[JTC: This is an earlier prediction (than “The End of Fiat,” above) from economist Macleod. He predicts here that global fiat systems will collapse, and politicians will attempt to replace them with gold tenders *that they will fix*. In order to reestablish even a basic economy, they’ll have to keep their mitts off it … at least for a while. He also takes serious issue with the notion that cryptocurrencies could possibly be the chief exchange mechanism of the future.]

The Psychology of Money

By Alasdair Macleod

[Goldmoney via LewRockwell.com December 25, **2020**]

The world stands on the threshold of monetary hyperinflation with the US dollar leading the way. The final months of fiat money are coming into view.

What will replace them — bitcoin or gold?

This article argues that the final solution is bound to be with central banks and government treasury departments retaining their control as issuers of money by the only means at their disposal: deploying their gold reserves to back their currencies, not as fiat, but as credible gold substitutes.

Central banks own no bitcoin, which effectively rules it out. They may try their own equivalents, central bank digital currencies, but they are simply another form of fiat money and will also fail — assuming there is enough time for them to be introduced. In any event, the eventual replacement for fiat money needs to be beyond government control (other than the state acting as a monetary trustee, ensuring gold coins are always available for exchange) and flexible enough for its users to collectively set the quantity that acts as money. A formulaic medium such as bitcoin does not provide this flexibility, but gold clearly does and has proved its suitability in the past.

Introduction

For anyone interested in the history and qualifications of money as a circulating medium the current times are fascinating, being the *fin de siècle* of fiat currencies. Any doubt that fiat currencies are failing is being banished. The days when governments can finance their schemes by debauching their currency are numbered. Consequences flow.

A meaningful debate about why they are failing is yet to be had. Only very few, who have an idea of monetary history and an understanding of the economics of inflation, are aware of an impending monetary crisis, but there are early signs they are being joined by a widening circle of thinkers. But for all the believers in the macroeconomics of Keynes, there is for the moment, a state of profitable bliss, of money-making in anything financial. They do not realise it yet, but when everything rises in price it is because the purchasing power of the currency in which they are measured is falling.

But belief for these macroeconomic investors is everything, because with belief you can evade reality. Belief is a condition where things held in the mind are true. There can be no evaluation. It provides the foundations of attitude and behaviour. Over the decades the Keynesian cohort has led itself to believe in governments and their statistics at the expense of humanity and those beliefs have become increasingly divorced from economic reality. For them, inflation is no longer of money, but redesignated to prices, leaving the weapon of debasement concealed from the public. Prices are indexed to rise by a targeted two per cent — paying that little bit more for everything every year is good for us, apparently. Bull markets are perpetual. Banks will always be bailed, so counterparty risk becomes a theoretical problem, never to be realised. And while most of us might be persuaded these speed bumps are inevitable, we now find that whole economies need to be bailed.

It is all thanks to the magic money tree, which can be stripped repeatedly by central banks, now that official inflation, which everyone accepts as the truth, is contained by a goal-sought two per cent. The belief that a rising GDP represents economic growth allows governments to make up the numbers simply by spending more. And because the continual debasement of the currency guarantees that the dumbest trend follower will make money in financial markets, Keynesian beliefs continue to be reinforced, notwithstanding the reality.

Of one thing we can be certain and that is hyperinflation of the quantity of money will destroy the mainstream’s dreams. That time is now upon us, but the blind deaf and mute Keynesians and their followers will wake up to reality late in the hyperinflationary collapse.

There are two other cohorts we must consider: those who believe that gold and/or silver will return as money out of the destruction of fiat, and a new class of believer who understands the relative supply dynamics of bitcoin relative to the rapid and increasing expansion of government currency. There is a gentle rivalry between believers in precious metals and cryptocurrencies, the former sticking to the lessons of history and the latter enthused by the technology.

The problem we have to deal with is that, for now, the majority in all three cohorts are comprised of believers and not realists. They all believe they are right but have applied little thought to the demise of fiat and what it means. Nor have they stopped to think how its replacement will come about and what that replacement will be. This article attempts to answer these questions.

The certainty of fiat destruction

Now that fully two-thirds of US Government spending in the second half of fiscal 2020 was funded by monetary inflation (the other third being from revenues which fell sharply) we can say that without a miraculous change in circumstances and financing policies, the dollar is on a hyperinflationary course. For what has happened is continuing to happen, and irrespective of who commands the White House in late-January, the political imperative rules out cuts in government spending and demands it to be increased instead, even while government revenues continue to fall.

In the face of mounting bankruptcies and supply chain failures it behooves the government to do whatever it takes to rescue businesses and prevent an economic slump. Its advisers are Keynesian priest-like figures, who argue that government spending must be increased to save the economy. They say more deficit spending is required, and modern monetary theorists argue that the increase in government debt will be owed to itself. In this the MMTs have a minor point: US Treasuries bought by the Fed is effectively debt owed to the government by a government department, its own central bank. But otherwise, MMT is simply a justification for unfettered inflationary financing of government spending.

The hyperinflationary conditions in the second half of fiscal 2020 are therefore certain to continue, and as the dollar is diluted by successive increases in its quantity, the nominal amounts of inflationary issues of money and credit must rise to achieve the imaginary benefit. At the time of writing, a stopgap of $900bn has currently been agreed in Congress, but President Trump has rejected it as being too little and reflecting vested interests. Further increases will inevitably follow, because the Keynesian priesthood knows of no other means of dealing with the current economic situation.

Monetary debasement can only continue for as long as its users continue to accept fiat currency as the medium of exchange. To reject an established unbacked state currency for transactional purposes is a last resort, and naturally, in the general public there is great reluctance to do so. But, unless the government reins in its spending and balances its budget, the fate of its currency is for it to be eventually rejected and to become useless.

The path to valuelessness is uneven, faith being maintained in the currency until it is no longer tenable. The dilution of its purchasing power by the inflation of its quantity is one factor; faith in it is ultimately the overriding factor. The continual abuse of that faith is what leads to a currency's demise. The first to be alerted are the users of foreign exchanges, and it is here that the dollar will face a destructive weakening. Foreigners own considerably more dollars and dollar-denominated assets than Americans own the equivalent of in foreign currencies. Having had the exorbitant privilege of issuing the world's reserve currency for seventy-five years, most American ownership of foreign-related financial assets is denominated in their own dollars.

A year ago, many of my American friends argued that I was wrong to be bearish about the dollar because foreigners would always need to own them, and in the event of a worldwide financial or economic panic, they would increase their demand for dollars as a safe haven. It is an argument that is only valid so long as the dollar is not over-owned; but in a contracting global economy with diminishing international trade the dollar is needlessly owned and is already being sold down.

The history of fiat money breakdowns usually features a substantial fall in the currency's purchasing power on the foreign exchanges before the domestic population becomes aware of what is happening to its medium of exchange. The fall in foreign exchange values is accompanied naturally by a rise in prices for commodities and raw materials. The Keynesian priesthood initially argues in favour of the benefits of a weaker currency, measured against other currencies and not so much against commodities, because it becomes more competitive for trade purposes, until, of course, the fall in international purchasing power creates embarrassing problems. The first of these is the withdrawal of the government's principal source of finance that does not originate from its central bank: foreigners no longer retaining net dollar surpluses from the balance of trade to reinvest in government, corporate and agency debt. The balance of payments no longer balances.

Meanwhile, government spending in excess of tax income still needs to be financed. In effect, the foreign holders of dollars are sending a clear message: "The interest I earn on my dollars fails to compensate me for potential capital losses, and so long as that is the case, I will continue to sell my dollars". Though unwelcome, the only solution to a falling dollar becomes clear: a rise in interest rates will be necessary for the currency to be stabilised in the foreign exchanges.

This solution is only accepted by the Keynesian priesthood with the greatest reluctance, and is seen as a last resort, in denial of the failure of their cherished beliefs. They start by intervening in the foreign exchanges, but to no avail. They may introduce price controls. They may suppress or confiscate key inflation markers, such as ownership of gold. All this is to no avail. The longer they delay, the higher must be the hike in interest rates to protect the currency. But with interest costs already a significant element in the government's budget, higher interest rates make the situation for it even worse.

The government is ensnared in a debt trap, from which, in the absence of massive cuts in spending, there can only be one outcome: the bankruptcy of the government, and indebted businesses with accumulated malinvestments shut out of credit markets. These zombies form a substantial part of the US economy, as they do in Europe, the UK and Japan, and a significant portion of bank credit (and therefore losses to the banks) is exposed to their inevitable failure.

Keynesians and MMT supporters tell us that a government that issues debt in its own currency cannot go bankrupt. They avoid telling us that the condition is only true so long as there is some value yet to extract from the diminishing purchasing power of its inflating currency.

At this juncture, let us take stock of the current situation facing the dollar and its immediate future:

• Hyperinflation of the dollar commenced in the second half of fiscal 2020 (March to September), a condition which is bound to continue, so long as Keynesian beliefs and the electoral mandate to prevent an economic slump at all costs persist.

• The $900bn covid temporary relief package, currently rejected by President Trump as too small, will be followed by further inflationary financing in 2021, which will of necessity be larger than that of fiscal 2H 2020. A moment's thought on the evolving scale of the covid crisis should put all doubts to rest that this is the case.

• At the last count, foreign ownership of US dollar financial assets and cash deposits in the US banking system amounted to $28.5 trillion. The momentum behind the maintenance of the balance of payments is clearly diminishing and we can confidently expect further selling in the foreign exchanges to drive the dollar significantly lower.

• The fall in the dollar on the foreign exchanges will require an increase in interest rates to stabilise it. An increase in dollar rates at a time of growing economic difficulties goes against the Keynesian creed, will be unavoidable, and will seal the fate of government deficit financing. Being unable to refinance their debt, zombie corporations will begin to collapse, and a full-scale economic crisis ensues.

These developments are in process or can now be anticipated with a high degree of certainty. The only thing to add is that all other fiat currencies are affected by similar inflationary factors. For simplicity's sake the ratio between the dollar's purchasing power on the foreign exchanges and commodity markets is considered to be a separate topic, so as to not confuse the basic issues of a widespread currency failure.

To the current observable developments listed above, we can add the following bullet points, which are likely to evolve from them.

• A global banking crisis is unavoidable, probably starting in the Eurozone. US bank exposure to EU banking deposits in dollars will be withdrawn and sold. Instead of a flight to dollar safety, it is likely that there will be an intensified flight from dollars. Counterparty risks with other banks, such as the British, and those with foreign-owned prime brokers could result in substantial disruption in US financial markets. It is certain that the US Treasury and the Fed will continue to underwrite risks in the entire US banking system in that event.

• The US banking system will have to absorb bad debts from both covid and supply chain failures. The sheer scale of these probably constitute a greater threat to US banks than counterparty risks from foreign bank failures, but a combination of the two will ensure a banking crisis in the US and elsewhere will be considerably more difficult to deal with than the Lehman crisis twelve years ago.

• In the wake of a banking crisis, equity markets are bound to suffer a major reverse. The consequences are that the mirage of wealth creation in financial markets will disappear and foreign selling of financial assets and of the dollar will almost certainly accelerate.

• Bank loans secured with financial assets will no longer be covered, leading to the possibility of a repeat of the domino effect behind the multiple banking failures in 1930-33.

• The Fed has managed to keep the purchasing power of the dollar stable by maintaining an asset bubble in US Treasury debt, and by extension in US equities. A combination of banking problems and rising interest rates forced on the Fed by the foreign exchanges will end these conditions and inevitably the dollar will then be taken down with collapsing bond and equity markets.

Clearly, the violence of these likely events has the potential to challenge the American public's confidence in the dollar over a foreshortened period of time. For now, the public believes in the government's control over markets. People are generally unaware of the dangers ahead. But as a cohort, they are beginning to drift into one or the other of the other two cohorts: supporters of cryptocurrencies and precious metals.

Dealing with a fiat currency collapse

The outcome of current inflationary policies is increasingly obvious to those who care to think about it. We are coming to the end of the monetary era of fiat currencies. The common assumption of those aware of it appears to be that it will lead to a reset controlled by governments, clubbing together to manage the situation. Attempts to develop central bank digital currencies are consistent with governments seeking an alternative to existing currencies, but CBDCs are still fiat and will not survive the public's rejection of unbacked government money.

The problem with a government monetary reset is it ignores the origin of the problem — that governments cannot be trusted with money. While a government reset might be attempted it is bound to fail, because on the basis of experience humanity will reject it, unless it is credibly backed with metallic money, or as bitcoin hodlers presumably hope, governments abandon the money business entirely.

However, successful action will be born out of a crisis, and the only available anchor to money is gold, owned in quantity by central banks and government treasury departments. Anyone who thinks governments will just stand back and let the people decide for themselves what is money, leading to us carrying around gold and silver coins, or transacting with cryptocurrencies between mobile phones, has failed to learn the lesson of government control. If only to prevent individuals taking away control of money from the state completely, governments will be forced to turn what is left of fiat money into gold substitutes to ensure widespread distribution. In this context, a gold substitute is a form of money exchangeable on demand by the holder for gold coinage at a fixed rate. In other words, the monetary system can only return to the generally accepted monetary conditions that existed prior to the First World War.

There will be other difficulties. The Keynesian priesthood will have been discredited, leaving an intellectual vacuum. Being the only nations with unencumbered and undeclared bullion reserves free of leasing and other forms of double-counting, China and Russia will probably be the first to credibly back their currencies with gold substitutes, while the geopolitical implications and the loss of the dollar's hegemonic role is bound to be taken badly in Washington.

But we know the eventual outcome. The only question is how long it will take for the crisis to accelerate and end, and how long it will take for governments to reinstate their gold reserves as backing for their new currencies, acting as gold substitutes. Most governments have gold: none of them have bitcoin.

The crypto cohort

In the markets, there is considerable uncertainty over the monetary qualifications of leading cryptocurrencies, particularly bitcoin. Other than mainstream investors, who still cling to the Keynesian creed, there is an emerging crypto cohort who have so far not addressed the subject of a possible replacement of fiat adequately, riding high on recent price gains for bitcoin and other cryptocurrencies, which they persist in measuring in dollars and other national currencies. In other words, they understand the effect of the relative rates of issue between cryptos like bitcoin and fiat currencies, and they buy into the concept that cryptos are potentially a better form of money than state-issued fiat for that reason. But for nearly all of them fiat unconsciously remains the principal form of money: fiat remains the objective value in crypto transactions.

There is little doubt that measured in fiat cryptos such as bitcoin can continue to rise priced in fiat significantly from here, and growing numbers of respected investment managers in the fiat cohort are now buying into this concept. With central banks working on their own centralised digital currencies, respectability is loaned to the crypto class. The lack of new supply in bitcoin in particular presents an attractive performance opportunity relative to other portfolio investment assets. In other words, this current wave of cryptocurrency buying is not with the intention of hedging out of fiat risk but intended to be sold for fiat at a future date.

The conditions likely to benefit the crypto cohort most are the continual existence of depreciating fiat which never quite dies and therefore is never actually replaced. That condition, such as occurs in Argentina, requires a better form of money, in this case dollars, to circulate alongside the peso. And because the economic activity continues with the sounder currency, the depreciating peso continues with it. The more likely outcome, a collapse of the whole fiat currency regime and its replacement with gold substitutes raises the question that really matters: can distributed ledger cryptocurrencies survive being priced in gold?

In any event, it is hard to see how they can be used as a pricing medium, assuming state currencies re-emerge as credible gold substitutes. If they are to gain a monetary role, cryptos will need to be stable enough to act as the objective value in transactions. Furthermore, future values need to be both stable and calculable so that business investment in production of both consumer goods and of the higher levels of production can be contemplated. It is all very well for the crypto cohort to revel in spectacular gains measured against fiat currencies, but if a borrower of, say, bitcoin, is faced with the prospect of significantly lower prices for his end product measured in bitcoin, it is no use to him as a financing medium.

This is probably the most important reason cryptocurrencies cannot act as money. Their innate volatility and inflexibility render them unsuitable for the financing of production. And without the money function the idea of bitcoin continuing to act as a store of value is only possible until the successor to fiat is a stable form of money. Whatever that outcome turns out to be, a return to monetary stability will make hoarding money largely redundant, replaced by personal liquidity relative to anticipated purchases of goods, and savings, whereby hoarded money is invested in and loaned to businesses. If the successor to fiat is to be bitcoin, it will have to survive this radical change of use.

Furthermore, consideration must be given to the financial structure of a post-fiat world. Today the sum total of OTC derivatives is over $600 trillion according to the bank for International Settlements, with a further $30 trillion in listed futures and a further $43 trillion in options. These are paper on paper, which will evaporate with fiat, destroying the financial world as we know it. Speculation and the pseudo-speculation of risk hedging with derivatives will die. Unfortunately for lovers of cryptocurrencies, if, as we must conclude, gold wins the race for the replacement of fiat, they will have turned out to have been mere speculation, drowned alongside all that paper.

Nevertheless, the crypto cohort is likely to have an important effect, in that it sparks an early realisation in a growing part of the wider population about what government is doing with money. That is likely to speed up the collapse of fiat currencies compared to what would otherwise occur.

The gold cohort

Like the crypto cohort, supporters of precious metals taking over the role of money are considerably smaller than the mainstream. We can exclude investors in mining shares and physical ETFs on the basis they are only seeking exposure to them as investments, intending to measure and take their profits in them at a future date —

again in a fiat currency retaining its role of objective value. And promoters such as the World Gold Council dare not mention the moneyness of gold for fear of frightening off investors in their ETF.

The true supporters of metallic money are those who hoard bullion and coin, ensuring there is no counterparty risk. Not only does this rule out securitised representations of precious metals, but putting them under the control of a bank, even on an allocated basis, does not qualify as clear title of ownership.

The retention of physical gold and arguably, silver, is a bridge to a post-fiat future. As argued above, after an unsettling period the future is almost certainly based on gold and fiat money being reassigned to become gold substitutes. Unlike bitcoin, gold possess a flexible supply, which is determined by its users and is beyond the control of governments. To annual mine supply is added gold being used for non-monetary purposes. A rise in gold's purchasing power leads automatically to an increase in supply from sources such as jewellery though enhanced scrap, and a fall in purchasing power leads to increased jewellery sales. In any event, throughout recorded history the additions from mining to above-ground gold stocks have approximated to population growth, making gold for money purposes no less scarce today than it was in the past.

This flexibility in the supply of monetary gold and the stability of prices allows the originary rate of interest to be both low and stable. It allows entrepreneurs to do business calculations with a high degree of certainty, knowing in terms of goods the value of money in five- or ten-years' time. And savers, who provide the monetary capital for future production can be confident of the future capital value of their savings when lending them for business investment purposes.

A return to the monetary arrangements that existed before the First World War shows that price stability combined with free markets and free trade, as argued and demonstrated by adherents of the Manchester school in the nineteenth century, is the sure path to future prosperity in a post-fiat world.

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