
Achieving a Stable Dollar

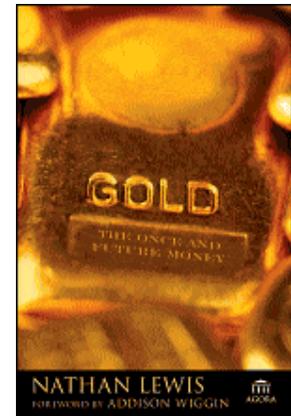
October 6, 2011

Nathan Lewis

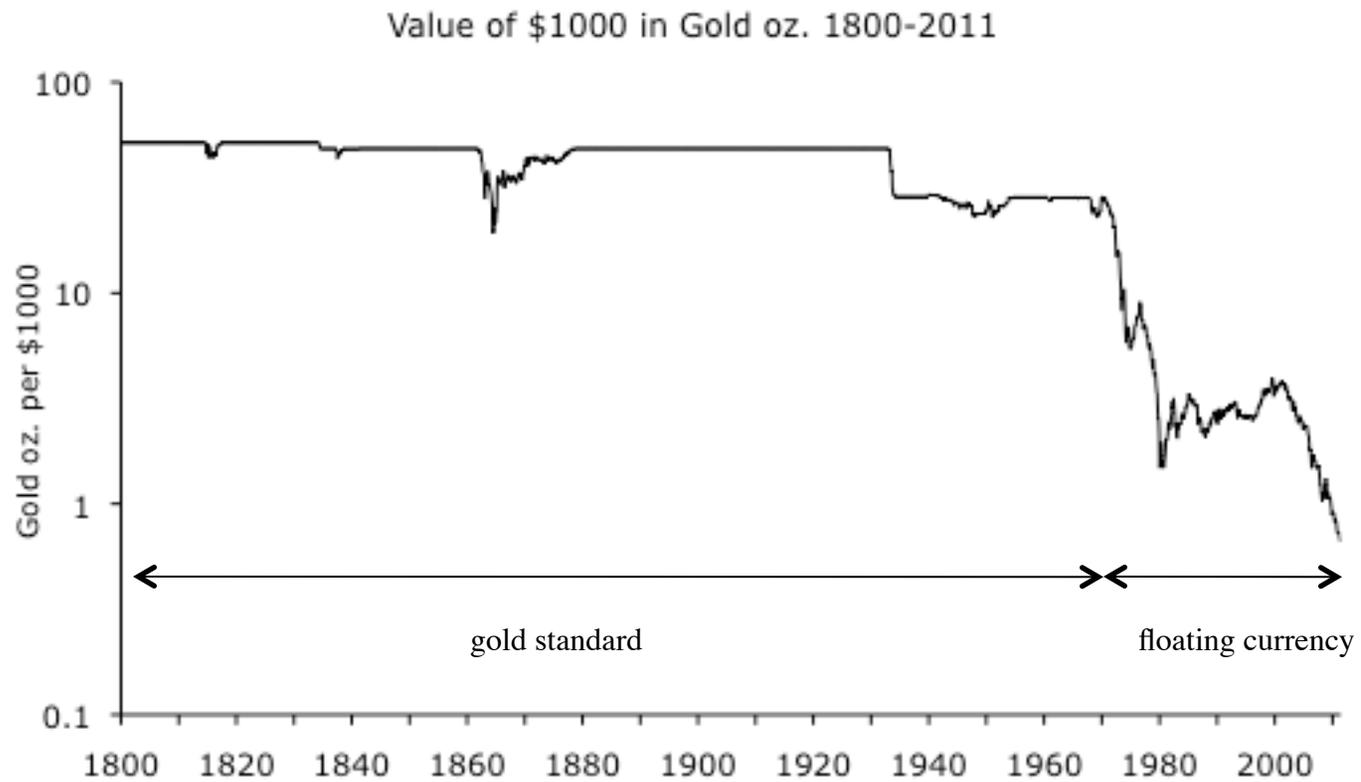
Kiku Capital Management LLC

Gold: the Once and Future Money (2007)

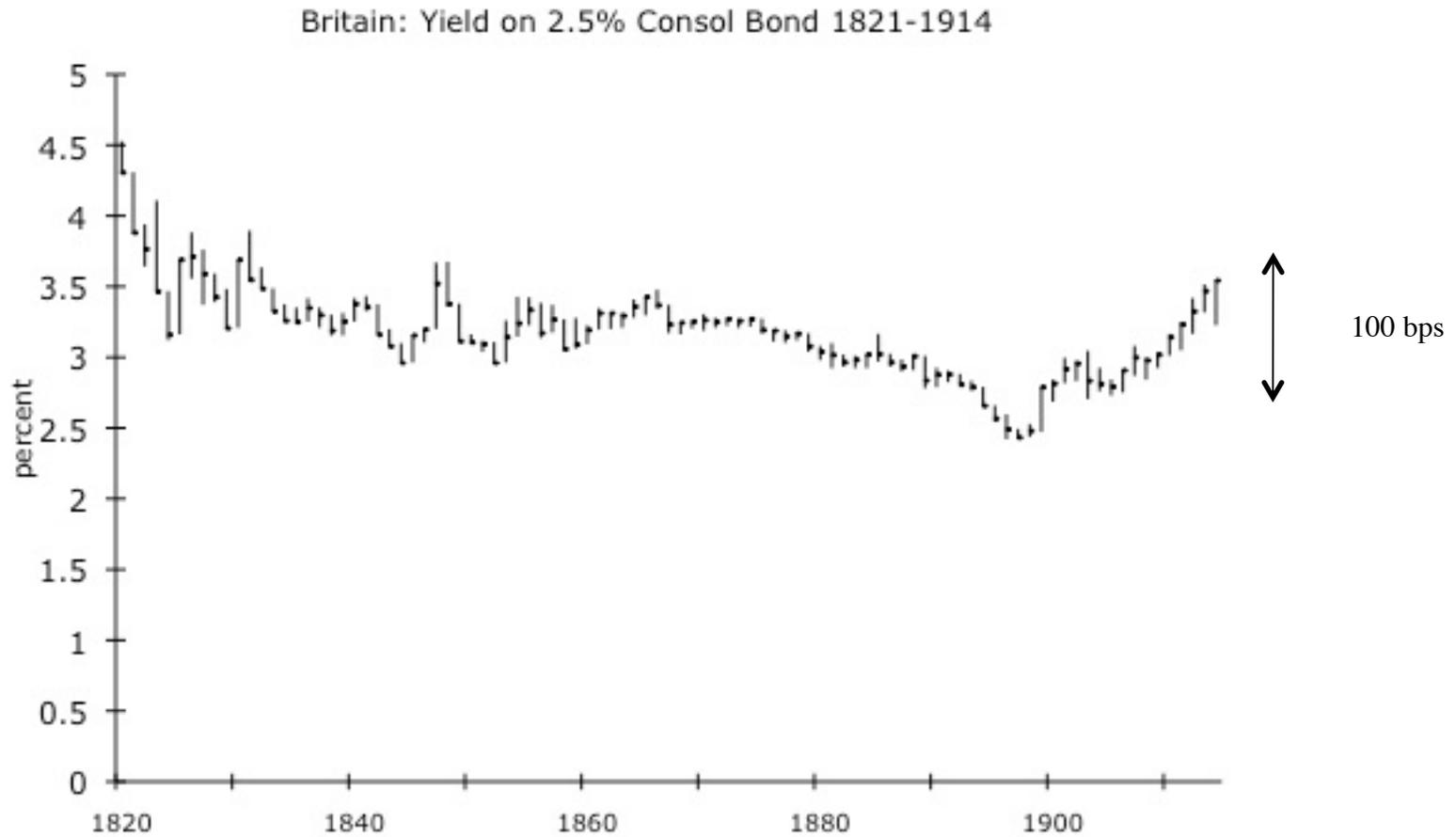
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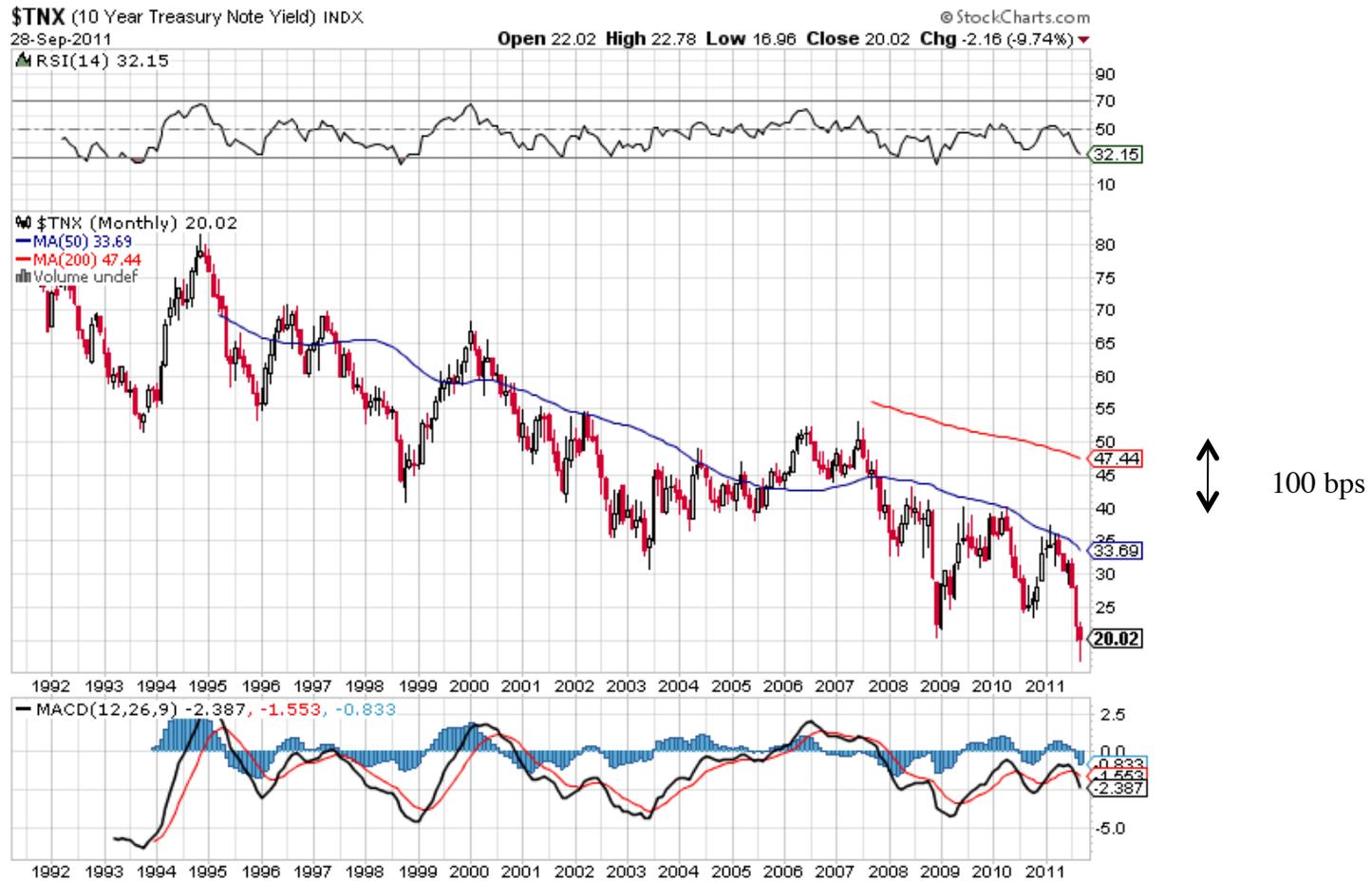
From 1789 to 1971, the U.S. used a gold standard system. There was one permanent devaluation in 1933.



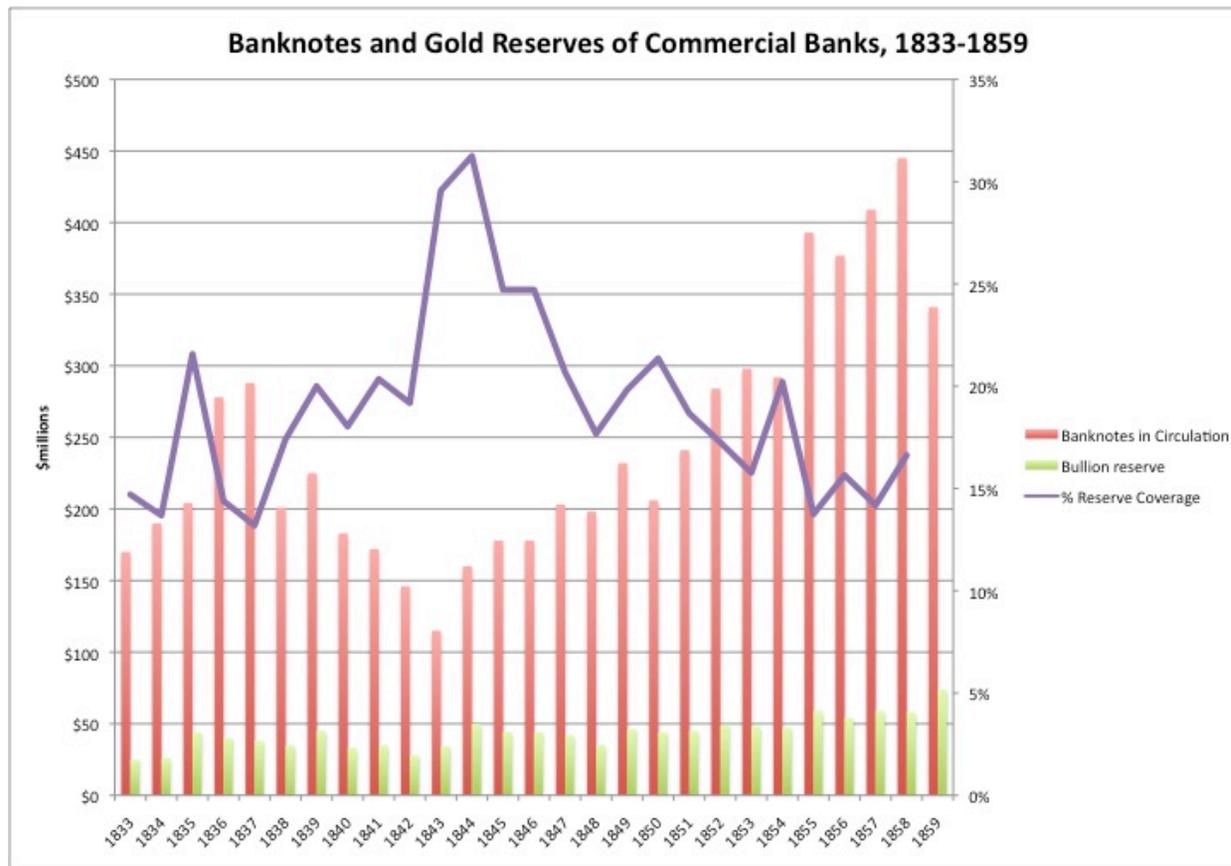
Almost a whole century within a 100 bps range. No central bank today can touch this performance.



Certainly not the Federal Reserve.



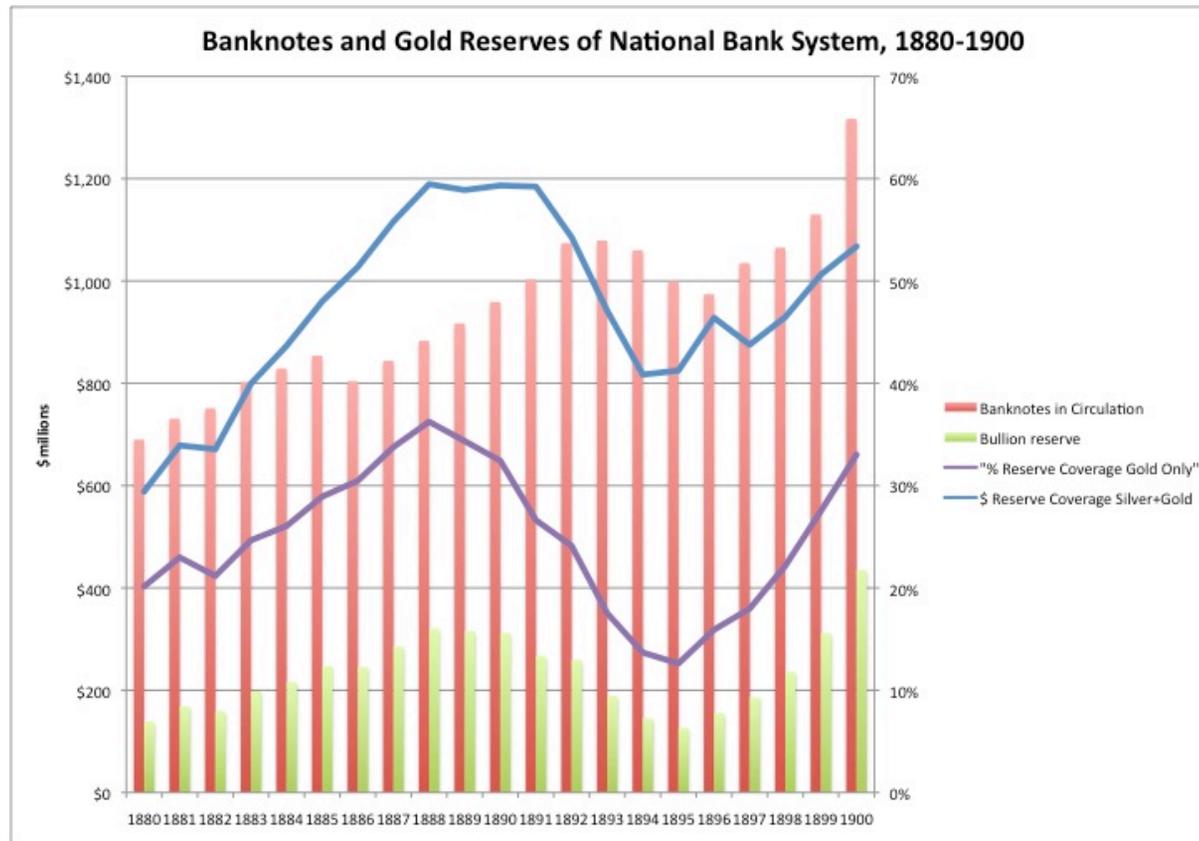
Neither the U.S. nor Britain ever had a “100% reserve” system. Bullion reserve coverage averaged around 20-40%.



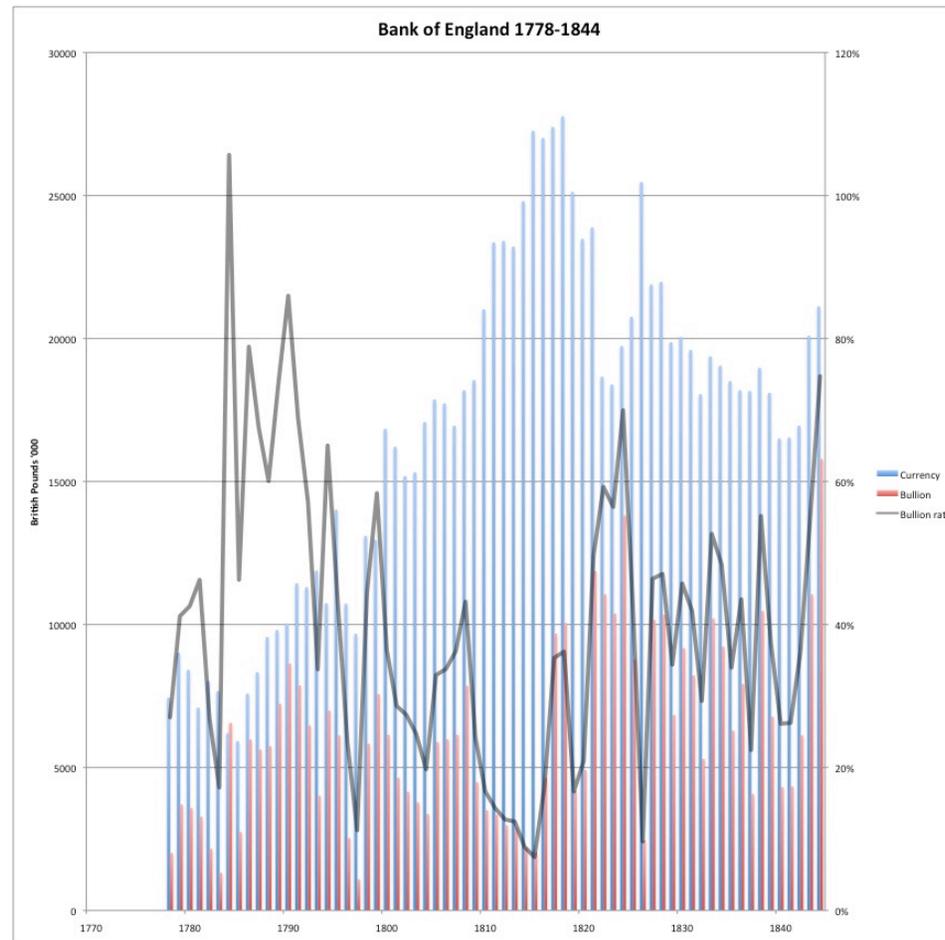
From 1775 to 1900 (125 years), the U.S. base money supply increased by an estimated **163x**. (\$12 million to \$1,954 million)

However, the amount of gold in the world increased by about **3.4x** during that time period.

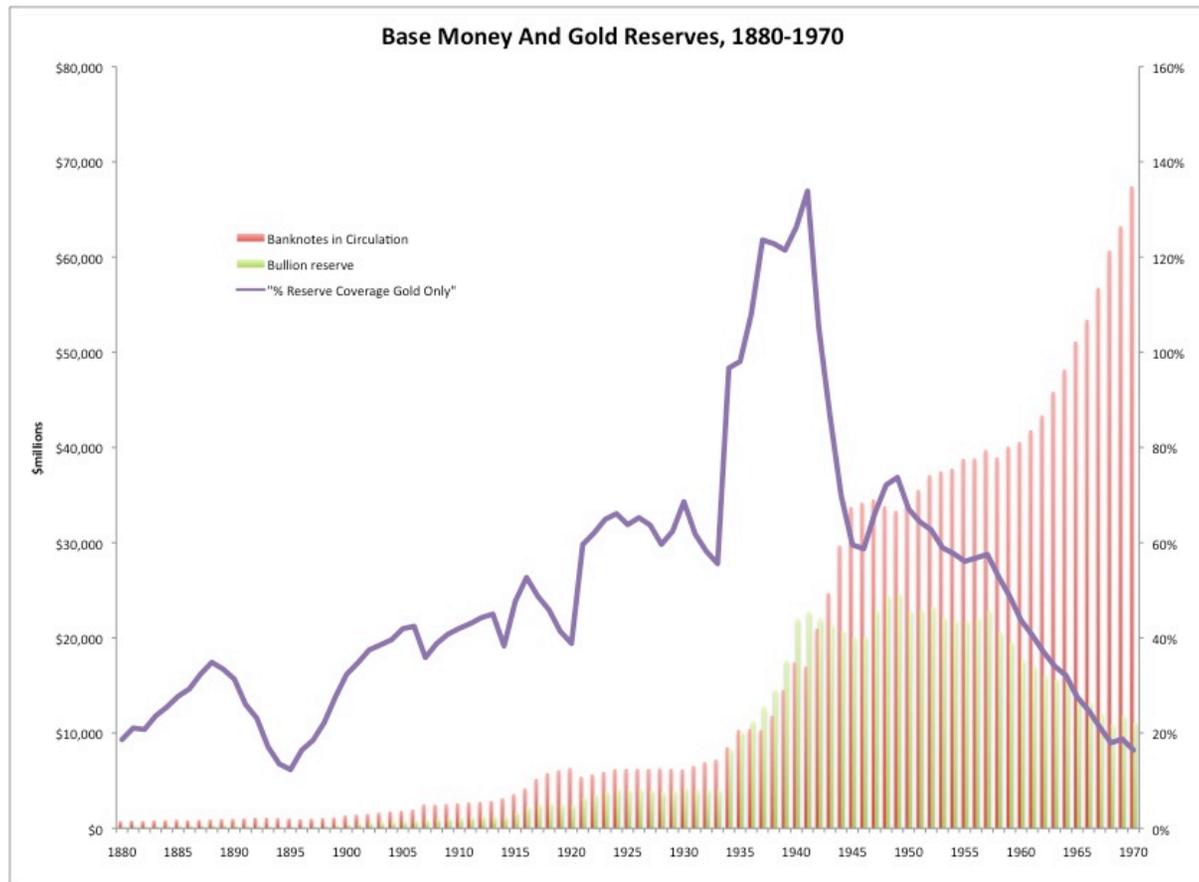
The “money supply” under a gold standard is **NOT** linked to mining!



The Bank of England never had a “100% reserve” policy.
(Note: the pound was a floating currency from 1798-1821.)



The U.S. only had “100%+ reserves” for a brief time around World War II.



How can worthless paper trade like gold for 233 years?

“It is on this principle that paper money circulates: the whole charge for paper money may be considered seignorage. Though it has no intrinsic value, yet, by limiting its quantity, its value in exchange is as great as an equal denomination of [gold] coin, or of bullion in that coin ...

It will be seen that it is not necessary that paper money should be payable in specie to secure its value; it is only necessary that its quantity should be regulated [adjusted] according to the value of the metal which is declared to be the standard.”

David Ricardo, *Principles of Political Economy and Taxation*, 1817.

At the time, the British Pound had been a floating currency for twenty years. Ricardo became a Minister of Parliament in 1819, and in 1821 Britain returned to the gold standard.

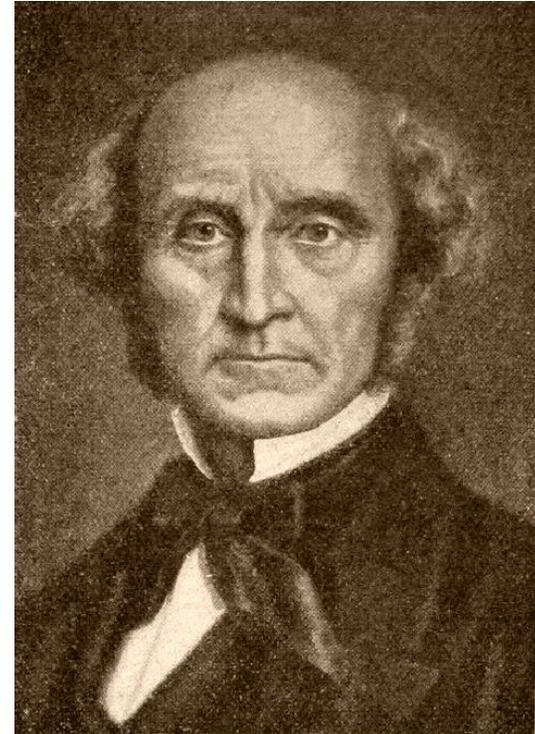
The British gold standard of the 19th century was operated by Ricardo's principles.



What if paper money were not redeemable?

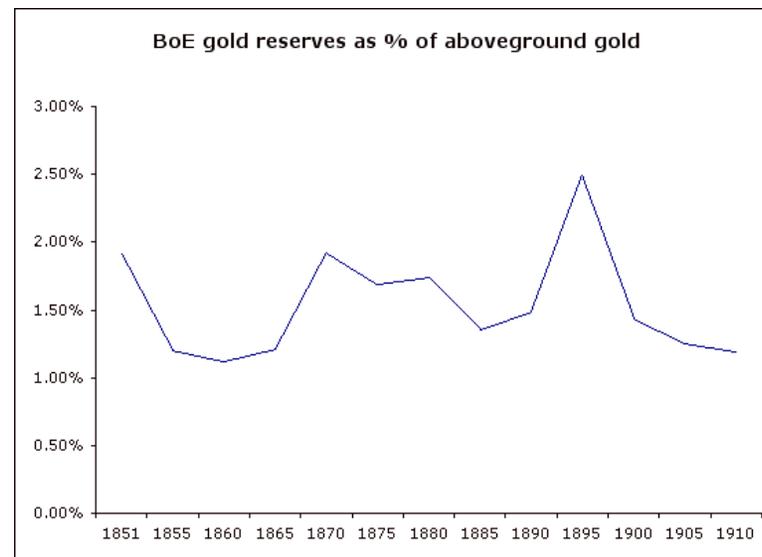
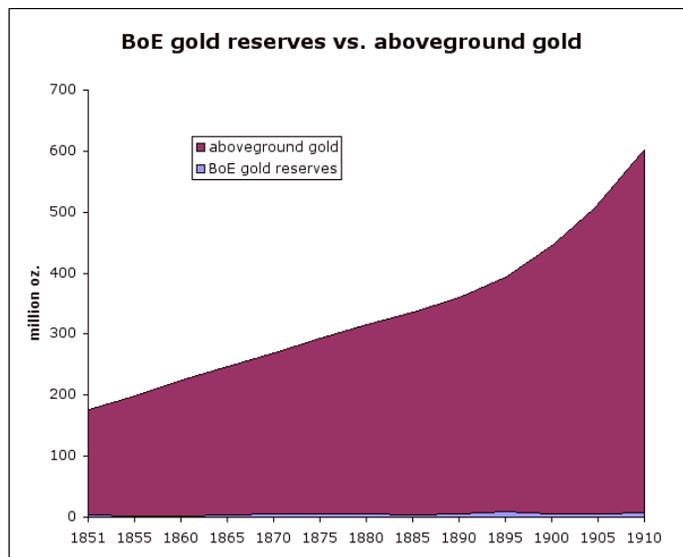
"If, therefore, the issue of inconvertible paper were subjected to strict rules, one rule being that whenever bullion rose above the Mint price [gold parity], the issues should be contracted until the market price of bullion and the Mint price were again in accordance, such a currency would not be subject to any of the evils usually deemed inherent in an inconvertible paper."

John Stuart Mill, *Principles of Political Economy*, 1848.



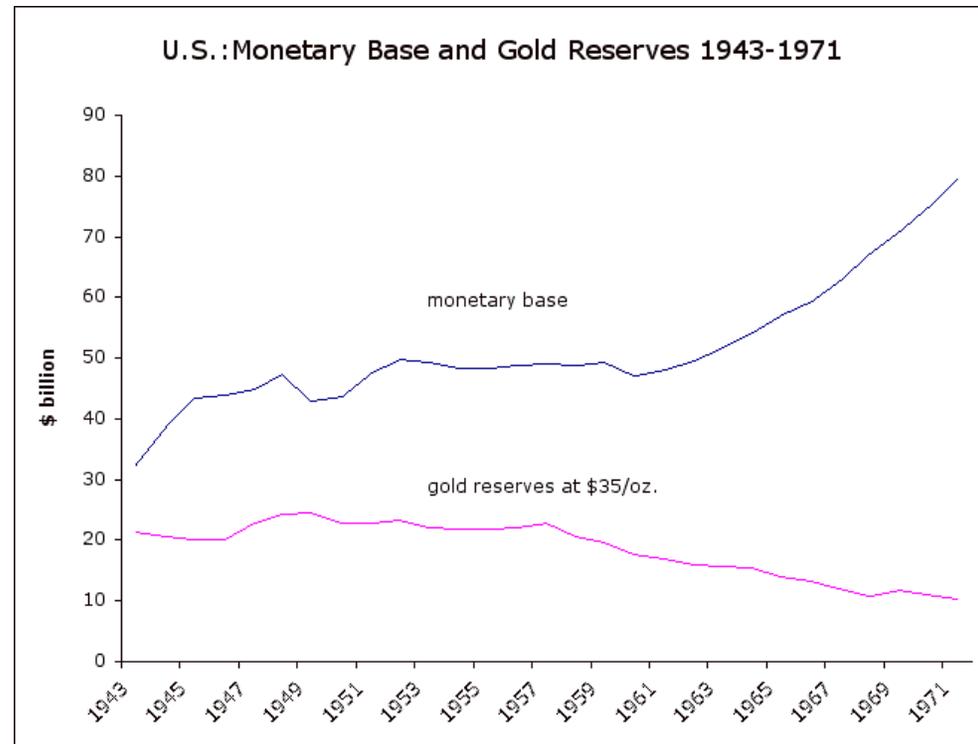
How to do it right:

- Bank of England pegged to gold in 1698.
- By 1845, the pound was the premier international currency and London was the world's financial center.
- Many other governments effectively pegged their currency to the pound (and thus to gold) -- much like Bretton Woods.
- The BoE held almost no gold (7m oz. in 1910).
- It didn't matter!



How to blow up bigtime:

- In 1941, the U.S. had 641m oz. of gold, equivalent to 44% of all the gold in the world.
- Almost one hundred times more gold than the Bank of England in 1910!
- The Bretton Woods agreement of 1944 formalized the transfer of monetary leadership from Britain to the U.S.
- The U.S. did not properly manage the supply of base money in accordance to gold standard principles.
- The system failed in only 27 years.



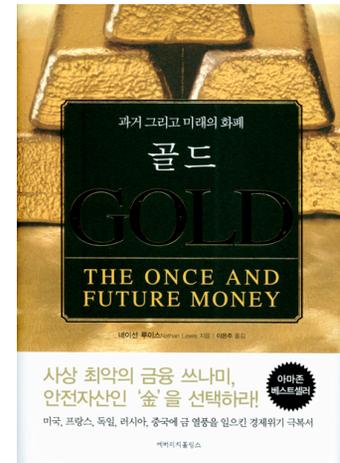
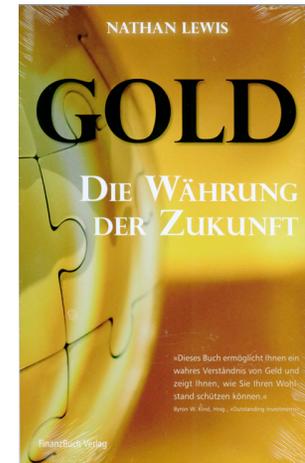
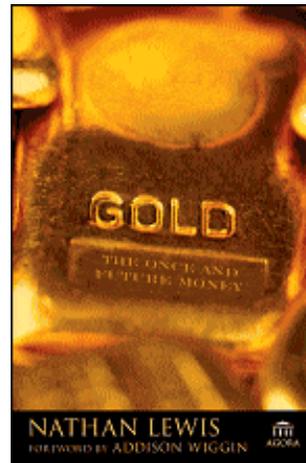
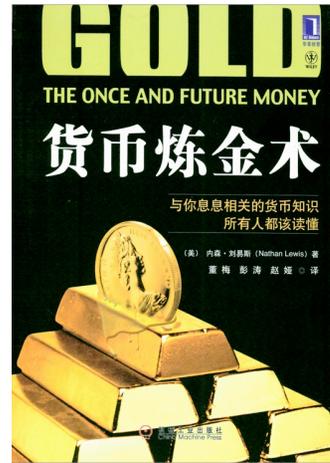
Thank You

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Newworldeconomics.com



For hundreds of years, silver and gold traded around 15:1. Thus, they were equivalent. This is no longer true.

Logarithm of Gold/Silver Price Ratio (ounces of silver per ounces of gold)

chart by amCharts.com



Two Monetary Paradigms

Classical Paradigm “Hard Money”

- “Rule of Law”
- Stable currency value is goal.
- Avoid government manipulation.
- Gold link enables stable money.
- Unstable money causes problems
- Leave credit up to the bankers.
- Interest rates left to market.
- Fixed exchange rates are good.
- “You can’t devalue yourself to prosperity.”



Adam Smith vs. James Denham Steuart



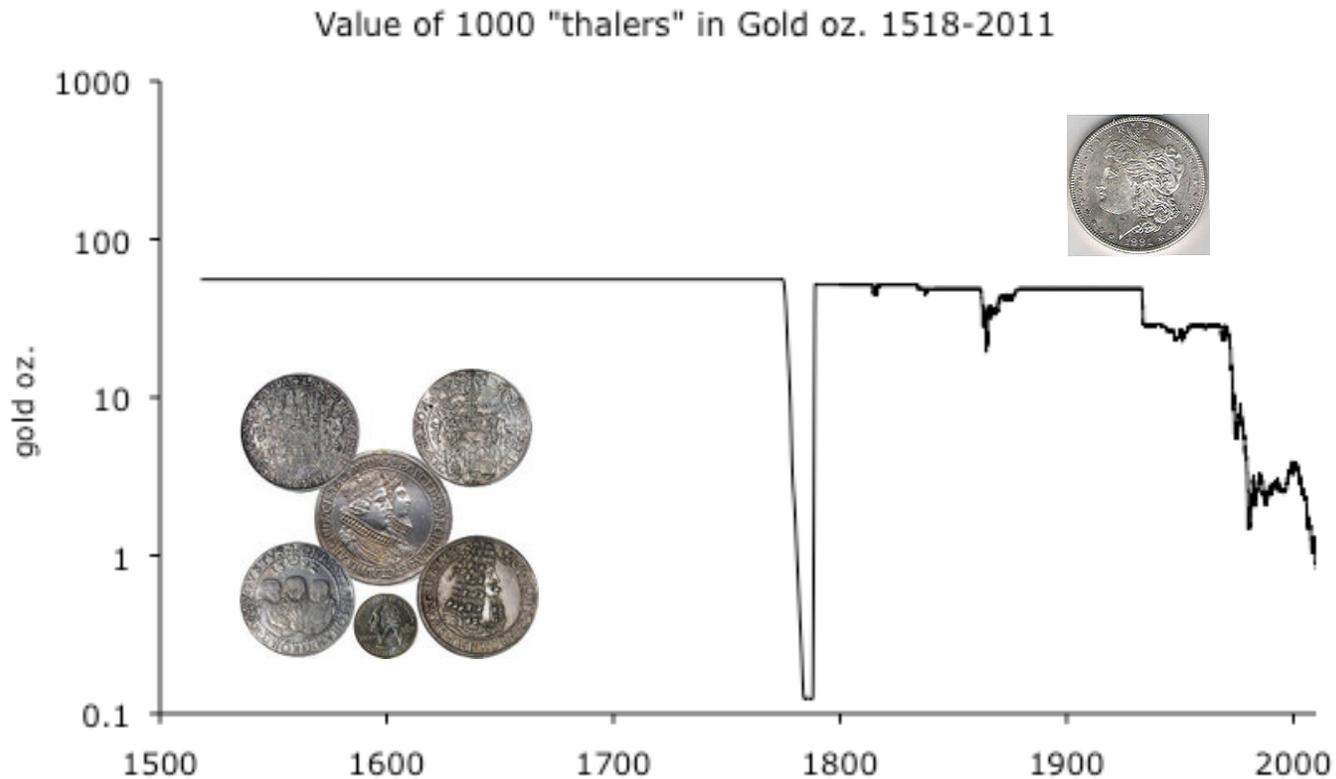
Mercantilist Paradigm “Soft Money”

- “Rule of Man”
- “Full employment” is goal.
- Constant government “management.”
- Gold link prevents management.
- Money manipulation solves problems.
- Manipulate credit for macro effect.
- Interest rates managed.
- Floating currencies allow “adjustment.”
- “In the long run, we’re all dead.”

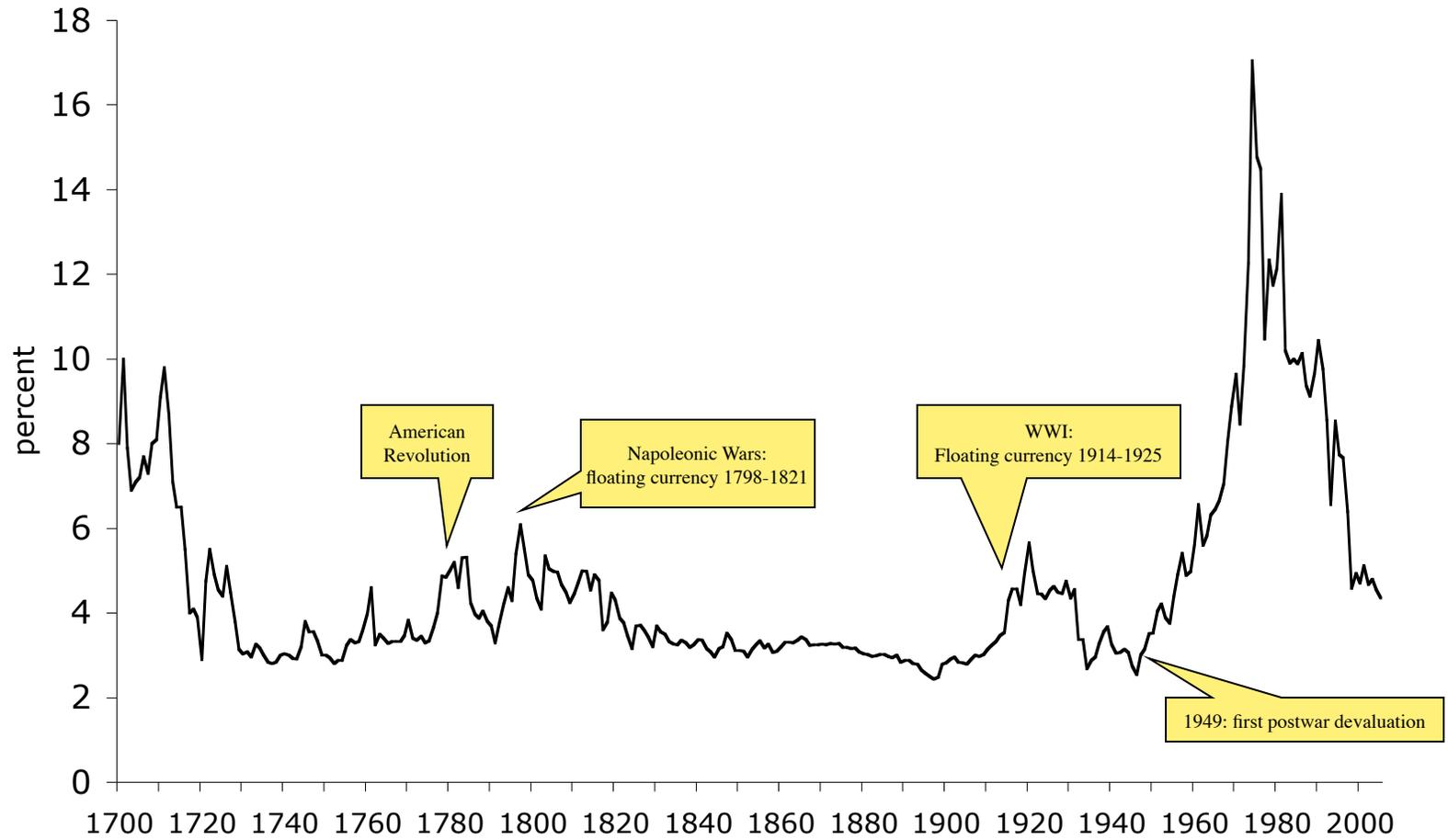
We are in a Mercantilist paradigm today!

The European tradition of the “thaler” goes back 500 years. The Austrian “thaler,” the Spanish “dollar,” and the U.S. dollar were all basically identical silver coins (about 29 grams of silver).

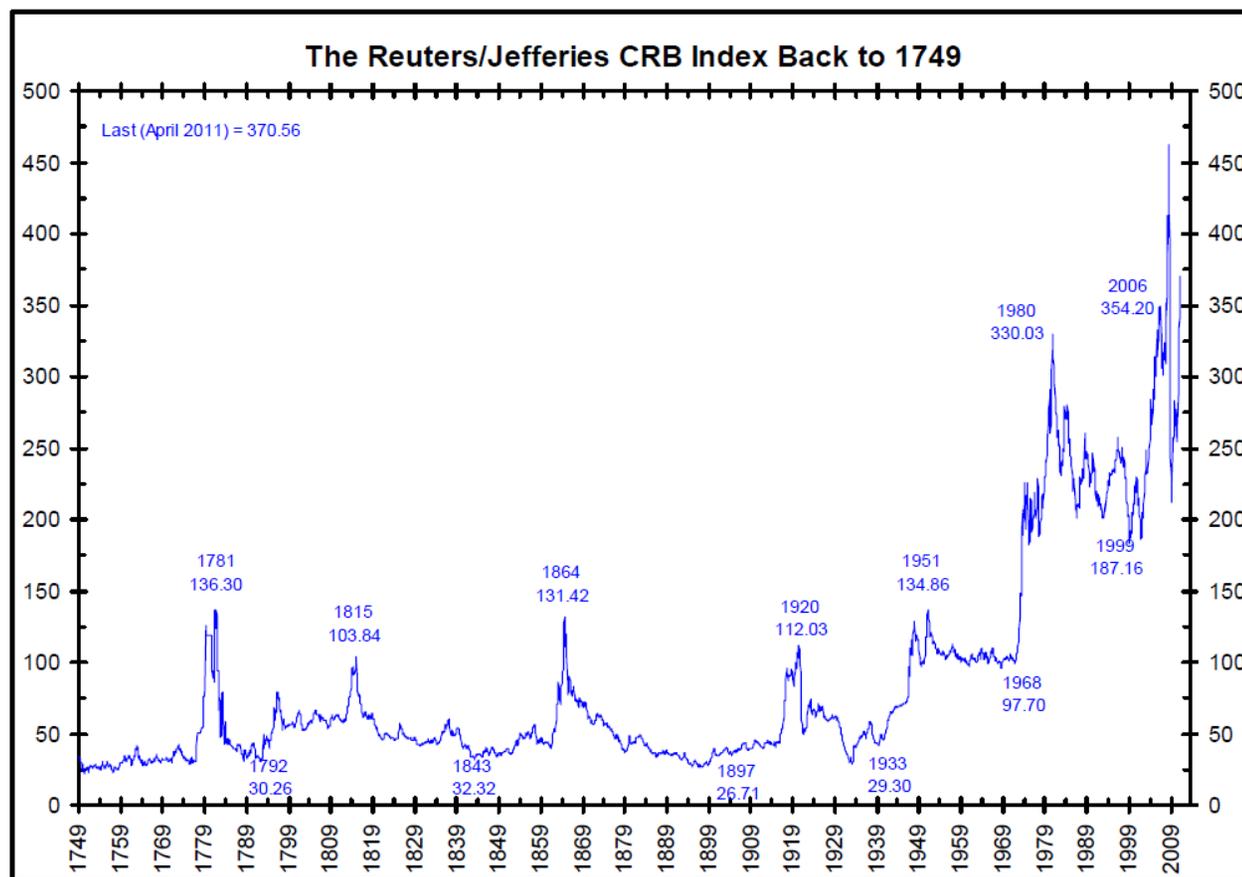
For 400 years, a “stable thaler” meant 29 grams of silver (or the equivalent in gold).



Britain: Yield on 2.5% Consol Bond 1700-2005



Commodity prices sometimes rose, especially during wartime, but there was no long-term inflationary trend.



A gold standard system is one in which the **VALUE** of the currency is linked to gold.

This can be accomplished in two basic ways:

- 1) Use full-weight coins.
- 2) Use token coins or paper bills whose **supply is managed** such that their real market value is equivalent to the gold parity target.

Thus, a gold standard system that uses paper currency is about **managing the supply of paper currency** to maintain a gold target. **It is not about gold.**

Thus, we can see that the amount of gold in reserves is, in principle, irrelevant. Having (or not having) reserves does not change the value of gold.

The quantity of money (base money) is a residual. The proper quantity is the one that produces the desired parity value.

Peripheral countries often had even less, relying upon British and U.S. government bonds instead.

