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The Role of Gold in the unified GCC Currency

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Abdulaziz O. Sager

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"When national debts have once accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue if it has ever been brought about at all, has always been brought about by a bankruptcy; sometimes by an avowed one but always by a real one, though frequently by a pretended payment."
Adam Smith (1723-1790), *The Wealth of Nations (1776)*

"Paper money eventually returns to its intrinsic value – zero."
Voltaire (1694-1778)

Introduction

Monetary authorities are currently planning to peg the unified GCC currency to the US dollar in 2010, thus continuing the dollar peg that continues to exist for local currencies. Although the Euro or a currency basket is sometimes taken into consideration as an additional component to a future currency peg, gold as a monetary metal has not been mentioned and as an option appears completely out of the picture. In this paper, it is suggested that this is unadvisable and that the GCC countries are ill prepared for the unfolding crisis of the paper dollar standard. In order to illustrate this further, the first three parts of this paper will analyze the problem of the paper dollar standard from a historical and global perspective. The following sections will then deal specifically with the situation in the GCC countries and arguing that a Gold component represents an alternative that should be seriously considered.

The unsustainable paper dollar standard

Even the most ardent proponents of today's world economic order have ample reason to feel uneasy about the current state of affairs. Since the late 1960s, the three major economies - US, Japan and Germany - have witnessed major declines in the growth of their GDP, productivity, real wages and profits. Only unemployment has

been rising.[1] Within this overall negative trend, serious imbalances have occurred, which are especially worrisome for economies such as those of the GCC countries that are heavily dependent on the US dollar. The US now displays a public debt of USD 7.3 trillion and a current account deficit that constitutes more than 5% of GDP Year-on-Year (USD 0.5 trillion).[2]

These are no easy figures to digest for the GCC countries as their currencies are pegged to the US dollar and their major export good (oil) is settled in US dollars. Moreover, a great portion of their imports must be paid in currencies that constantly appreciate in relation to the greenback. The overall picture is even worse. Total US debts, including those of households and public agencies, have been ballooning since the 1980s. The accumulated figure of USD 37 trillion is 340% higher than GDP (Graph 1). Currently, five dollars of additional debt buy only one dollar of GDP growth. On top of this, the US needs capital imports of more than USD 2 billion per day to finance its current account deficit, which is approximately 80% of worldwide savings.[3] This situation is highly unsustainable. Compared to a dwindling economic base, this debt has in effect become too high to be effectively repaid. It will either default or more likely be inflated to such an extent that it will not hurt to "pay" it back. For the GCC countries, with their dollar-pegged currencies, this will mean loss of wealth and financial stability.

1- See Table 1. For a further explanation of the "long downturn" of the world economy see Robert Brenner, "The Economics of Global Turbulence: A Special Report on the World Economy, 1950-98," *New Left Review* 229 (May/June 1998). South East Asian countries and China, often exaggeratedly hailed as an alternative, are and will be similarly affected. Paul Krugman, "The Myth of Asia's Miracle," *Foreign Affairs* 73, no. 6 (1994), pp. 62-78 and Joe Studwell, *The China Dream* (New York, 2002).

2- Financial data by Bloomberg.

3- Eric Hommelberg, "Gold & US$," November 25, 2004, available under www.gold-eagle.com/editorials_04/ hommelberg112404.html.

Table 1: The long downturn of the world economy since 1960
(average yearly growth rates except unemployment rate)

	1960-73	1973-79	1979-90	1990-96	1997-2000
GDP					
USA	4,0	2,6	2,4	2,1	1,7
Japan	9,2	3,5	3,9	1,6	-0,8
Germany	4,3	2,4	2,1	1,7	0,7
G7	4,8	2,8	2,55	1,6	-
Productivity (nat. economy)					
USA (GDP/ hours)	2,6	1,0	1,0	0,7	2,6 (per worker)
Japan (GDP/ worker)	8,2	3,0	3,0	1,0	1,4
Germany (GDP/ worker)	4,0	2,7	1,5	1,85	1,2
Real wages (nat. economy)					
USA (per hour)	2,8	0,3	0,4	0,3	0,6
Japan (per worker)	7,7	2,8	1,6	0,6	0,3
Germany (per worker)	5,4	2,5	1,0	0,9	0,9
Capital stock (priv. Economy)					
USA (net)	4,0	3,4	3,2	2,1	-
Japan (gross)	12,2	7,35	7,9	4,7 (1990-95)	-
Germany (gross)	6,4	3,6	3,0	2,7 (1990-94)	-
Unemployment rate					
USA	4,8	6,7	7,0	6,3	4,4
Japan	1,3	1,9	2,5	2,6	4,2
Germany	0,8	3,4	6,8	7,6	8,9
G7	3,1	4,9	6,8	6,9	-

Source: Organization of Economic Cooperation and Development (OECD), Historical Statistics 1960-1995 (Paris, 1997), Statistical Annex, European Economy, no. 64; Historical Statistics 1970-2000 (Paris, 2001), pp. 42, 51, 76, 86.

The Euro and other paper currencies as questionable alternatives

Given such circumstances, it has been repeatedly discussed to peg the planned common currency of the GCC countries in 2010 to a currency basket with a considerable Euro component rather than solely to the US Dollar. Such diversification could lead to a greater consistency of import and export incomes and thus is indeed advisable compared to the total dollar dependency the GCC countries are relying on at the moment. Yet, although the foreign trade position of Euroland looks sound compared to that of the US, The European countries are equally prone to deficit spending. Most importantly, since its growth model is heavily dependent on exports to the US and continued US deficit spending, the Euro could be regarded as a derivative of the paper dollar standard rather than a strong independent currency of its own. This dependency is even more applicable in the case of Asian countries that additionally lack developed domestic markets and any kind of unified political system. Thus, the Euro and other currencies (e. g. Yen) still remain paper currencies with their inherent problems of devaluation. For this reason, gold as an additional anchor of stability, under the conditions of coming currency crises, should be taken into consideration as an important alternative.

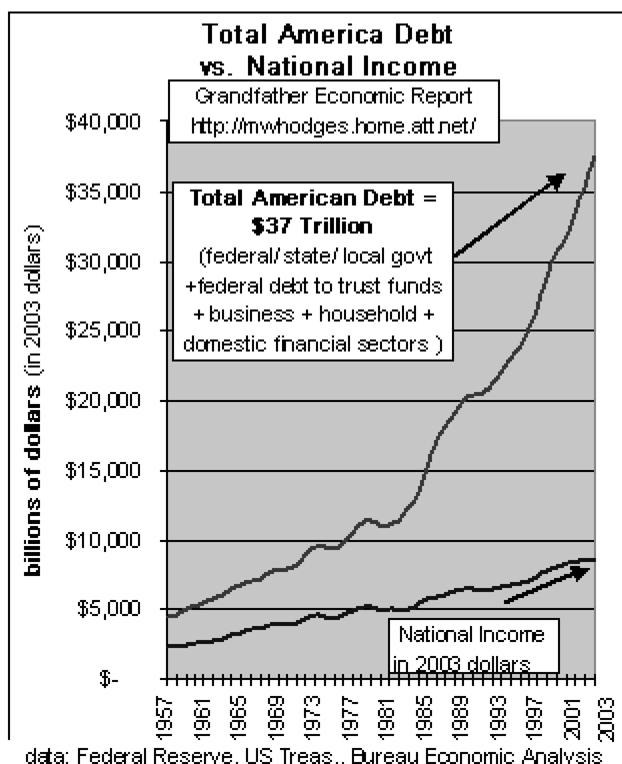
The "barbarous relic" and critical silences of mainstream economics

Although gold played a vital monetary role as currency in the 5,000 years before 1971,[4] the question if it could be of monetary importance nowadays appears utterly ridiculous to most economists. Following the view of John Maynard Keynes who described it as a "barbarous relic," current theorists claim that it would not make sense any more to dig a precious metal out of the

4- For a concise overview, see Peter L. Bernstein, *The Power of Gold: The History of an Obsession* (New York: 2000).

ground just to bury it again in bank vaults. They oppose the constraints of a gold standard arguing that it limits the fiscal and monetary stimulation that modern economies need. Some even see a decisive responsibility of such limitations for the Great Depression of the 1930s.[5] The sole advantage of gold for them is that it looks nice as jewellery for the women of the world.

Graph 1: Total American Debt vs. National Income



Source: Grandfather Economic Report: *www.mwhodges.home.att.net/*

5- Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression*, 1919-1939 (Oxford: 1992).

A minority faction following ultra liberal economists of the Austrian school of economics such as Friedrich von Hayek or Ludwig von Mises would however like to see a monetary role for gold. They believe that the use of a gold standard restricted government spending and contributed to price stability from the 19th century until the outbreak of World War1. Furthermore, they regard the subsequent gold exchange standards of the interwar period and the Bretton Woods system as flawed, as they diverted from the ideals of free market economies and natural scarcity that the Gold Standard had offered.[6]

Both of these camps fail to address important points. On the one hand, state intervention and the move away from gold was necessary to spur large-scale capitalist development and the accompanying infrastructure of regulating states. On the other, the current paper dollar standard with its imbalances has however become equally unsustainable.

A tricky gold market, a failed Gold Dinar and unprepared GCC central banks

Meanwhile, with paper money being printed abundantly, some have taken a closer look at gold as it represents a scarce natural resource that cannot be duplicated infinitely. This seems all the more true as there is more than a hint that the gold market has been artificially suppressed in the last decade by leased central bank gold that is being sold into the physical market. Thus, much more gold may have left Western central bank vaults than is officially acknowledged, and continues to exist as derivative short position in the banking system. This peculiarity of the gold market may considerably reduce the possibilities of acquiring physical gold as a hedge against financial turbulences in the future.

6- For a libertarian pro gold standard view, see Hans F. Sennholz, Murray N. Rothbard, and Mark Skousen, *Gold, Freedom, and Free Markets* (Economic Philosophy for Prudent Investors, 2004).

Even in the Islamic world, the possibility of gold standard has been raised. In a series of conferences in the years 2002 and 2003, former Malaysian Prime Minister Mahathir proposed the implementation of an Islamic Gold Dinar. The idea was to settle bilateral trade between Islamic countries and offer an alternative to the pitfalls of turbulences at the currency markets that badly hurt Malaysia in the wake of the 1998 Asian crisis. This initiative, however, has not materialized so far and particular reasons can be provided as to why it could not function under the prevailing conditions of international trade and division of labor (this will be further explained in the following section). This scepticism notwithstanding, gold is a superb means of asset diversification and preservation and it will augment the manoeuvrability and options that monetary authorities have when faced with a future currency crisis. Unfortunately, while private households in Arabia are already using gold intensely, the regional central banks do not seem to take notice of this alternative and are ill prepared.

The demise of the Bretton Woods System

After World War II, the US became the undisputed superpower of the Western world. Economically, its position was sound: It commanded 50 % of worldwide industrial production, with solid advantages in productivity compared to other nations. It had a healthy surplus in its current account, owning about 71% of world wide gold reserves. And because of the war, it was also the creditor of the former allies. Thus, the focus was on the US and the dollar when the reconstruction of Europe and the containment of the second newly emerging superpower, the Soviet Union, were discussed.[7]

7- See Ernst Lohoff, "Die harte Landung des Dollar: Von der währungspolitischen Pax Americana zum Weltmarkt ohne Weltgeld," *Krisis* 16/17 (1995) under: www.giga.or.at/others/krisis/e-lohoff_harte-landung-des-dollar_krisis15-17_ 1995.html; Also Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton: 1998).

At the conference of Bretton Woods in 1944, a system of fixed exchange rates was decided. As such, the dollar was fixed to gold and functioned as an anchor to the world's currency system. By the 1960s, however, the economic situation had changed. Protectionism and the Marshall Plan on the one hand, and unproductive consumption patterns of the US on the other hand, allowed Europe and Japan to catch up economically. The US started to run increasing current account deficits and there was a constant drain of gold from the US to Europe. Eventually, it became unclear whether the US would be able to comply upon request with its promise to exchange dollars for gold. Thus, the Bretton Woods system was in danger of loosing its ultimate anchor: the gold backed dollar.

Measures were set up to defend this anchor, or at least to keep up the illusion of it. In 1960, the central banks created the Gold Pool in order to intervene in the gold market and to defend the fixed rate of USD 35 per ounce of gold against speculative attacks that started after markets became aware of the weak position in the US current account. Additionally, the trading partners of the US were urged to hold their dollars and not to exchange them into gold. In the end, these measures proved to no avail. France, for example, opposed this practice openly in 1965, when President de Gaulle demanded the return to a gold standard. Exacerbated by its military spending during the Vietnam War, the US also continued to pile up huge structural deficits,. The result was that by 1971, the US defaulted on their obligation to pay gold for dollar and closed the gold window. The Bretton Woods system had finally collided under the pressure of financial imbalances that could not be maintained any longer. The dollar had *de jure* lost its status as the anchor of the currency system and from now on would become a free floating currency.

De facto however, the dollar kept its role as the anchor of the international financial system to this day, as most international trade continues to be factored in dollars and as the dollar remains the most important reserve currency constituting about 70% of worldwide reserves. That is all the more astonishing as no

adjustments have been undertaken since 1971 to cure the serious imbalances that had developed until that time. In fact , the treasury secretary of the Nixon administration, John Conolly, let the Europeans know that "the dollar is our currency, but your problem" with the US continuing to amass deficits that it financed via the rapidly developing Eurodollar markets. Here, it is noteworthy that the deficits that brought the Bretton Woods system to fall were minute compared to the debt that the US has accumulated in the meantime. This is the situation that exists to this day. The dollar is still the anchor of the international financial system, but it is no longer backed by gold and current account surpluses such as at the end of World War II. Instead, huge mountains of debt and the good faith of the international community of creditors have taken their place.

The seriousness of the situation is made clear by the central role that the dollar plays today. The dollar is not simply the currency of a country, but it ensures the liquidity of the world economy. The US is the only country in the world that can pay its imports with its own currency. Being privileged to finance a trade deficit with the printing press is no doubt a comfortable position. Yet, all nations that run trade surpluses with the US like Western Europe, Asia and the OPEC countries have also been comfortable with this situation. The acceptance of the ever increasing amount of paper dollars as payment for their exports and the reinvestment of these very dollars in dollar denominated assets (treasuries, stocks) have ensured growth and employment at home, and have given them the fancy feeling of being rich on paper. Economists, governments and corporations have been eager to justify this situation by all kinds of new age economics and creative bookkeeping.[8] As first formulated by Robert Triffin in the 1960s,

8- The American growth and productivity "miracle" of the 1990snineties that has been excessively hailed by all kinds of experts is mainly a statistical fake enabled by creative bookkeeping on the macro level like hedonic price indexes, substituting one item for another when its prices rise and a more than incomplete statistic of unemployment. See John Williams, "Behind the Government's Numbers," (October 6, 2004) available under: http://www.gillespieresearch.com/cgi-

the world nowadays is still facing the dilemma between the availability of world money and its credibility. On the one hand, the world economy is craving for the liquidity of the world money that is supplied to it by the above mentioned deficit circles; on the other hand, the credibility of this very world money is undermined by the same deficit spending that creates the liquidity in the first place. The question is how long will this party last? As a matter of fact, the continued weakness of the dollar and the disturbing statistical evidence are strong signs that it is coming to an end.

An alternative to the paper dollar standard? Exploring the Gold Standard

The search for alternatives to the paper dollar standard is not new. It started in the 1960s, as the French minister of Finance Jacques Rueff and President de Gaulle opposed the right of the US to what they called "deficits without tears" and publicly deliberated about a return to the Gold Standard. The US would have none of it as this would have meant tolerating the ensuing fiscal modesty that would have constrained its hegemonic military consumption and ambition.[9] Other nations that had built their growth model on US deficit spending were not delighted either. As most of its currency reserves (86%) were in gold at that time, the proposal of France was of course not altruistic. A return to the Gold Standard would have given it a remarkable starting advantage that would have been unacceptable for countries with less gold reserves like Japan (17%), for example.[10] As such, it had the character of an academic proposal

bin/bgn/article/id=344; Casey Research: What we now know - Newsletter, November 22, 2004 and Lester C. Thurow, "Die Illusion vom Jobwunder: Viele Arbeitslose werden von Amts wegen gar nicht mehr registriert," *Die Zeit*, October 25, 1996, p. 41.

9- For an historic elaboration of the argument of economically unproductive hegemonic military spending and resulting "imperial overstretch" see Paul Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict 1500-2000* (New York: 1987).

10- Lohoff, Ernst, *op.cit.*, p. 16.

rather than that of a serious political initiative.[11] It quickly became apparent that the role of government intervention had become too important and the unlimited supply of credit money that was needed to realize such intervention rendered a return to the Gold Standard unsuitable. Societies in the 19th century were still in a nascent state of capitalist development and included considerable areas of non-capitalist production (e.g. face-to-face household economies and agriculture) that did not require regulation by the state. But the creation of large-scale markets and mass production needed massive government regulation in various fields like administration, infrastructure and education. If necessary, the state could also step in as investor when no one else wanted to or could not take the risk. Thus, the continuous rise of government expenditure as percentage of GDP since the 19th century is not accidental. It is also not a Keynesian-socialist conspiracy as some liberals and ardent defenders of the Gold Standard want to have it, but a basic necessity of capitalist development.[12] It is this historic dimension that the neoclassical mainstream of economics fails to grasp by religiously believing in the axioms of *homo oeconomicus* and ahistoric modelling.[13]

As the Gold Standard ties the money supply directly to the balance of trade and therefore to the competitiveness of a country, it leaves little room for the kind of monetary and fiscal intervention

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11- In the 1920s, Great Britain and other countries tried to reintroduce the Gold Standard seriously (1925-1931) but finally aborted it because of its deflationary effects. The French attempt in the 1960s was equally buried quite rapidly.

12- The percentage was well below 10% in the 19th century and reaches up to 50% in industrialized countries nowadays. Karl Polanyi describes in historic detail how this development of market *and* state took place and how both have been two sides of the same medal. They have been by no means alternatives excluding each other, as many liberals are seeing it. See Karl Polanyi, *The Great Transformation: The Political and Economic Origins of our Time* (Boston: 2001 - originally 1944). Also see Immanuel Wallerstein, *Historical Capitalism*, (London: 1983).

13- John Brohman, "Economism and Critical Silences in Development Studies: A Theoretical Criticism of Neoliberalism," *Third World Quarterly* 16, no. 2 (1995), pp. 297-318, 304.

and stimulation that capitalist development has required since the last century. Therefore, it was not only the disruption of World War I where tax revenues often met less than 5% of expenditures that brought the Gold Standard to fall, but the ensuing capitalist development with its need for state intervention, stimulation and credit money rendered a return to it as futile.

It is important to be aware that the Fordistic coherence between mass production, mass employment and mass consumption is not conceivable without the modernizing approach of regulating states and their massive use of credit money and participation in the social, economic and political spheres. In this sense, it is true when the French economist Charles Rist said that democracy killed the Gold Standard.[14] However, the opposite would be true as well in that a reintroduction of a gold standard would cause massive deflation and would be the final nail in the coffin of the ailing paper dollar standard and the widely accepted social model for which it stands, i.e. mass participation in the economic and political field. The reintroduction of a gold standard would effectively rule out state intervention and would affect the whole social fabric as it has emerged over the last century of modernization and as we now know it. Some proponents of a gold standard do not seem to keep that in mind, but cling to an ideal of a society of small merchants and craftsmen exchanging their goods like in a medieval village.[15] And while that may have some charm, such a regression would be impossible, as you cannot turn back the clock of history. Unlike in the 19th and early 20th century, people's lives nowadays are fully commodified and monetized. Therefore, apart from some surviving

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14 Robert Mundell, "The Relationship between Currencies and Gold,“ World Gold Council: The Euro, the Dollar and Gold, Proceedings of a Conference held in Rome, November 2000, pp. 23-31, available under: www.gold.org/value/reserve_asset/gold_as/imf/RomeConf/RomeProceedings.pdf .

15- "Americans may be forced on a local level to return to many of the self-sufficient, pro hard money, and anti-centrist attitudes and values held by the pioneers who once created the Lone Star Republic of Texas," Bill Fox, "Id Monsters, Self Deceptions and $1000 Gold," (March 23, 2004): available on www.financialsense.com/fsu/ editorials/fox/idmonsters/part3.html, p. 17.

productivity islands, many weaker economies would be confronted with a serious crisis. It would be a remonetization of gold facing demonetized people. People, who have already been declared useless by a failing paper dollar standard could easily slip into civil war. In some Third World regions, such a scenario can be already observed.[16] Thus, a move away from the paper dollar standard to a gold standard would at least require further discussions about how capitalist sectors could be partly transformed and be replaced by alternative modes of reproduction.[17]

Asset protection, manoeuvrability of central banks and the role of gold

Money basically fulfils two functions: it is a means of payment and a store of wealth. As a gold standard would have massive deflationary effects, a hypothetical reintroduction of gold as a means of circulation would face serious problems and raise significant questions about socio-economic issues involved. But the ailing paper dollar standard and negative real interest rates in the USA put gold into the spotlight when it comes to the second function of money - store of wealth. In that respect, gold has an impeccable track record. Long-term studies show that gold has been able to keep its purchasing power, not only over years, but over

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16- Robert *Kurz, Schwarzbuch Kapitalismus: Ein Abgesang auf die Marktwirtschaft* (Berlin: 2003), pp. 897-901. While indulging in their monotonous glorifications of competition and survival of the fittest, ultra liberals like von Hayek seem to unapologetically accept such scenarios as long as it is for the sake of "free markets." For a radical criticism of his ideas, see ibid pp. 751-755.

17- This is beyond the scope of this paper and the discussion about it is still regarded as "esoteric." Possible further reading include André Gorz, *Reclaiming Work: Beyond the Wage-Based Society* (Cambridge/Malden: 1999); Jeremy Rifkin, *The End of Work: The Decline of the Global Labor Force and the Dawn of the Post-Market Era* (New York: 1995); and Robert Kurz, "Marx 2000," (February 1, 1999) under www.exit-online.org/html/link.php?tab=transnationales&kat= English &ktext=Marx%202000.

centuries.[18] A suit cost an ounce of gold in the Middle Ages as it did in the 19th century and like it does now.[19] No paper currency can pride itself with such a track record. And while 10 years from now it is highly unlikely that 400 dollars will buy a suit, an ounce of gold still will. Thus, gold is a superb means of asset diversification and protection as it is inversely correlated with other asset classes like equities, bonds or currencies. When institutional frameworks and contractual obligations fail (e.g. due to economic crisis or war), gold keeps its liquidity and purchasing power. It is no one's liability. Therefore, it is not only advisable for private persons to hold a good percentage of their assets in gold, but the old traders saying "invest 10% of your money in gold and hope that it doesn't work"[20] makes sense for central banks as well. The European Central Bank maintains an interest in gold as it stipulates that its members hold at least 15% of their currency reserves in the ancient metal. Meanwhile, the US still holds its majority of currency reserves in gold, while flooding the rest of the world with its paper receipts. In his younger years, Alan Greenspan, the chairman of the Fed, even declared gold as indispensable for free capitalist markets.[21] In the aftermath of the Asian crisis, Korea and Thailand

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18- Stephen Harmston, "Gold as a Store of Value", *World Gold Council Research Study* No. 22, November 1998: under http://www.gold.org/deliver.php?file=/value/stats/research/pdf/RS-22.PDF, pp. 5; See also Roy W. Jastram, *The Golden Constant – The English and the American Experience 1560-1976* (Berkeley: 1977).

19- The suit example is basically correct but admittedly simplified for the sake of the argument. A closer look at developments of productivity and increase in gold production lead to a more detailed picture. For a discussion about the application of purchasing power parities in gold over long periods see Bill Fox, op.cit., p.4.

20- In the turbulent 1970s, seventies many Swiss banks actually advised their customers to hold up to 40% of their assets in gold. Ferdinand Lips, *Gold Wars: The Battle against Sound Money as Seen from a Swiss Perspective* (New York: 2001), p. 94.

21- See Table 3. In his article "Gold and Economic Freedom" of 1966, Alan Greenspan hailed gold as the only means to protect the citizens' wealth against inflation induced by reckless government spending. Ironically, it has been Greenspan himself at a later stage in his life who contributed to such a currency

raised gold from their citizens in exchange for local currency securities, in order to serve their external debt obligations. Furthermore, during wartime gold often has been the only accepted form of payment for necessary imports. One of the biggest uses of gold by a government authority happened in 1933, when the US needed to create inflation and stimulate spending to overcome the Great Depression. As the US still maintained a gold cover clause of its currency and hoarding of gold as a means of savings was popular due to the economic crisis, this alternative had to be abolished. Therefore, gold possession of private individuals was declared illegal, the gold cover clause was severed and the gold price was deliberately raised from USD 20.67 to USD 35. This sudden 41% devaluation of the dollar enabled the government to pursue its policy of economic stimulation in the New Deal era.[22] Given these examples from the official sector and given the traditional appeal of gold as a store of wealth in regions like India, Arabia and Asia, it is no wonder that a banker stated: “We tried to make gold just a commodity but we did not really succeed.”[23]

The GCC currency systems and a trade weighted currency peg

Well into the 1960s, the economies of the GCC countries remained underdeveloped. They were characterized by large shares of subsistence economies and primitive commodity trade. Accordingly, coined precious metal currencies were the medium of exchange like the Austrian Maria Theresa Thaler, the British Gold

debasement via loose monetary politics. For the article, which first appeared in The Objectivist and was later reprinted in Ayn Rand’s “Capitalism: The Unknown Ideal,” see www.321gold.com/fed/greenspan/ 1966.html.

22- Paul van Eeden, “The Gold Price,” *The International Speculator* 24/4 (April 2003): www.paulvaneeden.com/ Lbrary/200304%20Gold.php. Private gold holdings remained illegal in the USA until 1975.

23- Robert Raymond, “Introductory Remarks,” Gold and the International Monetary System in a New Era, World Gold Council conference, November 19, 1999, p.7.

Sovereign and the Saudi Arabian Silver Riyal.[24] In 1952, Saudi Arabia issued its own Gold Sovereign. The establishing charter of the Saudi Arabian Monetary Agency (SAMA) of 1952 even prohibited the issuance of paper currency. But the increasing integration of the Arabian Peninsula into the world economy stipulated stronger outward orientation and credit and monetary expansion. Therefore the charter of SAMA was amended in 1960 to allow for the issuance of note currency and the Riyal was subsequently linked to the US dollar, which itself was still linked to gold at that time. Other Gulf countries followed suit after the devaluation of the British Pound in 1967.[25] The linkage to the major world currency made sense for developmental reasons also as the dollar crisis was not yet apparent. The major export good, oil, was factored in dollars and the economic relations with the US were especially close ever since Standard Oil had started to explore for oil in Saudi Arabia in the 1930s which ultimately led to the establishment of the Arabian American Oil Company (ARAMCO) in 1944. Once the dollar started to depreciate in the 1970s, only Oman continued to entertain a dollar peg. Other GCC countries tried to cushion the impact by switching to currency baskets like the IMF's Special Drawing Rights (SDR). Saudi Arabia did so in 1975 and the UAE, Qatar and Bahrain followed suit in 1978. Kuwait entertained a separate currency basket with a dollar component of about 70%. Effectively, however, the ties to the dollar remained very strong, as the Riyal floated in a band of 14.5% to the SDR often showing a stronger correlation with the dollar than with the SDR itself. Qatar, the UAE and Bahrain on the other hand chose the pre-1973 SDR parity, which was very close to the dollar. Thus, the Gulf States entertained a de facto dollar peg since 1979. Finally in 2003, the GCC countries returned officially to a dollar peg, which is supposed to be continued in a unified GCC currency in 2010.

24- Ragaei El Mallakh, Saudi Arabia, Rush to Development: Profile of an Energy Economy and Investment (London: 1982), pp. 289-294.

25- Henry T. Azzam, *The Gulf Economies in Transition* (London: 1988), p. 159.

Given the trade relations of GCC countries (Table 2) and the fragile nature of the ailing paper dollar standard, it is uncertain whether that will be a wise step. Imports from the European Union (EU) outnumber those from the US by nearly three to one. Of course, the dollar still remains the world's major trading currency. Thus, it does not account for the US trade alone. But it is questionable if Asian countries that account for a similar portion of imports like the EU can continue to amass paper dollar receipts indefinitely. It is rather likely that at some point they will have to modify their dollar-peg (China) or give up intervention in the currency markets (Japan). Therefore inflation and financial instability will trickle into the GCC monetary system via the dollar peg. Central Bank officials are trying to talk down the impact by pointing out a supposed seasonality of dollar weakness and increased possibilities for GCC non-oil exports. Some have even mentioned an altruistic readiness of exporters to give their Arab friends rebates because they are badly hurt by the declining dollar. But that may prove to be wishful thinking. As outlined above, this weakness is not seasonal but structural and represents the culmination of a decade old imbalance. Non-oil exports still remain low in the GCC countries and are often comprised of processed imported goods that have become more expensive. Thus, it is by no means clear if non-oil exports will really increase and whether they will be able to counterbalance the negative impact of dollar weakness.

An additional problem is that the majority of the USD 740 billion of GCC investments abroad are held in US dollars, thus further augmenting the negative impact.[26] The outcomes are already discernible, prices for food, pharmaceuticals and fuel have risen sharply for example. The parliament of Kuwait even declared an additional allowance of USD 680 for its citizens in order to help them to make ends meet.

26- *Khaleej Times*, December 20, 2004.

Table 2: Trade relations of GCC countries, 2001:

(Million US dollar)

Intra GCC trade	6.403,33
Arab countries Imports (IM)	4.256,38
Arab countries Exports (EX)	3.393,07
Arab countries Surplus/ Deficit (S/D)	-863,31
Islamic countries IM	4.530,85
Islamic countries EX	5.033,82
Islamic countries S/D	502,97
E.U. IM	28.528,55
E.U. EX	11.743,46
E.U. S/D	-16.785,10
USA IM	9.832,42
USA EX	13.516,35
USA S/D	3.683.93
Japan IM	8.083.35
Japan EX	12.650,18
Japan S/D	4.566,83
Rest of the world IM	24.494,82
Rest of the World EX	42.223,77
Rest of the World S/D	17.728,95
Total IM	79.726,37
Total EX	88.560,65
Total S/D	8.834,28
For comparison:	
Total IM E.U. 15 (2000)	3.305.700,00
Total EX E.U. 15 (2000)	3.256.400,00
Total IM USA (2000)	1.103.100,00
Total EX USA (2000)	1.466.900,00
GDP USA (2003)	10.345.100,00
GDP E.U. 15 (2003)	8.186.800,00
GDP Japan (2003)	4.876.100,00
GNP GCC (2003)	342.952,00

Source: The Cooperation Council for the Arab States of the Gulf: Statistical Bulletin No. 12 (2003): http://library.gcc-sg.org/gccstatvol12/toc/index1.htm; OECD: istorical Statistics 1970-2000, Paris 2001 and Annual National Accounts: www.oecd.org/dataoecd/48/4/33727936.pdf.
Note: The included UAE export data excludes oil exports.

The allegiance of GCC countries to the dollar may be motivated by their dependency on the US for security and may as such not be purely economic in nature.[27] Nevertheless, the question must be raised whether the GCC States could avoid the outlined predicament by moving away from the dollar and implementing a currency basket with a strong Euro component. Economic Nobel Laureate Robert Mundell deems the advent of the Euro as the single most important event in the history of currencies since the dollar inherited the currency leadership from the British Pound after the outbreak of World War I.[28] As the GDP and the number of inhabitants of the Euro-area are comparable to those of the US or even surpassing it, the dollar for the first time is facing a real competition in terms of its transaction domain. Formerly, the thinness of markets for hard currencies like the Yen, the Swiss Franc and the Deutsche Mark limited movements out of the dollar for the lack of sizeable alternatives. In terms of the Euro, Mundell sees other important features of a dominant international currency like sound monetary policy, political stability, absence of capital controls and fall-back value as being sufficiently provided. He also deems the lack of a central government as not being too critical since the end of the Cold War, and points out the substantial gold and currency reserves of the Euro-area that provide a kind of "virtual" fall-back value, although the Euro like the dollar is a fiat currency with no direct linkage to any intrinsic commodity value. All in all, Mundell expects the Euro to acquire the status of an international reserve currency by 2010 with a comparable standing like the US dollar.

Euroland indeed represents a remarkable transaction domain that is already spreading beyond its borders to Eastern Europe, the

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27- This dependency increased dramatically after the second Gulf War. See Hasan Hamdam Al-Alkim, *The GCC States in an Unstable World: Foreign-Policy Dilemmas of Small States* (London: 1994), p.70 and 109.

28- Robert Mundell, "The Euro and the Stability of the International Monetary System," (January 1999): www.robertmundell.net/pdf/ The%20Euro%20and%20the%20Stability%20of%20the%20International%20Monetary%20System.pdf, p.1.

Mediterranean countries and West Africa. Yet, some words of caution are in order. The Euro's foreign trade position may look sound compared to that of the US, but it is similarly prone to deficit spending, which can already be seen by the repeated violations by such countries as France and Germany of the Maastricht stability criteria. This deficit spending is not likely to end anytime soon given current sluggish economic growth, demographic imbalances and the costs of EU extension into Eastern Europe. Therefore, the Euro still remains a paper currency with its inherent problems of devaluation. Moreover, the absence of backing by a central political entity and by an actively intervening Fed could conceivable be a bigger problem than Mundell conceives. Cynically as it may sound, dominant international currencies have not been backed by economic might alone, but by military power as well. Besides gold there has been always the more profane metal backing of lead and in this respect the EU is only a pale shadow of the US.[29] Furthermore, the European Central Bank (ECB) concentrates on price stability rather than on deliberately propping up the stock market. While conservative minds may see that as a sensible policy, the financial markets have become used to the ample liquidity doses applied to them by "Easy Al" Greenspan and prefer the rather loose interventionism of the Fed.[30]

But most importantly, Euroland depends on US deficit spending for its growth model. It is this very US deficit spending that has formed the fragile backbone of the world economy for the last decades. The dependency is not as high as in Asia and in emerging market countries with dollar-pegged currencies, but still exists to such an extent that the recent Euro appreciation has made European politicians bite their nails. Thus, one can think of the Euro as a derivative of the paper dollar standard rather than a strong

29- See F. William Engdahl, "A New American Century? Iraq and the Hidden Euro-Dollar Wars," (2003): www.currentconcerns.ch/archive/2003/04/ 20030409 .php.

30- Barry Eichengreen, "The Euro as Reserve Currency," Working Paper, November 1997, http://emlab.berkeley. edu/users/eichengr/research.html , pp. 19-23.

independent currency of its own. This is all the more true for Asian currencies, which have underdeveloped domestic markets, serious conflicts of interests (Japan vs. China), no unified political institutions whatsoever, high dependency on exports to the USA, and USD currency reserves that appear completely exaggerated (e.g. Japan USD 800 billion, China USD 500 billion).

This scepticism notwithstanding, it is of course advisable for GCC countries to harmonize their currency links with their trade relations and to diversify their external assets away from the dollar. Here, the Euro is specifically worth mentioning, as it shows a certain degree of independence.[31] But it will always be a "second worse" scenario and the Euro will continue to be part and parcel of the unfolding crisis of the paper dollar standard. Any meaningful currency policy will have to anticipate the possibility of such a crisis. Within this framework, gold will regain importance, even if it is difficult to predict at this stage what its role may look like. More likely, it will be the role of a traded asset protector rather than that of a renewed gold standard.[32]

Hazem Beblawi has pointed out that the oil economies of the Gulf countries and their petro-dollar recycling in Western securities markets do not generate income in the strict sense, but represent a mere exchange of a real asset (oil) for a financial one. In that sense it is paramount for the GCC countries to develop their ability to produce real assets on their own in order "to sustain the long-run economic viability of (…their) states, given the transient nature of the oil."[33] Some headway has been made in that respect. Saudi Arabia, for example, has built up a substantial petrochemical industry and the UAE and Bahrain have developed into important

31- Even so the GCC countries should not jump on the bandwagon hastily after the recent appreciations, but rather buy the dips.

32- Robert Mundell, Robert: "The International Monetary System in the 21st Century: Could Gold Make a Comeback?," (March 12, 1997): www.robertmundell.net/pdf/The%20International%20Monetary%20System %20in %20the% 2021st%20Century.pdf , p. 10.

33- Hazem Beblawi, *The Arab Gulf in a Turbulent Age* (London: 1984), p. 67.

service centres and tourist destinations.[34] But future investments can only be ensured when the accumulated financial assets will keep their value in terms of real assets. Today, US treasuries have a negative real interest rate, even when one applies the official inflation figures that have been softened by the political correctness of dubious statistical methods.[35] Therefore, longer maturities appear especially uninteresting. The stock market on the other hand, is commanding valuations at historical highs and does not look attractive either.[36] Thus, it is obvious that gold as a real asset is an important tool to maintain the capacity for future investment, as it is more than a mere financial asset, which always has a liability on the other side. Together with a concise development strategy, it could provide crucial independence and be more interesting than simply switching from petro-dollar to petro-euro recycling. If so, why has the recent attempt to establish an Islamic currency solution failed?

Limitations for GCC currency solutions

During a series of conferences in 2002, Mohammed Mahathir, then Malaysian Prime Minister put forth the idea of an Islamic Gold Dinar that should serve to settle bilateral trade between Muslim

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34- United Nations, Economic and Social Commission for Western Asia (ESCWA), *Economic Diversification in the Oil-Producing Countries. The Case of the Gulf Cooperation Council Economies (New York: 2001),* p. 15 and 26; Also, Ugo Fasano and Zubair Iqbal, "GCC Countries: From Oil Dependence to Diversification," IMF Paper (2003) available under: www.imf.org/external /pubs/ft/med/2003/eng/fasano/.

35- Bill Cross, portfolio manager at Pimco, one of the biggest fixed income funds in the world, estimates the current US inflation rate to be one percentage point higher than the officially acknowledged 3.5%. Amey Stone, "A Federal Inflation Conspiracy? Influential Bond Guru Bill Cross is saying the government is intentionally understating the CPI," (October 12, 2004): www.businessweek.com/bwdaily/dnflash/oct2004/nf20041012_5021 _db035.htm. See also Richard Benson, "Inflation Disinformation," (December 28, 2004): www.goldeagle.com/editorials04/benson 122804.html. He estimates US inflation at 6 %.

36- The current P/E ratios for the S&P 500 and NASDAQ Composite are 20 and 51 respectively (Bloomberg data). In times of severe recession, the P/E ratios of stock markets normally fall well below 10.

countries. An envisaged multilateral arrangement with various countries could follow suit. This was the first time that concrete measures were undertaken to realize such an Islamic Dinar, which had been already discussed among Muslim intellectuals since the 1960s. Malaysia had been in talks with Iran, Saudi Arabia, Morocco, Libya and Bahrain. The talks made some progress especially with Iran, which had repatriated its gold reserves from London the same year for political reasons. The two countries repeatedly stated to envisage a settlement of bilateral trade in Gold Dinar for 2003.

By randomly surfing through the Internet during the height of Islamic Dinar advertisement in 2002 and 2003, one could have gained the impression that the Islamic world was on the verge of skipping any payments in dollar or other paper money and switching to a gold standard like that in the good old 19th century. Gold bugs in east and west hailed the prospects and ideals that they associated with the implementation of such a gold standard: Honest money for honest work, fair trade and inflation free growth perspectives for all. One year later, basically nothing has happened, although in January 2004 Mr. Mahathir during a visit to Saudi Arabia once more proposed that the GCC countries sell their oil for gold. While some coins have been struck, these will apparently only gain the interest from coin collectors. Overall, there does not seem to be any interest in a real remonetization of gold via the Gold Dinar. Iran has not engaged in a settlement of bilateral trade with Malaysia and the GCC countries that had uttered some interest in the idea quietly have withdrawn, rather discussing diversification into the Euro.[37]

The IMF forbids its member countries to fix their currencies to gold, but the idea of Mahathir's Gold Dinar is not a currency as such. The local currencies of the participating countries are expected to continue to exist, but without tying their monetary policies to the development of the balance of payments in Gold

37- Tim Wood, "Gold Dinar fiat fiasco continues," (July 27, 2004): www.mineweb.net/columns/americannotes/ 336075.htm .

Dinar. That means that after a trade deficit with a partner country occurred, a drain on gold reserves would not lead to an adjustment in the money supply. The normal adjustment mechanism of a gold standard thus would not work, i.e. inflation and decrease of exports when elasticity of foreign trade is given in the surplus country - and deflation and increase of exports when elasticity of foreign trade is given in the deficit country. As a result, the deficit country would run out of gold reserves soon. It would have to get the gold from another Gold Dinar country with which it ran a surplus or it would have to borrow it, otherwise trade between the two countries would have to cease.

Given the trade relations between Malaysia and Islamic countries that is exactly what one would expect. Malaysia produces oil, follows an aggressive stance of export-oriented industrialisation and shows a robust trade surplus with Islamic countries. Therefore, it would suck the gold reserves of its Islamic partners dry during the course of trading arrangements in Gold Dinar. Given the low gold reserve base of Arab central banks (Table 3), such a scenario could in some cases happen within 3 months based on 2001 figures.[38] Thus, with trade arrangements in Gold Dinar, Malaysia, would be able to prop up its tiny gold reserve of 36.9t which currently constitutes only 0.9% of its currency reserves and which it has sold down from 73.1 t after the Asian crisis in 1998. That situation greatly reduces the likely success of the Gold Dinar.

Apart from the notes of caution about deflationary effects, the reintroduction of gold in a monetary system would instead have to happen more on a global scale than only in conjunction with the settlement of bilateral trade. Otherwise, one would not have the possibility to level out trade imbalances with one country by trading with a third partner. Additionally, like the intra-regional trade between the countries of the Middle East, trade between Malaysia and Islamic countries is rather small. In 2001, it constituted only 8% of its trade with the US and only 1.4% of its total trade of USD

38- Tim Wood, "Assessing the impact of Malaysia's gold plan," (August 19, 2002): www.mineweb.net/ sections/gold_silver/74670.htm.

Table 3: World Official Gold Holdings (October 2004)

Rank	Country	Tonnes	Gold's % share of reserves
1	Euro area incl. ECB	12.192,8	43,7%
2	USA	8.135,5	59,8%
3	Germany	3.433,2	48,1%
4	IMF	3.217,3	n.a.
5	France	3.024,6	55,2%
6	Italy	2.451,8	53,6%
7	Switzerland	1.442,7	28,2%
8	Netherlands	777,5	49,6%
9	ECB	766,9	n.a.
10	Japan	765,2	**1,2% (!)**
11	China: Mainland	600,0	**1,6% (!)**
12	Spain	523,3	34,4%
13	Portugal	482,3	57,6%
14	Taiwan	421,8	**2,3% (!)**
15	Russia	389,2	5,7
16	India	357,7	3,9 %
19	United Kingdom	312,5	9,0%
20	Lebanon	286,8	22,8%
25	Algeria	173,6	5,8%
26	Libya	143,8	7,9%
27	**Saudi Arabia**	143,0	7,7%
37	**Kuwait**	79,0	13,7%
38	Egypt	75,6	6,8%
40	Pakistan	65,3	7,4%
46	**Malaysia**	36,4	0,9%
51	Syrian Arab Republic	25,9	n.a.
52	Morocco	22,0	1,9%
61	Jordan	12,8	3,1%
70	Tunisia	6,8	3,2%
77	**Bahrain**	4,7	n.a.
	Qatar*	0,6	0,2%
	Oman**	0	0%
	UAE***	0	0%
	GCC	227,3	n.a.
	All countries	28.248,1	9,6%
	All above ground gold ever mined	Apr. 120.000,00	

Source: World Gold Council (WGC): World Gold Holdings, October 2004: www.gold.org/value/stats/statistics/ archive/index.php
**Qatar sold itself down from 25,3t to 8,3t in 1994 after having accumulated gold in the eighties*
**Oman sold its last 9t in 2001*
**** UAE sold its last 12,3t in 2002*

162 billion. Once again, this points to the whole problem of imbalances and asymmetric relationships in international trade and economic development that would have to be addressed during the implementation of a Gold Dinar or any other alternative monetary system. The trade relations between GCC nations and other Arab and Islamic countries are simply not developed enough to justify a common currency scheme (Table 2). Currency areas are about economic coherence and not about religious and cultural affiliation. That is also a reason why ideas about a future GCC currency attaining the status of an Islamic reserve currency may prove to be too ambitious. Besides its limited transaction domain, worries about external and internal political stability would weigh heavily.[39] So far, underdeveloped and restricted local capital markets would also reduce the currency's attractiveness for international holders.[40] All the more important would be some "virtual" fall-back value in form of gold reserves such as the ECB is doing with its stipulation that at least 15% of currency holdings should be in gold. Currently, the gold reserves of the GCC countries are not sufficient to represent such a virtual fall-back value. Furthermore, as will be seen in the next section, it may become increasingly difficult to acquire further gold reserves because of the tricky nature of today's gold market.

The manipulation of the gold market since the nineties

Various studies have come to the conclusion that gold is severely underpriced. They expect a gold price of at least USD 700; some estimates even reach USD 1500 and more. The chosen approaches are manifold and include comparisons between the gold price and money supply (M3), long term ratios of the gold price with oil and stock markets, supply and demand figures in the gold market or the

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39- See Al-Alkim, *op.cit.*, chapter 3-6.

40- Ugo Fasano and Zubair Iqbal, "Common Currency. GCC Countries Face Fundamental Choices as they head for Monetary Union," *Finance and Development* 39, no. 4 (December 2002), available under www.imf.org/external/pubs/ft/fandd/2002/12/fasano.htm, p. 2.

hypothetical amount of gold needed for a reintroduction of a gold cover clause.[41] Although the liquidity driven stock market frenzy and serious currency crisis in some emerging markets (Mexico, Asia, Russia) supported the US dollar in the 1990s and thus reduced the attractiveness of gold, the sell off in gold between 1996 and 2001 that propelled it below USD 260 is highly suspicious, as it happened during a time of increasing supply deficits in the gold market. This has led a number of distinguished experts who are affiliated with the Gold Antitrust Action Committee (GATA)[42] to assume that Western central and commercial banks have manipulated the gold market since the middle of the 1990s in order to defend the paper dollar standard. Such interference is quite reminiscent of the gold market interventions in the sixties during the establishment of the Gold Pool. The evidence collected encompasses comparisons between different kind of statistics and issuers, historical probabilities and standard deviations as well as anecdotal material about more or less obvious efforts to suppress the gold price. While this is not the place to discuss the material in great detail,[43] it is important to be aware of the basic argument and its implications for the future gold price, should the paper dollar standard deteriorate further.

Based on 2000 figures, Frank Venoroso challenges the official statistics of Gold Fields Mineral Services (GFMS) and the World Gold Council (WGC) and assumes that annual mine

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41- Van Eeden, op. cit.; Tim Wood, “Gold-oil link all but dead in 2004,” (August 10, 2004): www.mineweb.net /sections/energy/oilgold.htm; H. Reginald Howe, “Dow/Gold Ratio=1 at 3000$: Don’t Laugh!,” under www.goldensextant.com/ commentary5.html; Frank Veneroso, “Facts, Evidents and Logical Inference. A Presentation on Gold/ Supply/ Demand, Gold Derivatives and Gold Loans,” (May 2001): www.gata.org/fv.pdf; Bill Fox, op. cit., p. 18.

42- GATA was founded in 1999, see. www.gata.org.

43- Frank Veneroso, Reginald H. Howe, Mike Bolser and James Turk have conducted the most important studies so far. For a thorough compilation, see John Embry and Andrew Hepburn, “Not Free and Not Fair. The Long-Term Manipulation of the Gold Price,” Sprott Asset Management Special Report, August 2004 under: www.sprott.com.

production (2,568 t), scrap supply (602 t) and official central bank sales under the Washington Agreement of 1999 (400 t) are only partly covering an estimated world wide demand of 4,844t. Venoroso thinks that the supply gap of about 1,274 t and the supply gaps of preceding years have been closed by leased central bank gold. That leads him to the breathtaking thesis that instead of the officially acknowledged 5,000 t on lease and swap arrangements, up to 16,000 t of a total of 28,000 t may have actually left the vaults of central banks. Venoroso points out that the gold carry trade that started in the 1980s gradually went out of hand. Thereby, central banks are leasing gold to the commercial banks for a low leasing rate of about 1%. The commercial banks sell the gold in the market and invest the proceeds in higher yielding assets like treasuries, thereby earning a nice spread. As the commercial banks now have a delivery risk of physical gold to the central bank, they can hedge themselves against a gold price rise by going long on the derivative markets. Mining companies, proprietaries trading desks and hedge funds have taken the short side of these trades. Thus, on a limited base of physical gold, a gargantuan mountain of derivatives has developed. And this mountain continues to grow, although mining companies have reduced their hedges dramatically in recent years.[44] To put it in a nutshell, the gold still exists in the books of central banks as receivables, and on the books of hedge funds and commercial banks as liabilities. But the actual physical gold itself has long left the vaults and now hangs around the necks of the women of the world. These women are the “ultimate longs” in the market while the banking system stays out in the rain with a gigantic derivative short position of up to 16,000 t.

44- It is estimated that the notional value of derivative ”paper gold” is 10 times higher than yearly physical production and nearly as high as all official sector gold. H. Reginald Howe, “Gold or Dross? Political Derivatives in Campaign 2000,” August 2000, www.goldensextant.com/campaign 2000.html#anchor48727 and Howe, “Hitting the Iceberg,” December 20, 2003, www.goldensextant.com/commentary 26.html#anchor25233.

At current prices, it is inconceivable that this short position could be covered. A much higher gold price would be needed. This, in turn, would not only seriously hurt the profits of the banking system but would also endanger the already ailing paper dollar whose liquidity is fuelling the US and world economy alike. This is why Veneroso, Embry and others assume that an official sector of central and commercial banks has started to manage the gold price at least since the plight of the LTCM hedge fund in 1998, which purportedly held a huge short-position in gold. Occurring trading patterns suggest that apart from lending physical gold into the market, the gold price is suppressed by derivative short selling and spread trading. Similar accusations exist in the case of silver.[45]

This management will ultimately fail, as the supply gap will increase rather than decrease.[46] Gold production is expected to decline significantly in coming years as mining companies reduced their investments in new projects during the last decade of suppressed prices. As a mining project needs 5-8 years to mature to production, this will not change anytime soon. Groundbreaking new technologies that could raise the output drastically like the discovery of cyanidation in 1887 are not likely. And epochal new discoveries like those in USA, Australia and South Africa in the 19th century[47] can also not be expected, as nowadays such terra

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45- The case for silver is even more compelling, as there exists a supply gap since the beginning of the eighties and there are no central bank reserves. Silver the “poor man’s gold”, played a role in monetary systems until the 19th century and is also an important raw material in the electronic industry. Its long-term historic ratio to gold is 1:15, which is way above the current 1:60 and could even lead to steeper rises in price than gold. It remains to be seen if it could regain monetary importance during the unfolding crisis of the paper dollar standard, but as its use is not exclusively monetary we leave it aside here. For the manipulation story of silver, see the various articles of Ted Butler on www.investmentrarities.com/tb-archives.html. For silver as an investment case, see Marion Butler, “The Case for Silver,” October 19, 1999: www.gold-eagle.com/editorials_99/mbutler 101899.html and various articles on www.silver-investor.com .

46- Rhona O’Connell, “Gold demand growth outstrips production,” November 25, 2004, www.mineweb.net/ sections/gold_silver/393445.htm .

47- See Peter L. Bernstein, *The Power of Gold..., op.cit.*, pp. 219-238.

incognita of mining does not longer exist. On the demand side, Western investment demand has not even kicked in yet like it did in the 1970s, while retail demand in important markets like India, Arabia and Asia remains stable or is even rising despite augmented gold prices. Additionally, other central banks than the Western ones are actually buyers (e.g. China, Russia, Argentina), as they need to diversify their dangerously one-sided currency reserves.[48] That is especially true for China, which is sitting on a huge pile of USD 500 billion in currency reserves, while officially having gold reserves of only 1.6% of that amount (Table 3). Actually there are repeated rumours that in recent years China may have bought more than the 200 t that it officially acknowledges, and the reopening of the Shanghai gold market in 2001 after over fifty years of closure may not be accidental. Finally, Japan has announced that it may purchase gold as well, in order to diversify its similarly one-sided currency reserves (USD 800 BN).

The likely outcome is the current manipulation scheme of the gold price will fail like the Gold Pool in the sixties. Once it fails, it will be highly difficult and expensive to accumulate a gold reserve. This is especially true for central banks that have low gold reserves like those in the GCC countries.

Shrewd women and unprepared Central Banks: Private and official gold holdings in the GCC countries

A comparison between private and official gold holdings in the GCC countries reveals a divergent picture. While the private sector shows great appetite for the ancient metal, representing an important source of worldwide demand, the region's central banks only hold small portions of gold, both on an absolute level and

48- The deputy chairman of the Russian central bank, Oleg V. Mozhayskov, recently spoke publicly about the importance of gold as a reserve asset and gold price manipulation by Western central banks, citing the Gold Antitrust Action Committee (GATA): www.gata.org /RCBTakesNote.html.

relative to their overall currency reserves (Table 3). Private gold demand per capita income in GCC countries is one of the highest in the world. Dubai's imports alone will more than double to 600 tonnes in 2004, which is close to 15% of yearly worldwide demand. Although about half of that amount is further exported to India, the world's biggest consumer (ca. 25%), enough remains in the region to make it the second most important source of global demand.[49] Jewellery in Western countries is mainly bought for aesthetic reasons; the craftsmanship is rewarded with a considerable premium to the actual gold content. On the contrary, the demand for jewellery in Arabia, India and Asia often has an essentially monetary motivation, like the purchase of bars and coins. Regardless of the specific design, it is sold in kind and serves as a store of wealth for the whole family. In case of death, divorce or other pitfalls of life, it provides important material insurance.

Thus, there is a general affection in the region for gold as an asset class. This affection was shared by the official sector in the past, as the region's central banks built up a considerable reserve base during the 1970s.[50] This stance, however, has changed. During the last decade, the UAE, Oman, Qatar and Bahrain have sold down their gold reserve to zero or close to zero. Nowadays only Saudi Arabia and Kuwait entertain a reserve base worth mentioning, but even that reserve is not high relative to the overall currency reserves. Furthermore, Kuwait owns its gold only legally but not physically anymore, as it leased out its entire gold reserve of 79 t in 1999.[51] Historically, central banks have not reported changes in

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49- Rhona O'Connell, "Dubai, City of Gold – and of diamonds?," (October 11, 2004): www.mineweb.net/ sections/ gold_silver/352638.htm .

50- See Table 4. Timothy Green, *The New World of Gold: The Inside Story of the Mines, the Markets, the Politics, the Investors* (New York: 1981), pp. 178-185; Ferdinand Lips, *Gold Wars…*, *op.cit*., p. 95.

51- See I.M. Vronsky, "An open letter to his Excellency The Governor Sheikh Salem Abdul-Aziz al Sabah ref. the Central Bank of Kuwait's decision to lend gold,“ (October 21, 1999):www.gold-eagle.com/gold_digest_99/ vronsky 102399.html; Also Ferdinand Lips, *op.cit*., p. 143.

their gold reserve when lending gold. This summarization of gold and gold receivables under one item was extended to swaps in a remarkable reform of IMF bookkeeping in 1999.[52] That is why in the official statistics (Table 3), countries like Kuwait are still commanding a gold reserve, while in reality they only possess paper gold, as the real stuff has left their vaults years ago with uneasy prospect of returning should third parties default. In the case of Kuwait, it is at least possible to deduct the amount of leased gold because of an official announcement. Some few central banks are reporting it also in their official statistics (e.g. Portugal, 70% of its gold leased and swapped out), but in most cases the official central bank statistics treat gold and gold receivables as one item and deal with the issue of gold lending in a highly secretive and suspicious way.

Table 4: Development of gold reserves in GCC countries 1960-2004

	1960	1965	1970	1975	1980	1985	1990	1995	2000	2003
Saudi Arabia	16	64,9	105,8	95,8	142	143	143	143	143	143
Kuwait	0	46	76,6	124	79	79	79	79	79	79
UAE	0	0	0	0	17,9	25,4	24,8	24,7	12,3	0
Bahrain	Na	Na	Na	Na	Na	Na	Na	Na	Na	4,7
Qatar	0	0	5,8	5,8	14,8	33,5	25,9	8,3	0,6	0,6
Oman	0	0	2	0,9	6,5	9	9	9	9	0

Source: World Gold Council (WGC): Official Reserves 1948-2003, www.gold.org/value/stats/statistics/gold_reserve/index.html

Contrary to other central banks in the world (e.g. Euroland, Russia, China) the GCC countries do not show a tacit verbal acceptance of a monetary role of gold either. Recently a high-ranking official of the Saudi Arabian central bank publicly deliberated about selling gold for paper assets. This is strikingly reminiscent of verbal interventions of other central bank officials in the past that obviously had the task to talk the gold market down.

52- John Embry and Andrew Hepburn, *op.cit.*, p.55.

The officially announced sales of British and Swiss gold reserves since the nineties are a case in point. No seller with a profit maximising motivation announces such a transaction instead of selling it quietly in the market. Thus, Great Britain managed to sell half of its gold reserve at historic bottom levels, achieved an opportunity loss of close to two billion dollars so far and disqualified itself for participation in the Euro, as the ECB stipulates a 15% share of gold in overall currency reserves, while the UK now only has 9%. It seems that Saudi Arabia is inclined to follow suit in these attempts at defending the paper dollar standard, a defense that is likely to remain futile in the end.

Conclusion

The paper dollar standard is a dead man walking. Its debt, accumulated over the recent decades, is too high to be effectively repaid. It will either default or be inflated to such an extent that it will not hurt to “pay” it back. Therefore, the accrued imbalances in global finance and the inherent weakness of worldwide growth models that rely on a continuance of US deficit spending are likely to usher in a serious crisis of currency systems during the course of the coming years. As the dollar is not only the currency of the US but the most important reserve, trade and debt currency on which all the other nations rely, it will not be a regionally confined currency crisis as happened in Mexico, Asia or Russia in the nineties; but will affect all other currencies and economies as well. That is also true for the Euro. Although it is less weak than the dollar, it will be affected and eventually engage in competitive devaluations with other currencies rather than emerge as a new world currency.

Gold will be a suitable means of asset protection and ultimate payment in such a scenario. It will preserve the wealth of individuals and central banks alike and will ensure important manoeuvrability for the latter. At the same time, the need for Gold accumulation could lead to serious conflicts between citizens and government agencies, should the latter try to get a hold of the accumulated gold of its citizens by declaring it illegal like in the

USA in 1933, or by pressing for an exchange into local paper currency like in Korea and Thailand in 1997/ 98.

While individuals in the GCC countries highly value gold as a means of asset protection, GCC central banks are particularly ill prepared for such a crisis scenario. With currencies pegged to the dollar, oil factored in dollars and most of its currency reserves and investments in dollars, they are highly affected by the woes of the paper dollar standard. At the same time, they only have tiny gold reserves or none at all. In contrast to other central banks that have cautiously started to anticipate a post paper dollar standard environment (e.g. Euroland, Russia, China), the GCC monetary authorities indulge in official oaths of allegiance. During the recent GCC monetary union conference in Bahrain, the IMF asked the GCC countries to peg their common currency in 2010 to the dollar. The justification given rested solely on the successful maintenance of the paper dollar standard. As stated: "Since most exports and external assets have been dollar-denominated, the peg assured external stability. It also provided a credible nominal anchor for monetary policy, ensuring price stability."[53] Yet while may be true for the past, once the paper dollar standard is tumbling the whole argument takes the opposite direction - to instability of external trade, prices and monetary policy. Thus, apart from further diversification of their economies and gradual diversification into "second worst"-currencies like the Euro, GCC countries would need to reclaim their leased out gold and build up a substantial gold reserve, as long there is still the time to buy it. Once the crisis scenario unfolds and the attempts of central and commercial banks at gold price suppression fail, the gold price will more than rise – it will explode to the upside.

Having stressed the importance of gold as a means of asset protection one has to point out the serious problems of a hypothetical reintroduction of a gold standard. It would cause massive deflation and present the definite end of Fordism and the

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53- *Gulf News*, November 25, 2004.

Welfare State. Therefore, it would have to be accompanied by unorthodox debates about possible alternatives to the prevailing modes of capitalist production. The socio-political consensus in many GCC states would be questioned as well, as the preceding mode of receiving welfare transfers in exchange for renunciation of political participation would not work any more.

About the Author

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