The fiasco of fiat money and the excellence of gold money

Commodity Club, Zurich, 15 June 2016

By Thorsten Polleit

Good evening ladies and gentlemen,

I feel honoured to be invited to this educational dinner event at the Commodity Club Zurich.

Thank you for affording me this opportunity to share my thoughts with you on the fiasco of fiat money and the excellence of gold money.

There are seven points I'd like to speak to tonight, so without further ado, let's dive right in with my opening argument ...

#1: Gold is perfect money.

People want and need gold for all kinds of reasons—industrial applications, jewellery, investments, and, of course, for monetary purposes.

As malleable as this precious metal may be, the bottom line is that gold really is money. In fact, it's the *ultimate means of payment*.

Former Federal Reserve chairman Alan Greenspan summed it best when he said:

"Gold is a currency. It is still, by all evidence, a premier currency. No fiat currency, including the dollar, can match it."[1]

History bears this out. Money has taken on many guises over the centuries, but precious metals have always been the preferred format, and gold and silver especially.

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[1] Interview at the Council of Foreign Relations, 29 October 2014.

And for very good reason: A medium of exchange has to have certain *physical properties*. It must be scarce, homogeneous, durable, mintable, portable, and it has be intrinsically valuable. That's why we still say that something immensely valuable is worth its weight in gold.

Pardon the pun, but gold and silver fit the bill. Their high value per unit of weight is undeniable, and they are supremely money-like in all other respects.

This brings me to argument …

#2: Gold was replaced by fiat money for political rather than for economic reasons.

What, you may ask, is fiat money then? Well, the US dollar, the euro, the Chinese renminbi, the Japanese yen and the Swiss franc are all fiat monies.

Fiat money is a kind of money that has been made legal tender by government decree. All fiat monies have three things in common:

For one, the state (or its agent, the central bank) has the monopoly on its production.

For the other, it is produced by way of bank credit expansion; in other words, it's literally created out of thin air.

And finally, it's intrinsically valueless. Fiat money is just brightly coloured paper and intangible bits and bytes that can be produced at any time, and in any amount deemed politically expedient.

Governments want to exert total control over the quantity of money so they can manipulate its buying power to suit their political ends.

Gold stands in the way of such machinations, so it had to go.

Austrian economist Ludwig von Mises had something interesting to say about this, and I quote: *"The gold standard makes the determination of money's purchasing power*

independent of the changing ambitions and doctrines of political parties and pressure groups. This is not a defect of the gold standard; it is its main excellence."[2]

As you can gather, gold was indeed replaced by fiat money for political rather than for economic reasons.

Now allow me to explain why that is a problem with argument ...

#3: Fiat money causes trouble on a grand scale.

Fiat money is inflationary. Its buying power dwindles over time, and history has shown that this entropy is almost as irreversible as gravity.

Fiat money enriches a select few at the expense of many others. The first to get new money benefit to the detriment of latecomers.

What's more, fiat money fosters speculative bubbles and capital misallocations that culminate in crises. This is why economies boom and bust.

Fiat money lures states, banks, consumers and firms into the pitfall trap of excessive debt. Sooner or later borrowers find themselves in a deep hole with no way out.

Fiat money is easy to come by so the state can finance its adventures. Easy money; easy come, easy go. And the government keeps growing as it keeps spending.

As the state expands and flourishes like weeds in an untended garden, this outgrowth strangles the free market economy, causing production and employment to decline.

Now that we know what the problem is, let's see what this bodes for our financial future with argument …

#4: Low interest rates are here to stay.

Interest rates in many currency areas are at record lows.

[2] Mises, L. v. (1998), Human Action. A Treatise on Economics, The Scholar's Edition, Ludwig von Mises Institute, Auburn, US Alabama, p. 471.

Central banks have slashed short-term rates to zero and even lower, thereby dragging down longer-term bond yields.

They did this for a reason, and it is why low interest rates are probably here to stay.

Fiat money is to blame for this. Central banks have no choice but to keep pushing down interest rates if they want to pump up fiat money to keep the whole system afloat.

Otherwise, the phony boom contrived by credit expansion and borrowing at unnatural low interest rates will come crashing down.

Central banks certainly mean business when it comes to propping up the fiat money system, as the most recent financial and economic crisis of 2008/2009 goes to show.

The Fed bailed out the banking industry by knocking interest rates down to record lows and printing up vast quantities of money, a policy they call quantitative easing.

Most importantly, though, the Fed succeeded in mitigating market players' *concerns about loan defaults*. The floodgates opened, credit started flowing again, and the flat-lining fiat money system was reanimated.

Hammering down interest rates until they hit rock bottom is easy, but economic and political constraints make it rather difficult to haul them back up again.

And that brings us to my next point, argument ...

#5: Hunting for yield will inflate asset prices.

Things start getting messy when interest rates hit rock bottom or burrow deeper to go subterranean.

That is when investors start saying goodbye to bond markets and hello to other assets such as stocks, real estate and commodities. And when more buyers start shovelling money into any of these markets, prices go up, up, up.

Once all asset prices are inflated to a similar extent, the precarious fiat money system will be poised at the tipping point between inflation and deflation.

Deflation – a regime of falling prices – would unveil the unsound nature of the fiat money system for all to see. And the edifice of production and employment built on fiat money would come crashing down, toppled by deflation.

And that brings me to argument ...

#6: Central banks will take harsh measures to prevent the fiat money system from collapsing.

Central banks can be expected to go all-out in their rescue efforts to keep the fiat money system afloat.

Take, for instance, the European Central Bank (ECB). It suppresses market interest rates and prints up new money to prevent overstretched banks and states from defaulting on their payments.

In fact, the ECB's recent practice of buying bonds could actually be tantamount to starting up an enormous money printing machine. Here's why:

The overnight deposits held in euro banks currently amount to around 5.6 trillion euros. Banks' cash reserves, however, are just 844 billion euros. This tells us that they have a largish funding gap of around 4.8 trillion euros.

If the ECB is determined to close the funding gap (thereby effectively immunizing banks against a run on deposits), it may have to monetize an equivalent of around 50 percent of all outstanding euro area government bonds.

Needless to say, the ECB's QE does not bode well for the euro's internal and external buying power.

So, would the ECB be willing to pull out all the stops if necessary? It certainly seems so; even helicopter money looks to be hovering around as an option. These days, the idea that a central bank would issue new money and hand it out to someone or other – consumers, firms, banks or states – no longer seems so preposterous.

You may be asking yourself about the logistics of it: How on earth do you disperse all this cash? Well, there are several ways to circulate helicopter money. The first that comes to mind is to drop freshly printed banknotes from helicopters, which explains the term's origins.

Another crowd-pleasing alternative would be to strike a deal with, say, McDonalds to wrap hamburgers in 20-euro bills and sell them at 2 euros each.

Central banks could also decide to push interest rates further into negative territory. Of course, they'd have to discourage the use of cash, or ban it outright, for this to work.

And all the signs say we're already heading in that direction.

Central banks are also propping up the fiat money system with *liquidity swap agreements*.

This is a reciprocal deal where central banks lend money to each other – in practically unlimited amounts, if need be.

Here's how this works. Let's say the Fed provides the ECB with a 100 $ deposit. The Fed then enters that amount in the right column of its balance sheet, and the ECB enters the 100 $ deposit on the left column of its balance sheet.

To balance the books, the ECB grants the Fed a euro deposit (recorded on the right hand side of the ECB balance sheet), while the Fed shows the euro deposit on the left of its balance sheet.

And with that, the ECB can now lend US dollars to euro banks in need.

In October 2013, the Fed, ECB, Bank of Japan, Bank of England, Bank of Canada and SNB made their liquidity swap agreements *permanent*. And the Peoples' Bank of China got in on the action rather eagerly by signing up for further liquidity swap agreements.

These agreements have serious ramifications.

Central banks are now in a position to fend off any credit default in the international banking or financial system, if this is deemed politically desirable.

Perhaps most important, with this move central banks have orchestrated an alliance in which they can cooperate and coordinate closely amongst themselves, thereby paving the way towards a single world monetary policy.

Need I point that this would open a can of worms the likes of which the world has never seen? Savers and investors would have good reason to fear the dictates of a global inflation policy from which there is neither refuge nor escape.

And this brings me to my final point, argument ...

#7: Gold is currently an undervalued currency.

It is quite difficult to put a fair value on the gold price. One way to address the valuation issue is to look at the long-term relationship between the price of gold and its determining factors.

We can compare today's gold price to its long-term track record to assess if gold is under-, over-, or fairly valued at this time.

Of course, a host of factors influence the price of gold.

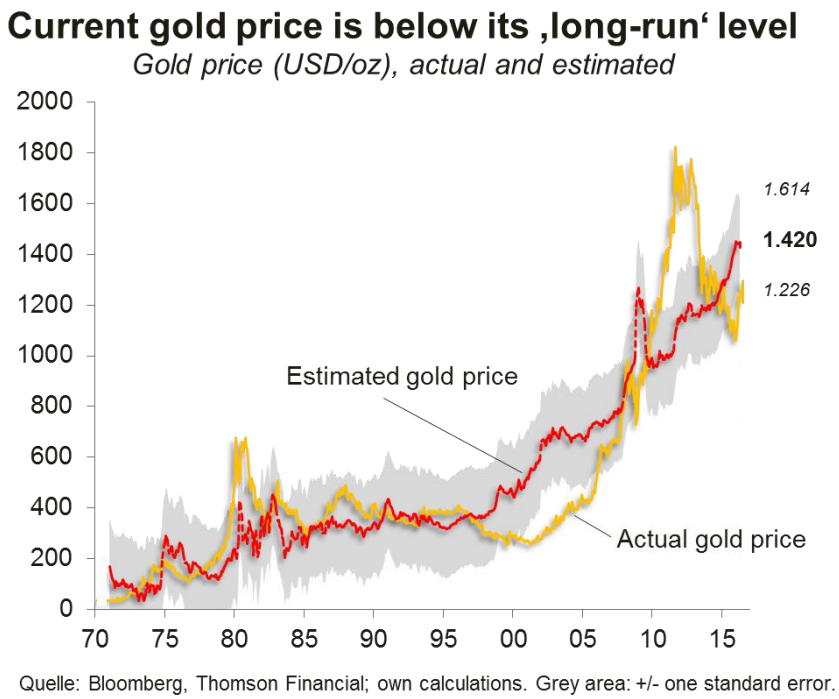
For one, rising global output can be expected to push the gold price up as higher incomes drive demand, eventually outstripping the supply of gold.

What's more, rising amounts of money in circulation can also be expected to drive the price of gold up, and rising interest rates to drive the price down.

Inflation should also send gold prices upwards.

If stock returns soar, the price of gold should stall; if credit risk climbs, so should the price of gold.

The graph shows the actual as well as estimated long-run price of gold (USD/oz) from January 1971 to April 2016, estimated on the basis of three factors: the US money stock M2, US credit spreads and the inflation-adjusted Federal Funds Rate.



The yellow line denotes the actual price, and the red line the estimated price. The grey area around the estimated price denotes one standard error of the regression.

As this equation would suggest, the current gold price of around 1.250 USD/oz is actually below its long-run level, which comes to around 1.420 USD/oz. In other words, gold isn't expensive at all if we see through the lens of this exercise, which takes the long view. In fact, the gold price has upside potential.

Ladies and gentleman, we live in a world ruled by fiat money. That means investors have no choice but to grin and bear both booms and busts. American economist Murray Rothbard had a refreshingly vivid simile for the juice that keeps this tired old nag in the running:

"Like the repeated doping of a horse, the boom is kept on its way and ahead of its inevitable comeuppance by repeated and accelerating doses of the stimulant of bank credit. It is only when bank credit expansion must finally stop or sharply slow down … that retribution finally catches up with the boom. … [T]he longer the boom is kept going, the greater the malinvestments that must be liquidated, and the more harrowing the

readjustments that must be made."[3]

Gold is not only the ultimate means of payment. It is also a line of defence against the evils of fiat money. As Mr Greenspan so pointedly put it a couple of years ago:

"Gold still represents the ultimate form of payment in the world. Fiat money in extremis is accepted by nobody. Gold is always accepted."[4]

Holding gold as part of your currency portfolio is one thing. But is it the only thing?

Well, the savvy investor would want to reap a positive real return on capital – especially in view of the inflationary effects of fiat money and a turbulent economic environment.

A positive real return on capital can be earned by investing in good companies; that is, by buying good stocks.

For my part, I always let Benjamin Graham's wise words guide me. He said, "*Investment is most intelligent when it is most businesslike*."[5]

But not every company will do. You want to invest in great companies with business models that are resistant to inflation.

Great companies have pricing power. They're able to carry higher input costs over to their products' prices, thereby earning a positive real return on capital even in times of inflation and economic turmoil.

Of course, you have to be sure to buy at decent prices. Even the best company's shares won't be a sound investment if they're bought at too high a price.

What's more, buying good stocks at a price that is well below their intrinsic value provides the investor with a *margin of safety* – which reduces risk.

[3] Rothbard, M. N. (2006), For A New Liberty. The Libertarian Manifesto, Ludwig von Mises Institute, Auburn, US Alabama, p. 237.
[4] Congressional Testimony, May 20, 1999.
[5] Graham, B. (2003), The Intelligent Investor. A Book of Practical Counsel, Revised Edition, HarperBuiness Essentials, p. 523.

As I eat my own cooking, let me mention that in December 2012 my partner Matthias Riechert and I set up an investment fund to which I act as an economic advisor.[6]

Our fund invests in good companies with inflation-resistant business models, running a concentrated portfolio.

We see gold as a currency, and consider it as part of our cash holdings when we deem it advisable to hold liquidity.

I have great confidence in the principles that guide our investment decisions. They are sound, time-tested, and they will afford our investors the opportunity to take advantage of the turmoil ahead brought on by fiat money.

Ladies and gentlemen,

Thank you so much for taking the time to hear what I have to say about the fiasco of fiat money and the excellence of gold money.

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[6] For more information see *www.polleit-riechert.com*.