The Value Crisis

Will the dollar again be the government scapegoat?

By Matt Blackman

During the Great Depression the Federal Reserve and U.S. government took some drastic steps to try and fix the economy. In the final analysis, it took more than a decade and a world war to finally get it back on track. We are in a similar predicament once more. How big is the risk of history repeating itself?

In 1834, the U.S. Congress put the country on the gold standard fixing the price of an ounce of gold at $20.67. This followed a similar move by England in 1819 but other industrialized nations did not follow suit until the 1870s. Until World War 1, western nations enjoyed a period of "unprecedented prosperity with relatively free trade in goods, labor and capital."

But the situation began to unravel following the war. England was forced off the gold standard once and for all in 1931 following massive outflows of both gold and capital after the stock market melt and speculative bubble broke in 1929. Faced with a deteriorating economy and falling revenues, Herbert Hoover U.S., president from 1928 – 1932, signed the Smoot-Hawley Act in a protectionist move that quickly decimated global trade. When this only made things worse, he drastically increased taxes and raised interest rates to stop a speculative run on the dollar and shore up government revenues. The move saved the dollar but exacted a terrible economic toll in the process.

Uncertain about the health of the U.S. economy, investors in other countries holding deposits in U.S. banks began to withdraw gold. This was possible because U.S. government policy was that it would exchange dollars for gold at the fixed price of gold and vice versa. Between 1931 and 1933, these withdrawals climbed which was a critical reason why the money stock fell. It was a situation that called for rapid action.

'New Deal' Experiment

"There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."

— Lenin

On the day after Franklin D. Roosevelt was sworn in as President (March 4, 1933), his first official act was to order all banks to close and declared a banking holiday. Only after banks received a government license would they be allowed to re-open under the Emergency Banking Act (March 9, 1993). It was a move designed to halt the runs on banks by panicked depositors. He also signed into law the Glass-Steagall Banking Act that tightened control over the investment practices of banks. This was followed by the creation of the Federal Deposit Insurance Corporation (FDIC) to insure all deposits in banks up to $2,500, increased to $5,000 in 1934. These moves were designed to renew confidence in the banking system.

But they were only the first steps in trying to fix the broken economy.

During the 1932 Presidential Election campaign against Republican incumbent Herbert Hoover, Roosevelt gave the nation a hint to what direction he would take in an October speech if he were elected.

“We have two problems: First, to meet the immediate distress; second, to build up a basis of permanent employment. As to immediate relief, the first principle is that this nation, this national government if you like, owes a positive duty that no citizen shall be permitted to starve. In addition to providing emergency relief, the federal government should and must provide temporary work wherever that is possible.”

It was all part of his pivotal election message,

“I pledge you, I pledge myself, to a new deal for the American people.”

But the most controversial step, considered by many a dark moment in U.S. economic history, was the Gold Reserve Act of 1934 passed on January 30 making it illegal for U.S. citizens to own gold and requiring them to exchange it for U.S. dollars. The very next day, Roosevelt fixed the value of gold to $35/oz from $20.67 the day before, which instantly devalued the dollar by 69%. Without a doubt, this was the single most confiscatory act by government in U.S. history.

Where are we today? With gold trading around $850/oz (December 16) means that it now takes $41.12 to buy something that cost $1 in 1933. This works out to a 97.6% devaluation of the dollar. But I’m getting ahead of myself.

Roosevelt’s Redistribution

“Inflation is probably the most important single factor in that vicious circle wherein one kind of government action makes more and more government control necessary. For this reason all those who wish to stop the drift toward increasing government control should concentrate their effort on monetary policy... I do not think it is an exaggeration to say history is largely a history of inflation, usually inflations engineered by governments for the gain of governments.”

— Friedrich Hayek

Between 1930 through 1938 the government took drastic action in an attempt to address the deteriorating economy and mounting jobs losses. I counted 24 major measures (not including The Gold Reserve Act or the 1931 rate hikes and other actions by the Federal Reserve) which at the time had been the most powerful set of economic stimulus packages to occur in U.S. history.

It was an experiment that effectively launched John Maynard Keynes’ *General Theory of Employment, Interest, and Money* (1936) that espoused his left-leaning, interventionist theory that government spending, tax cuts and monetary expansion could be used to counteract economic slowdowns. In other words, Keynes believed that during economic malaise, the government should act as buyer of last resort to provide the aggregate expenditures sufficient to achieve full employment. At the time, both FDR and Keynes were somewhat ironically proclaimed to be “saviors of capitalism.”

But even though the government intervened in an unprecedented and massive way in the economy, many today argue that not enough was done. So was FDR’s ‘New Deal’ approach successful? And could more have been done to address the problem?

As the next figure shows, by the time FDR came to power in March 1933, the damage had been done to the Dow Jones Industrial Average. After finally hitting bottom in early July 1932 at which

point the Dow had seen nearly 90% of its value destroyed, confidence began to slowly but surely return but this change would only be apparent later. It was during this period of wide-spread pessimism that the fate of incumbent Herbert Hoover was sealed.

Figure 1 – Weekly chart of the Dow Jones Industrial Average from 1929 to 1944 showing how stocks moved during the Great Depression. As this chart shows, stocks got decimated between 1929 and 1932, staged an impressive bear market rally to 1937 then got cut in half again to 1942. The Dow would not rise above its 1929 highs until late 1954. Fourteen years after Black Monday in October 1929, stocks were still worth less than half of their peak highs. Chart by Metastock.com

After hitting rock bottom on July 9, 1932 stocks rallied 50% to September before giving much it back, rallied briefly with FDR's victory but then fell until March 3, 1933. Once FDR took office however, investors liked his tough stance and quick action. In 1929, there had been a total of 25,000 banks in the U.S. After FDR's mandated bank holiday imposed by the Emergency Banking Act in March only 12,000 remained according to Ivan Pongracic in *The Great Depression According to Milton Friedman.*

Of the fifteen most industrialized countries of the day, the U.S. suffered the greatest in terms of industrial production decline which fell 46.8% between 1929 and 1933 at which point one in four men was unable to find work.

Stocks subsequently doubled in price over the next four months even though the unemployment rate hit a high north of 25% that year (see table 1). As we see from the table, unemployment was slow to respond dropping to 14% in 1937 which was still many times higher than it had been in the late 1920s.

Growing tensions in Europe were at least in part responsible for the 1933-37 recovery. U.S. money supply increased nearly 42% during this period stemming largely from "a substantial gold inflow to the United States caused in part by rising political tensions in Europe that eventually led to World War II," according to Encyclopedia Britannica.

Year	Unemployment Rate	Real GDP (in billions of dollars)	Federal Spending (in millions of dollars)
1929	3.2%	$951.7	$3,127
1930	8.9%	$862.1	$3,320
1931	16.3%	$788.8	$3,577
1932	24.1%	$682.9	$4,659
1933	25.2%	$668.6	$4,598
1934	22.0%	$719.8	$6,541
1935	20.3%	$778.2	$6,412
1936	17.0%	$888.2	$8,228
1937	14.3%	$932.5	$7,580
1938	19.1%	$890.8	$6,840

Source - The Great Depression - Fed Bank St.Louis

Table 1 – Table showing the unemployment rate, GDP and federal spending through the Great Depression.

From a stock market perspective at the time, it could be argued that Keynes' new theory and FDR's New Deal had been successful – after all, by 1937 the Dow had rallied more than 400% from the 1933 bottom.

But then something strange happened. Stocks hit a wall and started to decline. Unemployment climbed back to nearly 20% in 1938 as the economy again entered recession and by mid-year, the Dow had fallen back to 100 and was still down 70% from its 1929 highs.

What had gone wrong? It was clear that there was more to Keynes' theory than had originally met the eye.

Massive government intervention had put men back to work, raised minimum wages, reduced the number of foreclosures and saved banks. But these benefits came at tremendous cost. Taxes remained high and that combined with higher mandated wages and a maximum work week imposed by the National Recovery Act and Fair Labor Standards Act, made it more difficult for private businesses to survive in challenging economic times. This resulted in the double whammy of slower private sector growth and reduced tax revenues for government. Public works projects competed with private enterprise for workers who were instead engaged in "economically wasteful activities such as carving the faces of dead presidents into the sides of mountains" according to Pongracic.

In the final analysis, "[t]he economy improved after Franklin D. Roosevelt's inauguration in March 1933, but unemployment remained in the double digits for the rest of the decade, full recovery arriving only with the advent of World War II," according to Ben Bernanke in a March 2004 speech. In other words, despite the hundreds of billions (trillions in today's dollars), it took more than a decade and a world war to finally get the economy back on track. It would take another nine years after the war ended before the Dow would again reach its 1929 highs.

The Bernanke Ultimatum

"The monstrous credit and debt bubble in the United States, through years of over-accommodation by the Federal Reserve, has created an economy with an array of horrible and massive dislocations and imbalances that make a sustained recovery impossible."

— Kurt Richebacher

Unfortunately, there is no way of knowing how long the recovery would have taken in the absence of government intervention but the chances that it would have taken longer are slim indeed. The big difference is that this option would have occurred without putting the government (and the taxpayer) so seriously into hock.

Why is this argument important today? It is clear based on recent actions taken since the current market and economic melt began that the Keynesian approach is very much alive and well in Washington.

It is interesting to note that Fed Chairman Ben Bernanke is an expert on the economic history of the 1930s and has even written a book about it called *Essays on the Great Depression*, a depression that he blames in large part to a failure of the Federal Reserve to act given their monetary powers and the gold standard that existed at the time.

In a March 4, 2004 Fed speech entitled *Money, Gold and the Great Depression*, Bernanke explained how the gold standard restricted the Fed's ability to control money supply and forced them to raise interest rates just as the economy was failing to defend the dollar. As proof of his contention, he cites the fact that those countries that left the gold standard earliest suffered the least economic pain.

In concluding his Fed speech, Bernanke cited two important "lessons" of the Great Depression which reveal much about his approach to the situation we face today.

1) "The gold standard orthodoxy, the adherence of some Federal Reserve policymakers to the "liquidationist" thesis (that weak banks should be allowed to fail as a harsh but necessary prerequisite to the recovery of the banking system), and the incorrect view that low nominal interest rates necessarily signaled monetary ease, all led policymakers astray, with disastrous consequences."
2) "Price [and financial] stability should be a key objective[s] of monetary policy. By allowing persistent declines in the money supply and in the price level, the Federal Reserve of the late 1920s and 1930s greatly destabilized the U.S. economy and, through the workings of the gold standard, the economies of many other nations as well."

To any serious student of the Bernanke doctrine, his outspoken support of supply-side economist Milton Friedman, a staunch opponent to the Keynes interventionist approach, would seem to put the Fed chairman firmly on the side of the free market. But his words, policy statements and recent actions place him closer to the opposite end of the spectrum.

As we have witnessed since markets began to falter in late 2007, when the chips are down, Ben Bernanke's true Keynesian colors coming shining through. His solutions, "technology called the printing press" and his not-so-subtle references to Milton Friedman's famous helicopter money drop (an idea that he has taken to dizzying new heights), have earned him the well-earned moniker, Helicopter Ben.

So what more can we expect from Dr. Bernanke in making good on his promise in the ongoing economic chaos?

Then and Now

"By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens." — Unknown

In the following two tables, we see a comparison of government and Fed actions taken during the Great Depression (table 2) compared with what has been done during the current crisis (table 3).

YEAR	GOVERNMENT ACTION	DESCRIPTION
1930	**Smoot-Hawley Act**	Imposed punitive tariffs on thousands of imports.
1932	**Hoover Administration raises top tax-rate from 25% to 63%.**	Deemed necessary due to falling government revenues.
1933	**Emergency Banking Act**	As his first official act, Roosevelt closed banks for the purposes of examining their financial health
1933	**The Banking (Glass-Steagall) Act**	Tighten banking regulations, restrict investment practices.
1933	**Federal Deposit Insurance Corporation (FDIC)**	Insure banking deposits to $2,500. Increased to $5,000 the following year.
1933	**Tennessee Valley Authority (TVA)**	Created to build more than 20 dams & create jobs for the Tennessee River watershed.
1933	**Agriculture Adjustment Administration (AAA)**	Raised farm prices through subsidies & paid farmers not to grow crops/livestock.
1933	**Civilian Conservation Corps (CCC)**	Put 2.5 million to work in conservation projects.
1933	**Federal Emergency Relief Administration (FERA)**	Money into public works, projects to create jobs.
1933	**National Recovery Act (NRA)**	Regulated wages, conditions, production & prices and set min. wage.
1933	**Public Works Administration (PWA)**	Launched projects such as Grand Coulee Dam for a total of 34,000 construction projects.
1933	**Civil Works Administration (CWA)**	Program to fund construction, repair, infrastructure jobs affecting 4 million workers.
1934	**Federal Housing Administration (FHA)**	Designed to improve housing conditions, insure mortgages.
1934	**Securities & Exchange Commission (SEC)**	Required full stock disclosure and regulated market.
1935	**National Labor Relations Act (Wagner Act)**	Legalized collective bargaining, but led to wave of strikes.
1935	**National Youth Administration (NYA)**	Provided more than 4.5 million jobs for young people and youth training.
1935	**Social Security Act of 1935**	Created administration of a national pension fund for the aged and unemployed, public assistance for dependent mothers, children and disabled people.
1935	**Works Progress Administration (WPA)**	To build infrastructure incl. roads, airports, schools providing about 3 million jobs.
1935	**Rural Electrification Administration (REA)**	Offered loans to electric companies and farm co-ops to build power plants/powerlines.
1935	**Federal Music Project (FMP)**	Cultural program employing 16,000 musicians at its peak.
1935	**Federal Theatre Project**	Employed 12,700 theatre workers to present plays in

	(FTP)	more than 1 million performances.
1935	**Federal Writers Project (FWP)**	Cultural program employing 6,685 writers (peak).
1937	**Farm Security Administration (FSA)**	Enacted to aid sharecroppers (who farmed leased land).
1938	**Fair Labor Standards Act**	Banned child labor, set minimum wage, cut work week to 40 hours.

Table 2 – Partial summary of government actions to deal with the weakening economy between 1930 and 1938. Source – The Great Depression – Fed Bank St. Louis

The next table compiled by Barry Ritholtz, President of Ritholtz Capital Partners, a New York hedge fund, shows the bailout programs and costs so far to November 30, 2008.

Bailout Programs	maximum amount $	current amount $
Federal Reserve - $5.255 trillion - 62%		
Commercial Paper Funding Facility LLC (CPFF)	1,800,000,000,000	270,879,000,000
Term Auction Facility (TAF)	900,000,000,000	415,302,000,000
Other Assets	601,963,000,000	601,963,000,000
Money Market Investor Funding Facility (MMIFF)	540,000,000,000	0
Unnamed MBS Program announced 11/25/08	500,000,000,000	0
Term Securities Lending Facility (TSLF)	250,000,000,000	190,200,000,000
Term Asset Backed Securities Loan Facility (TALF)	200,000,000,000	0
Other Credit Extensions (AIG)	122,800,000,000	122,800,000,000
Unnamed GSE Program announced 11/25/08	100,000,000,000	
Primary Credit Discount	92,600,000,000	92,600,000,000
ABCP Money Market Fund Liquidity Facility (AMLF)	61,900,000,000	61,900,000,000
Primary Dealer and Others (PDCF)	46,611,000,000	46,611,000,000
Net Portfolio Maiden Lane LLC (Bear Sterns)	28,800,000,000	26,900,000,000
Securities Lending Overnight	10,300,000,000	10,300,000,000
Secondary Credit	118,000,000	118,000,000
Federal Deposit Insurance Corporation - $1.788 trillion - 21%		
FDIC Liquidity Guarantees	1,400,000,000,000	0
Loan Guarantee to Citigroup*	249,300,000,000	249,300,000,000
Loan Guarantee to Lending arm of General Electric	139,000,000,000	139,000,000,000
Treasury Department - $1.15 trillion - 13.5%		
Troubled Asset Relief Program (TARP)	700,000,000,000	350,000,000,000
Fannie Mae / Freddie Mac Bailout	200,000,000,000	0
Stimulus Package	168,000,000,000	168,000,000,000
Treasury Exchange Stabilization Fund (ESF)	50,000,000,000	50,000,000,000
Tax breaks for banks	29,000,000,000	29,000,000,000

Federal Housing Administration - $300 billion - 3.5%		
Hope For Homeowners	300,000,000,000	300,000,000,000
Total - 100%		
	$8,490,392,000,000	$3,124,873,000,000
* $306 billion in guarantees, with Citi absorbing the first $29 billion in losses. Additional losses are split 90% US Gvt, 10% Citi.		
The math is 306 - 29 = 277 * .90 = 249.3		
http://www.ritholtz.com/blog/wp-content/uploads/2008/12/us-government-rescue-programs.xls		

Table 3 – Tally of bailouts, guarantees, asset purchases, tax breaks, Federal loans, grants to homeowners and other action taken to try and tame the credit crisis of 2007-08.

Source – www.Ritholtz.com

As both tables demonstrate, the actions taken during both challenging periods were unprecedented and no one can say that the FDR Administration in the 1930s did not move swiftly and dramatically to stem the damage of the Great Depression.

But as we learned later, although these actions provided temporary solutions to the problem, they also contributed to the severity and duration of the Great Depression that in the final analysis took a world war to finally bring to an end.

Will the action being taken today suffer a similar fate?

Fiat Fiasco

"Let's turn inflation over to the post office. That'll slow it down." — Morris Udall

As we see from the next chart, the monetary base or money in circulation has increased an incredible 75% in the last year showing just how rapidly the Fed has kicked the printing presses (and helicopters) into high gear. How does it compare to the past?

The recent rate of increase in money supply is three-times higher than ever before with second place high occurring in June 1940 as the U.S. prepared for war (see figure 2). Although the U.S. did not enter the war until December 1941, the country was actively engaged in providing war materials and weapons to allies England and Russia through the lend-lease program. And that required lots of money to finance it.

It is also interesting to see what occurred in the aftermath of the 70% devaluation in the dollar following Roosevelt's Gold Reserve Act (1934). As we see, it marked the beginning of a new inflationary phase in American monetary history as governments learned how to use printing presses to kick-start the economy and finance deficits.

The next period in which printing presses were actively engaged occurred in the 1970s with the advent of stagflation. It would take drastic action by Fed Chair Paul Volker that included cranking the Fed funds overnight rate above 19% on two occasions in 1980 to finally tame the inflation beast and end stagflation. Like any deflationary period, the correction caused both economic and social damage but it did rebalance the economy and set the foundation for the twenty-year bull market that followed.

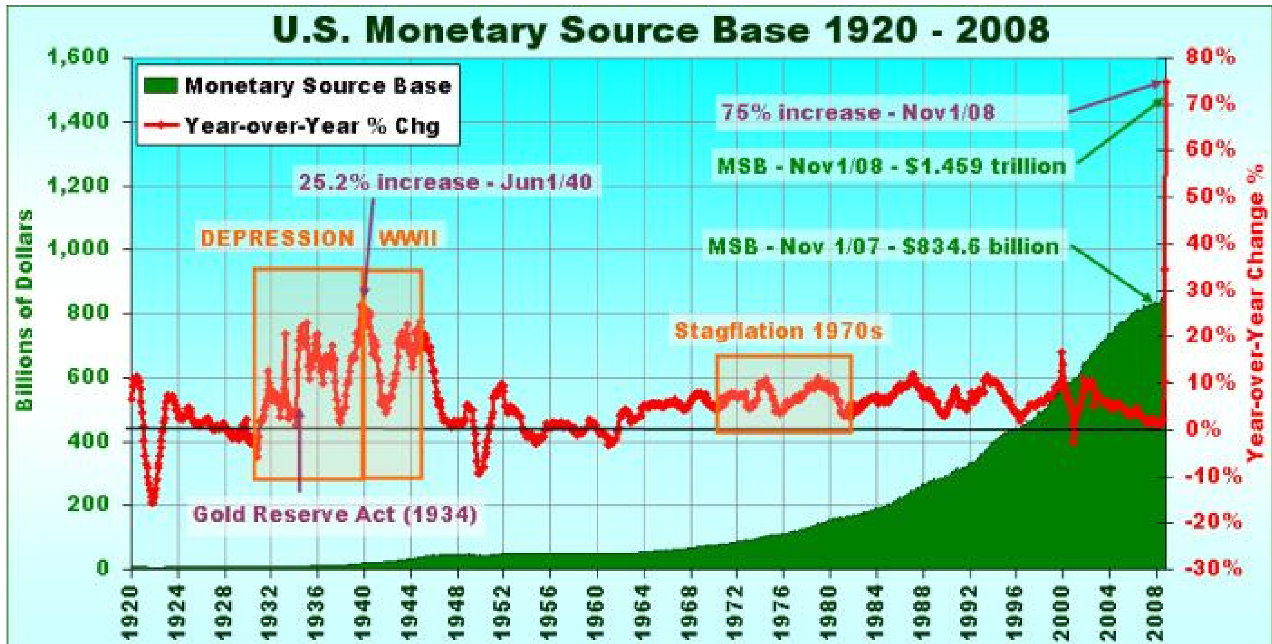

Figure 2 – Chart showing monetary source base since 1920 with the previous high year-over-year increase in money supply hitting 25.2% in 1940 as the U.S. ramped up the lend-lease program supplying war materials to her allies for World War II. As of the most recent data available to November 1, 2008, the Fed had nearly doubled monetary base in the last year (up 75%) from November 1, 2007. Data – St. Louis Fed

Getting Real

"The Fed has already increased its liabilities (bank reserves) from roughly $800 billion a few months ago to approximately $2.5 trillion today. If we were on a gold standard, this would be the equivalent of the Fed tripling its gold reserve holdings."

— Paul Brodsky & Lee Quaintance

Before we consider what might be, let's first look at what is. It's not a pretty picture.

Debt at all levels of the economy has grown dramatically since the 1980s. As we see from figure 3 comparing total household net wealth and total credit market debt (debt at all levels of the economy) to GDP, household net wealth remained more or less stable relative to GDP between 1950 and 1996 but then started to build as the internet and tech stock market bubble gathered momentum. This bubble peaked and began to deflate in 2000. It then dropped to 2002 but thanks to Greenspan's gift of 50-year low interest rates to address the deflating, a new bubble began to form. The housing and asset bubble peaked in 2006 and are now in the process of deflating with more dire consequences than any of the Fed or leading economist of the day could anticipate.

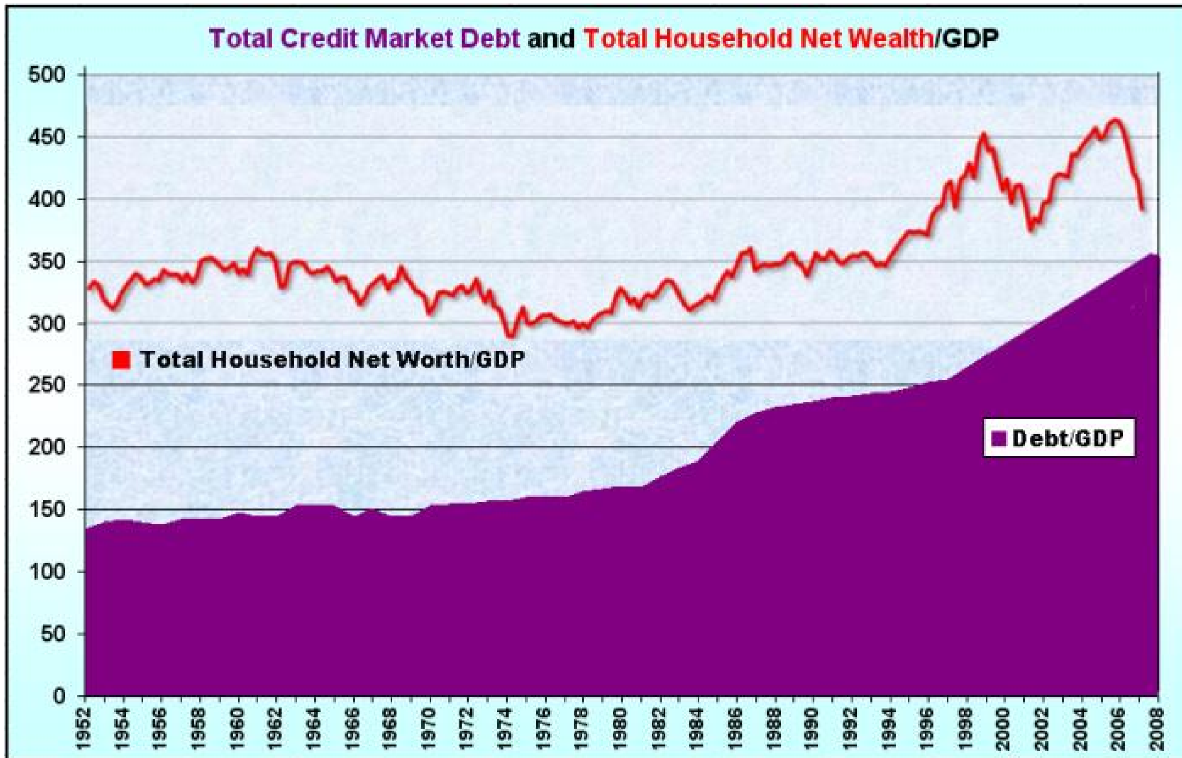

Figure 3 – Comparison of total credit market debt versus household income both expressed as a percentage of GDP. As this chart shows, household net wealth remained more or less stable from 1952 into the mid-1990s after which it jumped during the formation of the internet stock market bubble, fell then skyrocketed again during the housing bubble. Total credit market debt on the other hand has steadily grown as a percentage of GDP doubling from 162% ($4.8 trillion) in 1981 to 350% ($49.6 trillion) by 2008. Source – Federal Reserve and CalculatedRiskBlog.com

Contrast this with total debt. It began to grow dramatically relative to GDP in the mid-1980s and has continued to expand at an alarming rate. But the real growth began in 2000. Between that year and 2008, debt grew 25% faster than the economy (as measured by GDP). As figure 3 shows, the debt-to-asset relationship is on a collision course and it is only a matter of a few years before total debt overtakes net household wealth. Household debt is now 122% of household income and growing rapidly. A slowing economy is accelerating this convergence.

Should we be worried?

According to Ned Davis Research, “the problem with large deficits [and debt] is that over time, they weaken the Fed's ability to guide the U.S. economy. This occurs when the private sector must raise interest rates in order to compete with the financing needed by the public sector (the "crowding out" effect). Higher interest rates eventually slow economic growth, at which point the Fed must act with greater authority in order to direct larger amounts of borrowed capital. This leverage most likely increases economic risk by making the economy more volatile and more vulnerable to outside shocks.”

“High debt levels also have another side effect: disinflation. Because consumers and businesses have limited spending, they must retrench once they reach their saturation points. When the demand for goods and services diminishes due to the over-extension of credit, the result is disinflation.”

Ben Bernanke’s solution to this problem is clear. He outlined it in a 2002 speech to the Federal Reserve entitled *Deflation: Making Sure “It” Doesn’t Happen Here*.

"Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services."

What impact has the Fed's approach of making and keeping the cost of money low had? In nominal terms, the Dow Jones Industrial Average is down 25% from its 2000 highs. Given the tough economic environment, it could be a lot worse, couldn't it?

But in real terms, the Dow has been in a brutal bear market since 1999 when priced in gold. As the next figure shows, the Dow was down more than 75% at its November 2008 lows.

Figure 4 – Monthly chart of the Dow Jones Industrial Average denominated in gold. As the chart shows, the Dow has been in a bear market in real terms since mid-1999 and was down more than 73% in real terms as of December 5, 2008. Chart by GenesisFT.com

What about the dollar? It's down from 2000 but it's been rallying in the last few months hasn't it? But priced in gold, the picture looks a lot more depressing. As we see from the next figure, the greenback was down a whopping 85% priced in gold before it began to recover in July.

Figure 5 – In terms of gold, the U.S. dollar has taken it on the chin since 2000 and is still down more than 80% even after the recent rally. Chart by GenesisFT.com

No matter which way you look at it, the dollar has already been decimated. How much worse could it get?

Dr. James Conrad, an investor and trader of bonds, stock, options and precious metals for 37 years, proffered some interesting insights in a December 4 article entitled *The Manipulation of Gold*.

"Anyone who reads the written works of our Fed Chairman knows that Bernanke's long term plan involves devaluing the dollar against gold. He often extols the virtues of former President Franklin Roosevelt's gold revaluation/dollar devaluation, back in 1934, and credits it with saving the nation from the Great Depression. According to Bernanke, devaluation of the dollar against gold was so effective in stimulating economic activity that the stock market rose sharply in 1934, immediately thereafter."

"It is only a matter of time before gold is allowed to rise to its natural level. Assuming that about half of the current increase in Fed credit is eventually neutralized, the monetized value of gold should be allowed to rise to between $7,500 and $9,000 per ounce as the world goes back to some type of gold standard. In the nearer term, gold will rise to about $2,000 per ounce, as the Fed abandons a hopeless campaign to support COMEX (New York Mercantile and Commodity Exchange) short sellers, in favor of saving the other, more productive, functions of the various banks and insurers.

Why? Dr. Conrad provides an interesting explanation.

"Revaluation of gold, and a return to the gold standard, is the only way that hyperinflation can be avoided while large numbers of paper currency units are released into the economy. This is because most of the rise in prices can be filtered into gold. As the asset value of gold rises, it will soak up excess dollars, euros, pounds, etc., while the appearance of an increased number of currency units will stimulate investor psychology, and lending and economic output will increase,

all over the world. Ben Bernanke and the other members of the FOMC Committee must know this, because it is basic economics."

What if the U.S. were still on the gold standard? Is a value between $7,500 to $9,000/oz. realistic?

Paul Brodsky and Lee Quaintance, who operate QB Partners, a private New York-based investment fund, have done the math. They explained it in a December 10 article entitled *The Shadow Gold Price*.

“To identify the intrinsic value of the dollar today, we examine the corollary – the intrinsic value of gold in dollar terms, which we dub “The Shadow Gold Price” (SGP). To do so we assume that Federal Reserve Bank liabilities are again exchangeable into gold (recall, FRB reserves are bank assets – the stuff that used to have to be gold). [It is arrived at by dividing the dollar amount of current Fed liabilities by official gold holdings.] This calculation, while simple, is intellectually honest and produces a breathtakingly large “equilibrium” gold price of approximately $9500 per ounce today ($2.5 trillion divided by U.S. official gold holdings of 8100+ metric tons).” See the next chart.

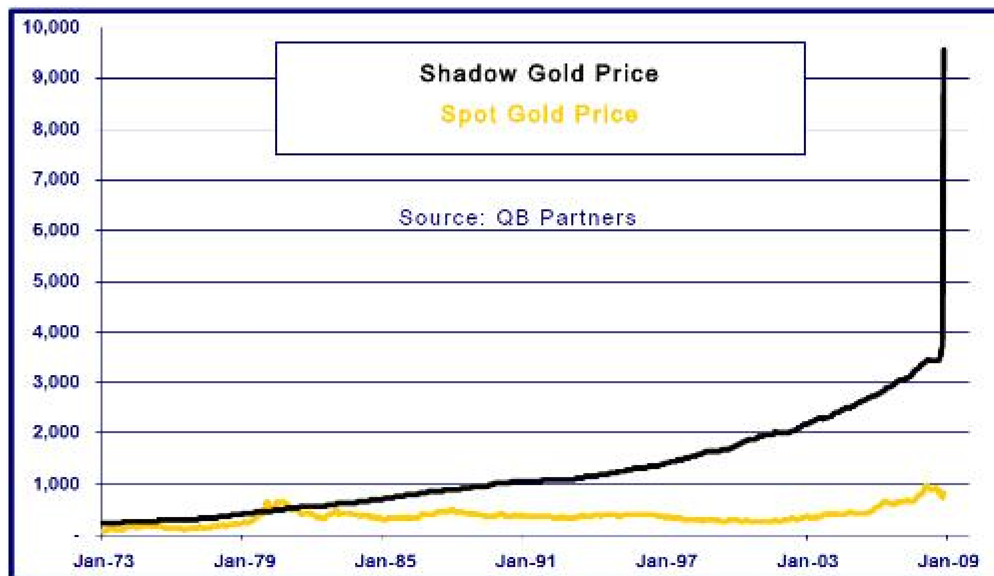

Figure 6 – Graphic showing the spot price of gold compared to the Shadow Gold Price calculated to reflect the price of gold if the U.S. was still on the gold standard that existed before January 31, 1934 by Paul Brodsky and Lee Quaintance. The SGP has tripled in the last few months as Federal Reserve liabilities have skyrocketed from $800 billion a few months ago to more than $2.5 trillion recently which is equivalent to the Fed tripling its gold reserves.

Going back to the chart of the Dow priced in gold (see figure 4), if priced in the Shadow Gold Price instead of the spot gold price, the Dow would now be worth less that it was during the last serious recession lows in 1982.

Tough Love

“The gold standard would keep you from printing money and destroying the middle class. Every country where you have runaway inflation, there's no middle class.” — Ron Paul

Anyone who is a parent knows that it is sometimes necessary to discipline those in your care. Nothing is more difficult than seeing your child suffer and any punishment doled out must be balanced with a good measure of love.

But just as harmful as being overly strict is the indecisive approach of giving the child anything he or she wants whenever they want it. What would happen if your child could have and do whatever they wanted without facing consequences for their actions? As any parent knows, this would result in a selfish, spoiled, inconsiderate and unhappy child with a high probability of being unable to build meaningful relationships and cope in the real world.

Recessions are necessary when asset prices get out of whack with real metrics and soar beyond affordability or what is economically practical. And the more out of control the situation gets, the more severe the correction must be to re-establish proper balance. Sometimes this can result in depression. Yes, they are painful and politically unpopular but without these necessary periods of price and wage re-alignments, we would eventually fall prey to Zimbabwe-style hyper-inflation of many million percent per year resulting in a loaf of bread costing hundreds of thousands of dollars or more. But by that time, no matter how much money you had, it would not enough to buy the necessities of life.

We now live in an era in which governments and central banks either do not have the fortitude or wherewithal to do what is necessary. Printing tons of cash in an effort to keep bubbles from breaking is like letting your child eat all the candy he or she wants and do whatever they wish. It is a short-term feel-good solution with serious long-term implications.

Profligate printing of dollars will have a cost which will ultimately be far greater than the pain we would have to endure in the next few months or years to get our economy back on track again based on sound monetary policy.

In lieu of this necessary corrective action, we face two possible outcomes. We will be doomed to a multi-decade long malaise like occurred in Japan (that did not use printing presses to correct the problem but instead failed to address systematic failures and not letting weak banks and corporations go bankrupt). But more likely given the amount of cash being pumped into the economy is that we will see a return to double-digit inflation in relatively short order which will then require a Volker-style solution with interest rates moving rapidly above the existing rate of inflation to cure it.

Such action will eventually stop deflation in its tracks but the problem is what happens before and after. Before we see an increase in inflationary pressure, expect a slow but steady growth in inflation that will gain momentum at a troubling pace. It is difficult to know exactly what form that will take at the beginning. Will it be stagflation, disinflation or deflation? Each comes with its own set of problems.

However, by the time central banks recognize there is a problem and take action, the freight train will be traveling far too fast to stop it without jamming on the brakes. And the more out of control the situation, the greater the risk of a train wreck.

Precious metals anyone?

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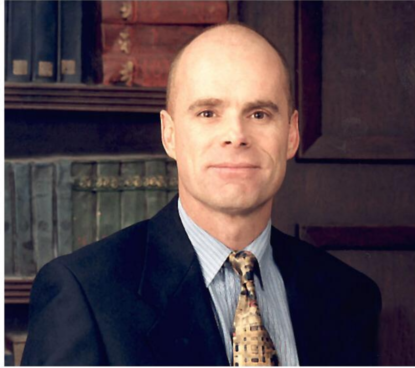

Matt Blackman is a technical trader, author, reviewer, keynote speaker and regular contributor to a number of trading publications and investment/trading websites in North America and Europe. Blackman is the host of a trading website **http://TradeSystemGuru.com** and writes a weekly stock market letter.

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