The Golden Revolution:

- Why a Gold Standard lies in our near future, and how we might get there

By John Butler, Chief Investment Officer, The Amphora Commodities Alpha Fund

Contrary to the conventional wisdom of the current economic mainstream that the gold standard is but a quaint historical anachronism, there has been an unceasing effort by prominent individuals in the US and also a handful of other countries to try and re-establish a gold standard ever since President Nixon abruptly ended gold convertibility in August 1971. The US came particularly close to returning to a gold standard in the 1980s. This was understandable following the disastrous stagflation of the 1970s and severe recession of the early 1980s, at that time the deepest since WWII. Indeed, Ronald Reagan campaigned on a platform that he would seriously study the possibility of returning to gold if elected president.

Once successfully elected, he remained true to his word and appointed a Gold Commission to explore both whether the US should and how it might reinstate a formal link between gold and the dollar. While the Commission's majority concluded that a return to gold was both unnecessary and impractical – Fed Chairman Paul Volcker had successfully stabilised the dollar and brought inflation down dramatically by 1982 – a minority found in favour of gold and published their own report, *The Case for Gold*, in 1982. Also around this time, in 1981, future Fed Chairman Alan Greenspan proposed the introduction of new US Treasury bonds backed by gold as a sensible way to nudge the US back toward an explicit gold link for the dollar at some point in future.

In the event, the once high-profile debate in the US about whether or not to return to gold eventually faded into relative obscurity. With brief exceptions, consumer price inflation trended lower in the 1980s and 1990s, restoring confidence in the fiat dollar. By the 2000s, economists were talking about the 'great moderation' in both inflation and the volatility of business cycles. The dollar had been generally strong versus other currencies for years. 'Maestro' Alan Greenspan and his colleagues at the Fed and their counterparts in many central banks elsewhere in the world were admired for their apparent achievements.

We now know, of course, that this was all a mirage. The business cycle has returned with a vengeance with by far the deepest global recession since WWII, and the global financial system has been teetering on the edge of collapse off and on for several years. While consumer price inflation might be low in the developed economies of Europe, North America and Japan, it has surged into the high single- or even double-digits in much of the developing world, including in China, India and Brazil, now amongst the largest economies in the world.

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The economic mainstream continues to struggle to understand just why they got it so wrong. They look for explanations in bank regulation and oversight, the growth of hedge funds and the so-called 'shadow banking system'. They wonder how the US housing market could have possibly crashed to an extent greater than occurred even in the Great Depression. Some look to global capital flows for an answer, for example China's exchange rate policy. Where the mainstream generally fails to look, however, is at current global monetary regime itself. Could it be that the fiat-dollar-centred global monetary system is inherently unstable? Is our predicament today possibly a long-term consequence of that fateful decision to 'close the gold window' in 1971?

I believe that it is. But what that implies, given the damage now done to the global financial system, is that there is no way to restore a sufficient degree of credibility and trust in the dollar, or other major currencies for that matter, without a return to some form of gold standard. This may seem a rather bold prediction, but it is not. The evidence has been accumulating for years and is now overwhelming.

Money can function as such only if there is sufficient trust in the monetary unit as a stable store of value. Lose this trust and that form of money will be abandoned, either suddenly in a crisis or gradually over time in favour of something else. History is replete with examples of 'Gresham's Law', that 'bad' money drives 'good' money out of circulation; that is, that when faith in the stability of a money is lost, it may still be used in everyday transactions – in particular, if it is the mandated legal tender – but not as a store of value. The 'good' money is therefore hoarded as the superior store of value until such time as the 'bad' money finally collapses entirely and a return to 'good' money becomes possible. This monetary cycle, from good to bad to good again, has been a central feature of history.

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In the present instance, we find a growing number of countries expressing concern about the stability of the dollar amid relentlessly expansionary US monetary policy, excessive dollar reserve accumulation and the associated surge in inflation, including China, India and Brazil. The 'Arab Spring' of 2011 originated in part from soaring food price inflation.

Concern is increasingly giving way to action. China has entered into bilateral currency swap arrangements with Russia, Brazil, Argentina, Japan, South Korea and Thailand as all these countries seek to reduce their dependence on the dollar as a transactional currency. As the dollar's role gradually declines, global monetary arrangements are likely to become increasingly multipolar, as there is no single currency that can realistically replace the dollar as the pre-eminent global monetary reserve. The euro area has major issues with unsustainable sovereign debt burdens and an undercapitalised financial system. Japan's economy is too small and too weak to provide a dollar substitute. And while China's economy has been growing rapidly, its financial system is not yet mature or robust enough to instil the necessary global confidence in the yuan as the dominant reserve currency. Yet growth in global trade continues apace, to the benefit of nearly all economies. A global currency facilitates global trade.

It was precisely a multipolar world amid rapidly growing international trade that ushered in the classical gold standard in the 1870s. Although gold had been in the ascendant in global monetary affairs for several years, growing German political and economic clout provided an important tipping point as Germany favoured gold for settlement of international balance of payments. While the Bank of England was the dominant central bank of its day, reflecting British economic power, it never sought to impose a gold standard on its trading partners. Rather, it accepted the gold standard as an international *fait accompli*.

The US Federal Reserve may find it plays a similar role in the near future. While it is certainly possible that, in order to restore confidence and trust in the dollar, the US relinks the dollar to gold on its own initiative, more likely is that another country, or group of countries, where economic power is in the ascendant, where there are large and growing current account surpluses, and where a meaningful amount of gold has already been accumulated, will be the first movers. All of the BRICs are potential candidates, as are certain oil-producing countries and, possibly, Germany and Japan.

When presented with a *fait accompli*, the US will have little choice but to go along or find that the dollar not only loses reserve currency status entirely, but also is no longer accepted for international transactions. In the event, we believe a decision to accept the new global gold standard will be rather easy to reach.

While it is unclear just what kind of gold standard will prevail – history provides a range from which to choose, some of which worked better than others – the key point is that, whatever form of standard prevails, it must restore a sufficient degree of credibility and trust in global monetary affairs. That requires that, simultaneously alongside the return to gold, there must be a dramatic deleveraging of the undercapitalised financial system in the US, euro area, UK, Japan and also a handful of other countries. Fortunately, this is easily accomplished. All that is required is that the rate of gold convertibility is set at a gold price sufficiently high to imply that existing debt burdens, now clearly excessive, are reduced to levels that can be credibly serviced from existing levels of national income and, in the case of sovereign debts, from tax revenues.

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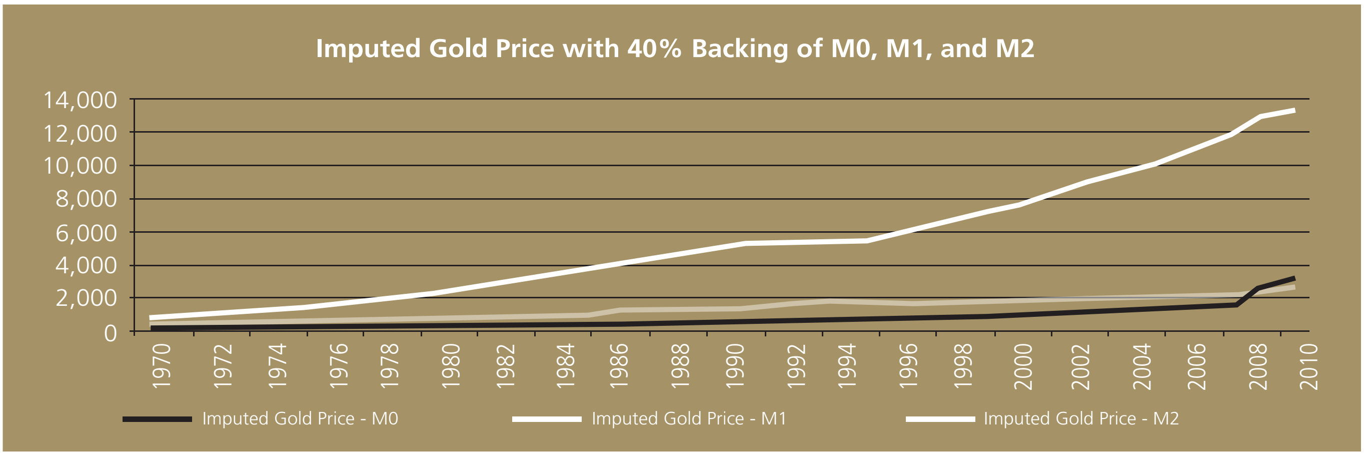

However, given just how overleveraged financial systems are, and how large sovereign debt burdens are becoming amid unprecedented peacetime deficit spending, the rise in the price of gold will need to be an order of magnitude higher than it is today. That may surprise some, given that the price of gold has been rising for years. But what should really surprise us is that the growth of money and credit has been far greater. Simply taking the numbers as they are and allowing the gold price to rise sufficiently to compensate for decades of cumulative, excessive money and credit growth implies that a credible gold conversion price in dollars would be above $10,000. The credible, sustainable conversion prices in euros, yen, sterling and other developed world currencies would also lie far higher than where they are today.

From an investor's perspective, there are far greater implications of a return to a gold standard than merely the large rise in the gold price. The dynamics and determinants of interest and exchange rates, and risk premia for the entire range of assets, are going to change. For example, for those countries that return to gold, exchange rates will become essentially fixed. Interest rates, however, while nominally still under the control of central banks, will need to be set at market-determined levels, not below, or gold reserves will be depleted, eventually leading to a funding crisis. Risk premia for most assets will need to rise, primarily because, constrained by the gold standard, both monetary and fiscal authorities will have less flexibility to provide stimulus during economic downturns. As such, cyclical profit swings will tend to be larger, as will the number of bankruptcies.

While a lack of policymaker flexibility and increased risk of corporate bankruptcy might concern some investors, consider that it was precisely an excess of policymaker flexibility – chronically loose monetary and fiscal policy – which got the developed world into its current predicament. This point is clear: poorly managed fiat currencies and the financial systems built upon them caused the global credit crisis, not gold. And what a world of 'too big to fail' needs are reforms that indeed allow large firms to go bankrupt from time to time, so that capitalism can in fact work as intended.

It is worth considering why bankruptcy has become such a bad word. While no investor wants to lose money on a bankrupt enterprise, when looking at a capitalist economy as a whole, bankruptcy is absolutely essential to economic progress. Josef Schumpeter's 'creative destruction', unlocking resources in unproductive enterprises and moving them to where they can be more efficiently employed, or mixed with new technologies or business techniques, is what capitalism is all about. Real long-term economic progress depends on it.

There are other reasons not to fear gold but rather embrace it. A gold standard will reward savings, something that is sorely lacking in much of the developed world. It will rationalise government finances, in particular by making it difficult if not impossible for countries to incur large debts and then try to pass these off on future generations, something of dubious morality. Absent easy money, it will force economies to become more flexible, and labour and capital to become more mobile. By implication, financial leverage will also be limited and 'too big to fail' will instead become 'too big to bail'. Indeed, absent easy money or bailouts, the financial sector will only grow to the extent that it actually serves the broader, productive economy. Huge numbers of engineers and other quants who went to the City looking for outsize bonuses will make their way back into real industries making real things, where they will be joined by fresh graduates and lay the groundwork for what is likely to be an era of great industrial innovation.

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Investors should not fear the golden revolution. Rather, they should welcome it. After all, they don't call particularly prosperous historical episodes 'Golden Ages' for nothing.

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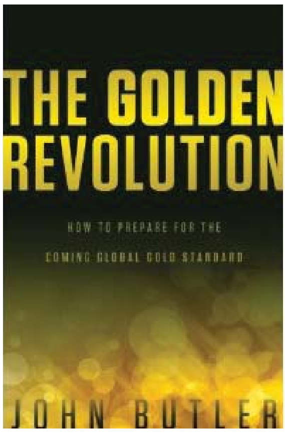
A cum laude graduate of Occidental College in California, John holds a Masters Degree in International Finance and Economics from the Fletcher School of Law and Diplomacy, associated with Harvard and Tufts Universities.



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