THE CAPITALIST ADVISOR

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A Fifth Decade Into the Uncharted Territory of Paper Money

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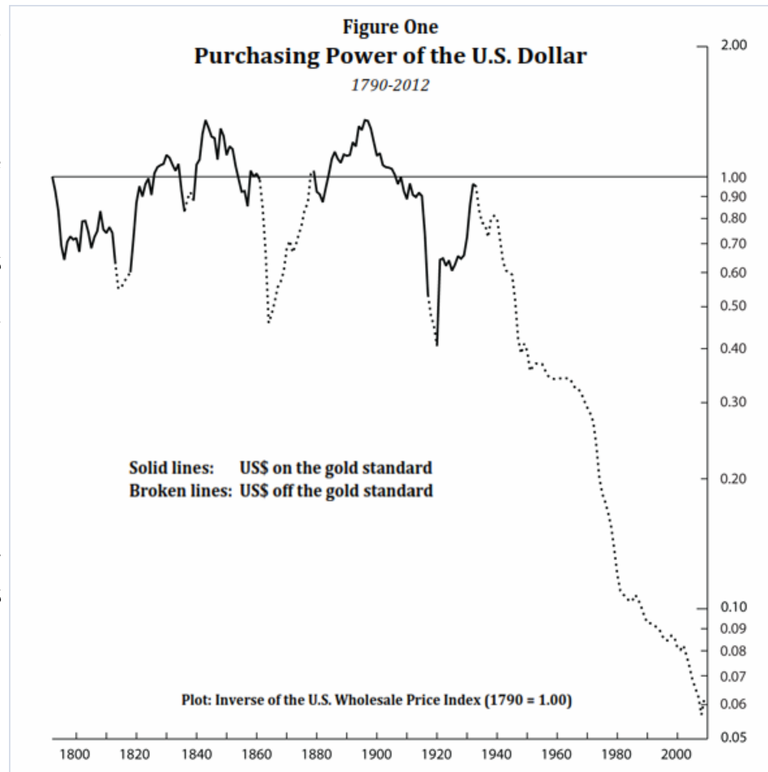
Forty-one years ago today – on August 15, 1971 – the U.S. dollar enjoyed its last formal link to gold, a link that was deliberately broken that day by U.S. president Richard Nixon, when he yanked the dollar out of its central post in the Bretton Woods international monetary system (established after World War II, in 1946). That fateful (and fatal) decision for the dollar was heartily endorsed by then-Treasury Secretary John Connolly, by his Undersecretary for Monetary Affairs (Paul A. Volcker), and by the most prominent Republican economist of the time (Milton Friedman). The supposed GOP "free-marketeers" of that decade effectively jettisoned any last vestige of the sound money free markets require.



In August 1971 it was already well-known that for decades Democratic-Keynesians assaulted gold as a "barbarous relic," and called for policies operated by political "discretion" instead of fixed rules; their aim was to unleash government so it could grow without limit in size, scope, power, and cost. By now we know they succeeded. But in the end, the venerable, long-lived, system of gold-based money, which had previously coincided with constitutionally-limited government, laissez-faire capitalism, balanced budgets, the industrial revolution, and fast-rising living standards, was murdered by the Republicans.

In fact the U.S. left the gold standard in stages, starting in 1933; the complete break was only finalized in 1971. Figure One illustrates the sorry result. Since 1933 the dollar has lost about 95% of its initial purchasing power, as illustrated by a plot of the reciprocal of the U.S. wholesale price index; the rise in the dollar prices of goods and services has reflected directly the decline in the purchasing power of each dollar.

In 1790 America's first Treasury Secretary, Alexander Hamilton, put the U.S dollar on a bimetallic standard (silver and gold), as required by Article I, Section 8 of the U.S. Constitution, and similar to the system that had been successfully operated in Britain since 1714. Figure One makes clear that in U.S. history since 1790, so long as the dollar was tied to "specie" (i.e., "hard money" – silver and gold), it maintained its purchasing power. This was money that was not politicized, hence not debased.

Figure One depicts how only in those episodes when the U.S. went off the gold standard, for example during the Civil War (1861-1865), when it issued purely paper-based

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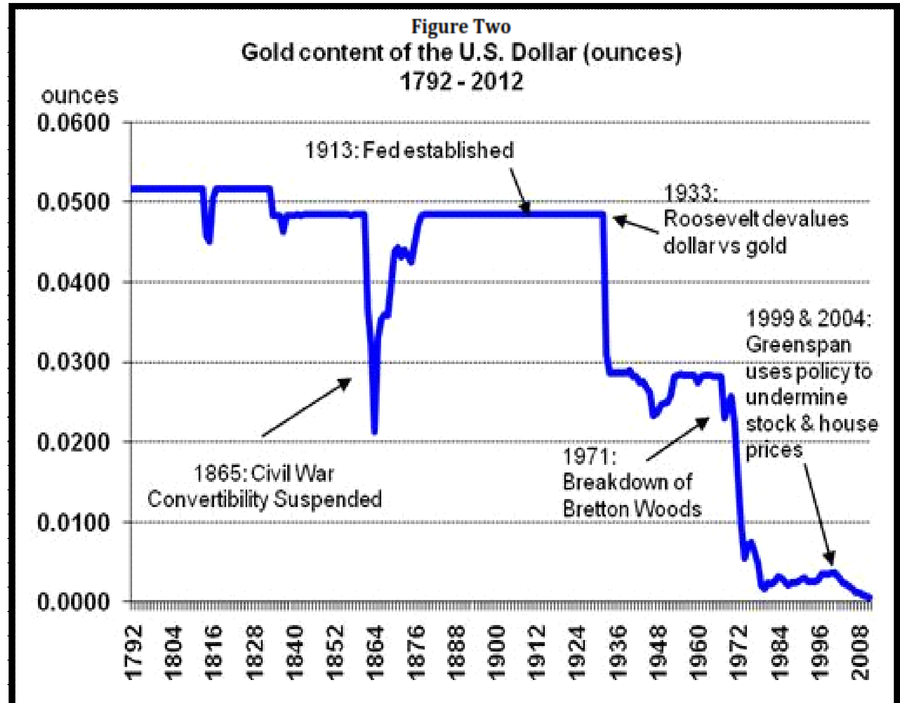
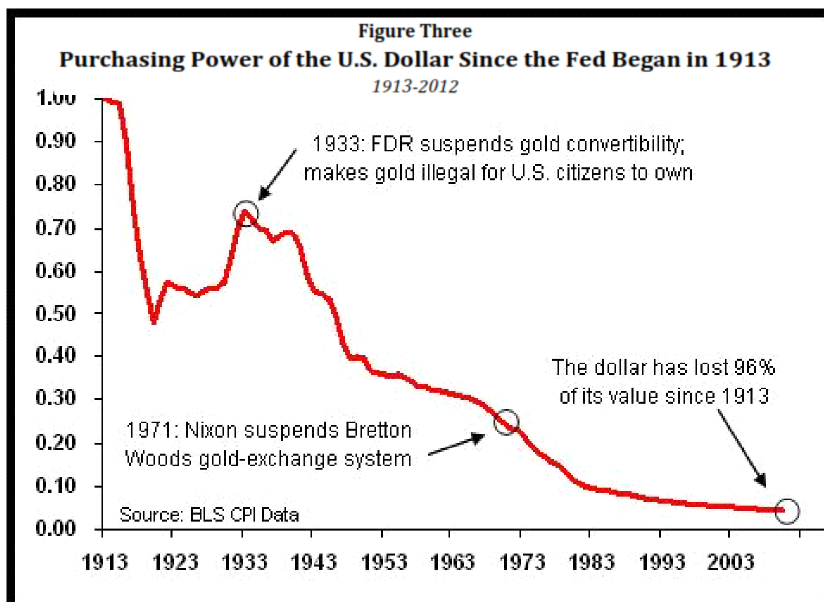
"greenbacks," did the dollar lose material purchasing power (nearly 60%, at one point during the Civil War).



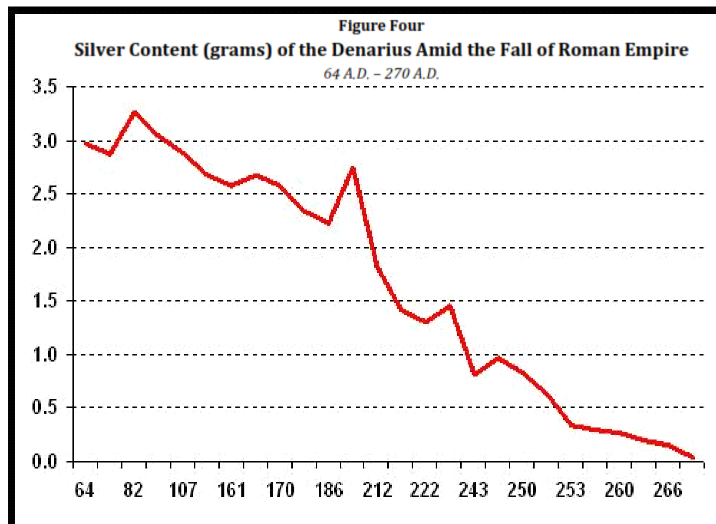
To its credit, the U.S. returned to the gold standard after the Civil War; the "resumption" was first announced legislatively in 1875 and then carried it out in practice painlessly, by early 1879. As Figure One shows, the dollar regained its purchasing power during this time, and then held its value until the eve of World War I (1914-1918), when it faltered only because other nations went off the gold standard, under war pressures. Notice (in Figure One) how the value of the gold-based U.S. dollar was roughly the same in 1900 as in 1800; thus the price level was roughly the same in each year. This was a dollar with long-term stability and solidity – and it provided an indispensable foundation for America being able to achieve long-term and robust prosperity in the 19th century. In sharp contrast, for most of the past century, the dollar's value has declined, and it has declined most when it's been unhinged from gold.

The past 41 years are unprecedented in modern history, because prior to 1971 the U.S. dollar had never been unhinged from gold for so long (nor has Britain's pound been unhinged for this long; it was off from 1797 to 1821). We're now moving into the fifth decade of purely paper money, globally; nowhere in the world is any currency related formally or officially to gold. The apex of global financial integration – with historically maximal cross-border flows of goods, capital and labor – occurred in 1890-1910, when 60 nations were on the gold standard. For the first time there was a *single world money*. That was the height of mankind's monetary achievement; it's been downhill ever since World War I.



Since 1971 we've had no uniform, international money of objective, non-political value to speak of. As a result, we've also had no international monetary system *per se*. As a result, we've also had no international monetary (or fiscal) responsibility at all. Yet this is what the paper-money enthusiasts have wished for and fought for: ever-large governments with the power to spend, borrow, and print money virtually without limit. That's what we now have, and it's the main reason why, in recent decades, we've also had an increasing number of financial crises and wrecks, accompanied by less investment, less growth, and less-robust returns on stocks and bonds.

Historically, these financial assets have performed far better when denominated in a gold dollar than when denominated



in a paper dollar, and in the latter case, the better performing asset has been gold itself. Since 1971, for example, gold has increased by 4500%, but the S&P 500 is up by only 1309%. In *real* terms stocks have *declined* since 1971 (gold's gain has been nearly 3½ times larger than gain on stocks), yet finance professors keep insisting that the best bet is always "stocks for the long run."

Perhaps the biggest myth associated with central bankers is that they care deeply about "fighting inflation." The false claim also implies that central bankers are not the cause of inflation. Nothing could be further from the truth. Central banks were established to help their sponsoring governments finance themselves more easily, usually to wage wars; and lo and behold, government borrowing and money-printing are less taxing to voters than . . . taxes. That's why monetary debasement has intensified most when central banks have been most in control and least-constrained by the gold standard (i.e., over the past century).

Historically, the only time central banks have behaved themselves and preserved monetary values is when they've been on the gold standard, devoid of policy discretion. But they've also conspired to assist their extravagant, over-spending political sponsors in issuing ever-more national debt and then to "monetize" it (i.e., inflate it away), whenever necessary. If there's a better machine working for limitless government (and thus for limitless money-printing) than a central bank, it's a central bank that's off the gold standard. Anything goes. What were once seen as "temporary suspensions" of gold-redeemable money (as some claimed even in 1971) soon became permanent. Since 1971 there's been a perpetual, on-going series of defaults and "mini" national bankruptcies. *Every inflation is a default.* Economists now debate not *whether* there will be a monetization ("quantitative easing") but *how many more* there will be, and how *frequently* they'll be adopted.

Perhaps fewer than a dozen economists are left in the world who know how the gold standard worked, what it has meant that the world is no longer on it, and how to use the floating gold price to forecast stocks and bonds. But no astute investor can afford to be ignorant of such matters – and that's why August 15, 1971 still matters.

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