GOLDCORE

CURRENCY WARS: BYE, BYE PETRODOLLAR - BUY, BUY GOLD

Chris Sanders

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Preface

Currency wars are probably one of the greatest risks posed to the wealth of nations today.

In September 2010, Guido Mantega, Brazil's finance minister, warned that an "international currency war" had broken out, as governments around the globe peg their currencies and devalue their currencies against each other. His comments were echoed by senior Russian and Chinese officials.

The G20 said last week that there would be no currency wars and some central bankers such as the ECB's Mario Draghi have recently dismissed talk of "currency wars" as excessive. Sir Humphrey, the wily civil servant in 'Yes Prime Minister', always stressed how important it was “to never believe anything until it is officially denied.”

Currency wars are set to deepen as most industrial nations in the western world are close to insolvent and look on the verge of recessions – potentially deep ones.

The fiscal situation of the U.S., the largest economy in the world, is appalling with the national debt having increased from $5.7 trillion in 2000 to over $16.5 trillion today. Besides the U.S. national debt of over $16.5 trillion, the U.S. has off balance sheet debt or unfunded liabilities of between $70 trillion and $100 trillion. The U.S. will never be able to pay these debts back and so will attempt to inflate them away through currency devaluation. This poses risks to the global reserve currency status of the dollar - especially as the world moves to a multi polar world where India, Russia, Brazil and China exert their increasing economic and political power.

This is why it is important to consider the energy money nexus and to look holistically at the world of energy and money as Chris Sanders has done in this interesting insight. Currency wars and the threats posed to the U.S. dollar as the global reserve currency of the world, make owning physical gold essential to all who wish to preserve wealth in the coming years.

We do not endorse the opinions of guest contributors but where we find an argument interesting and potentially valuable to our clients and the public in helping to protect and grow wealth, we share it.

Mark O’Byrne

Head of Research

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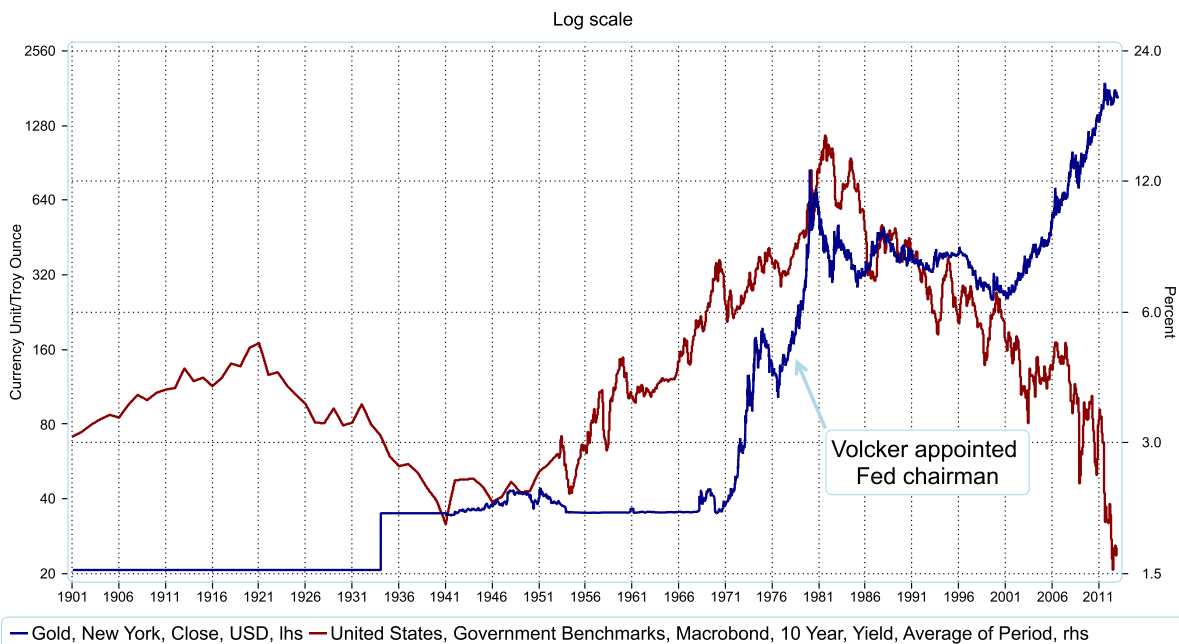
Gold in the Crossfire of the Global Currency War

Since the United States ended the US dollar's gold convertibility in 1971 the world financial system has lacked a universal numéraire, or basis of value. Theretofore since the end of the Second World War, nations could accumulate reserves in US dollars, confident that the dollar's value in terms of gold was fixed. Thereafter this was not possible. Currencies could be exchanged for one another, but it has basically been a free for all in the foreign exchange markets umpired by central banks. Having persisted now for two generations, floating exchange rates have developed an air of permanence in spite of periodic – dare I say frequent – crises and associated volatility and uncertainty.

The US dollar is still the world's principal store of value and represents the largest component in official foreign exchange reserves. This proportion is declining. From 44% of official world FX reserves in 1995 it has declined to 34% due to the accumulation of euros, the proportion of which has risen from nil before 1999 to 14% of world reserves today.[1]

The dollar's key role has put paid to the predictions of financial catastrophe theorists of that earlier generation. The spectacular rise of gold and silver in the 70s and early 80s was just as spectacularly shot down by the decisive monetary policy of the Volcker Fed, laying the groundwork for a thirty year decline in interest rates.



[1] Source: IMF COFER database

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Consider that in 1981 when that generation's bull market in gold was peaking, you could buy a ten year US government note yielding 12.5%, which meant you doubled your money in six years just clipping your coupons. With gold on the other hand you had to pay storage and you collected no income unless you could lease it. No one, not even the gold bulls, expected that the US government would default. As the yanks say, it was a no-brainer. Perhaps never before in history have so many made so much money with so little effort as did bond investors in the 1980s.

As for the dollar, it responded to the Volcker interest rate rises by rallying off its 1970s lows as if it were once again convertible to gold. While interest rates were surely important in making the dollar attractive, the fact that most of the world's trade in petroleum was denominated in dollars certainly helped. In case anyone had other ideas, the US military busied itself from the mid-70s garrisoning the Persian Gulf and building a string of bases to protect Saudi Arabia.

The US was the gatekeeper, its currency was the medium of exchange, and everyone needed oil. It helped too that all the new sources of oil coming on stream at the time were in the western hemisphere and solidly in NATO's sphere: Prudhoe Bay, offshore Gulf of Mexico and the North Sea. For the dollar it was bye-bye gold, hello oil. Enter the Petrodollar Standard.

The Soviet Union, the world's other oil superpower, found itself embroiled in a no-win war in Afghanistan, making it unlikely to cause too much trouble for the US and NATO anywhere else. Just to make sure things stayed that way the boffins at the CIA managed to supply the Soviets industrial process management software that, amongst other things, the Soviets used to manage the flow of oil

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in its pipelines. This resulted in one of the most spectacular coups of the inaptly named Cold War, the destruction in 1982 of one such pipeline in one of the largest industrial accidents in history to that time.[2] The coup de grace for the Soviets was the collapse in the price of oil along with that of gold as dollar interest rates soared. Soviet oil revenues collapsed and so did the Soviet Union.

How times change. The Prudhoe Bay, Gulf of Mexico and North Sea oil provinces are all well past their peak production and total world conventional oil production peaked in 2005. Tight oil and gas in shale notwithstanding, the US and its NATO allies are farther from energy independence than ever. Russia is now producing almost as much oil as it did in the late 1980s. Russia now has a pipeline from Siberia to the Sea of Japan with a spur to China, and is busy building a gas pipeline to accompany the oil pipeline. It has completed the two gas lines of its Nordstream project carrying natural gas to Germany from Russia across the Baltic, and plans are in place to extend this across northern Europe and the North Sea to Britain. It has plans to build a South Stream pipeline across the Black Sea to Southern Europe. The West's Nabucco project, intended to carry Azeri and Iraqi gas to Europe, remains dead in the water primarily because there isn't enough gas to fill it without supplies from Iran.

Western banks, which profited and grew fat from the thirty-year bull market in bonds and the associated growth in credit, have proven to everyone but themselves not that they are too big to fail, because fail they have, but rather that their governments are too supine to allow them to do so and consequently are themselves failing.

In the course of this evolution of failure, the opportunity to restructure the western financial system afforded by the Panic of 2008 has been lost while the national treasures of the United States and Europe have been devoted to propping them up so that they can become even more "too big to fail." This ensures that the Panic of 2008 will have been nothing but a dry run for the Panic of 20?? which could arrive at any time.

In the background world energy shortages are growing as more and more energy has to be devoted to producing net energy, meaning that world net energy production is falling. This is because of the difficulty of producing energy at the margin. This is well illustrated by the concept of the net energy sink, a concept illustrated first by analyst Euan Mearns and developed by Charles Hall and David Murphy. As marginal production moves to different technologies, degrees of difficulty and so on, the marginal net energy, or EROI – energy return on (energy) investment – delivered falls exponentially. This makes an already questionable but aptly dubbed monetary policy of QE4EVA even more problematic than it already is, for it ensures that there will be no real growth to validate the exponential increase in debt that is being issued.

[2] See the Wiki article: http://en.wikipedia.org/wiki/Siberian_pipeline_sabotage

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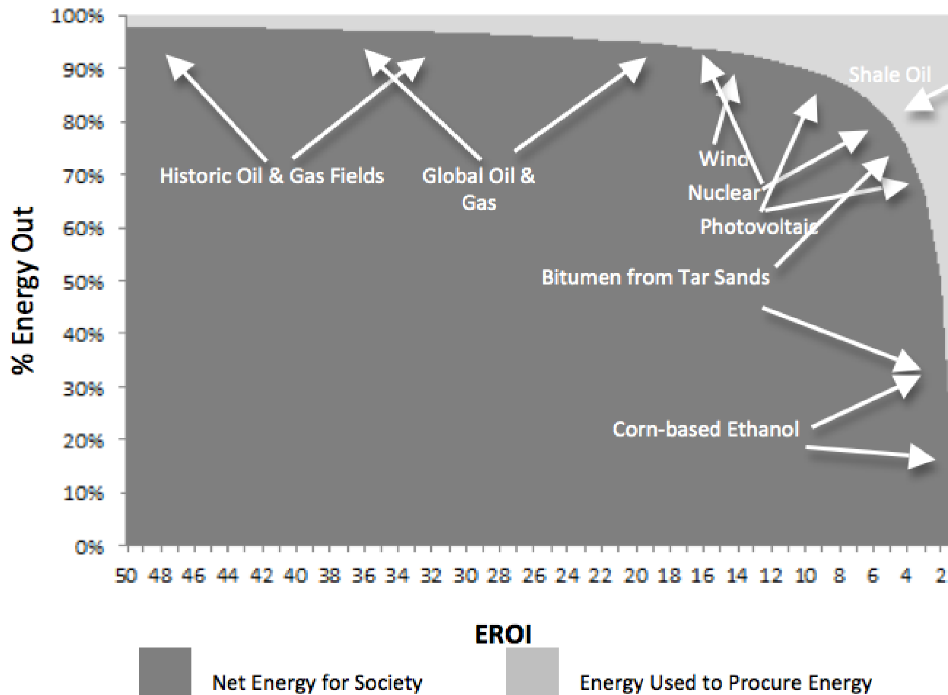

Source: Sanders Research Associates Limited, modified from Hall and Murphy, Mearns

Quantitative easing can have no purpose other than to ignite inflation, and indeed it appears to be doing so while government statisticians in the US claim otherwise by endowing goods such as the shirts on our backs with magical quality improvements from year to year, and the august economics department at MIT "proves" there is no inflation with their highly questionable "Billion Prices Project."

Those of us old enough to have worked throughout the era discussed in this article and old fashioned enough to have a preference for data series with inter-temporal comparability prefer the approach used by economist John Williamson of shadowstats.com who simply calculates inflation the way it used to be calculated before the calculation was "improved." That number has been diverging since the late 1980s from official US CPI, a fact that will surprise no one who actually does their own shopping and notes higher prices, poorer quality, and under filled containers.

For my part, I think it instructive to compare charts of the nominal price of oil denominated in paper dollars with the price of oil in real money, i.e. gold. In real money the price has been remarkably stable for more than a century, with a gentle trend upward, exactly what one would expect as the *energetic cost* of producing it rises with the decline of the easy to produce, first-found provinces.

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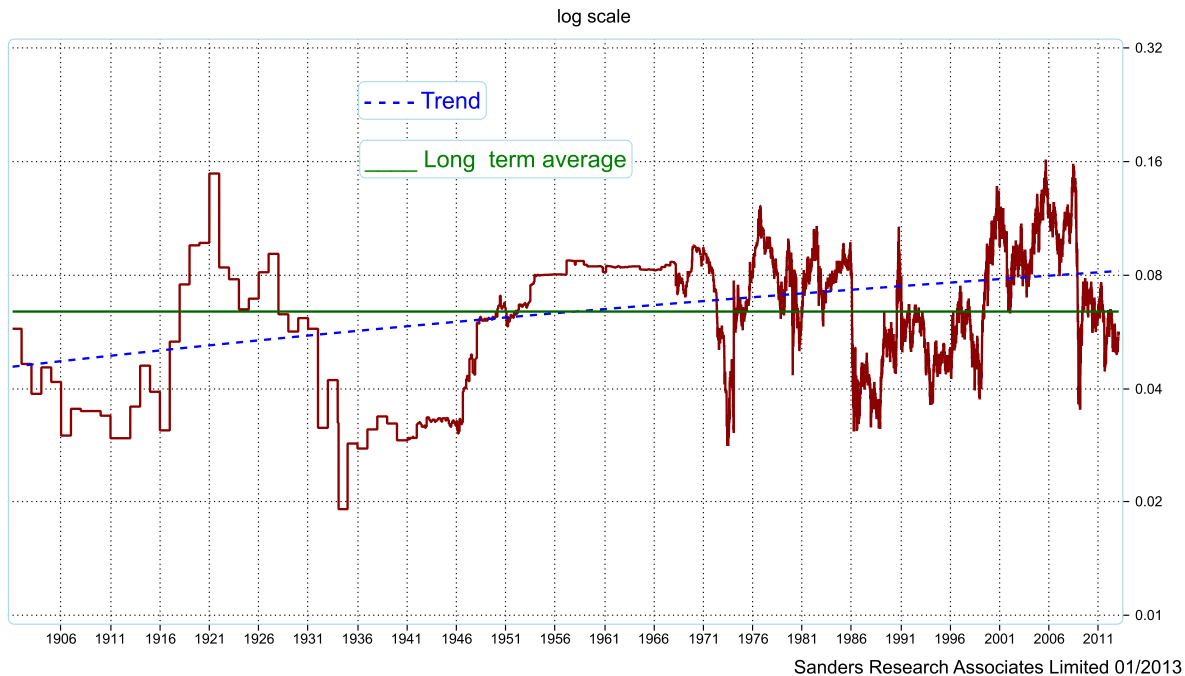

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Enter China

It has only been during the last fifteen to twenty years that China has figured in this story. Its transformation has been remarkably rapid in that period, accumulating more than 30% of the world's foreign exchange reserves in the period. While China's reserve composition is a state secret, it is safe to say that in spite of an on-going program of diversification, the lion's share of its foreign exchange reserves is still held in dollars.

From a Chinese perspective, this is a problem on the one hand because so much of their reserves are lent back to the US in the form of purchases of US bonds. On the other hand, it carries with it some advantages, not least of which is that they have plenty of dollars with which to purchase oil. This is good, because they are already mopping up 10% of total world oil exports, having started near zero not much more than ten years ago.

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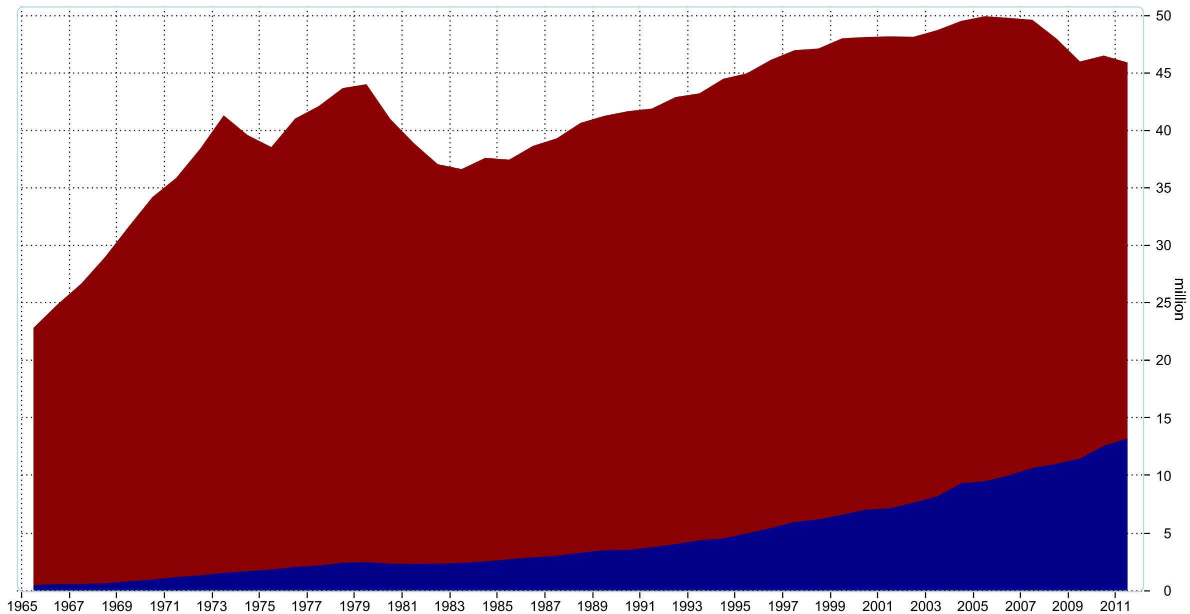
10% may not sound like a lot, but China's oil imports as a proportion of world oil exports is increasing exponentially. True, this is happening off a low base, but exponential growth has a way of starting small and ending big. This is not remotely sustainable, given that other large countries such as India, not to mention the United States, are also dependent on imported oil. Then there are the oil exporting states themselves, whose domestic demand is rising while their ability to continue raising production is constrained. One by one they too are becoming net importers. China itself is an example, as is the UK.



Neatly illustrating the global divergence in strategic interests is the fact that OECD (read NATO) oil consumption is falling, "financing" increased consumption by China and India. Now how long can that last?

Currency War?

With energy costs rising globally and energy output remaining flat it is no wonder that the political class is having trouble managing the division of an economic pie that is getting smaller.

No wonder too that currency debasement is one of the policies of choice if for no other reason than that it is easier than inventing a perpetual motion machine. The fed, the ECB and the BoJ are all locked into QE, which has gone on so long that even a modest rise in interest rates could not be serviced except by issuing yet more debt.

No wonder the recent G20 communique regarding currency wars was greeted with skepticism.

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QE makes the positions of countries such as China, India and Brazil problematic, because it forces them to buy dollars, euros and yen to stabilize their own currencies and in the process results in unwanted yuan, rupees and reals flooding their domestic economies. It is not surprising that under the circumstances demand for gold worldwide has been so robust in recent years.It is also no wonder that Russia has been calling periodically for new currency arrangements that include some sort of gold backing for currency. This of course would suit Russia just fine, since it has comparatively abundant oil and natural gas, as well as a lot of gold. China too would no doubt welcome an arrangement that enhanced the stability of its reserves, and its own gold purchases represent a step in that direction, as does the growing list of bilateral trade deals it has entered into.

In this context, it is especially interesting that on the 16th of January, Germany's Bundesbank announced the repatriation of all German gold reserves held in France and 300 tonnes of that held with the Federal Reserve. Germany's action is noteworthy, all the more so because for some time it has publicly derided the idea of gold reserve repatriation.

As noteworthy as Germany's decision to repatriate gold is, the news that it will take the Fed seven years to make good the delivery is even more so. This is good news for no one but the Fed, which has made sure that there is plenty of time for the movers to have coffee breaks. Given today's febrile global political and economic environment, it will do nothing to enhance "stability" or "credibility." Indeed, the likelihood is the opposite, especially in Europe, where we can be sure to hear demands from other quarters besides the German public for a full accounting and repatriation of national gold reserves.

American consultant James Rickards, in his very useful book *Currency Wars*, posits a scenario in which the US authorities confiscate all gold – private and government – held within the borders of the United States as part of a package of financial controls to shore up the US dollar and economy. I cannot comment on the probability of such an eventuality apart from observing that it would not be unprecedented. What one can say is that given Rickards's ties to the intelligence and military establishments, one can assume that it has been discussed at length in those circles.

One might even construe it as a warning. Whether it is or not, there is little doubt that uncertainty about the global economic outlook and outcomes is rising. In such times, investors are best advised to prioritize wealth preservation. Consider the following chart:

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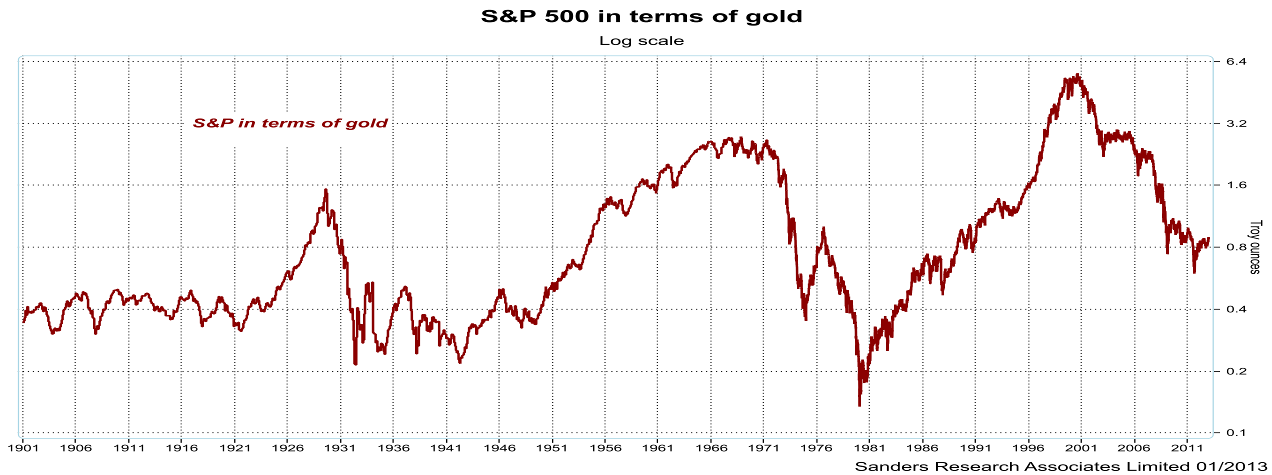

It is plain from the above that all the monetary easing in the world did not preserve value in stocks. Nor, by historical comparison, does there appear to be much reason to think that it will do so over the course of the next ten or fifteen years.

Over the past decade, only one class of asset, precious metals, has offered security. But it is clear that having title is not enough, as the Bundesbank is tacitly admitting: don't take IOUs.

Buy bullion, and store it.

Chris Sanders

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About GoldCore Insight

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