

Bring back the link between gold and the dollar

*By Richard Duncan
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The events of September 2008 - the nationalisation of Fannie Mae, Freddie Mac and AIG; the disappearance of the investment banking industry in the US; and the Bush administration's \$700bn bailout to save what is left of Anglo-American (NYSE:AIG) capitalism - demonstrate that the 37-year experiment with fiat money and floating exchange rates has failed catastrophically.

When Richard Nixon destroyed the Bretton Woods International Monetary System in 1971 by closing the "gold window" at the Treasury, he severed the last link between dollars and gold. What followed was a spiraling proliferation of increasingly spurious credit instruments denominated in a debased currency. The most glaring and lethal example of this madness has been the growth of the unregulated derivatives market, which has ballooned in size to \$600,000bn, the equivalent of almost \$100,000 per person on Earth.

Under the post-Bretton Woods dollar standard, credit growth powered economic growth. In the US, the ratio of total credit to gross domestic product rose from 150 per cent in 1969 to 350 per cent in 2007. Credit financed consumption and sucked in imports with a devastating impact on America's trade balance. By 2006, the US current account deficit had reached almost \$800bn.

As the dollar standard flooded the world with funny money, economic instability spread around the globe. The reinvestment of "petrodollars" created the Latin American economic boom in the 1970s and then the third world debt crisis of the 1980s. Japan's trade surplus with the US drove up Japanese property prices in the late 1980s until the imperial gardens in Tokyo were worth more than California; and then produced the lost decade in Japan when that bubble popped in 1990. Next came the rise and fall of the Asian miracle bubble. Each economic convulsion resulted from the excessive influx of dollars into those economies. No regulatory regime could cope when confronted with such an extraordinary incursion of exogenous money.

The Bretton Woods collapse severed the link between the world's currencies and gold. Central banks were then free to create as much money as they wished. Between 2001 and today, central banks outside the US created the equivalent of about \$6,000bn. This can be seen in the seven-fold increase in foreign exchange reserves in that

period. The money created (which accounted for most, if not all, of Federal Reserve chairman Ben Bernanke's so-called global savings glut) was used to buy dollars and suppress the value of the currencies of US trading partners to perpetuate their trade advantage.

When those dollars were reinvested in dollar-denominated assets, it was America's turn to bubble. As central banks bought up US treasury bonds, they drove up their price and drove down their yields. However, there were not enough new Treasury bonds being issued to absorb the rest of the world's trade surplus earnings, so central banks bought Fannie and Freddie debt as well. That allowed those government-sponsored enterprises to acquire or guarantee more than half of all the mortgages in the country before they failed. Between unnaturally depressed interest rates and the buying spree by Fannie and Freddie, US property prices surged. The US housing bubble followed the ill-fated Nasdaq bubble. However, the inflation of the US housing market was one bubble too far. When it imploded, the global financial system was hurled into crisis, leaving the 21st century version of Anglo-American financial capitalism discredited.

The lesson that must be learnt from this disaster is that "free market" capitalism under a fiat money regime does not produce the same blessings (sustainable prosperity) that are produced by true free market capitalism within a monetary system anchored by gold. When President Nixon severed the link between the dollar and gold, he changed the nature of the Anglo-American economic model and ultimately destroyed it.

The world cannot return to a gold standard overnight without provoking a brutal contraction of credit and a global depression. However, neither can we afford to pretend that nothing has changed and that the global economy can continue to function on the dollar standard. The time has come to convene a forum of the world's leaders to hammer out and begin the transition to a new rule-based international monetary system predicated on sound money and balanced trade. Current Group of 20 efforts fall well short of what is required.

The writer is author of *The Dollar Crisis: Causes, Consequences, Cures*