

HON. RON PAUL OF TEXAS Before the U.S. House of Representatives April 25, 2006 What the Price of Gold is Telling Us

The financial press, and even the network news shows, have begun reporting the price of gold regularly. For twenty years, between 1980 and 2000, the price of gold was rarely mentioned. There was little interest, and the price was either falling or remaining steady.

Since 2001 however, interest in gold has soared along with its price. With the price now over \$600 an ounce, a lot more people are becoming interested in gold as an investment and an economic indicator. Much can be learned by understanding what the rising dollar price of gold means.

The rise in gold prices from \$250 per ounce in 2001 to over \$600 today has drawn investors and speculators into the precious metals market. Though many already have made handsome profits, buying gold per se should not be touted as a good investment. After all, gold earns no interest and its quality never changes. It's static, and does not grow as sound investments should.

It's more accurate to say that one might invest in a gold or silver mining company, where management, labor costs, and the nature of new discoveries all play a vital role in determining the quality of the investment and the profits made.

Buying gold and holding it is somewhat analogous to converting one's savings into one hundred dollar bills and hiding them under the mattress-- yet not exactly the same. Both gold and dollars are considered money, and holding money does not qualify as an investment. There's a big difference between the two however, since by holding paper money one loses purchasing power. The purchasing power of commodity money, i.e. gold, however, goes up if the government devalues the circulating fiat currency.

Holding gold is protection or insurance against government's proclivity to debase its currency. The purchasing power of gold goes up not because it's a so-called good investment; it goes up in value only because the paper currency goes down in value. In our current situation, that means the dollar.

One of the characteristics of commodity money-- one that originated naturally in the marketplace-- is that it must serve as a store of value. Gold and silver meet that test-- paper does not. Because of this profound difference, the incentive and wisdom of holding emergency funds in the form of gold becomes attractive when the official currency is being devalued. It's more attractive than trying to save wealth in the form of a fiat currency, even when earning some nominal interest. The lack of earned interest on gold is not a problem once people realize the purchasing power of their currency is declining faster than the interest rates they might earn. The purchasing power of gold can rise even faster than increases in the cost of living.

The point is that most who buy gold do so to protect against a depreciating currency rather than as an investment in the classical sense. Americans understand this less than citizens of other countries; some nations have suffered from severe monetary inflation that literally led to the destruction of their national currency. Though our inflation-- i.e. the depreciation of the U.S. dollar-- has been insidious, average Americans are unaware of how this occurs. For instance, few Americans know nor seem concerned that the 1913 pre-Federal Reserve dollar is now worth only four cents. Officially, our central bankers and our politicians express no fear that the course on which we are set is fraught with great danger to our economy and our political system. The belief that money created out of thin air can work economic miracles, if only properly "managed," is pervasive in D.C.

In many ways we shouldn't be surprised about this trust in such an unsound system. For at least four generations our government-run universities have systematically preached a monetary doctrine justifying the so-called wisdom of paper money over the "foolishness" of sound money. Not only that, paper money has worked surprisingly well in the past 35 years-- the years the world has accepted pure paper money as currency. Alan Greenspan bragged that central bankers in these several decades have gained the knowledge necessary to make paper money respond as if it were gold. This removes the problem of obtaining gold to back currency, and hence frees politicians from the rigid discipline a gold standard imposes.

Many central bankers in the last 15 years became so confident they had achieved this milestone that they sold off large hoards of their gold reserves. At other times they tried to prove that paper works better than gold by artificially propping up the dollar by suppressing market gold prices. This recent deception failed just as it did in the 1960s, when our

government tried to hold gold artificially low at \$35 an ounce. But since they could not truly repeal the economic laws regarding money, just as many central bankers sold, others bought. It's fascinating that the European central banks sold gold while Asian central banks bought it over the last several years.

Since gold has proven to be the real money of the ages, we see once again a shift in wealth from the West to the East, just as we saw a loss of our industrial base in the same direction. Though Treasury officials deny any U.S. sales or loans of our official gold holdings, no audits are permitted so no one can be certain.

The special nature of the dollar as the reserve currency of the world has allowed this game to last longer than it would have otherwise. But the fact that gold has gone from \$252 per ounce to over \$600 means there is concern about the future of the dollar. The higher the price for gold, the greater the concern for the dollar. Instead of dwelling on the dollar price of gold, we should be talking about the depreciation of the dollar. In 1934 a dollar was worth 1/20th of an ounce of gold; \$20 bought an ounce of gold. Today a dollar is worth 1/600

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of an ounce of gold, meaning it takes \$600 to buy one ounce of gold.

The number of dollars created by the Federal Reserve, and through the fractional reserve banking system, is crucial in determining how the market assesses the relationship of the dollar and gold. Though there's a strong correlation, it's not instantaneous or perfectly predictable. There are many variables to consider, but in the long term the dollar price of gold represents past inflation of the money supply. Equally important, it represents the anticipation of how much new money will be created in the future. This introduces the factor of trust and confidence in our monetary authorities and our politicians. And these days the American people are casting a vote of "no confidence" in this regard, and for good reasons.

The incentive for central bankers to create new money out of thin air is twofold. One is to practice central economic planning through the manipulation of interest rates. The second is to monetize the escalating federal debt politicians create and thrive on.

Today no one in Washington believes for a minute that runaway deficits are going to be curtailed. In March alone, the federal government created an historic \$85 billion deficit. The current supplemental bill going through Congress has grown from \$92 billion to over \$106 billion, and everyone knows it will not draw President Bush's first veto. Most knowledgeable

people therefore assume that inflation of the money supply is not only going to continue, but accelerate. This anticipation, plus the fact that many new dollars have been created over the past 15 years that have not yet been fully discounted, guarantees the further depreciation of the dollar in terms of gold.

There's no single measurement that reveals what the Fed has done in the recent past or tells us exactly what it's about to do in the future. Forget about the lip service given to transparency by new Fed Chairman Bernanke. Not only is this administration one of the most secretive across the board in our history, the current Fed firmly supports denying the most important measurement of current monetary policy to Congress, the financial community, and the American public. Because of a lack of interest and poor understanding of monetary policy, Congress has expressed essentially no concern about the significant change in reporting statistics on the money supply.

Beginning in March, though planned before Bernanke arrived at the Fed, the central bank discontinued compiling and reporting the monetary aggregate known as M3. M3 is the best description of how quickly the Fed is creating new money and credit. Common sense tells us that a government central bank creating new money out of thin air depreciates the value of each dollar in circulation. Yet this report is no longer available to us and Congress makes no demands to receive it.

Though M3 is the most helpful statistic to track Fed activity, it by no means tells us everything we need to know about trends in monetary policy. Total bank credit, still available to us, gives us indirect information reflecting the Fed's inflationary policies. But ultimately the markets will figure out exactly what the Fed is up to, and then individuals, financial institutions, governments, and other central bankers will act accordingly. The fact that our money supply is rising significantly cannot be hidden from the markets.

The response in time will drive the dollar down, while driving interest rates and commodity prices up. Already we see this trend developing, which surely will accelerate in the not too distant future. Part of this reaction will be from those who seek a haven to protect their wealth-- not invest-- by treating gold and silver as universal and historic money. This means holding fewer dollars that are decreasing in value while holding gold as it increases in value.

A soaring gold price is a vote of "no confidence" in the central bank and the dollar. This certainly was the case in 1979 and 1980. Today, gold prices reflect a growing restlessness with

the increasing money supply, our budgetary and trade deficits, our unfunded liabilities, and the inability of Congress and the administration to reign in runaway spending.

Denying us statistical information, manipulating interest rates, and artificially trying to keep gold prices in check won't help in the long run. If the markets are fooled short term, it only means the adjustments will be much more dramatic later on. And in the meantime, other market imbalances develop.

The Fed tries to keep the consumer spending spree going, not through hard work and savings, but by creating artificial wealth in stock markets bubbles and housing bubbles. When these distortions run their course and are discovered, the corrections will be quite painful.

Likewise, a fiat monetary system encourages speculation and unsound borrowing. As problems develop, scapegoats are sought and frequently found in foreign nations. This prompts many to demand altering exchange rates and protectionist measures. The sentiment for this type of solution is growing each day.

Though everyone decries inflation, trade imbalances, economic downturns, and federal deficits, few attempt a closer study of our monetary system and how these events are interrelated. Even if it were recognized that a gold standard without monetary inflation would be advantageous, few in Washington would accept the political disadvantages of living with the discipline of gold-- since it serves as a check on government size and power. This is a sad commentary on the politics of today. The best analogy to our affinity for government spending, borrowing, and inflating is that of a drug addict who knows if he doesn't quit he'll die; yet he can't quit because of the heavy price required to overcome the dependency. The right choice is very difficult, but remaining addicted to drugs guarantees the death of the patient, while our addiction to deficit spending, debt, and inflation guarantees the collapse of our economy.

Special interest groups, who vigorously compete for federal dollars, want to perpetuate the system rather than admit to a dangerous addiction. Those who champion welfare for the poor, entitlements for the middle class, or war contracts for the military industrial corporations, all agree on the so-called benefits bestowed by the Fed's power to counterfeit fiat money. Bankers, who benefit from our fractional reserve system, likewise never criticize the Fed, especially since it's the lender of last resort that bails out financial institutions when crises arise. And it's true, special interests and bankers do benefit from the Fed, and may well get bailed out-- just as we saw with the Long-Term Capital Management fund crisis a few years ago. In

the past, companies like Lockheed and Chrysler benefited as well. But what the Fed cannot do is guarantee the market will maintain trust in the worthiness of the dollar. Current policy guarantees that the integrity of the dollar will be undermined. Exactly when this will occur, and the extent of the resulting damage to financial system, cannot be known for sure-- but it is coming. There are plenty of indications already on the horizon.

Foreign policy plays a significant role in the economy and the value of the dollar. A foreign policy of militarism and empire building cannot be supported through direct taxation. The American people would never tolerate the taxes required to pay immediately for overseas wars, under the discipline of a gold standard. Borrowing and creating new money is much more politically palatable. It hides and delays the real costs of war, and the people are lulled into complacency-- especially since the wars we fight are couched in terms of patriotism, spreading the ideas of freedom, and stamping out terrorism. Unnecessary wars and fiat currencies go hand-in-hand, while a gold standard encourages a sensible foreign policy.

The cost of war is enormously detrimental; it significantly contributes to the economic instability of the nation by boosting spending, deficits, and inflation. Funds used for war are funds that could have remained in the productive economy to raise the standard of living of Americans now unemployed, underemployed, or barely living on the margin.

Yet even these costs may be preferable to paying for war with huge tax increases. This is because although fiat dollars are theoretically worthless, value is imbued by the trust placed in them by the world's financial community. Subjective trust in a currency can override objective knowledge about government policies, but only for a limited time.

Economic strength and military power contribute to the trust in a currency; in today's world trust in the U.S. dollar is not earned and therefore fragile. The history of the dollar, being as good as gold up until 1971, is helpful in maintaining an artificially higher value for the dollar than deserved.

Foreign policy contributes to the crisis when the spending to maintain our worldwide military commitments becomes prohibitive, and inflationary pressures accelerate. But the real crisis hits when the world realizes the king has no clothes, in that the dollar has no backing, and we face a military setback even greater than we already are experiencing in Iraq. Our token friends may quickly transform into vocal enemies once the attack on the dollar begins.

False trust placed in the dollar once was helpful to us, but panic and rejection of the dollar will develop into a real financial crisis. Then we will have no other option but to tighten our belts, go back to work, stop borrowing, start saving, and rebuild our industrial base, while adjusting to a lower standard of living for most Americans.

Counterfeiting the nation's money is a serious offense. The founders were especially adamant about avoiding the chaos, inflation, and destruction associated with the Continental dollar. That's why the Constitution is clear that only gold and silver should be legal tender in the United States. In 1792 the Coinage Act authorized the death penalty for any private citizen who counterfeited the currency. Too bad they weren't explicit that counterfeiting by government officials is just as detrimental to the economy and the value of the dollar.

In wartime, many nations actually operated counterfeiting programs to undermine our dollar, but never to a disastrous level. The enemy knew how harmful excessive creation of new money could be to the dollar and our economy. But it seems we never learned the dangers of creating new money out of thin air. We don't need an Arab nation or the Chinese to undermine our system with a counterfeiting operation. We do it ourselves, with all the disadvantages that would occur if others did it to us. Today we hear threats from some Arab, Muslim, and far Eastern countries about undermining the dollar system- not by dishonest counterfeiting, but by initiating an alternative monetary system based on gold. Wouldn't that be ironic? Such an event theoretically could do great harm to us. This day may well come, not so much as a direct political attack on the dollar system but out of necessity to restore confidence in money once again.

Historically, paper money never has lasted for long periods of time, while gold has survived thousands of years of attacks by political interests and big government. In time, the world once again will restore trust in the monetary system by making some currency as good as gold.

Gold, or any acceptable market commodity money, is required to preserve liberty. Monopoly control by government of a system that creates fiat money out of thin air guarantees the loss of liberty. No matter how well-intended our militarism is portrayed, or how happily the promises of wonderful programs for the poor are promoted, inflating the money supply to pay these bills makes government bigger. Empires always fail, and expenses always exceed projections. Harmful unintended consequences are the rule, not the exception. Welfare for the poor is inefficient and wasteful. The beneficiaries are rarely the poor themselves, but instead the politicians, bureaucrats, or the wealthy. The same is true of all foreign aid-- it's nothing more than a program that steals from the poor in a rich country and gives to the rich leaders of a poor country. Whether it's war or welfare payments, it always means higher taxes, inflation, and

debt. Whether it's the extraction of wealth from the productive economy, the distortion of the market by interest rate manipulation, or spending for war and welfare, it can't happen without infringing upon personal liberty.

At home the war on poverty, terrorism, drugs, or foreign rulers provides an opportunity for authoritarians to rise to power, individuals who think nothing of violating the people's rights to privacy and freedom of speech. They believe their role is to protect the secrecy of government, rather than protect the privacy of citizens. Unfortunately, that is the atmosphere under which we live today, with essentially no respect for the Bill of Rights.

Though great economic harm comes from a government monopoly fiat monetary system, the loss of liberty associated with it is equally troubling. Just as empires are self-limiting in terms of money and manpower, so too is a monetary system based on illusion and fraud. When the end comes we will be given an opportunity to choose once again between honest money and liberty on one hand; chaos, poverty, and authoritarianism on the other.

The economic harm done by a fiat monetary system is pervasive, dangerous, and unfair. Though runaway inflation is injurious to almost everyone, it is more insidious for certain groups. Once inflation is recognized as a tax, it becomes clear the tax is regressive: penalizing the poor and middle class more than the rich and politically privileged. Price inflation, a consequence of inflating the money supply by the central bank, hits poor and marginal workers first and foremost. It especially penalizes savers, retirees, those on fixed incomes, and anyone who trusts government promises. Small businesses and individual enterprises suffer more than the financial elite, who borrow large sums before the money loses value. Those who are on the receiving end of government contracts--especially in the military industrial complex during wartime-- receive undeserved benefits.

It's a mistake to blame high gasoline and oil prices on price gouging. If we impose new taxes or fix prices, while ignoring monetary inflation, corporate subsidies, and excessive regulations, shortages will result. The market is the only way to determine the best price for any commodity. The law of supply and demand cannot be repealed. The real problems arise when government planners give subsidies to energy companies and favor one form of energy over another.

Energy prices are rising for many reasons: Inflation; increased demand from China and India; decreased supply resulting from our invasion of Iraq; anticipated disruption of supply as we

push regime change in Iran; regulatory restrictions on gasoline production; government interference in the free market development of alternative fuels; and subsidies to big oil such as free leases and grants for research and development.

Interestingly, the cost of oil and gas is actually much higher than we pay at the retail level. Much of the DOD budget is spent protecting “our” oil supplies, and if such spending is factored in gasoline probably costs us more than \$5 a gallon. The sad irony is that this military effort to secure cheap oil supplies inevitably backfires, and actually curtails supplies and boosts prices at the pump. The waste and fraud in issuing contracts to large corporations for work in Iraq only add to price increases.

When problems arise under conditions that exist today, it’s a serious error to blame the little bit of the free market that still functions. Last summer the market worked efficiently after Katrina-- gas hit \$3 a gallon, but soon supplies increased, usage went down, and the price returned to \$2. In the 1980s, market forces took oil from \$40 per barrel to \$10 per barrel, and no one cried for the oil companies that went bankrupt. Today’s increases are for the reasons mentioned above. It’s natural for labor to seek its highest wage, and businesses to strive for the greatest profit. That’s the way the market works. When the free market is allowed to work, it’s the consumer who ultimately determines price and quality, with labor and business accommodating consumer choices. Once this process is distorted by government, prices rise excessively, labor costs and profits are negatively affected, and problems emerge. Instead of fixing the problem, politicians and demagogues respond by demanding windfall profits taxes and price controls, while never questioning how previous government interference caused the whole mess in the first place. Never let it be said that higher oil prices and profits cause inflation; inflation of the money supply causes higher prices!

Since keeping interest rates below market levels is synonymous with new money creation by the Fed, the resulting business cycle, higher cost of living, and job losses all can be laid at the doorstep of the Fed. This burden hits the poor the most, making Fed taxation by inflation the worst of all regressive taxes. Statistics about revenues generated by the income tax are grossly misleading; in reality much harm is done by our welfare/warfare system supposedly designed to help the poor and tax the rich. Only sound money can rectify the blatant injustice of this destructive system.

The Founders understood this great danger, and voted overwhelmingly to reject “emitting bills of credit,” the term they used for paper or fiat money. It’s too bad the knowledge and advice of our founders, and their mandate in the Constitution, are ignored today at our great peril. The current surge in gold prices-- which reflects our dollar’s devaluation-- is warning us to pay closer

attention to our fiscal, monetary, entitlement, and foreign policy.

Meaning of the Gold Price-- Summation

A recent headline in the financial press announced that gold prices surged over concern that confrontation with Iran will further push oil prices higher. This may well reflect the current situation, but higher gold prices mainly reflect monetary expansion by the Federal Reserve. Dwelling on current events and their effect on gold prices reflects concern for symptoms rather than an understanding of the actual cause of these price increases. Without an enormous increase in the money supply over the past 35 years and a worldwide paper monetary system, this increase in the price of gold would not have occurred.

Certainly geo-political events in the Middle East under a gold standard would not alter its price, though they could affect the supply of oil and cause oil prices to rise. Only under conditions created by excessive paper money would one expect all or most prices to rise. This is a mere reflection of the devaluation of the dollar.

Particular things to remember:

If one endorses small government and maximum liberty, one must support commodity money.

One of the strongest restraints against unnecessary war is a gold standard.

Deficit financing by government is severely restricted by sound money.

The harmful effects of the business cycle are virtually eliminated with an honest gold standard.

Saving and thrift are encouraged by a gold standard; and discouraged by paper money.

Price inflation, with generally rising price levels, is characteristic of paper money. Reports that the consumer price index and the producer price index are rising are distractions: the real cause of inflation is the Fed's creation of new money.

Interest rate manipulation by central bank helps the rich, the banks, the government, and the politicians.

Paper money permits the regressive inflation tax to be passed off on the poor and the middle class.

Speculative financial bubbles are characteristic of paper money-- not gold.

Paper money encourages economic and political chaos, which subsequently causes a search for scapegoats rather than blaming the central bank.

Dangerous protectionist measures frequently are implemented to compensate for the dislocations caused by fiat money.

Paper money, inflation, and the conditions they create contribute to the problems of illegal immigration.

The value of gold is remarkably stable.

The dollar price of gold reflects dollar depreciation.

Holding gold helps preserve and store wealth, but technically gold is not a true investment.

Since 2001 the dollar has been devalued by 60%.

In 1934 FDR devalued the dollar by 41%.

In 1971 Nixon devalued the dollar by 7.9%.

In 1973 Nixon devalued the dollar by 10%. These were momentous monetary events, and every knowledgeable person worldwide paid close attention. Major changes were endured in 1979 and 1980 to save the dollar from disintegration. This involved a severe recession, interest rates over 21%, and general price inflation of 15%. Today we face a 60% devaluation and counting, yet no one seems to care. It's of greater significance than the three events mentioned above. And yet the one measurement that best reflects the degree of inflation, the Fed and our government deny us. Since March, M3 reporting has been discontinued. For starters, I'd like to see Congress demand that this report be resumed. I fully believe the American people and Congress are entitled to this information. Will we one day complain about false intelligence, as we have with the Iraq war? Will we complain about not having enough information to address monetary policy after it's too late? If ever there was a time to get a handle on what sound money is and what it means, that time is today. Inflation, as exposed by high gold prices, transfers wealth from the middle class to the rich, as real wages decline while the salaries of CEOs, movie stars, and athletes skyrocket-- along with the profits of the military industrial complex, the oil industry, and other special interests.

A sharply rising gold price is a vote of "no confidence" in Congress' ability to control the budget, the Fed's ability to control the money supply, and the administration's ability to bring stability to the Middle East.

Ultimately, the gold price is a measurement of trust in the currency and the politicians who run the country. It's been that way for a long time, and is not about to change.

If we care about the financial system, the tax system, and the monumental debt we're accumulating, we must start talking about the benefits and discipline that come only with a commodity standard of money-- money the government and central banks absolutely cannot create out of thin air.

Economic law dictates reform at some point. But should we wait until the dollar is 1/1,000 of an ounce of gold or 1/2,000 of an ounce of gold? The longer we wait, the more people suffer and the more difficult reforms become. Runaway inflation inevitably leads to political chaos, something numerous countries have suffered throughout the 20th century. The worst example of course was the German inflation of the 1920s that led to the rise of Hitler. Even the communist takeover of China was associated with runaway inflation brought on by Chinese Nationalists. The time for action is now, and it is up to the American people and the U.S. Congress to demand it.