April 2010

How to go back to the Gold Standard

Last month we discussed the various reasons why a 100% gold backed currency was the most logical and desirable money for a free people. I made the case that it was the best system ever invented because of its track record of keeping inflation in check and for the discipline it forces onto banks and governments.

Many people erroneously believe that a gold standard would be too difficult to return to and that gold is a barbaric relic that has no place in our modern banking system. Why would we need gold when we have mortgaged backed securities, collateralized debt swaps, and derivatives? I agree with former Federal Reserve President, Paul Volcker, when he said that the only real financial innovation in recent years was the ATM machine.[1] The nature of man has not changed and therefore there is every reason for free people to want sound money that is a long-term store of value and cannot be printed at the whims of politicians.

The US abandoned the gold standard a short 39 years ago. In the grand time-line of history, this is not a very long time. Without the discipline that a gold standard imposes on banks and governments, imbalances have gone on much longer than they should have. As you can see from the chart to the left, America's debt to GDP ratio has gone parabolic. This ratio clearly spiked in the 1930s *after* the '29 crash due to the denominator (GDP) getting wiped out. As bad as our last recession has been, the contraction in GDP hasn't even come close to that of the Great Depression and our debt to GDP is already much higher than during the depression. This

Source "The End Game" presentation by John Mauldin

[1] http://transcripts.cnn.com/TRANSCRIPTS/1002/14/fzgps.01.html

cannot go on forever and at some point "backed by the full faith and credit of the U.S. Government" will be a cruel joke.

On top of our debt problems, we have trade deficits and unfunded liabilities that would never be allowed under a gold standard. The whole system is very fragile. Many foreign countries that have savings keep those savings in U.S. Government Bonds and Euro Government bonds. These same producing nations have to wonder what the dollar and the euro will be able to buy when they get paid back or if they will even be paid back at all. We have a system where Asians work very hard for relatively low wages, producing stuff that we want to buy. In exchange for their toil, we send them more paper! How much longer can this go on? In 1956, Eisenhower wanted Britain to withdraw from the Suez Canal. Rather than resorting to military pressure, he threatened to dump the U.S.'s large holdings of British bonds that we purchased during WWII and during the Marshal Plan. This would have crushed the British Pound and made imports very expensive for their economy. Britain withdrew from the canal and many mark that as the end date of the British Empire.[2] What kind of threats could our creditors impose on us? Could WWIII be an economic war?

The last major flaw with our current fiat system is the enormous fluctuations we get in currencies. Look at how the Euro Index lost over 20% in just 4 months in 2008 in the chart above. I do not envy the strategic planners at large multi-national corporations. How can you plan a business when major currencies can move .5% against each other in a day? The only group benefiting from these wide swings is speculators.

Americans are so used to using Federal Reserve Notes for money that we often don't think about how our monetary system works. Look at any denomination of U.S. paper money in your wallet. On the side with the president's picture, it says Federal Reserve Note. What is that? The U.S. Treasury states:

[2] http://en.wikipedia.org/wiki/Suez_crisis

> Federal Reserve notes are not redeemable in gold, silver or any other commodity, and receive no backing by anything[.] This has been the case since 1933. The notes have no value for themselves, but for what they will buy. In another sense, because they are legal tender, Federal Reserve notes are "backed" by all the goods and services in the economy.[3]

Richard Russell recently stated, "There is no definition for the dollar. The dollar can only be defined in terms of other currencies, and the currency that the dollar is mainly compared with is the euro. But it's absurd to judge the strength or weakness of the dollar in terms of the strength or weakness of the euro. The true test of the dollar is in its relationship to gold, not in its relationship to a sick currency like the euro. This is all part of the craziness that surfaced when the world abandoned the gold standard. Thus, I compare the world monetary situation to a ship at sea that has lost both its rudder and its anchor."[4]

We can't have rolling currency crises forever and it is immoral for each country to continue competing to see who can devalue their currency the fastest. I am going to make the not so bold prediction that we will have a new monetary regime within 10 years time. We should have heeded Thomas Jefferson's warning:

> And I sincerely believe, with you, that banking establishments are more dangerous than standing armies; and that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale.[5]

Economist, Murray Rothbard, said "Ultimately, the issue is a stark one: we can either return to gold or we can pursue the fiat path and return to barter."[6] I would rather *choose* to go back to the best monetary system known to man than to eventually be forced through a financial Armageddon.

Before we begin to discuss going back to a gold standard, I think it is important to discuss something very basic that most of us never think about—How does the Federal Reserve create Federal Reserve Notes? As mentioned on page two, they are backed by nothing and have "no value for themselves, but for what they will buy." According to *Putting it Simply*, a publication by the Boston Federal Reserve:

> When you or I write a check there must be sufficient funds in our account to cover the check, but when the Federal Reserve writes a check there is no bank deposit on which that check is drawn. When the Federal Reserve writes a check, it is creating money.[7]

Many people have never thought of where our modern money comes from. The Federal Reserve creates money (Federal Reserve Notes) out of thin air whenever they buy U.S. Treasuries, Fannie Mae bonds, or even Bear Stearns' toxic sub-prime mortgages from large banks. All of our money is backed by debt and there has to be more debt than money in our system at all times. After the Fed prints money, the banks further create money out of thin air through the magic of fractional-reserve banking. I don't have space to fully explain fractional-reserve banking. If you would like to

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[3] http://www.ustreas.gov/education/faq/currency/legal-tender.shtml
[4] www.dowtheoryletters.com
[5] http://memory.loc.gov/cgi-bin/query/r?ammem/mtj:@field(DOCID+@lit(tj110172))
[6] Murray Rothbard, *The Case for a 100% Gold Dollar* (Auburn, AL: Ludwig Von Mises Institute, 2005), 176.
[7] http://www.chrismartenson.com/crashcourse/chapter-8-fed-money-creation

learn more about it, I highly recommend that you pick up the following resources. They are well worth your time.

http://video.google.co.uk/videoplay?docid=-3449574836932931748#docid=-3685478902935835175

http://www.chrismartenson.com/crashcourse/chapter-6-what-money Watch chapter 6-8.

The Mystery of Banking by Murray N. Rothbard

The fact that we have a debt-based monetary system is hard for people to accept. Once you spend time learning how it works, I think you will agree that 100% banking and a gold standard is a better alternative to the mess that we are currently in. Let's move on to how we can go back to a gold standard.

Instead of reinventing the wheel, I have updated much of Murray Rothbard's plan to go back to a gold standard from his 1994 book, *The Case Against the Fed*. Murray wrote this excellent book one year before his death and you can read the entire book for free at http://mises.org/books/fed.pdf.[8]

Rothbard suggests that we start with the fact that the Federal Reserve is a corporation. Congress should write an act that treats it as a corporation and liquidate its assets pro rata to its creditors in exchange for gold backed notes. The first thing we should do is cancel all $776.7[9] billion in treasuries the Fed owns on its balance sheet. We would still have to pay the roughly $12 trillion left in debt that we owe to individuals and foreign countries, but it would make an immediate difference to the debt burden on the U.S. taxpayer. Rothbard asks, "…why in the world should taxpayers be taxed by the U.S. Treasury in order to pay interest and principal on bonds held by another arm of the federal government—the Federal Reserve? The taxpayers have to be sweated and looted, merely to preserve the accounting fiction that the Fed is a corporation independent of the federal government."[10] Let's get into the mechanics.

According to the World Gold Council, the United States has 8,133.5 tonnes of gold.[11] That is approximately 261.5 million ounces or $287.65 billion at a $1,100/ounce gold price. The debt on the Federal Reserve's balance sheet recently hit a record of close to $2.3 trillion.[12] If we cancel the treasuries owned by the Federal Reserve, that leaves us with $1.523 trillion of liabilities backed by the only real asset the Fed owns—its gold stock. The 261.5 million ounce gold stock is currently valued by the Federal Reserve at only $11 billion. This is because they arbitrarily fix the price of gold at $42.22 per ounce on their balance sheet. This has always seemed fishy to me when the current price of gold is around $1,100 per ounce.

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[8] The biggest difference between the plan that I outline below and Rothbard's, is that when he developed his plan in 1994, the Federal Reserve did not own the exotic securities that it does today. I am not qualified to place a value on the Bear Stearns mortgages and Government Sponsored Entities debt that the Fed owns today and am assuming that these get paid to creditors at 100%. Market participants may believe that the actual value may be much less and it would make sense for banks to take a haircut on these securities. In the event of haircuts, the dollar value of an ounce of gold would be less than I calculated.

[9] http://www.federalreserve.gov/releases/h41/Current/

[10] Murray Rothbard, *The Case Against the Fed* (Auburn, AL: Ludwig Von Mises Institute, 1994), 147.

[11] http://www.research.gold.org/reserve_asset/

[12] http://www.reuters.com/article/idUSTRE62O4X520100325

So we have a problem. The Fed has $1.523 trillion in liabilities balanced by only $11 billion in real assets. In order to fix this, the Federal Reserve will need to revalue its gold holdings and define each Federal Reserve Note (dollars) by the amount of gold backing it. Let's take the $1.523 trillion left over in debt and divide it by the 261.5 million ounces of gold. That gives us a gold price of **$5,824** per ounce. This would allow the Federal Reserve to pay its creditors off at 100% and immediately put us back on a gold standard. The dollar would be defined forevermore as a weight of 1/5,824 of an ounce of gold, just like it used to be defined as 1/20.67 of ounce of gold before Franklin Roosevelt confiscated the people's gold and then officially devalued the dollar to 1/35 of an ounce of gold.[13]

Many people think that this would cause major disruptions, massive deflation, or all out pandemonium. I concede that almost everything would drop dramatically relative to gold. Beyond that, I do not see any major changes—it is really just being honest with the amount of gold backing the liabilities of the Fed now. As discussed above, the dollar is currently backed by *nothing* and is redeemable only for what people will trade for it. It is a completely faith-based currency and at some point, people will lose faith in it just as they have with thousands of other fiat currencies throughout history. The fact remains that the Fed has 261.5 million ounces of gold and that is it. Re-pricing gold to $5,824 per ounce is only acknowledging the current reality.

It doesn't matter what the initial ratio of dollars to gold is. The important thing is that you stick with the ratio once you are on a gold standard. In *The Case for a 100% Gold Dollar,* Rothbard argues "… the supply of money essentially does not matter. Money performs its function by being a medium of exchange; any change in its supply, therefore, will simply adjust itself in the purchasing power of the money unit, that is, in the amount of other goods that money will be able to buy. An increase in the supply of money means merely that more units of money are doing the social work of exchange and therefore that the purchasing power of each unit will decline.[14]"

The next step in our process would be to abolish the Federal Reserve and exchange all Federal Reserve Notes for coins and paper that would be minted by the Treasury. The banks' demand deposits at the Fed would then be converted into gold and sent out to each member bank to be held in their own vaults so that they could convert each customer's paper receipts (new dollars) into gold at the customer's request. The FDIC should also be immediately disbanded and each bank would be free to operate on its own standing. Any bank that fails to redeem paper receipts for physical gold moving forward will immediately be closed and its assets liquidated on behalf of its depositors.

Many people find abolishing the FDIC a disturbing idea. I am not recommending that we abandon regulations or regulators. Instead, I am advocating a free market in banking. Here is my short list of problems with the FDIC:

1. The FDIC is already broke and will have to borrow money from the Treasury. When it does, the losses of some will be socialized by all.

[13] http://en.wikipedia.org/wiki/Gold_confiscation_order
[14] Murray Rothbard, *The Case for a 100% Gold Dollar* (Auburn, AL: Ludwig Von Mises Institute, 2005), 168.

2. They are not fulfilling their mandate of "prompt correct action."[15] Karl Denninger has covered this extensively in his excellent blog.
3. It punishes strong banks at the expense of riskier banks.
4. It invites moral hazard. Customers don't care what the bank does with their money. They shop banks based on interest rates.
5. It creates a seemingly more stable banking system as many banks are allowed to take too much risk together and then crash and burn together. If banks were allowed to fail more often, bankers would be more careful with their lending standards and we would not get the kinds of excesses we saw in the depression, S&L Crises, or Sub-Prime Crisis.

Without the Open Market Operations of the Federal Reserve, banks would be free to establish free-market interest rates and determine the type of leverage that is prudent with their depositor's money. Under our current system, banks only keep 1/10 of their deposits in reserve. I find this to be inherently risky. That means that on any given day, if 10% of the depositors ask for all of their money at a healthy bank, the bank is instantly bankrupt. This so called "reserve requirement" would be a lot higher in a free banking system and banks would behave less like casinos.

Another objection you often hear to going back to the gold standard is that it would not be fair to the people who don't own gold or gold mining stocks. I think Murray Rothbard answers this best when he said "I do not believe that we should refuse an offer of mass entry into Heaven simply because the manufacturers of harps and angels' wings would enjoy a windfall gain."[16]

The last objection that I wanted to address is that free banking and a gold standard would slow growth down dramatically. I believe people who espouse this belief have been fooled by the smoke and mirrors of inflation and unsustainable debt. Several years ago I noticed something strange with my wall. It was perfectly flat and the paint looked fine. As I began picking it at it, I realized that termites had eaten the wood and destroyed the sheet rock up to the paint. Paper money has allowed us the illusion of prosperity and growth. Behind the façade, is a rotting, unsustainable debt load.

My proposal would make it harder to borrow. It would also increase interest rates (not a bad thing if you have done the right thing and saved) and it would dramatically reduce volatility around the world. Sound money brings about real growth and protects the people from bureaucrats and their printing presses.

Markets

If there is one market that is experiencing a secular bull market, it is gold. Gold has now gone up 9 years in a row. There is a very interesting story that is not making it to the main stream media. On March 23, whistle blower Andrew McGuire contacted the Gold Anti-Trust Action committee and stated that he was told by JPMorgan Chase traders that they manipulate the precious metals markets. Here is part of the story from the GATA dispatch:

[15] http://market-ticker.denninger.net/archives/1558-The-FDIC-Must-Be-Indicted.html
[16] Murray Rothbard, *The Case for a 100% Gold Dollar* (Auburn, AL: Ludwig Von Mises Institute, 2005), 183.

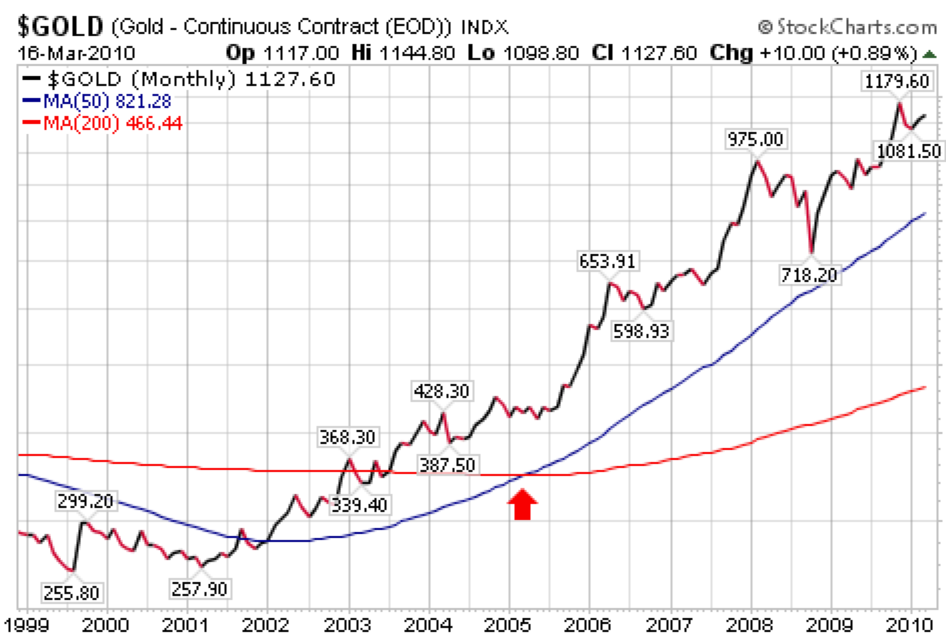
In November 2009 Maguire contacted the CFTC enforcement division to report this criminal activity. He described in detail the way JPMorgan Chase signals to the market its intention to take down the precious metals. Traders recognize these signals and make money shorting the metals alongside JPM. Maguire explained how there are routine market manipulations at the time of option expiry, non-farm payroll data releases, and COMEX contract rollover, as well as ad-hoc events.

On February 3[,] Maguire gave two days' warning by e-mail to Eliud Ramirez, a senior investigator for the CFTC's Enforcement Division, that the precious metals would be attacked upon the release of the non-farm payroll data on February 5. On February 5, as market events played out exactly as predicted, further e-mails were sent to Ramirez while the manipulation was in progress.

It would not be possible to predict such a market move unless the market was manipulated.

In an e-mail on February 5[,] Maguire wrote: "It is common knowledge here in London among the metals traders that it is JPM's intent to flush out and cover as many shorts as possible prior to any discussion in March about position limits. I feel sorry for all those not in this loop. A serious amount of money was made and lost today and in my opinion as a result of the CFTC's allowing by your own definition an illegal concentrated and manipulative position to continue."[17]

At the same time the Commodity Futures Trading Commission (CFTC) was conducting hearings on position limits in the precious metals markets. The CFTC regulates commodity trading and in public testimony they were told of manipulation in the markets they are supposed to be regulating.



_Source: Dow Theory Letters

Will they do a full-scale investigation of bullion banks or will they look the other way like the SEC did when Harry Markopolos handed Bernie Madoff to them on silver platter?

In the hearing, Adrian Douglas

[17] http://www.zerohedge.com/article/whistleblower-exposes-jp-morgans-silver-manipulation-scheme

of GATA pointed out that he believes that there is not enough physical gold in the world to settle the options contracts that are traded. He goes on to call it a Ponzi scheme of "paper backing paper." Jeffrey Christian, founder of the CPM Group later says, "…and the previous fellow was talking about hedges of paper on paper and that is exactly right. Precious metals are financial assets like currencies, T-Bills and T-bonds they trade in the multiples of a hundred times the underlying physical and so people buying them are voting and giving an economic view of the world…"[18]

Eric King of King World News states that this "…could be the largest fraud in history involving countries, banks, and government leaders." King recently interviewed Maguire. He stated that he felt betrayed by the CFTC for not being allowed to testify during their hearings and he has decided to take his story public. Maguire goes on to speculate that big players will begin to short dollars and go long silver once they realize that the bullion banks cannot deliver the physical silver.[19] If the accusations of Maqure, Christian, and Douglas are true, this could force many of the largest banks into bankruptcy because there isn't physical metal to cover their short positions and the price of precious metals would sky rocket. Below is the exclusive interview of Andrew Maguire and an interview with the founders of GATA. Stay tuned.

http://www.kingworldnews.com/kingworldnews/Broadcast/Entries/2010/3/30_Andrew_Maguire_%26_Adrian_Douglass.html

http://www.kingworldnews.com/kingworldnews/Broadcast/Entries/2010/3/31_GATA.html

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[18] http://www.zerohedge.com/article/former-goldman-commodities-research-analyst-confirms-lmba-otc-gold-market-paper-gold-ponzi

[19] http://www.kingworldnews.com/kingworldnews/Broadcast/Entries/2010/3/31_GATA.html