

## **Gold Stimulus**

By Scott Silva

Editor, *The Gold Speculator*

9-6-11

Gold is trading above \$1900/oz once again, pushed up by continuing financial turmoil in the Eurozone, weak US economic data and strong words from a voting member of the FOMC who reiterated his conviction that the Fed should continue its large scale monetary stimulus policies. Chicago Federal Reserve Bank president Charles Evans told a CNBC interviewer that “We need to do much more to increase the level of accommodation.” But Fed Chairman Bernanke did not announce a new policy at the annual Fed conference at Jackson Hole, Wyoming. In fact, the Chairman’s speech was underwhelming. The Fed is out of bullets, and Chairman Ben knows it.

Certainly, the Fed has very powerful monetary tools at its disposal. The Fed can set interest rates that banks charge each other for short term transactions, which influences the shape of the yield curve. Lower interest costs usually spur investment. The Fed can also provide liquidity to the general economy by buying US Treasury bonds and other long term fixed assets (Quantitative Easing). The Fed and most Keynesian economists believe Quantitative Easing can stimulate the economy in the same way Federal spending adds to aggregate demand. These monetarists believe that by adding Fed credit to member banks, more money becomes available to lend, demand deposits expand, along with economic activity. Since the financial meltdown of 2008, the Fed has maintained near-zero interest rates and added \$2.3 Trillion in monetary stimulus credit. Despite these massive stimulus measures, 2<sup>nd</sup> quarter US GDP growth has slowed to 1.0% (and 1<sup>st</sup> quarter GDP has been revised down to 0.4%) while the unemployment remains above 9%. Zero net new jobs were added in August.

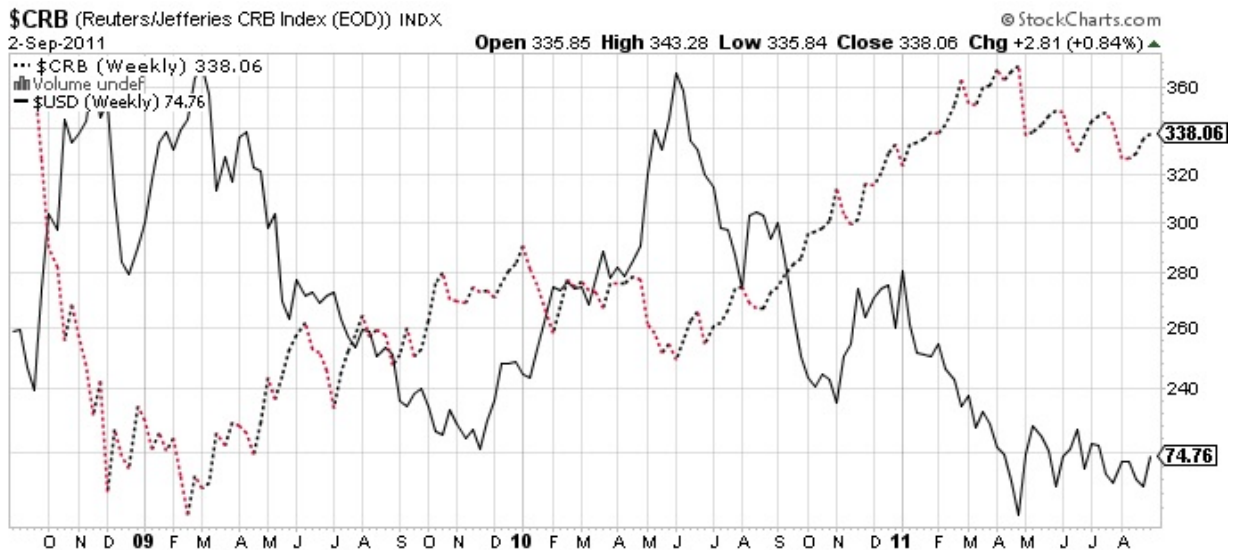
John Maynard Keynes attributed the deterioration of economic conditions despite muscular monetary stimulus measures to the “liquidity trap.” According to Keynes, this is the condition in which real interest rates cannot be reduced by any action of the central bank. The real interest rate cannot be reduced beyond the point at which the nominal interest rate falls to zero, however much the money supply is increased. The trap occurs when central planners are unable to promote investment by cutting real interest rates, even when rates are near-zero. Paul Krugman, the Princeton economist, believes that 70% of the world’s economies are in a liquidity trap.

We have seen this play out in recent history; the Fed should study what occurred in Japan. In 1991, the Bank of Japan hiked rates suddenly, bursting the speculative real estate and stock market bubble created by nearly twenty years of easy money. After asset values dropped by more than 60%, the Bank of Japan slashed rates to near-zero and implemented massive quantitative easing, setting up a classic liquidity trap. From 2001 to 2006 the Bank of Japan increased the monetary base by over 70 per cent. Japan’s economy ground to a halt and unemployment spiked. Stagflation took hold. The effects of the bubble's collapse lasted for more than a decade with stock prices bottoming in 2003. Japan’s “Lost Decade” is the direct result of central bank intervention and misguided monetary policy.

We know that increasing the money supply, in any interest rate environment, devalues currency in circulation. More money chasing the same assets drives prices up. Increased economic activity

combined with declining real output can produce hyperinflation, as we have seen in extreme cases such as Weimar Germany, Argentina and Zimbabwe. Conversely, contractions in the money stock push prices (and wages) down. In the 1930's the Fed reduced the money supply by 30% which deepened and extended the Great Depression.

To combat the current recession, the Fed has adopted a near-zero interest rate stance and injected trillions into the economy by purchasing US Treasury bonds and other fixed income securities, while extended unprecedented levels of Fed credit to member banks. Rather than turn the economy around, these measures have weakened the US Dollar and pushed prices up at the producer and the consumer levels. The CRB index, a broad measure of commodity prices climbed over 45% since the Fed made its first trillion dollar credit injection, then jumped another 35% after the Fed added \$600 Billion to the money supply through its second round of Quantitative Easing (QE2). Since QE2 took effect, the US Dollar has dropped nearly 16% in value.



Low interest rates usually help stocks. But equities have become quite volatile as nervous traders quickly sell on any hint of bad economic news, and rush in to buy on any whiff of positive data, hoping to have finally found the bottom. As of today, the Dow is down 4.59% year-to-date and the S&P 500 is down 8.33% year-to-date. Treasury yields are at record lows, which are pushing fixed income investors out to the long end of the yield curve. After inflation and taxes, this asset class is underwater, too.

Increasingly, investors have turned to gold in the safe-haven trade. Gold has gained 38% year-to-date and 52% over the last 12 months. While the US Dollar has declined, some analysts believe gold could become a shadow currency against which all other currencies are evaluated as the world monetary base expands. Central banks around the world have become net buyers of gold bullion. J P Morgan Chase is now accepting gold as collateral for client accounts. And retail investors are pouring into gold as the means to diversify their holdings and hedge against economic uncertainty. It wasn't long ago that \$1000/oz gold was considered unthinkable. Today \$2000/oz gold is within reach.



It is not likely that Washington will pivot abruptly away from its current economic azimuth. Wall Street is hoping for QE3, and it may get its wish. Gold and silver prices are telling us that the Fed will continue its near-zero interest regimen and will likely expand its bloated balance sheet in some novel and debilitating way, yet.

The simple truth is new government spending and more monetary expansion, even in the name of job creation, will not add permanent private sector jobs. More government spending only comes from higher taxes, more federal borrowing and the printing more paper money out of thin air. Every dollar of government spending comes out of the pockets of its citizens, which reduces economic activity. As we know from Proudhon, "Property is theft." If higher taxes don't ruin us all, inflation will.

So prudent investors must continue to act to defend their private property and protect their wealth. Investing in gold, the true sound money, is the way.

Investors from around the world benefit from timely market analysis on gold and silver and portfolio recommendations contained in *The Gold Speculator* investment newsletter, which is based on the principles of free markets, private property, sound money and Austrian School economics.

The question for you to consider is how are you going to protect yourself from the vagaries of the fiat money and economic uncertainty? 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](http://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