

One word: Gold.

By Scott Silva

Editor, *The Gold Speculator*

5-16-11

“I want to say one word to you, Benjamin. Just one word: Gold.” If Mr. McGuire had given that advice to Benjamin Braddock (a.k.a The Graduate) in 1967, Benjamin might be much better off today. Instead, his advice to the young man was “Plastics.”

In 1967, the average price for gold was \$34.95/oz. Of course, gold prices were not allowed to float in the US until 1971, but if young Benjamin had invested \$4,000 in gold instead of that little red Alfa Romeo Duetto Spider convertible, he would have made a small fortune by now, roughly 42 times his money. A pristine '67 Alfa Romeo spider is selling for \$15,000 or so today.

Why has gold increased so in value? One word: Inflation. The purchasing power of the US Dollar has decreased steadily since 1967. It would take \$6.47 today to buy the same item that sold for \$1.00 forty-four years ago, a 647% increase in price. Benjamin's college tuition alone would cost over \$212,000 today. Certainly, there have been periods in US history when prices did not rise each year. In the last century, average annual prices fell in 1921, 1927, 1928, 1930-1933, 1938 and 1939. In 2009, average annual prices declined 0.4%, but since then prices have increased each year. According the Bureau of Labor Statistics, the US inflation rate is 2.1%, but this number is understated. Fuel prices are up more 27% from last year. Food prices are up by double digits year-over-year. Import prices are up 11% from last year. Producer prices are up, too. Housing prices remain depressed, but overall, prices for almost all other goods and services are higher now than a year ago, and the year before that.

Some say that high commodity prices cause inflation. Others attribute higher inflation to corporate greed. With gasoline prices at \$4.00/gal or more, the lynch mobs are out for Big Oil CEO's. At a Congressional hearing last week, a senator remarked that “unchecked corporate greed has given them \$30 Billion in profits last quarter”. But the US oil refiners are accounting for the higher cost of imported oil, which has been at \$98-114/bbl for the last five months. Today US consumers are still paying \$4.00/gal to fill their tanks. And they are likely to buy gas at \$5.00 or more before demand decreases due to price.

These arguments miss the point about the cause of inflation. Higher commodity prices and corporate greed are not the causes of inflation. Contrary to popular opinion, inflation is not about price increases for goods and services. Inflation is about increases in money supply. The general increase in prices comes only by the increase in money stock. The inflation we are seeing now at every level is in fact due to increases in money supply. This is the case now, and it has been the case for every period of inflation in history.

Aristotle defined the four properties of “good” money. Money must be durable, portable, divisible and have intrinsic value. Aristotle's definition has stood the test of time. For more than 2,000 years sound money has been proven to be a good medium of exchange as well as a store of value. The only time gold money lost its intrinsic value is when governments debased coins used

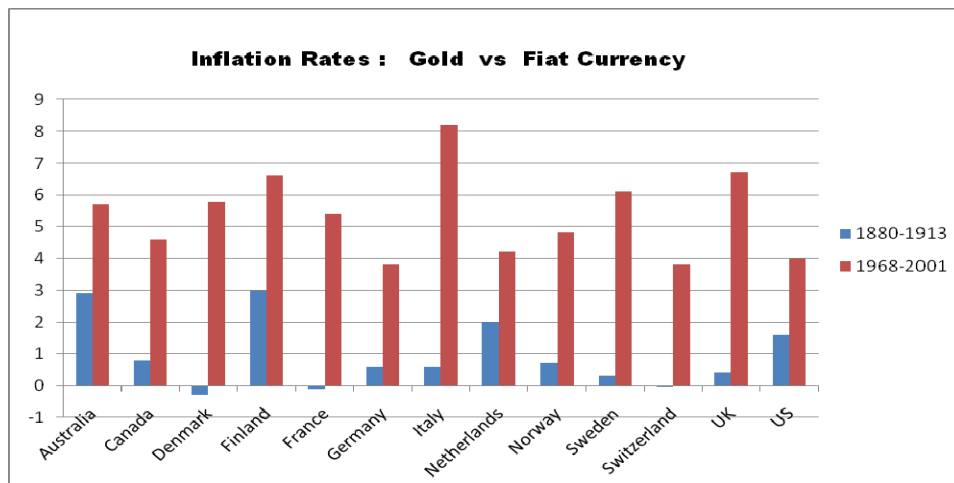
by the general public (reduced the gold content in a coin by substituting industrial metal at the same weight), while hoarding pure gold coins for themselves.

Fiat money has never been good money because it lacks intrinsic value. Governments debase fiat money by printing more of it. Increasing the money stock chases good money out in the same way Copernicus described in his 1519 treatise *Monetae cudendae ratio*: "bad (debased) coinage drives good (un-debased) coinage out of circulation." This concept has become known as Gresham's Law. These days, the Fed seems intent on codifying Gresham's Law. Since 2008 it has printed \$2.7 Trillion of the paper stuff to support various fiscal stimulus packages and bank and industry bailouts. More paper money chasing fewer goods and services causes prices to climb. Inflation is a tax on every consumer who buys with paper money.

An example of inflation brought on by the printing of fiat money occurred in the US Civil War era. During the war, both the federal and the confederate governments issued paper currency to finance war expenditures. The federal government issued \$450 million "Greenbacks." Inflation soared. Northern currency fluctuated in value, and at its lowest point, it took 2.59 inflated Greenbacks equaled \$1 in gold. The Confederate paper currency lost much more purchasing power; \$60-\$70 equaled a gold dollar.

At the end of the war, President Johnson authorized the Treasury to repay Federal war bonds with gold. This reduced the outstanding Greenbacks by 20 percent which propped up the value of Greenback dollars and drove down the Greenback price of goods. In the election of 1868, the Democratic presidential candidate Horatio Seymour repudiated the "Ohio Idea," which proposed that war debts be repaid with Greenbacks rather than gold. Predominantly western Democrats who first offered the fiat money financing idea became known as "Inflationists." Seymour lost the presidential election to Ulysses S. Grant 214 to 80. Inflationist policies financed other wars including WWI, Vietnam, Iraq, Afghanistan and now Libya (WWII and Korea were paid for primarily by tax increases).

Gold money leads to lower price inflation. Studies show that price inflation is lower under gold standard monetary regimes than in fiat money regimes. The classical gold standard prevailed in all the developed economies in the period from 1880 to 1914. Then, authorities maintained the value of national currency in terms of a fixed weight of gold, or the mint price. During this period, the mint price was set at \$20.67 per ounce of gold. Under the gold standard, the purchasing power of gold tends to equal the long-run cost of production.



We can see from the chart, from 1880-1913 inflation averaged about 3 percent annually in Australia and Finland, about 2 percent annually in the Netherlands, and slightly less in the United States. For the other nine countries, the average inflation rate was between plus and minus 1 percent for the period. Average inflation over 33 years of these 13 countries on the gold standard ranged from -0.6 to 3.0 percent.

Today's economies use fiat money and employ muscular monetary policy such as inflation targeting. Since the collapse of Bretton Woods, central banks have attempted to maintain low inflation and relative price stability. Clearly, these policies are failing. As the chart shows, the average inflation rate was much higher in the modern period (again for 33 years, from 1968 to 2001).

So what can the individual do today to protect his wealth against rising inflation? He can buy and own gold. Gold has maintained its intrinsic store of value against the ravages of inflation and debasement of fiat currencies for decades. Today's economic environment is characterized by unprecedented expansion of the money supply, which ensures prices will continue to rise for the foreseeable future.

The real price of everything...is the toil and trouble of acquiring it. The same real price is always of the same value; but on account of the variations in the value of gold and silver, the same nominal price is sometimes of very different values.

Adam Smith (1776)

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The question for you to consider is how are you going to protect yourself from the vagaries of the fiat money and growing inflation? We publish *The Gold Speculator* to help people make better decisions about their money. Our Model Conservative Portfolio gained 66.7% in 2010, and 55% for 1Q2011. Subscribe at our web site www.thegoldspeculatorllc.com with credit card or PayPal (\$300/yr) or by sending your check for \$290 (\$10 cash discount) The Gold Speculator, 614 Nashua St. #142 Milford, NH 03055