Chapter 2: THE FAKE DEATH OF MONEY

At this point, a key question from the previous chapter remains unanswered: what prompted the world to abandon gold in favour of non-gold coins, paper and electronic money after more than 25 centuries?

Armed with the hopefully enlightening knowledge that government issued legal tender is not money, the question clearly needs to be rephrased to: what prompted the world to abandon gold in favour of non-gold coins, paper and electronic ***currency*** after more than 25 centuries?

Or more precisely: what prompted the world to abandon money in favour of currency after more than 25 centuries? Let's continue our journey through the history of money, bearing in mind the charts from Chapter 1, to find out.

The next significant war on the timeline is World War I. This war also marks the beginning of a change in the pattern of price levels established over the previous 150 years. Following WWI the price level deflated as it had done after each and every war preceding it, but this time it did not revert to its historical mean. Instead, it began a steady incline that developed into an exponential increase in the 1970's and continues to this day. We're now nearing 100 years of persistent inflation with almost no deflation.

In order to understand the catalyst for this change, we need to look back just a year before the war started to an event that quite probably marked the beginning of the end of money. On 13 December 1913, President Woodrow Wilson signed The Federal Reserve Act into law, and the Federal Reserve was established. This was the first nail in the coffin for gold. The significance of this is that there is nothing 'Federal' about the Federal Reserve. It is the central bank of the United States, yet it is privately owned and its owners are completely anonymous – they may not even be American! Think about THAT for a moment.

Conspiracy theories aside, the likelihood that The Fed has significant foreign shareholders, if any at all, is slim. Far more likely is that The Fed is owned collectively by a consortium of banks. In fact, this was a primary reason The Fed was created in the first place: to act as the lender of last resort and provide stability during times of financial crisis. In other words, The Fed was created to bail out banks as and when required.

Prior to The Fed's existence, the US financial system suffered a number of financial panics, most recently at that time was the Banker's Panic in 1907. Financial panics don't just occur for no reason, they're almost always triggered by some kind of 'bubble'. A bubble in this context is a gross over-valuation of a financial asset, usually fuelled by speculation.

In 1907 the bubble came in the form of an attempt to manipulate the market value of United Copper Company shares for profit. When the scheme failed, the bubble popped and fearful depositors started withdrawing their money from the banks that were involved. This soon spread to affiliated banks and trusts, culminating in the failure of New York's 3rd largest trust at the time, The Knickerbocker Trust Company.

Contagion is a structural weakness of the financial system as banks often operate in consortiums to lend currency to large companies. When such loans go bad, multiple banks may be affected, sometimes triggering a 'bank run'. In simple terms, a bank run is the simultaneous withdrawal of currency by depositors. When panic sets in, depositors of affiliated banks may also start withdrawing their currency. Even though these banks may be financially sound, the simultaneous withdrawal of currency can force it to shut down if it's unable to secure more capital or depositors to cover the shortfall.

In 1907 John Pierpont Morgan (a.k.a. J.P. Morgan) came to the rescue with his own substantial financial resources and influence over other New York Banks. Together, they were able to lend enough currency to the 'good banks' to prevent them from failing. This bailout saved the financial system from further bank runs, but a long term solution to provide stability was needed. That solution was The Federal Reserve.

So we now know the Federal Reserve is privately owned, most likely by Banks or investors that control the banks, and it was created to ensure these banks got bailed out in a financial panic, which is often caused by bubbles fuelled by themselves in the first place. If that isn't worrying enough, the privately owned Federal Reserve doesn't actually have any of its own currency to bail out banks during a financial panic, insanely it simply 'prints' currency as needed. The Federal Reserve Act (1913) required The Fed to have gold backing for only 40% of its issued currency, which essentially allowed it to create an additional 60% of currency backed by nothing. No gold, no silver, no land, nothing.

The advent of World War I caused inflation to surge as insatiable demand for resources to fight the war caused US exports to boom. The US wasn't directly involved in the war until the latter stages, so it profited immensely from providing supplies and financing to its allies. In the decade following the war, US gold reserves almost tripled as it received repayments. The influx of gold increased the money supply and as a result, the price level did not return to its historical average.

Business boomed as new technologies such as cars, radios, aviation and motion pictures became widely available and infrastructure spending on roads, bridges and railways spurred other industries such as tyre manufacturing, automobile servicing and electrification. The prosperity spread to Europe by the mid 1920's as the US provided loans to rebuild infrastructure destroyed during the war, and the same new technologies improved European productivity.

This period became known as the Roaring Twenties. Stocks soared and even those without money could get in on the action with leveraged products such as margin debt. Margin debt allowed an investor with $10 to buy 10 x $10 shares instead of just a single share. If the stock went up to $15, the investor would make $50 profit less a nominal amount of interest, clearly a far greater return than $5 if the investor had just bought a single $10 share outright. As stocks were perpetually rising, this became a lucrative investment strategy.

The system was self-reinforcing; the more people that got in, the greater stocks climbed, fuelling one of the greatest stock bubbles in history. On October 28 1929, the bubble burst. Stocks plunged over 30% as the self-reinforcing phenomena that caused prices to skyrocket, was now working in reverse. An investor with $10 that invested in 10 x $10 shares would now *owe* the bank another $10 plus interest if the stock fell to $9. A 30% drop meant the investor would owe $30, triple the amount invested, plus interest. It's not hard to see how many investors would have not only lost their investments, but ended up in debt as well, making their financial situation even more precarious.

As a result, these investors were forced to tighten their belts and cut down on spending to pay off their 'new' debts. This caused a decrease in consumer spending across the economy, translating to lower corporate sales, lower profits and therefore lower stock valuations. Lower valuations drove stock prices further down, triggering even more margin calls, and the downward spiral continued. By July 1932, the Dow Jones Industrial Average had lost 89% of its value, and the US found itself in the middle of the biggest recession in history, The Great Depression.

The knock-on effect of this self-reinforcing downward spiral was that consumers and businesses began defaulting on their loans, leading to a rise in bank failures. Around 9,000 banks failed during The Great Depression and it's estimated that 4,000 of those failures occurred in 1933. This raises the question about what The Fed was doing as all this unfolded. After all, they were supposed to act as the lender of last resort, bail out troubled banks, and moderate the currency supply. If ever there was a time to shine and prove its worth, surely this was it?

Many economists, including Nobel Prize winning Milton Friedman, place blame for the Great Depression on the actions (or inaction) of The Fed as the crises unfolded. The claim is that increasing interest rates (from 3.5% to 5% in 1928 and from 5% to 6% the following year) triggered the collapse, and the failure to bail out certain large public banks, such as the New York Bank of America, caused widespread panic and the ensuing bank runs resulted in multiple bank failures that could have otherwise been prevented.

Others go further, blaming gold for the depression: As The Fed was required to maintain a 40% reserve ratio, it's asserted they were unable to print enough currency to rescue the banks and expand supply enough to restore confidence in the market. Furthermore, as the crisis unfolded, more and more people began to reclaim gold which The Fed was obliged to redeem at fifty paper dollars for a twenty dollar ounce of gold. Every ounce of gold redeemed reduced the absolute value of currency The Fed could print which only exacerbated the problem.

Another popular view is that of British economist John Maynard Keynes, who essentially believed The Great Depression was caused by lower aggregate spending, and that the government should have increased its own spending and investment to offset the decrease in private spending and investment.

The limitation of these views is that they see the role of The Fed as the surgeon in a heart bypass, rather than the GP whose role is to ensure the patient is fit and healthy and doesn't need a bypass in the first place! The bubble that led to Black Monday in 1929 didn't happen overnight. It accumulated over years of speculative practices and lending. Friedman correctly points to The Fed's rate hike in 1929 as the pin that burst the bubble, but it didn't create the bubble itself. Similarly, Keynes' observation that falling aggregate demand caused the depression is correct, but it fails to address the *root cause* of falling demand.

To find out what really caused The Great Depression, we need to rewind back to the start of the Roaring Twenties. Recall that gold reserves almost tripled over the ensuing decade, and business boomed on the back of new technologies. This was an unprecedented period of wealth creation. The Fed's mistake during this time was *lowering* interest rates by over 3%. This fuelled borrowing to expand business, and more borrowing as interest rates dropped, culminating in a debt binge that imploded when rates were later increased.

Margin lending enabled investors to borrow money to invest in more shares than they could afford. The lower the interest rate, the lower the cost of borrowing, and the easier it was to jump on the stock market gravy train. This fuelled the bubble and exacerbated the crash.

If The Fed hadn't raised rates as advocated by Friedman, the crash may have been delayed a year or two perhaps, but it wouldn't have prevented it, as the market was doomed to fail thanks to the preceding decade of excess leverage. Friedman also argues The Fed should have done more to limit bank failures, but an alternate view worth considering is that The Fed should have done more to *prevent* bank failures by earlier raising rates instead of dropping them.

In May 1933, newly elected President Franklin D. Roosevelt took the drastic action of confiscating gold in an attempt to stop gold 'hoarding' that was (incorrectly) believed to be stalling economic growth and making the depression worse. All gold coin, bullion and gold certificates were to be surrendered to the Federal Reserve in exchange for US$20.67 per ounce in paper currency. Violation was punishable by a fine of up to US$10,000 or a prison sentence of up to 10 years, or both. This was the second nail in the coffin for gold.

The following year, all gold held by the Federal Reserve was surrendered to the government under the Gold Reserve Act, and the price was simultaneously increased from $20.67 to $35. The government had essentially confiscated all the money in the US and devalued the currency by almost 70%. With gold now held in the Treasury and illegal to own, The Fed could now expand the currency supply without the restriction of redemption risk.

Roosevelt also enacted a number of government spending programs as advocated by Keynes, but evidence that any of these actions achieved the desired results is debatable. Ultimately, it was the next World War that propelled the US economy back to full health. Like World War I, the US didn't get involved at the outset, and benefitted massively from British and European demand for supplies and funding. Britain, France and others sent their gold reserves to the US as collateral for loans and to protect it from Germany.

By 1944, the US had accumulated approximately two-thirds of the world's gold reserves, prompting the Allied nations to implement a new monetary system that became known as Bretton Woods. Under the Bretton Woods system, participating countries fixed their currencies to the US Dollar, and the US Dollar was fixed to gold at $35 per ounce. The dollar became 'as good as gold' thanks to its dominant share of world gold reserves, and in the post war period countries all over the world began holding US Dollars as reserves. Third nail in the coffin.

World War II ended a little over a year after the Bretton Woods agreement was signed. But unlike preceding wars, there was no sign of deflation. Instead, prices increased and have continued to climb ever since.

This phenomenon was largely if not exclusively due to Bretton Woods. As the paper US Dollar was now the reference point for international trade instead of gold, the US was gifted artificial demand for its currency. For example, an Australian company exporting coal to Japan would price and pay for the coal in US Dollars rather than gold, the Australian Dollar or the Japanese Yen. The other significant advantage was that the US could now print its way out of debt. For example, if Japan owed $100 billion to the US, it would need to produce $100 billion of products (Toyota's, SONY TV's or whatever) and sell it to the US to *earn* $100 billion which it could then use to pay off its debt. On the other hand, if the US owed Japan $100 billion, it could simply *print* $100 billion and repay its debt.

As such, the US could literally print its way out of debt. This wasn't an issue at the time though, because the US was largely the world's creditor having lent currency to almost every country during the war. Bretton Woods enabled the US to go on a consumption binge as the rest of the world frantically rebuilt their economies after the devastating war. Over the next 72 years and counting, the US would go from the world's largest creditor, to the world's largest debtor.

Like The Roaring Twenties, the post-World War II period was a prosperous one. Great advances were made in aviation and other technologies, but this time The Fed gradually *raised* interest rates, effectively putting a lid on private debt and speculation getting out of control. This was also helped by the Glass-Steagall Act of 1933 that essentially separated commercial and investment banking activities. The act prevented commercial deposit-taking banks from investing in risky assets in order to minimize bank failures as far as possible.

As the world economy grew, war loans were gradually repaid and countries began to accumulate US Dollar reserves. At the same time, the Federal Reserve continued to print more and more currency to fund its rapid development. It soon became apparent that the US had abused its currency printing privileges. Although the Bretton Woods system did not require the US to hold any particular ratio of gold to currency dollars issued, the price of gold was fixed at US$35 per ounce, technically restricting US currency printing to the extent of its gold reserves.

In 1965, French President Charles De Gaulle called them out, noting that the system allowed “Americans to get into debt, and get into debt for free at the expense of other countries”. He went on to say that it was “necessary that international trade be established as it was before the great misfortunes of the world (referring to the two world wars) on an indisputable monetary base, one that does not bear the mark of any particular country. Which base? In truth, who can see, how one can have any real standard criterion other than gold”. France then began to redeem its Dollars for US gold reserves, and other countries soon followed.

The onset of the Vietnam War forced the US to print even more currency and as gold redemptions continued, it became clear that the US did not have enough gold to back its currency. In essence, this was a bank run, and in 1971 President Nixon put the fourth and final nail in the coffin for gold, by unilaterally withdrawing from the Bretton Woods system. Nixon blamed ‘speculators’ as the reason for default, rather than admit the US had overplayed its hand, and printed more currency than it could back with gold.

Since that date, money was removed from the international monetary system and we’ve since been left with an international currency system, a purely fiat currency, backed by nothing. In our chart, we can see that price levels began to increase much faster since Nixon defaulted on gold, as currency has been printed at an accelerating rate since then.

Around 600 fiat currencies have existed in the past, and every single one has failed, typically within 40 years. We’re now into the 46th year of this fiat system and the clock is ticking. If history is anything to go by, it’s only a matter of when, not if, this one fails too.

As for gold, it’s still money. The majority of bankers and finance professionals will tell you otherwise as it’s no longer legal tender, and while that may be true, it’s also true that today’s legal tender is currency, not money. Why else would every major economy continue to keep gold reserves? Gold is officially dead as legal tender, but unofficially, it’s very much alive. Its death was fake, and it continues to thrive in sovereign reserves. At the time of writing, the world’s top gold reserves are held by:

United States;	8,133 tonnes
Germany;	3,377 tonnes
International Monetary Fund;	2,814 tonnes
Italy;	2,451 tonnes
France;	2,435 tonnes
China*;	1,842 tonnes
Russia;	1,615 tonnes
Switzerland;	1,040 tonnes

Japan;	765 tonnes
Netherlands;	612 tonnes
India;	504 tonnes
European Central Bank;	504 tonnes

*China has been increasing its reserves rapidly in recent years and its unofficial reserves may be far more than the 1,842 tonnes reported.

Note that the International *Monetary* Fund has the third highest reserves in the world, and the European Central Bank also has a large hoard of gold. If that isn't enough of a hint that gold is still considered real money, why else would major economies and financial institutions keep such large quantities in their reserves? It's clear that gold is still lurking in the background of the global financial system, and is poised to make a return at some point. We'll explore the implications of this in a later chapter.