Certified Gold Exchange, Inc.

Views and Analysis on the Economy and Precious Metals

Special Report

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Why Invest in Gold Now?

Dr David Evans

Introduction

The reasons involve currencies, banking, and monetary history. These are complex areas, unfamiliar to most. Everyone knows how money works on an everyday level, but most people are surprised at the way the money system works at the high-finance level. The current money system has some systematic problems and is likely to undergo great stress in the next few years. This stress will effect the financial lives of everyone—many will lose, some will profit.

I've tried to present the case as simply and briefly as possible. Due to the inherent complexity of the topic, it's almost impossible to do it justice in a shorter piece. No special background or knowledge is required to understand what follows, just some time and an enquiring attitude.

Summary

Here are the fundamental reasons to invest in gold soon (in summary form):

1. Gold is more than just another commodity, it's a currency. It is THE currency that evolved in the marketplace over the last 5,000 years.
2. Gold and silver are the only currencies not created and controlled by governments. All of today's other currencies (dollars, euros, yen, pounds, renminbis, rupees, etc) are 'fiat' currencies, which means they do not represent anything tangible but are only worth something due to government decree (namely legal tender laws).
3. Governments always end up creating too much fiat currency out of thin air. All fiat currencies in the past have ended up worth very little, collapsing into hyperinflation or threatening to. All of today's fiat currencies have been fiat currencies for less than 34 years (all government currencies were convertible to gold until 1971).
4. The rate of creation of fiat currency accelerated markedly in 1995, leading to today's worldwide bubble in asset prices. In September 2003 the rate started to slow, suggesting that the bubble might end soon.
5. In the pain of the post-bubble period, governments will come under pressure to return to backing their currencies with gold.
6. Returning to currencies backed by gold is practical. Even the possibility that it might happen will cause the value of gold to rise considerably.
7. Today's fiat currencies are unfair. For example, because the US issues the world's reserve currency, the rest of the world sends the US real goods and services and just receives bits of paper or electronic bookkeeping entries in return—many ships travel to the US full of goods, but return half empty.
8. Governments and central banks have been suppressing the price of gold since 1995 by lending and selling their gold. They won't be able to keep it up forever. Then the price of gold and silver will soar.
9. The pressures of enormous debts will increasingly tempt the United States to inflate the US dollar so much that it will become almost worthless, in order that the debts can be easily repaid in near-worthless dollars. Gold will gain as the falling US dollar destroys trust in fiat currencies.
10. The finance industry and governments have promoted fiat currencies at the expense of gold in the public's mind for decades. From here, the investing public's attitude to gold can only become more positive.

Details

1. Gold is more than just another commodity, it's a currency. It is THE currency that evolved in the marketplace over the last 5,000 years.

Gold was the main currency in most of Europe, Asia and the Americas for most of the last few thousand years, up until 1971. Silver was also widely used, though to a lesser extent.

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Gold evolved independently as money in the world's main civilizations, because it is:

1. *Rare*
   About 5 parts per billion of the earth's crust. Difficult and expensive to mine.
2. *Indestructible*
   It does not tarnish or decay.
3. *Compact*
   If all the gold ever mined were made into a solid block whose base was the size of a football field, then it would be about 1.5 meters (5 feet) high.
4. *Malleable and divisible*
   You can easily reshape it, flatten it, and divide it into tiny pieces.
5. *Hard to find*
   The amount of mined gold has increased only slowly, rarely more than 2% per year.

Until 1971, government currencies were backed by gold. You could, at any time, exchange a unit of any of the world's main government currencies (such as a dollar, a yen, a pound, or a rupee) for a prescribed amount of gold. Currency notes were just certificates for various weights of gold. For example, from 1934 to 1971 you could exchange 35 US dollars for one ounce of gold.

Progressively from 1913 to 1971 governments withdrew the right to exchange government currency for gold. For example, from 1944 to 1971 a non-US currency unit (such as a yen or a pound) could only be exchanged for US dollars, and only national governments could go to the US government to exchange those US dollars for gold.

In 1971 President Nixon of the United States broke that nation's promise to always exchange 35 US dollars for an ounce of gold. Since then the world's government currencies have been 'fiat' currencies (see point 2 below)— they are not defined as a weight of gold, they have no connection to any commodity or anything tangible, and they are only worth what someone else is prepared to trade for them. The fiat currencies now 'float' against one another, with their relative values going up and down with economic trends or fashions.

The only significant use of gold today is for investment, that is, as a currency or a store of value. This includes jewelry—the fundamental purpose of gold jewelry is to store something valuable in your personal safekeeping. Gold has some non-investment uses such as in electronics, but the amount of gold used in these ways is relatively tiny. Almost all the gold ever mined is still in use today. Silver is different—the industrial uses of silver (photography, utensils, medicinal, electronics) outweigh its investment use, and much of the silver ever mined has been effectively lost because it is hard to recover.

2. Gold and silver are the only currencies not created and controlled by governments. All of today's other currencies (dollars, euros, yen, pounds, renminbis, rupees, etc) are 'fiat' currencies, which means they do not represent anything tangible but are only worth something due to government decree (namely legal tender laws).

All today's government currencies are 'fiat' currencies. A fiat currency is defined and created by a government. It is given meaning only by legal tender laws—national laws that say that the fiat currency has to be accepted as payment in that country, and thus force people to use the fiat currency.

The term 'fiat currency' came about because the legal tender laws that give it value are a 'fiat' (or authoritative pronouncement) of government. A fiat currency is a currency brought into existence by government decree (that is, by fiat).

The value of gold, on the other hand, is independent of any government laws. Unlike fiat currencies, gold is accepted as valuable without needing protection by laws.

3. Governments always end up creating too much fiat currency out of thin air. All fiat currencies in the past have ended up worth very little, collapsing into hyperinflation or threatening to. All of today's fiat currencies have been fiat currencies for less than 34 years (all government currencies were convertible to gold until 1971).

Fiat currency is created at the whim of politicians and bureaucrats. History's lesson on this point is clear: those in charge of a fiat currency always, eventually, due to some urgent government priority, create too much of the currency and it becomes worth less, and ultimately worthless.

As a government creates more of its fiat currency then there is an increasing amount of currency to pay for the same amount of goods and services, so the prices of the goods and services rises. The increase in the quantity of currency is called 'inflation', and the consequent rise in prices is measured to some degree by the CPI (consumer price index). The 'value' of a currency (how many goods and services a unit of the currency can buy) depends in the long run on how much the country's government inflates its currency.

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Gold, on the other hand, treats everyone equally. Unlike fiat currency, no one can conjure gold up out of thin air to spend for themselves and get others to do their bidding. Gold has to be mined, ounce by hard-won ounce. Because the supply of gold can only ever increase slowly, prices in terms of gold tend to stay roughly constant for centuries—changing mainly due to technological influences that make some goods relatively easier or harder to make.

There have been hundreds of fiat currencies in the past, in various countries at various times. In every single case, the currency eventually became worth much less and was abandoned because the people in charge of making it eventually succumbed to the temptation of making far too much of it.

Examples of fiat currencies include:

1. Chinese bark currency (notes printed on tree bark, as recorded by Marco Polo), 1260 – 1360. One of the earliest fiat currencies, ended in hyperinflation.
2. Banque Royale Notes in France, the 'Mississippi system' (designed by John Law). Issued in 1716. Collapsed worth nothing by 1720.
3. Continental bills, printed by the US Congress during the American Revolution. Began issue in 1775, shrank to 1/40 of their original value by 1780. Hence the saying 'not worth a Continental'.
4. Assignats in France during the French Revolution. Issued 1790–1796, collapsed to 1/600 of their original value by 1797.
5. Marks in Weimar Germany, after WWI. Issued from 1919 to 1924, collapsed to three trillionths of their original value. This was the currency that was carried in wheelbarrows towards the end.

The only fiat currencies that have not collapsed are today's fiat currencies (that is, none of the hundreds of previous fiat currencies ceased to be legal tender without first undergoing a massive loss of value). All of those currencies effectively became fiat currencies in 1971, when the United States abandoned its commitment to pay 35 US dollars for an ounce of gold (see reason 1, above). In the decades prior to 1971 there were no fiat currencies, because each currency unit was ultimately defined as a certain weight of gold.

In 1971 a US dollar was worth 1/35 of an ounce of gold. Today it is worth less than a tenth of that, about 1/400 of an ounce of gold (because gold is about US$400 per ounce). From an historical perspective, the only question is *how quickly* the US dollar loses value, not *whether* it will continue to lose value.

4. The rate of creation of fiat currency accelerated markedly in 1995, leading to today's worldwide bubble in asset prices. In September 2003 the rate started to slow, suggesting that the bubble might end soon.

The world's main currency and the currency used for most international transactions is the US dollar. Vast amounts of US dollars are used outside the United States. All countries hold the US dollar as their main reserve currency. The health of the world's economy depends on the US dollar.

In 1995 the number of US dollars started increasing quite markedly. The evidence is here in these monthly money supply statistics
http://www.economagic.com/em-cgi/data.exe/fedstl/m3ns+1
and graph
http://www.economagic.com/chartg/fedstl/m3ns.gif .
('M3 money supply' is about the best measure of the number of US dollars, albeit imperfect. NSA means 'non-seasonally adjusted'. It is the 'hidden' money supply increase, the M3 increase less the CPI, which is most relevant to bubble formation—because the extra money raises prices of items that are not well represented in the CPI, principally assets such as bonds, stocks, and housing. High M3 growth rates prior to 1990 were matched by similar CPI rates—they did not lead to bubbles because the rising prices were plainly visible in the CPI and monetary authorities were forced to take appropriate actions.)

In the early 1990's the money supply increased at about the CPI, just a few percent per year at most. But from 1995 to September 2003 the number of US dollars increased at about 8% per year, far faster than the combined rates of increase of goods and services and of the CPI. This extra currency flowed into buying assets, thereby pushing up asset prices. In a bubble, the principle supply-or-demand factor is the oversupply of currency. Similar increases in the amount of currency occurred in most of the world's fiat currencies, and a worldwide bubble in asset prices developed. As of early 2004, the prices of real estate, stocks, and bonds are all well above historical norms.

Starting in September 2003 the rate of increase in the number of US dollars has slowed to about 4% per year. A bubble requires rising asset prices to be maintained, because once a belief develops that asset prices are not rising then many people sell assets to repay the borrowed currency they used to buy those assets. Historically, bubbles usually end shortly after the flow of currency into the assets stops or reverses. The data thus suggests that the bubble may end in late 2004 or early 2005.

5. In the pain of the post-bubble period, governments will come under pressure to return to backing their currencies with gold.

This requires some understanding of the current fiat currency systems, and how the current bubble came about.

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How today's fiat currency systems work

In all the world's fiat currency systems, all currency is technically created by the act of borrowing. Currency is initially created by the government borrowing currency from its central bank (or 'reserve' bank), which the central bank creates out of thin air (the act of borrowing is inseparable from the act of creating the currency out of thin air, so we say the currency is 'created by borrowing'). All other currency is created by someone borrowing from a bank:

- About 90% of deposits made to a bank can be lent out by the bank. This system is called 'fractional reserve banking', because the bank retains a fraction of deposits as a reserve then lends out the rest.
- The depositors effectively still have their currency in the bank, while borrowers also have currency to spend. Hence, borrowing creates new currency.
- The borrowed currency generally ends up as a deposit in a bank, where 90% of it can be lent out again. And so on. In this manner, for each dollar that is deposited, $10 of loans are eventually created by the banking system.
- The system is safe enough as long as not too many bank depositors withdraw their currency at once.

By the way, 'printing' only creates physical notes or coins to be substituted as required for the currency created by borrowing—printing does not actually create the currency. Most currency exists as numbers in bank accounts.

Thus:

- All fiat currency is someone's debt. Someone out there is paying interest on every unit of fiat currency.
- A fiat currency is essentially a system of IOU's, a system of credit.
- Lower interest rates encourage borrowing and thus increase the rate of growth in the amount of currency (which causes some prices to increase).
- Higher interest rates discourage borrowing and thus decrease the rate of growth in the amount of currency (which causes some prices to decrease).
- The amount of currency owing on loans (the amounts borrowed plus interest) is *more* than the total amount of the fiat currency in existence (the amounts borrowed). So either the amount of fiat currency must continually increase, or there will be many failures to repay loans. A fiat currency system must expand to survive.

Governments, via their central banks, set short-term interest rates, essentially by decree. Due to fractional reserve banking, the amount of money expands or contracts in response. Consequently, we get the 'business cycle': More borrowing creates more currency, so prices start to rise, so the government increases interest rates, so borrowing decreases, which reduces the rate of growth in the amount of currency, so prices fall, so the government decreases interest rates, so more borrowing occurs, so more currency is created, … and so on. This is normal, but today's bubble is not like this.

The current bubble

The current bubble started in 1995 when the government of the United States and then some other countries lowered their interest rates and left them low. The amount of US dollars increased by 8% per year over 1995–2003, and the amount of the goods and services increased by about 3% each year, implying about a 5% per year increase in prices due to the extra currency. However, US CPI only increased at about 1% per year over this period, because:

1. The CPI only measures a narrow range of goods and services, many of which became cheaper in 1995–2003 because (a) their manufacture switched, for example, from the US to China, and (b) because the retail chain became more efficient (for example, Walmart).
2. The US government changed the methods used to calculate the CPI in about 1996, so as to reduce CPI increases. The most significant of these is 'hedonic' calculations for computers, which alone reduced the US CPI increases by at least 20% during 1997–2003. (The justification for hedonic calculations is to correct for qualitative improvements. For example, a 1,000 MHz computer bought in 2001 for $1,000 is considered to be ten times as much computer as a 100 MHz computer bought in 1997 for $1,000, so the CPI component for computers shows prices plummeting by 90% over the period. Of course, to buy a computer to write articles like this with still cost me $1,000, so the computer part of my cost of living stayed the same.) Another significant change is a system of simply lowering the weighting in the CPI of items whose prices are going up the quickest.

So which prices went up? The extra newly created currency was used to bid up asset prices, first stocks and bonds then real estate. Rising asset prices encouraged people to borrow to buy more assets, and that newly created currency further increased asset prices. A bubble developed. However, the central banks, particularly the US Federal Reserve under Alan Greenspan, did not raise interest rates to slow the rate of currency production. On the contrary, in response to various problems such as the Asian Crisis or the stock market fall of 2000, Greenspan acted to increase the number of US dollars.

As of early 2004, we now have the world's biggest ever bubble. Biggest by amount of assets (measured in any sensible way you like), biggest in scope (worldwide), and one of the most extreme (measured in terms of ratios such as debt to GDP or stock PE's).

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The bubble is built on debt: The currency brought into existence to bid up the asset prices is all debt. There are record amounts of debt in every sector of Western societies today; the ratio of debt to GDP in the West is substantially higher than it was in 1929. There is now so much debt that the central banks can no longer raise interest rates substantially without bankrupting much of the population. We are past the point of no return: the central banks can longer stop the bubble, they have to let it run its course. When no one has enough confidence or collateral to borrow any more currency then the bubble has to end, because asset prices cannot rise any further.

When the bubble bursts, asset prices will fall. Many people will find that their assets sell for less currency than they borrowed to buy those assets, and they won't be able to repay their debts. Fire sales of assets will lower asset prices further, making the problem worse and more widespread.

Where we are now

Governments are currently attempting to postpone the bursting of the bubble by creating more fiat currency. To date they have been successful: the bubble did not burst even in 2000 when stock markets fell severely, as evidenced by the growth rate of 9% that year in the number of US dollars (see the US money supply statistics in point 4). As the size and duration of the bubble grows, efforts to keep the bubble growing need to become more extreme—for example, worldwide interest rates are at record lows.

The problem for governments is to increase the amount of fiat currency fast enough to stop the bubble from busting, while maintaining people's confidence in its value. The principal mean of creating more fiat currency is to keep (both short and long term) interest rates low. The principal means of maintaining confidence is to promote the CPI as a measure of fiat currency unit purchasing power, while altering the CPI calculations so as to disguise the loss of purchasing power. Until 1990 or so the CPI measured the growth of money supply, but after that they have increasing diverged—the CPI now greatly underestimates the growth in fiat currency and thus its loss in purchasing power.

If the bubble bursts and the money supply growth rate goes negative then we will get deflation. There won't be enough currency in the economy to repay debts, and asset prices will fall. This is what happened in the Great Depression of the 1930's. The real economy suffered and unemployment was very high.

If government measures to create more fiat currency to keep the bubble going are too successful, or people lose confidence in the continuing value of the fiat currency because the CPI increases significantly, then we will tend to wards hyperinflation—as ever-increasing amounts of fiat currency are required. Most fiat currencies in the past have ended in hyperinflation. Hyperinflation destroys savings and jobs.

If governments can create enough but not too much new fiat currency, while maintaining people's belief in the continuing value of fiat currencies by increasing the CPI only slightly or slowly, then they will successfully have steered between deflation on one side and hyperinflation on the other. They have steered this course for the last few years, but it is becoming increasingly difficult. The bubble damages the real economy by misallocating resources, so unemployment creeps up. The CPI will creep up eventually due to the extra fiat currency and the dynamics of international trade. Simultaneous high unemployment and high CPI rises are a phenomenon known as 'stagflation', which we saw in the 1970's and which was ultimately cured by raising interest rates to over 15%. However due to today's high debt levels, such high interest rates are politically unacceptable—and make hyperinflation a more likely outcome than deflation.

Reforms to prevent a disastrous bubble from happening again

The economic pain, like the current bubble, will be huge. Many voters will have more debt than they can handle. This will lead to a huge political urge to do something.

Interest rates could be set by the market, not by bureaucrats. An historical lesson of the old Soviet Union is that its economy failed largely because bureaucrats could not set prices properly. In a market economy, a price is a mechanism that combines all the relevant information about the item into a single number. The price reflects all the factors of supply and demand, and rations the use of items to those willing to pay for them. The Soviet economy did not fail because its bureaucrats were stupid or lazy, but because it was just not humanly possible to know all the relevant information and to combine it properly to come up with a price that results in a good outcome for the economy. Without good pricing, people waste time and effort doing the wrong things. Markets, however, perform this function automatically and well, without bureaucratic interference, and have done for centuries.

The most important price in today's economies is the price of currency—the interest rate. High interest rates are a high price for new currency, and low interest rates mean new currency is cheap. In today's fiat currency systems, even in the western so-called 'market' economies, interest rates are decreed by a bureaucrat or politician. (Actually it is short term interest rates that are set by decree. Although long term interest rates are set by the bond market, they are heavily influenced by the central banks.) For example, in the United States the US Federal Reserve under Alan Greenspan sets interest rates. The current bubble developed because those in charge of setting interest rates set them too low for too long. The political advantages of low interest rates are compelling in the short term: an expanding economy, extra spending power for voters willing to borrow, and rising asset prices.

If we are going to persist with using fiat currencies, the most important and basic reform is to use a market mechanism to set interest rates. However, for various technical reasons (to do with synchronizing the interest rates charged by different banks and homogenizing the currencies issued by different banks into one currency) it is difficult to use a market mechanism to set interest rates in a fiat currency system.

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Modern central banks have been around since before 1700, and virtually every type of fiat currency experiment has been tried and rejected before. For example, Andrew Jackson won the US presidential election in 1832 on a platform of eliminating the third central bank of the United States (today's US Federal Reserve, which started in 1913, is the fourth central bank in the US—the previous three failed and were abandoned). There is nothing essentially new about today's system, except its worldwide reach. So, perhaps we should consider a return to the centuries-old practice of backing our currencies with gold.

It will take something of a crisis before we return to gold-backed currencies, because the finance industry and governments will resist it mightily. But the aftermath of the current bubble may provide enough of a crisis.

6. Returning to currencies backed by gold is practical. Even the possibility that it might happen will cause the value of gold to rise considerably.

All the world's government currencies were backed by gold in the decades to 1971: a unit of government currency theoretically represented a certain weight of gold, and under the right conditions could be exchanged on demand for that amount of gold.

We could return to that system. We would continue to use the current notes and coins, continue to use credit and debit cards, continue to order over the telephone or internet, and continue to use other electronic financial transactions. It is very unlikely we would ever use a gold coin for buying anything, just as we didn't use gold coins for decades before 1971.

The only difference would be that the notes and coins and amounts of currency would *represent* gold—and could, on demand, be exchanged for gold by banks or government. This would have consequences:

- All the world would be on one currency, gold. Currencies would no longer float against one another, so foreign currency exchanges, currency risk, currency hedging, and currency speculation would disappear (except perhaps for changing notes and coins at borders). A nation's industries would no longer risk losing their export markets because of fluctuations on the foreign exchange markets. The finance industry would lose a large source of easy income, but everyone else would benefit.
- Governments would not be able to create new currency at whim. They would have to repay their loans. Everyone else would benefit through lower inflation (inflation is a hidden tax that acts by eroding the value of any currency we have).
- The amount of currency could no longer expand faster than about 2% per year (see reason 1), so inflation would be very low, bubbles would be much less likely to occur, and economy-wide bubbles could not occur. Prices throughout the economy would be more stable than under the current system.
- Interest rates could be set by market forces, as they were until WWI. The financial history of the decades prior to WWI strongly suggests that interest rates would be more stable than the last few decades.

If the world returned to gold-backed currencies, the value of gold would rise. If the US were to back its current number of dollars (about US$9 trillion) with its current gold reserves (about 8,150 tonnes), the price of gold would be about US$34,000 per ounce! This figure is only a rough indication, because the US government might not fully back each dollar, or the amount of US dollars or US gold might change between now and a return to the gold standard.

Even if the world doesn't return to gold-backed currencies, the possibility that some or all countries might return to the gold standard will send gold prices much higher as the bubble ends. In 1980 the slight prospect of a return to the gold standard (which did not eventuate then) caused the gold price to rise to about US$880 per ounce, which is equivalent to about US$3,400 per ounce in today's dollars.

Don't confuse value with price in US dollars. Today an ounce of gold buys about 150 Big Macs in the US. In the event that the price of gold goes to US$20,000 per ounce (a fifty-fold increase), it may be that an ounce of gold only buys 750 Big Macs (a five-fold increase).

7. Today's fiat currencies are unfair. For example, because the US issues the world's reserve currency, the rest of the world sends the US real goods and services and just receives bits of paper or electronic bookkeeping entries in return—many ships travel to the US full of goods, but return half empty.

Most of us have to exchange our labor to get currency, and gold miners have to go to a lot of effort to mine gold. But some people in the economy (namely the government and the central bank) have the privilege to create currency out of thin air, effortlessly, thereby acquiring much power. Is that fair or desirable?

Newly created money buys things at the price levels that exist when the money is created and spent. But that extra money raises the general price level, so the currency saved by others loses value—things are more expensive when they later go and spend their money. So fiat currencies favor borrowing at the expense of saving. It is no coincidence that every sector of western societies is at record debt levels as of early 2004. How fair or wise is a system that favors debt over saving?

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The United States manufactures the world's reserve currency, the US dollar. Governments of countries all around the world hold vast numbers of US dollars as currency reserves, needed for international trade. To get those US dollars, those countries had to send real goods and services to the United States, and the United States sent them US dollars in the form of electronic bookkeeping entries or bits of paper (notes and bonds). So the United States gets massive amounts of goods and services in return for a few pieces of paper or electronic bookkeeping entries—just because the US dollar is the world currency. Currently many ships are arriving at the US loaded full of goods, but return from the US half empty or with low-value back-fill loads. Is it a coincidence that the United States is the world's richest country and can afford the world's biggest military forces? Is that fair or right?

People or countries that feel these aspects of the fiat currency system are unfair will welcome (indeed, insist upon) a return to the gold standard. Moves in this direction have already been made recently by Malaysia.

8. **Governments and central banks have been suppressing the price of gold since 1995 by lending and selling their gold. They won't be able to keep it up forever. Then the price of gold and silver will soar.**

Governments and central banks routinely intervene in currency markets. They generally don't acknowledge that they are manipulating the market while they are doing it, because that would dilute the effect of the intervention. However they usually acknowledge their interventions after the fact—it's not a secret, and is considered normal by everyone connected with currency markets. Gold and silver are currencies, albeit private currencies. Governments and central banks have routinely intervened in the gold and silver markets in the past, so it is reasonable to assume they might be doing so now. They don't directly and comprehensively deny it.

Governments benefit from the use of their fiat currencies. All the government currencies are thus in competition with gold and silver. Governments have an interest in promoting fiat currencies against gold and silver—that is, an interest in lowering the prices of gold and silver. The competition between gold and the US dollar is particularly intense, because the United States gains great advantage by the use of the US dollar as the world's reserve currency (see reason 7 above).

Thus governments, particularly the US Government, have the means, the motivation, and a track record of suppressing the price of gold and silver. It would be standard practice for them to suppress the price of gold and silver but not acknowledge it.

In 1995, governments, through their central banks, owned about 25% of the world's mined gold, about 32,000 tonnes. There is a lot of evidence to suggest (for example, see http://gata.org/) that the central banks have been lending their gold to bullion banks on long-term leases, who then sold the gold on the open market, which lowered the price of gold. The IMF even changed its rules for reporting central bank gold holdings in about 1997 so that the central banks no longer had to distinguish between how much gold they physically have and how much they have lent out—they just report both categories combined as how much they 'own'. This word game allows the central banks to hide the extent of their gold lending. For example Australia reports that it 'owns' about 79.9 tonnes of gold, but there are only a few bars of gold left in the Australian central bank because nearly all of it has been lent out.

The gold lent out by central banks has been sold at the retail level, largely in India. The bullion banks who owe the gold to the central banks will have to buy the gold on the open market when it comes time to repay the gold. Either this will force the price of gold up or, because they don't want the price of gold to soar, the central banks will allow the lenders to repay in fiat currency rather than in gold. The lent gold will probably not be recovered from the individuals in India etc. who now wear it as jewelry. Thus much of the gold lent out by central banks will probably never be repaid as gold. Official sales of central bank gold nowadays are often just a matter of the bank receiving fiat currency for gold that they previously lent out.

The amount of gold lent out by the central banks since 1995 is hard to estimate without official figures (of which there are few), but is probably about 15,000 tonnes, or about half of the gold that the central banks say they now 'own'. Spread over the nine years 1995–2004, that's about 1,700 tonnes per year. Annual 'consumption' of gold per year is only about 4,700 tonnes per year (the gold is mainly used in jewelry, but very little of it is actually lost forever from circulation), and the annual production of gold from mining and scrap is about 3,400 tonnes per year. So the surreptitious sale of 1,700 tonnes per year due to central bank lending would have had a large downward effect on the price of gold in that period.

For various reasons nearly all the remaining gold in the central banks simply cannot be lent out. There are indications that the central banks are already scraping the bottom of the barrel. As the central banks run out of physical gold to sell, the market price of gold will rise. The gold price rises of the last year suggests that this has already started.

It appears that the Western governments have effectively being selling their gold reserves at artificially low prices to people in Asia, particularly India, in order to promote their fiat currencies at the expense of gold. If the West is forced by the failure of its fiat currencies to return to gold-backed currencies, it may have to offer a lot to the gold owners in Asia to get that gold back again—that is, the value of gold will rise considerably.

9. **The pressures of enormous debts will increasingly tempt the United States to inflate the US dollar so much that it will become almost worthless, in order that the debts can be easily repaid in near-worthless dollars. Gold will gain as the falling US dollar destroys trust in fiat currencies.**

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Many people and organizations in the United States are deeply in debt.

The net present value of the unfunded liabilities of the US Government is US$44 trillion, which is the value of everything produced in the world for about a year and half, or about four times the yearly GDP of the United States. To pay these liabilities, the US government would have to raise income taxes by 69% indefinitely, or cut all Social Security and Medicare benefits by 56% indefinitely. In addition, the debt of the US Government is about US$7 trillion, increasing by about half a trillion each year. The current account deficit of the US is another half a trillion per year. Or, per person in the United States: US$150,000 of unfunded liabilities, $25,000 of federal debt, and $1,700 of extra federal debt and $1,700 of current account deficit per year. And there are state debts too. In addition, the ratio of private debt to GDP is at a record high, even higher than in 1929.

But the United States has an ace up its sleeve: nearly all that debt is denominated in US dollars. If the meaning of a 'US dollar' were to change to something worth very little, then most of that debt could be painlessly repaid (but not all of the debt—many of the unfunded liabilities of the US government are tied to the cost of living, so they not could be escaped so easily). That is, because much of those debts are in terms of nominal US dollars, if the US dollar became worth very little then much of the debts could be easily repaid. For example, if you borrow US$100,000 in 2003 when you are earning US$40,000 per year, you have a large debt. But if the US dollar inflates 100-fold by 2013 your income might be around US$4,000,000 per year, and repaying that US$100,000 will be easy. (However US$100,000 in 2003 would buy 37,000 Big Macs, but only 370 Big Macs in 2013.)

At the moment, the United States gains greatly by having a US dollar that is worth a lot and is used as the world's reserve currency—because the United States exchanges a few bits of paper for massive amounts of real goods and services (reason 8). But the debt being incurred by US voters is huge and growing quickly. Eventually the gain from supplying the world's reserve currency will be outweighed by the pain of the interest and repayments on the debts. At some point in the future, the only rational course for the United States will be to cause its dollar to be worth as little as possible.

The way for the United States to make its currency unit worth very little is to inflate it dramatically, that is, to increase the number of US dollars enormously. It would start down this path by reducing interest rates towards zero, to encourage as much borrowing and thus currency creation as possible. A next step would be for the government to create new money out of thin air to pay some of its bills. Both of these trends are already underway.

Repayment of those debts would be in name only, a technicality, because the value of the repayment as measured in say gold or Big Macs would be tiny compared to the original value of those debts. The lenders would feel ripped off. Only the United States has this option, because it provides the world's reserve currency. If the US Government can bring this off, it will be the world's biggest ever financial scam by several orders of magnitude. The next few years might be, as the Chinese say, 'interesting'.

The effect on commerce of this maneuver would be to scare people off fiat currencies for decades. No one would write a future contract in terms of a fiat currency. Only tangibles would be accepted, preferably gold. The world would return to a full classical gold standard very quickly. The value of gold would rise as dramatically as the value of the US dollar would fall.

10. **The finance industry and governments have promoted fiat currencies at the expense of gold in the public's mind for decades. From here, the investing public's attitude to gold can only become more positive.**

Gold and silver have been in competition with the fiat currencies (especially the US dollar) since 1971, and to a lesser extent since 1913. There is a great deal of power at stake. They say that "all's fair in love and war", but perhaps they should amend that to "all's fair in love, war, and high finance".

The finance industry and, to a lesser extent, governments would be the losers in a return to gold-backed currencies. The rest of us would be winners. With some of their power at stake, you might suspect that those in the finance industry and government would exaggerate, obscure, or deceive when it comes to gold and currencies.

Dr. David Evans
www.citigold.com

Certified Gold Exchange, Inc.
7010 Phoenix N.E., Suite 409
Albuquerque, NM 87110
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