THE NEW CASE FOR GOLD

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Chapter 2

Gold Is Money

People are fascinated by gold not because it is shiny, but because it is money. Understanding this fact is the starting place for understanding everything about gold.

There are many kinds of money in the world, of course. At times, different forms of money have competed for a role as the leading global reserve currency. Today, the dollar, the euro and bitcoin are all forms of money. So is gold.

What Is Money?

A classic definition of money has three parts: medium of exchange, store of value, and unit of account. If all three of those criteria are met, you have money of some sort. If you ask an economist, ‘What is money?’ they reflexively assume that only fiat currencies printed by central banks qualify and lapse into technical discussions about narrow or expanded versions of money supply called M3, M2, M1, or M0, which are all different. Each “M” is narrower that the one before. M0 is the narrowest consisting of bank reserves and currency. M0 is also called “base money” because it is the narrowest definition of money economists know. I call gold “M-Subzero” because even if economists don’t recognize it, it is the real base money behind the paper money supply.
Why Gold?

Gold bashers are quick to disparage gold as a “shiny metal” or “pile of rocks,” as if to say it had no particular attractions as a form of money. Even sophisticated economists such as former Federal Reserve Chairman Ben Bernanke have described gold’s continued storage in U.S. vaults as a “tradition,” with no suggestion that there was anything more useful to say about it.

In fact, the use of gold as money is not only ancient but eminently practical. Recently Justin Rowlatt of the BBC World Service conducted an interview with Andrea Sella, Professor of Chemistry at University College London, in which Prof. Sella provided an in-depth review of the periodic table of the elements to explain why gold, among all the atomic structures in the known universe, is uniquely and ideally suited to be money in the physical world.

We all recall the periodic table of the elements from high school chemistry class. It looks like a matrix of squares, one square per element, about eighteen squares wide and nine squares high, but with an irregular shape around the edges; hydrogen (H) and helium (He) stand above their peers. Each square contains the name of an element, and its one or two letter symbol, along with some useful information such as the atomic weight, atomic mass and boiling point. A total of 103 elements are represented this way, from hydrogen (atomic number 1) to lawrencium (atomic number 103). The important point for our purposes is there is nothing in the known universe that is not made of one of these elements or some molecular combination. If you’re looking for money, you’ll find it here.

Professor Sella deftly leads the reader through a tour of the table. He shows that most of the matter in the universe is completely unsuitable for money. He then zeros in on that handful of elements that are suitable and singles out the one that is nearly perfect for the purpose—gold.

Sella quickly dismisses ten elements on the right-hand side of the table including elements like helium (He), argon (Ar) and neon (Ne). The reason is obvious—they’re all gases at room temperature and would literally float away. They’re no good as money at all.
In addition to the gases, Sella rejects elements such as mercury (Hg) and bromine (Br) because they’re liquid at room temperature, and are as impractical as the gases. Other elements are rejected because they’re poisonous. Arsenic (As) and some others are disqualified for this reason.

Next he turns to the left-hand side of the table. This includes twelve alkaline elements such as magnesium (Mg), calcium (Ca) and sodium (Na). These are no good as money either because they dissolve or explode on contact with water. Saving money for a rainy day is a good idea, but not if the money dissolves as soon as it rains.

The next elements to be discarded are those such as uranium (U), plutonium (Pu), and thorium (Th), for the simple reason that they’re radioactive. No one wants to carry around a form of money that might cause cancer. Also included in this group are thirty radioactive elements created only in laboratories that decompose moments after they are created, such as einsteinium (Es).

Most of the other elements are also unsuitable as money based on particular properties. Iron (Fe), copper (Cu), and lead (Pb) don’t make the final cut because they rust or corrode. It’s bad enough when central banks debase your money, but no one wants money that debases itself.

Rowlatt and Sella continue on their trip through the periodic table. Aluminum (Al) is too flimsy to use as coins. Titanium (Ti) was too hard to smelt with the primitive equipment available to ancient civilizations.

Once the process of elimination is complete, there are only eight candidates for use as money. These are the so-called “noble metals,” situated about in the center of the table, consisting of iridium, osmium, ruthenium, platinum, palladium, rhodium, silver, and gold. All of these are rare, but only silver and gold are available in sufficient quantity to comprise a practical money supply. The rest are extremely rare, too rare to be money, and difficult to extract because of very high melting points.

Rowlatt completes his tour d’horizon this way:

“This leaves just two elements—silver and gold. Both are scarce but not impossibly rare. Both also have a relatively low melting point and are therefore easy to turn into coins, ingots and jewelry. Silver
tarnishes—it reacts with minute amounts of sulphur in the air. That’s why we place particular value on gold. 

It turns out gold (Au) has one final attraction—it’s golden. All of the other metals are silvery in color, except copper, which turns green when exposed to air. Beauty is not a prerequisite for money, but it’s a nice attribute for gold considering it passes every other test with flying colors.

Our ancestors did not use gold just because it was shiny or beautiful as modern critics suggest. Gold is the only element that has all the requisite physical characteristics—scarcity, malleability, inertness, durability, and uniformity—to serve as a reliable and practical physical store of value. Wiser societies than ours knew what they were doing.

Of course, this list of virtues does not mean that gold has to be money. Today’s money exists mostly in digital form. Electrons that store the digits don’t rust either. Then again, they’re not the least bit scarce.

Just because money is “digital” doesn’t mean it’s not part of the physical world. There is no escape from the periodic table of the elements. Digital money exists as charged sub-atomic particles stored on silicon (Si) chips. Those charges can be hacked and erased. Atoms of gold (atomic number 79) are stable and cannot be erased out by Chinese and Russian cyber-brigades. Even in the cyber-age gold still stands out as money nonpareil.

Gold Is Not an Investment

Gold is not an investment, because it has no risk and no return. Warren Buffett’s well-known criticism of gold is that it has no return and therefore no chance of compounding his wealth. He’s right. Gold has no yield; it’s not supposed to, because it has no risk. If you buy an ounce of gold and keep it for ten years, you end up with an ounce of gold—no more, no less. Of course, the “dollar price” of an ounce of gold may have changed radically

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in ten years. That’s not a gold problem; it’s a dollar problem.

To get a return on an investment, you have to take risk. With gold, where is the risk? There is no maturity risk, because it’s just gold. It won’t “mature” into gold five years from now; it is gold today, and always will be. Gold has no issuer risk, because nobody issues it. If you own it, you own it. It’s not anyone else’s liability. There’s no commodity risk. With commodities there are other risks to consider. When you buy corn, you have to worry: does it have bugs in it? Is it good corn or bad corn? It’s the same thing with oil; there are 75 grades of oil around the world. But pure gold is an element, atomic number 79. It’s always just gold.

**Gold Is Not a Commodity**

Gold has almost no industrial uses. It is not a commodity, because it’s not an important input to any production process, save a few. Look at any other commodity: copper is used for wires and pipes, and silver actually has many industrial uses in addition to being a precious metal. Other mining commodities are used as inputs in manufacturing and production; gold is not. Gold has some uses in electronics for coatings, connections, and things like that, but they are very limited—nothing material.

We know that gold is traded on commodity exchanges and reported in the commodity section of your favorite website. Breathless reporters describe gold price action from the commodities trading pits. Still, that does not make gold a commodity. That’s important for investors to understand, because there are many developments that affect commodities that do not affect gold in the same way.

Consider the situation in the Great Depression. The most daunting economic problem was deflation. Commodity prices and industrial production dropped precipitously. But from 1929 to 1933 the U.S. dollar price of gold remained fixed at $20.67 per ounce. Gold was performing a monetary role, not a commodity role.

In a matter of months, beginning in April 1933, the U.S. government forced the price of gold higher from $20.67 an ounce to $35.00 an ounce. The government did this to cause inflation; they were desperate to break
out of deflation, and gold led the way by government fiat. The prices of commodities and stocks soon followed. Gold did not act at all like a commodity; it acted like money. Today, governments again fear deflation, and seek inflation to help reduce the real burden of sovereign debt. Gold may again be enlisted to catalyze the inflation that central banks have thus far failed to produce.

Another example of gold’s non-commodity behavior can be seen in the correlation of gold to the Continuous Commodity Index in 2014. That index has sixteen components, including gold as well as iron ore, copper, aluminum, and agricultural commodities. Gold exhibited a high degree of correlation to the index from January through November of that year, which is to be expected. But, in November 2014, the index plunged and gold rose sharply in dollar terms. This coincided with plunging energy and base metals prices (accounting for the index move), and growing Russian and Chinese demand for gold (accounting for the gold move). Gold had suddenly stopped trading like a commodity and began trading like money. This behavior is the shape of things to come.

**Gold Is Not Paper**

Wall Street sponsors, U.S. banks, and other members of the London Bullion Market Association (LBMA), have created enormous volumes of “gold products” that are not gold. These are paper contracts.

These products include exchange-traded funds, ETFs, the most prominent of which trades under the ticker symbol GLD. The phrase “ticker symbol,” is a giveaway that the product is not gold. An ETF is a share of stock. There is some gold out there somewhere in the structure, but you don’t own it—you own a share. Even the share is not physical; it’s digital and easily hacked or erased.

The legal structure behind GLD is a trust, and the trustee has some physical gold in a vault. This is generally true of gold ETFs. The GLD vaults are in London. There is a set of authorized participants who make a market in the GLD trust shares. These are the large LBMA members such as Goldman Sachs, JPMorgan, and
Much of the activity of the authorized participants consists of arbitrage between the physical gold market and the market for GLD shares. If there is selling pressure on GLD shares, the authorized participant can buy the shares as a market maker and sell physical gold short. Then the dealer can deliver the shares to the trustee, receive physical gold in exchange, and cover the short physical position, thereby pocketing a profit measured by the difference between the share price and the physical price. This arbitrage is not unlike the “gold points” arbitrage that existed between New York and London in the years prior to 1914, except that it is no longer necessary to ship physical gold across the North Atlantic to make a profit. Nowadays, the gold just sits in an LBMA vault or the GLD vault depending on the flow of the arbitrage.

Investors in GLD take other risks besides not having physical gold and being targets of digital hacking. For example, officials could close the New York Stock Exchange, leaving investors unable to trade the shares. Those who say the exchange will never be closed should recall that it happened due to a software glitch on July 8, 2015, during Hurricane Sandy in 2012, and after 9/11. Famously the New York Stock Exchange was also closed over four months at the outbreak of World War I. Power outages or electronic problems could also close the exchange again at any time. With an ETF you’re locked into that digital system.

The London Bullion Market Association also sells gold through paper contracts that act like unregulated futures. The gold underlying these contracts is described as “unallocated,” which means the owner has no claim to any particular physical gold. The seller does have some physical gold, but not enough to satisfy the potential claims of all the unallocated gold buyers. Banks can sell $10 or more of these contracts for every $1 of physical gold they hold. They hope that all the holders don’t show up at once and ask for the gold, because if they do, they’re not going to get it.

Owners of gold under these contracts have to give notice to the bank if they want to convert from unallocated gold to gold that is specifically allocated and held in custody. The notice period gives the bank time to locate some physical gold to cover the contract.

If too many customers claimed physical gold at once, the bank could terminate the contact and simply
provide the counterparty with cash at the closing price as of the date of termination. The customer would get a check at that closing price, but they’re not going to get the actual gold. That’s the best case. In a worst case, the bank could fail and the gold investor would get nothing at all.

So these paper contracts might offer price exposure to gold markets, but that’s a far cry from actual gold. If there’s a demand shock or a buying panic for gold and the price of gold is skyrocketing, that’s exactly when these paper contracts are going to fail, because there will not be enough physical gold to satisfy all the claims. Only physical gold in non-bank custody is real gold.

**Gold Is Not Digital**

Gold is a physical, not digital, currency. This provides insurance against the risks to which digital currencies are exposed.

For the most part, the dollar is a digital currency. We may have a few paper dollars in our pockets, but not many relative to our needs. If I go to the grocery store, I may pull out a 20-dollar bill, but I’m more likely to pull out my debit card.

When you get your paycheck, it’s probably a direct deposit to your account from your employer. When you pay your bills, you likely use online banking. When you go shopping, you probably use a credit or debit card. The amount of cash you’re using is tiny relative to the volume of your economic transactions.

The largest securities market in the world, the United States Treasury market, hasn’t had a physical paper certificate since the early 1980s. There might be a few old paper certificates floating around in someone’s attic, but the Treasury bond market today is completely digital, as is the payment system. The cashless, digital society is already here. Some observers are concerned about what they call “the war on cash.” Don’t worry—the war on cash is over and the government won.

As a practical matter, honest citizens cannot get access to large quantities of cash without being suspected
of drug dealing, terrorism or tax evasion. Along with that suspicion comes government surveillance. Citizens without gold have no choice but to go along with the digitization of wealth.

Digital wealth is subject to power outages, infrastructure and exchange collapses, hackers, and online theft. What good is even a billion-dollar portfolio if it can be wiped out overnight?

What if the government shuts down the banks and reprograms the ATM machines to limit you to three hundred dollars a day for gas and groceries. The fact that you might have $100,000 in the bank is irrelevant. Government regulators will say three hundred dollars a day is more than enough for gas and groceries until further notice.

This is the exact scenario that has played out in the Eurozone in Cyprus in 2013 and Greece in 2015. Savers should have some physical gold as insurance against this bank freeze scenario.

**History of Monetary Collapse and End of the Gold Standard**

Gold is money, but its status as money has been disparaged continually by governments and economists, especially in the period since the international monetary system collapsed and America ended the convertibility of dollars into gold in 1971. The monetary collapse in 1971 should have come as no surprise. The international monetary system actually collapsed three times in the twentieth century—1914, 1939 and 1971—and perilously close to collapse in 1998 and 2008.

Since today’s international monetary system is largely based on the U.S. dollar, a new collapse will be triggered by a collapse of confidence in the dollar and its role as a store of value. It may be surprising, but such collapses do happen every thirty years or so. Based on the monetary history of the past century, we’re probably at the end of the useful life of the current international monetary system and fast approaching a new one.

Prior monetary collapses have not meant the end of the world. People did not go into caves and start eating canned goods. Monetary collapse meant that the major financial and trading powers of the time sat down around
a table and rewrote what they call the “rules of the game,” which is a shorthand expression for the operation of the international monetary system.

For example, after the 1914 collapse, there was a monetary conference in 1922 in Genoa, Italy, where the major powers rewrote the rules of the game and attempted to reintroduce the gold standard. After the 1939 collapse, there was a larger, well-known international monetary conference in Bretton Woods, New Hampshire, in 1944 that rewrote the rules of the game around a dollar-gold standard. Then after the collapse in 1971, when Nixon suspended the convertibility of dollars for gold, there was a series of conferences, the most famous being the Smithsonian Agreement in December 1971. Numerous subsequent negotiations took place all the way up through the Plaza Accord in 1985 and the Louvre Accord in 1987, which rewrote the rules of the game once again.

The period from 1971 to 1980 was one of temporary chaos as the U.S. muddled through and moved toward floating exchange rates. It was a dreadful period of economic performance. The U.S. had three recessions between 1973 and 1981. The dollar price of gold went from $35 an ounce to $800 an ounce. Inflation took off. The value of the dollar was cut by more than half.

The dollar was rescued by Paul Volker and Ronald Reagan beginning in 1981. This is when the world moved to a new “dollar standard,” also known as the King Dollar period.

In effect, the U.S. told the world that even in the absence of a gold standard, the dollar would be a reliable store of value. This meant ending dollar inflation and making the U.S. an attractive destination for dollar investments. Volcker’s monetary policy and Reagan’s tax and regulatory policies accomplished these goals. U.S. trading partners were essentially told they could anchor to the dollar. The sound dollar standard was successful from 1981 to 2010, a period characterized by solid growth until 2007, and with long economic expansions in the 1980s and 1990s.

So, from 1870 to 1971, the international monetary system used variations on a gold standard with interruptions for wars. For 30 years, from 1980 to 2010, the world did not have a gold standard, but had this dollar standard instead. Now we have no standard and no anchors whatsoever in the international monetary
system. It should come as no surprise that since 2007 we have been living with confusion, volatility, and suboptimal performance in the markets and the economy.

When the next collapse comes, there will be another such meeting as those held in Genoa in 1922 and Bretton Woods in 1944. Investors today need to look ahead and ask, “What will the new rules of the game be?” Based on the answers, they can figure out how they should construct their portfolios today to protect their net worth when this inevitable turmoil comes.

**Gold Never Went Away**

It is generally believed that President Nixon closed the gold window on August 15, 1971, and the U.S. has been off the gold standard ever since. Since then two generations of students have been rigorously brainwashed by policymakers and professors to believe that gold has no role in the international monetary system.

The truth is, gold has never gone away. The power elites stopped talking about it and publicly ignored it, but they held onto it. If gold is so worthless, why does the U.S. have over eight thousand tons? Why do Germany and the IMF keep approximately three thousand tons each? Why is China acquiring thousands of tons through stealth or Russia acquiring over one hundred tons a year? Why is there such a scramble for gold if it has no role in the system?

It’s highly convenient for central bankers to convince people that money has nothing to do with gold because that empowers them to print all the money they want. Everyone from Ben Bernanke to Alan Greenspan and others have disparaged gold saying it plays no part in the system. Along with the power to control money comes the power to control behavior and politics. But gold is still the foundation, the real underpinning, of the international monetary system.
Gold and the International Monetary System

Gold is making its comeback in the world monetary system. When you look at what’s actually going on in the world as opposed to the happy talk you hear on television, it is clear that the world is already on a shadow gold standard and is moving back to a more formal gold standard—treating gold as money. We’re seeing signs of that already; it’s not just something that will happen in the future. The evidence that gold is moving back towards the center is clear, and it’s happening for a number of reasons.

The International Monetary Fund (IMF) is the third largest holder of gold in the world. (Number one is the United States, number two is Germany, and number three is the IMF. It is likely that China is actually the second largest holder of gold, but its actual holdings are not publicly disclosed and impossible to confirm.)

The IMF plays a pivotal role in the global monetary system, with far more power and influence than one might assume based on its technocratic and bureaucratic demeanor. The IMF likes to posture as a sort of benign friend to small, emerging countries, but, in reality, it’s more like a large, rapacious corporation that makes a donation to charity every now and then just to show how generous they are.

The IMF was created at the Bretton Woods Conference in 1944. It took a few years to get up and running in the late 1940s and early 1950s. It started as a swing lender for wealthy countries experiencing short-term balance of payments deficits.

Consider a country running a balance of payments deficit year after year. One of the ways to fix the deficit would be to cheapen its currency to make exports more competitive. But cheapening the currency wasn’t allowed under the Bretton Woods fixed exchange rates. Instead the IMF would provide a loan to tide you over while you made structural reforms to your economy. Such reforms would attempt to lower unit labor costs, improve productivity or improve the investment climate—whatever was necessary to get the current account back towards a surplus. Once the capital account was in surplus, the swing loan from the IMF could be repaid.

In extreme cases, the IMF allowed devaluation, but only after all other monetary and structural solutions had been exhausted.
This swing lending system broke down in the late 1960s and early 1970s when the UK steeply devalued sterling against the dollar, and the U.S. suspended gold convertibility. The fixed exchange rate system died soon afterwards. Since then, we’ve had floating exchange rates.

After the 1980s, the IMF wandered in the wilderness for almost twenty years with an uncertain mission. In the 1980s and early 1990s they acted as a lender to emerging markets, because their original mission of stabilizing exchange rates under Bretton Woods was gone.

The IMFs reputation suffered badly in the 1997-1998 Asia financial crisis. There was blood in the streets—and not metaphorically. People were killed in riots in Jakarta, Indonesia and Seoul, Korea. Many people to this day, most famously Nobel Prize winner Joe Stiglitz, attributed this financial crisis to bad advice from the IMF.

By 2000, the IMF was like a whale that had washed up on the shore and couldn’t get back to its mission in the sea. No one quite knew what they were doing and how they should be doing it. By 2006, there were public calls to abolish the IMF.

Then a funny thing happened on the way to abolishing the IMF. We had a global financial crisis in 2008, and suddenly, the IMF was back in the game. It became the de facto secretariat of the G20 club of the most powerful developed and emerging markets countries. The G20 acts as a kind of board of directors with the IMF as a staff and agency to implements the will of the board.

The IMF has its own governing board, but interestingly, if you look at that membership by country, there’s a lot of overlap with the G20 membership. The G20 member countries and the countries of the 24 members of the IMF executive committee are, by and large, the same. The G20 was a group of heads of state that didn’t have a staff while the IMF has a ready-made staff. Since 2009, the G20 summits have worked hand in glove with IMF technical capabilities, staff and analysts. New lending facilities have become highly politicized as seen in Ukraine and Greece.

The fact is the IMF has always been a rich countries’ club. The IMF voting mechanism requires an 85% vote to make any significant changes such as a change in the articles (the governing document) or to approve a major lending initiative. The United States has over 16% of the votes, which means that if all the other members
combined voted against the United States, it still wouldn’t be enough to make anything happen. None of this is by coincidence, of course; the U.S. has always been the largest voice in the IMF, and the headquarters of the IMF are in Washington, DC.

One of the big governance issues in the world of international finance right now involves changing these voting arrangements. If you approach the issue in terms of how much your GDP as a percentage of world GDP, and compare that to your IMF vote, rich countries are over-weighted, and emerging markets are under-weighted. China is a good example. China is about 14% of global GDP, but its vote in the IMF is less than 5%. Legislation that would change this to give China a larger voice has been stuck in the U.S. Congress since 2010. Recognition of China’s rightful place in the IMF hierarchy is being held hostage by the U.S. in exchange for China’s good behavior in the battle over currency manipulation against the U.S. dollar.

Now the IMF is back to its original mission of lending to rich countries, mostly bailing out Europe, where the overwhelming majority of its money is directed. The bulk of the IMF’s money is not going to poorer countries like Botswana or Mali or Jamaica. It’s going to Poland, Greece, Portugal, Ireland and, for political reasons, Ukraine.

This new lending spree requires new sources of funding for the IMF itself. If you’re going to lend money, where do you get the money to lend? Banks can take deposits, pledge assets to central banks, or create money out of thin air. The IMF doesn’t have a teller window where you can make a deposit, but it does borrow the money. It issues notes. Interestingly, these notes are not denominated in dollars. They’re denominated in Special Drawing Rights (SDRs), worth about $1.40 each as of this writing, although the SDR value fluctuates with the market.

What is an SDR? Well, it’s world money. But not the kind you carry around in your pocket. You can’t go to an ATM and withdraw a bundle of SDRs. But SDRs are money, and they play an increasingly important role in global finance as the power of the dollar declines. There’s actually a trading desk inside the IMF that can swap SDRs for other hard currencies. Here’s a simple example of how that works. In 2009 the IMF issued 182.7 billion of SDRs equivalent to about $255 billion at current exchange rates. The way they issue them is in
accordance with a quota, which is simply the word they use for a country’s share. If I have a 5% quota at the IMF and the IMF is issuing 100 billion SDRs, then I’m going to get 5 billion SDRs or 5% of the total issued. Many IMF members had quotas, but didn’t need the SDRs, and wanted other hard currencies instead.

Hungary is a good example. Going back to the early 2000s, Hungarian banks offered customers mortgages in two currencies. They could take a loan in local currency, which is the forint, or they could take the loan in Swiss francs provided by European banks in Vienna or Zurich that could fund the loans. Swiss franc mortgages were about 2% and forint mortgages were about 9%, so most of the borrowers took Swiss franc mortgages assuming the exchange rate would remain fixed. But it didn’t. The forint collapsed, and suddenly the mortgage debt relative to the borrower’s local income increased dramatically. Defaults skyrocketed.

If you’re Hungary and the IMF gives you SDRs, your reaction is that you really need Swiss francs so your central banks can help the local banks repay the inter-bank loans. Now you call the IMF trading desk and say, “Offer me dollars for my SDRs.” The IMF desk will call a place like China and say, “Do you have a bid for SDRs?” China says, “Yes, we do.” China will send dollars to the IMF and get SDRs in return while Hungary will get the dollars, sell them on the spot to buy Swiss francs, and then use the francs to help their banks. That’s the way to turn your SDRs into something else if you need them.

The IMF doesn’t issue SDRs except in liquidity crises. The next time there is a global liquidity crisis, it will be bigger than the capacity of the Federal Reserve and other central banks to contain. The Fed has used up its balance sheet—used up its dry powder, if you will—dealing with the last crisis. They have not been able to unwind the balance sheet, and it’s unlikely they will for a decade. The same is true of the other central banks, so they have no further capacity to print money without destroying confidence. They might have some legal capacity to print more, but they are at the limit of what they can credibly do.

It is in this new liquidity crisis that the world will turn to the IMF and be re-liquefied by the issuance of SDRs. That process may work without impinging confidence because so few understand it. The massive issuance of SDRs will be highly inflationary in dollar terms, but policymakers in Washington will simply point the finger at the IMF as an unaccountable agency.
One effect of a massive issuance of SDRs will be to hinder capital formation by destroying the real value of dollar-denominated assets. The only shelter in the storm will be hard assets, including gold. Astute individual investors are positioning their portfolios that way today, and so are major powers such as Russia and China.

What if people lose confidence in the IMF and the SDR solution? Who bails out the IMF? Right now there isn’t anyone. Turning to the IMF is not kicking the can down the road; it’s more like kicking the can upstairs from private debt to sovereign debt to multilateral debt issued by the IMF. The IMF is the penthouse; you can’t kick the can any higher. The only thing standing behind them is their 3,000 tons of gold and the gold held by their members in the U.S. and Europe.

This is why I keep returning to the subject of gold. This is why I continue to calculate gold-to-money ratios, and gold-to-GDP ratios, and develop dollar price projections of $10,000 per ounce, possibly higher. If confidence in national paper money is lost and you try to bail out the system with a different kind of fiat money, specifically the SDR, what good does that do? If it works at all, it will only be for two reasons. One, almost no one understands it, and two, we won’t have SDRs in our pockets. SDRs will be used by, for, and between countries—not by individuals. SDRs won’t be transparent. They will exist and be highly inflationary if printed in sufficient quantities, but no one will actually see them because they are the most technical and abstract form of money ever created.

If SDRs work, it will be in part because so few people understand them. Still, if people do understand, they are likely to lose confidence. In that, scenario, the only recourse is gold.

**Shadow Gold Standard**

Countries around the world are acquiring gold at an accelerated rate in order to diversify their reserve positions. This trend, combined with the huge reserves held by the U.S., Eurozone and the IMF amount to a shadow gold standard.
The best way to evaluate this shadow gold standard among various countries is to use the ratio of gold to the gross domestic product, (GDP). This Gold-to-GDP ratio can easily be calculated using official figures and compared across countries to see where real gold power resides.

The big winners—the real center of gold power in the world—are the nineteen nations that make up the Eurozone and issue the euro. Their gold as a percentage of GDP is over 4 percent. The United States’ ratio is about 2.7 percent. Interestingly, Russia’s ratio is also about 2.7 percent. Russia only has one-eighth the amount of gold the U.S. has, but their economy is only one-eighth the size of the U.S. economy, so the ratio is comparable. However, Russia is one of those nations acquiring more gold and seems set on passing the U.S. and matching the Eurozone. Japan and the UK are major economies but their gold ratio is anemic; about 0.7 percent.

The most interesting case is China. The official gold reserves of China are reported as of July 2015 at 1,658 tons. Yet we know from various reliable sources including mining production and import statistics that their actual gold stock is closer to 4,000 tons. I’ve spoken to refiners and secure logistics firms, people who actually handle physical gold in addition to official sources, and included their information in my estimates. On the whole, there is enough credible information available to support this estimate at a minimum. It is also entirely possible that China has considerably more than 4,000 tons of gold.

China, like Russia, is acquiring gold so that they have a comparable ratio to the U.S. and Europe. This ratio will be critical when the monetary system collapses since it will form the basis for any monetary reset and the new “rules of the game.”

In any monetary reset, countries will come together, as I have described, and sit around the table. One can think of that meeting as a poker game. When you sit down at the poker table, you want a big pile of chips. Gold functions like a pile of poker chips in this context. This doesn’t mean that the world automatically goes to a gold standard. It does mean that one’s voice at the table is going to be a function of the size of its gold hoard.

There are only about 35,000 tons of official gold in the world. The phrase “official gold,” means gold owned by central banks, finance ministries, and sovereign wealth funds. This does not including gold jewelry and gold held in private hoards.
This means that China’s acquisition of over 3,000 tons of gold in the past seven years represents approximately 10 percent of all the official gold in the world; a huge shift in gold reserves in favor of China. This explains China’s non-transparency. The gold market is liquid, but thinly traded. If China’s intentions and actions were fully disclosed, the price of gold would likely be much higher. This is always true when a huge buyer shows up in a thin market. China wants to keep the gold price as low as possible until it completes its acquisition program.

China is trying to acquire enough gold so that when the international monetary collapse comes and the world has to re-cut the deal, they’ve got a prime seat at the table. Countries like Canada, Australia, and U.K. with small gold-to-GDP ratios will be seated away from the table, along the walls. These small gold powers will essentially be spectators in the global monetary reset and will have to content themselves with whatever system the U.S, Europe, Russia and China devise. In this scenario, Germany will speak for Europe, so the new system will be based on a U.S.-German-Russian-Chinese monetary condominium administered by the IMF. These major gold powers are already preparing for this outcome. This is what I mean when I refer to the shadow gold standard.

**Conclusion**

Gold is money. Despite disparagement by policymakers and economists, it will remain as a store of wealth *par excellence*, and continue to play an integral part in the world’s monetary system. In part, we can thank the French who took a stand at the IMF in 1975 and insisted on a role for gold in official reserves even when it was no longer a monetary reference point at the time.

Academic economists don’t seem to care about gold. It is mostly ignored, and never studied in a monetary context. Still, gold has never completely gone away. It still matters behind the scenes. Gold is still poised in the reserves of the international monetary system and will be even more important in the years to come.
Understanding gold provides us with a frame of reference for an understanding of the future of the international monetary system. In the chapters ahead we’ll look at how smart investors are investing in physical gold to protect themselves from the complex economic forces and instability we face in the twenty-first century.

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