanding ***why*** we are headed toward all-out, balls-to-the-wall, in-your-face wheelbarrow hyperinflation. This is it, the point I'm trying to get across to you.

That inflow of free goods that is structural to the status quo operation of the US government is more dangerous to a monopoly currency issuer than the war reparations debt in Weimar Germany. The USG is incapable of reducing that inflow of real goods voluntarily and so the non-hyperinflation of the dollar requires it to flow in for free. And it has been, up until recently.

Today we are debasing our monetary reference point in defense of that inflow of goods from abroad. And, at this point, it is entirely attributable to the USG alone, and not to the US economy at large which has contracted, unlike the government. MMT says that Bernanke's QE is a simple like-kind swap of paper for paper, or money for money. Cullen: "What they've essentially done via QE2 is swap 0.25% paper for 2% paper and call it a day." In a sense, it is. But it is removing newly created credit money (debt created by the USG) from the system and replacing it with newly created base money. By increasing the volume of the base which credit references for value, simultaneous with a constant inflow of necessary goods, we are in essence devaluing—or more precisely debasing—the credit money flow that flows in the opposite direction of the goods flow. The fact that this doesn't show up *immediately* in consumer prices is perfectly normal.

Henry Hazlitt: *"What we commonly find, in going through the histories of substantial or prolonged inflations in various countries, is that, in the early stages, prices rise by less than the increase in the quantity of money; that in the middle stages they may rise in rough proportion to the increase in the quantity of money (after making due allowance for changes that may also occur in the supply of goods); but that, when an inflation has been prolonged beyond a certain point, or has shown signs of acceleration, prices rise by more than the increase in the quantity of money. Putting the matter another way, the value of the monetary unit, at the beginning of an inflation, commonly does not fall by as much as the increase in the quantity of money, whereas, in the late stage of inflation, the value of the monetary unit falls much faster than the increase in the quantity of money. As a result, the larger supply of money actually has a smaller total purchasing power than the previous lower supply of money. There are, therefore, paradoxically, complaints of a 'shortage of money.'"*

Again, I want you to think about that last line or two, "As a result, the **larger supply** of money actually has a **smaller total purchasing power** than the previous lower supply of money. There are, therefore, paradoxically, complaints of a "**shortage of money**."

So what does the supply of money have to do with the catastrophic loss of confidence that ***is*** hyperinflation? Yes, the catastrophic loss of confidence **drives prices higher**. This makes the present supply of money **insufficient** to purchase a steady amount of goods (USG junkie fix). True balls-to-the-wall hyperinflation requires a feedback loop of both value and volume. Value drops, so volume expands, so value drops more…. Without the feedback loop, you simply get the Icelandic Krona or the Thai Baht. With the USG in the loop, you get Weimar!

Think about a debtor who owes a hard debt to a loan shark versus a junkie who owes a regular, ongoing, hard fix to himself. Which one is worse off? Which more desperate? As I wrote above, this intractable problem cannot be solved in the monetary plane, except through dollar hyperinflation!

Big Danger in "A Little Inflation"

I just received an advance copy of Jim Rickards' new book, Currency Wars (thank you Steve and Jim).

And while I haven't had a chance to read it yet (because I've been working on this post), I have it on good authority that Jim thinks the Fed is actually targeting 5% annual inflation right now while saying 2% or a little more. This sounds credible to me.

So what's the danger in a little inflation?

If the dollar sinks, like they (the USG/Fed) want, sure, our exportable goods will become relatively cheaper abroad (even though their price here won't drop) and their (our trading partners') exportable goods will become more expensive here. This will appear as good old-fashioned price inflation, since we'll now have to ***outbid*** our own trading partners ***just to keep our own production***, and pay more for theirs. And while the domestic private sector has already crashed its lifestyle somewhat, the currency issuer has ***increased*** its "lifestyle" to compensate.

The bottom line is that ***the USG cannot crash its own lifestyle***. And when the dollar starts to "sink", that pile of pennies in the video above will be insufficient (not enough money). Luckily, that pile of pennies represents the budget of the currency issuer himself. So he'll just increase it, to defend his lifestyle, while scratching his head at why the trade deficit has nominally widened rather than narrowing as he thought it would when he trashed the dollar.

One of the strongest arguments that the USD will not hyperinflate like Weimar or Zimbabwe is that the USG's debt is not denominated in a foreign currency. If it were, this would be a different kind of hyperinflationary feedback loop we were facing. If all the USG debt was in a foreign currency and the dollar started falling on the foreign exchange market, that debt service would lead to hyperinflation. But that is not the case. So it's not the FX market (monetary plane) that is the big danger to the dollar.

The dollar is the global reserve currency, ***so it is the physical plane that is the biggest threat to the dollar*** in the same way the FX market was a threat to the Weimar Mark. And it is not the nominal debt service that is the threat like it was in the Weimar Republic, but it is the structural (physical plane) trade deficit. To the USG, that is the same threat as nominal debt service denominated in a foreign (hard) currency was to Weimar Germany.

As the German Mark fell, there was "not enough money" to pay the debt. And with a little inflation, there is "not enough money" to buy our necessities from abroad.

Not Enough Money

On October 6, the Bank of England released this publication announcing a £75 billion increase in QE. In the press release, they mentioned inflation:

"CPI inflation rose to 4.5% in August. The present elevated rate of inflation primarily reflects the increase in the standard rate of VAT in January and the impact of higher energy and import prices. Inflation is likely to rise to above 5% in the next month or so, boosted by already announced increases in utility prices. But measures of domestically generated inflation remain contained and inflation is likely to fall back sharply next year as the influence of the factors temporarily raising inflation diminishes and downward pressure from unemployment and spare capacity persists." (BOE)

That same day, Mervyn King made headlines saying "the UK was suffering from a 1930s-style

shortage of money."

"There is ***not enough money***. That may seem unfamiliar to people." he told Sky News. "But that's because this is the most serious financial crisis at least since the 1930s, if not ever."

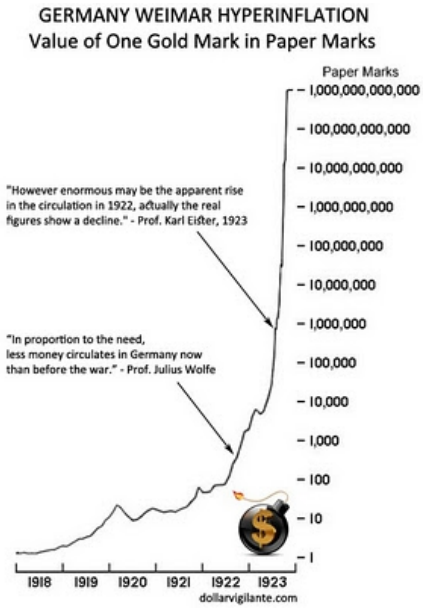
Mervyn King - £75Billion QE2 – 6/10/2011

It should be obvious from this video that Mervyn King, at least, does not get that expanding the base which debases the economy's money is not the best response to "not enough money." You don't have enough money, so you make what you've got worth less? Perhaps he meant the monetary base is too small for the credit clearing system. He did, after all, reference the 1930s rather than the '20s. But, sadly, that's not the case because he clearly said "we are injecting 75 *billion* (with emphasis reminiscent of Dr. Evil) pounds directly into the British economy." But in King's defense, he's doing no different than the Fed or the Reichsbank:

"While it is often claimed that the [Weimar] central bank contributed to the inflation by purchasing debt from the treasury, actually it operated much like the Fed: it bought government debt from banks…" (L. Randall Wray)

"In proportion to the need, less money circulates in Germany now than before the war." (Julius Wolfe, 1922)

"However enormous may be the apparent rise in the circulation in 1922, actually the real figures show a decline." (Karl Eister, 1923)



(Source)

Sidebar Post-within-a-post

FOA on Inflation>>Hyperinflation

I know this post is long. But just remember that no one is forcing you to read it, certainly not me. I give freely of my time to put these together for you… to share deep concepts that I believe are vital to your financial well-being. So enjoy the length, don't despise it. There is no filler here. It is all pure gold. But if you're one who prefers short sound bites, I'm also on Twitter @FOFOA999. ;)

I handpicked some more quotes from FOA that many of you have already read. But perhaps they will have a deeper meaning today, given a new perspective on moneyness. These are all from his last month of regular posting in 2001. And, clearly, dollar price inflation was on his mind that month.

People like to say that A/FOA got it wrong, because the timing didn't seem to play out exactly as they inferred it would. But I would like to proffer another view. Perhaps FOA was unaware of the lengths to which the PBOC was prepared to go in supporting the dollar and the US trade deficit over the next decade.

China was admitted into the World Trade Organization on December 11, 2001, one month *after* these posts. And it wasn't until 2002, after FOA stopped posting, that China really began to ramp up its trade with the US and to purchase US bonds in size. From '99 to '01 China's Treasury holdings were flat at around $50B, but from 2002 they began a parabolic rise that has now ended and is once again flat.

So if China has backed off from supporting the dollar today, in the same way that the European CBs had backed off right when FOA wrote these posts, well then perhaps they are more relevant today than the day they were written. So with that thought in mind, enjoy!

FOA (10/3/01; 10:21:26MT - usagold.com msg#110)
The makings of a dust storm

For decades hard money thinkers have been looking for "price inflation" to show up at a level that accurately reflects the dollar's "printing inflation". But it never happened! Yes, we got our little 3, 4, 8 or 9% price inflation rates in nice little predictable cycles. We gasped in horror at these numbers, but these rates never came close to reflecting the total dollar expansion if at that moment it could actually be represented in total worldwide dollar debt. That creation of trillions and trillions of dollar equivalents should have, long ago, been reflected in a dollar goods "price inflation" that reached hyper status. But it didn't.

That "price inflation" never showed up **because the world had to support its only money system until something could replace it. We as Americans came to think that our dollar, and its illusion of value, represented our special abilities; perhaps more pointedly our military and economic power. We conceived that this wonderful buying power, free of substantial goods price inflation, was our god given right; and the rest of the world could have this life, too, if they could only be as good as us! Oh boy,,,,,, do we have some hard financial learning to do.**

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Over the years, all this dollar creation has stored up a massive "price inflation effect" that would be set free one day. Hard money thinkers proceeded to expect this flood to arrive every few years or so; the decades passed as those expectations always failed. Gold naturally fell into this same cycle of failed expectations, as the dollar never came into its "price inflationary" demise.

A number of years ago, I began to learn from some smart people about the real political game at hand and how that would, one day, produce the final play in our dollar's timeline. Indeed, you are hiking that trail with us today; us meaning Euro / gold / and oil people. All of us Physical Gold Advocates that have an understanding about gold few Americans have ever been exposed to.

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Our recent American economic expansion has, all along, actually been the result of a worldly political "will" that supported dollar use and dollar credit expansion so as to buy time for Another currency block to be formed. Without that international support, this decades-long dollar derivative expansion could not have taken place. Further, nor would our long term dollar currency expansion produce the incredible illusion of paper wealth that built up within our recent internal American landscape.

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The relatively small "goods price inflation" so many gold bugs looked for will be far surpassed and the "hyper price inflation" I have been saying is coming is now being "structurally" set free to run.

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Why "structurally", why now?

For years now, "politically", the dollar system has had no support! Once again, for effect, "Politically NO", "Structurally Yes"!
…To this end, I have been calling for a hyper inflation that is being set free to run as a completed Euro system alters Political perceptions and support. That price inflation will be unending and all-encompassing. While others call, once again, for a little bit of 5%, 10%, 15% price inflation, that lasts until the fed can once again get it under control,,,,,,,,, I call for a complete, currency killing, inflation process that runs until the dollar resembles some South American Peso!

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FOA (10/5/01; 10:55:19MT - usagold.com msg#112)
Discussing the World with Michael Kosares

When it came to using fiat money in our modern era, it made little difference what various inflation rates were in countries around the world; 50%, 100% 1,000%,,,,,, they went right on playing with the same pesos. There have been countless third world examples of this dynamic, if only we look around. Mike, look at what happened in Russia after they fell,,,, the Ruble stayed in use and function with 6,000% inflation. My god they still use it now.

… The ensuing domestic price inflation will waste away all buying power of dollars overseas.

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FOA (10/8/01; 08:04:08MT - usagold.com msg#113)
Gold on the trail.

The US placed its money into this current equation in 1971. Then it failed to accept the internal price inflation that over-printing its money demanded and a remarking of its gold reserves would expose to the world.

… While hard money historians, to the man, clamor for a return to honest government and a dollar backed with gold; they leave out an important step in the process that history says will never be skipped. **Once a nation embarks down a road of inflating its currency for local political use, the cast is set for a constant redenominating of the money unit; that is "real bad" price inflation. However, modern economic evolution has presented an even more profound reply. Once a nation embarks down a road of inflating its currency for international political use, the cast is set for the world to find said fiats useful limits, then drop it from use; that is super price inflation as a result of fiat replacement. To this end we come.**

… This incredible currency expansion will break out into the open with real price inflation as never before witnessed in the US. In turn, foreign holders of dollar-based assets will, not only, demand price performance of their "paper gold" hedges, even as they are compelled to shift a larger portion of their asset bases into Euro positions.

… As dollar price inflation roars, and physical gold demand soars; the dollar gold markets will completely fail their past hedging purpose as they become locked into a political cash settlement mode. A mode that forces an ever expanding discount against spot physical trading in Europe and the world.

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FOA (10/9/01; 10:05:48MT - usagold.com msg#117)
PIZZA,,,, Bronco's,,,,,, Tonne of Yellow Metal,,,, and USAGOLD: Ha Ha,,, a gold advocates dream come true (ssssmile)

Dollar hyperinflation and super high gold prices are closer than many think.

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FOA (10/15/01; 07:49:09MT - usagold.com msg#120)
Continuing from my last talk:

It's no wonder that Alan Greenspan has commented so often on the need to control derivatives yet has no workable plan to counter their function. Truly this dynamic was created to counter his function and few can understand this! In effect, the dollar was placed on a one way street that required it to be inflated into infinity. All as a means of protecting dollar originators; the US banking system. Dollar leverage, that is actually US liabilities, is now built up endlessly. This all points to a nonstop, end time need for an uncontrollable inflationary expansion by our fed.

…Now, we will follow this trend in an accelerated fashion, until all derivative process is exposed as nonfunctional outside a massive hyperinflationary policy.

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FOA (10/20/01; 08:50:20MT - usagold.com msg#122)
Taking broader steps: heading towards a clearing

Our evolution of thought will find its roots in an inflationary financial crisis that is now beginning to unfold in dollarland. In fact, "all" dollar hedging systems will most likely meet the same fate as the effects of a real, serious price inflation in local US markets escalates.

… Once real inflation begins to demand that these hedges truly spread financial risk with real performance, resulting in a pile up of loses, the political solution used time and again will return as the time honored utility that saves the day:

------change the rules------!

… ECBMBs (European Central Bank Member Banks) never really sent out very much real gold; they just lent their good name to the BBs. That means cash pooling for the loans also. So, when a new currency transition workout proceeds, the members of the ECB are receiving Euro cash in payment for gold loans. In hindsight; it will be seen that they lent the commitment to sell gold only long enough for US inflation to end the dollar's timeline and bust its dollar system.

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FOA (10/25/01; 09:30:26MT - usagold.com msg#124)
A quick report and comment from my office on the trail.

As the gap between inflation rates and returns on Euros grows, that currency will be seen more and more like a world class money. World class; in that the Central Bank is more driven to keep the money strong and not base its policy on local politics the way the US does.

---- Remember: Unlike the Fed, which has a mandate to boost jobs, the ECB's main task is to combat inflation.------

… Truly, if the dollar IMF system can be the reserve for all internal US banking assets; then the Euro could easily do the same in Europe. Especially as US inflationary money printing eventually drives our price inflation rate to a level that makes dollars and dollar debts, outside the US, valueless assets! Paying back those debts will be like tossing a nickel where one once launched a bill to settle a debt.

… Of course I own dollars and will likely keep using them right thru any super inflation. I never expect the dollar to disappear. Most hard money investors, with extra funds to hold, also have that same view.

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FOA (10/26/01; 09:01:38MT - usagold.com msg#126)
Still at the Trail House

Somewhere in the middle of all this; real savers will supply Euroland with a solid base of credit wealth that can be borrowed without driving their local price inflation thru the roof. Then: other national economies will have a market that shares realistic price levels for all goods. Then; all economic systems will begin a non-inflationary expansion that centers around Euro use! All of this period will mirror our (US) internal coming inflationary expansion **that limits our ability to import or export. Think about it.**

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FOA (10/26/01; 21:21:33MT - usagold.com msg#127)
A few comments on comments!

…Only trouble is that they never understood that fiat inflation using a world reserve currency, like our dollar, is different from other systems. We buy cheap social policy and economic expansion with the blood and sweat of foreign productivity. I bet Old Breuer thinks its ok for a business to buy $1.00 running shoes from asia and sell them in Dollar land for $120.00. Then he would point out that shoe inflation is only running at a few percent because those shoes went up $3.00 last year. Oh well.

The Euroland Germans, and the ECB studied our ways for a long time and now fully understand how to attract other nations into a fair game. The Euro will become a "world standard" more so than a reserve because they want it to be a fair currency that's accepted for its value. For the Euro to gain American financial acceptability later, it will do so because it will be the "last man standing" when this inflation storm resides.

… Can't push that string? Pick it up and heave it in a third world like inflationary pitch. That ball will fly, brother,,,,,, oh will it fly!

… Japan is a different problem. They have been locked into the US dollar economy for so long that they cannot escape. There is simply no way that China will let them into the Euro house. The HK / China central bank system, also known as Big Trader, simply wields too much economic sway between Asia and Europe. In historical precedent, the orient express always headed to Europe and never saw "The Japans".

Actually, Japan doesn't want to go there and has risked a decade of time waiting for some economic change in the US. I have said from way back, that Japan will go down with our (US) inflationary tide. They will waste away their dollar assets following our lead. Those that think that these peoples want to be part of a third world currency block do not know them. I do,,,, but that is another story.

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FOA (11/2/01; 12:35:27MT - usagold.com msg#128)
Gold,,,,,, Gold,,,,, Who has the Gold?

Now, for the hundredth time they say: "Mises is correct, the markets cannot be faked, so a little

deflation will follow this inflation!"

Baloney! **The evolution of Political will is now driving the dollar into an end time hyper inflation from where we will not return. <u>That is our call.</u>** Bet your wealth on the other theorist's call if you want more of Their last 30 years of hard money success.

… Gold must rise in value many many times just to regain its wealth barter asset value. Perhaps $10,000 to start. Then, it will run with any and all dollar inflation,,,,, even Euro inflation that ECB people openly admit must be a part of a dollar to Euro transition.

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FOA (11/3/01; 14:39:16MT - usagold.com msg#129)
An "inflationary depression" is in the cards -- a "price deflation" doesn't have a chance!

When a currency system comes to the end of its reserve use, I'm speaking politically, its domestic market will come to a point where it can no longer export "real price inflation" in the format of; "shipping its excess currency outside its borders". This happens because internal money inflation, that is super currency printing, is increased so much that it overwhelms even its export flow. Worse, even that export flow later tumbles as the fiat falls on exchange markets.

The effect is that local "passive inflation", built up over decades and fully reflected in "Sir John's" paper assets, spreads out as "aggressive inflation" and hyper price rises begin…

Remember; in political inflation's, money is printed to save the assets as they are currently priced;

… The politics of wealth today is centered around gold bullion and only gold bullion: that is where the wealth and power will be manifest: this is where the gains will be! To bet on the rest of the hard market is to bet against the coming inflation making your asset whole!

End Sidebar

Conclusion

This post represents about seven weeks of bouncing around Thoughts and ideas, and close to a hundred emails with Costata and JR. Thank you to both of you! A lot of time went into this, and I think I've included everything I wanted to, but I'm sure I'll think of something else as soon as I hit publish. ;)

And so now, let's look back at the questions I set out to answer in one post. Let's see if I hit my target:

1. Is money really just one single thing and then everything else has varying levels of moneyness relative to real money?
2. Is gold real money?
3. Or is money whatever the government says it is?
4. Or is it whatever the market says it is?

5. Is silver money in any way today?
6. Are US Treasury bonds money?
7. Is real money just the monetary base?
8. Or is it all the credit that refers back to that base for value?
9. Is money supposed to be something tangible, or is it simply a common unit we use to express the relative value of things?
10. Is money really the actual medium of exchange we use in trade?
11. Or is it the unit of account the various media of exchange (checks, credit cards, PayPal) reference for value?
12. Should the reference point unit itself ever be the medium of exchange?
13. Some of the time?
14. All of the time?
15. Never?
16. Is money a store of value?
17. And if so, for how long?
18. Is money supposed to be the fixed reference point (the benchmark) for changes in the value of everything else?
19. Or is it simply a shared language for expressing those changes?
20. Is money something that changes over time?
21. Or is money's true essence the same concept that first emerged thousands of years ago?
22. Does the correct view of money produce answers that are vastly superior to the blind conjecture prescribed by all other views?

Alright, well maybe I didn't answer them all as specifically as you thought I would. But what I hope I did do was to provide you with some food for thought and encouragement to use your own mind in answering these questions for yourself. Sure, I could have simply answered them all in a checklist. The post would have been a lot shorter if I had done it that way! But what's that old saying about giving a man a fish, you feed him for a day, but teach him to think for himself in concepts and he might just discover Freegold ***before*** it is upon us? It's something like that anyway.

Sincerely,
FOFOA

FOA: *My friend, our message and our position is that we are in one of the most exciting times of all the history of gold! We have seen that during times with the most radical transitions, the majority are usually defending the wrong asset. This unfortunate situation need not impact everyone today. If better judgment is the result of a full understanding, then some who read here will be exposed to tools that could help them avoid the mistakes of our Western hard money majority.*

For Western Gold Bugs today, their culture, their system and their recent knowledge is all ensconced within the last 30 years of paper wealth. Yet they are using a hard money defense, written by masters preceding our modern era. They struggle to use that logic out of context, as it is thought to apply to this gold market today. These two precedents are leading them to reflect their gold values in some form other than physical ownership in possession. This mistaken detour from gold's true purpose will once again prove, by reality, the value of owning real gold.

Standing aside this group is the Physical Gold Advocate. For them, for us, these times will contain the

greatest gain in real wealth ever seen. For those who are falling behind, gold is still within your grasp.

TrailGuide

Saturday, May 5, 2012

Inflation or Hyperinflation?

Whilst discussing the demise of the Canadian penny in front of a Congressional panel, Fed Chairman Ben Bernanke demonstrates that "transactional currency is simply a notional, purely symbolic token medium of exchange, much more replaceable, resource-efficient and environmentally friendly than mining stupid metals for stupid coins." (NotReal News)

Remember my post around this same time last year titled Deflation or Hyperinflation? At that time, the debate between deflation and hyperinflation was all the rage, and so I wrote a post to a prominent and long-time deflationist named Rick Ackerman, who later stopped by in the comments. In fact, most of my hyperinflation posts have been written in the context of the deflationists' arguments.

I can't say that the debate has shifted from deflation to inflation over the last year, but it sure seems that the arguments coming across my desk these days are for rising inflation with the exclusion of hyperinflation. My position hasn't changed. But this does give me the opportunity to present my position against a different premise, that of inflation without currency collapse. I would guess that some of you will have a completely different view of hyperinflation by the time you finish this post. If so, please let me know in the comments.

But first I need to make it clear once again that this hyperinflation discussion is not about timing. It's about how it all ends, and it's better (for a saver) to be a decade too early than a minute too late. The other side (whoever it may be) often tries to make the debate about timing. It is not about timing and I don't do timing, but that doesn't mean the end is far away. If anything, it's overdue in the same way a big earthquake can be overdue. In 'Deflation or Hyperinflation?' I wrote:

The whole point of the [hyperinflation] debate is about the denouement, the final outcome of this 100-year dollar experiment. It is about the ultimate end, and the debate has been going on ever since the 70s when the dollar was separated from gold and it became clear that there ***would*** *be an end. The debate is about determining the best stance someone should take who has plenty of net worth. And I do mean PLENTY. People of modest net worth, like me, can of course participate in the debate. But then it can become confusing at times when we think about shortages or supply disruptions of necessities like food. Of course you need to look out for life's necessities first and foremost. But beyond that, there is real value to be gained by truly understanding this debate.*

Here is FOA on timing, from a post in which he specifically predicted dollar "hyper price inflation":

Timing?

We, and I, as physical gold advocates, don't need timing for this position! Timing is for poor, paper traders. We are neither and our solid, long term, one call over several years to hold physical gold will confirm our reasoning. There is no stress for me to own this ancient asset as it is in a good proportion to all my other wealth.

There is no trading an economic system whose currency is ending its timeline. Smart, quick talking players will joke at our expense until fast markets and locked down paper gold positions block their "trading even" move into physical at any relative cheap price. Mine owners will see any near term profits evaporate into a government induced pricing contango that constrains stock equity with forced selling at paper gold prices.

My personal view

They will, one day in the future, helplessly watch their investments fall far behind a world free market price for physical gold. Further into the future, one day, mines will make money on the last thousand per ounce price for gold; only the first $XX,000.00 of price will not be available to them.

Yup, that was back in October of 2001. Bad timing? How have your mining stocks done lately? I know of one FOA reader who went "all in" with gold coins that year to the tune of somewhere around $400K. He had just retired from his previous life as a trader. Today his golden nest egg is worth $2 million, ***and*** he has been living off of it for most of that time! So much for bad timing, eh?

My argument for hyperinflation is FOA's argument. So you'll see me use FOA's terms. You'll see me quote a lot of FOA. And you'll see me restate the same call he made back in 2001. His call was clear and unchanging. His argument wasn't wrong then and it is even more pressing today, which I will explain. And just to be clear about FOA's call, here it is from that same post:

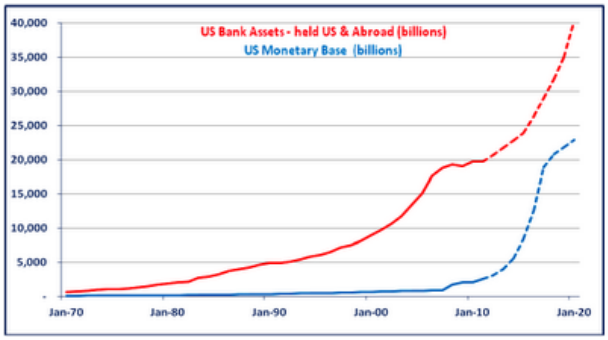
"While others call, once again, for a little bit of 5, 10, 15% price inflation, that lasts until the fed can once again get it under control,,,,,,,,, I call for a complete, currency killing, inflation process that runs until the dollar resembles some South American Peso!"

"Complete, currency killing" hyperinflation is a one-time event. In a moment I'll explain the reasoning behind this call and why it still stands. But first, let's take a look at a couple of the "inflation but not hyperinflation" arguments that have come into my sights.

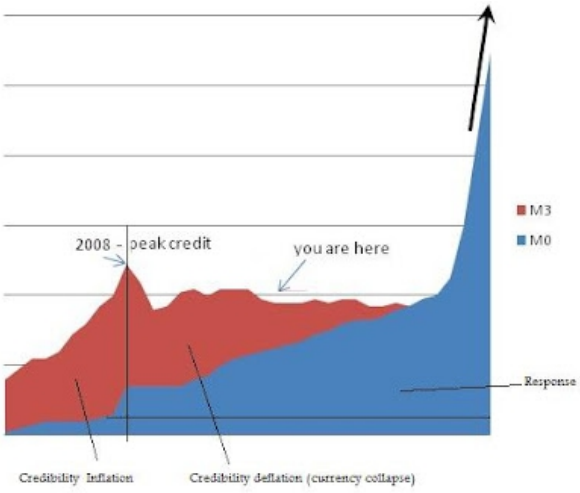
"An Adult Approach"

In An Adult Approach – II (Defining Relative Real Value) Lee Quaintance and Paul Brodsky of QB Asset Management (or QBAMCO) laid out a nice argument for what sounds a lot like FOA's front lawn dump but without the "complete, currency killing" hyperinflation. In it, they explained that the process of "re-collateralizing unreserved credit" which began in 2008 will likely end with all of the assets backing today's bank money being replaced with new base money.

In other words, US dollar monetary base (today at around $2.6T) will be increased to cover and replace today's US bank assets (almost $20T). But they aren't predicting that the entire money supply will become base money, as happens during hyperinflation. Instead, they think that as credit money has all but been replaced with base money, "bank animal spirits will once again take over and we will have a new leveraging cycle." They provided the following conceptual illustration to help us visualize what they are projecting:



Then they ask (and answer), "Will the lines meet or cross? We don't believe so…" I'm going to give you a longer excerpt, but I wanted to highlight this point first, because it is where my view differs from their view. The lines meeting and crossing is exactly what it looks like during hyperinflation, when bank credit disappears (because price inflation is running too hot to issue credit at any practical interest rate) and the entire money supply becomes base money in amounts which overtake the previous amount of credit money. The lines meeting and crossing could look something like this conceptual illustration (by DP):



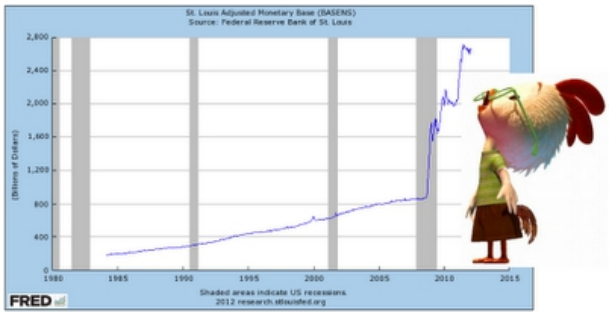
Here is part of FOA's famous front lawn dump:

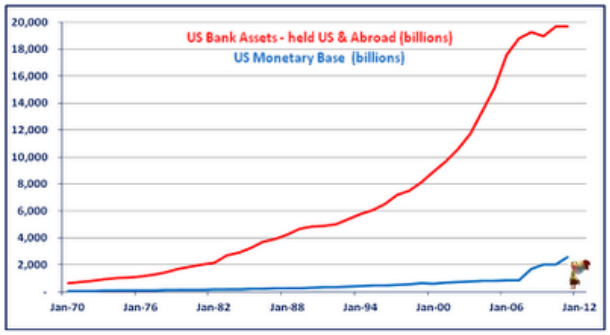
"My friend, debt is the very essence of fiat. As debt defaults, fiat is destroyed… hyperinflation is the process of saving debt at all costs, even buying it outright for cash… because policy will allow the printing of cash, if necessary, to cover every last bit of debt and dumping it on your front lawn!"

So their thesis is that the Fed buys almost all of today's bank assets (debt) for cash, but then during this

process the banks, now almost fully reserved, start lending again and a new credit cycle begins without a systemic collapse. And what this will do to prices is deliver "a higher General Price Level" and "a CPI rate higher than the rate at which the GPL rises." I emailed with Paul about this call being much more tame than some things he has written in the past and he wrote back that he thinks my hyperinflation projection is "a very fat-tailed event" while they are "trying to be much more moderate in [their] projections."

I hope to show in this post that avoiding this "fat-tailed event" is the *most* unlikely scenario. It is not just about the gap between unreserved deposits and base money and bank levering/de-levering cycles. **It is about a currency that has reached the end of its timeline when the removal of *structural support* (an FOA term) meets the largest spending/dollar-emitting machine the world has ever known.** But first, here's a more complete excerpt from their paper, or you can read the whole thing at the link:

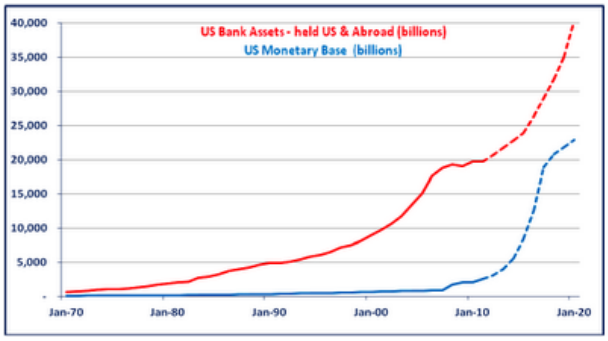
> **Magnitude of the Problem**
>
> Central bankers struck a match under the global economy in 1981 and it continues to burn. The match began to burn their fingers in 2008 when the process of "re-collateralizing" unreserved credit got underway.
>
> 
>
>
> The familiar graph above shows the increase in USD base money that began to de-lever the US banking system in 2008. Though we have written in the past about total dollar-denominated debt exceeding $50 trillion, all of that debt does not have to be paid down. (Most of it is fully-reserved because its creditors are not levered.) But there is an identifiable portion of dollar–denominated debt issued by highly levered creditors – banks.
>
> *We believe the debt-to-money gap that must and will be greatly reconciled in short order is the ratio of bank assets to the monetary base. As the graph below shows, the US Monetary Base was only 13% of US Bank Assets on December 31, 2011.*The banking system is the source of unreserved credit and is on the hook to use its collective balance sheet to be the transfer mechanism for economic stimulation through monetary policy. And as they have already demonstrated repeatedly, monetary policy makers feel the need to de-lever the banking system today so it may then extend credit to the rest of the economy tomorrow.



Of course, the US banking system is not alone. According to the Financial Stability Board, worldwide bank assets (including US bank assets) were approximately $95 trillion in October 2011 (USD terms). Meanwhile the IMF reported that as of December 2010 the global supply of base money was approximately $12 trillion (USD terms). These figures put the worldwide proportion of base money-to-bank leverage roughly in line with the US.

Given: 1) the exorbitant leverage currently in the global banking system, 2) current negative real output growth in developed economies, 3) current negative real interest rates, 4) uniformly poor monetary, fiscal and demographic conditions across most developed economies, and 5) already wary populations beginning to get restless; we have difficulty imagining that global banks, labor, savers, politicians and investors will be able to endure current conditions much longer before demanding the financial reset button be pressed to complete bank de-levering.

We provide the graph below merely to make it easier to conceptualize the nature of such a de-levering, as we see it. (This is not necessarily a prediction of timing or magnitude.) The takeaway is that base money (in the form of physical currency in circulation) and bank deposits will have to rise at a much steeper rate than bank assets until the banking system is more fully reserved. (At some point we think bank animal spirits will once again take over and we will have a new leveraging cycle.)



The graph above illustrates the forces behind a high-tech jubilee. The *burden of repaying* past systemic debt will have been greatly reduced through base money inflation, (that shifts the GPL [General Price Level] higher, including revenues and wages), while the integrity of systemic debt remains intact (nominally). The integrity of the banking system will also remain intact, as would the creditworthiness of most debtors.

> So we anticipate the sum of physical currency and bank deposits to continue to rise to stimulate nominal GDP growth and the ratio of bank credit-to-base money to contract further. Will the lines meet or cross? We don't believe so but we do think the gap will narrow substantially before bank assets can grow materially again. Thus, *we expect the rate of change of the General Price Level to equal the rate of change of the sum of physical currency and bank credit LESS some accommodation for productivity gains.* It is reasonable to expect:
>
> 1) A higher General Price Level
>
> 2) A CPI rate higher than the rate at which the GPL rises
>
> 3) Levered asset inflation rates that very likely will be nominally positive but negative in GPL terms and, even more so in CPI terms

"Merely Strong Inflation"

Another "inflation but not hyperinflation" post which crossed my path the other day was Get Ready for 'Hot' Inflation by Gregor Macdonald. In it he writes:

> Ideological deflationists and inflationists alike find themselves both facing the same problem. The former still carry the torch for a vicious deflationary juggernaut sure to overpower the actions of the mightiest central banks on the planet. The latter keep expecting not merely a strong inflation but a breakout of hyperinflation.
>
> Neither has occurred, and the question is, why not?
>
> The answer is a 'cold' inflation, marked by a steady loss of purchasing power that has progressed through Western economies, not merely over the past few years but over the past decade. Moreover, perhaps it's also the case that complacency in the face of empirical data (heavily-manipulated, many would argue), support has grown up around ongoing "benign" inflation.
>
> If so, Western economies face an unpriced risk now, not from spiraling deflation, nor hyperinflation, but rather from the breakout of a (merely) strong inflation.

After reading his post, I asked Gregor in a comment and a tweet:

"With our government's budget deficit at twice the rate of the trade deficit, and with the drop-off in foreign CB support for our government debt, how can we possibly have "merely strong inflation"?"

Here was Gregor's reply:

"Because the subject is so vast, and because I'd like to make a comment that is useful, I'll just respond briefly to FOFOA on his remarks regarding my present concern for a strong inflation, and my lack of

concern for a spiraling deflation or hyperinflation...

*So, while there are many components required to foster/create/spark either strong inflation or hyperinflation--which have been discussed and articulated historically in the corpus of work done on the subject--there is in my opinion one factor, and one factor alone, that *must* be present in all hyperinflations. And that factor is the social, behavioral component in which the users of the currency *must* cross a tipping point where they are inclined to effectively throw the currency away, in exchange for any other good or currency, at some notable rate of speed. Without this behavioral shift, without this social decision, without the psychological change in perception that leads to this type of crowd behavior, there will be no hyperinflation.*

So, you won't find me predicting USD-zone hyperinflation or even the risk of such any time soon, because the requisite social-psychological shift is a large and heavy object that needs a collapse in confidence to move from its current state of inertia.

Instead, I am genuinely concerned with a breakout of strong inflation, owing to a convergence of very large global trends: primarily the reaching of the Lewis Turning Point in non-OECD countries, and the relentless advance of resource scarcity. OECD currency users, meanwhile, from Japan to Europe to the US remain largely trapped within their currencies and their sovereign bonds, and will remain trapped in these until they aren't.

True, nothing goes on forever. Wake me when the managers of trillions of OECD pension assets panic out of their own currencies, and their own sovereign bonds, and I will finally be willing to entertain the risk of hyperinflation in OECD currency zones: EUR, JPY, USD. Perhaps this happens sooner than I anticipate. But I wager that it happens much later than most anticipate.

G"

There are three good points in Gregor's reply which I want to address, so I'll just list them out right here:

1. A psychological tipping point must be present in all hyperinflations. Me: But is this mass-psychological tipping point the cause, or simply a visible effect (symptom) that is sometimes mistaken as the cause? A loss of consciousness is also present in all deaths.

2. A social-psychological shift is a large and heavy object that needs a collapse in confidence to move from its current state of inertia. Me: Is it really so large and heavy to move? Or is it, as I wrote in this post, something that "can stop on a dime and reverse course 180 degrees overnight, from greed to fear, based on a single news item"?

3. "Wake me when the managers of trillions of OECD pension assets panic out of their own currencies, and their own sovereign bonds." Me: They may well panic out at some point, but again, will that be a cause or an effect? I will show that it is 100% effect and that, if that's what you're waiting for until you're willing to entertain the risk of hyperinflation, you will be a day late and a dollar short to make any preparations that were contingent upon entertaining the risk.

There's one other item that I want to mention because it also contributed to my decision to write this

post. And that is this "no hyperinflation" wager offered up by someone in the MMT camp:

> **The United States will not experience hyperinflation (defined by 3 consecutive months of 6% Month over Month inflation according to the Billion Prices Project measurement of MoM inflation) from April 17th 2012 to April 17th 2017.**
>
> Many people claim the United States will experience hyperinflation, because of a massive increase in the monetary base. The monetary base has shown a huge increase as you can see at FRED under BASE, http://research.stlouisfed.org/fred2/series/BASE
>
> The bulk of the increase in the monetary base happened in late 2008. This prediction gives nearly 9 years for hyperinflation to occur in the United States - many times any reasonable "long and variable delays" between monetary base increases and inflation could logically be linked.
>
> Other people point to so called Quantitative Easing as a trigger for hyperinflation. The first rounds of QE happened in early 2009. This prediction gives 8 full years for the hyperinflationary impacts of QE to manifest in the United States.
>
> Modern Monetary Realism (www.monetaryrealism.com) and Modern Monetary Theory (www.moslereconomics.com) both say there will be no hyperinflation due to the increase in the monetary base. MMR and MMT claim inflation is not likely at all. High inflation might be caused by either vastly higher energy commodity prices due to supply constraints or increases in the notional value the government pays for goods and services. The large increase in the cost of oil has not caused runaway inflation as of April 25, 2012, simply because it was not large and sustained enough. There has been no large increases in the values paid by the U.S. government through April 2012.
>
> Since neither of these two circumstances has happened or are likely to happen in the U.S. during the next 5 years, there will be no hyperinflation in the U.S. as defined by the above prediction for the next 5 years.

Aside from the fact that it would be silly to take the hyperinflation side of a dollar-denominated bet, as I wrote in the comments, I am also not interested in taking this bet because it is a timing bet and I think that sends the wrong message. But I did want to mention it because it makes some specific points which are relevant to this post.

1. That "high inflation" might be caused by supply constraints (similar to the effect of resource scarcity which Gregor mentioned) or increases in the notional value (I think he meant price) the government pays for goods and services.

2. That because there have been no large price increases from 2008 through 4/25/2012, they are unlikely during the next five years.

I will show you that he is looking at the wrong things in saying that if base money creation in 2008 didn't cause price inflation yet, then it won't for the next five years. There are some important

differences between today and 2008. For example, the federal budget deficit in 2008 was "only" $438B while the trade deficit was much larger at $698B. And in 2007 the federal budget deficit was even smaller, at 23% of the trade deficit. The 2007 budget deficit was only $162B while the trade deficit was $696B. Today that situation is reversed. So prior to 2009, the foreign sector was supporting the sum total of both the US private and government sector deficits, leaving some room for the private sector and foreign support to contract while the government sector expands. And that is exactly what happened.

Today the federal budget deficit is more than twice the trade deficit, and the foreign sector is supporting less than half while Fed printing supports the rest. Additionally, there are signs today that foreign support is waning even more. I will get to those later, but this is the very recipe for hyperinflation which FOA described, only an order of magnitude worse than in 2001 when he was writing. So anyone who wants to take that silly bet will only lose because the dollars they'll win will be virtually worthless.

A/FOA's Call

In his final month of full posts, from 10/3/01 through 11/3/01, FOA countered both the deflationists and the inflationists (who he grouped as the "hard money thinkers") in his drive to explain how the dollar reserve system will end in hyperinflation. Here's a quick sampling from that last month to show you what I mean:

FOA 10/3/01 - For decades hard money thinkers have been looking for "price inflation" to show up at a level that accurately reflects the dollar's "printing inflation". But it never happened! …

That "price inflation" never showed up because the world had to support its only money system until something could replace it. We as Americans came to think that our dollar, and its illusion of value, represented our special abilities… Oh boy,,,,,, do we have some hard financial learning to do.

FOA 10/25/01 - Somewhere in the 1970s era I was exposed to the thinking of several different deflationists. It seemed that all of their conclusions came to the same end: that dollar deflation would rule the day, no matter what... Deflation was always the final outcome.

FOA 10/3/01 - The relatively small goods "price inflation" so many gold bugs looked for will be far surpassed and the "hyper price inflation" I have been saying is coming is now being "structurally" set free to run.

FOA 10/9/01 - Dollar hyperinflation and super high gold prices are closer than many think.

FOA 11/2/01 - The evolution of Political will is now driving the dollar into an end time hyper inflation from where we will not return. That is our call. Bet your wealth on the other theorist's call if you want more of their last 30 years of hard money success.

Get the point? Good. Now one other thing is that, as I am explaining what I learned from FOA, FOA was explaining what he had learned from Another:

FOA 10/3/01 - A number of years ago, I began to learn from some smart people about the real political

game at hand and how that would, one day, produce the final play in our dollar's timeline. Indeed, you are hiking that trail with us today; us meaning Euro / gold / and oil people. All of us Physical Gold Advocates that have an understanding about gold few Americans have ever been exposed to.

Now that you know the A/FOA position (hyperinflation camp, not inflation, not deflation), the A/FOA call ("hyper inflation from where we will not return. That is our call."), and the pedigree of the A/FOA message ("us meaning Euro / gold / and oil people… few Americans have ever been exposed to"), let's get on with the details.

Structural Support

FOA 10/3/01 - Our recent American economic expansion has, all along, actually been the result of a worldly political "will" that supported dollar use and dollar credit expansion so as to buy time for Another currency block to be formed. Without that international support, this decades-long dollar derivative expansion could not have taken place. Further, nor would our long term dollar currency expansion produce the incredible illusion of paper wealth that built up within our recent internal American landscape.

The relatively small goods "price inflation" so many gold bugs looked for will be far surpassed and the "hyper price inflation" I have been saying is coming is now being "structurally" set free to run.

Why "structurally", why now?

For years now, "politically", the dollar system has had no support! Once again, for effect, "Politically NO", "Structurally Yes"!

For another currency block to be built, over years, the current world economy had to be kept functioning. To this end the dollar reserve system had to be structurally maintained… Truly, the recent years of dollar value was just an illusion. An illusion of currency function and value, maintaining the purpose of holding the world financial and economic system together for a definite timeline. Politically, the world does not hate America; rather they hate the free lifestyle our dollar's illusion value brought us yesterday and today.

If our dollar is going to fall so fast and so far in value that it will be called "hyperinflation", then the dollar must be tremendously overvalued today, right? In fact, and these are FOA's words, "***Dollars have no value at all*** *except for our associating remembered trading value with them.*" A barrel of crude oil isn't worth $100 because a one hundred dollar bill has a value equal to a barrel of oil; rather we remember that a barrel of oil will trade for the same amount of natural gas that also relates to those same 100 units. Money is an associated value in our heads. It's not a physical item.

Yet for the last 30+ years, the fully fiat dollar, a purely symbolic token currency, has been behaving as if it actually *is* an item of value equal to the real goods and services the US has received through its perpetual trade deficit. Understanding how this was even possible is the only way to understand how it will end.

FOA 10/25/01 - I mean that our whole dollar landscape has now become just a trading asset arena: it's now evolving away from any meaningful currency use to trade for real goods. It can head in no other

direction because our local economic structure, the USA economic base, cannot possibly service even a tiny fraction of the buying power currently held in dollars worldwide.

FOA 10/5/01 - The game is to let the US economy suffer from its own bloated expansion by moving slowly away from supporting foreign dollar settlement with CB storage. This is more than enough to end the dollars timeline as we are already stretched to the leverage limit. They know that Greenspan has but one policy to use and that will be super printing. He is doing it now, right on que!

And here we find the key to the kingdom: "**supporting foreign dollar settlement with CB storage.**"

All currencies have the value of whatever they can buy. In a sense, they get their value from price tags offering prices denominated in their unit. But this MoE (medium of exchange) usage demand is not enough for the dollar. It is not enough that foreign goods are priced in dollars. The dollar requires another kind of usage demand: SoV (store of value) usage.

The reason for this is simple. The US is the only originator of new dollars and the US has run an unending trade deficit for 37 years, so the US has been exporting an unending stream of dollars for 37 years. To some extent, that pool of external dollars can circulate outside of the US as long as some foreign goods, like oil, carry a dollar price tag. But that is not enough.

Without foreign CBs supporting this system of foreign dollar settlement by mopping up the unending glut of dollar emissions, the market price mechanism would collapse the US trade deficit in a heartbeat.

Now I've got to make an important point about stock and flow here. We need not be concerned about the stock of dollars held by these foreign CBs, which today stands at more than $5T. The real danger is the unstoppable *flow* of dollars. No one needs to dump their dollar holdings to collapse the dollar. In fact, they won't dump and I don't expect them to dump, at least not until collapse is well underway.

All they need to do is to slow down mopping up the gushing, unending flow. Here's how fragile the dollar actually is. It is supremely overvalued because its SoV arena, its "trading asset arena" as FOA termed it, simply dwarfs the MoE arena where all currencies get their value. But what threatens the dollar's massive overvaluation most clearly and presently today is only that tiny, marginal portion of the flow: the deficit portion or the unstoppable net-emission of dollars.

Trillions of dollars circulate (change hands) every day, and orders of magnitude more sit idle in investments. But the real threat to all of it is the net-emission of dollars which must be mopped up (stored) by someone. This is the structural support that holds the whole system together: foreign CBs perpetually gorging themselves on Treasuries. It's not that they might sell their stock of Treasuries. The real threat is that they might slow or stop their rate of accumulation relative to our rate of emission.

Big Danger in a Little Marginal Flow

What do I mean by "marginal flow"? Well, first there's something you need to understand about flow. Stock and flow are not directly comparable because while stock is a measure of units, flow is a measure of units per time. We can look at the ratio of stock to flow over a period of time, but I'm not even interested in that in the case of the dollar. With dollar flows, we have the prices of goods and services

which are far more relevant to the marginal (deficit) flow of dollars than any measure of the total stock of dollars.

I'm also not really interested in the flow of dollars within the monetary plane of "investments". Investments within the monetary plane change price regularly, sometimes with great volatility, yet without crashing the entire global monetary and financial system. But that real stuff in the physical plane, stuff like food, energy, medicine and industrial inputs, is (remarkably) relatively stable on its dollar price tags over time (at least compared to currencies going through hyperinflation). So we don't need to picture the dollar flow as a portion of the entire dollar stock, we can instead picture it as a flow of real goods and services as long as we focus on the goods and services portion of the BOP. And we also know that government spending (the federal budget) is all on goods and services in the physical plane, not on "investments" in the monetary plane.

So what do I mean by "marginal flow"? The US is the dollar's home, its creator and its legal tender zone. Most everything here carries a dollar price tag. But the US also trades with the world outside of its own currency zone, and in so doing it emits dollars. Last year the US spent $2.66T abroad, but we also took back most of those dollars by selling *our* stuff abroad. In fact, we took back $2.1T of the $2.66 we sent out. So netting it out, we net-emitted $560B last year. That's 560B dollars created here in the dollar creation zone and sent out into the non-dollar (homeless dollar) zone. That's marginal (deficit) flow. But there's more.

Before I get to the "more", let's reduce this to an easier time-frame. In a stable currency (like the dollar), the prices of necessities like food, energy, medicine and industrial inputs don't change much over a one-year time period. But prices *can* change overnight, and that's what I'm predicting. So I'm going to start quoting these annual statistics in daily flow amounts, by dividing the annual number by 365. That, of course, includes weekends and holidays. And while our beloved monetary plane closes down for weekends and holidays, the physical plane of necessities runs 24/7.

So looking at it as a daily flow, last year the US in aggregate emitted about $7.3B per day to the world outside of its boundaries and took back in only $5.8B. So the US is a net-emitter of about $1.5B per day. But there's more. In 2009, the federal budget deficit overtook our trade deficit in dramatic fashion. As I said earlier, in 2007 the federal budget deficit was only 23% of the trade deficit. In 2008 it was 63%. And in 2009 it jumped to 367% of the trade deficit. In 2010 the federal budget deficit was 259% of the trade deficit, and in 2011 it was 232%.

You don't see this comparison very often, budget deficit to trade deficit. And the actual percentages don't really matter much. What matters is that it went over 100%. What matters is that, since 2009, the US government (USG) is a net-emitter of more dollars than the US in aggregate emits to the outside world.

So what? Well, the USG emits about $9.8B per day while it takes in revenue of only about $6.2B. So

the USG is a net-emitter of $3.6B per day. That's the marginal flow I'm talking about. And there's big danger in that daily flow of $3.6B.

In 2008, the US in aggregate (private sector and public sector combined) net-emitted $1.9B per day to the outside world. This is like a broken water main that cannot be shut off, and must be mopped up by someone. But that year the USG only gushed $1.2B per day. So the foreign mess we created was only 63% attributable to the USG. The other 37% came from private sector deficit spending. But ever since 2008, that broken water main gushing dollars abroad is 100% attributable to the USG alone. And not only that, but it's now spilling out here at home, on our own front lawn!

The USG today is spending $3.6B more than it is taking in, each and every day. That's a big mess of dollars flooding out of the USG. $1.5B per day is flooding outside of our zone while $2.1B is staying right here on our front lawn. This is all flow. It is ongoing and unstoppable. And it all must be mopped up by someone. And by someone, I mean either the foreign sector, the domestic private sector or the Fed buying up US Treasuries. $3.6B per day, an unstoppable, unending broken water main gushing out dollars. Marginal flow!

Don't be fooled by the misdirection. QE, twist, whatever; it's not about interest rates or helping the economy recover. It's 100% about disguising and managing this uncontrollable, unstoppable mess. It's more like a broken sewer line than a water main now that I think about it.

Sure, the Fed needs to keep interest rates from rising. Because what happens when interest rates rise? The value of the entire $35T bond market starts to collapse and bond holders panic. The Fed doesn't want that, so don't bet on them letting interest rates rise. But as I said, I'm not worried about the stock of dollars. I'm worried about this broken sewer line we call the federal budget deficit which means no one has to sell a single bond. In fact, someone has to continuously buy $3.6B ***more*** each and every day, including weekends and holidays.

And if prices start to rise as they do in a 'hot' inflation, I propose to you that the USG will not cut back in real terms. So if prices were to rise by, say, 10%, the USG net-emittance of dollars would rise by 10% to $3.96B per day. And because the trade deficit is 100% attributable to the USG ever since 2008, the trade deficit would also rise 10% to $1.65B per day. The USG will not be outbid for goods priced in dollars. Price is what determines who gets a scarce good, and the USG will not be deprived. They even said so in a recent Executive Order! And where are goods and services prices discovered? In the minds of investors with pensions and IRAs, or at the margin where dollars flow?

"Supporting foreign dollar settlement with CB storage"

For decades up until today, foreign dollar settlement has been supported by foreign CBs storing the glut of dollars emitted by the United States, just as FOA said. And by "support", he meant keeping dollar prices stable in the face of a glut of dollars coming out of the US, but to the detriment of the living standard of their own population.

This lack of dollar price inflation to match the monetary expansion of the dollar over the last 30 years has fostered many crazy economic theories to explain how the dollar can't collapse. In fact, most all economic theories today have some explanation or another describing the miracle of the magical dollar. But what they all miss is the political component which supported the dollar for all these years by

mopping up that marginal (deficit) flow.

CB storage works, surprisingly, by duplicating the glut of dollars abroad. The CB mops up the dollars and then duplicates them by sending them back to the US public and private sectors (in proportion to each sector's deficit attribution, today 100% USG, 0% private sector) so they can be spent again, and also keeping those same dollars in CB reserves as a debt of the United States. Since 2009, it's all attributable to the USG, so every day, as a billion-plus dollar glut piles up, the foreign CB sends it back to the USG and also stores it in its own vault with a new billion-plus in Treasuries.

But in order to do this, that foreign CB needs to duplicate it again in its own currency. So the foreign CB prints an amount of its own currency needed to buy up the dollar glut, thereby transferring the monetary inflation to its own population and keeping the dollar price tags from changing. No (or low) dollar price inflation. Foreign dollar settlement continues. Support!

Not understanding the political element of foreign CB support is why low dollar price inflation has confounded an entire generation of hard money thinkers. And yet, again today, having finally given in to the miracle of the magical dollar theories, they will be once again confounded as the dollar collapses in hyperinflation upon the removal of that support. But fear not. FOA and I are here to help!

FOA 10/3/01 - For decades, hard money thinkers have been looking for "price inflation" to show up at a level that accurately reflects the dollar's "printing inflation". But it never happened! Yes, we got our little 3, 4, 8 or 9% price inflation rates in nice little predictable cycles. We gasped in horror at these numbers, but these rates never came close to reflecting the total dollar expansion if, at that moment, it could actually be represented in total worldwide dollar debt. That creation of trillions and trillions of dollar equivalents should have, long ago, been reflected in a dollar goods "price inflation" that reached hyper status. But it didn't.

That "price inflation" never showed up because the world had to support its only money system until something could replace it. We, as Americans, came to think that our dollar and its illusion of value represented our special abilities; perhaps more pointedly our military and economic power. We conceived that this wonderful buying power, free of substantial goods price inflation, was our god given right; and the rest of the world could have this life, too, if they could only be as good as us! Oh boy,,,,,, do we have some hard financial learning to do.

Over the years, all this dollar creation has stored up a massive "price inflation effect" that would be set free one day. Hard money thinkers proceeded to expect this flood to arrive every few years or so; the decades passed as those expectations always failed. Gold naturally fell into this same cycle of failed expectations, as the dollar never came into its "price inflationary" demise.

A number of years ago, I began to learn from some smart people about the real political game at hand and how that would, one day, produce the final play in our dollar's timeline. Indeed, you are hiking that trail with us today; us meaning Euro / gold / and oil people. All of us Physical Gold Advocates that have an understanding about gold few Americans have ever been exposed to.

Our recent American economic expansion has, all along, actually been the result of a worldly political "will" that supported dollar use and dollar credit expansion so as to buy time for Another currency block to be formed. Without that international support, this decades-long dollar derivative expansion

could not have taken place. Further, nor would our long term dollar currency expansion produce the incredible illusion of paper wealth that built up within our recent internal American landscape.

The relatively small goods "price inflation" so many gold bugs looked for will be far surpassed and the "hyper price inflation" I have been saying is coming is now being "structurally" set free to run.

Why "structurally", why now?

For years now, "politically", the dollar system has had no support! Once again, for effect, "Politically NO", "Structurally Yes"!

For another currency block to be built over years, the current world economy had to be kept functioning. To this end the dollar reserve system had to be structurally maintained; with its IMF agenda intact, gold polices followed and foreign central bank support all being part of that structure. Truly, the recent years of dollar value was just an illusion. An illusion of currency function and value, maintaining the purpose of holding the world financial and economic system together for a definite timeline. Politically, the world does not hate America; rather they hate the free lifestyle our dollar's illusion value brought us yesterday and today.

Now that the Euro block is passing a point where the Euro currency is viable; this same past dollar support that built America's illusion wealth will now fall away. In its place we will see the beginnings of a currency war like no other in our time.

This very change in structural dollar support is the same change that has been impacting our fed's actions for over a year now. This change is the difference between my call for super price inflation and the endless calls past hard money thinkers have made. Their on again / off again goods "price inflation" outlook is based on the same failed analysis that expects price rises because the fed was into another "printing money faster" cycle. I point out that that cycle has come and gone many times without a price inflation anything close to our total, long term, dollar creation.

Further

To this end, I have been calling for a hyper inflation that is being set free to run as a completed Euro system alters Political perceptions and support. That price inflation will be unending and all encompassing. While others call, once again, for a little bit of 5, 10, 15% price inflation, that lasts until the fed can once again get it under control,,,,,,,,, I call for a complete, currency killing, inflation process that runs until the dollar resembles some South American Peso!

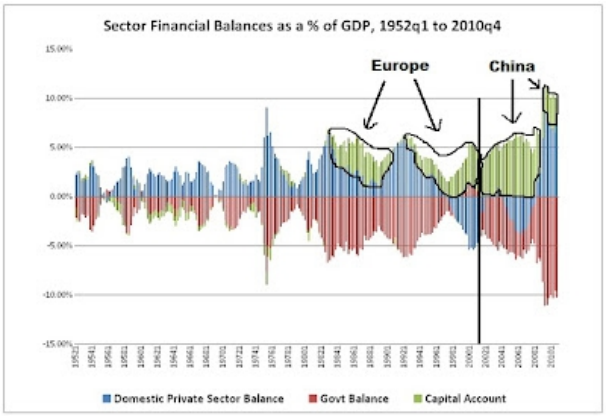
[…]

Greenspan will not embark on a dollar building policy again! Even if he changes his mind about leaving. Unlike our past inflation cycles, he has only one act to follow because he must support the internal economic dynamics of this country as its dollar falls from reserve status. There will be no inflation "cycle" on this go around. The creation of a competing Euro currency block has changed his policy dynamic.

The fed has cut rates below perceived price inflation levels already and will cut again and again; even

in the face of real, published, soaring, official statistical CPI. The die has been cast and the game is in process.

That was written in October, 2001. So what happened? It's simple really. From my post, Moneyness, the black dividing line is right around October, 2001:



> People like to say that A/FOA got it wrong, because the timing didn't seem to play out exactly as they inferred it would. But I would like to proffer another view. Perhaps FOA was unaware of the lengths to which the PBOC was prepared to go in supporting the dollar and the US trade deficit over the next decade.
>
> China was admitted into the World Trade Organization on December 11, 2001, one month *after* these posts. And it wasn't until 2002, after FOA stopped posting, that China really began to ramp up its trade with the US and to purchase US bonds in size [mop up the deficit flow of dollars keeping dollar prices low and stable]. From '99 to '01 China's Treasury holdings were flat at around $50B, but from 2002 they began a parabolic rise that has now ended and is once again flat.
>
> So if China has backed off from supporting the dollar today, in the same way that the European CBs had backed off right when FOA wrote these posts, well then perhaps they are more relevant today than the day they were written.

Here is Ben Bernanke from a speech in 2005 noticing the shift in dollar support from "industrial countries" (Europe) to "developing countries" (China) which took place sometime "between 1996 and 2004":

> The collective current account of the industrial countries declined more than $441 billion between 1996 and 2004, implying that, of the $548 billion increase in the U.S. current account deficit, only about $106 billion was offset by increased surpluses in other industrial countries. As table 1 shows, **the bulk of the increase in the U.S. current account deficit was balanced by changes in the current account positions of developing countries**, which moved from a collective deficit of $90 billion to a surplus of $326 billion--a net change of $416 billion-- between 1996 and 2004.

Of course in 2005 the federal budget deficit was only $317B while the trade deficit was $708B. So the

foreign sector was still supporting the sum total of the US public and private deficits by mopping up the entire glut of dollar net-emissions to the tune of $708B per year, or $1.94B per day. And this would be a good time for me to put down a common myth propagated by Ben Bernanke as well as, well, everyone else.

It is a myth that QE is a result of the Fed's concern for the economic outlook or even about keeping interest rates down. That's just what they want you to be focused on, rather than the real reason for QE. Notice that QE began at the same time as the federal budget deficit overtook and surpassed the trade deficit. Not only that, but the amount of QE matches close enough for government work the difference between the budget deficit and the trade deficit.

It is also a myth that QE is sterile money creation because (as they like to say) it is all just sitting on the banks' balance sheets as excess reserves held at the Fed rather than circulating in the economy. In fact, it is ALL circulating in the economy because the USG spends that money *into* the economy. Government dollar emissions simply come with bank reserves. If you don't understand this, please go back and review my banking system model in Peak Exorbitant Privilege.

So if you're watching "economic indicators" and Treasury market figures and interest rate curves trying to guess if there will be more printing, aka QE3, you should instead ask yourself if the USG will cut a quarter of all its spending habits this year, or ever. That would be roughly equivalent to cutting all of Medicare, or all of Social Security, or all of defense spending, or a third of each, just to give you an idea of how much they are printing.

What we have today, in essence – nay, in reality – is the USG running a ***daily*** deficit of $2.1B against its own economy and another $1.5B per day against the rest of the world. FOA explained that what this means in essence – in reality (when you are the printer of the global reserve currency) – is the fleecing of the standard of living of someone else:

FOA 2/26/00 - So, dollar hyper inflation never arrived and gold did not make its run because world CBs bet your productive efforts on supporting the dollar reserve. In the process, the US standard of living was raised tremendously on the backs of most of the worlds working poor. But this is not about to last!

FOA 3/10/00 - My point was that their actions can only be justified from a position of "buying time"… Their Central Banks support polices were a decision to waste their citizen's productive efforts in a process that held together a failing currency system.

FOA 4/19/01 - What changes is the recognition of what we do produce for ourselves and what we require from others to maintain our current standard of living… We will come to know just how "above" our capabilities we have been living. Receiving free support by way of an overvalued dollar that we spent without the pain of work.

FOA 7/16/01 - The American dollar has bought its makers a lifestyle that is at odds with this new thrust in money use. A reserve currency today must allow its value to be set solely upon its money function [MoE arena], not its function of retaining wealth [SoV arena]. Use trends today are forcing money creation policy and money values to be determined by wealth outside the official money realm. All the while the dollar holders are fighting to stop this from happening.

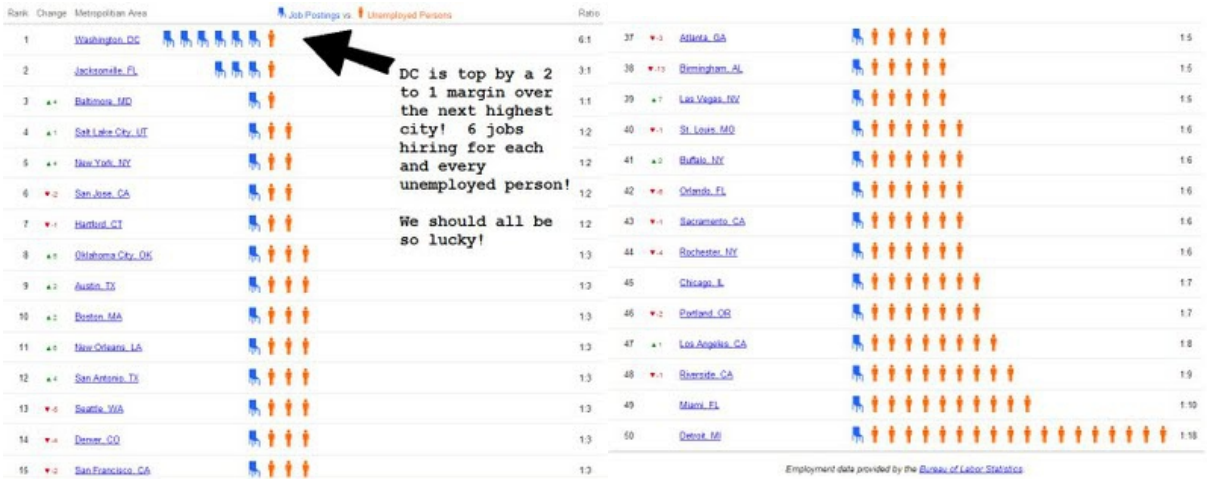
FOA 7/20/01 - For years American lifestyles encouraged its political system to protect their banking /debt credibility at all costs; so we could buy others' real goods without sending real wealth to pay for it. We did this in the only way we knew how; in body, mind and spirit, our political economic purpose promoted the dollar and its debt to be as good as gold and a substitute for real wealth holdings. Even a substitute for real wealth to be held in reserve behind other currencies!

FOA 10/5/01 - Even the third world didn't want to hear it. They figured that any return to a hard money system would hark back to a time they remembered well. These guys suffered during the early century and no one was going to tell them that the gold standard wasn't at fault. The US is today, and was then, robbing them blind but the situation seemed, to them, that this new dollar standard was building them up. Looking at it all,,,,, we robbed the Japan life style standards the most. All to buy us an almost free standard and they loved it.

FOA 10/8/01 - We managed this threat with help from our Euro friends; somehow thinking they enjoyed and wanted our fleecing their lifestyle to the same degree we did it to the rest of the world. Their cooperation, we will find out, was but a structural policy that bought time; time for a dollar replacement to be made.

FOA 10/26/01 - Again; this all works as long as the world "buys into" using our dollars. As I said; an expanding fiat works to grow the economy thru expanding credit buying power because the fed can support the system with credit creation that has no "inflation premium". That lack of premium only exists as long as Americans can exchange free credit for real physical goods. Once this perception changes it's over. Once the world understands that it's not local US goods that stands behind dollar growth, but less expensive foreign goods,,,,,,,,,, the stage is set for our "supporters" to sell to themselves! Making themselves
"lifestyle rich". All they need is Another currency unit.

Here's the bottom line, and the absolute ***correct*** way to view the USG's deficit spending today. Starting in 2009, the US private sector was no longer "fleecing lifestyle" from the rest of the world through the exorbitant privilege of its currency (a privilege which began in 1922 and peaked in 2005). Beginning in 2009 the USG started fleecing lifestyle from its own economy (in addition to the rest of the world) while ironically calling it "economic stimulus". This is the meaning behind these shocking images from 2009, which I first used in my 2009 post, No Free Lunch:



Global resources are being fleeced by the USG at the rate of $1.5B per day, while American resources, above and beyond the normal "internal revenue service," are being fleeced at the rate of $2.1B per day. The foreign resource fleecing is being enabled by foreign CBs (mostly China up until recently) buying Treasuries, and the local resource fleecing is enabled mostly by QE, but also partly by your pension fund manager buying you some of those tasty yield-free Treasuries.

It is no wonder at all that the stock market is doing relatively well given the unstoppable domestic sewage – I mean dollar – leak that is the USG's deficit spending. Unfortunately (for everyone) the stock market doesn't sterilize the sewage against goods and services price inflation the way the Treasury market does. The dollars just flow right *through* the stock market to the sellers.

But as I wrote above, it doesn't really matter what percentage of the trade deficit the budget deficit is, just that it's over 100%. As long as it's over 100%, the entire trade deficit is 100% nominally attributable to the USG, which means if we get some "hot inflation" either the USG will have to give up some of its consumption in real terms, or else defend its "lifestyle" with the printing press, right there at the margin where prices are discovered.

I don't expect this inflation to originate inside the US. In fact, as long as foreign CBs are structurally supporting the dollar reserve system by mopping up our $1.5B per day outflow, the American people are getting a pretty good deal on their own fleecing. I mean, even though we are being fleeced of $2.1B per day in "lifestyle" by our own government (in addition to taxes), for that fleecing we are actually receiving $3.6B per day back in government. ROI! So even though government is terribly wasteful, *our* wasteful government is still being subsidized by y'all! "Life is so fucking good I can taste it in my spit."

And because the US private sector deficit spending in aggregate has contracted to well below zero since 2008, I have a hunch that a lot of the fat has been cut out of the "basket" of US imports. The trade deficit has dropped from $698B in both 2007 and 2008 to $500B in 2010 and $560B in 2011. I bet all of that ~$130B drop has come from private sector consumption reduction (private sector crashing its living standard). In fact, the "private sector consumption drop" is probably greater than ~$130B and the USG has made up some of it by expanding *its* consumption. But the USG doesn't consume cheap consumables from Walmart. The USG consumes important stuff… stuff we generally call necessities.

Looking at the top imports from 2008 as well as the fastest growing imports of significance (say, over $5B per year at least), the top "necessities" are oil, medicinal preparations, petroleum products, coal, fertilizers and pesticides, food oils, oil field equipment, feedstuff and foodgrains, unmanufactured steelmaking materials, industrial organic chemicals, and semifinished iron and steel.

Again, this is just a hunch, but that's probably a good list of things to watch for price increases that could quickly turn hyper when the USG refuses to be outbid… if and when the foreign CB "structural support" slows down and the rest of the world stops exporting necessities to the USG for nothing but paper that will soon be worthless. So now that we know what to watch for, let's take a look at the state of that "structural support" today.

The US Treasury puts out a list of Foreign Holders of Treasury Securities. The latest update, which was put out on April 30th, covers Treasury holdings through February 2012 and shows each month for a whole year, in this case beginning in February 2011. The top row is China because China has the most Treasuries. And looking across for the year we can see that China's holdings are pretty flat, except that they peaked at $1.3T in July and then dropped all the way to $1.178T in February.

It looks like Japan (line 2) really picked up the slack though, buying $205B in Treasuries from February to February. I guess we better hope that Japan keeps running a trade surplus! Oops…

> Japan Swings to Trade Deficit
>
> 4/19/12—Japan swung back into a trade deficit in March as a steady rise in energy imports outweighed a rebound in automobile exports after last year's flooding in Thailand.

But fear not! Zero Hedge is on the case:

> 2/29/12 - Best advice: keep a track of that Chinese trade surplus. If it becomes a deficit (just like Japan did recently), that is the first signal that things are changing dramatically from an international flow of funds perspective. It also means that unless the US finds subtitute demand, most likely from within, the only remaining buyer will be the entity that already has the largest holding of US paper - the Federal Reserve.

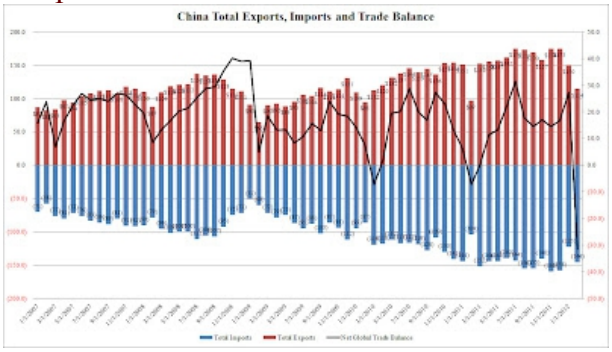
That last year of Treasury data, from Feb. to Feb., shows that the increase in foreign Treasury holdings covered the trade deficit for that year. If we look down at the last line, grand totals, and subtract Feb. 2011's total from Feb. 2012's we come up with an increase in "structural support" of $633.3B. And if we add up the monthly trade deficit for those same months we come up with $565.5B. Once again, close enough for government work. So I guess it's a good thing *someone's* still propping up the dollar. But wait! Here's another one from Zero Hedge only ten days later:

> **China Posts Biggest Trade Deficit Since 1989**
>
> 3/10/12 - In addition to all the US election year propaganda and delayed after effects of central banks injecting nearly $3 trillion in liquidity to juice up the US stock market, something far more notable yet underreported has happened in 2012: the world stopped exporting. Observe the following sequence of very recent headlines: "Japan trade deficit

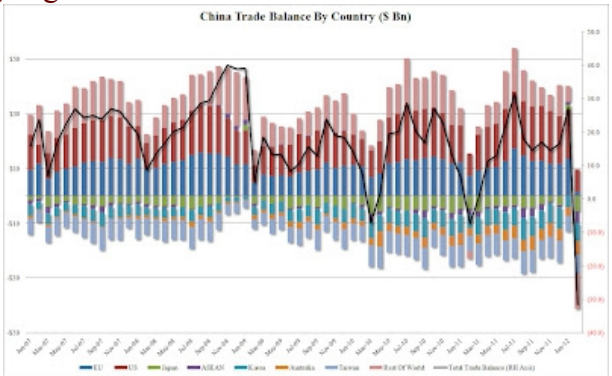
hits record", "Australia Records First Trade Deficit in 11 Months on 8% Plunge in Exports", "Brazil Posts First Monthly Trade Deficit in 12 Months " then of course this: "[US] Trade deficit hits 3-year record imbalance", and finally, as of late last night, we get the following stunning headline: "China Has Biggest Trade Shortfall Since 1989 on Europe Turmoil."

[…]

China total imports and exports - whoosh:



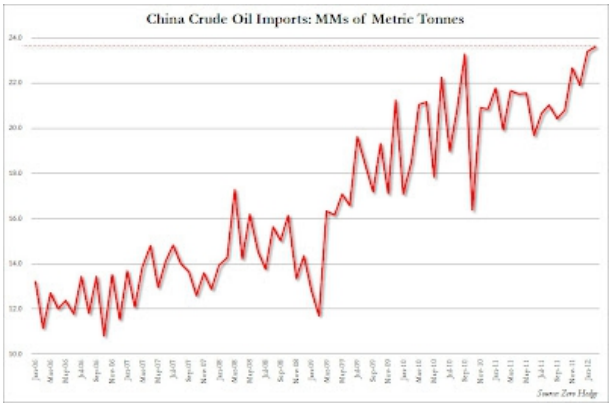
China trade balance by region - whoosh:



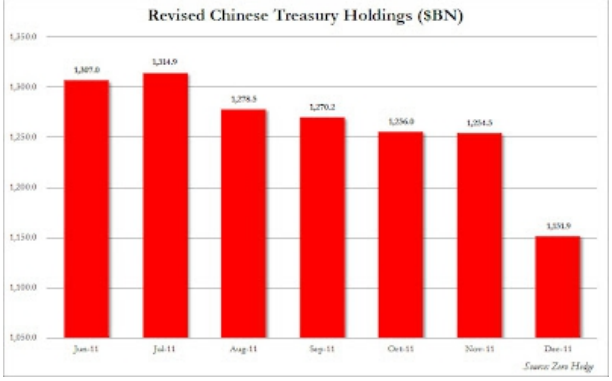
China trade with the US - whoosh:

China trade with the EU - whoooooooooooooooooosh:

However, definitely no whoosh here:



Oh, and let's not forget this particular whoosh:



...Is it starting to make sense now?

You can nitpick that data all you want, but one thing is as clear as an azure sky of deepest summer. This is a very different picture from the China of 2002 embarking on a "parabolic rise" in US dollar "structural support". In fact, even though it is true that some combination of Japan, oil exporters, Caribbean banking center, Taiwan, Switzerland, Russia, Luxembourg, Belgium and Ireland (to name a few) managed to cobble together the necessary support last year, the dollar is now living off of a willy-nilly support system rather than the "structural support" it enjoyed for the last 30 or so years. If FOA was here, he'd probably say something like this:

The relatively small goods "price inflation" so many gold bugs looked for will be far surpassed and the "hyper price inflation" I have been saying is coming is now being "structurally" set free to run.

Of course "hot inflation" is coming! But how long will it last? How long *can* it last without the structural support of foreign CBs mopping up the dollars the USG will be printing in order to defend its own "lifestyle" in real terms? How far can prices rise without hitting that hyper feedback loop at the margin where prices are discovered? The USG is net-emitting $3.6B per day today, and the problem is that the USG is not an economy. It is a consumer and a printer. So the daily net-emission of global dollars is now backed, not by an economy, but by the largest consuming entity ever known to man!

Lee and Paul are correct that the commercial banking system will soon be fully reserved. But I don't think those new reserves will come directly from the Fed in exchange for bank assets. Now that the government deficit has surpassed the trade deficit, all foreign support is Treasury buying, not private sector debt like MBS. The crossing of this Rubicon means that maintaining the Treasury market takes structural precedence over all other assets. It also means that every new dollar the USG decides to spend puts new reserves into the private sector banking system, raising its ratio of reserves to deposits. So the new reserves coming into the banks will be coming from domestic USG deficit spending via QE or whatever they decide to call it next time. And I believe that those bank assets and "unreserved credit" will simply die on the vine of worthless tokens as the USG crushes its own currency defending its lifestyle.

Gregor is correct about the "benign" inflation we've had, not just for the past decade, but for the past three or four. This is what FOA was talking about. "Yes, we got our little 3, 4, 8 or 9% price inflation rates in nice little predictable cycles." But hyperinflation "never showed up because the world had to support its only money system until something could replace it." The euro was born, then came China, and my call is that hyperinflation "is now being 'structurally' set free to run."

If you print enough money, you can get the price of everything to rise. Just look at Zimbabwe if you don't believe me. But printing doesn't make all prices rise in unison. Gregor makes a good case for the "Middle Class Squeeze" combined with asset price deflation, an inflation/deflation double whammy, as well as resource scarcity-driven subsistence inflation leaving no discretionary spending room for the poor or those in developing countries. And from the "Executive Summary" of his part 2: "Rising wages in the developing world create upward price pressure everywhere globally." I agree with Gregor on all counts!

So yes, I agree with Gregor that "hot inflation" is coming and it's a real risk. But inflation generally suppresses consumption in real terms. As Gregor says, "it quickly begins to drive out spending for discretionary goods in favor of true basics." But this doesn't apply to the USG who can "spend" infinitely in extremis. Gregor concludes his part 1 with this:

> The United States currently enjoys reserve currency status, which enables it to borrow cheaply, and which keeps capital circulating through our government bond markets, which are the largest in the world. Given the backdrop to our post-credit-bubble environment, it is now the consensus view that we will cut a path similar to Japan's as we oscillate from weak growth back to the stimulative rescue policies of the Federal Reserve.
>
> There is therefore a sense of complacency about an escalation in prices.

That highlighted portion is the premise on which virtually *everyone* in America is operating, without even understanding what it really means. It is the miracle of the magical dollar theories laid as the solid foundation under any and every discussion. One of my readers, Michael, a medical doctor, was attending a conservative "Tea Party-ish" meeting in California yesterday. The meeting included US Senators and Representatives, and they were totally operating on the premise of the miracle of the magical dollar theories. You can read his interesting report here.

The point is that the premise rests on 90 years of history which only makes sense if viewed properly. It rests on 50 to 60 years of political support followed by 20 years of structural support from Europe and another 8 or 9 years of structural support from China. Today both political and structural support are gone, and the "solid foundation under any and every discussion" of monetary matters in America is what I am generously terming the "willy-nilly support" of the rest of the world. In other words, we have no say in the matter. Our fate is in *their* hands. Which kind of renders the premise invalid, doesn't it?

I agree with Gregor that "hot inflation" is coming whether you like it or not, for all the reasons he explains and more. My only disagreement is that Congress will take it more hyper than we've seen in all of fiat history, so fast it will peel the skin off your face, because they are operating on a false premise. The miracle of the magical dollar theory premise is a false premise because it completely misses what's going on. And anyone who's waiting for those operating under a false premise to panic out of their dollar holdings before even entertaining this reality is like someone waiting for the loss of consciousness before entertaining the possibility of death.

The dollar is so vastly overvalued today because the rest of the world has kept it on life support for 30 years past its expiration date. It is the stability of dollar prices at that small marginal flow that sustains the illusion of wealth in the entire, massive monetary plane. And yet the modern "hard money thinkers" think that we can somehow retain this level in real terms by simply devaluing the dollar against gold and then managing that new "gold value". I wish all the modern hard money thinkers – you know who they are so I don't need to mention any names – would just take a few minutes and listen to FOA and maybe, just maybe, see how wrong they are. It's all in that last page of The Gold Trail, but I tried to make it bite-sized in a recent blast of Tweets. #HMS means Hard Money Socialist which describes all of these guys. If you don't understand, go see for yourself. These are all FOA quotes from that last page (edited for Twitter):

"Truly, to this day, #HMS think their ideas are the saving grace of the money world. It isn't now and never was then." #FOA

"This political process of fixing money to gold has ruined more economies, governments and societies than anything." #FOA

"It just flies right past them that the ECB wants gold as a dollar replacing *asset*, not local money backing." #FOA

"#HMS call for "official money gold" as the only way governments can go. That will not ever be allowed again." #FOA

"These are the same people that hold free markets on a high plateau as the goal for everyone. Yet,

they talk a story of gold control." #FOA

"Fortunately for the majority of world physical gold owners, the hard money socialist game has ended." #FOA

"Late comers to this understanding will encounter a true free market, but their buy in price will be at a much higher natural level." #FOA

"In the late 60s, #HMS seemed so natural. However, even then, I had some serious people pointing me in a different direction." #FOA

"This is all happening while Western style Hard Money Socialists are defending their stance by saying Euro is just another fiat. Ha!" #FOA

"Western thought is gold=money. This simple picture from the middle ages banking renaissance is used to bastardize the gold story to this day." #FOA

Please go read that last page of The Gold Trail after reading this post. Start at the bottom and read up. It's in reverse order, unlike the first five parts. There's so much more there than the little bits I included here. It's the very last words he wrote before he stopped writing. I know that some people think I approach these A/FOA archives somewhat religiously. Well, I do!! Look at the subtitle at the top of this blog! Not in any way similar to spiritual faith, but My God, has anyone – and I do mean ANYONE – explained what's going on today better than these guys?

Sincerely,
FOFOA

PS. If you appreciate this blog and my efforts here over the past 3 ½ years, 360 posts and more than 32,000 comments, please consider making a donation to support my continuation of this project. These donations are my only source of income.

Saturday, November 10, 2012

Moneyness 2: Money is Credit

"Gold is the only money the world has ever known"
Sounds like a simple thought, but it isn't.
To understand the following you must rethink your basic
knowledge of money and investments. Get your aspirin ready.
–ANOTHER

What will change is how we view money and wealth
Everything else in Freegold flows from that!

My purpose in writing this post is to state my personal view of the concepts of money and wealth as clearly as possible. I think that my view is useful in both understanding our unfolding present landscape as well as profiting from that early understanding. There are other views of money and wealth which are much more widely accepted, and I hope to explain why I think their biggest flaws are found in their useless conclusions and the destructive prescriptions to which they logically lead.

Anyone who chooses to read this post is free, of course, to take it or leave it, because all I care is that you see and consider it. If there's one thing I know, it's that I cannot claim credibility for myself, that judgment is up to you. So think of this post as a "stack of rocks" marking this spot on the trail. And since I can't say it any better than FOA did a decade ago, here's what I'm trying to say:

FOA: *"I (we) expect none of you to consider anything said here as credible. Everything is given as I understand it. If you came with a notion that I am someone who sees the future, grab the children and run far away. For these Thoughts, and my ongoing commentary, are meant to impact exactly as the "gentleman" said they would. People hear them, and whether believed or not, the words leave a mark. A mental mark on the trail, if you will. And later, after the world turns, our little "stacks of rocks" will be easier to understand next time you are passing this way. In fact, your ability to find your own way will forever be enhanced for having seen this path in a different light."*

There is no authority for the money concept

The first thing that is important to understand is that money (and later banking) was never designed, patented, invented and then rolled out such that we can pull up the original plans and put centuries-old debates to rest. It simply emerged over thousands of years. There is no original set of rules and definitions. There is only reality, a menu of different perspectives from which you can choose to view

reality and the conclusions that are logically drawn from each perspective, and then how useful those conclusions end up being in hindsight.

Economists and philosophers, from John Locke to Adam Smith and Jean-Baptiste Say, to Marx and Menger, Mises and Keynes, Friedman and Hayek, to Minsky and Rothbard, have, for centuries, been adding their perspectives to the debate and collective understanding of the emergent concepts of money and banking. This has led to several formal schools of thought on the subject which I argue can be generally divided into two camps—the easy money camp and the hard money camp.

I'll tell you right up front that I think my perspective is far more useful, especially right now, than those offered by either camp. But one of the revelations that I found most vexing while walking this trail was that, in terms of describing money, the easy money camp has always been closer to reality than the hard money camp. Even so, the usefulness of the (macro *and* micro) conclusions (and prescriptions) coming out of both camps has run the gamut over the last few centuries due to what I think is a fundamentally flawed view of the big picture—a flaw which, in and of itself, has set the two camps perpetually and unnecessarily at odds with each other.

I make no prescriptions here, only observations. Even the personal action I endorse for savers—buying physical gold bullion coins and bars—is not recommended beyond what you understand. In other words, I don't even need to recommend it. If you understand, you will do. But if you do without understanding, your results may vary.* So I'm only sharing my perspective and, if it makes sense to you, you'll know what to do with it.

The goal of this post is to present a lens through which you can see the true role of money and wealth/savings in your daily life today and in the Freegold future. Only time reveals all things, including the full extent of any reward for understanding changes ahead of time and then acting with the full force of that understanding. But I can tell you, from personal experience, that there is an immediate reward from understanding something and then acting upon that understanding. And that reward is peace of mind.

In as few words as possible

Since I'm writing at length here, I thought I'd start out with a kind of abstract for those who can't stand long posts. Blondie once asked me how I would describe money in as few words as possible. My answer was: "Money is credit." I followed that up with a little more detail: "More specifically, it is the recording of current balances of credit. It can be recorded in your head, represented on an institutional ledger, or carried in your pocket as pieces of paper or metal with numbers recorded on them. But notice that it's the recorded numbers and *not* the paper/metal in your pocket that constitutes the money."

But you can't possibly understand the pure money concept without also understanding the wealth concept. The pure concept of wealth is really simple. It's only attribute is possession (or at least unambiguous ownership of something tangible, if it's not in your immediate possession). Your wealth includes all of your owned possessions, from the air you breathe down to your comfy, worn-out slippers. Value is subjective—it's in the eye of the beholder. Value comes from utility (usefulness) to the user. If something in your possession has no use to you, no value, then it is likely that you won't go to the hassle and expense of continuing to possess it. You'll probably just throw it away. So possession is the distinguishing characteristic of wealth, which also puts wealth squarely in the physical plane.

What sets your gold apart from your stinky slippers and other items you possess is that it is the most tradable—tradable wealth! Imagine that! It is tradable because someone else values it too, unlike your slippers. But not only does someone else value it, but almost anyone anywhere in the world values it nearly equally, even the Giants! How many of your other possessions would measure up to the quality standards of a Giant? None, I imagine. This is what FOA meant by "equal footing".

That's basically it in a nutshell. Those who have been following the comments know that Blondie prefers the term "credibility" more than "credit". It's a fine line, and I could go either way. In this post I'll use both words *almost* interchangeably, but I think I'll stick with "credit" as the closest proxy for the pure concept of money.

Okay, I guess a few more words are needed

Think of it like this. Value is subjective—it's in the eye of the beholder. *You* value your slippers, but no one else does. Gold is the one item in the world that comes closest to having a relatively objective value because your knowledge that others value it for the same reasons you do is the very reason you value it in the first place. It's the reason behind gold's utility as a store of value or, phrased another way, a wealth reserve. Salience is a good descriptor.

Credibility, like value, is also subjective. But unlike value it's not something you can claim for yourself. Only someone else can judge you credible. Ergo, credibility must be earned. It is subject to the judgment of others. Credit is like spendable credibility. Money is the fungible exercise of credit (accepted everywhere, even by those who don't understand why you're so darn credible even when you're wearing such ugly slippers). A bank doesn't really give you credit. You earn it before you ever walk into the bank.

If you want to buy a house, you don't need to have saved the full price of the house. All you need to have is earned credit/credibility. You walk into the bank, the bank checks your credit and, if it is not found wanting, facilitates the fungible exercise of your credit/credibility. And then, because it's now fungible, it circulates!

The real world operates on massive amounts of credit. And by real world, I mean the businesses that make everything in your life. Credit is not just about consumer credit cards, evil speculators maxing out their margin and housing bubbles. And the hard money view of "money" as something we all want to hoard is just as pedestrian a view as thinking credit (or debt) is something intrinsically bad. Money has always—ALWAYS—been credit/debt. That's not bad at all. Debt is simply credit (or credibility) fungibly facilitated and then exercised!

Short post fans can stop reading here

FOA wrote so much good stuff on this subject of which I excerpted some and extrapolated more and carried on into MMT and hyperinflation in my first Moneyness post that I implore any new readers to stop here and go read the first one first. I'm not going to rehash anything from that post, so if you haven't read it, it's like you're starting in the middle of a book.

Useless conclusions

I want to start by detailing how a faulty premise can logically lead to useless conclusions and worse—occasionally to destructive prescriptions. The faulty premise I want to discuss is one that is almost universally accepted in today's hard money camp. It is just one example among so many that I can't count them all, but it will also set us up to discuss why money is, and always has been, credit.

This premise was posted here in the comments a few days ago by a reader named Herb. So I'll just cut and paste it here from Herb's comment:

The reason gold is money is because it has the premier attributes of money. You know, the good old textbook qualities of fungibility, divisibility, portability, etc, etc. You can no more deny gold is money than you can deny that a dog is canine or a cat is feline. It simply is what it is.

Indeed, those are great attributes, along with durability, easy recognition and a relatively stable supply! But are those truly the attributes of the original money concept, or are they more befitting the concept of a salient tradable wealth reserve? **Is there a difference between money and a tradable wealth reserve? And if so, why is it important to understand this difference?** The answer is that not understanding the difference leads to useless conclusions about money and banking and terrible prescriptions for remedies whenever problems arise.

Obviously I am simply describing two different perspectives here. And hopefully we can all agree that common sense says Herb's list of "textbook qualities" at least applies to the very best tradable wealth reserve (or reserve asset). So then the main difference between perspectives is whether or not the concept of money is the same as the concept of a tradable wealth reserve/reserve asset. The hard money camp says yes; I say no. And to judge this distinction I think we need to look at the conclusions drawn from these two different premises.

FOA wrote that, in antiquity, gold was used as a tradable wealth reserve, not as money. From Moneyness:

FOA: *Gold, that wonderful metal that has all the unique qualities to function as our one and only wealth medium, and we just can't use it without altering its purpose. You know, the Lydians had it right, back around 430 BC. They didn't struggle with the concepts of money, like we do today. They just stamped whatever pieces of gold they found laying around and kept it for trade. There was no need to clarify for certain that their gold money needed properties of "utility", store of value, medium of exchange, etc. etc.. They didn't need to identify these qualities were in gold before they stopped questioning if it was safe to use gold as savings. Gold was owned and the knowledge that people owned it and carried it for trade was alone enough to make it "worth its weight as wealth".*

You see, back in antiquity there existed another property that could override our need for modern definitions of tradable wealth. That property was found in the one identifying mark of wealth that transcended all ages; real possession!(smile) This factor and this one factor alone had the ability to activate all the other modern attributes of money properties, even when the knowledge of these attributes was unknown in the ancient era.

It was only when governments stamped official denominations and numbers onto pieces of gold that we can say the money concept was applied to gold. But as I said earlier, it was the number recorded on the metal, not the piece of metal itself, which constituted the use of the money concept. FOA mentioned this as well. Again, from Moneyness:

To understand gold we must understand money in its purest form; apart from its manmade convoluted function of being something you save. Money in its purest form is a mental association of values in trade; a concept in memory not a real item. In proper vernacular; a 1930s style US gold coin was ***stamped in the act of applying the money concept to a real piece of tradable wealth. Not the best way to use gold****, considering our human nature.*

There is a key concept hidden in that paragraph. If we look at all of history we find a whole host of materials that have been used to record the money concept—electrum, gold, silver, copper, iron, nickel, zinc, paper, wooden tally sticks, Yap stones, even silicon microchips buried in secure computer servers for the last 40 years or so. But even from the very beginning this was a sub-optimal use of gold in particular, because it had naturally emerged as the leader of the pack of tradable wealth reserve items due to our list of "textbook qualities".

But let's say that you reject this notion that money is really only the credit notation and insist that it is, instead, the physical item itself. What is the harm in that? Well, I think it leads to some horribly wrong

conclusions, especially about how banks work.

Banks facilitate the fungible exercise and circulation of credit. If I have plenty of credit, I can walk into any bank and get a loan. Then I can spend that loan and my credit (money) will begin to circulate throughout the economy as a medium of exchange. But if I am to accept that money is actually some tangible wealth reserve item, then I have to be skeptical about the source of that bank loan.

If, on careful examination, the bank has less of these physical wealth items in reserve than it has in outstanding liabilities, I might craft the common description of fractional reserve banking to explain what I found. This would lead me to the cynical notion that banks are somehow cheating by counterfeiting the real money that they have on deposit or in reserve. It would probably just remain my theory until some sort of crisis happened, and then it could mature into an outright accusation of fraud.

Reserves, of course, have always been vital to the business of banking. They are how banks settle up amongst themselves, and in the case that a bank customer decides to transact in a distant land outside of his local system of bank settlement (or locally in a black market), reserves are what the bank gives the customer to take with him. But this idea that the reserves are the real money and the credit is some sort of counterfeit or fraudulent money leads to horribly wrong conclusions and destructive prescriptions whenever a banking crisis occurs.

There is a big hump to get over here if you are in the hard money camp. Simply, get over this idea that banks need to have something to lend. This is the faulty premise: that banks lend *something* to the borrower. They do not. The borrower already has the credibility, the credit, and the banks are simply facilitating the exercise of that credit so that it can be used in transactions, and so that the counterparty to those transactions doesn't need to understand the borrower's credibility. The bank has already verified it and now stands behind it. This is the very essence of money.

In fact, banks are not (and should not be) constrained by the amount of reserves or capital/equity they have. But that's not to say they are not constrained. They are, just not by reserves and capital as this faulty premise leads some to believe. Instead, they are profit constrained; they want to make a profit. And because of this, they are experts at verifying credit and managing their reserves.

I realize this is difficult to see given the current state of the modern banking and financial landscape, but worse, it is impossible to see without a proper perspective on money. Without a realistic view of money, a proper understanding of banking is impossible. And without that, if you happen to be one of the few with the drive to be heroic, you'll be spinning your wheels on "solutions" (prescriptions) that range from useless to disastrous.

I'm not describing the current state of banking. I am describing the timeless state of the emergent banking model. There is nothing wrong with it. You can hang bankers from lampposts and rage against "fraudulent thin air debt-based money" and "fractional reserve lending" all you want, but that will do nothing heroic. The solution to this crisis is already unfolding, and anything short of relaxing in your lawn chair and explaining the show to your neighbors while watching it unfold is the opposite of heroic.

The latest antihero movements I've seen have come from some who read this blog. Perhaps I isolate myself (I do), but that's why I'm writing this post right now—because of these "movements" which

crossed my highly-filtered field of view. Freegold combined with full-reserve banking a la the Chicago Plan which completely misunderstands money was one, and Freegold combined with CB's tasked with centralized "control over the credit volume created by their commercial banks" was the other.

This is why I think it is very useful (at least in the peace of mind department), even for regulars of my blog who presumably understand gold, to also have a deep understanding of money. And this is why I am writing this difficult post. Don't spin your wheels unnecessarily. Embrace the view that money is credit, to the full extent possible! Freegold is all about enabling savers with a realistic understanding of money and wealth… everything else flows from that. Money is not wealth, no matter how stable it is.

Money is credit

Money is credit; it is quite literally "money of the mind." Money is one of those intangible things, very powerful, but not something to be saved for the unknown future.

I should state right up front that I have no problem with fractional reserve banking or fractional reserve lending, except when we do it with gold. I think that even using the term fractional reserve banking reveals someone who doesn't understand money very well. I went into some detail on it in my Honest Money post. It's a long post, but here are the first couple of paragraphs setting the stage:

What is honest money?

And what does it mean "to return to honest money?"

The most common answers to these questions have roots in the Austrian School of Economics, developed and made famous by the Austrian economists Carl Menger (1840-1921), Ludwig von Mises (1881-1973) and Friedrich Hayek (1899-1992). At least the most common answers today come from modern followers of the Austrian School. And modern practitioners will tell you that gold and silver are honest money, and that the way to return to honest money is to make money harder and/or to limit or eliminate fractional reserve banking.

But this meme of honest money has been canonized in such a simplistic way that its proliferation has become a bit of a credibility problem for those who promote it, and a source of confusion among their more credulous followers. So I have a slightly different take on honest money that I'd like to share with you.

That old story about how the banker lends out more paper receipts than the gold he has on deposit has done a great deal of damage to the collective understanding of money, in my opinion. I think this is why FOA spent so much time discussing the pure concept of money, what it is, how we use it, where it came from and how it has been corrupted over the years to fit a hard money agenda which led to a modern understanding of money in the hard money camp that's not consistent with reality. His discussion begins in Gold Trail III – The Scenic Overview with "The Gold of Troy" and continues onto the next page. I included several excerpts from his discussion in Moneyness.

The idea that "fractional reserve banking" is bad, wrong, or the flaw in the system, is simply wrong in my opinion. The way the real economy has always used "the pure concept of money" is, in one simple word, credit. When physical gold emerged as the most versatile item for long-distance trade, that was not really the use of money per se. It was still just a tradable item, one of many, and simply the best on the road. When it was used as money was when we started trading using credit *denominated* in it. But that doesn't mean that there was an ounce of gold for every "ounce of credit" in existence.

That early banker who issued more receipts than the gold he had on deposit issued those receipts (lent them out) against the credibility or the ***character*** of the borrower—and his promise to repay the debt. We do this all the time in the real economy—issue credit to our clients and receive credit from our vendors based on their known credibility or character and this is what keeps the economy running. There is not a monetary base unit set aside for each unit of credit we extend to our clients. If there had to be, the economy would grind to a standstill.

Centralizing, aggregating and harmonizing this system of credit (money!) was an evolutionary leap in the right direction. Banks created a fungible credit system that could be centrally cleared. No longer did I need to extend credit directly to my client (although I still do to some extent), but he could get some of the credit needed to get the job done from his bank and pay me a deposit so that I could give my vendors a deposit. **This is how money lubricates the economy!**

And this credit (money!) is not backed primarily by gold, property or any kind of collateral. It is backed first and foremost by the character of the borrower and the credibility of his promissory note. Additional backing (like collateral) can lower the risk of loss through default and can thereby lower the interest rate. But collateral backing is in no way a universal element of credit (the pure concept of money).

Here's a great excerpt by Randy Strauss from my 2009 Gold is Money – Part 3 post that was especially revelatory to me in understanding that money is credit, not the reserves used for clearing and settling credit, and recognizing a flaw in the "fractional reserve banking is bad" meme – money is credit backed by character, not by reserves. Notice that it takes place in 1907, before the Federal Reserve even existed and while we were still on a gold coin standard, yet top bankers of the time like JP Morgan and George F. Baker had the same, deep understanding of money that I am describing in this post:

"The following is a post by Randy (@ The Tower) describing the end of the gold coin standard and the dawn of the Federal Reserve System:

Continuing our investigation into the meaning/essence of "money"... In 1907 America was on the Gold standard and WITHOUT any central bank. Many modern goldbugs might be inclined to yearn for those

"good ol' days" when "money was money and banking was as it should be!"

However, that year is best known by the Panic of 1907 in which the people's economy was plagued by runs on trust companies, banking panics, and a bear market in stocks. Across the nation, banks were unable (and refused) to deliver gold coins and currency to satisfy the requests of depositors for withdrawals of money from their own accounts -- and 246 banks collapsed. It is not difficult to see how the frustration of depositors unable to obtain currency from banks (even solvent ones!) holding their deposits would lead to pressure for political intervention and change.

For a quick exercise in perspective, imagine what you would do today if faced with the same situation in which your bank could not give you any currency ($1s, $5s, $10s, $20s $50 or $100s) to carry away with you as a representation of the money residing in your bank account. No problem. You would simply write a personal check to meet your spending needs, or perhaps ask for a bank draft, or wire the money wherever it needed to go. Amazing! What IS money??? How did you get yours; where did it come from? How do you know what its value is?? Ponder that, and now we return to our glimpse at history...

Panic of 1907

In the wake of this banking panic, a National Monetary Commission was formed to undertake a scholarly look at the failings of America's financial system. Of these, the four major flaws cited were that the banks were decentralized, clearing methods were inefficient, the huge cash holdings of the federal government were not distributed where most needed, and the currency supply was inelastic. **(Please ponder for a moment how or why the CURRENCY supply would ever be an issue if the amount of MONEY found in banks were at a one-to-one ratio with the currency (gold) that represented it**. Surely, in this absence of a central bank there couldn't be more money than gold coin! That's impossible!!) By 1911, the Commission had recommended a plan for a "Reserve Association of America" as the solution to these defects, giving rise two years later to what became our central bank -- The Federal Reserve System. However, that's another story for another time.

Through the coordinated stabilizing actions of three prominent NY bankers to arrest the banking panic [J.P. Morgan, George F. Baker (First National Bank), and James Stillman (National City Bank / Citibank)], their wealth and power was perhaps made more conspicuous in the eyes of the nation than perhaps it would otherwise have been. A prominent Wall Street lawyer named Samuel Untermyer suggested that there was a "Money Trust", and The Wall Street Journal also took notice of affairs and wrote, "So long as Congress will not give us what every other civilized country possesses, a central bank, it forces Wall Street to improvise something of the kind itself."

Samuel Untermyer

The House Banking and Currency Committee formed an investigative subcommittee to determine whether a Money Trust existed in NY. The chief counsel was Sam Untermyer, **and I think you might gain some insights about the true nature of money** from the testimony delivered by Morgan and Baker before the committee in Washington DC at the beginning of 1913.

George F. Baker

In questioning Baker about the proposal for banking reform regarding expanded disclosure of bank assets and investments, Untermyer probed, "Why should not the assets, and the detailed assets, be a matter of public knowledge?"

Baker replied, "Business would come to rather a standstill."

Untermyer demanded, "I want you to explain to the committee why."

Baker declined, "I can not explain it."

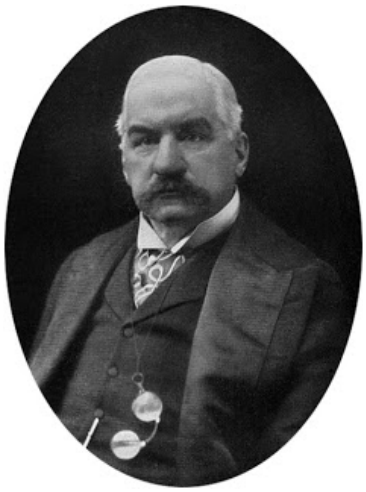
Untermyer pressed further, "You mean you can give us no reason?"

Baker admitted, "It would be exposing all the details of that business to the whole world."

After following a sidetrack in questioning, Untermyer returned to this issue, asking, "Why should the public do business on confidence when it can get the facts?"

To which Baker proclaimed, "Mr. Untermyer, THE FUNDAMENTAL PRINCIPLE OF BANKING, perhaps more than some others, is CREDIT." [emphasis added]

It seems that George Baker sensed (rightly?) that the public, familiar with their Currency being a tangible asset (gold coin), **would NOT be readily comfortable with the truth about Money. That is to say, that they might struggle to accept the reality that their Money Supply, as represented on the books of the bank, was created by credit, and existed through the grace of confidence. In effect, the tangible Currency had become a mere symbol for the Money (credit) it represented while circulating outside of bank account ledgers.**



John Pierpont Morgan

If you don't care to believe my assessment, I have another point for you. When Untermyer had J.P. Morgan on the witness stand, he asked him, "Is not commercial credit based primarily upon money or property?" [In this exchange, it appears that Untermyer ignorantly used the word "money" as equivalent to gold coin, a usage which Morgan plays similarly until his concluding point about granting CREDIT.]

"Morgan responded, "No, sir, the first thing is CHARACTER." [emphasis added]

Untermyer, shocked, reiterated, "Before money or property?"

Morgan reassured, "Before money or anything else. Money cannot buy it. [credit]"

Untermyer remained obstinate against this notion, as though there were communication difficulties, and

pressed again on this point.

Morgan then conclusively stated his conviction on the point that commercial CREDIT is based on character: "Because a man I do not trust could not get MONEY from me on all the bonds in Christendom."

From two eminent bankers who surely knew their business, you now have it that the creation or granting of Money (the extension of Credit) has more to do with the creditworthiness of the borrowers than the collateral that secures against possible default. And recall, these comments occurred while on a gold standard AND in total absence of a government-sponsored central bank -- which was authorized (against Baker's preference) a year later.

As you come to understand how Money and Credit are interrelated, the more you will understand the separate Wealth of gold and why you need it now more than ever."**

It might be tempting after reading that to think that the banks, through their "fractional reserve banking", *caused* the Panic of 1907. But, again, that would be to misunderstand how the economy has used "money" since the beginning of time. If that's all you get from Randy's post, then perhaps you are one who, as George Baker sensed, and because of your hard money upbringing, *would NOT be readily comfortable with the truth about Money.*

The inclusion of savings in the money creation process is the very root of the problem

Today all money is credit, even the monetary base. Today we use government credit as a base reference point for the private economy's credit. To view this in the proper light, I like to think of the base, or the government's credit, as a negative to the system, and the economy's credit as a positive. When the government borrows to spend it never really pays back in real terms, because governments are always net-consumers.

We enable essential government functions through taxes, the parts of government which are a necessary foundation for a functioning economy, but beyond what politicians can get away with through direct taxation, the rest of government is essentially a negative force on the monetary system. That's what I mean by government credit is a negative as opposed to private credit which is economically positive. It's a tough concept to swallow right now because everything is so topsy turvy on both the government and private banking sides, but that's really the gist of it.

What allowed it all to get so out of whack to the point that it is today is very simply the inclusion of savers' savings in the monetary process. This inclusion can be most clearly seen with the emergence of debt securitization in the 70s and 80s. Banks extend credit, but securitization allowed them to sell their income stream to savers for a fee. This cleared their books for more lending. Eventually lending standards had to be reduced in order to feed the demand for securitized debt from the savers. The added risk of lower lending standards wasn't a big concern because the banks never planned to sit on that risk; they planned to offload it to savers, China and German pension funds. This led to sub-prime and ultimately to collapse.

It is not that securitization reduces the banks' risk and liabilities. It is an ongoing process which gradually increases the risk banks face while reducing the profitability of their primary business model

—lending at interest—forcing them to rely too heavily on fees and speculation for income. They are selling their profitable loans first while adding new riskier ones for the next round of securitization. What securitization does over time is make the risk of default from poor quality loans systemic so that it must be socialized in the end.

There are only so many profitable loans that can be made at any given point in time. Eventually you run out of responsible people with good credit with whom to extend loans. With securitization, the banks started making more profits from the fees from selling securitized bonds to savers (mostly pension funds and foreign CBs) than from their normal business. So once you've run through all the good borrowers with credit, where do you go? You create new borrowers by lowering lending standards, especially if your profit is now coming more from sales commissions than from interest. This was demand-driven, not bankster-greed-driven. The banks met the demand and made a profit from the fees while being spurred on by ignorant politicians. The banks never wanted to carry sub-prime mortgages on their books to maturity, but once the collapse began they had no choice. Neither did the Fed.

Without securitization, banks would never get down to the sub-prime "bottom-of-the-barrel" borrowers (and purely speculative borrowers). There are plenty of good, credit-worthy (producing) borrowers to keep the banks in business, but not if the savers are hogging all the prime "income streams". Eventually, even the savers started buying up the sub-prime MBS garbage and then, when a few debtors started defaulting, it took down savers, banks, hedge funds and day-traders alike.

Take away the demand from savers and the banks will stick to the prime borrowers so that they can turn a profit from their primary business. This is also how we devolved into such a debt-driven consumption economy… because of the systemic demand for our debt.

Debt is not bad by nature. It is the natural essences of money, period! Money is debt. That's not a bad thing! But yes, because debt is the essence of money, bad debt leads to bad money.

And it's more than just securitized debt held by savers that brought us to this point. It is systemic in that our international trading partners like China stacked up our debt rather than settling trade imbalances by purchasing a tangible reserve asset on the open market with the left-over currency. It is the stacking of debt which allowed for the non-inflationary expansion of the US govt. (USG) consumption machine just like the stacking of MBS by savers allowed for the expansion of sub-prime and consumption-based debt. This led to a USG addicted to an artificially high rate of consumption which led to the necessity of QE once the budget deficit exceeded the trade deficit.

There is no need for bank deposits to be any more than the money we all earn and then spend within a normal period of a few months. That’s all of the money anyway. Think about it! And if no one is sitting on "money" (credit) for more than a few months, then mild inflation (like 2% p.a.) is not only inconsequential, but it becomes economically beneficial and desirable.

The inclusion of the savers' savings in this process only damages the savers disproportionately to everyone else. And it damages the savers more the more they save. Inflation "taxes" savers disproportionately. But not in Freegold. As I said above, Freegold is all about enabling savers with a realistic understanding of money and wealth… everything else flows from that. Money is not wealth, no matter how well it is managed.

Thinking about the bank runs of the 1930s in terms of fractional reserve banking is an interesting exercise. It certainly was a problem in 1933, and it was precisely this problem that was the reason behind the FDR confiscation—to stem the tide of bank runs. Today that kind of a bank run is a thing of the past. That's not to say it cannot happen, but that even if it did, everyone would get their money in the end, unlike the 30s. And that is because today the CB can create commercial bank reserves at will.

Opponents of fractional reserve banking (FRB) blame the banks and the practice of FRB for the shortage of reserves in the 30s. But I think that misses the bigger issue. If the system's store of value simply floated in value and was available to anyone at any time at the current price, the runs would have never occurred. They occurred precisely *because* money (credit) was denominated in the store of value, the system's ultimate reserves. It is the lending of credit denominated in, and redeemable at a fixed exchange rate for, tangible reserves that is the problem.

Today we have a better system. Floating gold as reserves behind the CB money (Eurosystem model) and the CB money (CB credit) as reserves behind the economy's money (commercial bank credit). So the ultimate reserves in the system float in value against everything else and float in price against the money, and are therefore available to anyone, anywhere, anytime.

Try to imagine the gold ounces at the banks in the 30s floating in value relative to paper dollars rather than being fixed in value. You might have a deposit of $X,XXX, but that number only references a fixed number of paper dollars, not a fixed number of gold ounces. In the case of a bank run, if everyone wanted to withdraw their deposits, perhaps preferring a withdrawal in gold, then the bank would do a self-evaluation and likely render over the requested deposits in dollars telling the customers to go and shop for the gold themselves. The price of gold would simply rise.

Back in July, Lee Quaintance asked me this: *"If debtors seek to borrow in the medium which they plan to spend (fiat paper money) and lenders seek to lend (save) only in a medium which they believe will maintain its purchasing power (gold), does not the entire borrowing/lending platform simply break down? This seems to be a manifestation of Gresham's Law, no? Can the spending and savings medium truly then be separated if no one is irrational enough to lend in paper money terms?"*

Truly, it is supremely ***rational*** to lend (grant credit) *only* in terms of paper units. It is likewise *irrational* to forsake the sublime paper unit avenue and opt instead to put your tangible reserves out on loan where they will then be subject to both devaluation and risk of non-repayment. Remember, and this is a key point, banks only require nominal performance. If a promissory note held by a bank devalues in real terms, the bank's liabilities devalue equally. So there is no loss to the bank through currency devaluation.

"For more about why FRB and time deposit maturity transformation are not the root of the problem—the root is simply the lending of the monetary reserve, a problem that would still exist even with Rothbard's 100% reserve banking—please see my Reply to Bron*. Here's a short excerpt:*

*** Spending Gold into the marketplace, whether by the owner or by a borrower, would tend to result in prices "that weigh more"--cost more Gold, that is.*

*** As ever more Gold is borrowed out of other people's savings to be spent into the economy, the*

Gold's purchasing power is lessened from what it otherwise would be...hurting those who have elected to hold their Gold instead of risking it by lending it out as a source of income.

[notice in the above that we have all the bad devaluation effects without a single bank entering the equation!]

*** For Gold to find its truest value, all savers must retain their Gold for their own use. Its properly retained value will more than make up for the foregone interest income. Gold must not be lent! [Gresham's law alone is adequate to achieve this.]"*

What about bank reserve ratios and capital requirements?

What about them? Haterz gonna hate, loverz gonna love, and central plannerz gonna plan, right? But that still doesn't change the essence of money. Credit/credibility exists within the economy in amounts that are unconnected to the capital or reserves at the banks. It is the banks' business to enable the fungible exercise (and circulation) of that already-existent credit whenever it shows up wanting to be exercised. That's how banks contribute to society.

A reader asked me a question about an article that someone posted in the comments. The title of the article is "The Myth of the Money Multiplier" but it could just as easily have been called "The Myth that Central Planners Actually Control the Size of the Money Supply through the Transmission of Monetary Policy".

Interestingly, the author of the article, Steve Keen, makes some of the same observations I am making here, like "In the real world, banks extend credit… and look for the reserves later" and "bank lending creates deposits… reserves are largely irrelevant." The term he likes for this is endogenous money, which is remarkably close to how I am describing that "money is credit" in this post. But even though he seems to understand money and banking very well, there's a vital ingredient missing from his money model which I think leads to faulty conclusions and prescriptions.

His point in the article is that Bernanke is now pushing on a string that is not going to translate into credit inflation or revive consumer demand. I agree. But his implied conclusion/prescription is apparently that, because "the textbook treatment of money in the transmission mechanism" (meaning how CBs purport to control commercial bank money creation) doesn't actually work the way other people say it does, we need to find a *new* way for central plannerz to constrain these banks gone wild and that we would have never gotten to the point of collapse if we hadn't let Capitalism run awry through an empirically unconstrained banking system.

So, while he understands "modern monetary theory" very well, he doesn't understand the wealth concept (unambiguous ownership of something tangible) and therefore he still equates money and wealth (along with most everyone else) which leads him to the conclusion that monetary reserves are the real money while "endogenous money" is just a problem of Capitalism that needs a new centralized regulation model. He sees "debt deflation" – a contraction in "endogenous money" which has been overextended due to the reasons I cited above – and concludes that the lack of an observable constraint on the banks (he doesn't see that banks are actually profit constrained in the absence of the systemic demand for debt securitization cited above) is responsible for booms and busts, including the

catastrophic bust we are still heading into today.

What I'm trying to say is that, because he doesn't have a full understanding of money (remember at the top of the post I proposed that you cannot properly understand money without also understanding the pure wealth concept), he draws the conclusion that the banking model is to blame, and also that deflation will be the outcome. I, on the other hand, conclude that the systemic *choice* to use debt as savings and reserves is the primary cause, and that there's nothing fundamentally wrong with the banking system. I also conclude that USD hyperinflation will be the outcome. More on that in a moment.

Anyway, my reader's question was this, first quoting from the article:

"M2 averaged about $7.25 trillion in 2007 ... bank loans for 2007 were about $6.25 trillion... if we consider the fact that reserve balances held at the Federal Reserve were about $15 billion and required reserves were about $43 billion, the tight link drawn in the textbook transmission mechanism from reserves to money and bank lending seems all the more tenuous."

If required reserves were $43 Billion and bank loans were $6.25 trillion does that mean the required reserve ratio was 0.69% (43/6,250), or to put it another way, that the money multiplier was 145 (6,250/43)? How can that be? Do banks have a capital cushion on top of reserves, which at 0.69% system-wide would be razor thin?

Is my thinking correct about the money multiplier being 145 in the example Keen cites. This would put the Reserve requirement ratio below 1%, effectively unconstrained. I am guessing this is possible because capital adequacy ratios are a better metric than the reserve requirement ratio?

I replied yes, you are basically correct, but I say "so what?" You are talking about the money multiplier, reserve ratios and capital adequacy requirements as if they are constraints. As I said, they are not. Banks are not lending deposits. They are not lending ***anything***. They are simply facilitating the exercise of credit/credibility that already exists in the economy. You earn credit, and then in order to exercise it you go to the bank which facilitates your desire to exercise your credit (purchasing power).

The problem is that some people who didn't have credit were facilitated anyway (sub-prime, for example), because the system today demands debt well beyond what banks would normally facilitate given that they are naturally profit constrained and would otherwise have to carry the debt on their books.

Who cares about the reserve ratio? The CB can create commercial bank reserves with the click of a mouse today. They can swap a bank's assets (promissory notes) with reserves, temporarily or permanently, in any amount, at any time. Commercial bank reserves were more important back in 1933 when they included gold coins. But today they are not. Just look at the changes since Steve Keen's 2007 example.

Today, required reserves are $107B and reserves held at the Fed are $1.5T, for excess reserves of $1.4T with an M2 of $10.2T. So what's the big deal? If your money multiplier of 145 and reserve ratio of 0.69% mattered, then today the problem is fixed! Today's multiplier, using your same math from above, is 6.8, down from your 145 in 2007. And your 0.69% reserving is back up to a very comfortable 14.7%

today. So problem solved, right?

Remember what I wrote in my first email?

"There is just what emerged (what is), the perspective from which you choose to view it, the conclusions you draw from that perspective, and how useful those conclusions end up being in the long run."

What conclusions were you drawing from that 2007 data and how useful did they turn out to be in 2012? If they were important, then the problem seems to be resolved, right? Or maybe the problem is something else. Maybe the problem isn't that the banks are unconstrained and don't know when to stop making loans.

Maybe the problem is that the insatiable systemic hunger for new debt as reserves/savings drove lending standards and interest rates down to the point of collapse. It's a little bit of a different perspective from Steve Keen's, don't you think?

Say what?

Since I'm already talking about Steve Keen, I want to take this opportunity to point out how the widespread misunderstanding of money and wealth leads to conflict, macroeconomic problems and flawed analysis. And the corollary to this point is that the emergent widespread understanding of these concepts that Freegold will naturally usher in will solve these same conflicts and problems.

In Nudge Nudge, Wink Wink, Say No More, Steve Keen, author of "Debunking Economics", debunked Say's law which, very roughly stated, says supply equals demand in the physical plane even with the inclusion of money. Or, perhaps, supply comes from demand while demand is supplied by supply which comes from demand created by supply. A circular logic no doubt, but profound nonetheless. From Wikipedia:

In Say's language, "products are paid for with products" (1803: p. 153) or "a glut can take place only when there are too many means of production applied to one kind of product and not enough to another" (1803: p. 178-9). Explaining his point at length, he wrote that:

> It is worthwhile to remark that a product is no sooner created than it, from that instant, affords a market for other products to the full extent of its own value. When the producer has put the finishing hand to his product, he is most anxious to sell it immediately, lest its value should diminish in his hands. Nor is he less anxious to dispose of the money he may get for it; for the value of money is also perishable. But the only way of getting rid of money is in the purchase of some product or other. Thus the mere circumstance of creation of one product immediately opens a vent for other products. (J. B. Say, 1803: pp.138–9)

Keen correctly notes that Say's Law is widely disregarded in economics today, so I guess it was an easy target to debunk. A common criticism of Say's Law is that it only applies to a simple barter economy, and that he didn't really understand money since he was apparently describing an economy devoid of the capitalist drive to accumulate wealth. But it seems to me that Say might have understood money

and wealth on a much deeper level than any of his critics.

I don't know, but let's take a closer look and you can decide for yourself. Here are a few excerpts I took from Steve Keen's paper debunking Say's Law. I tried to capture the essence of his argument here, but I'd still recommend reading the full article linked above.

Belief in Say's Law is a minority position in economics today. Those who adhere to it appear to believe that it is a self-evident truth that is misunderstood by modern economists of all persuasions, and that properly understood it is not only true, but the foundation of an accurate appreciation of the functioning of a market economy and the phenomenon of the trade cycle.

I concur with the majority perspective that Say's Law is fallacious, but not for reasons that make me a member of any defined majority in economics at large.

[…]

As Marx showed far better than did Keynes, the conditions under which Say's Law is correct are not those of a capitalist economy.

[…]

> Use-values must therefore never be looked upon as the real aim of the capitalist. Neither must the profit on any single transaction. The restless never-ending process of profit making alone is what he aims at. This boundless greed after riches, this passionate chase after exchange-value, is common to the capitalist and the miser; but while the miser is merely a capitalist gone mad, the capitalist is a rational miser. The never ending augmentation of exchange value, which the miser strives after, by seeking to save his money from circulation, is attained by the more acute capitalist, by constantly throwing it afresh into circulation. (Marx 1867: 151)

Say's 'Law' therefore, is not a recondite insight into the nature of a market economy, but evidence of a basic failure to comprehend capitalism.

[…]

While we 'do not consume money', people certainly do seek to 'conceal' (or accumulate) it. Though a capitalist will undoubtedly consume with part of the money he accumulates, it is not true that 'he may be considered as already asking for the merchandise which he proposes to buy with this money' since if he converts all his profit into consumables, he has failed to accumulate wealth – to be a capitalist.

As Marx puts it, capitalists are characterised not by an equality of their supplies and their demands, but by an *inequality*. This inequality is possible because … production produces a physical surplus that the capitalist hopes to turn into a monetary surplus:

> The capitalist throws less value in the form of money into the circulation than he draws out of it . . . Since he functions . . . as an industrial capitalist, his supply of commodity-value is always greater than his demand for it. If his supply and demand in this respect covered each

> other it would mean that his capital had not produced any surplus-value . . . His aim is not to equalise his supply and demand, but to make the inequality between them . . . as great as possible. (Marx 1885: 120-121)

[I want to pause here to point out that the "net" portion of a term I use for savers—"net-producers"—represents the "inequality" between what is produced by a saver and what he consumes.]

Thus as Marx emphasises in the immediate term and Veblen in the long term, a capitalist's supply, if he is successful, is greater than his demand.

[Also, a net-producer's production is greater than his consumption.]

There is an inherent inequality at the core of capitalist society, and the simple balance of Say's Law collapses.

[…]

Marx also realised that… money has an essentially new role in addition to those of medium of exchange and measure of account: it is now also a measure of accumulation. Failure in accumulation can now result in money being withdrawn from circulation, which in turn can lead to deficiencies in aggregate demand:

> money functions neither only as measure, nor only as medium of exchange, nor only as both; but has yet a third quality… It is very true that money, in so far as it serves only as an agent of circulation, constantly remains enclosed in its cycle. But it appears here, also, that it is still something more than this instrument of circulation, that it also has an independent existence outside circulation, and that in this new character it can be withdrawn from circulation just as the commodity must definitely be withdrawn. We must therefore observe money in its third quality. (Marx 1857: 202-03)

In this 'third quality', money is more than the mere lubricant for barter that Say perceived. It is also the form in which wealth is accumulated:

> The third attribute of money, in its complete development, presupposes the first two [measure and medium of exchange] and constitutes their unity. Money, then, has an independent existence outside circulation . . . as money, it can be accumulated to form a treasure . . . This aspect already latently contains its quality as capital. (Marx 1857: 216)

[…]

Expanding debt also becomes an essential characteristic of a growing economy, as Minsky realised… in the aggregate there had to be an inequality between income and spending if the economy was to continue growing in the context of a constant or rising price level:

> If income is to grow, the financial markets, where the various plans to save and invest are

> reconciled, must generate an aggregate demand that, aside from brief intervals, is ever rising. For real aggregate demand to be increasing, . . . it is necessary that current spending plans, summed over all sectors, be greater than current received income and that some market technique exist by which aggregate spending in excess of aggregate anticipated income can be financed. It follows that over a period during which economic growth takes place, at least some sectors finance a part of their spending by emitting debt or selling assets. (Minsky 1963 [1982]: 6)

[…]

All attempts to provide a formal expression of Say's Law rest on the same fallacious proposition that there is neither the desire nor the possibility to accumulate wealth for its own sake in a capitalist economy.

[…]

Therefore Say's Law – and Say's Principle, and Walras' Law, and all other concepts which portray the sum of all excess demands as zero – is thus a 'law' applicable only to a market economy without capitalists and the accumulation of wealth. We live in a market economy with capitalists and with the accumulation of wealth, and we will continue to live in such a society for the foreseeable future. Say's Law is thus irrelevant to the world in which we live. Rather than discussing Say's 'Law' any further, we should consign it to the dustbin of the history of economic thought.

Some interesting thoughts in there, huh? I think it's clear from this article that there's not much difference between money and wealth in his view. The "accumulation of wealth" which he says is capitalism means the accumulation of more and more money. And this, he says, leads to a supply glut and insufficient demand which leads to deflation and depression.

"if [a "capitalist"] converts all his profit into consumables, he has failed to accumulate wealth – to be a capitalist."

"production produces a physical surplus that the capitalist hopes to turn into a monetary surplus"

"If [a "capitalist's"] supply and demand in this respect covered each other it would mean that his capital had not produced any surplus-value"

Would a net-producer's demand equal supply if, in his "accumulation of wealth" he purchased Veblen goods and physical gold? Someone has to supply those hard assets and gold, right? Mr. Market and his price adjustments would, in this scenario, make "the sum of all excess demands equal zero" as all wealth accumulation would have to be matched by either new wealth production or wealth dishoarding by net-producers of the past.

"Therefore Say's Law… is thus a 'law' applicable only to a market economy without capitalists and the accumulation of wealth."

Using my definition of wealth, which I propose is a necessary element in understanding the reality of

money, this statement suddenly appears fallacious. I honestly wonder if Steve Keen would agree. Or does his disdain for (his Marxian idea of) Capitalism run too deep? I don't know. But enough about the wealth concept. Let's see if Say understood money.

Say wrote that "a product is no sooner created than it, from that instant, affords a market for other products to the full extent of its own value."

He's talking about the creation of credit, aka credibility, aka purchasing power. Imagine you've got a crazy inventor working for years on a contraption and everyone just laughs at him saying "that'll never work. It'll never fly." Then one day he finishes his project and it flies! It's going to change the world, and everyone applauds! He has instant credibility (purchasing power) that he didn't have before. And the world is also a richer place for it.

He may not yet have actual product units to sell, but he can certainly afford to immediately improve his standard of living while also funding the production of units of his new invention for sale to the marketplace. In fact, depending on how earthshattering his invention is, he may have more credit than he needs for his standard of living and business overhead. This is surplus value, which he is unlikely to spend until after he starts selling units.

At the point that he sells units which the public values higher than his cost of production plus the cost of his standard of living, he will start to accumulate wealth from that surplus value. But, in fact, the purchasing power used to accumulate wealth – the surplus value – was present long before he actually exercised it. Sure, he could have bought gold on credit as soon as his invention's success revealed his credibility, but that's not usually the way it's done.

It seems clear, at least to me, that the widespread misconception—and thereby the misuse—of the money and wealth concepts goes back centuries at least. And that this simple misunderstanding has led to some longstanding conflicts, major macroeconomic failures and entire schools of flawed economic analysis, some of which are reflected in the above paper. (See also my post The Debtors and the Savers)

I think it can be stated as simply as this: When a single medium is used as both money and wealth, it leads to a conflict between those who choose to accumulate wealth and everyone else. This applies to both hard and easy money systems. It's like FOA said, applying the money concept to gold coins was "not the best way to use gold, considering our human nature."

The accumulation of wealth need not be a drain on anyone. When viewed properly, it is apparent that the "wealth circuit", supplied and demanded only by those who accumulate and dishoard wealth, is isolated from the "money circuit" through the magic of Mr. Market and his price adjustments. It's only when we call money wealth, and wealth money, that we join the circuits creating conflict and crashes.

And my main message here is simple. No one *needs* to understand this for a change to take place. Because, when the current system crashes, what will change is how we view money and wealth. Everything else I talk about flows from that one change.

Hyperinflation

Credit requires some unit of reference. You could borrow an egg from your neighbor and you might say, "thanks, I owe you." If you happen to take that debt seriously, your unit of reference might be one egg. Money is essentially our shared use of a common reference point which makes credit fungible and allows it to circulate. This is what I wrote in Moneyness:

The pure concept of money is our shared **use** of some *thing* as a reference point for expressing the relative value of all other things. Money is the *referencing* of the thing, not the thing itself. As FOA said, money is "a value stored in your head!" Money is not something you save. "Money in its purest form is a mental association of values in trade; a concept in memory not a real item… the value is in your association abilities. This is the money concept, my friends."

Money is not something you save. Wealth is what you save. Yet money still needs something to reference. When hyperinflation occurs, it occurs not in money itself, but in that reference unit. It is true that, when ounces (or any other unit) of gold is used as the sole reference item, hyperinflation per se is unlikely because gold has that property of a relatively stable supply. But again, that's not the best use of gold because of its intrinsic salience as the tradable wealth item par excellence.

But hyperinflation is not just about the supply of the reference unit, it is more about its perceived value relative to everything else. Hyperinflation begins when the perceived value of that common reference point goes into free fall. This could hypothetically happen with something like gold if, say, aliens arrived and explained to us that exposure to gold was somehow harmful, perhaps limiting our lifespans to only one century. Then you might see something *like* hyperinflation as humans quickly devalued their golden reference point against all else. But again, I'm only talking about the hypothetical here to make the point that hyperinflation begins with the perceived devaluation (currency collapse) of the monetary reference point.

Today we use the US dollar as the common monetary reference point unit. The US dollar gets its value from price tags that list dollar amounts rather than from the cost of making a dollar. I realize that this seems paradoxical, or some kind of circular logic, but it's actually quite sublime, and it works!

It is true, however, that we only get full-blown hyperinflation, like we saw in Weimar and Zimbabwe, with government "fiat money". Circulating real money (bank credit!) all but disappears when full-blown hyperinflation takes hold. So you see, hyperinflation is not really about money. It is about the loss of confidence in our shared reference point, which is usually because it has been abused by the government, and which often leads to a vicious feedback loop of further abuse by the government.

It's a shame that the most efficient form of money ever devised by mankind has this downside, but I think you'll find that the risk of abuse is worth the innumerable benefits, especially once there is a systematic and foolproof way to protect yourself from the worst of it! And this is why Wim Duisenberg so proudly stated that the euro "is the first currency that has not only severed its link to gold, but also its link to the nation-state."

Tribal Life & Government "Fiat Money"

With the potential for abuse and the risk of hyperinflation, why do we keep returning to government "fiat money"? Why do we, the productive economy, lend to our Tribal Chieftain and Tribal Council enough of our credibility to allow them to print currency for the good of the tribe and then use that

currency as the reference point for money? Is it really forced upon us as some in the hard money camp proclaim? The answer is no, we demand it.

Since the beginning of time, man has been exploring and discovering the advantages of tribal life. Of course we must give up some measure of individual freedom to be part of a tribe, but in most cases the benefits have far outweighed the costs.

Given the current state of "tribal leadership" and "government money" in the US, I thought it quite timely to include a few posts from FOA which can be found here. They might even help us understand the outcome of this most recent election. Has the US really passed some disastrous tipping point of human desire for free stuff, or was this election just business as usual?

Trail Guide [FOA] (2/12/2000; 9:52:36MDT - Msg ID:25137)
Reality

Hello ORO,
Well, I knew that if I only asked, we would all receive! Boy did you deliver in ORO (Msg ID:25113).

Good stuff for everyone to read, my friend. You mentioned; """ The comments below - particularly those to Aristotle, are somewhat harsh. I hope this is taken in the spirit of friendly criticism."""

Sir, you can serve me (and probably everyone here) your "harsh" anytime. Waiter ,,,,,,,, I'll have a double order of that please! (smile)

OK, brace yourself ORO ,,,,,, a big plate of my "Trail" harsh coming up!

==========

You write:
-------There are consequences to the existence of a fiat currency and for the use of debt money for trade settlement. FIAT HAS NEVER BEEN THE CHOICE OF THE PEOPLE ACTING IN COMMERCE OF THEIR OWN ACCORD. Even when wildly popular, fiat money has not had a single instance when it had not been established by force - by laws imposing its use.----------

ORO,

On a larger scale there was always more to it than this. Human society has from the very beginnings formed tribes and picked sides against each other. When we are not battling nation against nation, we jockey for position within our own groups. Right down to "me and my neighbour against the three houses down the street. As a tribe ,,, as a nation ,,,,,, as a group ,,,,,, our war is really a human problem with each other and always has been. In better context; the problems are in the way we use our laws and governments to gain advantage over the next in line.

Whether through force (war) or democratic means, **we subject ourselves** to the order of governments. We rightly perceive that,,,,,, the order gained from this action ,,,,,,, the security of a group, overcomes the rights and property lost on an individual level that living in a tribe requires. It's been this way through the ages. It's a political process that has always had its in-house battles ,,,,, namely portions of

society try to circumvent their percentage of lost rights and property by maneuvering the rules (laws) in their favor. Yes,,,,,if I can gain the advantages of tribe life and still keep my "lost portions",,,,, I'm gaining wealth to the disadvantage of the group. Truly, the most obvious action of not paying your taxes,,,,, and that's only a small item when viewing the world battle as a whole.

So, how does this apply to money?

When you and others say """ FIAT HAS NEVER BEEN THE CHOICE OF THE PEOPLE ACTING IN COMMERCE OF THEIR OWN ACCORD """ ,,,,, this is true.

This is true, but this was never the thrust of the argument. The use of money in any context, fiat, gold or seashells, **has always entailed the use of borrowing and lending**... And as long as economies function at a profit, debts are made and paid back without argument. However, when the eventual downturn arrives, some portions (perhaps a large portion) of the owed wealth (debt) cannot be returned.

It's here,,,, at this point in tribal life,,,,,,, that all of the context from above comes into play. The "reality" of life on this earth is this: ,,,,,,Some portion of society will use their influence or control of the leaders to make their debts easier to pay. In fact,,,,, it's times 2 for that number of government influencers ,,,, because **even the ones that have debt owed to them will try to alleviate an impossible pay back situation to save the ones that owe them face.**

You see,,,,, tribal life and the human nature that comes with it ,,,,,,,, will not allow any money system to "completely" destroy the wealth of a good portion of society. Even if everyone is plainly shown that they are going to lose something ,,,,,,they would still opt for the good of the overall tribe. **This is why we return,,,, time and again to fiat monetary systems.** In the few examples where a gold system brings the harsh reality of loses to bear on a nation,,,,,, usually war is the result. Not a good outcome.

Yes, we can break gold into many small parts,,,,, 'stamp it into coins and circulate gold certificates as money. We can borrow it, lend it and also circulate gold bonds as the economy grows. It is the perfect "weights and measures" monetary system. Exactly representing our productive efforts in every facet of human endeavour. **But, when the losses mount, our tribal human tendencies will not allow us to support a government or banking system that forces these real losses on only a portion of the group. Never has,,,, and never will! Without this escape valve, we go to war ,,,,,, internally or on a world scale,,, so we all can share the loss,,, one way or another. As a human society of thousands of years,,, outside of war,,,,, we have learned to inflate our loses upon everyone as a whole,,,,, for the good of the keeping the whole from each others throats. Even to the point of a total loss of the current system,,,,, and all the destruction that entails for everyone.**

Yes, indeed,,,,,,,we will transition to the next fiat system from the dollar, when the time comes. Believe it!

Further:

For myself and other observers ,,,,, we know about "peace on earth" and live our life in this context but,,,, as a member of the world tribe,,,,,, and following our best interest,,,,,, **one must still arrange his affairs to shield their family from the "I'm going to get yours" times we live in.** Should we get our leaders to help us? Well, the leaders of this world can only be but a reflection of us as a whole. Yes,

many things are not right, but they can only strive to do what can be done, not what must be done.

Consider the dilemma:
If a small portion of society telegraphs thoughts that "if we cannot have our oil we will go to war",,,,,,,, how would you force them to not elect officials that ease their pain from a gold money system? What's right and what's wrong is not the issue,,,,,, it's what this present generation will live with that rules. If they will break the gold yoke, no matter what,,,, then why place gold on them? **Is it not better to at least free the "knight" (gold) for the good of those that would stand with him?**

During the period we are now entering,,,,,we can see all the ugly aspects of a fiat system that is failing its tribe. Look far and wide and witness the various groups ,,,, all jockeying for position as they use whatever influence they have to lessen their own private losses. If this had been a gold system, the outcome would be the same,,,,, as players force their leaders to lessen the gold debts that could not be paid. They would raise the price of gold and inflate their way out of it,,,,,, for better or worse ,,,, come hell or high water.

So, my friend (smile),,,,,,, as you can see,,,,, I completely agree with all of your post. Only, my trail is hiked with a different mind. "Another" mind set, if you will. We use the life experiences of man to dictate the best path to follow. As such,,,,,, Gold must not be part of any money system,,,,,, it must reside as a freely traded asset without debt or paper to resemble it. In this position ,,,,, its value can fully represent the ebb and flow of the affairs of man. And in doing so retain *the wealth of man as a holding of things*. Truly, the "Wealth of Nations" in the people's hands. We move forward by starting at the beginning of time.

We'll talk much about this and all the affairs of the world,,, including gold,,,, on the gold trail.

"We walk this new gold trail together, yes?" I hope to see everyone there when I return.

Trail Guide

Trail Guide (2/14/2000; 8:08:19MDT - Msg ID:25302)
Gold

ALSO: The point I was trying to make in #25137 (and the question I was asking) was this;
A full gold money system works during level and rising economic dynamics. It also works "VERY" well during a downturn. In fact it works "Perfectly" all the time! **It's the lending of money that creates debt, be it gold debt or fiat debt ,,,, and the failure of that debt during a downturn is what causes the pain.**

I ,,,,, we as gold bugs ,,,,,, most financial thinkers ,,,,, do not debate this point. The argument is that: If the pain dynamic (losses) of a financial downturn is not "Somewhat" shared by society as a whole ,,,,, the economic dislocation always intensifies until we go to conflict. (see my earlier post)

It's during the downturns that society in general will not tolerate a full gold system because it concentrates the losses upon their rightful owners. As such "these same" are usually "wiped completely out" and the fallout effects on the social and economic structure can be widespread

and very destructive to tribal life.

Again, history has proven, time and time again that humans will not allow the full (natural) effects of gold money ,,,,, if it threatens to create factions. They accept gold during long periods until conflict (internally political or externally war) forces a break in the gold bond.

We, as nations, will break the "gold bond" by calling for the shared pain of inflation. Whether we (as countrymen) understand the reasoning behind it or not; currency inflation (not price inflation) in the modern world is carried out until its debt destroys the current system ,,, thereby sharing all the pain of the losses before it. We then move into the next fiat system.

The question:

Is it not better for all ,,,, if we remove gold from the official currency structure by forcing derivatives failure and creating a free physical only marketplace,,,,, so as to keep "us" ,,,,,, ourselves ,,,,,, from controlling it through our politicians?

Through "legal tender laws" currently in place ,,, let's force us (ourselves) to continue to create debts only in paper. As such, "they" ,, "we" can manipulate the fiat as needed for society.

Does this not place gold in its rightful position of being a "real currency asset" as it was chosen to be used from the beginning of time? A private money <u>for trade and savings</u> that's outside the 'contract / debt' system. Your thoughts?

Trail Guide

Robert Mundell:
--------I think that legal tender is a very old institution. It certainly goes back thousands of years and legal tender is an institution, whether we like it or not is going to stay. ----------

Robert Mundell :
------There's no institutional mechanism by which we could ever duplicate the kind of financial system we have under a system that relied almost entirely upon gold. Of course you could always have a system that used a lot of paper that was in some sense convertible into gold. You could always find a price of gold that you could convert that paper theoretically into gold. **But I don't think anyone has thought in terms of <u>the enormous price of gold</u> that would be required in order to achieve that**.----------

Larry Parks:
---------George Soros says in his book Soros on Soros that the gold standard had to be given up because it did not make possible a lender of last resort. And says Soros, because financial markets are in his words "inherently unstable" you have to have a lender of last resort.-------

Trail Guide (2/14/2000; 18:20:51MDT - Msg ID:25335)
Freegold

Thanks for your reply, ORO.

My comments presume that readers have read our full posts.
Your major point, logic and comments that I got from your post (25310), followed by my comments:

ORO's POINT:
I pointed out that it is the existence of a "lender of last resort" that causes the debt boom

ORO's Logic:
It is obvious then, that had there not been a lender of last resort there would not have been a substantial credit crunch, because the lenders would not have taken the same risks they allowed themselves once a promise of bailout was given, and thus would have avoided the credit boom.

ORO's Comments:
The argument is false in that it is circular. (FOA note: I think he is referring to my logic?) The lender of last resort was there in the first place, the inevitable credit boom followed, the credit crunch followed - just as inevitable - and a further lender of last resort was needed. History shows that the credit policies of the BOE led to its bankruptcy before WWI and before the Fed was created. This was among the reasons for the argument for the Fed being pressed. All the previous lenders of last resort were tapped out and a new one was necessary. In 1929-1930 the Fed was tapped out and the gold standard obligation was abolished shortly after.

My (FOA's) Comments:
ORO, I cannot accept that a "lender of last resort" causes a debt boom. It presumes that a great portion of lending is done for reckless, uneconomic reasons. Yet, at the end of great expansions many projects that were considered "blue chip" in the beginning still go bad. Sometimes, the most necessary economic activity is curtailed because people's needs change during the course of life ,,, not to mention a recession. Thus changing business dynamics.

How many instances can we document where banks lent into real demand ,,,,,,, backed with the very best demographic patterns ,,,,, only to find the loan blow up from changing demand. Oil in the late seventies would be a convenient example for us (smile). People were breaking down the doors of the old "Texas Commerce Bank" in Houston ,,,,,,, all in an effort to finance hugely profitable petroleum projects. This was no flash in the pan, as the oil industry had a progressive expansion history of 15++ years before this. **Truly, a lender of last resort was the very last thing on their minds.** [FOFOA: Reserves were the last thing on their minds.] Later, even paper based on $10 producing reserves was trashed! Certainly there are many, many other examples,,,,,,,, most are of a more mundane, unglamorous nature, but fine examples.

Further:
Was this really circular thinking on our part? Did the Lender of last resort exist during the 'South Sea Bubble" or the "Tulip mania",,,,,, and did the "Black Plague" of Europe shut down a few sound financial systems then? I think gold was the norm in that period?

ORO, this portion of your thinking needs to include the other side of the lending aspect,,,,,, **people want and demand loans for sound, economically justifiable, profitable projects,,,, and they get them on sound lending principles.** [FOFOA: Real credit exists and then banks facilitate it] Still, some 90% of them can become only "at the margin" when demand changes. And typical of our human society, we all shift at once.

Truly, my friend, bank loans often fail because human events change the course of money dynamics ,,,,,, and it does so in a way that is beyond the vision of any lender. Be the lender you, me or a group of people such as a bank, large portions of deals go bad just as much from human affairs as from "over lending".

After all, the entire economic structure of the world is nothing more than a people dynamic ,,,,,,,,, **in the long run it's just too risky to bet one's physical gold on (huge smile)!** [FOFOA: from above – "Truly, it is supremely ***rational*** to lend (grant credit) *only* in terms of paper units. It is likewise *irrational* to forsake the sublime paper unit avenue and opt instead to put your tangible reserves out on loan where they will then be subject to both devaluation and risk of non-repayment."]

Yes, our present financial system gives the impression of total insanity,,,, but we are looking at the very "end of the timeline",,,, not how it began. It all starts with the very first loan and progresses until everyone has borrowed "too much", but no one wants the music to stop. Last resort lenders then become the norm because society will lose "across the board" if everything is "marked to the market". It is not a circle (smile) as it starts and ends with the currency system (gold or fiat) everyone demands to borrow into. It all ends in the shared pain of debt collapse as the debt is discounted to zero from price inflation ,,,, even if it's based on gold ,,,,,, gold that cannot be returned. Not much different from our present gold loan structure. We will move on to the next money system when this one ends.

If it were gold we started with? The banker would lend his gold only to find the same metal returned to his bank as a new deposit. The "society at large" would remove his franchise if he did not re-lend that same gold during "good times", "booming times" no less! Round and round the gold goes.

Reserve lending hits its limit and society demands the limits be raised again ,,, and again ,,, and again! Lender of last resort ,,,,,, or not.

In our modern world we must remove gold from the official money system, place it in a free market and people will use it as wealth money, not borrowing money. Then the fiat can come and go as the wind! Yes?

You agree now! I'm so very glad!

Trail Guide

Trail Guide (2/14/2000; 21:11:17MDT - Msg ID:25350)
Freegold

Elwood,

I have read much of Mises and even a few others. Actually, I completely agree with them that the Gold money systems of the nineteenth century worked very well. As such we do not fall into any of the groups that argue against that concept. Our problem is with people (smile).

In a Money and Freedom speech at a Mises meeting Mr. Joseph T. Salerno made this point:

-------Unfortunately, the monetary freedom represented by the gold standard, along with many other freedoms of the classical liberal era, was brought to a calamitous end by World War One.----------

Further, he stated:
------Within weeks of the outbreak of World War One, all belligerent nations departed from the gold standard. Needless to say by the wars end the paper fiat currencies of all these nations were in the throes of inflation of varying degrees of severity, with the German hyperinflation that culminated in 1923 being the worst.--------

My point (as an extension of earlier posts):
No country, however rich in gold or resources, can continue to fight a war once their money runs out! Consider ,,,,,,, You and your family as a country, a nation ,,,,,, you are under attack and have spent the last of your gold ,,,,,You will print money and continue the effort, no matter the inflationary costs,,,, come what may!

Many nations utterly failed to return to the original gold standard simply because they were mostly tapped out from the war. At the best, the richer, surviving countries would have taken a major economic hit by going back into a full gold system. All the eventual gold deals and non-deals were little more than a part of the progression of events that led us here today. All in an effort to keep from fully marking to the market the cost of a shared loss in war, defence and other financial failures.

There is not one person among us that ,,,,,,,,, if their family was completely broken from the war experience ,,,,,,,,,, would have asked for a return to gold. In full a honest context, millions would have starved in the process. The world opted to share the loss and spread it out as far and as long as possible.

The war experience is but one example of why society has such a hard time with an official gold system during times of stress. Over and over again we have seen where gold is the very best holding and defence against private and public financial loss. Yet, when large scale national loss threatens society as a whole ,,,,,, it's always the money system that receives the brunt of the demands for change. Society demands that whatever money system is in place at the time of stress be shifted so as to spread the burden amongst all. Is it right?,,,,,, is it just?,,,, I do not think so. But it is what we do and have done for a long time!

Today, if gold can be forced out of the official money system, it will be to the benefit of everyone during times of stress in the future. In times of war people spend the legal tender in commerce. Yet they save the food, liquor and necessities. A common currency of the world would be just such a necessity to hold as part of your wealth.

Trail Guide

Money versus Wealth

The essence of money is credit, which is a reflection of the amount of credibility in the economy currently being exercised and circulated. In reality, in fact, even if not in the textbooks, money is a reflection of ongoing and planned future production. Wealth, on the other hand, which is everything physical that is owned and possessed, is the embodiment of past production.

So here we have a very simple dichotomy. Money reflects present and future production while wealth ***is***, in fact, production from the past. But there's more. Money is an extremely useful, vital, and very powerful tool used by the Superorganism. But it is also used by those central plannerz. Price signals are what the Superorganism gets from money, and price signals are also what central plannerz try to control. Strangely, it is what we demand from them.

It is the very nature of our humanity that makes money a poor substitute for wealth when saving for an unknown future. And it is the nature of money itself that makes not understanding this simple view so widely destructive in the long run.

The fallacious premise that money and wealth are—or should be—one and the same (or at least managed to attain parity) is the flaw I mentioned at the top of the post "which, in and of itself, has set the two camps perpetually and unnecessarily at odds with each other."

The de facto abandonment of this premise in both camps is what I see coming. There is no need for anyone to convince the camps that they will abandon this premise. As ANOTHER said, time will prove all things. You cannot convince them of this. Only the unfolding of time can.

What you *can* do is consider – with a measure of intellectual integrity – the effects that will flow from a more realistic widespread view of the concepts of money and wealth. And, most importantly, how that view applies to you and how you use money and wealth/savings in your daily life.

Today, money is widely used as wealth, or at least as a measure of one's wealth. If you believe that the current system is not sustainable, perhaps even at the end of its timeline, it would be incongruent not to consider the implications of this simple change in widespread perception. Here are a few things ANOTHER had to say about it. I present these now because I find them to have enhanced meaning in the context of this post:

When an investment in stocks, bonds, bank accounts, CASH, businesses etc. is priced in US$ currency you are really holding the "intentions of providing value" locked away in the thoughts of another mind.

One day (it has already started) a type of nuclear chain reaction will occur in the currency markets as people start "unvalueing" the thoughts of others. Little by little all debts owed will be marked down.

The "wealth of nations" are held as "thoughts of value" not real value! And even these thoughts are "in debt" as they are owed to other nations. As it has always been, time moves the minds of people to change, and with this, the thoughts of value also change. In this day, as not in the past, the loss of paper value as a concept will destroy the very foundation of wealth that this economic system is built on. This drama has started and is well underway!

How can one know value in currency, when paper does not lie still? It moves at night, where no one can see, and this we hold to prove our worth? **Real things know not this paper value, for they hold tight in the earth. In this time, we do stand firm with value and watch as "thoughts of others**

change in the wind"!

Thinking ahead

There has been some debate recently in the comments about the functions of gold (and other less-salient items of tradable wealth) and currency as it relates to savers after the transition. It has been suggested that, because gold will finally be functioning properly, currencies (money) will become relatively stable and will therefore function as savings for the masses.

Here's what I think.

What will change is how we view money and wealth. Everything else flows from that. But it is not our change in view that is causing the transition. It is the other way around. The transition will cause a widespread change in view. What is causing the transition is the de facto failure of the present system.

In the future, I think that if you are saving for something known, especially something with a known currency price like a down payment or a car, you'll save currency or "money". But if you're saving for the unknown future, you'll apply your newfound understanding of the difference between money and wealth and you'll probably choose gold, the most salient and liquid of the tradable wealth items.

This view even scales up from the individual to the national or regional level. I think that short-term trade imbalances—due to known factors that are expected to be short-lived—will be recorded in currency or even debt terms. But structural or long-term imbalances will be settled in gold through the open market, effectively eliminating structural or long-term imbalances.

Gold is real, tradable wealth. Money is not wealth, no matter how well it is managed. You will understand this distinction in the future and you will act upon that understanding.

Today I hold gold for the expected revaluation, because the weight of gold that I find I can still buy because the former system is still functioning is so vastly disproportionate to the relative shrimp I am. But even after the transition, I expect that I'll still feel the amount of gold I possess is vastly disproportionate to my "size". So I expect that I will, at that time, apply my new understanding of wealth and trade some of my gold for other tradable wealth items that are better suited for display and enjoyment in life than gold.

There's a reason I keep mentioning other "hard assets" like antiques, fine art, classic cars and high-end real estate when talking about Giants today. That's because those items are the closest thing we have to "Freegold-like savings" today. And yet they are only accessible to the Giants because of their nose-bleed prices. But they are still quite inferior to Freegold. They are not as portable, durable or liquid as gold, but most importantly, they are not divisible like gold which, as FOA said, puts us shrimps "on equal footing" with the Giants!

Another recent debate in the comments was whether our central plannerz of the future will target consumer price inflation, monetary inflation or the price of gold to achieve stability.

Here's what I think.

I think that this whole question is somewhat "old paradigm" thinking. In the "new paradigm" I think I'd say that the real economy will manage the money supply since, as I proposed above, "money is a reflection of the amount of credibility in the economy currently being exercised and circulated."

Of course the monetary base will still be subject to abuse by governments in places where, unlike the Eurozone, the government retains ultimate control of the central bank. But like I said above, I think you'll find that the risk of fiat currency abuse is worth the innumerable benefits, especially once there is a systematic and foolproof way to protect yourself from the worst of it!

And remember, this is why Wim Duisenberg so proudly stated that the euro "is the first currency that has not only severed its link to gold, but also its link to the nation-state." I don't really think the euro architects came up with this ground-breaking idea because they thought they were smarter central plannerz than the Superorganism! ;)

In Conclusion

FOA: In this light we should know that our real things in life will not change all that much. Your tools, chairs, clothes and cars will remain yours. Houses and land, TVs and boats, all will retain the exact same "value" they always had. What will change is our ability to use our currency and paper assets as a medium to measure the "real value" that's always so inherent in these items, yet so well hidden in our perception of today. Yes, the currency price of things will greatly change, even as their "use value" moves little. Such is the nature of dying paper money systems. Such is the ending of a currency timeline!

Trail Guide

ARI: So you see, learning how the world works is all about each man coming to the understanding about the real wealth we all require to best ensure our survival. Knowing that Gold is the master proxy for our life's day-to-day and year-to-year shifting requirements for food, clothing, shelter, and energy, it simply makes more sense to gather in Gold for later use than to gather in clothes (that we may outgrow,) food (that may spoil,) houses which are more than our needs, or energy (that we can't store.) You see, time bears witness to this undeniable fact: Gold can be called wealth because it is an enduring wealth proxy in exchange for our life's needs. Currency, on the other hand, serves a specific modern economic purpose--to be borrowed and inflated in placation of man's immediate desires. It is not wealth, it fails as a proxy for the Gold it tries to immitate. Do not confuse the two.

Understanding how the world works is easy as soon as you understand the Wealth Hierarchy. Like this: Earn money/currency, buy what you need, save Gold, enjoy what life has to offer.

Real wealth. Get you some. ---Aristotle

ANOTHER: Sir, Thank you for reading my thoughts, as I do read yours! As in all life, "events make truths", not the words of Another. "time will prove all things" Thank You

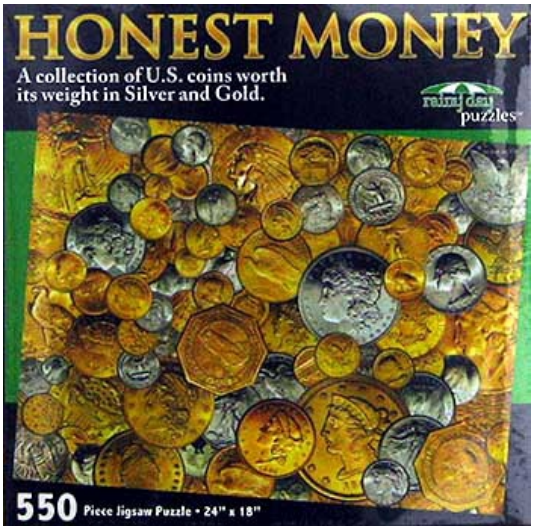
Sincerely,
FOFOA

*If you buy gold because of my blog without really understanding my view, I think it is possible that you will sell your gold "to lock in a profit" with the worst timing in the last 5,000 years. You don't want that on your headstone, now do you?

**For anyone who would like to read J.P. Morgan's full testimony before the House Bank and Currency Committee on Dec. 18 and 19, 1912, with cross-examination by Samuel Untermyer, for context, here is the full 55 page transcript of Morgan's testimony as archived by the Library of Congress: http://memory.loc.gov/service/gdc/scd0001/2006/20060517001te/20060517001te.pdf

Wednesday, May 25, 2011

The Return to Honest Money



What is honest money?

And what does it mean "to return to honest money?"

The most common answers to these questions have roots in the Austrian School of Economics, developed and made famous by the Austrian economists Carl Menger (1840-1921), Ludwig von Mises (1881-1973) and Friedrich Hayek (1899-1992). At least the most common answers today come from modern followers of the Austrian School. And modern practitioners will tell you that gold and silver are honest money, and that the way to return to honest money is to make money harder and/or to limit or eliminate fractional reserve banking.

But this meme of honest money has been canonized in such a simplistic way that its proliferation has become a bit of a credibility problem for those who promote it, and a source of confusion among their more credulous followers. So I have a slightly different take on honest money that I'd like to share with you.

My definition is that honest money is simply money that does not purport to be something it is not. I'm sure this doesn't seem any simpler than saying gold and silver are honest money, at least not on the surface. But I think that once we explore this subject a little more deeply, you'll find that mine is a much more elegant view of a very important topic.

As you will see, I'm not here to challenge the Austrian forefathers, Menger, Mises and Hayek. In fact, my view is perfectly compatible with theirs. Where it differs is with some of the modern gold standard advocates and promoters. In my view they have improperly reconstructed the money concept that was deconstructed by their forebears.

I realize that some of you already have your defensive wall up as you sense that I am about to attack the dogma with which you identify. But I invite you to bear with me here. The view is quite nice from

where I sit. As Aristotle wrote, "it is the mark of an educated mind to be able to entertain a thought without accepting it." Costata took some flak in the last post for asking the reader to suspend disbelief. But this is all he meant. Try thinking in terms of the principles and concepts I will present, and then you can apply that view to both my conclusions as well as your own established beliefs. This is the proper way to take in a new view, and then you can decide to either accept or reject it, but at least you will have seen it.

I do believe that we are in the process of returning to honest money. I believe this transition is necessary, natural and inevitable (unstoppable). And that last part is why I sit back as an observer, rather than getting all worked up as an activist. To my way of thinking, all you can do now is take action to preserve your own wealth as we roll onward into this brave new world.

Sell the Gold in Fort Knox?

Congressman Ron Paul is one of the leading proponents of a return to honest money and a return to the gold standard. He is also a firm believer in Austrian economics and has authored six books on the subject. There was a curious headline on Drudge the other day that read, "RON PAUL: Sell the gold in Fort Knox." Here's the link and a quote:

The next big question on the federal debt limit could be whether to start selling the government's holdings of gold at Fort Knox — and at least one presidential contender, Ron Paul, has told The New York Sun he thinks it would be a good move.

The question has been ricocheting around the policy circles today. An analyst at the Heritage Foundation, Ron Utt, told the Washington Post that the gold holdings of the government are "just sort of sitting there." He added: "Given the high price it is now, and the tremendous debt problem we now have, by all means, sell at the peak."

Mish then came out with a post saying that Ron Paul had not said this. He wrote that the Sun must have gotten it wrong:

People have been sending me an article all evening that says Ron Paul proposes selling gold to pay down the national debt. The article is nonsense and it took me all of 5 seconds to spot the error.

Somehow the New York Sun confused Ron Paul with some clown I have never heard of named Ron Utt, or the Sun misrepresented a statement Paul made.

[...]

Addendum:

I have read the Sun article several times now looking for other possibilities. The only other thing I can come up with is the possibility Paul may have said something to the effect of wanting the government to mint and sell more gold coins, but that does not equate to selling gold reserves to pay down debt.

Thus, I keep coming back to the thesis that the Sun is inadvertently mixing statements of Ron Paul with Ron Utt or the Sun has misinterpreted or worse yet, hugely misrepresented a statement Paul said.

I'm not trying to make a big deal out of this story, but I wanted to bring it to your attention because it got me thinking about Ron Paul and his honest money ideas. I'll admit that I'm not an expert on Ron Paul's ideas like Mish is, but I could certainly think of a few reasons why Dr. Paul might make that statement, not the least of which being that the gold that was nationalized in 1933 needs to get back into private hands.

Gold does the most good for any currency zone being in the private ownership of its productive citizens rather than the public ownership of big government. Remember that I, too, made a "crazy proposition" for the US gold with regard to Treasury's cash funding running out in Reference Point: Gold - Update #2. So I'm not sure Mish got this one right. Perhaps it will have been clarified by the time I publish this post.

Ron Paul and Honest Money

In any case, I know that Ron Paul advocates returning to "honest money," and to him that means some kind of a gold standard. So, because I'm not a Ron Paul expert, I did a little research. I wanted to get a general handle on what realistic and actionable ideas the gold standard crowd has today for returning us to their concept of "honest money," other than the simplistic dogma: ldo, gold and silver is honest money.

My hope is that if we can come to an understanding of the realistic propositions of the gold standard advocates, we can then compare them to Freegold in terms of practicality (feasibility), level of honesty (in terms of the money concept) and probability. And then I also hope to compare both concepts, gold standard and Freegold, to the words of the Austrian masters in their deconstruction of the money concept. One would expect them to be more consistent with the ideas of modern Austrian School hard money advocates than with the thoughts of the anonymous ANOTHER and FOA. I guess we'll see about that.

What I learned about Ron Paul from my research is that he sort of has two overlapping ideas about how to move forward into a gold standard. Over the last four decades he has somewhat gone back and forth between these two ideas based on the political climate of the time. The first one can be summed up as "End the Fed."

Ron Paul first became interested in economics in the early 60s when he read the warnings of Austrian economists predicting that the US would not be able to maintain the gold standard at $35/oz. because it was printing too much paper. He was skeptical but still interested for the next ten years while the gold price somehow stayed fixed at $35, despite what he had read. But then, in 1971, the Austrian economists were proved correct when the US suddenly abandoned the $35 gold fix and the entire gold exchange standard in one fell swoop.

This revelation is what got Ron Paul interested in politics, and even more interested in economics. During the 70s he became a proponent for ending the Fed and in 1976 he ran for congress and served (that time) until 1984. But then during the 80s and 90s we had "Paul Volcker saving the dollar" and Credibility Inflation, which changed the political climate somewhat. It was during this time that Ron Paul seems to have developed his second position, which can be summed up as "competing currencies."

Competing Currencies?

The idea with competing currencies, since the political will towards ending the Fed had pretty much dried up in the 80s, was to make it legal for gold and silver to trade as currency. With gold and silver contract settlement supported by the courts, "obviously" (presumably) they would win out over fiat in the currency competition of the free market.

It was during this "competing currency phase" in the 80s and 90s that Ron Paul spearheaded the American Eagle gold bullion program by presenting the idea to Reagan's Gold Commission which led to the Gold Bullion Act of 1985. You might remember the video I used in my Indicium post that was a 1983 debate between Ron Paul and Fed Governor Charles Partee. In it, Congressman Paul argues for the gold standard while Partee explains the value of a ***floating*** gold price:

In the video Partee said that he wanted the Gold Eagle coin as an "indicium of public attitudes toward financial conditions in the country" and that "you destroy that 'indicia value' when you have a gold standard." What do you think? Does this sound at all like Robert Zoellick's recommendation to use gold as a "reference point?"

Indicia—plural for indicium—comes from Latin for "sign," "clue" or "indication." In law it is sometimes synonymous with "circumstantial evidence." Partee elaborated saying he wanted gold to be an "indicator" and therefore the price needed to "vary" [Me: float].

Here's the clip as I posted it, set to start at 19:30 referencing the following two minutes:

Gold versus Discretion: Ron Paul Debates Charles Partee

I imagine that Ron Paul viewed the American Eagle gold coin program as merely a step in the right direction. But when he spoke of allowing a gold-backed currency to compete with the dollar, he was not necessarily talking about physical gold coins circulating. He was more interested in a paper or electronic currency that would be fixed to gold by weight, just like Bretton Woods, but redeemable to anyone, and possibly run by a private enterprise like American Express (which he mentioned).

His idea was that as long as you allowed the courts to enforce contracts essentially denominated in gold by weight, this hard currency would win out in the free market. Here is a clip from a 1995 interview with Ron Paul in which he explains that there is "no way they are going to go back on the gold standard now" and eschews the idea of a Central Bank sponsored gold standard. So the way he wanted to address that reality was to legalize a "parallel standard" that would allow the use of a private gold standard in the marketplace. It is set to start at 4:50 and my reference runs for five minutes until the end of this segment:

Ron Paul - Honest Money, 1995 (Part 2 of 4)

At 7:55 is where Ron Paul mentions Amex as the host of a possible private market money, backed by gold, and also backed by the government guaranteeing the fulfillment of contracts denominated in this hard, free market money. From there he is prompted by the interviewer to talk about money as "wealth". This is a key distinction that the modern hard money movement does not understand: the

distinction between ANY circulating transactional currency and wealth.

FOFOA's Dilemma

There will be much more on this later, but very quickly I'd like to share with you a new "dilemma" coined by one of my readers. It is in the spirit of Triffin's dilemma which I wrote about in my post coincidentally titled Dilemma. The fullness of *this* post will hopefully explain the following in detail, but here it is in short, from my South African friend calling himself The Motley Fool:

FOFOA's dilemma: When a single medium is used as both store of value and medium of exchange it leads to a conflict between debtors and savers. FOFOA's dilemma holds true for both gold and fiat, the solution being Freegold, which incidentally also resolves Triffin's dilemma.

Yes, thank you MF! This *must* be viewed in the context I laid out in The Debtors and the Savers. It is not only important, it is the key that unlocks the view. There is an interesting nuance in modern society that many miss. And it is that there is a significant number of people that are both debtors *and* savers. They have loads of debt through their mortgages and credit cards, but they also have saving in their IRAs, company 401Ks and union pensions. These camp-straddlers, on average, have a zero net-worth as their debt cancels out their savings. But they are useful, conceptually, in viewing how the future monetary and financial system will work.

Today we denominate both transactions and savings in dollars: the dilemma! So the dollar's collapse, today, will wipe out both their savings *and* their debt. Net-worth will remain zero. Remember that this is a conceptual exercise, a thought experiment to help you see. Now if you take the deflationists' view you must imagine their savings being wiped out but their debt remaining. They will be broke and owing. And somehow, the deflationists think, this will keep the dollar not only functioning transactionally, but make it even stronger.

Okay, here's the meat of the thought experiment. I want you to imagine the opposite; that these debtor/savers had their debt wiped out, but their savings remained intact. So their net-worth would go from zero to high, and their lifestyle would improve. How would this affect the bankers? That's right, it would not make them happy. And this is exactly how Freegold works to keep the currency honest and the banks chained to prudence. More on this in a moment, because I can hear some of you screaming disbelief.

Back to Ron Paul

So during the 80s and 90s the idea of ending the Fed had lost some of its political appeal and Ron Paul went for the more Libertarian idea of letting the people choose their own money in a free market. But then, lately, the Fed has been taking more popular heat, so Ron Paul has gone back in that direction with the 2009 release of his book titled 'End the Fed'. But even so, Paul is still hedging his position with the competing currencies idea because he is smart enough to know that you can't just end a 100-year monetary tradition without some seriously disruptive economic and financial consequences for which he obviously doesn't want to be blamed.

Here is Ron Paul in 2009, prior to the release of 'End the Fed', talking about competing currencies. And he's talking about a hard currency to compete **with the Fed's dollar**. This is obviously a secondary idea

and a hedge to the popular "End the Fed" idea.

Ron Paul: Gold Standard 1/30/09 Fox Business

Here's a little bit of the transcript, beginning at 1:25:

Ron Paul: *...and now we have a bigger problem. The transition would be pretty tough, and I've written and talked a lot about this and you'd have to devise a system where there would be a transition where maybe* ***you could have a gold standard competing with a paper standard and then obviously gold would win out****.*

Reporter: *Well sure.*

Ron Paul: *People would eventually go to gold because the paper, we're getting down to the bottom right now. The last thing before they really rush to gold is the Treasury bill.*

[...]

Reporter: *This is a silver certificate that was issued, I guess they stopped issuing it about thirty, forty years ago something like that. But is this what you are envisioning? ...there it says, "Silver certificate for gold or silver." Is this what you want again?*

Ron Paul: *To some degree, but there's been a lot of writings about how you might do this in the private market and not have a government monopoly, because* ***we did have shortcomings in our gold standard because we had bimetallism and we had artificially fixed prices between gold and silver. You don't want that, you either have to be on a gold standard or a silver standard****, but you could... Hayek has written about baskets of currencies and having this work in the private market. A competing currency could be private but, yes, eventually what you'd want to do, a lot of people say, "Oh we don't want no gold, we can't carry all that gold around in our pockets."*

Reporter: *Right.*

Ron Paul: *No, I think your point that you're making is right. You're still going to have certificates or you're going to have electronic entries. There are people today who are trying to promote this idea through electronic gold, but the problem is the legal tender laws force us to use dollars in all settlements, so one of my goals in Washington to move in that direction would be to repeal legal tender laws. Actually, all we need to do is obey the Constitution because it's still very clear it hasn't been repealed that only gold and silver can be legal tender. Believe it or not, they don't even obey the Constitution anymore.*

Two Monies

I couldn't agree more with Ron Paul above where he said, "we did have shortcomings in our gold standard because we had bimetallism and we had artificially fixed prices between gold and silver. You don't want that, you either have to be on a gold standard or a silver standard." What he's talking about is a fundamental mistake that was made in the Coinage Act of 1792 that haunted the American money system on a few occasions over the next 200 years. From Ron Paul's book, The Case for Gold:

The Coinage Act established a bimetallic dollar standard for the United States. The dollar was defined as both a weight of 371.25 grains of pure silver and/or a weight of 24.75 grains of pure gold—a fixed ratio of 15 grains of silver to 1 grain of gold. Anyone could bring gold and silver bullion to the Mint to be coined, and silver and gold coins were both to be legal tender at this fixed ratio of 15:1. The basic silver coin was to be the silver dollar, and the basic gold coin the 10-dollar eagle, containing 247.5 grains of pure gold.

The mistake was price-fixing the two metals to each other, and this error cost the US Treasury a lot of gold 100 years later, leaving it to be bailed out by none other than JP Morgan. Now I want you to pay attention to this recurring concept of **two monies**, be it gold and silver erroneously price-fixed, or Ron Paul's hard currency competing with (floating against) the Fed's dollar. This is an important concept that will keep coming up, so I just want to draw your attention to it at this point.

End the Fed?

Even though Ron Paul is clearly a practical thinker, he is also a politician who enjoyed a groundswell of support in 2008 from the "End the Fed" crowd. Here is the opening of a 2009 speech to the US House of Representatives in support of the Federal Reserve Abolition Act in which Paul implored Congress to end the Fed and reinstate the gold standard, without offering much elaboration on how that would happen:

Madame Speaker, I rise to introduce legislation to restore financial stability to America's economy by abolishing the Federal Reserve…

…Abolishing the Federal Reserve will allow Congress to reassert its constitutional authority over monetary policy. The United States Constitution grants to Congress the authority to coin money and regulate the value of the currency. The Constitution does not give Congress the authority to delegate control over monetary policy to a central bank. Furthermore, the Constitution certainly does not empower the federal government to erode the American standard of living via an inflationary monetary policy.

In fact, Congress' constitutional mandate regarding monetary policy should only permit currency backed by stable commodities such as silver and gold to be used as legal tender. Therefore, abolishing the Federal Reserve and returning to a constitutional system will enable America to return to the type of monetary system envisioned by our nation's founders: one where the value of money is consistent because it is tied to a commodity such as gold. Such a monetary system is the basis of a true free-market economy.

In conclusion, Mr. Speaker, I urge my colleagues to stand up for working Americans by putting an end to the manipulation of the money supply which erodes Americans' standard of living, enlarges big government, and enriches well-connected elites, by cosponsoring my legislation to abolish the Federal Reserve.

Today it seems that Ron Paul is publicly more guarded with his 'End the Fed' specifics, but he wasn't always that way. In the following paper, Murray Rothbard (1926-1995) describes Ron Paul's ideas during his first stint in Congress (1976-1984) which included liquidating "the Fed's gold" (perhaps not

so far off from the recent statement Paul reportedly made to the New York Sun about liquidating Fort Knox):

Rothbard: *Abolition of the Federal Reserve would mean that its gold supply now kept in Treasury depositories would have to be disgorged and returned to private hands. But this gives us the clue to the proper definition of a gold dollar. For in order to liquidate the Federal Reserve and remove the gold from its vaults, and at the same time tie gold to the dollar, the Federal Reserve's gold must be revalued and redefined so as to be able to exchange it, one for one, for dollar claims on gold. The Federal Reserve's gold must be valued at some level, and it is surely absurd to cleave to the fictitious $42.22 when another definition at a much lower weight would enable* ***the one-for-one liquidation of the Federal Reserve's liabilities as well as transferring its gold from governmental to private hands****.*

Let us take a specific example. At the end of December 1981, Federal Reserve liabilities totaled approximately $179 billion ($132 billion in Federal Reserve notes plus $47 billion in deposits due to the commercial banks). The Federal Reserve owned a gold stock of 265.3 million ounces. Valued at the artificial $42.22 an ounce, this yielded a dollar value to the Federal Reserve's gold stock of $11.2 billion. But what if the dollar were defined so that the Federal Reserve's gold stock equaled, dollar for dollar, its total liabilities—that is, $179 billion? In that case, gold would be defined as equal to $676 an ounce, or, more accurately, the dollar would be newly defined as equal to, and redeemable in 1/676 gold ounce. At that new weight, Federal Reserve notes would then be promptly redeemed, one for one, in gold coin, and Federal Reserve demand deposits would be redeemed in gold to the various commercial banks. The gold would then constitute those banks' reserves for their demand deposits. The abolition of Federal Reserve notes need not, of course, mean the end of all paper currency; for banks, as before the Civil War, could then be allowed to print bank notes as well as issue demand deposits.

This plan, essentially the one advocated by Congressman Ron Paul (R.-Texas)*, would return us speedily to something akin to the best monetary system in U.S. history, the system from the abolition of the Second Bank of the United States and the pet banks, to the advent of the Civil War.*

Rothbard then proceeds to expand a bit on Ron Paul's early plan, taking it even further, which might set off a few warning bells amongst some of my fine readers:

We could, however, go even one step further. If we were interested in going on to 100 percent reserve banking, eliminating virtually all inflation and all bank contraction forevermore.

[...]

To go over immediately to 100 percent gold, the dollar would be newly defined at 1/1,696 gold ounce. Total gold stock at the Federal Reserve would then be valued at $445 billion, and the gold could be transferred to the individual holders of Federal Reserve notes as well as to the banks, the banks' assets now equaling and balancing their total demand deposits outstanding. They would then be automatically on a 100 percent gold system.

From the standpoint of the free market, there is admittedly a problem with this transition to 100 percent gold. For the Federal Reserve's ***gold would be transferred to the commercial banks up to the value of their demand deposits by the Federal Reserve's granting a free gift of capital to the banks by that amount****. Thus, overall, commercial banks, at the end of December 1981, had demand deposits of $317*

billion, offset by reserves of $47 billion. A return to gold at $1,696 an ounce would have meant that gold transferred to the banks in exchange for their reserve at the Federal Reserve would also have increased their reserves from $47 to $317 billion, via a writing up of bank capital by $270 billion. ***The criticism would be that the banks scarcely deserve such a free gift****, deserving instead to take their chances like all other firms on the free market. The rebuttal argument, however, would stress that, if a 100 percent gold requirement were now imposed on the banks,* ***their free gift would do no more than insure the banking system*** *against a potential holocaust of deflation, contraction, and bankruptcies.*

Getting to Hard Money

As I have mentioned, Ron Paul's honest money ideas have evolved since these early days. In fact, in many ways he is quite a bit closer to Freegold today than he was in the early 80s. He is still stuck to the idea of a fixed price for gold, but he seems to have evolved from a one-time government price-fixing to more of a market-based "decision" on how high the price of gold should be fixed. He still wants to denationalize the US gold hoard and get it into circulation, but he seems to have evolved to more of a Hayekian competition of privatized currency, which begs the question of how to denationalize the gold.

Basically, it seems that over the last 30 years he has evolved his ideas from strictly "end the Fed and institute a new gold standard" as described by Rothbard above, to a more measured approach of "allow a competing currency to circulate which will (presumably) win the day and weaken the Fed and lead to its end." But even still, I think Rothbard's description above reveals some important issues that are still lacking clarification; issues that I have written about on this very blog.

For one thing, as I have written several times, **the Fed does not own the US stockpile of physical gold**. It is a common misconception, even among some scholars, that in 1933 the gold was taken *by* the Fed when, in fact, it was taken ***from*** the Fed and placed in collective ownership via the United States Treasury. The gold had previously been base money inside the banking system (the Federal Reserve System) and was removed from the Fed and placed in the Treasury. In fact, today the Fed is custodian of only 5% of the Treasury's gold (418 m/t). The rest (7,715 m/t) is in the custody of the US Mint, which is part of the Treasury Dept., held in Fort Knox, West Point and Denver. So ending the Fed hardly implies the necessary denationalization of the gold.

(On a side note, I just noticed that Gary North came to Ron Paul's defense in saying the US should sell its gold to pay down the debt. Gary says Ron Paul is right, and he ends his short piece with this: *"The gold bugs honestly trust the Federal government to restore a gold standard someday. There has not been one since since 1933 that any government on earth will do this, but somehow, the gold bugs believe, it will do it in the future."*)

A few other thoughts that are addressed here at FOFOA but not above, and not in the hard money circles of today, are how do you define gold? Should we include paper gold like Bullion Bank liabilities, futures contracts, mining forward sales and ETFs in the new gold standard? And how do we define the link between the dollar and gold? How do we fix the price and then defend that fixed price? In the past we did that by running down the gold reserves from 22,000 tonnes to 8,000 in 20 years. And lastly, how will we transition from the dollar being the global reserve currency, held in bulk overseas, to defending a new fixed price of gold in dollars? These are tough questions, and I think I have a few of the answers.

Fractional Reserve Banking

There is another angle to Ron Paul's honest money ideas that deals with fractional reserve banking (FRB). There is a debate within the Austrian/Libertarian movement between those that say FRB should be illegal in a Libertarian society and those that say we should just institute a "gold standard" and let the free market take care of the FRB issue. Paul is Rothbardian in that he falls on the side of making it illegal. They believe that FRB (for demand deposits) as well as borrowing short and lending long (for time deposits) is fraudulent and creates the Austrian Business Cycle of booms and busts. You can listen to the very beginning of this for a quick view of the debate from Walter Block, another Rothbardian. And from Paul's End the Fed:

Rarely do people ask what the fundamental source of instability really is. For an answer we can turn to a monumental study published in 2006 by Spanish economist Jesús Huerta de Soto.[1] *He places the blame on the very institution of fractional-reserve banking. This is the notion that depositors' money that is currently in use as cash may also be loaned out for speculative projects and then re-deposited.*

[...]

The institution of fractional reserves mixes these two functions, such that warehousing becomes a source for lending. The bank loans out money that has been warehoused — and stands ready to use in checking accounts or other forms of checkable deposits — and that newly loaned money is deposited yet again in checkable deposits. It is loaned out again and deposited, with each depositor treating the loan money as an asset on the books.

In this way, fractional reserves create new money, pyramiding it on top of a fraction of old deposits...

This is obviously a problem, but I'm not going to spend much time on this FRB issue because there is a very simple and elegant solution that the remainder of this post will explain. Do you remember earlier when I drew your attention to the recurring concept of "two monies," be it gold and silver bimetallism or Ron Paul's hard currency competing with (floating against) the Fed's dollar? Well, we can apply this "two monies" concept to the term "fractional reserve banking" as well.

In this iteration of the concept, the "fractionals" are the easy paper notes circulating as currency and the "reserves" are the store of value for those paper notes. We solve the issue by simply cutting the parity fix between the two and allowing them to float in value against each other. Fractionals can then always be exchanged for an equal value of reserves and vice versa, but the floating reserves are never lent. More on this concept in a moment.

The debate mentioned above within the Austrian/Libertarian community boils down to a free market solution versus a government dictate against FRB. But either way, all Austrian Economists agree that the real issue is credit expansion, which is at the heart of one of Mises' greatest insights – the Austrian business cycle theory (ABCT).

Briefly, ABCT blames the boom-bust economic cycle on *fractional-reserve banking*, or the expansion of credit without an actual act of saving by someone in the economy. When credit is expanded beyond reserves, the resulting drop in interest rates is artificial (i.e. not due to actual increase in loanable funds). This sets in motion an unsustainable boom period of malinvestment and erroneous capital

consumption that sows the seeds of the inevitable bust. This process is supplemented by government intervention to protect privileged bankers from being "caught" short by the market and allows credit to expand far more than it would without such intervention. This practice of absolving privileged bankers of their legal obligations via intervention was institutionalized in 1913 with the creation of the Federal Reserve.

And an understanding of ABCT provides the context for understanding why Freegold is unfolding. Freegold simply offers a different way of controlling credit expansion that is more effective than the modern Austrian suggestions of making money harder and/or limiting or eliminating fractional reserve banking. There is no need for all that convolution, just separate the store of value so it cannot be fractionalized and then non-productive credit expansion will be as limp as a eunuch (which comes from this comment by yours truly). Snippet:

But debt itself is not the cause of our problems today. Today we have a situation where the vast majority of excess production value (excess capital) is enabling massive amounts of global malinvestment through new debt creation. That has peaked and is now contracting. But the problem is not the debt itself. The problem is the enabling effect of excess capital not having ***a viable alternative that floats against the currency****. The problem is the lack of the adjustment mechanism of Freegold.* ***There is no viable counterbalance against uncontrolled debt growth today. So we are only left with credit collapse and hyperinflation of the monetary base to clear the malinvestment from the system****.*

It is easy to blame this on debt as a principle, but unless you don't mind being wrong, there are some deeper explanations out there. Debt under Freegold will not reach such destructive levels. "Easy money" thinkers may or may not get their debt-free money, but if they do they will suddenly realize the flaw in their reasoning. Oops! ***That it can only have expandable value (needed for the welfare state) if producers are willing to hold it while it expands.*** *Without that, socialist welfare expansion will simply dilute the value of the currency and be as limp as a eunuch.*

Sidebar:

For more about why FRB and time deposit maturity transformation are not the root of the problem—the root is simply the lending of the monetary reserve, a problem that would still exist even with Rothbard's 100% reserve banking—please see my Reply to Bron. Here's a short excerpt:

** Spending Gold into the marketplace, whether by the owner or by a borrower, would tend to result in prices "that weigh more"--cost more Gold, that is.

** As ever more Gold is borrowed out of other people's savings to be spent into the economy, the Gold's purchasing power is lessened from what it otherwise would be...hurting those who have elected to hold their Gold instead of risking it by lending it out as a source of income.

[notice in the above that we have all the bad devaluation effects without a single bank entering the equation!]

** For Gold to find its truest value, all savers must retain their Gold for their own use. Its properly retained value will more than make up for the foregone interest income. Gold must not be lent! [Gresham's law alone is adequate to achieve this.]

And for a brief explanation of how Freegold-RPG is different than what we have now, see How is that different from Freegold?:

…it will be stable because of two main factors:

1. SUPPLY - Gold will trade on a stable supply of above-ground physical gold in the absence of external influences like "paper gold" (Bullion Bank "BB" liabilities that can be created on demand by a mere book entry on a BB balance sheet, etc.).

2. DEMAND - Gold will also trade on a stable demand due to the global clarity that will emerge as to gold's best and highest function—being only a physical wealth reserve asset and nothing else.

How we get there is easy to visualize. As the physical reserves within the BB system are all moved into allocated accounts, at some point the remaining claims will simply have to be cash-settled. At that point all paper gold markets will cease to exist and all that will be left is the stable supply of above-ground physical gold in the absence of external inflatable (or deflatable) influences.

Two Monies – The Separation of Monetary Roles

If you would like, you can think of my "two monies" concept as "the recurring duality of money" because it will recur throughout this post as we deconstruct the money concept. What we'll find is that even with many *potential* monies in play, we'll always naturally end up with two that attain "monetary status" in different **time-related** roles through the forces of regression, the network effect, game theory's focal point and a dash of legal tender dictate.

Back in October of 2009 I wrote a series of posts called Gold is Money.

Gold is Money - Part 1
Gold is Money - Part 2
Gold is Money - Part 3

In this series I introduced the concept of the separation of monetary roles into different media, not fixed at parity to each other. It's like saying "fiat is for earning and spending while gold is for saving." Or you could even say "silver is for spending and gold is for saving" as Ender likes to say. It really doesn't matter what medium will win out for the spending role, but as you will see, the winner can be reliably predicted using the concepts mentioned above.

To some of my readers this revelation was like a light bulb suddenly lit. For others, this idea became a real barrier to understanding what I was writing. So in this post I'd like to take another look at the necessary separation of the monetary functions from a new angle. Hopefully this new perspective will add a few more into the "light bulb" group. But first, here are a few excerpts from Gold is Money.

From Part 1:

Functions of Money

"Money", as it is understood today, has three main roles. The late Dr. Willem F. Duisenberg, former President of the ECB, in his famous acceptance speech for the International Charlemagne Prize in 2002 stated it well...

> What is money? Economists know that money is defined by the functions it performs, as a means of exchange, a unit of account and a store of value.

And from FOA in that same post:

Owning wealth aside from official money units is nothing new. Building up one's storehouse of a wealth of things is the way societies have advanced their kind from the beginning. What is new is that this is the first time we have used a non wealth fiat for so long without destroying it through price inflation. Again, a process of using an unbacked fiat to function as money and building up real assets on the side. Almost as if two forms of wealth were circulating next to each other; one in the concept of money and the other in the concept of real wealth.

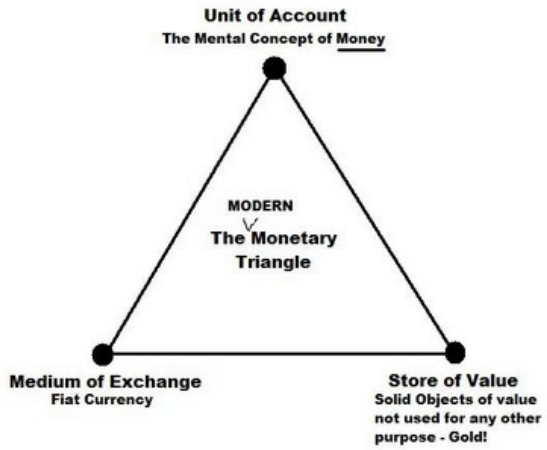
This trend is intact today and I doubt mankind will ever pull back from fiat use again. Fiat used solely in the function of a money concept that I will explain in a moment.

Understanding all of this money evolution, in its correct context, is vital to grasping gold's eventual place in the world. A place where it once proudly stood long ago.

All of this transition is killing off our Gold Bug dream of official governments declaring gold to be money again and reinstitution some arbitrary gold price. Most of the death, on that hand, is in the form of leveraged bets on gold's price as the evolution of gold from official money to a wealth holding bleeds away any credible currency pricing of gold's value in the short run.

To understand gold we must understand money in its purest form; apart from its manmade convoluted function of being something you save.

In Part 1 I also introduced the Modern Money Triangle:



And I concluded with this:

The human concept of money is changing whether we like it or not. It is being torn apart. Gold, as a wealth reserve and wealth asset, will exist and trade parallel to the world of fiat, the world of credit and debt. Producers and savers will finally have the option to switch tracks so to speak. To get on a parallel track that avoids the inevitable collision with the debt-hungry collective their savings have always faced.

And as we pass through this phase transition, as gold switches from the transactional track to the wealth-reserve track, it will take on a whole new meaning... and a whole new value! The non-dollar part of the world already knows this. This is why they are buying gold now!

A Flaw

In Part 2 I explained how the evolution of the money concept over maybe 2,500 years led to what we think of as money today: the three functions all tied into one. And I also explained how the modern bastardization of the money concept led to a fatal flaw in today's system:

This system of lending a purely symbolic monetary CONCEPT instead of lending real wealth requires the perceived value of that CONCEPT to remain relatively stable or else the entire banking system will collapse. It is to this end that bankers, governments, politicians and economists always try to entangle (think: forced quantum entanglement) gold into the money system and control (manage) its value in order to keep their CIRCULATING DEBT CONCEPT viable and valuable.

This is the problem with the architecture of the dollar, versus how all non-reserve fiat currencies will work in a free gold environment. The dollar must cheat in order to retain any illusion of stability. There are other ways for a fiat to remain stable. Responsible currency management is one. And in a system where the value of all real things (including gold) float freely against the parallel universe of fiat currencies, this will be how they will work.

When the dollar became a mere concept in 1971, so did all fiat currencies in the world. Their only value lies in the tradable value associations we give them, based on what can be purchased in the parallel universe of real things. But because we have been encouraged to save these symbolic debt concept units in lieu of anything with real value, a mismatch has grown to epic proportions whereby not even a fraction of these debt units can be traded back into the real economy at anywhere near today's prices.

We have lent, borrowed, saved, sliced, diced, sold, resold and insured so many units of a mere CONCEPT while neglecting to pay attention to the comparative size of the real economy with which the CONCEPT must run in parallel.

I went on to explain how the value of the transactional medium of exchange will inevitably be sacrificed in a vain attempt to save the system. And that this is why it is so dangerous to hold your wealth in that same transactional medium today. This is why there are "two monies!"

You see they are now faced with a dilemma they will not discuss publicly. On one side is their product, the conceptual unit of credit account, their currency. And on the other side is their offspring, the

financial system, Wall Street. What saves one will kill the other. They can save the present value of their product and kill their offspring through starvation. Or they can save their offspring by delivering what it desperately needs to survive... a constant expansion of credit (aka monetary inflation). But this will, of course, kill the value of their product, the currency.

They can save one or the other, but not both. And it was always known, but has now been proven, that the system will be saved at ANY cost. (Unfortunately for them, they did not think it through far enough to realized that the cost of saving their offspring will also kill it and a whole lot more. But that line of Thought is straying a little too far from the topic of this post.)

In order to survive, the system, the financial industry, Wall Street NEEDS a constantly increasing supply of CREDIT! If the population won't give their own blood to save this dying Frankenstein monster, then the CB's and governments WILL! It is happening now. Right under our noses. For more than a year now!

This is why it is SO important that we hold only physical gold in our own personal possession in order to escape this tangled mess. Only touchable, graspable physical gold metal under full ownership conveys ALL of the properties that have come to be attributed to this kingly wealth asset. By contrast, financial contracts denominated in gold as facilitated by bullion banks, gold derivatives, gold loans, gold depositories, gold pool accounts, gold ETF's, or known by any other name, are all at their core pure and simple... (wait for it)... CREDIT. And what feeds the monster?? All together now……
CREDIT EXPANSION!!

This is the very beginning of starting to understand the concept of "two monies" not tied or fixed to each other by value, but floating *against* each other in value. We understand this instinctively, but today's system fools us into doing something that is very dangerous to our wealth today:

Today's paper currencies are not just a medium of exchange, but they are still a pretty good store of value in the short term. The greater the rate of price inflation, the shorter the term that you will want to be holding the actual currency. Wealth assets, on the other hand, are the store of value for the long term. This differentiation is understood by almost everyone today. And it is so close to the concept of Freegold that it will not be "a giant leap for mankind" to get there.

The only difference is that right now, most of the public has come to believe that wealth is simply paper ownership of wealth producing industries and paper claims on real assets that can never be recovered at today's values. This is true for most all items, not just gold. And as we hold these paper documents for the long term, understanding them to be better than holding the actual currency because they provide a "yield", the recoverability of the underlying real asset is being constantly eroded away. In other words, we are unknowingly losing principle at the same time as we think we are gaining a yield!

[…]

Our ancient instincts have not gone away. We have not "advanced" as much as we think. Our use of "the pure concept of money" has not changed since the days when we engaged in direct barter trade. We still want to accumulate wealth items along side and separate from our transactional "pure concept of money" which is really just a number in our mind, or marked down on paper. We know that this

"number" is not something to be saved, except perhaps for as long as it takes to arrive at the next transaction. (See: Fekete's A 'fairy' tale)

You see our modern money concept has been surreptitiously eroded into only one half of our ancient barter understanding of the money concept, and one half does not equal a whole. Most of today's money, other than the monetary base, is borrowed into existence. It represents a debt, and a debt is an incomplete transaction. It is only one half of what our instincts require as a wealth reserve, which is a fully completed transaction resulting in an accumulation of hard value. And yet we still buy these "wealth assets" denominated in only "half a concept", half of the monetary concept that our mind intuitively understands.

This is a flaw! It is a big one, especially now as "the other half" is waving the white flag of surrender and default. Some very smart analysts see this as deflationary. They truly believe that the waving of the white flag will make this "half a concept" actually rise in value against its parallel real world economic counterpart. But that is not what will happen.

A Different Approach

I began Part 3 by sharing with you my position as an observer of what is, not an activist for what I think should be. My position is in stark contrast to what you get from the gold standard advocates of all stripes. Sure, they have their disagreements, but they all seem to propose what they view as the perfect solution, which always requires unlikely political choices. Gary North is one that gets this distinction well.

North's position is very close to Ron Paul's. North gets the benefits of denationalizing and privatizing the gold. North, like Paul, wants to outlaw fractional reserve banking, which means his eye is on the wrong culprit. And North, like Paul, wants circulating "gold IOUs" at a fixed parity with, and redeemable in, physical gold. And he also gets the difficulty of enacting his vision, so he, like Paul, wants to amend the legal tender laws to allow a private, competing fixed gold standard.

In this post North describes "Two Kinds of Gold Standards," public and private, and as for a government-run gold standard he concedes, "any call by conservatives for the State to adopt a gold standard **is futile. No one will listen**." And in this post called "End the Fed, Get the Gold," North describes a complex idea he has for de-nationalizing the gold through a massive gold give-away. But alas, he must confess "This is why this essay is hypothetical."

I responded to the ideas presented in that second post (not directly to Gary) in this comment, in which I wrote:

If you cannot see that a two-way market (between the debtors and savers) for gold (that's buy and sell - "two way") is infinitely better than a mass give-away, then I really don't know what to say. You are what FOA and Aristotle would call a "Hard Money Socialist."

Getting the gold back into circulation is done through a free market price, not through a suppressed price give-away.

Gary North "realizes" this, even if he doesn't realize it: "If the price of gold rises, it pays someone to

own gold. So, people begin to buy gold. Gold-using producers start buying."

But debtors don't hold gold. Only savers accumulate. Producers! As he says. ***Gold is for saving, fiat is for spending.*** *The debtors will immediately sell their gold claims to the savers.*

In my mind, it would be infinitely better for the USG to acknowledge Freegold, declare a starting price of, say, $10,000/ounce, and then open the vaults and let the price float. ***They buy and sell at the market price through the banks****, starting at $10K.*

The price would soon stabilize, much higher than $10K of course, but ***the two-way market would be in effect. The gold would not be gone. The currency would be stable once again.***

You give it all away to the debtors at $42/ounce and let them sell it to the savers for their final $1,350 welfare check, where does that leave you?

Half the population wants easy money. The other half wants to save what they earn in gold. Can't you see this? *It is not about "the elites." They are all mostly in the easy money camp. If they give the gold away at $42/oz the elites will buy it right back from the poor and then lock down the price for a new gold standard. Buy themselves another 67 years in power perhaps. Is this what you want?*

Gary wants to divvy up the gold and then inflict Freegold. If you cannot see the disaster that this is, I don't know what to say to you. All to take power away from the central banks? This is the mistake. ***It is not their fault. As Greyfox said, "We have met the enemy and it is us." We are at fault, for saving in promises. We give THEM power.***

And Gary's proposal would do more harm than good to the overall modern economy. And it's not gonna happen anyway. It's a dream. A fantasy. A picket sign.

Would Gary's solution be okay with me? Sure! But it wouldn't last. And it won't happen, ***so it's purely academic, which he acknowledges. But Freegold is not!***

And furthermore, all the power Gary wants to take away from the bureaucrats will be taken away ANYWAY when the dollar loses its global reserve privilege, ***and that privilege's sister, the paper gold market. Gone. Done. That's all it takes.***

Can you see the difference in approach? Well here's how I kicked off Gold is Money Part 3:

Allow me to start by beating a dead horse. There is a vital difference between what may in fact be the ideal, perfect monetary system and what are the real monetary changes we are heading straight into today. My purpose for writing this blog is to share with you, and in return to receive your feedback on my own discovery and understanding of the latter. There are plenty of other sites that discuss the former.

If we can discover together where we are heading financially, economically and monetarily, and why we are heading there, then perhaps we can know, in advance, how the understanding of the global consciousness will evolve and unfold in the coming weeks, months and years. And, with this understanding, hopefully we can gain a certain peace of mind with regard to our own financial

decisions, positions and future as we head into very stormy waters.

I know from my own experience that a little peace of mind is a priceless asset. It is one worth sharing, and one worth growing. Sharing and growing this asset together with you is my goal.

Next I discussed some of the confusion that arises from our common modern understanding of the money concept, including this paragraph which hints at the problems with using the same media in two different monetary roles, even if it is a pure gold coin standard:

In fact, as a medium of exchange, money is only one half of a full barter exchange. The other half is when you change your money into that item you desire. But when physical gold is the common medium of exchange, then it is possible that the concept of a "medium" (or middleman) is incorrectly applied, because if gold was what you were after (for its store of value function), then the exchange is completed in only one step! Direct barter!

Actually, that paragraph hints at a whole slew of problems that have plagued us over and over again for centuries ever since we started using the same media for all monetary functions. But let's just continue on and maybe this will start to make some sense.

Next I ran through the problems we encountered with a couple different types of gold standard in the past; the gold exchange standard we had after 1913, and the gold coin standard we had before 1913, which is the one yearned for by the likes of Ron Paul and Gary North. That's right, there are problems that arise even in a gold coin standard. I implore you to read the post, but especially the account (in blue) by Randy Strauss. Here's a tease just to get you to go read it:

And recall, these comments occurred while on a gold [coin] standard AND in total absence of a government-sponsored central bank [i.e. before the Fed] -- which was authorized (against Baker's preference) a year later.

As you come to understand how Money and Credit are interrelated, the more you will understand the ***separate*** *Wealth of gold and why you need it now more than ever.*

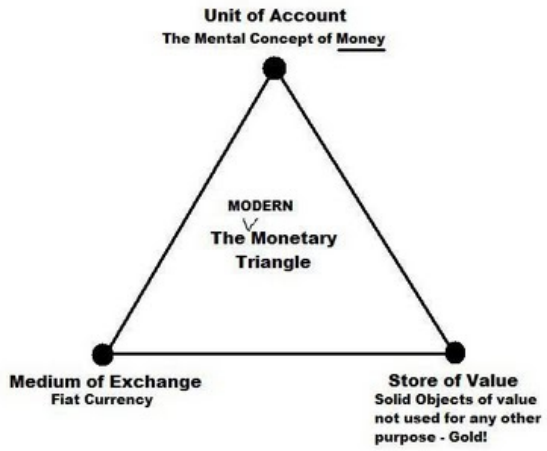
I went on to discuss how the money concept necessarily exists in the fourth dimension of time. How, if we only lived in a snapshot world of three dimensions, one medium would work fine for all of money's functions:

But here in the real world we must be concerned about how far we carry our money through the fourth dimension. Without this vital consideration, we stand to lose everything!

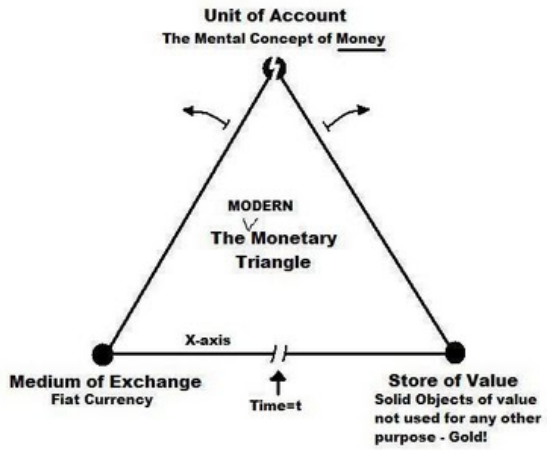
At this point in the post I discussed the separation of monetary functions through a few illustrations that I created:

Breaking the Triangle

In part 1 of this series I used a diagram I created called The Modern Money Triangle. The three corners of the triangle represented the three primary functions of our modern understanding of money.



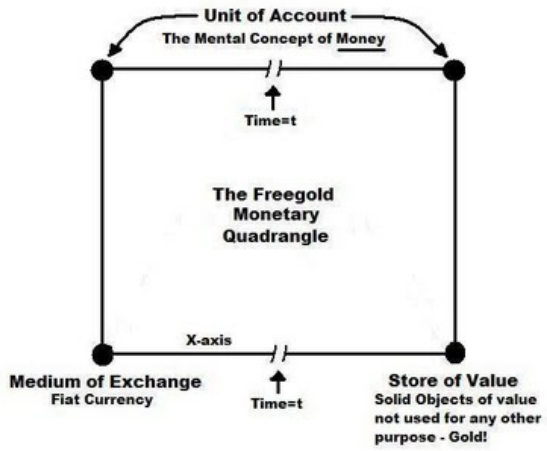
But as we pass through the coming phase transition in which the parity between paper gold and physical gold will be broken, cracks will start to form in certain parts of the triangle.



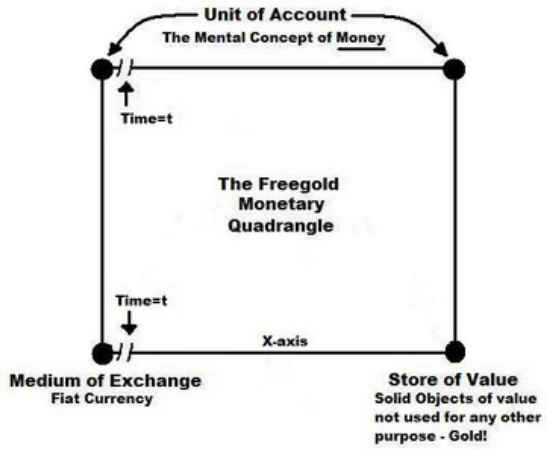
The fractures you see in this diagram are time related. **On a short timeline [length of time is the key variable: "t"] fiat currencies will perform our necessary monetary functions, medium of exchange and unit of account. But at some point on the time line, 'length of time', we will switch to a different medium, gold.**

On a long timeline, gold will perform our necessary monetary functions perfectly, store of value and long term unit of account. By the way, there is no upper limit on the 'time line axis' when it comes to gold. If plotted out it runs to infinity!

The outcome will be my new Freegold Quadrangle!



The "time line axis" represents the amount of time you are willing to hang onto the fiat currency you either earn or receive in payment. If the monetary authority is printing money, "t" will be shorter and shorter. In a hyperinflationary situation "t" will slide all the way to the left with a value close to zero.



As the new Freegold system of natural, pristine balance emerges, the fiat monetary authority will find its wisest move is to keep the money supply under control. And with a "wise" CB, gradually the "t" value will shift back to the right, little by little.

Clarify the View

This concept that the traditional monetary functions are now separating into non-fixed (i.e. floating) media has been both an epiphany for some and a stumbling block for others. My goal here is to clarify the view for those who cannot seem to get it. When comparing any two monies, circulation velocity (or the demand for money to the Austrians) correlates to, and is a measurement of, their respective store of value properties. In other words, the currency that circulates with greater velocity is in low demand, it's the "bad money" with a short store of value timeframe, while the slower currency is in high demand, it's the "good money" with a greater ability to store value through time.

This is a clear example of how the transactional and reserve functions of money are able to separate

right before our eyes into two different media. Think about Zimbabweans quickly spending Z$s while hoarding US$s. Ludwig von Mises called it a "secondary media of exchange."

The term "secondary media of exchange" obviously implies the existence of a "primary media of exchange." But why only two? Well, the answer is simple: because we are dealing with two needs, two separate functions or roles in which we use "money." The two roles are transactional and reserve (store of value). Another clear example can be found on the Eurosystem's Consolidated Financial Statement. The primary medium of exchange is on the right-hand side, and the secondary medium of exchange is on the left. Look at how Line #1 has grown in proportion to the whole of the reserves (secondary media of exchange) from 30% to more than 65% in a decade. Now ***that's*** how you spot a focal point!

Here's the new "FOFOA's dilemma" once again (with an added hyperlink for the adventurous!):

FOFOA's dilemma: When a single medium is used as both store of value and medium of exchange it leads to a conflict between debtors and savers*. FOFOA's dilemma holds true for both gold and fiat, the solution being Freegold, which incidentally also resolves Triffin's dilemma.*

Another quick Sidebar:

For any real economists out there, here's how Freegold resolves Triffin's dilemma.

Triffin's dilemma highlights two flaws in the dollar and its use as the global reserve currency. Flaw #1 is the dollar being a national currency and also a supra-national global reserve currency. Flaw #2 is the dollar trying to be as good as gold in the store of value role via US Treasuries. What I mean in flaw #2 is that the dollar's credibility is hurt by a rising price of gold and, therefore, it must systemically manage that threat by backing the fractionally reserved bullion banking system which eases the natural supply constraint of gold.

The euro has eliminated both of these flaws in its fundamental architecture. It is not a national currency and it does not oppose a rising (in the present case) or a free floating (in the future case) price for non-fractional physical gold reserves. I have written extensively on this topic, and the bottom line is that gold is not yet free floating, even today, because its market is encumbered by many forms of gold IOUs that trade at par with the physical stuff through the support of the dollar system.

You can obviously resolve Triffin's dilemma by removing both flaws. But removing #1 alone is not enough, while #2 alone ***is*** enough.

Triffin's dilemma observes that when a national currency also serves as an international reserve currency (as the US dollar does today), there are fundamental conflicts of interest between short-term domestic and long-term international economic objectives. But this is only the case if that currency does not embrace a "secondary media of exchange" that is allowed to float in value in a quantity not managed by the currency manager (i.e. physical only), and can be purchased and stored in lieu of retaining debt denominated in the primary medium.

Imagine, if you will, the euro supplanting the dollar's role as the globe's super-sovereign currency unit. This is (at this point) merely a conceptual exercise for all you anti-conceptual mentalities. Let's

compare the two with regard to Triffin's dilemma.

How often do we hear euro critics repeat that the euro, a currency without a country, has no political union to back it and is therefore worthless? The US dollar has a country, but in its role as the world's currency it also functions just like the euro, without a global political union.

The fundamental difference between these two units of account (the dollar and the euro) is their relationship with gold.

If you have followed my blog at all, you know that the euro has Freegold, the wealth consolidator and "real money" with no country, no links and no political union to back it. So which unit of account (€ or $) is closest to gold? Which currency, of these two, is most likely to be preferred as the global reserve currency next to Freegold in the wealth reserve role?

The point is, once "Freegold" (nature's wrath) inflicts itself upon us all, it won't really matter what is chosen/used as the super-sovereign or supra-national currency to lubricate international trade. It could be the euro, the yuan, the SDR, Facebook Credits or even the dollar! Triffin's dilemma will be gone. And you shouldn't worry so much over the transactional currency question, because that will be chosen through the market forces of regression, the network effect and game theory's focal point discovery at the international level.

A Practical and Probabilistic Comparison

Now that I'm almost done with the intro, and before we move on to the main body of this post which is the Austrian forefather's deconstruction of the money concept and how it fits perfectly with Freegold, let's take a moment to compare the gold standard concept to Freegold in terms of practicality and probability. We'll save 'honesty' until after we discuss the money concept.

What the hard money/gold standard crowd ultimately wants is a single unit to faithfully serve as both the monetary medium of exchange *and* long term store of value. A single unit is, in fact, what we have now as the dollar is the currency in widest use (network effect) and the US Treasury bond is the focal point global store of value. Both are denominated in dollars and are therefore a single unit through fixed parity. If the medium of exchange was to collapse, so would the store of value.

So the hard money camp would like to harden (make more difficult to obtain) that single unit by backing it with gold, making every single unit redeemable in gold, or at least allowing the free market to do away with any entity that fails to meet every redemption request. From a practical perspective this would obviously require major political and legal changes which is why this camp is full of activists with colorful picket signs. And this is why they have lowered their initial target to simply changing legal tender laws to allow their single hard unit to compete with the existing easy unit and, hopefully, theirs will win the popularity contest.

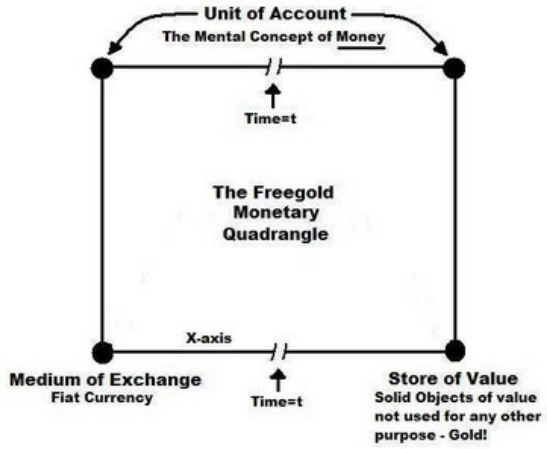
But in order to achieve such monumental changes, they really need a ground-swell of support from the people. You, dear reader, are probably much closer to their view than 95% of the rest of the population. So, from a probabilistic perspective, I'd like you to think about your own paycheck. How much of it goes right out the door to pay for food, utilities and your mortgage? 90%? And how much do you really

care that the 90% of the money you earn and only hold for a couple of weeks sustains its purchasing power for the next 100 years (for the benefit of those people you gave it to)? I only ask this to get you to think about what is important to the majority of the people.

The hard money/gold standard crowd wants to make every one of those dollars you earn hard (difficult to get) so that they retain their long-term purchasing power. They want the banks to hold gold on reserve for every single dollar you receive, even if it goes right out the door. There won't be many pay raises in your future if these guys get their way.

Or would you simply be happy as long as the 10% of your paycheck that you decide to save stores its purchasing power for 10, 20 or 100 years? Yes, see, this is what really matters… to everyone! And this is why the medium of savings must be separate from (and float in value against) the transactional currency. I'm certainly not arguing the benefits of inflation, because there is a better way to control inflation than simply making every single unit hard (difficult to obtain).

The economy needs the lubrication provided by transactional currency for it to run smoothly. Obviously not all of it is saved and stored as wealth. Only a small portion of the ***flow*** of transactional currency is saved. And those that would hope to print in order to buy are only stealing from that small portion that is saved. If you "do the math" you'll find that, in the long run, this is true. And if you separate that saved portion by using a secondary medium that floats in value, then inflationary policy becomes self-defeating to the currency manager. **This is how you have a true competing currency. Not two currencies competing for the medium of exchange crown. But a separate medium of savings competing against the medium of exchange for "pole position" on the 'Time=t' axis:**



This is Freegold, and it is unfolding today. It requires no activism or political/legal changes at this point. It is, how do you say, baked into the cake already? And once again, these posts briefly explain how we aren't quite there yet, how Freegold is different from what he have today, even though it is "already in the pipeline."

The Money Concept

FOFOA: The measure of any money's store of value is a continuum of time. It is directly linked to demand and velocity. Even the worst money (say, Zimbabwe dollars during the hyperinflation) works

as a very temporary store of value. Perhaps you read stories about workers in Zimbabwe getting paid twice a day and then running out to spend it before coming back to finish the shift. This is an example of the briefest time period in which currency stores value.

FOA: Was gold a medium of exchange? Yes, but to their own degree, so were the bowls. Was gold a store of value? Yes, but to a degree, so were dinner plates. Was gold divisible into equal lesser parts to define lesser barter units? Yes, but to a degree one could make and trade smaller drinking cups and lesser vessels of oil.

Here's the thing, 'store of value' and 'medium of exchange' are relative terms. Anything real stores value (a painting, a computer, a jewel), and lots of things are media of exchange in various settings (dollars, other currency, cigarettes in jail, etc). And for stores of value, there is a continuum as to how long things store value. What we are talking about is **degree**. And this gets to the heart of a semantic issue about money being media of exchange *and* a store of value.

Menger: [I]t appears to me to be just as certain that the functions of being a "measure of value" and a "store of value" must not be attributed to money as such, since these functions are of a merely accidental nature and are not an essential part of the concept of money.

Mises: Money is a medium of exchange. It is the most marketable good which people acquire because they want to offer it in later acts of interpersonal exchange. Money is the thing which serves as the generally accepted and commonly used medium of exchange. This is its only function. All the other functions which people ascribe to money are merely particular aspects of its primary and sole function, that of a medium of exchange.

Both of the above quotes get at the idea that, because money is a medium of exchange, it is also, to some degree, a store of value. Even Zimbabwe dollars were a brief store of value, but being a store of value isn't what money is all about. Being a store of value is not its central function—it is derivative of its being a medium of exchange. Being a medium of exchange is money's essence—what makes money money. This means that, by definition, money's ability to serve as a measure of value and store of value is secondary.

Now before I continue, I want to remind you of *my* definition of "Honest Money" from the second paragraph of this post. In that paragraph I wrote that my definition would eventually start to make sense, and right about now it should be starting:

"My definition is that honest money is simply money that does not purport to be something it is not."

Compare my definition to what the hard money/gold standard crowd says is "Honest Money":

"And modern practitioners will tell you that gold and silver are honest money."

Since we're dealing with the semantics of "money" here, we should keep in mind that the original Austrian definition of money was that it is primarily a medium of exchange. So in this light, are gold and silver the best monies? Let's check back with Carl Menger who is widely regarded at the founder of the Austrian School of economics:

Menger: [M]oney is the most appropriate medium for accumulating that portion of a person's wealth by means of which he intends to acquire other goods (consumption goods or means of production).

[…]

But the notion that attributes to money as such the function of also transferring "values" from the present into the future must be designated as erroneous. Although metallic money, because of its durability and low cost of preservation, is doubtless suitable for this purpose also, it is nevertheless clear that other commodities are still better suited for it.

And while we're at it, how about a little Hayek?

Hayek: If I were responsible for the policy of any one of the great banks in this country, I would begin to offer to the public both loans and current accounts in a unit which I undertook to keep stable in value in terms of a defined index number. I have no doubt, and I believe that most economists agree with me on that particular point, that it is technically possible so to control the value of any token money which is used in competition with other token monies as to fulfill the promise to keep its value stable.

Obviously I am including the link before each quote for those of you that think I am taking these out of context. But hopefully you'll start to see a pattern emerging from the quotes.

As I mentioned above, in the same way that a medium of exchange is to one extent or another also a store of value, stores of value are also to one extent or another media of exchange. The question is one of degree, and this is how, through market forces, we end up with "two monies." Being the focal store of value does not make something the best medium of exchange, and vice versa.

This might be a good time to take another look at the ECB quarterly statement. There it is, two monies. One on the left, one on the right. Separate roles. And for you euro-critics, have another read of this because you might want to brush up on your currency theory. Having a hard fixed rate currency is just like sharing a standardized meter, liter or gram.

And speaking of the left side of the ECB statement, here's some more Mises:

Mises: Gold is the money of international trade and of the supernational economic community of mankind.

Schwa! **Supernational economic community of mankind?** That almost sounds like gold is the money of the Superorganism!

A Second Money?

But what use could we have with a second money?

Mises: For some of them it is easier to find without delay a buyer ready to pay the highest price which, under the state of the market, can possibly be attained. With others it is more difficult. A first-class bond is more marketable than a house in a city's main street, and an old fur coat is more marketable than an autograph of an eighteenth-century statesman. One no longer compares the marketability of the

various vendible goods with the perfect marketability of money. One merely compares the degree of marketability of the various commodities. One may speak of the secondary marketability of the vendible goods.

He who owns a stock of goods of a high degree of secondary marketability is in a position to restrict his cash holding. He can expect that when one day it is necessary for him to increase his cash holding [p. 463] he will be in a position to sell these goods of a high degree of secondary marketability without delay at the highest price attainable at the market.

[…]

Consequently **there emerges a specific demand for such goods** on the part of people eager to keep them in order to reduce the costs of cash holding. The prices of these goods are partly determined by this specific demand; they would be lower in its absence. **These goods are secondary media of exchange, as it were, and their exchange value is the resultant of two kinds of demand: the demand related to their services as secondary media of exchange**, and the demand related to the other services they render.

What Mises is talking about here is the focal point effect. As more people focus on a single secondary "money" for the purpose of storing value outside of the primary medium of exchange, it starts to develop a separate kind of demand, apart from its other uses. And just so we're clear that he's not talking about money substitutes like bank credit:

Mises: One must not confuse secondary media of exchange with money-substitutes. Money-substitutes are in the settlement of payments given away and received like money. But the **secondary media of exchange must first be exchanged against money or money-substitutes if one wants to use them--in a roundabout way--for paying or for increasing cash holdings**.

Claims employed as secondary media of exchange have, because of this employment, a broader market and a higher price. The outcome of this is that they yield lower interest than claims of the same kind which are not fit to serve as secondary media of exchange. Government bonds and treasury bills which can be used as secondary media of exchange can be floated on conditions more favorable to the debtor than loans not suitable for this purpose. The debtors concerned are therefore eager to organize the market for their certificates of indebtedness in such a way as to make them attractive for those in search of secondary media of exchange. They are intent upon making it possible for every holder of such securities to sell them or to use them as collateral in borrowing under the most reasonable terms. In advertising their bond issues to the public they stress these opportunities as a special boon.

Here's an exercise only for the conceptual mentalities. Try applying that last paragraph to the concept of Freegold. I did, and it makes a whole lotta sense in the context of this blog!

Okay, so if we pay attention to the network effect of those that actually have intergenerational-sized wealth to preserve, and we look for the focal point that game theory predicts will be the winner within the Eurosystem's ConFinStat, we can pretty much know without a doubt what the new "secondary medium of exchange" winner will be. But what about the primary? Shouldn't it be silver or something? Or isn't there some big NWO power that's going to inflict upon us a sinister new SDR? Or perhaps, should we all buy Bitcoins and Facebook Credits to prepare for barter exchange during TEOTWAWKI?

In Austrian economics there are basically two halves to the explanation of money. One half is Carl Menger's explanation of the marginal utility of money that emerged long ago from a system of direct barter, and the other half is Ludwig von Mises' regression theorem that connects modern money to Menger's emergent money through our time-value memory and expectations of a money's ability to store value. And what I hope to show you is that the natural progression toward Freegold (true honest money in my book) is consistent with both Menger's marginal utility argument and Mises' regression theorem, while the difficult regression back to a fixed gold standard is not.

Robert P. Murphy on Menger: ...Because of this, owners of relatively less saleable goods will exchange their products not only for those goods that they directly wish to consume, but also for goods that they do not directly value, so long as the goods received are more saleable than the goods given up. In short, astute traders will begin to engage in indirect exchange. For example, the owner of a telescope who desires fish does not need to wait until he finds a fisherman who wants to look at the stars. Instead, the owner of the telescope can sell it to any person who wants to stargaze, so long as the goods offered for it would be more likely to tempt fishermen than the telescope.

Over time, Menger argued, the most saleable goods were desired by more and more traders because of this advantage. But as more people accepted these goods in exchange, the more saleable they became. Eventually, certain goods outstripped all others in this respect, and became universally accepted in exchange by the sellers of all other goods. At this point, money had emerged on the market...

Taking the above in the context of the ongoing monetary evolution to Freegold, gold is more "saleable" as a store of wealth or in Mises' words, a "secondary media of exchange" in part because of its historical monetary function, which raises its salience:

FOFOA: There is nothing that makes "Grand Central Station" a location with a higher payoff (you could just as easily meet someone at a bar, or the public library reading room), but its tradition as a meeting place raises its salience, and therefore makes it a natural "focal point."

And also because it has the highest marginal utility at storing wealth (the gold tank can absorb an unlimited inflow), gold wins the "market process" as the store of value as Freegold evolves and the "money functions" separate into transactional medium and store of value:

FOFOA: Will that 26th gold coin purchase provide the same utility or diminished (less) utility than the first? Remember, the only utility of gold coins is that they retain their value for thousands of years. That's all they do. And hoarding them doesn't interfere with any other economic activity, at least not when they are not "official money."

The answer is "the same utility," because unlike ANYTHING else, (yes, even silver), gold has INFINITE marginal utility in this particular role.

Moldbug: However, because silver was fully demonetized in the 20th century and gold was not, the market capitalization of the gold stockpile is 60 times the capitalization of the silver stockpile. Thus, comparable volumes of gas are pressing in to the gold tank and the silver tank, but the silver tank is 60 times smaller. It is actually surprising that silver has not risen faster and harder.

But this present advantage is also silver's long-term Achilles heel. The silver tank, being so much smaller, cannot take this kind of pressure. It will almost certainly explode. I have personal advice for those playing the silver market: bring your steel balls.

Regression

And speaking of historical function and its salience as a focal point - as to the other half of the Austrian money theory, the Mises Regression theorem:

Robert P. Murphy on Mises: People value units of money because of their expected purchasing power; money will allow people to receive real goods and services in the future, and hence people are willing to give up real goods and services now in order to attain cash balances. Thus the expected future purchasing power of money explains its current purchasing power.

But haven't we just run into the same problem of an alleged circularity? Aren't we merely explaining the purchasing power of money by reference to the purchasing power of money?

No, Mises pointed out, because of the time element. People today expect money to have a certain purchasing power tomorrow, because of their memory of its purchasing power yesterday. We then push the problem back one step. People yesterday anticipated today's purchasing power, because they remembered that money could be exchanged for other goods and services two days ago. And so on.

So far, Mises's explanation still seems dubious; it appears to involve an infinite regress. But this is not the case, because of Menger's explanation of the origin of money. We can trace the purchasing power of money back through time, until we reach the point at which people first emerged from a state of barter.

So, basically, marginal utility explains the original emergence of money while Mises' Regression theorem explains the long-running connection of modern money to its ancient origins. Regression kinda gets a "bad" money "in the door" and then human memory and expectations provide inertia. But part of the beauty of Freegold is the embrace of marked-to-market physical gold reserves, which will, if you understand the concept, provide a well-developed and stable price discovery for currency priced in physical gold which will allow ready exchange by anyone, anywhere, any time. Two monies, floating in stasis, freely exchangeable on demand.

So in this way, Freegold does not violate Mises' Regression theorem because the regression needed to maintain the transactional currency doesn't go back far at all. In fact, it's almost instantaneous. You will always accept the primary medium of exchange for your goods and services because the market for the secondary has been stabilized and made infinitely sustainable through a floating price in conjunction with the elimination of paper IOU encumbrances.

Regression tells us that we accept a currency because we think in terms of it, we remember in terms of it. Can you see some overlap between the above: "People value units of money because of their expected purchasing power;" and this from FOA?

FOA: Naturally, for gold to advance as the leading tradable good it had to have a numerical unit for us to associate tradable value with. We needed a unit function to store our mental money value in. In much

the same way we use a simple paper dollar today to represent a remembered value only. Dollars have no value at all except for our associating remembered trading value with them. A barrel of oil is worth $22.00, not because the twenty two bills have value equal to that barrel of oil: rather we remember that a barrel of oil will trade for the same amount of natural gas that also relates to those same 22 units. Money is an associated value in our heads. It's not a physical item.

The first numerical money was not paper. Nor was it gold or silver; it was a relation of tradable value to weight. A one ounce unit that we could associate the trading value to. It was in the middle ages that bankers first started thinking that gold itself was a "fixed" money unit. Just because its weight was fixed.

In reality, a one ounce weight of gold was remembered as tradable for thousands of different value items at the market place. The barter value of gold nor the gold itself was our money, it was the tradable value of a weight unit of gold that we could associate with that barter value. We do the very same thing today with our paper money; how many dollar prices can you remember when you think a minute?

It is because we think in dollars, or pesos, or rubles that we continue using those units as the primary media of exchange. It is human inertia that keeps them working. You can no more easily switch to a different unit, like a Bitcoin for example, than you could switch America to the metric system (like they tried in the 70s) or get an entire people to switch languages. Even Murray Rothbard was hip to this:

Rothbard: Money, however, is desired not for its own sake, but precisely because it already functions as money, so that everyone is confident that the money commodity will be readily accepted by any and all in exchange. People eagerly accept paper tickets marked "dollars" not for their aesthetic value, but because they are sure that they will be able to sell those tickets for the goods and services they desire. They can only be sure in that way when the particular name, "dollar," is already in use as money.

Can you see how this might be problematic for a "competing currency" in the Ron Paul sense? A currency that will be competing against "the dollar" for the transactional or "primary medium" role?

Rothbard: Hayek should be free to issue Hayeks or ducats, and I to issue Rothbards or whatever. But issuance and acceptance are two very different matters. **No one will accept new currency tickets, as they well might new postal organizations or new computers. These names will not be chosen as currencies precisely because they have not been used as money, or for any other purpose, before**.

One crucial problem with the Hayekian ducat, then, is that no one will take it. **New names on tickets cannot hope to compete with dollars or pounds which originated as units of weight of gold or silver and have now been used for centuries on the market as the currency unit, the medium of exchange, and the instrument of monetary calculation and reckoning.**

And with that, here is some more from FOA. Bear in mind, here, that FOA used the term "Mises" to represent the modern "hard money/gold standard crowd" or as I called them, modern practitioners:

FOA: My typical hard money shared long held belief, back then, was always:

----"Gold is the only official money of the world and will return to these roots one day"-------- and

-----" some worldwide financial dislocation will drive all governments back to this position"-----!!!!

It wasn't going to happen, no matter what, short of nuclear war. All we had to do was look around and see how people the world over were attached to using fiat currencies. The economic system itself was morphing into new ground as world trade learned to function very efficiently with fiat digital settlement. And that's something the 70s crowd said could never happen. That was how many years ago?

A lot of the Mises crowd tried to point out that ---- "hey, this is all very good but if you were on a gold system this economic game would be all the more better" ----! Ha Ha, no one cared,,,,,, why risk what was already in process. Even the third world didn't want to hear it. They figured that any return to a hard money system would harken back to a time they remembered well. These guys suffered during the early century and no one was going to tell them that the gold standard wasn't the fault. The US is today, and was then, robbing them blind, but the situation seemed, to them, that this new dollar standard was building them up. Looking at it all,,,,, we robbed the Japan lifestyle standards the most. All to buy us an almost free standard [of living], and they loved it.

When it came to using fiat money in our modern era, it made little difference what various inflation rates were in countries around the world; 50%, 100% 1,000%,,,,,, they went right on playing with the same pesos. There have been countless third world examples of this dynamic, if only we look around. Mike, look at what happened in Russia after they fell,,,, the Ruble stayed in use and function with 6,000% inflation. My god they still use it now.

No,,,,,,, my guys are dead on the money with respect to the political dynamic that's playing out. The world is heading towards a huge financial / currency crack up, but it won't work out with gold coming back into the money game. This very long term transition is playing on a move away from dollar domination with Europe preparing to suffer less than us by pulling in as many other political trading blocks as they can.

When you look at who they are reaching for; every one of these blocks wants gold moving higher to shelter their dollar trading losses. None of them expect to unload dollar reserves because our end time trade deficit won't permit it. They can't just send the dollars to each other, buying their own goods; that would never exhaust the external dollar float. Hell, they now have their own money to do trade with, the Euro.

If you're still with me, I hope you are starting to see some of the problems with all of the various "hard money" propositions. Even competing currency ideas like e-gold or GoldGrams are unlikely to be adopted according to Mises' Regression theorem:

Timothy D. Terrell on Regression and new currency viability: ...If the digital currency plan requires people to trade and quote prices in terms of **something other than the widely used dollar, yen, mark, euro, or other established currency, Mises's regression theorem would imply that the plan is doomed**. Well before e-money became possible, Rothbard addressed this problem:

Even the variant on Hayek whereby private citizens or firms issue gold coins denominated in grams or ounces would not work, and this is true even though the dollar and other fiat currencies originated centuries ago as names of units of weight of gold or silver. Americans have been used to using and

reckoning in "dollars" for two centuries, and they will cling to the dollar for the foreseeable future. They will simply not shift away from the dollar to the gold ounce or gram as a currency unit. [4]

What will work is a plan that simply facilitates the exchange of already-recognized currencies...

Thinking it Through

This kinda throws a wrench in the whole competing currencies idea to which the hard money crowd has somewhat retreated. Just like Mexico still uses the peso and Russia the ruble, we'll likely be thinking in terms of dollars long after it collapses. Which brings us back to their only other idea, which is to somehow make the dollar redeemable in physical gold at a fixed weight and in any quantity the dollar-holders demand.

If this sounds a little bit familiar, it should. Yes, we've tried that before. Of course the hard money crowd would like to change it up a bit this time, although they can't quite agree on the right combination of changes. Here are a few of their suggestions:

1.) Denationalize both the dollar and the gold so it can be fixed by the free market.
2.) Outlaw fractional reserve banking.
3.) Renationalize the dollar (end the Fed) and redefine it as a fixed weight of US gold.

Obviously there are major hurdles to each of these, as well as serious impracticalities and contradictions. Monetary systems tend to evolve naturally, in their own version of punctuated equilibrium. And the rare changes that actually take hold throughout history, whether judged morally good or bad in hindsight, whether ultimately credited to politicians or the free market, have always been aligned with this evolutionary process.

And today, the dollar's past relationship to gold is problematic for all of their ideas, yet not for Freegold. Here is Murray Rothbard again:

Rothbard: Before proceeding to investigate what the new definition or weight of the dollar should be, let us consider some objections to the very idea of the government setting a new definition. One criticism holds it to be fundamentally statist and a violation of the free market for the government, rather than the market, to be responsible for fixing a new definition of the dollar in terms of gold. The problem, however, is that we are now tackling the problem in midstream, after the government has taken the dollar off gold, virtually nationalized the stock of gold, and issued dollars for decades as arbitrary and fiat money.

I also wrote about some of the "midstream" problems for the dollar in Confiscation Anatomy:

FOFOA: The US gold hoard is now off the table. Think of a poker cheat who pockets his winnings yet still wants to play. When he loses he writes paper IOU's to the other players. Can he ever pull his money back out of his pocket without having it taken away? Think of an individual who declares his own insolvency and defaults on his obligations to pay, only to resurface later with a windfall inheritance. What problems will he face?

[…]

The US government will never take this risk! It will never expose itself to this legal nightmare! The US is already a golden outlaw!

To skirt the obvious problems in dealing with these issues head-on, some of the hard money camp has subtly retreated even further, now asking for a mere "commodity standard." Here is Ron Paul again:

News Anchor: *And just one more thing which is that when you talk about the right course, if I am not mistaken, you want to go back to the gold standard? Is that the right way to run monetary policy, in your opinion?*

Ron Paul: *No, but I'd like to go forward to a* ***commodity standard****. There were a lot of flaws in the old gold standard because there was bimetallism and a fixed price between gold and silver.*

[...]

I really like the idea of ***allowing the market to determine what backs the currency****, make sure there are no-fraud laws, and really look into the matter whether or not we should have fractional reserve banking.*

Reminds me of the old saying, "what a tangled web we weave…" You see, it's kind of like playing Whack-a-Mole when you resist the nature of the beast. Unfortunately for the US, it's gold, not "commodities" that is the money of the Superorganism. Mises again:

Mises: No government is, however, powerful enough to abolish the gold standard. Gold is the money of international trade and of the supernational economic community of mankind. It cannot be affected by measures of governments whose sovereignty is limited to definite countries. As long as a country is not economically self-sufficient in the strict sense of the term, as long as there are still some loopholes left in the walls by which national governments try to isolate their countries from the rest of the world, gold is still used as money. It does not matter that governments confiscate the gold coins and bullion they can seize and punish those holding gold as felons. The language of bilateral clearing agreements by means of which governments are intent upon eliminating gold from international trade, avoids any reference to gold. But the turnovers performed on the ground of those agreements are **calculated on gold prices. He who buys or sells on a foreign market calculates the advantages and disadvantages of such transactions in gold. In spite of the fact that a country has severed its local currency from any link with gold, its domestic structure of prices remains closely connected with gold and the gold prices of the world market.**

Did you catch that? In his magnum opus, published in 1949, Ludwig von Mises described **Reference Point: Gold**, which is the underlying nature of a global marketplace that reveals where our monetary evolution is actually heading! Here are a few of my posts on the subject:

Reference Point Revolution!
Reference Point: Gold - Update #1
Reference Point: Gold - Update #2

Ron Paul is absolutely correct about at least one thing. Fractional reserve banking is the problem, and it

will soon be history. But I'm not talking about fiat fractional banking, I'm referring to fractional reserve **Bullion Banking**. This is the root of all our monetary problems! It is even the root of the problems that arise in the fiat currency banking system. I realize what a bold statement this is, but I have gone into great depth on this blog exploring it from many different angles. Here are a few recent posts on this subject for those that are interested:

The View: A Classic Bank Run
Who is Draining GLD?
Reply to Bron

So what *is* honest money? And what does it mean "to return to honest money?"

Honest money is simply money that does not pretend to be something it is not. And the only way you get there is with "two monies." One that is a primary medium of exchange but does not pretend to also be the primary store of value. In doing so, it will actually become a pretty good short term store of value as it finds stability through stasis with a floating counterweight.

And a second one that *is* the focal point primary store of value, but does not pretend it can also be a primary medium of exchange at the same time. (There is no need to lend or borrow the secondary medium of exchange!) In doing so, it will become the greatest "secondary media of exchange" that ever existed! It will be a sight to behold!

And yes, we *are* returning to honest money today! The signs are everywhere, the most prominent being the rising price of gold against a falling dollar. Those who are buying gold, like China, Russia, Europe, India, Asia and the Middle East, are preparing for the return to honest money. They are preparing because they realize there is a huge advantage in preparing for something that is coming versus just watching it arrive from the sidelines. Yet, for some reason, we don't hear them demanding a new fixed dollar-gold standard from the US. Hmm. Fool me once, shame on you. Fool me twice, shame on me!

As you browse the web you will find dozens or even hundreds of interpretations of what the rising price of gold means. You now have mine to add to the pile. It means we are in the process of returning to honest money. But there are those that would like to take advantage of this to fix (read: manage) the price of gold to the US dollar *once again*. Does this sound honest to you?

There is a good reason why my future gold price projections are roughly one order of magnitude greater than those who want the US to manage the price of gold and to fix that price to the dollar… once again. It's also why those giants that exist outside of the dollar-centric world of the hard money activists are buying gold, and only gold, in preparation for the transition. Here are a few of my posts that will give you a clue to the "order of magnitude" difference:

It's the Debt, Stupid
How Can We Possibly Calculate the Future Value of Gold?
Gold: The Ultimate Wealth Consolidator
Relativity: What is Physical Gold REALLY Worth?
The Value of Gold

I would recommend reading them in that order.

So let's see. I think we have a winner. Let me check my scorecard:

	Fixed Gold Standard (one money for two functions)	Floating Freegold (two monies for two functions)
Feasible		X
Probable		X
Honest		X

And the best part is the probability, because there's no activism required. All you can do is prepare your own savings to be safely shuttled through the transition. So put down that picket sign, take off the t-shirt, undo the CAPSLOCK and go buy yourself some physical gold. Then, just like the Giants, you will be prepared for the return to honest money.

And finally, a big, dramatic tip of the hat to JR for his invaluable contribution to this post!

Sincerely,
FOFOA

Friday, March 25, 2011

Reference Point Revolution!

I read a great article from Imprimis, the free publication put out by Hillsdale College in Michigan, titled The Floating Dollar as a Threat to Property Rights. [1] The article started out with the curious case of the incredible shrinking kilo (a problem normally faced only by drug lords that employ users as traffickers). Apparently this one particular metallic cylinder securely housed at the International Bureau of Weights and Measures near Paris, France, is *the* "reference kilo" for not only the global metric system, but even the U.S. customary system in which 2.2 pounds equals this particular kilo.

The problem is, it's shrinking! So far it has only shrunk by 50 micrograms, about the weight of a fingerprint on Earth. [2] But even so, this is a big problem for scientists that deal in exacting calculations that require global standardization. The problem boils down to the definition of a kilogram. The global standard definition of a kilo is **this particular cylinder!** It was cast in platinum and iridium by Johnson Matthey in 1879, adopted by the first general conference for weights and measures in 1889, and has been the global reference point for the measurements of mass ever since. But some scientists are now complaining that with the exacting tolerances of today's high-tech world, the 21st century kilo needs a new definition. Modern science needs a better reference point for mass. [3]

This got me thinking about reference points, and how they have all—in every single case; temperature, distance, force, pressure, time, etc.—changed and evolved their definitions throughout history to best fit the cutting-edge needs of the time. [4] This is a trend that always faces the opposing forces of inertia—the resistance to change—and progress—the need for change.

Another obvious trend in the evolution of reference points, when viewed in a long-line historical context, is the expansion from local to national to regional and finally to global standardization. This trend, especially, faces the opposition of inertia as national reference points have become part of the national identity of their people. The remnants can be seen everywhere. For temperature we have Fahrenheit and Celsius. For mass we have avoirdupois ounces, troy ounces and metric grams. The

world is littered with national currencies. And even foreign languages are a good example of our innate resistance to global standardization.

This trend toward global reference points is a practical—not a moral—evolution. It will continue whether we like it or not. It is an artifact of the human Superorganism. [5] What ends up happening most times is that nations will keep their old reference point for identity purposes, but they will either adopt the best external reference point as a secondary standard or they will affix (peg) to the definition of the most widely used reference point, also known as the focal point. [6] We see this in almost everything. English has become the global standard among many foreign languages. The Imperial pound is pegged to the metric kilogram, as noted above. And prior to 1971, the world's major national currencies were all pegged to gold through the U.S. dollar, another national currency.

The main point here is that while our symbols of national (or regional) identity will always be with us, the unfolding of future "new and improved" reference points will always be global in scope. Just as time moves in only one direction, it can be no other way. In other words, new global standards will be layered on top of quaint and sentimental artifacts of the past. [7]

But let me be clear about one thing before I move on. It is not sufficient to simply move forward without knowledge of and respect for the path that brought us to the present, which is what "the easy money camp" likes to do. Nor is it advisable to run forward while looking backward, expecting the past to reveal what may be directly in front of us, as we so often see in "the hard money camp." [8] To properly prepare for the future, we must know the past—know the Trail that we are on—while not looking backward to find objects that lie ahead.

And now, onward…

The point of the Imprimis article was that the U.S. dollar, not unlike the kilogram—being an important reference point for value especially in the United States—has gone through a number of definitions punctuated by abrupt, often painful, degradations. In the beginning the U.S. dollar was defined as 371¼ grains of silver, with the U.S. adopting the Spanish dollar's definition because of its widespread use as a reference point for value. Later the dollar was redefined as 1/20th of a troy ounce of gold, and then degraded to 1/35th. Then in 1971 the de facto definition of a dollar was removed and the U.S. dollar began to "float" (or more appropriately, "sink") as a reference point.

Throughout the various definitions above, the dollar was gradually adopted by other nations until it became the de facto global reference point for value. Or so we in America and the West think. In fact, gold was always the global reference point and the U.S. dollar's definition—a definition that was defended at the U.S. Treasury gold window by spewing gold—became a means to the acquisition of the value reference point itself. If the dollar had been that global reference point, the world would have been happy merely accumulating dollars, and Nixon would have never had to close the gold window.

It turns out that the dollar was always a poor reference point for value because its definition could simply be changed or removed altogether for political expedience, over and over, again and again. Yet some in the U.S., some with a patriotic yet myopic perspective, think that all we need to do is redefine the dollar so that it can once again become the global benchmark of value. Something it never was in the first place. And something it never will be. (All the dollar ever did was adopt the reputation of an external reference point and then fail to live up to it. Over and over, again and again.)

Long in the past, before telephones and air travel, before computers and the Internet, local and national reference points were far more important and relevant than what was happening on the other side of the planet. But today, and moving forward, it matters more how the many national currencies will relate to each other, how they will exchange, on what reference point their exchange will be judged, than what any individual locality or nation does to change or manipulate its own currency. As I wrote above, the trend toward global reference points is a practical—not a moral—evolution. It will continue whether we like it or not. It is an artifact of the human Superorganism.

And this got me thinking about the concept of Purchasing Power Parity, or PPP. With the advent of global air travel, I can take $10,000 out of my bank in the morning, get on a plane, and get off in another country in the evening, exchanging my $10,000 at the airport for the local currency. This little exchange should not cost me anything in purchasing power, it should essentially be free, or else I wouldn't do it. Or perhaps if I actually *gained* purchasing power by flying somewhere, I would do it more often! But the fact of the matter is that while the PPP concept works in principle, it doesn't always work in practice. Especially given a variety of purchasing choices in the marketplace, some of which are more native to one country than another.

The question comes down to the overvaluation or undervaluation of various economic currencies. The way ants—and by ants I mean economists (see footnote #5)—try to deal with this question is by using "baskets" of goods or currencies. But the problem with baskets is that i) they present too many moving parts, and ii) they present the option (temptation) for political manipulation (e.g. CPI "basket" and SDR "basket of currencies"). And for these two (obvious?) reasons, baskets make poor reference points for value.

Just yesterday, Professor Michael Pettis wrote in Is Loan Growth in China Slowing?:

"... a few years ago people suggested that the RMB might be undervalued by 30%. Since then the RMB has appreciated by 20-25%. And yet today people are still arguing that the RMB may be undervalued by 30%. How is it possible that so much appreciation has not seemed to affect the estimates of undervaluation?

"Before answering it is worth pointing out that ***there is no way that anyone can determine precisely the amount of undervaluation of the RMB, or any other currency, and so any estimate can be nothing more than that – an estimate based on many moving parts****. There are plausible reasons for arguing that a currency is undervalued or overvalued, but there is absolutely no way to determine* ***with any precision*** *by how much.*

"This difficulty is compounded by the fact that many analysts are simply getting the math wrong. So for example when people say the RMB is undervalued by 30%, they often mean that the dollar is overvalued by 30%. These two claims may sound like the same, but of course they aren't. If the RMB is undervalued by 30%, it means that the dollar is overvalued by 43%, not 30%. I have seen ***so much confusion*** *on this issue that I pretty much* ***give up*** *on* ***trying*** *to understand what people mean when they discuss currency changes without seeing their actual numbers."*

That's right! We need a single moving part! And by we, I mean not just the ants, but the colony, the Superorganism. The human Superorganism desires to streamline the concept of PPP as much as

possible, for its own benefit. And the way that is done is by using a single global reference point. But as I wrote in *Life in the Ant Farm*, we individuals are not nearly as smart as the Superorganism. Case in point—Reference Point: Big Mac!

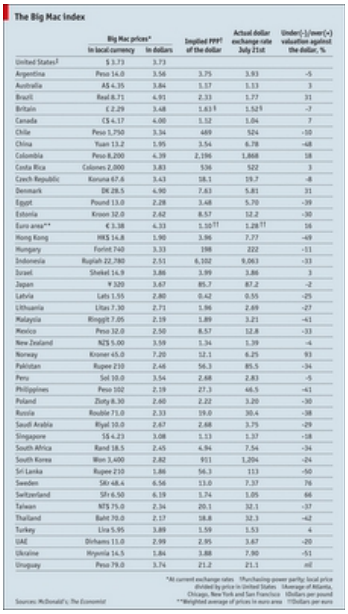
At any given point in time every currency has a certain purchasing power inside its own legal tender zone, and then it has a different purchasing power outside the zone. The Economist magazine has been publishing the Big Mac Index every year since 1986. The index is a humorous way of looking at the purchasing power parities of various currencies using the McDonald's Big Mac as the Reference Point.

Other variants of this index have used as the Reference Point, the Apple iPod, a cup of Starbucks coffee, and even Ikea's Billy Bookshelf. The Economist describes its original, ground-breaking index thusly:

> The Big Mac index is based upon the theory of purchasing-power parity (PPP), the notion that a dollar should buy the same amount in all countries. Supporters of PPP argue that in the long run, the exchange rate between two currencies should move towards the rate that would equalise the prices of an identical basket of goods and services in each country.
>
> Our "basket" is a McDonald's Big Mac, produced in 110 countries. The Big Mac PPP is the exchange rate that would leave hamburgers costing the same in America as abroad. Comparing actual rates with PPPs signals whether a currency is under-or overvalued.

Two of the Economist's findings for 2010 were that the most expensive place to buy a Big Mac (with U.S. dollars) was in Norway, where it cost US$7.20 (on 7/21/10 after exchanging your dollars into the local Kroner currency), and the cheapest was in the Ukraine at US$1.84. Interpreting this data is where it gets a little tricky.

Click on images to enlarge



The Big Mac index

	Big Mac prices* in local currency	Big Mac prices* in dollars	Implied PPP† of the dollar	Actual dollar exchange rate July 21st	Under(-)/over(+) valuation against the dollar, %
United States‡	$ 3.73	3.73			
Argentina	Peso 14.0	3.56	3.75	3.93	-5
Australia	A$ 4.35	3.84	1.17	1.13	3
Brazil	Real 8.71	4.91	2.33	1.77	31
Britain	£ 2.29	3.48	1.63§	1.52§	-7
Canada	C$ 4.17	4.00	1.12	1.04	7
Chile	Peso 1,750	3.34	469	524	-10
China	Yuan 13.2	1.95	3.54	6.78	-48
Colombia	Peso 8,200	4.39	2,196	1,868	18
Costa Rica	Colones 2,000	3.83	536	522	3
Czech Republic	Koruna 67.6	3.43	18.1	19.7	-8
Denmark	DK 28.5	4.90	7.63	5.81	31
Egypt	Pound 13.0	2.28	3.48	5.70	-39
Estonia	Kroon 32.0	2.62	8.57	12.2	-30
Euro area**	€ 3.38	4.33	1.10††	1.28††	16
Hong Kong	HK$ 14.8	1.90	3.96	7.77	-49
Hungary	Forint 740	3.33	198	222	-11
Indonesia	Rupiah 22,780	2.51	6,102	9,063	-33
Israel	Shekel 14.9	3.86	3.99	3.86	3
Japan	¥ 320	3.67	85.7	87.2	-2
Latvia	Lats 1.55	2.80	0.42	0.55	-25
Lithuania	Litas 7.30	2.71	1.96	2.69	-27
Malaysia	Ringgit 7.05	2.19	1.89	3.21	-41
Mexico	Peso 32.0	2.50	8.57	12.8	-33
New Zealand	NZ$ 5.00	3.59	1.34	1.39	-4
Norway	Kroner 45.0	7.20	12.1	6.25	93
Pakistan	Rupee 210	2.46	56.3	85.5	-34
Peru	Sol 10.0	3.54	2.68	2.83	-5
Philippines	Peso 102	2.19	27.3	46.5	-41
Poland	Zloty 8.30	2.60	2.22	3.20	-30
Russia	Rouble 71.0	2.33	19.0	30.4	-38
Saudi Arabia	Riyal 10.0	2.67	2.68	3.75	-29
Singapore	S$ 4.23	3.08	1.13	1.37	-18
South Africa	Rand 18.5	2.45	4.94	7.54	-34
South Korea	Won 3,400	2.82	911	1,204	-24
Sri Lanka	Rupee 210	1.86	56.3	113	-50
Sweden	SKr 48.4	6.56	13.0	7.37	76
Switzerland	SFr 6.50	6.19	1.74	1.05	66
Taiwan	NT$ 75.0	2.34	20.1	32.1	-37
Thailand	Baht 70.0	2.17	18.8	32.3	-42
Turkey	Lira 5.95	3.89	1.59	1.53	4
UAE	Dirhams 11.0	2.99	2.95	3.67	-20
Ukraine	Hryvnia 14.5	1.84	3.88	7.90	-51
Uruguay	Peso 79.0	3.74	21.2	21.1	nil

*At current exchange rates †Purchasing-power parity: local price divided by price in United States ‡Average of Atlanta, Chicago, New York and San Francisco §Dollars per pound **Weighted average of prices in euro area ††Dollars per euro

Sources: McDonald's; The Economist

Depending on your cognitive agility, there are any number of mental contortions that you can do with this data while extracting whatever value may be hiding in it. For example, you can imagine that Big Macs are a currency and the local currencies are the object of desire. Or that U.S. dollars purchased with Big Macs transported to foreign countries are the goal. You can pretend that Big Macs have the properties of gold, like durability, divisibility and portability, and imagine the arbitrage opportunity based on these charts, and how that arbitrage would affect the currency exchange.

In fact, there is a bit of real value that can be extracted from this little exercise that I'll get to in a moment. But first, the clearest lesson is that Big Macs make a poor global reference point for value for many obvious reasons.

What makes something a reference point is that everything else in its category is measured against *it*. Like the cylinder at the top of the page, all mass everywhere is ultimately measured against this one

cylinder. For the category of value, the value of anything anywhere would be measured against the value of the reference point. And in the case of value, this reference point should be a thing that can be owned and valued by anyone anywhere, so that it acts properly as a baseline reference point for the value of everything else. It should also, ideally, provide the same utility to anyone anywhere.

The point is that it can't be something that is only found in Asia, or something that is only made in the US. And it can't be a product like a Big Mac that would not be valuable to vegetarians or food snobs. It needs to be something that has the same utility to everyone, that utility being that it is only something valuable to buy and store so that later you can redeem that value in some other way. A reference point can be used in its unit of account function even without the presence of the physical item. But the focal point item for a value reference point needs to be something that CAN actually be gotten and used exactly the same by anyone anywhere.

And as we continue on this train of thought, it becomes clear that the ideal reference point for value is, in fact, the single focal point reserve asset chosen by the human Superorganism. It also becomes clear that today the U.S. dollar is filling this role, somewhat haphazardly, and also under the opposing forces of inertia—the resistance to change—and progress—the need for change. It could be said that we in the West are providing the inertia while the rest of the world is pushing for change. At least that's what I see happening.

Clearly, we in the West still measure the value of anything anywhere against the dollar. Think about it for a second. Can you tell me the value of a condo in Hong Kong? How about the value of a night in a five-star Singapore hotel? And what's the value of a 50' yacht in Dubai? You'd likely quote me all three in dollars, especially if you are a Westerner. As FOA pointed out, we assess the relative values of any two things—like an apple versus a banana—by mentally converting them into dollars.

And while our Western minds have been trained to use the dollar quite efficiently in this way, there are a few technical problems with the dollar being the reference point of value. Not unlike the kilo cylinder at the top which is causing problems for some scientists, the dollar, too, is shrinking.

The main problem, which the Imprimis article points to, is that the dollar is no longer defined as anything other than how the market decides to value it on any given day. This could be called a floating definition. So the article proposes that the needed fix is to redefine the dollar. Perhaps we could redefine the dollar to be equal to one Big Mac! The U.S. Treasury could then buy all McDonald's restaurants everywhere and defend the dollar by globally spewing Big Macs for a buck. Can you think of any problems with this plan?

Okay, let's imagine they redefined the dollar to be 1/5,000th of an ounce of gold. Can you think of any problems with this? I can. What will be the definition of gold? Does this sound like a silly question? Well, today "gold" is trading at around $1,435 per ounce, and this price is discovered through the dynamics of supply and demand in a market that includes claim checks on unallocated pools of gold, shares of funds that are physically non-divisible below 10,000 ounces, and promises of future delivery of gold from a variety of sources including mines (gold that is still underground), hedgefunds (gold that will have to be sourced if demanded) and banks (gold which is fractionally reserved). These markets all trade (fluctuate) in dollars. If the dollar is suddenly defined as a piece of gold, what will happen to these markets?

Maybe they should just define the dollar as 1/500th of a share of GLD! Then the U.S. Treasury could defend the definition by spewing GLD shares! Or they could define the dollar as 1/500,000th of a COMEX contract! Or better yet, they should just define the dollar as 1/5,000th of a Bullion Bank liability for an ounce of gold. The Treasury could partner with JP Morgan and defend the definition by spewing liabilities!

What we have here is not a problem with the definition of the dollar, the quaint and sentimental reference point artifact of the past. What we have is a problem with the definition of gold, the 21st century (and all others too) reference point of value!

I said earlier that there was a bit of real value to be discovered by thinking about the Big Mac index. And that discovery is that a Big Mac hamburger actually has one characteristic or property that makes it a better reference point for value than either the dollar or even the modern definition of "gold." That property is physicality! Big Macs only come in one variety, a discrete, physical hamburger. There are no Big Mac futures or forward sales, no unallocated Big Mac pool accounts, and the only way to deliver a Big Mac is to either make it on the spot or physically transport it to where it is demanded. Can you imagine if they handed you a BB (Big Mac Bank) liability at the drive-thru window?

I wrote above, "pretend that Big Macs have the properties of gold, like durability, divisibility and portability, and imagine the arbitrage opportunity based on these charts, and how that arbitrage would affect the currency exchange." Such an arbitrage would ultimately flatten that first chart, making a Big Mac cost the same number of dollars in any country you traveled to. In fact, gold (under its modern definition) acts just this way.

The definition of "gold" today, at least in financial circles, is completely messed up. Why do you think I have to constantly say *physical* gold? And not only that, I continuously have to define what I mean by physical whenever I say it! It's ridiculous. Ask any fund's manager how much they have in gold. He'll likely quote you a number around 5-10% that includes mining stocks, paper promises and a host of other precious metal stocks. Ask him about *physical gold bullion*, specifically, and he'll quote you a much lower percentage that likely includes only PHYS and GLD. Those are the financial definitions of "gold" and "physical gold" today.

The problem is that the arbitrage that makes PPP work with gold today is too easily and asymmetrically achieved, which ends up favoring some currencies over others. What I mean is that hamburgers are actually a "harder currency" today (harder=more difficult) than "gold" under the common Western understanding of "gold investments." [9] Like I said, to be delivered Big Macs must either be produced on the spot or physically delivered from another place. Gold, on the other hand, can be sold into demand with the click of a mouse that creates a new liability on the balance sheet of JP Morgan or one of the other Bullion Banks. This is asymmetric in that most Bullion Bank gold liabilities originate from London and New York, and it is a definitional problem that makes it impossible for the term "gold" to be used to define anything else, like the dollar.

So before we can even consider the definition of the dollar, we must first solve the problem with the definition of "gold." And once solved, we may find the question of redefining the dollar to be a moot point. But whether you believe me or not about it becoming moot, we must still face first things first.

In order for a **thing** to perform as a reference point for value, when market demand for that thing rises

it *must* be met with the difficulty of the physical, not satiated with the ease of promises. **This is the main reason currency makes a poor reference point for value.** When demand for currency rises it is hoarded which slows the economy. *Value* is the output of the economy. **It is the opposite of currency.** When the demand for currency is collapsing, the demand for value is rising, and vice versa.

This is why Central Banks came into being in the first place; to make sure that rising currency demand does not hurt the economy. This is why the BOJ injected trillions of yen after the earthquake; to protect vital economic activity from the spiking demand for currency.

I know this is a difficult concept to swallow, but **value and currency are polar opposites**, which is why, if gold is the reference point for value—which it is—it cannot function properly and also be an economic currency—or tied at a fixed parity (price) to currency in any way! To view an economic currency built to function properly alongside the reference point gold, look no further than the architecture of the euro. [10] This is why the first ECB President stated clearly and publicly that the euro "is the first currency that has… severed its link to gold." [11]

I want to mention one more very significant advantage to physical gold being the global reference point for value. In another recent article by Michael Pettis, who I mentioned earlier, titled The dollar, the RMB and the euro?, talking about the struggles ahead for the RMB, he writes:

*"Although China will struggle to bring its current account surplus down, there are only two ways it can do so (*remember *that the current account surplus is equal to savings less investment)."*

The two ways he lists are 1) increase internal investment, a non-starter in China right now, or 2) get the people to spend their money (consume) rather than saving it—decrease savings. It's a shame that he can't see that China is already doing this by encouraging its people to buy the physical reference point of value itself. By buying physical gold, Chinese savings don't raise the current account surplus, they LOWER it. It's still very real savings, but it acts like consumption on the balance Pettis describes. More correctly, his "accounting identity" should read, "current account surplus is equal to non-gold monetary savings less investment." Or stated another way, "paper savings = production – consumption (including physical gold purchases)." And surprise-surprise, China is apparently already ahead of the game.

By encouraging savings in gold, this raises demand for gold inside China and uses up some of the dollars that would have otherwise been recycled back to be borrowed and spent by the US Treasury. In other words, every ounce of gold that flows into China today represents $1,430 that Bernanke will have to print via QE rather than borrowing from China.

What it means

What this Reference Point Revolution (RPG/Freegold) means for Western savers like you and me is that at some time this year or next (see footnote #7) perceptions of value will likely be shattered: "like a mirror in pieces on the floor, revealing another mirror standing right behind it, providing another perspective… the perspective will be of necessity, a rude awakening, so to speak… so much value is just perception only, not reality, and that perceived value will go up in flames, to reveal this perspective from which more accurate valuation will spring… the mass of acting humans (aka economy) will better understand money and savings, intuitively, through this perspective… gold will no longer be talked about, treated, and therefore viewed as a commodity, it will cross over to the other side of the fence…

most won't care to really understand in any detail, they will just know that it is reality and will approve of its prospects… The value of gold will change as people's perception of its utility to them changes." [12]

"Can you imagine a gold price of AT LEAST $100,000 per ounce? How about a real purchasing power increase, measured in today's dollar purchasing power, to somewhere between $10,000 and $100,000? In the bell curve below we can see that the most probable PP landing zone is between $25,000 per troy ounce and $85,000 per troy ounce. Can you think of a better reason to invest in physical gold coins right now? How about protection from hyperinflation? $100,000 is the bare minimum in this case. The top is infinite! Imagine $12 trillion per troy ounce... the size of today's US national debt reduced to one single gold coin you could buy tomorrow! Can you imagine it? It doesn't really matter if you can't see it like I do, as long as you buy the coin. As JFK liked to say, 'a rising tide lifts all boats', not just the ones that believe in rising tides." [13]

"So how much of your perceived wealth have you locked into a real, solid, "good as gold" wealth reserve? I shouldn't have to say this because it is so obvious, but it is clearly better to "cash out" of the paper game and "lock in" your profits BEFORE the two biggest bubbles in history pop. That way you beat the rush, so to speak." [14]

The demand necessary to perpetually sustain a revaluation of gold at, say, $55,000 per ounce is already present in the gold market. One only has to understand why Giants—people with enough money to actually move the price of gold—do not find it in their best interest to use their money to move the price of gold. "Gold is neither expensive nor cheap today. It is theoretically free. It is a monetary conversion, like buying a Treasury or a money market fund. To the Giants, do you think gold is a game of "how big is my slice of the pie?" Or is it "how much is my slice of the pie worth?" Is it better to have a 15% slice of a commodity pie, or a .4% slice of the global wealth pie? Is it more likely that all the gold in the world combined, when used as a wealth reserve, will be worth a large percentage of everything? Or that it is worth only 30% of the known oil reserves?" [15]

"But right now, for perhaps the first time in history, individuals can join central bankers and the true Giants of the world by participating in the ultimate hedge fund. One that, like modern hedge funds, focuses on the hedge itself as the key investment with the most leverage, with the expectation of life-changing returns. And the main differences between this and traditional hedge funds are 1) much less risk, and 2) it is open to ALL individuals, including you!" [16]

"Freegold is our destination with or without the euro. Even on the outside chance that an SDR or a similar super-sovereign currency is accepted as the new global reserve currency, it would have to contain gold at Freegold valuations in order to be viable, accepted and trusted, in the same vein as Randy's comment about an EMF. So any way you cut it, the future comes to us with really high value gold by today's standards." [17]

"Anyway, this is what Freegold is all about. It is about deducing the inevitable implications of an unstoppable avalanche. And it is about fiat currency finally finding its natural equilibrium with a parallel physical gold wealth reserve. And trust me, fractional paper gold promises won't work in this new world, so equilibrium will likely be somewhere north of $50,000 per ounce (and that's from just the functional change, don't even ask me about the inflation-adjusted price)." [18]

"Take it for whatever it's worth, which, of course, only you can decide for yourself. The $IMFS is failing. Please don't let the fears, envy or baseless doubts of others obscure this reality. You can choose to participate in the recapitalization of world finance or you can be a victim of it when the lights go out. The choice is right in front of you. So decide what you'd rather be: a participant in the rebuild, or a victim of the collapse. Amazingly you still have this choice available as I type these words." [19]

"As ANOTHER and FOA taught us, a time of systemic transition is completely wrong for trading on technicals. Instead, it is the PERFECT time to consolidate on fundamentals, then sit back and wait. The reward, as ANOTHER put it, will be enough for one's lifetime. And what is gold? Oh yeah, it's the ultimate wealth consolidator." [20]

And now, for all you FOFOA noobs, I will close, as I so often do, with another mind-blowing excerpt from FOA's Gold Trail. [21]

My friends and I are Physical Gold Advocates. We own physical outright and do so employing the same reasoning mankind used in owning gold throughout most of history. However, there is a major difference between our perceptions of this historic reasoning and the current Western perceptions so many of you are attuned to. Our's is not a mission to unseat the current academic culture concerning money teachings; rather it is to present the historic and present day views of the majority of gold owners around the world. Those of simple thought and not of Western education. Plain people that, in bits and pieces, own and use the majority of above ground gold.

Most contemporary Western thought is centered around gold being money. That is; gold inherently has a money use or money function; built into it as part of the original creation. This thought presents a picture of ancient man grasping a nugget of gold, found on the ground, and understanding immediately that this is a defined "medium of exchange"; money to buy something with. This simple picture and analysis mostly grew in concept during the banking renaissance of the middle ages and is used to bastardize the gold story to this day. Even the term "money", as it is used in modern Bible interpretations, is convoluted to fit our current understandings.

Much in the same way we watch social understandings of music, literature, culture and dress evolve to fit current lifestyles, so too did gold have a money concept applied to it as it underwent its own evolution in the minds of political men. This is indeed the long running, background story of our Gold Trail; an evolution, not of gold itself, but of our own perceptions of this wealth of ages. A evolving

message of gold that is destined to change world commerce as it has never changed before.

Onward my friends

In ancient times there was no concept of money as we know it today. Let me emphasize; "as we perceive money today". Back then, anywhere and everywhere, all things known to people were in physical form. All trade and commerce was physical and direct; barter was how all trade was done.

If one brought a cart to market, loaded with 20 bowls and 20 gold nuggets, he used those physical items to trade for other valued goods. The bowls and gold had different tradable value; as did every other thing at the market. Indeed, gold brought more in trade than bowls. Also true; if a barrel of olive oil was in short supply, it might bring even more in trade than all the gold in the market square.

The understanding we reach for here is that nothing at the market place was seen as a defined money value. All goods were seen simply as tradable, barterable items. Gold included. Truly, in time, some items found favor for their unique divisible value, greater worth and ease of transport. Gems, gold, silver and copper among others, all fit this description. These items especially, and more so gold, became the most tradable, barterable goods and began to exclusively fill that function.

But the main question is: was there money in that market place? Sure, but it was not in physical form. Money, back then and today, was a remembered value in the minds of men. Cumbersome it may have been, but even back then primitive man had an awesome brain and could retain the memory values of thousands of trades. In every case, able to recall the approximate per item value of each thing traded. That value, on the brain, was the money concept we use today.

Eventually gold climbed to the top of in the most tradable good category. Was gold a medium of exchange? Yes, but to their own degree, so were the bowls. Was gold a store of value? Yes, but to a degree, so were dinner plates. Was gold divisible into equal lesser parts to define lesser barter units? Yes, but to a degree one could make and trade smaller drinking cups and lesser vessels of oil. Perhaps gold became the most favored tradable good because the shear number of goods for good traded made a better imprint on ones memory; the worth of a chunk of gold in trade became the value money unit stored in the brain.

Seeing all of this in our modern basic applications of "money concept", almost every physical item that naturally existed or was produced then also held, to a lesser degree, gold's value in market barter. But most of us would have a hard time remembering a bowls value and thinking of a bowl as money. The reason this is such a stretch for the modern imagination is because bowls, like physical gold, never contained or were used in our "concept of money". Back then, as also today, all physical items are simple barterable, tradable goods; not of the money concept itself. Their remembered tradable value was the money.

Money, or better said "the money concept", and all physical goods occupy two distinct positions in our universe of commerce and trade. They have an arms length relationship with each other, but reside on different sides of the fence and in different portions of the brain.

For example: say I take a bowl to the mint and place an official government money stamp on the underside. The bowl now is stamped at $1.00. Then I take one tiny piece of gold to the mint; one 290th

of an ounce or at today's market a dollar's worth. They stamp that gold as $1.00. Which physical item would be money? Answer; neither.

Using ancient historic reasoning and the logic of a simple life; the bowl could be taken to the market square and bartered for another good. Perhaps a dinner plate. In that barter trade, we would most likely reach an understanding; that the "bowl for plate trade" imprinted our memory with what a digital, numeric dollar concept is worth. Again, the 1.00 unit was only stamped on the bottom for reference. While the dollar concept is only a rateable unit number to compare value to; like saying a painting is rated from one to ten when judging appearance.

We could do the exact same thing without 1/ 290th ounce piece of gold as with the bowl above. In the process we again would walk away with the knowledge of what a $1.00 unit of money value was worth in trade. The physical gold itself was not the money in trade; the value of the barter itself created the actual money value relationship. Again, the most important aspect for us to grasp here is this:

----- The use of physical gold in trade is not the use of money in trade. We do not spend or trade a money unit, like the dollar, to define the value of gold and goods: we barter both goods and gold to define the worth of that trade as a remembered association to the dollar money unit. That remembered worth, that value, is not an actual physical thing. A dollar bill nor an ounce of legal tender gold represent money in physical form. Money is a remembered value relationship we assign to any usable money unit. The worth of a money unit is an endless mental computation of countless barter trades done around the world. Money is a remembered value, a concept, that we use to judge physical trading value. -----

Onward

Naturally, for gold to advance as the leading tradable good it had to have a numerical unit for us to associate tradable value with. We needed a unit function to store our mental money value in. In much the same way we use a simple paper dollar today to represent a remembered value only. Dollars have no value at all except for our associating remembered trading value with them. A barrel of oil is worth $22.00, not because the twenty two bills have value equal to that barrel of oil: rather we remember that a barrel of oil will trade for the same amount of natural gas that also relates to those same 22 units. Money is an associated value in our heads. It's not a physical item.

The first numerical money was not paper. Nor was it gold or silver; it was a relation of tradable value to weight. A one ounce unit that we could associate the trading value to. It was in the middle ages that bankers first started thinking that gold itself was a "fixed" money unit. Just because its weight was fixed.

In reality, a one ounce weight of gold was remembered as tradable for thousands of different value items at the market place. The barter value of gold nor the gold itself was our money, it was the tradable value of a weight unit of gold that we could associate with that barter value. We do the very same thing today with our paper money; how many dollar prices can you remember when you think a minute?

This political process of fixing money value with the singular weight of gold locked gold into a never ending money vs gold value battle that has ruined more economies, governments and societies than

anything. This is where the very first "Hard Money Socialist" began. Truly, to this day they think their ideas are the saving grace of the money world. It isn't now and never was then.

When investors today speak of using gold coin as their money during a full blown banking breakdown, what are they really speaking of?

In essence, they would be bartering and trading real goods for real goods. The mention of spending gold money is a complete misconception in Western minds. Many would bring their memories of past buying with them and that is where the trading values would begin. Still, it would take millions of trades before the "market place" could associate a real trading value to the various weight units of gold. It took mankind hundreds of years to balance the circulation of gold against its barterable value. Only then could a unit weight value become a known money concept. In that process, in ancient times, gold had a far higher "lifestyle" value than it has seen in a thousand years. This value, in the hands of private owners, is where gold is going next.

If you are following closely, now, we can begin to see how easy it is for the concepts of modern money to convolute our value and understanding of gold. It is here that the thought of a free market in physical was formed. Using the relationship of a free physical market in gold, we will be able to relate gold values to millions to goods and services that are currency traded the world over. Instead of having governments control gold's value to gauge currency creation; world opinion will be free to associate the values of barter gold against barter currency. In this will be born a free money concept in the minds of men and governments. A better knowledge and understanding of the value of all things.
-FOA (2001)

Sincerely,
FOFOA

[1] Hillsdale College is a small liberal arts college with a student body of about 1,300. It does not accept federal or state taxpayer subsidies for any of its operations. Imprimis is dedicated to promoting civil and religious liberty by covering cultural, economic, political and educational issues of enduring significance. The content is drawn from speeches delivered at Hillsdale College events. Imprimis is one of the most widely circulated opinion publications in the nation with over 1.9 million subscribers. That's a lot of readers for this type of monetary article. And this article was the only content in the Feb. edition.
[2] A kilogram is a scientific measure of mass, not weight, because weight is not universal while mass is. An ounce of gold on the moon, for example, would only weigh as much as 5 grams on Earth.
[3] One of the leading alternatives for a 21st-century kilogram is a sphere made out of a Silicon-28 isotope crystal, which would involve a single type of atom and have a fixed mass. Another is to link the kilogram to a fundamental unit of measurement in quantum physics, the Planck constant. This redefinition would bring the kilogram into line with the six other base units that make up the International System of Units (SI) – the metre, the second, the ampere, the kelvin, the mole and the candela. None of these are now based on a physical reference object – the metre is defined in terms of the speed of light, for example, while the second is based on atomic clocks.
[4] An appropriate example is that before the metallic cylinder, a gram was defined as "the absolute weight of a volume of pure water equal to the cube of the hundredth part of a metre, and at the temperature of melting ice."
[5] For an explanation of the term Superorganism, please see my post Life in the Ant Farm.

[6] For an explanation of the term Focal Point, please see my post Focal Point: Gold.
[7] Punctuated Equilibrium is a good description of how monetary evolution proceeds. Here's an example of what I mean. Notice the regularity of the cycle. Your homework assignment is to uncover what the dates represent in the monetary evolutionary cycle:

—Equilibrium—
1893-1897 **Punctuation**
—Equilibrium—
1930-1934 **Punctuation**
—Equilibrium—
1968-1971 **Punctuation**
—Equilibrium—
2008-____ **Punctuation**
—Equilibrium—

From the cyclical pattern above, it seems to me like ____ should be either 2011 or 2012. What do you think? Should we ask Marty?

For an explanation of the term Punctuated Equilibrium, please see my post Evolution.
[8] For an explanation of the terms "hard and easy money camps," please see my post The Debtors and the Savers.
[9] "When we talk about gold money we often use the term "hard money." And one misconception that pops into most people's mind is that "hard" money means hard like a rock, or hard like a piece of metal versus "soft" like a piece of paper that folds nicely into my wallet. Or the ultimate soft, a digital electron that moves at the speed of light.

"This may not seem like a big deal, but I think it is. What is actually meant by "hard" money is that it is difficult, or hard to get. The opposite of hard being easy, not soft. Hard money cannot be expanded easily (without risk) because it has an anchor in the physical world."
From Just Another Hyperinflation Post - Part 2
[10] For more on the euro's architecture, please see my post Reference Point: Gold - Update #1
[11] The full line was, "It is the first currency that has not only severed its link to gold, but also its link to the nation-state." See Acceptance speech by Dr. Willem F. Duisenberg, President of the European Central Bank, Aachen, 9 May 2002
[12] Quoted from Julian's excellent comment.
[13] From Gold is Wealth
[14] From Gold: The Ultimate Un-Bubble
[15] From Gold: The Ultimate Wealth Reserve
[16] From Gold: The Ultimate Hedge Fund
[17] From Synthesis
[18] From Equilibrium
[19] From How Can We Possibly Calculate the Future Value of Gold?
[20] From Gold: The Ultimate Wealth Consolidator
[21] Please see the top of this blog for to whom it is a tribute.