CHAPTER 2

What Is Money?

Money is the foundation stone in the political framework of a civilized community. . . . But stable community requires a stable currency.

—Lewis E. Lehrman, *Money, Gold, and History*

What is money? Millions of words have been written attempting to answer this question. Most of them have decreased, rather than increased, understanding. The answer is simple. Money has three roles in an economy:

1. It is a measure of value.
2. It is an instrument of trust that permits transactions to take place between strangers.
3. It provides a system of communication throughout a society.

Measurement. Trust. Communication. In order to function in these roles, money, above all, must be stable. When it isn't, it becomes impaired and an economy suffers. In the worst instances, when money stops working altogether, a society can be destroyed.

Money is a tool that *facilitates* transactions. It does not create them. And money, in and of itself, is not wealth—nor does increasing the supply of money by the whims of central bankers mean that wealth will be created. In fact, the opposite is the case.

This chapter discusses how money functions as a standard of measurement, a facilitator of trust, and a system of communication. Disasters wrought by bad monetary policy have all occurred because of a failure to grasp these three fundamental principles.

Money Is a Unit of Measurement

Money is a standard of measurement, like a ruler or a clock, but instead of measuring inches or time, it measures what something is worth.

Imagine what the world would be like if the number of minutes in an hour changed each day or if the number of inches in a foot kept changing. Life would become infinitely more difficult. How could a music teacher know what to charge for an hour-long music lesson if one hour was composed of 60 minutes one week and 70 minutes the next? How could an architect design a house if a foot consisted of 12 inches on a given day but a short time later it was 15 inches? Imagine how tricky it would be to bake a cake if the recipe called for 45 minutes in the oven, and you had to figure out if those were nominal minutes or *inflation-adjusted* minutes.

Just as we need to be sure of the number of inches in a foot or the minutes in an hour, people in the economy must be certain that their money is an accurate measure of worth. When the value of money fluctuates, as it so often does today, it produces uncertainty in addition to unnatural and often destructive marketplace behavior—artificial booms and busts that breed

malignant economic and social consequences. Graphic examples include Germany after World War I and the United States during the 1970s, as well as in the past decade.

People, Not Government, Invented Money

People accustomed to Uncle Sam's ubiquitous dollar and other national currencies rarely recognize that government did not invent money. Money originated in the marketplace as a solution to a problem. It arose spontaneously, like the spoon or the personal computer, in response to a need. In this case, the need was for a stable unit of value to facilitate trade.

The earliest coins were invented in ancient times in response to the challenges of barter. In order for a successful exchange to take place, there had to be what economists have called a "double coincidence of wants." Each side had to want the precise item offered.

For example, if *Forbes* magazine had sold an advertisement before the advent of money, we might have been paid with a herd of goats. For the sake of illustration, let's say iPads existed in those days and we wanted to buy them for our writers. We'd take our herd of goats to an Apple Store. But the proprietor informs us that he wants sheep instead of goats. So now we have to figure out how to swap goats for sheep. In the process we would have to hire a shepherd to make sure wolves didn't eat the sheep. The shepherd wants to be paid in wine. We have red wine, but he wants white wine. You can readily see how utterly inefficient and cumbersome barter is for getting things done.

In economics class we all learn that money is a medium of exchange, that it has certain physical characteristics. It should be fungible. One unit, like a gold bar or coin, should be interchangeable with another, and it should be portable and easy to store for use later. (That's why, as some have observed, chocolate

coins in gold wrappers would not work as money, especially in hot weather.)

First and foremost, money must be stable.

The Virtues of Stable Money

Stability is best achieved by a link to a commodity. Over the centuries, precious metals, such as silver and especially gold, most often have served this purpose. But other commodities, such as seashells, fur, fish, corn, rice, and tobacco, have also worked as currencies. Tobacco notes were used as money during colonial times. Prisoners of war used cigarettes as money during World War II, as did the Germans for several years after the war.

Milton Friedman's classic book *Money Mischief* tells the famous story of South Pacific Islanders who traded with giant stone coins known as *fei*. Because the islanders believed this money had great intrinsic value, the fei was extremely reliable as an indicator of worth. But the currency failed miserably when it came to portability. According to an eyewitness, it "[consisted] of large, solid, thick, stone wheels, ranging in diameter from a foot to twelve feet." Islanders had to insert a pole in the center of one of these giant coins to roll it around.

One couldn't ask for a less convenient currency. But the giant stones worked as currency because the islanders believed that they were a reliable measure of value. The Pacific Islanders did not fear that their tribal council would suddenly decree that there should be twice the number of fei—and their money would be worth less.

When Money Doesn't Work

Having a track record for soundness also helps fortify a currency. That's one reason why money has generally little value

in communist nations racked by shortages of consumer goods. How can you know that your money is an accurate measure of worth if there's very little to buy? The Cuban government, for example, knows the Cuban peso is nearly worthless. That's why it demands that tourists buy pesos with dollars at a grossly inflated price far above black market rates.

In the Soviet Union, consumers were always hungering for decent meats, fruits, and vegetables. But even if you had a fistful of rubles, your money usually couldn't buy these scarce staples unless you were politically connected and had access to special stores used by the party elites.

All the East German ostmarks in the world could not have bought a Trabant, the government-manufactured automobile. The infamous clunker was harder to get than a BMW, not because it was desirable but because the Trabant was virtually the only vehicle East Germans were allowed to get, and Trabants were strictly rationed.

Little wonder that both the ostmark and the ruble were perceived as nearly worthless. Communist currencies all sold in black markets at a fraction of their official exchange rates. The country's communist governments may have maintained the charade of a sound and stable currency, but the reality of the marketplace said something different: you never knew the purchasing power of your money because you couldn't be sure what goods would be available from day to day.

In the Soviet Union, the situation was summed up by the commonly heard expression "we pretend to work, and they pretend to pay us." Not surprising that productivity and the quality of products was notoriously poor.

The communist currencies and the fei also illustrate the second critical characteristic of money: it's about trust.

In Money We Trust—or Not

Money facilitates trade by creating trust between both sides in a transaction. In the days of barter if you exchanged, say, eggs for a loaf of bread, you could not be certain whether you would be getting fresh bread or day-old bread. But if you exchanged your eggs for money, you could trust in the value of what you were getting.

The media like to portray money as a fomenter of conflict. In fact, throughout history, money has promoted cooperation, bringing together buyers and sellers who are total strangers but who agree upon a standard measure of value. The historian Jack Weatherford and others have described how money has transformed society by making traditional kinship and social relationships less important. For this reason money creates a meritocracy, empowering smaller players to challenge the established order.

The power of money to create meritocracy was why Alexander Hamilton, the first secretary of the treasury under George Washington, proposed a new U.S. Mint that would produce coins as small as copper cents and half-cent pieces in order to make possible prices that were affordable for the poor. Born in the West Indies to a single mother, Hamilton had a unique appreciation of the ability of money to promote a culture of opportunity that enabled outsiders to rise. In the words of biographer Forrest McDonald, Hamilton keenly understood that "money is oblivious to class, status, color and inherited social position; money is the ultimate, neutral, impersonal arbiter." Hamilton built a financial system based on money and markets because he wanted America to be, in McDonald's words, a "society fluid and open to merit."

Money must be trusted for an economy, and also a society, to function. The value of money has less to do with whether it is made of metal or paper and more to do with *perceptions*.

People can lose faith in money as a result of a cataclysmic event—for example, a war. But more often this loss of faith happens when governments, for whatever reason—such as building bloated welfare states or financing costly military conflicts—print too much money or seem likely to do so in the future.

A profound and far-reaching loss of faith can produce a disastrous, self-fulfilling scenario: a massive sell-off of a currency on the foreign exchange market. At its worst, this kind of attack can bring on a death spiral and collapse in monetary value. This can accelerate inflation at home and cause a government to sharply raise interest rates, throwing an economy into severe recession. It can set off a panic that can spread to other nations.

In 2013 when the Federal Reserve indicated that its promiscuous bond buying would taper off and thereby lead to higher U.S. interest rates, emerging countries such as Brazil, India, Turkey, and Indonesia saw the value of their currencies weaken in anticipation that banks and companies would pull money out of those nations to take advantage of rising interest rates in the United States.

Foreign exchange markets were ready to attack their currencies because they had little faith that the governments of these countries would do what was necessary to maintain currency stability. This could have easily been accomplished had these nations used the dollars held in reserve by their central banks to buy their own currencies and shore up their value. But such relatively simple steps are rarely taken or executed correctly because most nations today don't understand the importance of having stable money.

A similar loss of trust brought on the devastating Asian currency crisis in 1997. That disaster was precipitated by Thailand's easy domestic money policy as well as by the U.S. dollar, which had been strengthening as a result of growth-inducing tax cuts and the inadvertent tight money of the Federal Reserve.

A strong U.S. economy was causing investors to dump the baht and other currencies in favor of the dollar. Observers felt too many bahts were being created to keep it pegged to the greenback at a fixed exchange rate. Like most other monetary bureaucrats, Thailand's central bankers didn't know how to defend the baht, which would have meant temporarily reducing its supply. In its advice to other nations, the International Monetary Fund (IMF) was just as ignorant. In fact, it recommended devaluations.

Foreign exchange traders soon realized policy makers in Thailand didn't perceive the importance of maintaining a stable currency. Their loss of faith in the integrity of the baht led to a collapse.

Trustworthy Money: The Bedrock of Prosperity

When a country has stable, trustworthy money, the opposite scenario unfolds: people want to hold their currencies. Capital and investment flow into countries with stable money. That's why stable money is the bedrock of prosperity.

The classic example is Great Britain. The British pound was tied to gold at a fixed rate for over 200 years and holds the record for stability. After Great Britain formally established the ratio for the pound to gold in 1717, lenders could rest assured they would be paid back in money that wouldn't lose its value. Capital creation and investment in the country exploded. The strength of Great Britain's currency helped create capital markets that turned that island from a second-tier nation to the mightiest industrial power in the world.

Propelled by its stable money and capital markets, Great Britain gave us the steam engine, railroads, and countless other advances that marked the beginning of the modern era. Its spectacular success led the United States and other countries to follow

its example. The late nineteenth century saw the era of the classical gold standard. The United States, most of Europe, and eventually Japan pegged their currencies to gold. More wealth was created by far in the 1800s than all the previous centuries put together.

In the twenty-first century, there is no such thing as stable money. But countries that manage to keep their currencies relatively sound tend to be better economic performers; examples are Switzerland, Singapore, and China. It's easier for them to have a vibrant economy because transactions are made easier.

In this era of unstable money, nations that have relatively sound currencies can occasionally suffer from too much of a good thing. During the sovereign debt crisis of 2011, which imperiled the euro, many sought refuge in Swiss francs. The value of the Swiss franc shot up so high relative to the euro that it hurt Swiss exporters. The Swiss government eventually had to place a cap on the franc's value vis-à-vis the euro.

The Importance of Monetary Demand

When you have desirable money you have global demand. The importance of demand in determining the value and supply of money is widely unappreciated.

Demand for money is created by a strong and growing economy. Proportionately there is a greater supply of U.S. than Canadian or Australian dollars because there are more uses for the U.S. dollar globally. The U.S. dollar is more desired around the world than those other currencies because our economy is bigger and our capital markets are deeper.

How can a government increase demand for its money? To quote Austin Powers: *behave*. Signal to markets that a future devaluation is unlikely by implementing economy-boosting, pro-market initiatives and by showing fiscal restraint.

After the United States cut tax rates and did not pass costly national healthcare reform in the late 1990s, money flowed into the States, strengthening the greenback. People wanted to invest in America, and they wanted more dollars.

Keynesians and monetarists focus too much on supply of money rather than demand. If demand is not there, an attempt to create money sets up what in the 1930s was called "pushing on a string." The economy doesn't move.

Economic Torpor and a Crisis of Faith in the Dollar

Stagnation has essentially been the story since the financial crisis of 2008–2009. The last several years have seen an explosion of the Fed's balance sheet, enormous stimulus spending, the historic expansion of government—most notably the thousands of pages of regulations coming from Dodd-Frank financial reform and the Affordable Care Act—along with record levels of government debt. These misguided policies have suppressed both the economy and monetary demand, undermining long-term faith in U.S. currency.

The price of gold, you may remember, shot up to a breathtaking high of $1,900 an ounce in 2011. And as we noted, the rating agency Standard & Poor's downgraded U.S. credit in 2011. China, our largest foreign creditor, and many others have worried that a U.S. default on bond payments could set off a worldwide financial meltdown many times worse than the 2008 financial crisis; that would cause the dollar to collapse. Even absent such a dire scenario, they worry that the dollar faces a long-term decline.

The Chinese see the U.S. economy as stalled and U.S. leadership as floundering. They see a government paralyzed by political disarray, seemingly unable to govern itself. During the 2013 partial government shutdown, an angry commentary by

the Chinese government's Xinhua News Agency slammed "the cyclical stagnation in Washington for a viable bipartisan solution over a federal budget and an approval for raising debt ceiling [that] has again left many nations' tremendous dollar assets in jeopardy and the international community highly agonized." The editorial renewed calls for a "de-Americanized world" with a new reserve currency "to replace the dominant U.S. dollar, so that the international community could permanently stay away from the spillover of the intensifying domestic political turmoil in the United States."

Default was averted when Congress and the president eventually agreed to end the government shutdown. But this has not stemmed concerns about the dollar. To the contrary: Republicans agreed to let the Obama administration raise the debt ceiling and borrow even more. The move had some observers wondering whether the dollar's collapse was not a matter of if, but when.

The Bitcoin and Other Alternative Currencies

When people lose trust in a currency, alternatives start springing up. That is happening today as the result of faltering confidence in the dollar. In 2012 thirteen states were considering laws that would allow people to use gold and silver currency in place of the dollar. Other recent alternatives include the now-banned Liberty Dollar and the more recent and highly controversial digital currency known as the bitcoin.

These initiatives are not as radical as they sound. People today forget that for a good part of U.S. history, Americans used more than one currency. From the mid-1830s to the mid-1850s, it was legal in the United States to use gold and silver coins from different countries along with the U.S. dollar, as well as coins from U.S. mints. The Spanish silver dollar was used heavily in colonial America and as late as the mid-1800s.

Utah governor Gary Herbert may have had this history in mind when he signed a bill into law that allowed gold and silver coins from the U.S. Mint—American Gold and Silver Eagles—to be used in that state as money.

Then there's the bitcoin. The digital currency was designed as a stateless alternative to traditional money. A fixed number were created that could be purchased and used in online transactions beyond the reach of government or banks, in addition to being traded. Offering the advantage of freedom from government fiat and surveillance, the bitcoin initially created excitement and attracted a passionate following.

The euphoria came to an end when the digital money drew legal scrutiny. Its promise of anonymity made it a perfect cover for illegal transactions, including drug dealing. In 2013 the FBI arrested the drug kingpin known as Dread Pirate Roberts, a.k.a. Ross William Ulbricht, who used bitcoins for drug deals in the online black market known as Silk Road, which he allegedly created. The 29-year-old former grad student was collared inside a San Francisco public library, and his site was shut down by the Feds.

In 2014, Tokyo-based Mt. Gox, the world's largest bitcoin trading exchange, shut down abruptly when it was revealed that hundreds of thousands of bitcoins had been stolen. The massive sell-off that followed caused the currency to virtually collapse.

Critics attributed the failure of the bitcoin to the fact that it is unregulated and anonymous. The real reason was that it isn't really money. The high-tech bitcoin may have captured the imaginations of those seeking alternatives to the dollar, but with its wild fluctuations it is not a stable measure of value. For that reason, it can't function as an instrument of trust.

Forbes.com writer Kashmir Hill set out to live on bitcoins for a week. She invested $600 in bitcoins at $126.69 each. When

she finally received the digital money, online trading had sent the value of her bitcoins up to $142 each.

Unfortunately, their value could also plummet just as fast—as much as 61% in a single day. To put that in perspective, the Dow crashed about 13% on Black Monday of 1929 and about 23% on Black Monday of 1987.

Little wonder that long before the crash of the bitcoin, Hill found few places willing to accept them.

The story of the bitcoin shows how money attempts to rise up when there is a need. But even if people were able to develop a viable alternative money, it would probably not last long in today's unstable environment because of a principle known as Gresham's law: *bad money drives out good*. History has shown that when money is debased, people tend to hoard the "good," accurately valued money while dumping the "bad," overvalued money in the marketplace. Gresham's law was why the printing of paper money by the colonial governments of New England drove out the silver coins that were also in circulation, pushing monetary values down further.

There's no refuge from the destruction caused by the debasement of money.

Money Communicates

Trust is not the only reason that we need currency stability. Stability is essential if money is to fulfill its role as an instrument of communication in the marketplace. The economist Friedrich Hayek explained that money facilitates communication in the market, and in society, through the mechanism of prices.

The price system is why products and services in a free economy seem to spring from out of nowhere without a bureaucrat ordering them to appear. Hayek observed: "The most

significant fact about this system is the economy of knowledge with which it operates, or how little the individual participants need to know in order to be able to take the right action."

Prices don't simply inform buyers and sellers in a particular transaction; they also provide information that producers and consumers throughout an economy use to make decisions. Rising prices, for instance, indicate *increasing demand* for a product or service. Conversely, when the price of a product drops, rendering it less profitable, that's a signal people no longer want what is being offered.

One example is portable cassette players. Thirty years ago Sony created a sensation when it came out with the Walkman. You could listen to music with great fidelity on a pair of light headphones from a small device that you could keep in your pocket. The price of the very first Walkman sold in Japan was $1,000. It debuted in the United States at around $200 in 1979 dollars. Sales and profits went through the roof—overnight, everyone was making them.

Then a new technology appeared: the portable compact disc player. Demand for cassette players dropped—and so did prices and profits. Producers turned their attention to CD players. Then came the iPod and downloadable digital audio content. Portable disk players too became history. There are still portable cassette and CD players, but there's far less demand for them; you can now get one of those devices for as little as $20.

Prices also convey advances in productivity. Thirty years ago, a cell phone that was as big as a shoebox cost $3,995. Cell phones are now many times smaller and more powerful and they cost a fraction of that—and they're free with some calling plans.

Another example, out of many: flat-screen TVs. Prices are less than a tenth of what they were a decade ago, and they incorporate far more sophisticated technology.

That's why advocates of the need for price stability are often off base. They can mistake price changes resulting from shifts in productivity and supply for inflation or deflation. In a vibrant, innovative, and productive economy, prices as a whole should decline as producers find ways to make products more cheaply. A dozen years ago the memory device in the iPad would have cost $10,000. Today, it costs a mere $50.

The prices and profits facilitated by money are what allow a market economy to provide for the needs of society. When money is made artificially unstable by government, the information it provides ends up being corrupted. Both producers and consumers respond to distorted market signals. The end results are gluts, shortages, or market bubbles.

Money Is Not Wealth

As a standard of measurement, an instrument of communication, and a promoter of trust, money facilitates the creation of wealth in a society. But money itself is not wealth. Money is simply a tool.

Adam Smith was among the first to recognize this truth. Smith defined money as "an instrument of commerce and a measure of value." Artificially increasing the amount of money in the economy, he wrote, was as futile as increasing the number of cooking pots when there was no demand for them. In his influential masterwork *The Wealth of Nations*, he offered the brilliant observation that money, like other tools, appeared spontaneously when there was a need:

> If the quantity of victuals were to increase, the number of pots and pans would readily increase along with it, a part of the increased quantity of victuals being employed in purchasing them, or in maintaining an

additional number of workmen whose business it was to make them.

Just as buying too many unneeded cooking utensils would impoverish a family, Smith wrote, government attempts to acquire vast amounts of gold or silver "necessarily diminish[es] the wealth which feeds, clothes, and lodges, which maintains and employs the people."

Unlike others of his time—and, indeed, these days—Smith recognized how money advanced society by facilitating profit-making. Giving the example of the manufacturing of pins, he explained how the increase in productivity brought about by the division of labor means that "every workman has a great quantity of his own work to dispose of beyond what he himself has occasion for." The surplus goods and services, he explained, are then used as capital to create more wealth and "a general plenty diffuses itself through all the different ranks of the society."

The *Wealth of Nations* was published in 1776, the year the Declaration of Independence was signed. Smith's ideas about free trade and sound money—and his rejection of mercantilism, with its state controls—enormously influenced the Founding Fathers, including, most notably, Alexander Hamilton.

Hamilton faced the challenge of restoring the economy of the young republic that had been devastated by the Revolutionary War and the relentless money printing of "Continentals." Like Smith, he knew history. The key to recovery, he wrote, was "introducing order into our finances." In order to remain independent and not fall back into the clutches of Great Britain, the new nation needed a banking system with expertise in the uses of credit:

> Banks were the happiest engines that ever were invented for advancing trade. Venice, Genoa, Hamburg, Holland, and England are examples of their utility. They owe their riches, commerce, and the figure they have made . . . to this source. Great Britain is indebted for the immense efforts she has been able to make in so many illustrious and successful wars essentially to that vast fabric of credit raised on this foundation. 'Tis by this alone she now menaces our independence.

Following the example of Great Britain, Alexander Hamilton established the First Bank of the United States, as well as a mint with a dollar fixed by law to a specific weight in gold. Hamilton's system of banking and stable money quickly attracted and generated capital. It turned the American economy into the leading industrial power in the world.

THE NUGGET

Money measures wealth, but it does not create it.

CHAPTER 4

Money Versus Wealth

Why Inflation Is Not a Good Thing

> It isn't the gold we have that makes us rich. It's what we make, our know-how, our productivity. So long as this country produces more and better, the world will continue to want what we make.
>
> —Malcolm Forbes

In November 2013, Janet Yellen, who was soon to succeed Ben Bernanke as head of the Federal Reserve, testified at her Senate confirmation hearing about her views of the economy, the role of central banks, and recent Fed policies, including the gargantuan monetary expansion known as quantitative easing (QE). The job of chairman of the Fed, the leading central bank, is probably the most powerful nonelected government position in the world. Its actions have a major impact on the lives not only of Americans but also of people throughout the world.

The media covered the hearing with only tepid interest, as though Yellen were just another midlevel bureaucrat. The real focus that week was the disastrous rollout of President Obama's Affordable Care Act (popularly known as Obamacare). For

weeks, controversy had raged over what had gone wrong with the government's new health insurance initiative and what was needed to fix it. Even media long supportive of Obama were proclaiming that the program wasn't working.

Little such media indignation, however, was directed at another government failure mentioned at the Yellen hearing, one with implications more far-reaching than Obamacare: the inability of the Fed's historic monetary stimulus, quantitative easing, to restore the economy.

This massive injection of liquidity, *the largest monetary expansion ever*, was a disaster more momentous than the launch of Healthcare.gov. Five years and three rounds of quantitative easing had produced miserably feeble GDP growth of just under 2%, about half the level of a decade earlier. The biggest monetary stimulus ever had produced the weakest recovery from a major downturn in American history.

Combined with the zero interest rates of the past several years, quantitative easing should have delivered a charge to the economy sufficient to revive Keynes himself. Since QE started in late 2008, the Federal Reserve had increased its balance sheet from $900 billion to $3.7 trillion in 2013. Around the time of Yellen's confirmation hearing, required bank reserves had already reached $124 billion. Excess reserves—the money above and beyond the required reserves that banks are allowed to lend—were a staggering $2 trillion and rising, many times the normal level.

The problem was that QE also involved the arcane strategy of suppressing interest rates known as Operation Twist. As mentioned, the Fed normally lowers—or raises—short-term interest rates. But under Operation Twist, it was buying bonds to suppress long-term rates as well. The real "twist" was that instead of stimulating job creation, Operation Twist was doing the opposite. It was directing credit to certain sectors of the

economy—the federal government, large corporations, and the housing sector—away from the small businesses that have traditionally been the economy's job creators. Because of post–financial crisis legislation, the Fed was also paying banks to hold on to their excess reserves.

In other words, QE was working against a recovery. Job creation was at its worst level since the 1930s.

Yet because the media and policy makers are uncomfortable with the subject of monetary policy, there was little of the robust questioning and debate about QE that swirled around the Affordable Care Act. There have been no headlines like "Federal Reserve Stimulus Disaster" or "QE Rollout a Miserable Failure."

Monetary Obesity Is Not Healthy

We need food to live. But too much food leads to unhealthy obesity. The same applies to money. We need money for commerce. But just as too much food can be bad for your health, an oversupply of money can undermine the health of an economy.

If expanding the monetary base was the way to economic vitality, Zimbabwe would be the richest country in the world. When that country first became independent in 1980, the Zimbabwe dollar was worth more than the U.S. dollar. In the early 2000s, after redistributionist reforms led to the destruction of the country's agricultural economy, the Zimbabwe government responded to the crisis with a manic printing of money. The result was a hyperinflation second only to that of Hungary after World War II. By 2011, Zimbabwe was printing 100-trillion-dollar bills that became a hot novelty item among collectors. Eventually it had to abandon its currency and start over.

The story of monetary expansion is not a story of wealth creation but rather of wealth destruction. History contains

countless examples: from the eighteenth-century French debacle of the Mississippi Bubble, described later in this chapter, to the wild colonial inflations preceding the American Revolution to the German hyperinflations of the early 1920s and after World War II to the 1970s U.S. stagflation. Over the past decade, reckless monetary expansion has rocked countries like Venezuela and Argentina. In the United States, it led to the collapse of the housing market, the 2008 financial crisis, and subsequent global stagnation.

Keynesians and monetarists are on the wrong side of history. Increasing the supply of money cannot create prosperity because that is not how wealth is created. Wealth and growth come from *innovation*. Henry Ford's mass production of the automobile, for instance, transformed society by creating jobs in entirely new industries, from fast food to auto repair and even to home building. (Car ownership made the suburbs possible.)

Over the last several decades, we've seen this kind of job creation as a result of the personal computer. Twenty years ago, there were no jobs in "social media" or in designing Internet sites, or in retail stores devoted to selling things like iPads.

Keynesians, however, are convinced that monetary expansion spurs economic activity and employment. There may be a growth spurt. But much of the activity, like the feverish home buying and mortgage lending that took place as a result of the cheap dollar in the early 2000s, is artificial. And as we saw with the housing market, it ultimately collapses.

Excess liquidity also slows growth by distorting credit markets and impeding capital creation. Expanding the money supply encourages the misallocation of resources.

When governments destroy the value of money, one can no longer trust prices. People make bad decisions. Like misguided hikers who have been given a bad map or a corrupted GPS device, the economy can end up wandering in circles, stagnating

like Spain in the Middle Ages or the United States in the 1970s. Or, as in Weimar Germany or Zimbabwe, the economy can go over a cliff.

Why Hasn't There Been More Inflation?

Keynesians and monetarists largely dismiss today's fears of the inflationary effects of QE and the weakening dollar. Economist Paul Krugman, with his usual note of negativity, accuses advocates of stable money of "inflation hysteria." In her Senate testimony, Janet Yellen deflected concerns with bureaucrat-speak, insisting that "at this stage, I don't see risks to financial stability" from current Fed policies. It is true that despite the immense injection from QE, the United States has yet to see severe, across-the-board rises in the cost of living. According to the Consumer Price Index, the rate of increase in 2013 got as low as 1.1%.

CPI numbers, however, don't reflect the price rises people have been experiencing. Meat prices are the highest they have been in about a decade. Gas prices have come down from their very highest highs, but the price of a gallon of gas is about double what it was less than 10 years ago. Consumers are also seeing plenty of price hikes in other places. Financial analyst Michael Sivy wrote in *Time* magazine that he was shocked to discover the price of ink cartridges for his printer increased by 25% in less than one year.

He and others believe that prices are rising faster than government statistics indicate because of changes in methodology that have caused the Consumer Price Index to understate the rate of inflation. CPI metrics change so frequently that measurement methods, in the words of investor and financial commentator Peter Schiff, bear "scant resemblance" to what they were just a few decades ago.

Schiff created a market basket of essential goods needed for daily living—such as eggs, milk, gasoline, and bread—and compared their price changes to CPI statistics for the same period. Between 2002 and 2012, the CPI reported a total of 27.5% inflation. But the prices of goods in Schiff's market basket increased more than 44%.

What would inflation be today if CPI statisticians were using the old metrics? John Williams, economist and founder of American Business Analytics & Research, features charts using CPI methods of the 1970s and 1980s on his website Shadow Stats.com. He comes up with an annual inflation rate that ranges from as low as 5% to as high as 10%.

Prices rise and fall, as we've noted, for any number of reasons—from changes in supply and demand to increases in productivity. To what extent do the recent price increases have to do with the weakening of the dollar? The best place to look for the answer is gold prices. Gold is the purest indicator of the dollar's value because the supply and demand of the precious metal do not vary dramatically from one year to the next. Gold is not vulnerable to weather like agricultural commodities or to sudden surges in supply or demand that affect oil and gas prices.

Gold prices, as we all know, have increased to stunning levels in the past several years. They have come down some, but in early 2014 the price of gold was three times what it was in 2003; it took 200% more dollars to buy gold than it did a decade ago. In other words, our money is worth much less.

Commodities have also risen sharply. The Thomson Reuters Continuous Commodity Index (CCI) measures six categories of commodities, including energy, grains, meats, and precious metals. From December 2008 to November 2013, the CCI increased from around 370 to 506, an increase of nearly 37%.

On Forbes.com investment advisor Richard Finger voiced the widespread concern about the economy's inflationary direction: "Nobody knows the ultimate denouement of money printing on this scale. Germany tried 'abnormal' money printing in the early 1920's after WW I and the result was hyperinflation, the collapse of the German economy, and the rise of Hitler."

What will happen as the Fed continues to pile more money on top of hyperinflation-level bank reserves? The answer is that we're in uncharted territory. Forecasting disastrous inflation may be the equivalent of refighting the last war—an analysis too closely based on events of the past. Indeed, something different may be happening: a historic decline into a corrosive environment of stagnant growth. Instead of a deadly pneumonia, we may be experiencing a chronic disease that saps away America's traditional vitality. Either prospect is destructive and underscores the need for a stable dollar.

The Danger of a Little Inflation

Right now the Fed is scaling back the amount of bonds it buys each month and hinting at future interest rate increases. Nonetheless the monetary base remains enormous by historic standards. Keynesians, including IMF officials, central bankers, and finance ministers, have of late been beating the drums for "a little more inflation." In an eyebrow-raising article titled "In Fed and Out, Many Now Think Inflation Helps," Binyamin Appelbaum in the *New York Times* suggested in the fall of 2013 that the Fed under Janet Yellen would expand the monetary base enough to spur price increases. According to the *Times*, Yellen believes:

> A little inflation is particularly valuable when the economy is weak. Rising prices help companies increase profits; rising wages help borrowers repay debts. Inflation

also encourages people and businesses to borrow money and spend it more quickly.

The story quoted a Harvard economist who proposed expanding the monetary base to achieve an inflation rate of around 6%. He made this astonishing statement: "A sustained burst of moderate inflation is not something to worry about. *It should be embraced* [our emphasis]."

Proponents of QE make a distinction between severe inflation, which they see as unlikely, and moderate inflation, which they think can be a good thing. The notion that there can be harmless inflation is a toxic fallacy. The real estate bubble of the early 2000s that brought on the 2008 stock market panic resulted from the weakening of the dollar that took place in the early and mid-2000s before quantitative easing.

Whether the rate is 2% or 12%, inflation fundamentally distorts market behavior because it impairs the critical signals provided by the price system. People who see prices going up rapidly will start buying on the mistaken assumption of increased demand. Or else, sensing trouble, they'll seek to shelter their money. Either way, events can easily spiral out of control.

In the words of noted historian Amity Shlaes: "The thing about inflation is that it comes out of nowhere and hits you." She gives the example of 1972, when "all appeared calm . . . before inflation jumped to 11% by 1974, and stayed high for the rest of the decade." Inflation similarly shot up, almost overnight, after both world wars.

Germany suspended its gold standard and started running the printing press in 1914 at the start of World War I. But it took six years for a real hyperinflation to get started. Inflation was moderate at first. The dollar and gold price of the mark improved sharply in 1920–1921. Shlaes tells us, "Many financial analysts thought the Weimar authorities weren't producing enough money." A *New York Times* headline at the time declared: "Tight Money in German Market: Causes of the Abnormally Rapid Currency Deflation at Year-End." In actuality, Shlaes writes:

> The Germans didn't know it, but they had already turned their money into wallpaper; the next year would see hyperinflation, when inflation raced ahead at more than 50% a month. It moved so fast that prices changed in a single hour. Yet even as it did so, the country's financial authorities failed to see inflation. They thought they were witnessing increased demand for money.

Prices, however, continued rising. Finally, Germans lost faith. The mark began to collapse. "Disillusionment," warns Shlaes, "can come as fast as a gust."

The Absurdity of the Phillips Curve

Policy makers insist on stoking inflation because of their rigid belief in the Phillips curve, the unscientific and unproven theory that price increases are the way to the Holy Grail of full employment.

Back in the 1950s, William Phillips, a New Zealand economist, helped promote this idea with a graph that became known as the Phillips curve. It showed the supposed correlation between inflation and unemployment. According to Phillips and his fellow Keynesians, vigorous growth corresponded to price increases, while lower inflation correlated with higher jobless levels. In other words, there was a trade-off between inflation and employment. Stable money, they concluded, is bad for the economy.

Advocates of this preposterous theory maintain that raising or lowering inflation is like adjusting the climate controls

on a thermostat. Just as you'd use your climate control keypad to raise or lower the temperature in your living room, loosening or tightening up on the money supply, they believe, can increase or decrease the level of employment.

Seven Nobel Prizes have been awarded to economists whose work disproved the Phillips curve: F. A. Hayek, Milton Friedman, Robert Lucas, Robert Mundell, Finn Kydland, Edward Prescott, Edmund Phelps, Thomas Sargent, and Christopher Sims. Yet Keynesian policy makers and pundits cling to this idea, despite the Fed's $4 trillion balance sheet expansion that has left labor participation rates at a 35-year low.

Economic historian Brian Domitrovic pointed out on Forbes.com that "inflation and unemployment regularly move in tandem." They don't move the way Keynesians would have you believe. In the inflationary boom/bust era of the 1970s and early 1980s, unemployment reached higher levels than during the financial crisis. The very opposite was the case in the 1980s. After Ronald Reagan cut taxes and stabilized the dollar, in Domitrovic's words, "inflation and unemployment both rappelled down a cliff."

The United States has had what could be characterized as "full employment"—jobless rates of under 5%—during eras of stable or relatively stable money. Two dramatic examples are most of the 1920s and 1960s.

Cheapening the value of money is not the way to create real, sustainable employment. Jobs are created in a healthy economy when entrepreneurs start companies like Starbucks or Staples that succeed in the marketplace. They get capital to expand and hire more people.

This is not what takes place in an inflationary economy. There may be some job creation—Germany had low unemployment during its hyperinflation of the 1920s—but the burst of activity is the result of false market signals and misdirected

resources that come from government's distortion of money. It is ultimately artificial and unsustainable. Very little new wealth ends up being created, and sooner or later much more is destroyed.

Former congressman Ron Paul sums it up: "If governments or central banks really can create wealth simply by creating money, why does poverty exist anywhere on earth?"

Stimulus or Redistribution?

The Appelbaum *New York Times* article about the advantages of inflation draws a different picture. The paper reported that plenty of people on Main Street as well as in Corporate America would actually *welcome* inflation. In fact, the reporter suggested, they could barely wait for it to get started:

> The school board in Anchorage, Alaska, for example, is counting on inflation to keep a lid on teachers' wages. Retailers including Costco and Walmart are hoping for higher inflation to increase profits. The federal government expects inflation to ease the burden of its debts.

It is true that some people benefit, at least at first, from inflation's burst of activity. But, as we've pointed out, very little new wealth is being created. It is simply being transferred from one group in the economy to another.

Murray Rothbard, noted economic historian, made the point that inflation favors "firstcomers," those who are the earliest recipients of the new money. They include not just retailers like Walmart and Costco, singled out by the *New York Times*, but also countless others who benefit when people start spending the government's newly created money. The losers are "latecomers" who are slower to receive the inflationary money. They

generally belong to fixed-income groups such as retirees and people on salaries.

Forbes.com contributor Richard Finger puts it bluntly. The Fed's low-interest-rate, easy money policies, he says, "punish the virtuous, the millions of responsible savers. . . . They can no longer count on decent risk-free returns for retirement."

Bill Taren, a Florida retiree, found that his retirement account at his credit union paid a measly 0.4% interest. Meanwhile inflation was averaging 2.8% in 2012. Horrified by his dwindling savings, he and his wife decided to stuff their money under their mattress. He explained that at least that way "we can see the cash when we want."

Debtors Win, Creditors Lose

The seventeenth-century philosopher John Locke was among the first to observe that inflation rewards debtors who are able to pay what they owe with less valuable money, while stiffing creditors who get paid back in less valuable currency. In his words:

> Whether the creditor be forced to receive less, or the debtor be forced to pay more than his contract, the damage and injury is the same, whenever a man is defrauded of his due; and whether this will not be a public failure of justice thus arbitrarily to give one man's right and possession to another, without any fault on the suffering man's side, and without any the least advantage to the public, I shall leave to be considered.

Government, of course, is the biggest debtor of all. By diluting the value of your money, it gets extra money to spend—or to pay its debts. As Keynes famously acknowledged, inflation is a

stealth tax whereby "government can confiscate, secretly an
unobserved, an important part of the wealth of their citizens."

Uncle Sam also gets to pay back bondholders, such as Chin
and others that have bought U.S. Treasuries, in cheaper dollar
This is especially true with QE, thanks to record low interes
rates under Operation Twist that are saving Washington hun
dreds of billions of dollars, which it would otherwise have ha
to pay to bondholders.

Richard Finger calculates that if the U.S. government pai
normal historical rates of interest on its $17 trillion nationa
debt instead of the Fed's current rock-bottom rates, it would b
facing, he calculates, an additional $500 billion interest expens

In other words, lower interest rates as a result of QE mean
$500 billion windfall for Washington—money that makes it eas
ier for politicians to keep spending. For example, $500 billio
is nearly enough to cover benefits paid to participants from a
of Medicare, which amounted to $536 billion in 2012. And it i
many times the amount the administration needs to keep ex
panding the food stamp program, which now costs around $8
billion a year.

Manias, Bubbles, and Distortions

Weakening a currency may produce activity that looks lik
wealth creation. But real wealth creation, as we've noted, come
from meeting genuine needs of the marketplace—inventin
new technologies like the iPad or the flat-screen TV that improve productivity and raise standards of living. Activity that results from monetary policies intended to stimulate an econom
on the other hand, is a response to artificial price signals and i
usually misdirected.

In the inflationary 1970s, for example, higher prices fostered the mistaken perception that developed nations wer

running out of energy. The price of oil went from $3 a barrel to almost $40. Capital flooded oil production. The number of workers in the energy industry soared. The same thing happened in the last decade. Since 2008, the number of employees in the oil and gas industry has increased by over 30%. This was only partly due to the surge in exploration accompanying the growth of hydraulic fracturing technology ("fracking"). It was also on account of the herd or bubble mentality created by inflation.

There are two kinds of bubbles. The first takes place naturally in a free economy when people jump on a promising technology, like the PC boom in the early 1980s or auto manufacturing in the early twentieth century (or, for those who remember the 1950s, the hula hoop craze). People start new businesses in a promising sector until it gets too crowded, and some of them fail. They can set the stage for later success, like Apple's failure with its Newton handheld device, which paved the way for smartphones and other mobile devices. Forbes publisher Rich Karlgaard calls such ventures "noble flops."

The second kind of bubble is created when people respond to inflationary price signals. Money tends to flow into protective investments instead of into entrepreneurial job-creating ventures. How does buying a bar of gold translate into production and economic growth?

During the German hyperinflation of the 1920s, Germany's panicked citizenry bought every hard asset they could get their hands on, including diamonds, works of art, and real estate. Adam Fergusson noted in his classic chronicle of the era, *When Money Dies*, that families bought pianos even if they didn't play them. The act of buying was a form of speculation. People were rushing to put their money in possessions with value, because they didn't know what their money would be worth the next day.

Inflation also misdirects money in other ways—for instance, by sending it into nonproductive investments like tax shelters. They were a way of life during the 1970s, when inflation kept pushing people into higher tax brackets. Seeking to avoid "bracket creep," tax filers invested in everything from producing azaleas and almonds to mink and trout farms. Markets were distorted by activity that took place solely for the purpose of tax avoidance. Movie production soared, as did the amount of vacant office space. Tax shelter madness also helped fuel the collapse of the savings and loans in the 1980s.

Most tax shelters were eliminated with Ronald Reagan's tax reform of 1986. In the low-tax, low-inflation years that followed, there was little need for them. Just a warning: if the Fed attempts to engineer a little inflation, mink farming and other tax schemes may soon make a comeback.

The Subprime Mortgage Meltdown: The Twenty-First Century Mississippi Bubble

Though widely blamed by politicians and the media on predatory lending, the subprime mortgage disaster of 2008 that started the worldwide financial crisis was the twenty-first century's answer to the eighteenth-century inflationary debacle known as the Mississippi Bubble—the result of a loose money scheme engineered by the Scottish mathematician John Law.

The extremely colorful Law was the author of a tract titled *Money and Trade Considered, with a Proposal for Supplying the Nation with Money*. It made the Keynesian-style argument that increasing the supply of money would boost trade, employment, and production. After serving time in prison for killing a romantic rival in a duel, he escaped to France. Using his aristocratic connections, he managed to convince the French government that his expansionary scheme was the answer to the crushing debts left over from the reign of Louis

XIV. Law was appointed to the powerful position of controller-general of finances, where he got his chance to put his loose money theory into practice.

Law consolidated France's trading companies into a monster monopoly known as the Mississippi Company. Owning a vast swath of what today is the central United States, the public-private company sold shares to investors throughout Europe. A mania for New World real estate ensued. Law had also created a virtual central bank that pumped immense amounts of liquidity into the French economy. France's total money supply exploded. Inevitably, investors lost faith in Law's overhyped New World scheme. Combined with a roaring inflation, the bubble burst, devastating creditors throughout Europe and nearly bankrupting France. Law was forced to flee the country.

The subprime mortgage meltdown of 2008 contains more than a few echoes of the Mississippi Bubble. As with John Law's French debacle, the crisis was the result of excessive amounts of liquidity created by a central bank, the Federal Reserve, that ended up fueling giant government-created enterprises. Here the culprits were Fannie Mae and Freddie Mac, the mortgage companies originally created and later spun off by the U.S. government.

Responding to political pressures for affordable housing that intensified under the Clinton administration in the 1990s, Fannie Mae and Freddie Mac set out to make housing loans more available. They did this through the securitization of mortgages—the risk-spreading practice of buying and bundling mortgages and selling them to investors as mortgage-backed securities.

As the push for affordable housing accelerated, Fannie Mae and Freddie Mac were bundling increasingly risky subprime mortgages. In the early 2000s, the loose money policies of the Bush administration poured gasoline on a fire that had already

started to burn. In an attempt to stimulate the economy after 9/11, the Fed, in a series of steps, lowered the federal funds rate to 1%, and the banks loosened their lending standards.

Between 2000 and 2003 the monetary base grew at levels equivalent to the inflationary 1970s. The dollar price of gold moved upward. The size of the subprime mortgage market grew 200%.

Inflation's herd instinct took hold among buyers and sellers. No longer were home buyers asked for the traditional 20% down before buying a house. "Stated income loans" became common. They were also known as "no-doc" or "liar loans" because borrowers could give just about any income figure and it was rarely checked. Little wonder just about everyone wanted to get in on the action. A homeless man in Saint Petersburg, Florida, managed to buy five houses. Speculators rushed into the market. The weak dollar corrupted pricing information, leading people to believe that housing prices and demand could only go up. If that homeless investor defaulted? No big deal. The houses would be worth more than his mortgages.

The bubble started to deflate when the Fed started to raise interest rates, which reached 5.25% in June 2006. Hundreds of thousands of foreclosures shook major financial institutions that were the holders of this debt, setting off a chain of events that led to the collapse or forced sale of major Wall Street houses and commercial banks.

Making matters worse was the recent reestablishment of the accounting regulation known as *mark to market*, which forced banks to unnecessarily write down the value of their capital. Mark to market made banks holding subprime mortgages look even more troubled than they actually were, attracting the attention of short sellers who threw bank stocks into a death spiral. (When mark-to-market accounting was drastically changed starting in March 2009, the bear market promptly ended.)

The financial panic in the fall of 2008 nearly took down the U.S. financial system and pushed the global economy into the severest economic crisis since the Great Depression. Alex Pollack of the American Enterprise Institute points out that much of what was destroyed was artificial wealth created by inflation. "A lot of the . . . wealth," he explains, "was an illusion—an illusion created by the housing bubble." The collapse in housing prices brought inflated prices back down to reality. He concludes, "So in fact, the wealth didn't disappear: it was never really there in the first place."

John Law had to flee France in disgrace. In contrast, Federal Reserve chairmen Alan Greenspan and Ben Bernanke, whose easy money policies led to the housing bubble, made a great deal of money writing memoirs and giving speeches, and their institution at the heart of the debacle, the Federal Reserve, ended up with vast new powers unprecedented in American history.

Monetary Expansion and Income Inequality

In the storm of recriminations following the Panic of 2008, Occupy Wall Street held months of street protests in New York City and around the country decrying the pain caused by the crisis and assailing the financial sector for reaping seemingly disproportionate gains. The demonstrators were protesting free enterprise. But the Fed was the real culprit.

A little-appreciated reality of inflation, confirmed by a succession of studies, is that it increases income inequality. One Northwestern University researcher found a significant relationship between the expansion of the money supply and the amount of income inequality as measured by indicators of income inequality like the Gini coefficient.

While a weakening dollar hurts people on fixed incomes, monetary expansion delivers windfalls to certain sectors of the

economy, like the financial industry, among the first to benefit from the Fed's bond buying. In September 2012, when Ben Bernanke announced that the Fed would buy around $40 billion in mortgage-backed securities per month for the next three years, Wall Street was ecstatic. Markets closed at their highest level since 2007.

Not everyone was as enthusiastic. The dollar, that barometer of investor jitters, took a hit: the price of gold jumped to $1,772 an ounce, and the dollar's value fell in relation to other currencies.

Anthony Randazzo, director of economic research at the Reason Foundation, put it this way, "quantitative easing has made it cheaper for the government to borrow, has artificially propped up the housing market (making it take longer to recover), and has dramatically manipulated the distribution of capital in financial markets. And the economy has not been in recovery."

Windfalls for Authoritarians

Another largely overlooked consequence of the dollar's decline has been massive wealth transfers to commodity-producing nations often hostile to the United States. Remember, when money is devalued, people invest in commodities and hard assets. Advocates of energy independence should be angered to learn that, thanks to the weakening dollar, the oil-producing countries of the Middle East, Venezuela, and Russia have reaped gains in the hundreds of billions of dollars.

The giant windfalls are not due to America's increasing use of foreign oil. Consumption has actually been decreasing because of fracking, which has opened up new domestic energy sources. More money has continued to flow to oil-producing nations because of the cheapening dollar—resources that could

have gone to job-creating investments, research into medical technologies, and cures for diseases.

Before the end of the Bretton Woods standard, from 1947 to 1967, the dollar price of a barrel of oil rose at an annual rate of less than 2%. After Richard Nixon freed the dollar to float, oil producers started sharply raising prices. On January 1, 1974, the Organization of Petroleum Exporting Countries (OPEC) raised the dollar price of a barrel of oil from $4.31 to $10.11.

Forbes contributors Ralph Benko and Charles Kadlec calculated in 2011 that if the United States were still on the Bretton Woods gold standard:

> A barrel of oil today would sell for less than $2.80 a barrel, and the price of gasoline would probably be around 30 cents a gallon. The increase in the price of oil in the past 45 years is not due to OPEC. It is due to a fall in the value of the dollar.

They quote Keynes: "Those to whom [debauching the currency] brings windfalls, beyond their deserts and even beyond their expectations and desires, become 'profiteers' who are the object of hatred of the bourgeoisie, whom inflationism has impoverished, not less than of the proletariat."

The Real Effect of Artificially Lowered Interest Rates

There's another reason that loose money policies fail as a stimulus. Governments and larger enterprises may be able to borrow more, but the smaller entrepreneurs who are the economy's foremost job creators often end up with less access to capital, because credit usually ends up being rationed.

The Fed's monetary policies were a critical reason for the credit drought that persisted for more than five years after

the height of the financial crisis. Industrialist Lynn Tilton, CEO of Patriarch Partners, complained in 2013 to the *Wall Street Journal* that the reason "we haven't seen a sufficient number of startups" is that "there's not a lot of financing right now."

Congresswoman Cathy McMorris Rodgers and others say that the Fed's zero interest rates were the reason bank lending was so tepid for so long. "This seems counterintuitive," she acknowledged. However, "there's a strange logic to it":

> With the private sector engulfed in so much uncertainty . . . banks are reducing credit to businesses, while increasing their purchase of government debt. The banks take in low-cost funds from the Fed and then lend it back to the government at a higher rate. This produces a small profit that—when done on a large enough scale—can become quite lucrative, indeed.

The misallocation of credit was also encouraged by QE's Operation Twist strategy of pushing down longer-term rates by purchasing long-term Treasuries and mortgage-backed securities. For the first time not only short-term but also long-term rates were at near-zero levels.

Distinguished economist David Malpass, Stanford University economist John Taylor, and a growing number of others make the disturbing observation that these Fed purchases have badly skewed credit markets. QE's focus on buying longer-term bonds means that mainly large companies end up getting cheap credit. Also benefiting are those so-called government-sponsored mortgage enterprises Fannie Mae and Freddie Mac, the originators of mortgage-backed securities. As mentioned, the federal government also benefits from lower interest rates, which allow it to run up deficits at virtually no cost.

In the meantime, commercial banks get Fed-created excess reserves and earn interest on those deposits. Bond underwriters and traders benefit too. Everyone benefits except smaller businesses that mostly rely on credit, along with ordinary citizens who are savers and investors, who are being paid the lowest interest rates ever.

The credit rationing that is a result of this process inhibits the formation of new capital needed to finance the Apples and Googles of tomorrow. Stock markets may reach dramatic highs and lows, but in the end they produce lower returns for investors during periods of unstable money. There's lots of activity, but it amounts to much less than it would have in a system with a stable dollar.

Meanwhile, Average Net Worth Is Declining

The artificial windfalls created by loose money can create the *appearance* of prosperity. After all, aren't people getting rich? Many may appear to be, but society as a whole is getting poorer. The cheapening of money destroys the purchasing power of every dollar you earn. It reduces the value of assets owned by individuals and businesses. Today's dollar buys less than 20% of what it did in 1971. In 2014, it was worth just 17 cents in 1971 dollars.

Findings by the Pew Research Center attest to this decline in the dollar's purchasing power: the median net worth of households headed by Americans 35 and younger has plunged from $11,521 in 1984 to just $3,662 in 2009—an astonishing 68% decline in wealth.

Thanks to improvements in technology, we may have a higher standard of living today, but a middle-class family with two incomes can barely afford what a middle-class family with one income did in the late 1960s and early 1970s. Kadlec and Benko point out:

> When the dollar was as good as gold, working people—not just rich people—prospered. Between 1950 and 1968, real median incomes of males rose steadily, climbing to $32,310 from $19,989 [in 2009 dollars]. That's an increase of 2.7% a year. But ever since 1968, real incomes went flat. Incredible as it may seem, the debasement of our dollar has taken away every penny of nominal pay increase for 41 years, leaving the median income in real terms in 2009 at $32,184, virtually the same as it was in 1968.

The dollar's decline is not the only cause of this. Over the past four decades, state governments as well as the U.S. federal government have steadily piled on taxes. Federal payroll taxes have soared. Couples have found that their combined salaries push them into higher tax brackets. States and municipalities have boosted property and sales taxes. A number of states have imposed income taxes since the 1960s. By one count, Uncle Sam imposes more than 50 taxes on Americans. Little wonder that it takes two incomes to do what one could have done 40 years ago.

Loose Money Addiction: Cautionary Tales

When talking about the perils of weak money, advocates of stable money frequently use the addiction analogy. Because it enables government borrowing and spending, it's easy for politicians to become dependent on artificial liquidity. As with all addictions, however, there are consequences, and ultimately a price to pay. Monetary expansion can be hard to stop. Politicians don't like to face the political costs of clamping down on inflation, especially when its false prosperity comes to an end.

In the early 1980s, the Fed under Paul Volcker swiftly boosted interest rates to draconian levels to end inflation. Texas's oil-based economy slid into depression. Big oil companies had to merge to stay alive; numerous wildcatters went under. Other parts of the country dependent on agriculture experienced a similar upheaval. Anger at the Reagan administration turned Iowa from red to blue.

The cure for inflation can be bitter medicine, but the alternative is long-term malaise and decline. More than a century ago, Argentina was the eighth-largest economy in the world, a vibrant frontier nation much like the United States. But the Argentine government in the twentieth century resorted to manic money printing to finance its welfare state. In recent decades, Argentina has endured a succession of currency crises with hyperinflation that has reached as high as 5,000%. It's hard to know definitively what the inflation rate is today because the administration of Cristina Fernández de Kirchner in Argentina has long been suspected of faking the numbers. The government actually tried—and failed—to make it a crime for anyone outside the administration to publish an inflation figure that contradicts its own statistics. Private sources put the annual rate at about 25%, more than double the government's numbers.

Argentina's devaluations and flagrant dishonesty have all but destroyed public confidence in the Argentine peso. These days people literally go into the street to exchange pesos for dollars in black markets. The real-world value of the peso is said to be anywhere from 35 to 50% lower than the official exchange rate. The Kirchner government, however, has refused to stop trashing the nation's money, which would necessitate an end to manic spending. Its "solution" has been imposing capital controls in a desperate attempt to halt the flow of hard currency out of the country.

Without a reliable currency, meaningful investment in Argentina has become virtually impossible. Devaluations also mean exports that bring in less revenue and a slowing economy. In the fall of 2013, the nation's economy had stalled and was teetering on the brink of yet another major crisis.

The story is much the same in socialist Venezuela. The country has suffered 10 major devaluations since the early 1980s. Under the late president Hugo Chavez, the bolívar was devalued 992%. This ocean of easy money has only managed to meet the short-term needs of the country's voracious government. Ultimately, it is never enough.

Decades of cheapening money have devastated Venezuela's economy and impoverished its people. Venezuelans have all the cheap gas in the world, which costs about 12 cents a gallon. However, they can barely afford cars or anything else. The *Financial Times* reported in 2013:

> The currency is woefully misaligned . . . a burger at McDonald's [costs] $12, two pounds of chicken $13 and a Volkswagen Golf $45,000. Buying a car—even at those exorbitant prices—is very difficult. Shortages are common for many staples: rice, oil, flour, milk, medicines and toilet paper—and cars. Even would-be buyers with money in hand need to join long waiting lists.

Brazil, along with a number of other South American countries, made an attempt in 1999 to wean itself from easy money and maintain a stable currency through "inflation targeting." The effort enabled Brazil to strengthen its currency and achieve a 7.5% growth rate in 2010. But the government's inability to stop spending, along with the strengthening dollar, has recently caused the Brazilian real to weaken along with the economy. Growth slowed to 1% in 2012.

Easy money sooner or later means stagnation, and not just in South America. One sees the same phenomenon in nations flooded with excess liquidity as a consequence of the "resource curse." Loose money from an overabundance of natural riches translates into economic lassitude.

Saudi Arabia, for example, is a massive welfare state. The jobless rate is nearly 11%. Ninety percent of the employees in private companies are expatriates. The situation is so bad that the Saudi government now fines companies that have too many foreign employees. One of the characteristics of countries with easy wealth is that people are not motivated to take jobs they may perceive as having low pay or being less than desirable. They don't have the drive to innovate or move up in the marketplace, because there is no need.

Why have the Middle Eastern region's immense oil riches failed to produce the growing entrepreneurial enterprises you find in nations like Singapore, Taiwan, South Korea, and Israel, countries with far fewer—or even no—natural resources? Why are there no high-tech or textile industries of the kind you'd find in those countries? The reason is that nations that rely on the riches from natural resources rarely develop the habits of commerce that are the real engine of wealth.

Tight Money Causes Problems Too

As mentioned, Keynesians see the economy as a closed system, an engine. In reality it operates more like a Rube Goldberg contraption. A single event sets off a succession of unintended consequences. This is why monetary bureaucrats get into trouble when they try to act as puppet masters.

We saw this in 1997 when the United States cut taxes. Among the highlights, the Clinton administration cut the capital gains tax from 28% to 20% and barred new Internet taxes.

The economy took off, as did the stock market. Demand for the dollar rose. The Fed didn't meet the demand by supplying enough dollars. The gold price fell. The central bank inadvertently began a deflation. Commodity prices tumbled. Corn, for example, plunged from over $5 a bushel in 1996 to under $2 a bushel in 1999. Oil got as low as $10 a barrel. Agriculture and traditional manufacturing buckled.

The result: investments moved away from those traditional sectors, and not because of genuine market forces. Where did investment money go? Into the tech sector. Thanks to the growth of the Internet, technology was in the midst of a boom. The Fed's tight money set off a chain of events that ended up inflating this boom at the expense of traditional industries.

In early 2000, the Nasdaq hit 5000, a level it has not yet touched since. Shortly thereafter, stocks started to wobble. The high-tech bubble was starting to deflate. By 2001, the economy had slid into recession.

Had the Fed allowed the economy to recover on its own, we might not be writing this book. But naturally, it didn't. Faced with the bursting of the tech bubble in 2001, two weeks before the inauguration of incoming president George W. Bush, Federal Reserve chairman Alan Greenspan changed course and began loosening. He cut rates from 6.5% to 6%.

He should have stopped easing when gold reached $350 an ounce. When the precious metal went above $400 an ounce in late 2003–2004 it was clear that the economy was going in an inflationary direction. But he continued lowering interest rates that were now inflating the housing bubble. We all know where things went from there.

Greenspan might have been able to avoid some of this had he kept an eye on the price of gold. But he did not appear to do so, which was surprising given his past support of gold-based money. In addition to being an anchor of value, the price of

gold is a vital barometer whose fluctuations tell you if there is too much, too little, or the right amount of money in the economy.

Unfortunately, not only Greenspan but also nearly all recent Fed chairmen have failed to appreciate the importance of gold as a barometer. Decisions are made too often on what are essentially hunches—and what the political climate is.

All this raises the larger question: Should the Federal Reserve really be in the business of fine-tuning the economy? The Fed was conceived during an agricultural era, when banks making crop loans could face seasonal cash squeezes during harvest time. It was supposed to provide a source of liquidity and also, like the Bank of England, be a lender of last resort. That is a very different role from the one that it has today: attempting to modulate normal business cycles.

Equilibrium is the pipe dream of academicians. In real life, the economy is not an engine, but a dynamic, serendipitous stew of human actions, needs, and desires. Unpredictable events constantly arise to thwart the earnest intentions of bureaucrats. The Fed—indeed, any government bureaucracy—is no more capable of successfully orchestrating the economic activities of millions of people than it would be to control the weather.

THE NUGGET

To paraphrase Ron Paul: if printing money created wealth, there'd be no poverty left on earth.

CHAPTER 5

Money and Morality

How Debasing Money Debases Society

> Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.
>
> —John Maynard Keynes

Among the great ironies is that Lord Keynes, the foremost proponent of monetary stimulus, penned one of the most famous and powerful summations of the societal disarray that occurs when money is destroyed. Keynes wrote these words in 1919, shortly before Germany's inflation flared up into the Great Disorder, the hyperinflation and social breakdown that preceded the rise of Adolf Hitler. He was convinced that there was a distinction between extreme inflation and more moderate levels, which he believed would stimulate an economy. History soon proved him tragically wrong.

CHAPTER 6

The Gold Standard

How to Rescue the Twenty-First Century Global Economy

Time will run back and fetch the Age of Gold.

—JOHN MILTON

You cannot have a gold standard system in the future if nobody knows how to do it.

—NATHAN LEWIS, *Gold: The Monetary Polaris*

FREEING THE DOLLAR FROM GOLD WAS SUPPOSED TO MAKE the United States stronger. Instead it has made the country weaker. It has eroded America's wealth and has jeopardized its leadership position as the world's strongest economy.

Something has to be done.

There is a growing consensus that the U.S. monetary system is broken. A 2013 Rasmussen poll found that an astounding 74% of American adults are in favor of auditing the Federal Reserve and making the results public. Only 10% oppose it.

A substantial number believe the Fed chairman has too much power over the economy. Momentum is building on Capitol Hill for a reevaluation of the role of the Federal Reserve System.

People are seeking solutions. We mentioned earlier the movement for alternative currencies. Lately there has been a push for another option that, until very recently, few people in policy circles would seriously entertain: a return to stable money through the use of a gold standard.

Gold.

Calls for a new gold standard are gaining support. The people are leading the way. Gold and silver coins are now accepted legal tender in the state of Utah. The states of Georgia and Montana have outlined ideas to allow the use of gold as payment in certain sectors of the economy.

Rep. Kevin Brady, chairman of the Congressional Joint Economic Committee, and Sen. John Cornyn are pushing a bill to create a bipartisan commission to conduct a thorough examination of monetary policy. Brady's bill is attracting sponsors in both the House and the Senate. Already, Rep. Ted Poe, another Texas Republican, has submitted a bill with a proposal for a new gold standard.

When the Cato Institute, a libertarian think tank, held an event discussing gold in the summer of 2013, the meeting drew hundreds of journalists, academics, entrepreneurs, key congressional staffers, and other policy thought leaders. Many had never before been interested in the subject of a gold standard. Ralph Benko, who edits the Lehrman Institute's *The Gold Standard Now* and is a Forbes.com columnist, marveled at the attendance, declaring, "This was no ordinary event. It may, in retrospect, be seen as the gold standard's Woodstock."

A return to gold-based money is not yet front and center on the national agenda. The policy establishment still dismisses it

as radical. But history has shown time and again that great social changes begin as seemingly radical ideas.

Why Gold?

We need gold because, as we've emphasized throughout this book, gold is the best and the only way to achieve truly stable money. Relinking the dollar to gold would eliminate the economic volatility and monetary crises that have been the consequence of fiat money. It would stop the erosion of our wealth that is taking place today as a result of Fed-engineered inflation. With a gold standard, *there would be no inflation*. That's right. We said it and we mean it. As critics so often misunderstand, no inflation does not necessarily mean an end to price instability. Prices, as we've explained elsewhere, will continue to rise and fall in response to changes in supply, demand, and productivity. As well they should. Gold would allow prices to convey real market values, not Fed-distorted ones.

In other words, gold would enable money, for the first time in decades, to completely fulfill its role as a facilitator of transactions, unimpeded and undistorted. People conducting business in the marketplace would have a tool that really works. Commerce would boom.

That happened in the late nineteenth century, when most nations, inspired by Great Britain's spectacular economic success after tying the pound to gold, spontaneously adopted a gold standard. The global economy experienced an explosion in trade, capital creation, and investment that remained unmatched for the next 100 years. Gold worked then because leaders and governments didn't violate the rules, as their successors did in the twentieth and twenty-first centuries. They believed in the principles of sound money. A gold standard would

deliver a stimulus to the United States and the world economy that Fed bureaucrats could only dream of.

Gold Takes the Politics out of Money

Gold takes decisions about the value and supply of money out of the hands of bureaucrats whose judgment is too often in error or driven by politics. Bureaucrats can no more guess the need for money than central planners could run an economy in the days of the Soviet Union. Seemingly sophisticated equations and various measures of money can never anticipate what people actually do.

The job of a government's central bank would simply be to maintain a stable gold price. In a gold standard system, the price of gold acts as a barometer. It indicates whether there is too much liquidity in the economy and whether we're heading toward inflation or if there's too little liquidity and possible deflation.

The demand for money reflects the ever-shifting actions and desires of billions of people in global markets, many of whom are reacting to thoroughly unanticipated events. Gold prices convey these changing needs better than anything else.

Why isn't the United States on a gold standard today? There are a number of reasons. The traumas of World War I and the Great Depression spurred the rise of neo-mercantilism and a new infatuation with activist government. If government could win wars by mobilizing the economy, many believed, imagine how society would benefit from its vast powers in peacetime, including greater control over money.

Then there are the hostile myths about gold that, like barnacles, remain stubbornly attached even today. Allegations range from "there's not enough gold in the world" to "the price of gold is too volatile" to even that "a gold standard constitutes the price fixing of money."

You'll also hear accusations that the gold standard caused the Great Depression and later created pressures leading to the end of the Bretton Woods system. That's like blaming a skyscraper's implosion on the tools used to build it, not on the violations of building codes that caused the collapse.

Debunking the Myths About Gold

Money simply reflects conditions in an economy. Like those construction tools, gold has repeatedly been blamed for economic destruction caused by obstacles that governments place in the way of commerce. First and foremost was the U.S. enactment of the Smoot-Hawley Tariff, which we will discuss later in this chapter. Placing onerous taxes on thousands of products, that toxic act of protectionism started the global trade war that triggered the Great Depression. Countries then deepened the slump with ghastly increases in taxes. A wave of devaluations followed. Nations, desperate to revive their economies, cast aside the wisdom of sound money.

Gold opponents also believe a peg to the precious metal opens up the United States and other nations to runs on gold supplies. This isn't true either. The focus on gold's supply (or the lack of it) is the same mistake made by mercantilist monarchs who thought gold in and of itself constituted wealth. As we emphasize in this chapter, gold's power lies in its effectiveness as a *measure*. A gold-based system can work even if a country doesn't own a single ounce of gold.

Gold Doesn't Mean a Fixed Supply of Money

Gold is far less rigid than most people realize. It is both flexible and stable. Contrary to the common perception, it allows the monetary base to grow, or to shrink, in response to transactions

and monetary demand while preserving the value of money. A gold standard no more means a fixed supply of money than a use of the metric system means there has to be a fixed number of rulers.

Why Not Silver or Something Else?

Why gold? After all, as we've discussed, many commodities throughout history have been used as currency. Gold, however, is the best way to sound money because it maintains its value better than anything else on earth. It is to stable, long-term purchasing power what Polaris, the North Star, is to determining direction—that is, an unchanging fixture, a constant.

Gold is indestructible. You can freeze it, heat it, smash it or burn it, but you cannot destroy it. It doesn't rot. It is not prey to termites or rodents or disease. Its chemical composition never changes nor does its weight if you melt it down. Gold is tough but malleable enough to be shaped into coins or bars. Unlike the fei that we mentioned earlier, the precious yellow metal packs considerable value into a tiny amount of space, making it easy to use and transport.

Gold is not subject to droughts or abundant harvests that can produce the supply shocks experienced by wheat or corn. It is not consumed or burned like oil or natural gas. Gold is mostly used for jewelry and other ornaments and as a reserve of value. Gold has some industrial uses and was once employed by dentists for fillings in our teeth. But these have little effect on supply, constituting a fraction of the amount of gold mined each year.

All the gold that has been mined is still in existence, over six billion ounces. Experts estimate that more than 90% of it is accounted for today. The rest is either buried in the ground, having been lost by careless owners, or lying at the bottom of the ocean. As Roy Jastram put it in his classic work *The Golden Constant*, "The ring worn today may contain particles mined in the time of the Pharaohs."

Even the massive influx of gold and silver from Spain's New World colonies resulted in price increases averaging only 1.7% a year. Giant finds such as the California and Australian gold rushes of the late 1840s, as well as the enormous South African discoveries of the 1890s, resulted in relatively mild supply spikes that never exceeded 5%—and the growth rate quickly returned to normal.

Beautiful to behold, gold has been treasured by all nations and cultures since human beings first walked the earth. It has intrinsic value. Other commodities have intrinsic value—oil, for example, is referred to occasionally as "black gold." The petroleum supply, however, fluctuates far too much to be of use as a monetary anchor, not to mention the disadvantages of bulk, storage, and perishability.

What about silver? For centuries, silver had a close ratio to gold; 15 to 16 ounces of silver were equivalent to an ounce of gold. The currencies of China and India were once fixed to silver. But in the latter part of the nineteenth century demand for silver declined with the increasing use of paper money. Improvements in mining technology also enabled supplies to increase. The value of silver to gold began to fall. By the mid-1890s, the ratio was about 30 to1. Today it is in excess of 60 to 1.

Every alternative to a gold standard has been tried, including no standard at all. If something were superior—another commodity or a basket of commodities—we would have found it. And so the answer to the question *Why gold?* becomes self-evident: in 4,000 years of human experience human beings have found nothing better. History shows that a gold-based monetary system is frequently abandoned, but it always reemerges. Always.

No Better Stimulus than Gold

Janet Yellen, Ben Bernanke, and other Keynesians have forgotten the global economic expansion that took place from the 1870s until 1914, during the era of the worldwide gold standard. In a unique interlude of monetary harmony, European nations, Japan, and the United States linked their currencies to gold.

The move toward the worldwide gold standard era began in the late 1600s in Britain with the Great Recoinage debate of 1696. Britain's currency had been debased by wear and tear, as well as by the age-old practice of coin clipping favored by governments as well as counterfeiters. They would slice precious metal off the edges of coins, and the shavings could then be melted down into bars or currency.

Almost 50% of the precious metal was missing from British coins by the end of the seventeenth century. It was decided that, to avert a monetary crisis, Britain would melt down and remint the damaged money. Traditionally such an occasion was an opportunity for a devaluation. British treasury secretary William Lowndes wanted the coins reissued at a far lower value. John Locke, the esteemed political philosopher, argued that such a devaluation was a violation of natural law, equivalent to an arbitrary seizure of property. The eminent Isaac Newton also opposed debasement, considering it an affront to science, a moral transgression no different from counterfeiting.

Parliament's eventual decision not to devalue was a victory for advocates of sound money. Newton, as Master of the Mint, formally fixed the pound to gold in 1717 at the once-famous rate of three pounds, seventeen shillings, and ten-and-one-half pence to an ounce (£3.89), a ratio that stood unchanged until 1931.

When it tied the pound to gold, Britain was a second-tier nation. Soon all of that would change.

Great Britain Leads the World into a Golden Era

By the end of the Napoleonic wars in 1815, Great Britain emerged indisputably as the world's major power and global center of innovation. The industrial revolution, gaining momentum since the early 1700s, reached full speed. Great Britain gave us such innovations as steam engines, steam-powered trains, and mass-produced cotton fabrics, to name a few. The city of Manchester became to manufacturing what Silicon Valley is today to high technology.

The United States underwent a similar metamorphosis after adopting sound money. Reckless money printing during colonial days and the War for Independence had left the finances of the young republic a shambles. Alexander Hamilton, the first secretary of the treasury, realized that the only hope for recovery lay in a system based on sound money. Among other initiatives, Hamilton established a mint with a dollar fixed by law to a specific weight in gold. The value was fixed at $19.39 per ounce. (In 1834 it was slightly devalued to $20.67.)

Overnight the economy sprang to life. Capital poured in from the Dutch and also America's former enemies, the British. Barely a century after Hamilton's reforms, the United States was the premier industrial power in the world, surpassing even Great Britain. This growth took place despite a chaotic banking system bogged down by politics and burdened with government restrictions.

Inspired by the success of Great Britain and to a lesser extent the United States, other nations began to follow their example. By the end of the nineteenth century, Germany, Italy, Spain, France, Russia, Japan, and even Greece all adopted gold-based money.

The Era of the Classical Gold Standard

The era of the classical gold standard was a unique interlude in history. It saw an explosion of trade and innovation that, in many respects, has yet to be equaled even today. Rarely in human history has there been such an increase in population and living standards—or such a free flow of people and capital. Money was not the only factor in the global boom; by discrediting mercantilism, Adam Smith and his fellow free-market thinkers had helped still the heavy hand of government in the economy. The nineteenth century was an era of economic freedom, with no restrictions on the flow of capital.

London became the world's center of finance. British investments played a significant role in the development of the United States and numerous other countries. Railroads, factories, and agricultural enterprises proliferated throughout the world, including India, Argentina, China, Malaya, and Africa.

This explosion of capital helped trade flourish despite a flurry of protectionist tariffs in the latter part of the nineteenth century. Enormous strides in shipping and the technological advances of the industrial revolution were raising living standards, bringing new products and services at lower prices to people around the world. The invention of refrigeration, for instance, meant a country such as Argentina could grow immensely rich by exporting beef in greater volumes and more cheaply than ever before. International trade as a proportion of global economic activity wouldn't reach the levels of 1914 again until almost a century later in 1996; capital flows, not until 1999.

Advances in the United States were particularly impressive. Between 1870 and 1914, real wages more than doubled even though the country had millions of immigrants. Agricultural

output tripled. Industrial production, led by Andrew Carnegie's application of new steel technologies, surged a jaw-dropping 682%. Tens of thousands of miles of new railroad tracks crisscrossed the continental nation.

The United States was hardly alone in experiencing such spectacular growth. Russia saw increases in oil and steel output after adopting a gold standard in 1897. The country became a magnet for foreign investment, especially from its ally, France. Russian bonds became a staple of the French bourgeoisie. The country also became the world's biggest exporter of grain, with the highest economic growth rate in Europe on the eve of World War I.

Contrary to the myth long perpetuated by the communists, Russia was moving in the right direction economically and was on the way to industrialization without communism, which retarded development and killed tens of millions of people.

No longer was military power the way to riches. Thanks to trade and the free flow of capital, smaller countries like Norway, Switzerland, and Holland with lesser armies—and lower military budgets—enjoyed higher standards of living than Germany or France.

By providing a shared standard of value and facilitating global trade, the worldwide gold standard also helped break down longstanding barriers between nations that had been adversaries. For example, France got a significant portion of its coal, the chief source of energy at the time and a critical component of explosives, from its archenemy Germany.

The era's focus on commerce also helped calm tensions between the warring nations of Latin America. Capital poured into the region, mostly from Great Britain. New opportunities attracted millions of immigrants who were more interested in bettering their lives than in battling their neighbors. The

incidence of warfare in South America declined so that by 1914 peace, not war, was the rule. The British author and Parliamentarian Norman Angell remarked in 1913:

> Just note at what is taking place in South America. . . . These countries, like Brazil and Argentine, have been drawn into the circle of international trade, exchange and finance. . . . *It is not because the armies in those states have grown* that the public credit has improved. Their armies were greater a generation ago than they are now. It is because they know that trade and finance are built upon credit.

Other examples of interdependence abounded. The naval rivalry between Great Britain and Germany did not prevent the owners of Germany's growing merchant marine from insuring their ships with British companies in London.

The pre–World War I era was no utopia (working conditions in factories were harsh by today's standards) and saw plenty of political agitation, but it was in retrospect a remarkably positive time, unrivaled in history. Unfortunately age-old forces of nationalism and political antagonisms eventually won out over the advances of commerce. Tensions between Austria-Hungary and Serbia set off the chain of events leading to World War I. Germany and Austria-Hungary, among others, had long military traditions. The military castes of both countries, particularly Germany, failed to grasp the fact that trade, not military muscle, is the true source of power. Few leaders at that time could have ever imagined that just a century later a commercially successful Germany with a significantly smaller army would be the dominant power in Europe, while Russia with a far larger military would lag behind.

Lower Interest Rates, Cheaper Capital, Gangbuster Growth

In today's command-and-control system of fiat money, lowering interest rates requires an act of largesse from a central bank. Under a gold standard system of sound money, interest rates naturally fall. That's because lenders can expect to be repaid in money that has not declined in value.

The cost of capital dropped dramatically in Great Britain after Newton tied the pound to gold in 1717. The Crown had previously rued the fact that it had been unable to borrow money at the low rates obtained by the fiscally prudent Dutch. In 1694 the newly created Bank of England lent the government of William III 1.2 million pounds at 8%. That was considered a concession to the new king, but it was far higher than the 4% rates the Dutch were paying.

After Great Britain adopted gold-based money, however, the government could issue bonds (called stock in those days) with no maturity at a rate as low as 3%. By the late 1800s that rate went down to 2½%. Between 1821 and 1914 the average yield of British government bonds—called Consols—that had no maturity was 3.15%.

The peg to gold also meant that Great Britain was now a better investment. Before the pound was linked to gold, fiat money had enabled a free-spending monarchy. A gold-based pound, however, signaled that Parliament—specifically, the taxpayers who made up the House of Commons—was firmly controlling the purse strings. (Unlike today's Keynesians, they knew that money didn't come from the tooth fairy.)

Nathan Lewis writes that lender confidence soared in the nineteenth-century gold standard era: "Interest rates worldwide converged to low levels. British debt was perceived to have

the lowest risk of either credit default or currency devaluation. Other governments' debt traded with a small risk premium."

The story was much the same in France and the United States: yields on French government debt started out at about 15% when the Bank of France was established in 1800. They slid to 3% by 1902. As for the United States, Lewis writes:

> The market recognized that gold indeed served as a superlative standard of stable value—that it was money *par excellence*, as Karl Marx wrote in 1867. Currency stability in turn engendered economic stability and provided the reliable foundation for all financial and economic activity.

Investors were so confident during the gold standard era that in 1896 Northern Pacific Railroad issued a 150-year bond at an interest rate of 3%!

The explosion of wealth creation that took place during the worldwide gold standard era was no anomaly. From 1946 to 1970, under the gold-based Bretton Woods system, U.S. industrial output surged 209%, an average of 4.8% a year. In the post–gold standard era this growth dropped dramatically: industrial production increased 159% between 1970 and 2012, a little more than 2% a year; in the period of 2000 to 2012, it rose a total of 7%.

No Credit Rationing

Under a gold standard the cost of money will be somewhat higher than it is today—after all, you can't get much lower than zero interest rates. But the Fed would no longer be artificially suppressing interest rates with its price controls. The result: credit and capital would be more widely available. Smaller

businesses will get loans at an affordable cost instead of getting no credit at supposedly near-zero interest rates. For most job-creating small businesses, credit in recent years has been a lot like government-rationed healthcare—supposedly free, but much of the time you can't get it.

A Return to Government Accountability

Gold makes governments *accountable*. Having to maintain a stable monetary value makes it harder to turn on the printing press to pay for political promises or to buy votes. Governments have to turn instead to borrowing and higher taxation, actions that require popular support. In other words, gold discourages the profligacy possible with fiat money by assuring that spending has consequences. Gold standard advocate Daniel Ryan explains:

> Government can still borrow, but they can't use the central bank to sidestep the consequences of excessive borrowing that every other borrower has to face: higher interest rates. A gold standard would forbid quantitative easing. Thus, a gold standard puts a lid on the shenanigans politicians like to use for political gain. We've all seen the effects of leaving monetary and fiscal discretion in the hands of politicians and their appointees: chronic inflation and chronic government debt. Had there been a gold standard, government debt would have never gotten out of hand like it has.

Government finance was never as self-restrained as it was during the classical gold standard era. With European nations becoming increasingly democratic and dependent on consensus, budget expenditures therefore had to be of a more careful

nature. Germany, for example, badly wanted to boost spending for its military to compete with rivals France and Russia, which were improving their armies. It also wanted a navy to rival Great Britain's. But the German government was constrained by the fiscal discipline imposed by the gold standard.

Germany spent only around 2 to 3% of its GDP on its military—a far lower percentage compared with the size of its economy than what was spent by nations like France (3 to 4%). The numbers, in other words, suggest that it could have easily spent more. In a sense, the prewar gold standard saved the Allies. Germany came within a whisker of winning the war in its early weeks. Without a gold standard, it is very likely that Germany's military outlays, and its military strength, would have been far greater.

Even without a gold standard, stable money fosters fiscal discipline, though to a lesser degree. We saw this during the Clinton administration, which generally maintained a steady dollar. In his book *The Agenda*, Bob Woodward quotes the president's incredulous reply when told by his advisors that, before spending to stimulate the economy, he first needed to cut a record-high national deficit. To do otherwise would imperil demand for the government's bonds and its ability to borrow. According to the book, the president exclaimed, "You mean to tell me that the success of the program and my re-election hinges on the Federal Reserve and a bunch of f****** bond traders?"

Top Clinton advisor James Carville told the *Wall Street Journal*: "I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody."

Because it would mean a return by government to fiscal accountability, the idea of gold-based money has traditionally struck fear into the hearts of many proponents of big government

who wrongly equate stable money with austerity. As we've pointed out, this is not true: Otto von Bismarck began the modern welfare state in Germany during the era of the classical gold standard. Great Britain likewise enacted a series of social welfare programs before World War I.

At the same time, Europe's great powers also were able to afford large military establishments. It was amazing to see how small military budgets as a proportion of countries' gross domestic product were before World War I. Great Britain, for example, was famous for its navy, yet its naval outlays were relatively small at less than 2% of GDP.

Gold allows governments to do more with fewer taxpayer dollars. It would lower the cost of capital for government as it would for the broader economy. Washington could more easily service its debt. There would be the added benefit of more tax revenue because the economy would flourish under a gold standard, especially when combined with a sensible tax and regulatory system.

A gold standard would allow government to deploy money more efficiently. It doesn't necessarily mean lower spending, because in a vibrant gold standard economy the tax base would be bigger.

Real Money Means Real Prices

Sound money via a gold standard would mean that median incomes would once again rise in real terms. When you have fiat money, as we've discussed, prices go up and real salaries go down. You're getting paid in money that is worth less and less.

A gold standard would obliterate inflation. From 1821 to 1914 the cost of living in Great Britain went up 0.1% a year. Compare that to the double-digit rate of inflation in the United States between 1971, when the link to gold was severed, until

1983, when that bout of inflation was conquered. Since then the average rate has been above 3%, based on the highly imperfect CPI calculations. In the real world it's higher; for example, a gallon of gas in the United States in 1971 could be bought for as little as 30 cents a gallon. Today it is around $3.50 and has been far higher.

Eliminating inflation is not the same as price stability. Prices will continue to fluctuate with gold-based money, but they would do so in response to changes in supply, demand, and productivity.

We're not saying that gold would mitigate the normal industry shakeouts that can sometimes occur or that it could prevent market distortions created by bad government regulation or excessive taxation. Gold-based money, however, would enable the market's system of communication to convey the *true* worth of goods and services being exchanged. In other words, price signals would be free of distortion.

Under a gold-based system, prices would tend to drop more than they do today because there would be lower commodity prices. Food and energy prices would likely be lower, as would the prices of goods and services that make heavy use of those commodities. Lower fuel prices, for instance, would cause airfares to drop. Imagine how much less punishing winter would be with half the fuel cost.

Gold would have prevented the housing bubble and other imbalances that have occurred in response to price signals distorted by the ever-weakening dollar. Oil would not have skyrocketed from $3 to nearly $40 a barrel in the 1970s, nor would there have been the exploration mania and eventual crash in the 1980s. Gold-based money would have spared us the other inflationary disasters in farmland, copper, commercial real estate, and gold prices—and the busts that followed when the Fed tightened and markets came back down to earth.

George Soros May Have to Find a New Job

A single fixed exchange rate under a gold standard would drastically reduce speculative trading and the windfalls it produces. As we've mentioned, much of the speculation that takes place in today's financial markets is a response to the volatility produced by the collapse of the Bretton Woods gold system.

Capital and brainpower instead would be directed into ventures that meet people's real-world needs and desires. No more tax shelters and protective investments. After all, why would you need to invest in gold unless you make jewelry or want to wear it? Society would benefit.

We had a taste of this after the early 1980s through much of the 1990s, an era of semi-sound money when the price of gold, despite ups and downs, averaged around $350 an ounce. The United States became a world leader of innovation. Cocktail chatter turned from tax shelters to tech investments. The Dow Jones Industrial Average surged 15-fold from under 800 to over 11,000. Short-term interest rates came down from their height of around 21% to 5%. The interest rate of long-term government bonds dropped from a high of 15.75% in 1981 to a little over 6% in the 1990s.

The Reagan boom saw huge job creation after inflation was conquered in 1982: in the rest of the decade 20 million jobs were generated. U.S. growth during this period exceeded the size of the West German economy, the third largest in the world. George Gilder has observed that the United States created more private sector jobs during that era than in all of Europe and Japan put together.

This occurred despite the economic depressions that took place in energy, agriculture, and commercial real estate. The U.S. economy in the 1980s was liquidating the malinvestments of the 1970s and roaring ahead with investments in technology,

media, autos, and other sectors. There was more capital for productive ventures because of the lower price of lending and borrowing that came about with more stable money. The 1980s saw the rise of the personal computer, telecommunications technologies like fiber and cellular, cable television, and other innovations. America's share of the global GDP moved upward.

The boom continued under the Democrats in the 1990s. The Clinton administration was, for the most part, a sound dollar administration. Then the George W. Bush administration started the United States on the road to a weak dollar policy, and all of us continue to live with the consequences. Despite the abundance of anti-Bush rhetoric, the Obama administration has only doubled down on the loose money policies of his predecessor.

A return to the sound dollar policies of Reagan and Clinton would mean more wealth creation through innovation. Forbes .com political economy editor John Tamny points out that, if the United States returned to gold, people like George Soros—or, for that matter, Paul Tudor Jones or John Paulson—could not amass such immense fortunes from speculation; they would have to channel their energies elsewhere.

Had Nixon never freed the dollar from gold, Tamny believes: "It's a fair bet . . . that the three (along with many of their numerous competitors) would have grown rich through the creation of efficiency-boosting software, a cure for cancer, and transportation advances that would make today's cars look positively pedestrian."

The Gold Standard: Four Possibilities

How do we get there from here? Implementing a gold standard would require choosing one of several systems of gold-based money. Most people are probably not aware that there are several

different gold standard systems. Two have been put into practice: *the classical gold standard*, which was used by the world's largest economies from 1870 to the outbreak of the First World War in 1914, and the *gold exchange standard*, which was used after both world wars. Another two have been proposed: a *100% gold-backed currency* and what we call *the gold price system*.

Each has its critics and supporters. But in all, gold is the yardstick of value. We thought a quick guide would be useful, since you are likely to hear more about them in the near future.

The Classical Gold Standard

The classical gold standard was the system established by Great Britain and later used by others during the nineteenth century. Countries pegged their currencies to a particular weight of gold. Anyone could take gold to a bank and exchange it for currency at a fixed rate, or they could swap money for gold. Governments during the classical gold standard era possessed gold reserves: gold bars. Most also had bonds denominated in foreign gold-based currencies.

Gold coverage—the ratio of gold reserves to the monetary base—varied and fluctuated in each country. Convertibility, however, was sacrosanct. A drop in a nation's gold reserves meant countermeasures had to be taken, such as raising interest rates to attract short-term money and perhaps cutting spending or raising some taxes to demonstrate fiscal prudence.

Contrary to myth, trade balances weren't needed for the system to work. Great Britain routinely had enormous trade surpluses and was proportionately the greatest capital exporter ever. The United States, by contrast, routinely experienced trade deficits and was a major capital importer. Yet the dollar remained successfully fixed to gold.

As we've noted, the classical gold standard was destroyed by the First World War. The breakup of the German, Russian,

Austro-Hungarian, and Ottoman empires produced numerous new countries with their own currencies and central banks, making the system harder to implement.

More critically, there was also the mistaken perception that wartime inflation had created a gold shortage—not enough gold to restore the kind of gold-backing prevalent before hostilities. Such a fear stemmed from the longtime misguided focus on the supply of gold rather than how it functions. Had nations simply pegged their currencies at the postwar value, gold could have resumed its role as a standard of measurement. The imagined shortage would have quickly disappeared. Instead the solution was to abandon the existing system in favor of a new one: the gold exchange standard.

The Gold Exchange Standard

The gold exchange standard was seen as the answer to the supposed gold shortage because it required fewer nations to hold gold than under the classical gold standard. The U.S. dollar and the British pound would be directly fixed to gold, but other countries could forgo using gold bars and instead link their currencies to dollars and pounds. Government reserves would include not only gold, but also U.S. and British government bonds.

Countries didn't mind this. Unlike piles of gold, bonds paid interest. Reserves could grow effortlessly. If nations wanted more gold, they could redeem their dollars and pounds to get it.

Gold standard purists then and today, however, were appalled by the substitution of debt for gold in government reserves. Believing that countries needed to hold physical supplies of gold, they considered such a use of leverage inflationary, little better than a pyramid scheme. Critics claim to this day that such flaws helped encourage an excess of credit creation

that produced the disaster of 1929. This was an incorrect reading of what was occurring in the market, which was rising because of an incredible surge in corporate profits. The cause of the Depression was the U.S. enactment of the Smoot-Hawley Tariff, which we discuss in greater depth later in this chapter.

Another gold exchange standard, the Bretton Woods system, emerged in the waning days of World War II, as we noted earlier. At that time, the United States owned more gold than the rest of the world's governments combined. So only the U.S. dollar was fixed directly to the precious metal, redeemable in gold bars solely by governments or central banks. Other currencies were tightly pegged to the dollar.

That was the problem. When Nixon closed the gold window in 1971, there was no gold-based currency in the world for the first time ever. This made resurrecting a new arrangement extremely difficult. Remember that the classical gold standard was preceded by Great Britain, the United States, and other nations having gold-backed currencies. The Bretton Woods gold standard would have worked if the United States had played by the rules and understood how to manage the system.

A 100% Gold-Backed System

Some gold standard supporters advocate a system where the currency is 100% supported by gold. That wasn't the case under a classical gold standard. Only a percentage of the money stock was covered; it was widely assumed that not everyone would simultaneously seek to redeem paper for gold. The system operated somewhat like our modern system of fractional reserve banking, under which banks loan out most depositor money, keeping only a fraction on hand as reserves.

For some of the same reasons that fractional reserve banking and its leverage have discomforted critics, some believe a gold

standard demands 100% coverage. In a 100% system, gold would support the *entire* money stock, making it 100% redeemable. Supporters of a 100% system like it because they believe it eliminates the risks of bank runs and the system failure that might come with dependence on leverage. Banks would have to have gold reserves on hand to redeem 100% of depositors' money.

Advocates also claim that, since the global gold supply grows at about 2% a year, in line with long-term economic growth rates, a 100% system would not be deflationary. Sadly, they're mistaken. Here's why: Say you pegged the dollar to gold at the market price, which has been fluctuating at around $1,200 to $1,400 an ounce. Given that the United States holds 261 million ounces of gold that would mean the total monetary base—the currency in circulation and bank reserves on deposit at the Fed—could not total more than $325 billion. That would require a huge contraction in the monetary base and a deflation to end all deflations. Even before the Fed's QE binges, the monetary base was a tad under $900 billion. Today it is $4 trillion.

Some respond that we could take a page from Franklin Roosevelt, who devalued the dollar from $20.67 to $35 in 1934, and jack up the dollar price of gold to $10,000 or more an ounce. Then you'd end up with the opposite problem: Weimar-style inflation.

A more realistic variation of this idea would be a gold-based currency board. Currency boards have been around for over 150 years. A government simply uses a sound or widely used currency to back its own money. Its money is 100% backed by that other currency. Several countries use such a system today, including Denmark, Bulgaria, and Lithuania. Hong Kong has had a currency board tied to the dollar since 1983. In these cases, their monetary bases are made up of only euros and euro-denominated bonds plus some gold. Their central banks have no discretion. People can turn in the local currency for euros at a fixed rate, and

vice versa. Their domestic money supplies are solely determined by the needs and wants of their own people.

So why not such an arrangement that is gold based? Johns Hopkins economics professor Steve Hanke, a world authority on currency boards who helped design them for Bulgaria and others, has outlined how such a system might work. Instead of a currency, such a board would "hold reserves in gold or in highly rated or liquid securities denominated in gold or fully hedged against changes in fiat-currency price of gold."

One could see how a currency board would work for a smaller country, but it would be impractical for a large country like the United States because of the difficulty of having a 100% backed dollar. And, as we have noted, it's not necessary.

The Gold Price System

This new version of the gold standard has been proposed in legislation introduced by U.S. Representative Ted Poe. It uses the precious metal as strictly a yardstick of value and does away with the need for nations to hold gold supplies. The system is the essence of simplicity. The dollar would be pegged to gold at, say, $1,200 an ounce. If the market price goes above that level, the Federal Reserve would engage in open market operations, selling bonds to extract reserves from the banking system until gold settled back to $1,200. Conversely, if the price went below $1,200, the opposite action would occur. The Fed would purchase bonds, which would put money back into the banking system. A strength of the gold price system, as Louis Woodhill has noted on Forbes.com, is that there is no way for speculators to attack the system by buying up supplies of gold. And as we've said, you don't need to hold any gold for the system to work.

The key challenge of this method is setting the gold/dollar ratio. Setting the price of gold at too low a level, such as $400 an

ounce, risks delivering a deflationary shock to the economy, as happened in Great Britain in 1925. Probably the best method would be to take a 10-year or even 5-year average of the dollar/gold price, mark it up 10% as insurance against deflation, and go with it.

A Gold Standard for the Twenty-First Century

If America is ever to attempt to restore the vitality of its economy, it must return to the tradition of sound money via a gold standard. Below we present a proposal for a new gold standard for the twenty-first century. It combines the fundamentals of the old systems, using gold as the yardstick of value, while avoiding the vulnerabilities: no more manipulating interest rates, no more misguided focus on the balance of payments, no worry about who buys U.S. debt, and no concerns if there's another big gold discovery.

The United States doesn't have to worry about stockpiles of gold. It simply must have the knowledge and the will to defend the ratio between the dollar and gold. The following list lays out the basic features.

A fixed dollar value that would be maintained by the Fed.

The twenty-first century gold standard would fix the dollar to gold at a particular price. As we mentioned, that price might be decided based on a 5- or 10-year average of recent gold prices, marked up as insurance against deflation. The Federal Reserve would use its tools, primarily open market operations, to keep the value of the dollar tied at that rate to gold.

The program would be phased in gradually.

The process need not run more than 12 months. The government should announce a certain date when the conversion to a gold standard will take place. A gradual phase-in will help markets prepare for the return to gold-based money. With no more fears of future inflation, a more natural gold price should reemerge, making it easier to arrive at the gold/dollar ratio. The transition period would also enable financial institutions and investors to adjust expectations about future interest rates and alter investment strategies to reflect a new environment of stable money. Global markets would make similar adjustments. The dollar would be permitted to fluctuate against gold with a range of 1%, the rate used under the Bretton Woods system for currencies against the dollar.

The system would be backed up by law.

To minimize the inclination of central bankers to exercise "discretion," procedures governing the twenty-first century gold standard would be codified into law. This legislation should also bar the Fed from manipulating interest rates. The U.S. central bank could no longer use its tools to fix the federal funds rate, the interest rate banks pay to one another for borrowing reserves. The Fed could still set the discount rate that banks pay to borrow money from the Fed at its discount window. That charge would be set above free-market rates of similar maturities so that banks don't use the window to get a cheap source of money to lend out.

Barriers to alternative currencies would be removed.

Removing barriers to alternative domestic currencies would also help to keep Washington playing by the rules. The rise of

competing currencies would be another signal to the Fed to defend the dollar. After all, people use U.S. dollars as a matter of convenience. To consider an alternative would mean a very real distrust of the dollar's integrity.

To permit currency diversity, no taxes or government fees could be levied on sales of gold and silver bullion, as is the case today. Capital gains taxes would also be a no-no. Onerous reporting rules that now afflict gold and silver bullion buyers would be prohibited. Individuals would be permitted to launch alternative currencies.

The convertibility of dollars into gold would be restored, if needed.

The twenty-first century gold standard would allow people to turn in dollars to the government to receive gold at a fixed rate and cash in their gold for dollars. Americans had that right, except in wartime, until 1933. They did not have it under the Bretton Woods system, when only central banks of other countries could redeem dollars for gold. This kind of convertibility, while not really necessary, would serve as one more safeguard to maintain sound money if the Fed does not do its legally mandated job of maintaining the dollar/gold ratio.

Instead of a formal gold cover of yesteryear, legislation for a new standard might specify that Uncle Sam would indeed be obliged to take dollars from all comers. In addition, the U.S. government would have to replenish its gold stocks if they fell below, say, 50 million ounces (the amount is 261 million ounces today). Washington's gold holdings would be audited yearly, as would the Fed itself. For its services, government would convert currency to gold at a fixed fee of 2% or more so as not to compete with private dealers.

Other currencies would be pegged to the dollar.

If the United States went to gold, other countries would likely fix their money to the dollar, if only for convenience. Numerous countries in Latin America and Asia already try to keep their currencies closely aligned to the greenback because doing so makes trading and investing with the United States much easier. Part of the task at hand would be to make sure that their central banks understand how to defend their ties to the dollar. (We've seen repeatedly, as in the Asian crisis of 1997–1998, how central banks lack the knowledge of how to defend their currencies from speculative attacks.) Of course, if a country wanted to attach its currency directly to gold instead of the gold-backed dollar, it could do so. The result would be the same: stable exchange rates.

The Fed would have a role, at least for now.

The Fed would continue to act as a lender of last resort and deal with panics that might arise from a 9/11 type of event.

Common Concerns About Gold

If a gold standard offers so many powerful advantages, some may ask, why hasn't the United States returned to it in the decades after Bretton Woods? One reason is that gold is ferociously dismissed by the Keynesians and monetarists dominating the policy establishment. Ronald Reagan, who created a Gold Commission in 1981, was a believer in sound money. Like John F. Kennedy, Reagan understood that, in the words of Kennedy, the dollar should be "as good as gold," that a great nation must have a sound currency. Unfortunately he was unable

to prevail over his advisors who, with the exception of the noted economist Arthur Laffer (of the Laffer curve fame), were almost unanimously opposed to gold. Had he done so, we might have a gold standard today.

The lack of real discussion has allowed myths and misconceptions about the gold standard to persist. Below we list several concerns that are frequently raised.

Gold shows too much price volatility to be a reliable anchor.

Opponents point to gold price fluctuations as proof that a gold standard would mean price volatility. In 2010 Chris Beam worried in Slate.com:

> Gold is notoriously volatile—its price has doubled over the last two years. If the Federal Reserve were to simply fix the dollar to the price of gold on a given day and demand for gold changed drastically, it would wreak havoc on the economy. If the Fed pegs the rate too low, for example, people would want to trade their dollars for gold, forcing the Fed to raise interest rates in order to make dollars more attractive. Even if the Fed were to pick the rate correctly, it would still have to make adjustments based on the economies of the United States' trading partners. If the dollar is growing in value, but another country's currency is decreasing in value, yet both currencies are pegged to gold, something has to give—either one of the currencies has to inflate or deflate, or the exchange rate has to be adjusted.

Put aside the misunderstanding of exchange rates. (If two currencies are pegged to gold, their exchange rates, by definition, are fixed.) The writer doesn't get the point about how the gold

standard fundamentally operates. The price of gold is volatile only when it has no link to the dollar. Remember, gold's intrinsic value makes it a refuge for investors fleeing unsound money. A good part of gold's price reflects anticipated future inflation and sheer uncertainty about what is to come. If the dollar were sound, there would not be the flight into, or out of, gold.

In 1980, when people feared that the United States was incapable of controlling an ever-worsening inflation, the dollar price of gold soared quickly from $220 to $850 an ounce. When emotions calmed, the dollar price fell to $300 an ounce. Gold shot to a record high of $1,900 an ounce in 2011. Since then the precious metal has come down considerably.

It is possible to pick a gold price that neither fuels inflation nor attempts to turn the clock back too far in time as Great Britain did after World War I. As for the concerns about our trading partners, remember that nations of the world voluntarily adopted gold standards following the lead of Great Britain in the 1870s—and their economies boomed.

There is not enough gold to have a gold standard today.

Critics complain that the United States has only about 261 million ounces of gold with a market price of roughly $325 billion. The monetary base is over $4 trillion, and the most commonly used money supply measure, M2, stands at almost $11 trillion. The total of M1, the most liquid part of the money supply, is $2.6 trillion. If the dollar were pegged to gold at its current value, they say, we would have to undergo a savage deflation that would make the British experience of the 1920s look like a sedate picnic.

What they don't recognize is that what makes gold work is not its supply, but rather its ability to provide a stable yardstick

of value. You don't need to have piles of this precious metal for a gold standard to work. Even during the heyday of the classical gold standard, no country ever had 100% gold backing for its money. Great Britain often had very low amounts of gold backing the pound, and the amount there and in other countries varied widely. (As we've said, you don't even need to own an ounce of the yellow metal to have your currency linked to gold.) Previously we explained how a twenty-first century gold standard would work with our current supply. If the United States decided to have convertibility—to give people the legal right to redeem dollars for gold at a fixed rate and vice versa—the U.S. government still has enough of the metal to make such a system work, even with the Fed's bloated balance sheet.

A gold standard would be too rigid.

The misconception here is that a vibrant economy would be held back because a fixed gold price would tie government's hands, preventing growth in the money supply. Gold, however, is far less rigid than critics perceive.

From 1775 to 1900 the U.S. population grew from 4 million to 76 million. During that time, America's mainly subsistence agricultural economy blossomed into an industrial colossus. In the process, the global supply of gold increased a little more than threefold while the money supply in the United States mushroomed 160-fold even though the dollar was fixed to gold.

A gold standard allows the money supply to expand naturally in a vibrant economy. Remember that gold, a measuring rod, is stable in value. It does not restrict the supply of dollars any more than a foot with 12 inches restricts the number of rulers being used in the economy.

What if a crisis like a major financial panic demands an emergency injection of liquidity? The Bank of England developed

the concept of the lender of last resort back in the 1860s under the classical gold standard. The Federal Reserve could easily fill the same function today if the United States reestablished a gold standard. At its discount window, banks could still put up sound collateral for emergency loans, preferably at an above-market interest rate so the borrowing institution would liquidate the loan as quickly as practicable. But such an event under a gold standard would be far less likely. As noted monetary expert Nathan Lewis wrote on Forbes.com, stable money has never caused a financial crisis.

Gold helped bring on and prolong the Great Depression.

The antigold narrative also blames the precious metal for the Great Depression. Supposedly, fears of creating a run on gold in Great Britain kept the United States from raising interest rates to curb its overheating stock market during the 1920s. The result, allegedly, was a credit bubble and falsely inflated economy that brought about the crash of 1929. Afterward, gold ostensibly kept governments from reviving their sliding economies.

Hogwash. The Great Depression was the tragic consequence of the Smoot-Hawley Tariff Act enacted by the United States in June 1930. Equity markets try to anticipate the future. This dreadful legislation was unprecedented, imposing an average 60% tax on over 3,000 import items. When it appeared that a destructive tariff of historic proportions might pass Congress, the stock market cracked and then crashed in September–November 1929. When, for a brief time, the tariff bill appeared it might falter, stocks rallied mightily, ending 1929 almost where they were at the beginning of the year. Then the monster came to life again and the slide resumed. Other countries, of course, noticed what was going on and prepared retaliatory measures.

The enactment of the Smoot-Hawley Tariff Act set off a worldwide trade war that was as disruptive to global commerce as the beginning of hostilities in 1914. Policy makers didn't know what hit them. Their responses, primarily tax increases, compounded the downturn. Great Britain raised income taxes in 1930 and again in 1931. Germany, particularly hard hit because it was dependent heavily on trade, imposed draconian taxes, deepening the slump. The United States passed a bill of massive tax hikes in the spring of 1932 that was made retroactive to the beginning of the year. Income tax rates were boosted astronomically, with the top rate going from 25% to 63%. Epitomizing the folly of it all was a stamp tax on checks, thereby encouraging people to withdraw cash from already beleaguered banks. This draconian legislation even included numerous increases of excise taxes on items such as candy and movie tickets.

Critics respond that when Great Britain went off the gold standard in late 1931, its downturn ended. Of course, as we have noted, devaluation can initially deliver a boost. But this eventually deepened the devastation by escalating the trade war. After London's devaluation, at least 20 countries quickly followed suit. The United States did the same in 1934, as did Italy and Belgium; France finally devalued the franc in 1936. These beggar-thy-neighbor devaluations, as they were called, were ultimately damaging to the global economy. In the end there were no winners. The experience compelled allied and neutral nations to convene in Bretton Woods, New Hampshire, in 1944 and create a new gold-based international monetary system.

A gold standard would be undermined by speculators.

Critics question whether it is possible to maintain a fixed dollar/gold rate in today's global markets, in which computer

technology makes possible giant trades and sophisticated speculators have access to vast resources. In 1992, for example, the British pound was tied to the German mark. Speculators led by George Soros attacked sterling by borrowing pounds and then selling them to buy marks. When it appeared that Great Britain, to save the pound, might need to raise interest rates as much as 100%, the humiliated government caved and it floated the pound. Soros and others then sold their marks for a greater number of pounds than they had borrowed, pocketing billions in profits.

Wouldn't a gold-based dollar be similarly vulnerable? The answer is: not if nations know how to defend their currencies. How can they do this? By using their reserves to buy their currency and maintain its rate by reducing the monetary base.

In early 2009 the Russian ruble faced a speculative assault. Russia then bought rubles, its monetary base declined, and the attack on the ruble failed. The United States has plenty of assets to mount a Russian-style defense against an attack on a gold-backed dollar.

Setting a fixed dollar/gold ratio is price fixing and therefore anti–free market.

Having fixed weights and measures is essential for fair and free markets. We don't let markets each day determine how many ounces there are in a pound or how many inches there are in a foot or the number of minutes in an hour. Money, similarly, is a measure of value.

Setting a new gold/dollar ratio is too difficult.

Gold standard critics commonly cite the painful deflation that roiled Great Britain in 1925 after it made the mistake of pegging

the pound to gold at its pre–World War I gold price even though wartime inflation had more than doubled the cost of living.

This mistake could have been avoided had Great Britain simply fixed the pound to gold based on postwar values. Compounding the government's error was that it left in place its high wartime taxes, which also depressed the economy. When it comes to setting a gold/dollar ratio, one needs to remember the famous quote from Thomas Wolfe: "You can't go home again."

A gold standard for the U.S. dollar has to be based on present-day values. The ratio shouldn't be fixed at, say, $35 an ounce or even the $350 that prevailed for much of the 1980s and 1990s.

The challenge in setting the price today, however, is that people in the last few years have been buying gold out of fears of inflation. The answer should be calculations that take into account forward markets in gold, in addition to the price of inflation-protected bonds. The key is to avoid too low a ratio. To ensure that nominal wages don't fall, a slightly high ratio is crucial. Whatever the method used, the key is to set a price so people know what the rules are and the economy can get growing again.

The gold standard isn't perfect. No system is perfect. But stable money has never ever brought about the systemic financial and monetary crises caused by fluctuating money. If we are ever going to meet the challenges and avert the crises that face us today, gold is the best hope there is.

THE NUGGET

Gold remains the monetary Polaris.
Every alternative has failed.

CHAPTER 7

Surviving in the Meantime

Protecting Your Assets from Unstable Money

Sell them and you'll be sorry,
Buy them and you'll regret,
Hold them and you'll worry,
Do nothing and you'll fret.

—OLD WALL STREET SAYING QUOTED IN *Investing in One Lesson* BY MARK SKOUSEN

BY THIS TIME, YOU'RE PROBABLY WONDERING *WHAT NO* As you read this book, the value of your wealth is ero ing. If you had $100,000 in cash in 2000 and did abs lutely nothing, it would have been worth only around $74,0 in 2013. That's right, the value of your money would have d clined by about 26%. And that is with the last decade's suppo edly low rates of inflation.

We believe that the economic and social consequences the continuing destruction of the dollar will sooner or late force the world to reawaken to the necessity of stable mone