PICK OF THE WEEK

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The love that dare not speak its name

Depending on where you live and how much you earn, so in the last five weeks you have seen a significant seasonal event, un-remarked as usual. This was the day when employees and employers alike have been allowed to earn some money. For until that day, everything you have earned this year has gone to the government by way of taxes. Now, and for the rest of the year, what you earn you can keep. It is odd that in modern times even the poorest members of society must, for at least the first 20 weeks of each year, work whilst all the income from their labour is appropriated by their rulers. Delightfully it's even more backwards than the feudal Middle Ages, because then at least the serfs were fed and housed for free - but apparently, this is progress.

Today's modern feudal treasurers have different problems. For in the small hours of the night, tucked up in their silk covered beds and away from the prying eyes of subservient apparatchiks, chancellors and central bankers writhe in their sleep with recurring night terrors. Occasionally murmuring of forbidden love, their ecstasy is crushed by more frequent groans of utter despair. For their subconscious reminds them that what they most crave they can never have and they are doomed to failure.

The history of money in less than 500 words*

Pre-history, when homo cave-potato decided he'd rather buy a club than make one, he needed a medium of exchange, and thus experimented with various forms of money including furs, cowrie shells, very large stones with holes in the middle, iron bars and blocks of salt. Each was unsuccessful; so early society soon settled on gold as the most practical medium of exchange, substituting it where supplies were limited, or when paying junior staff, with cheaper metals such as silver and copper. Although paper money has a long history, it was always explicitly understood that banknotes could be exchanged for something more tangible. Since 1855 the Bank of England has been writing a now historically ironic promise "*to pay the bearer on demand….. [in gold]*", even though any payment ceased in 1931. (This confusion is compounded by the fact that the 'pound sterling' refers to a weight in silver.) Almost all countries produce coins which look as if they are made from silver and copper to give them credibility.

Early bankers soon worked out that not everyone would want to cash in these IOUs at the same time, so began issuing more notes than were actually backed by physical gold. Occasionally these ruses were found out, hence bank crashes; but as a global system it worked pretty well until 1913, when restrictions were imposed. Rather than cause a savings panic amongst the newly-monied middle classes, the system was replaced with a "let's pretend" gold standard, which allowed for intra-government transfers of gold between debtor and creditor nations. This scheme limped along between major nations until July 1944 when, as a result of record wartime paper money printing, it too collapsed, to be replaced by the Bretton Woods Agreement. Now all currencies would be fixed, forever, at an agreed exchange rate to the dollar, which in turn was initially backed by physical gold held in Fort Knox, Kentucky and valued at $35 an ounce.

**There is an excess of turgid financial books on this. The facts are really pretty simple.*

This scheme survived for an even shorter period, collapsing in 1971 when France's Général de Gaulle, again in wartime (Vietnam) decided to cash in the excess dollars France had accumulated, in return for America's gold. This did not run at all well in Washington. America decided to renege on the agreement (in practice a form of sovereign default).

The next permanent solution was 'fiat money', i.e. paper backed by nothing at all. At the core of this structure were the beliefs that (largely elected) politicians would be prudent economic stewards and if necessary could pay any financial obligations through taxing their local populations. The immutable fact about fiat money is that, over time, all paper currencies become worthless. Hence the mighty dollar today buys the same as 3.8 cents in 1900. Sterling is worse, the Swiss franc best, losing only four-fifths of its value in the same period.

The history of gold in less than 310 words

Up until 1913, gold could be owned by anyone. Credit availability then was far more limited than now and inflation was self-correcting. So there were few reasons why its price should have varied much, and it didn't, even when supply surged from new gold fields in the Americas, South Africa and Australia. It was a true store of value – a key purpose of money. From 1913 onwards, private ownership became more and more difficult. The price was increasingly controlled by various arrangements fixed by a handful of central banks. The collapse of Bretton Woods removed the old $35 per oz. price cap which was then largely set by the free market. As a consequence, central bankers suffered a decade of near panic; for their populations immediately and very rudely showed an utter contempt for their politicians and financial authorities by increasingly preferring to own gold rather than the local funny money. Naked emperors do not like being figures of fun, so quietly agreed to regain control of the price. These various changes included taxing gold purchases, making its ownership illegal and, most important of all, prolonged and increasingly co-ordinated attempts to force the price down.

Thus, leaving aside ancient history, unlike all other commodities and currencies gold has only had one full cycle. Once freed in 1971, the price soared to a peak of $832 in 1980 and was then slowly brought back under central control at the turn of the century. A return to suppressing the price worked in part because of unprecedented international co-operation, and more because "new" forms of credit creation seemingly made gold's monetary role as irrelevant. The collapse of this new credit paradigm in 2008 means it too has become history. Funny money has joined the cowrie shell and large rock with a hole in the middle as socially interesting but failed experiments.

A new cycle begins

May 7th 1999 is a day that Britain's current "Prime Minister" (the real power is a recent appointee to the House of Lords) would choose to forget. As a truly awful market trader, he widely broadcast his intentions to sell over half Britain's gold reserves. In the next three years, 400 tonnes were sold between $256 and $296, leaving a mere 315 tonnes. The money raised was about $3.5 billion; its value today would be $12 billion. Less-widely publicised than his astonishing naivety is that heavy selling of gold by central banks was also a fashionable, pan-European phenomenon. They have dumped nearly 4,000 tonnes in the last decade. Countries as diverse as France, Spain, Netherlands, Portugal and Italy also bought into a novel theory that central banks could be great currency traders and investors. This new idea was not led by Mr Brown at all but surprisingly, the Swiss National Bank. Since 1999 it has sold 1,550 tonnes. In each case it is impossible to prove whether the proceeds of gold sales actually produced a better return than continuing to hold its reserves against a crisis. In the case of the Swiss, the difference between sales proceeds and today's price is about $22bn (a 'loss' of over $3,000 per yodeller); or to put it into another context, the amount received is about half the direct cash injections, write downs and capital raised by the single Swiss Bank UBS in the last 18 months. So empirically the money has not been well used. The implication is that, in Switzerland and across Europe, there has been a very high opportunity cost. Slowly realising in 2004 how dumb they were all looking, fourteen of Europe's central banks agreed a structure to limit how much of their gold reserves each could sell annually (the Central Bank Gold Agreement). With the usual clarity of hindsight, these sales signalled the last hurrah and the failure of a prolonged period of deliberately trying to distort the gold market.

Do as I say, not as I do

Even so, gold still accounts for 60% of Europe's reserves. Yet the developing world - suffering a post colonial inferiority complex - saw what their one-time masters were doing, so also eschewed gold. Thus it accounts for only 11% of their reserves. Meanwhile America (which years earlier had already given a strong hint of what it really believed about gold, by reneging on its IOUs to Général de Gaulle), still has 8,133 tonnes. This accounts for 79% of its reserves. For all the central bank learned papers and propaganda[1] that gold should play no meaningful part in national reserves policy, most developed western countries have steadfastly maintained gold at the core of their reserve systems, but the absolute and relative size of these reserves has shrunk considerably. In contrast, the size of reserves in Asian countries has grown like smoke, to the extent that just six 'countries'[2] – China, Japan, Taiwan, South Korea, Hong Kong and Singapore - now account for over half of the world's estimated $7 trillion of reserves. Of these, 66% is held in dollars, about three times greater than that held in euros; the yen and sterling each account for less than 1.5%.

Given that the US remains by far the world's largest economy and trading partner, and as most commodities are priced in dollars, there is logic to this. Yet there are two flaws to a fiat money, dollar-based reserve system. The first is that, whatever American leaders may occasionally say to placate their allies, both the government and population have almost no interest in the dollar exchange rate against any other currency. As an economy which at a pinch could (apart from oil) be almost entirely self-contained, this too is logical. The second flaw is that, also at a pinch, America could longer term be entirely self funding.

The recent implosion of the international banking system has led to all governments printing money at a record rate. The balance sheet of America's Federal Reserve has increased by over a trillion dollars since the end of 2007. The *target* for this year's budget deficit is $1.2 trillion. The Congressional Budget Office is forecasting a return to a budget surplus in 2019 (one underlying assumption is there will be no further recessions) and that by then, Federal debt will have increased from the current $11 trillion to $21 trillion. This excludes worrisome state (i.e. California) and local (such as school boards) budget deficits. The money printing is by any standard off the scale; one way to put this in context perhaps is that in ten years time, on official - thus optimistic - forecasts, America's Federal debt will be $3,000 for every person alive in the world today. Not that America is the worst, it's just the biggest. That whacky Silvio in Italy has a far greater problem, as does the UK.

Central bankers know of course that all currencies eventually become worthless – it is one of their night terrors - but they prefer it does not happen too visibly or quickly on their watch. Moreover, as most had bought into the mantra of Europe's industrialised countries that "gold is for girls and wimps" (despite ensuring most of their own reserves remain in that metal), they are embarrassingly naked. Of China's vast, nearly $2 trillion, foreign exchange reserves, a mere 2% is in gold. China is now in a dollar trap of its own making.

[1] *Consider for example Alan Greenspan, Chairman of the Federal Reserve Board from 1987-2006.Prior to his appointment he was strongly in favour of gold, stating before the Senate committee "I have been recommending a return [to the gold standard] for years". The members were stunned. In power he recanted.*

[2]*Almost no-one, including the UN and the US, recognises Taiwan; Hong Kong of course is part of China but financially separate.*

If it seeks to reduce its estimated $1.5 trillion of reserves in dollars (mostly in government bonds) the price will collapse. Worse still, unless it picks up its 'share' of newly minted American bonds the price will also collapse.

This explains China's sudden interest in, and many pronouncements on the international financial system, as well as the lifting of the veil of secrecy over its own reserves. Until this year, it had not commented on these in detail for the previous six. Now its Premier and central bank Governor have become almost garrulous; suggestions have included that the world should establish a new financial order, including perhaps the use of SDRs, lecturing US administration on fiscal prudence and curiously, threatening America that it might diversify and thus collapse the American bond market. (The equivalent of trying to mug someone with a stick of damp spaghetti). This threat included the sudden announcement that its gold reserves – last reported at 600 tonnes in 2003 - have since increased to 1,054 tonnes making it no. 5 in the world after Italy, and showing it could diversify if America refuses to listen. (There may also be a sub-plot; as the new kid on the block, it could be expected that China wants to be close to the US over time in the absolute level of its gold reserves.)

The dollar dummies

Yet for all the current uncertainty and noise, China and the other large, and largely Asian, holders of foreign currency reserves (or 'dollar suckers') have already worked out that they must diversify away from their giant dollar holdings, although they remain uncertain as to how. Their problem is size. Supposing China was to buy all this year's new mine supply, estimated at 2,500 tonnes. Leaving aside that such action would cause the price to soar, one tonne is worth approximately $30 million at $950 per ounce - so this would 'only' cost $75 billion, less than 5% of China's reserves. It could buy all its oil requirements for the next six months. That would only absorb 8% of reserves. Other Asian countries suffering a similar squeeze have tried other routes: South Korea attempted to buy an area of farm land in Madagascar larger than Wales, until international political and ecological shrieks forced it to withdraw; Singapore's Temasek (not officially part of the country's reserve system) made such disastrous forays into buying large blocks of shares, that last year the value of its funds fell by 47% (although it has since clawed some back). On a much smaller scale, China has also been trying foreign investment and larger political/infrastructure development in Africa, Sri Lanka and Bangladesh. For all the lack of success with these various experiments, the diversification urge will not stop. Moreover, some new policies are becoming clearer. It appears China will look to buy almost all its domestically produced gold production, a pattern which others may follow. From recently being a minnow in the sector, China is now the world's largest gold producer, outstripping South Africa, Australia or Brazil.

Last year, the world's central banks sold a mere 246 tonnes of gold, the smallest quantity in over a decade. These sellers were mostly Europeans, for the rest of the world's central banks were net buyers of gold for the first time in 15 years. Under the various central selling agreements, the latest of which will probably commence in September this year, it is becoming clear that, as these banks watch their own paper money being printed at a breakneck speed and observe their neighbours doing the same, they have become keener to hang onto what gold they still have. Given that, since 1977, Europe's central banks have been eager to hold the gold price down, their absence as the price fixer is a major change.

An absence of sellers?

There are an estimated 30,000 tonnes of gold above the ground in reserves. No-one has any serious notion of how much else there is elsewhere, on fingers, in teeth, in jewellery or coins and bars. Estimates for the total amount of gold ever mined vary between 250,000 to 350,000 tonnes, of which a significant portion will have been lost (buried hoards, at sea etc.). More recently, individuals have been the net accumulators, central banks the sellers. What exists above the ground is far more important than mine supply, which is likely to remain in a gradual downtrend. Current annual production of around 2,500 tonnes is down by over a third on peak levels of the 1970s and unlikely to rise much. Perhaps new giant deposits will one day be found but meanwhile, gold mining is becoming more expensive, deeper and more difficult. Thus the only realistic sources of new supply can be America, the IMF or the ECB. For the US, policy has long been blindingly clear: do nothing. Hence reserves (America has the largest gold backed reserves in the world, albeit small in relation to the size of the economy) have remained unchanged. It is unlikely Congress will allow any change. The IMF has notional control of 3,412 tonnes, of which 400 tonnes is due to be sold this year. Of all major international bodies, the IMF has the greatest, almost visceral loathing of gold, preferring its own whacky SDRs instead. These are the ultimate funny money, being a fiat currency based on a basket of other fiat currencies.*

Yet the IMF too may be chary of significant official sales because of its earlier failure. Between 1976 and 1980 *"in a bid to reduce the role of gold in the international monetary system"* it sold 1,600 tonnes. About half of this was at the official SDR35 price (about $58) back to underlying central bank owners. (This is so dumb: the 'Brownian notion' of prudent finances to an absurd extreme; the market price varied between two and 24 times greater). The other half was sold through a series of public auctions, initially 150,000 ounces per month rising to a peak of over 850,000. The policy of turning up supply was a poker game, trying to scare the market into believing that demand would be crushed. Yet as supply increased arithmetically, the amount bid for increased geometrically. It actually created a fire storm in the gold market, moving the price from $103 to $832. As abject failures in market interventions go, the IMF was the clear winner. Thus it would be loath to do so again; and it has another problem. The IMF does not own all the gold it holds; it belongs to its member states, which have pledged it to the IMF and could unpledge or replace with paper money. As already mentioned, most members are developing a marked propensity not to sell any more gold. The third potential source is the ECB or its member countries; many are the same nations with egg all over their faces which have been the vanguard of selling a substantial proportion of their reserves at much lower prices. That leaves only Germany (No. 2 gold owner in the world with 3,412 tonnes, 72% of reserves), noticeable only for the government's inability to agree how much to sell, or what to do with the proceeds. As important, the Bundesbank has always been a reluctant seller of significant quantities of the nation's gold because of its Weimar hyperinflation history.

Conclusions

Four decades on from a financial experiment with fiat money, the evidence suggests it is failing. Although governments will continue with the current system, relying on their ability to tax future generations, poor demographics alone in all advanced nations mean the odds that the current fiat money regime will survive unchanged for long are worsening. As suggested in previous reports, change may be driven by this recession, followed by years of stop-go economic activity and a series of sovereign defaults – which are *normal*. The largest central banks have doubled or tripled their balance sheets in the last 15 months. This is an explosion in fiat money. Giant budget deficits and rising unemployment ensure that government money creation will remain explosive for the foreseeable future. These problems are exacerbated by a variety of new events, for instance Asia's reserve diversification programmes and the marked reluctance of historic sellers to reduce their holdings further. It is simple school economics that a very finite supply of one form of money will respond to an almost fission-like increase in the supply of other forms of money, such as the amount of dollars, yen or euros in circulation.

** We refuse to use our good name to explain, thus add credibility. The simple facts are that SDRs were a 1969 artifice created by the IMF to justify its increasingly futile existence, seized upon by feebler economists (and a few decent idealists) as a job-justification scheme. No-one really understood how they work, because they don't.*

It is very easy to make a case that the gold price could enjoy or suffer (depending on your point of view) an explosive run. Given all economies (and businesses) are cyclical, then it is axiomatic that over time they will also revert to the mean. Therefore it can be expected that not just central banks, but also commercial banks and other financial institutions will revert to earlier policies of the 1970s and '80s – of holding a proportion of their 'core' capital in gold. (Bedlam has 10% of its balance sheet there already, and 10% -12% of all client portfolios are in gold shares.) Governments could try to prevent wider gold ownership as before, but new forms of ownership - such as gold ETFs - make it difficult to do so unless all leading nations agree simultaneously.

We have commenced only the second gold cycle under fiat money. Whether it has actually peaked already, or will shortly double, we can only divine by looking at chickens' entrails or throwing our rune-sticks. We use an average price of $850 per ounce in 2010 when valuing gold shares, as that is prudent, yet our damp rabbit's foot hints at a much higher price before the end of 2010 because the triggers are already in place: the absence of meaningful new mine supply, the cessation of central bank sales, explosive growth in money supply and of course, rising political uncertainty, which is the Siamese twin of recessions. Top economic schools used to train their pupils to sneer at little old ladies who kept their savings in gold coins in a sock rather than trusting national banks. Today it is clear which group are the financial dimwits; perhaps an inherent understanding of cycles can only be learned through longevity. We subscribe to the little old lady school of applied economics. We are therefore certain that central bankers' nightmares will worsen as their paper currencies devalue against the most trusted store of value, and in bed, the thing they secretly lust after.

Regards

Bedlam Asset Management plc

Quiz time

An easy gold question: - "Assume the total amount of gold ever mined is 300,000 tonnes. How many official Olympic size swimming pools would this fill?" Answers must be to at least one decimal place and give the workings. The first correct answer received will either be sent a bottle of France's finest champagne or if preferred, the winner can drop by our Global HQ to collect a Maria Theresa silver thaler.

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