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SPECIAL REPORT

In uncertain times, all that glisters is a gold standard

by Gillian Tett, Financial Times

"...the logistics of embracing a new gold standard would be mind-boggling. UBS, for example, calculates that the US reserves of gold are so small, relative to its monetary base, that a price above $6,000 an ounce would be needed to reintroduce a gold standard. To implement that standard in Japan, China and the US, the price would be more than $9,000."

A few months ago, Terry Smith, head of Tullett Prebon, the interdealer broker, chaired a panel at the World Economic Forum meeting in Davos which was asked to produce one concrete recommendation to fix the global financial crisis.

The top pick? Not anything on toxic assets or fiscal spending. Instead, this gaggle of leading financiers called for a new reserve currency, akin to an old-style gold standard.

"Two-thirds of the world's assets are denominated in a fiat currency issued by a country whose authorities are taking policy actions which seem inevitably to lead to its debasement," explains Mr Smith, noting that "it seems . . . the Chinese have now concluded that this is not acceptable".

Just a bit of pie-in-the-sky posturing of the sort that often occurs in high-altitude Davos? Perhaps. But Mr Smith is hardly a do-gooding, state-loving dreamer; on the contrary, Tullett Prebon is about as ruthlessly free-market as they come.

Moreover, these musings about a gold standard are currently cropping up in all manner of unlikely places. One savvy European property developer (who aggressively sold most of his holdings in early 2007) recently told me that he is now moving a growing proportion of his assets from government bonds into gold, even at today's elevated prices.

"The logical conclusion of where we will end up eventually is with some type of gold standard," he explains, arguing that future inflation will almost inevitably cause a future collapse in government bonds.

Half a world away in the Middle East, some sovereign wealth funds now say that they are stocking up enthusiastically on food and gold, due to similar reasoning.

Meanwhile, in New York a (still) formidable American hedge fund recently circulated private research that echoes the reasoning of Mr Smith. Most notably, this hedge fund points out that since the world abandoned the gold standard on August 15, 1971 credit creation has spiralled completely out of control.

But this four-decade long experiment with fiat currency is not just something of a historical aberration, it argues - but potentially very fragile too. After all, the only thing that ever underpins a fiat currency is a belief that governments are credible. In the past 18 months that belief has been tested to its limits. In coming years it could be shattered, particularly if the current wave of extraordinary policy measures unleashes a wild bout of inflation.

Hence that chatter about a gold standard. Indeed, as the debate bubbles up, some financiers are now even e-mailing each other an extraordinary little essay that Alan Greenspan himself wrote in support of a gold standard back in the 1960s, called "Gold and Economic Freedom".

In the years since he penned this essay, Greenspan has partly backed away from those ideas (and he blatantly ignored their implications when he was at the Fed.) But now they look prescient.

"Under a gold standard, the amount of credit that an economy can support is determined by the economy's tangible assets . . . [but] in the absence of the gold standard . . . there is no safe store of value," Greenspan wrote back then, pointing out that without a gold standard in place, there is little to prevent governments indulging in wild credit creation. "Deficit spending is simply a scheme for the confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights."

Of course, for the moment all this muttering about gold is simply wild speculation. Even if western leaders suddenly were to decide they wished to turn back the clock, the logistics of embracing a new gold standard would be mind-boggling. UBS, for example, calculates that the US reserves of gold are so small, relative to its monetary base, that a price above $6,000 an ounce would be needed to reintroduce a gold standard. To implement that standard in Japan, China and the US, the price would be more than $9,000. Moreover, right now few western governments have any motive to even entertain the debate, given that inflation may soon seem the least bad way to tackle the current overhang of debt.

But what this debate does show is just how much cognitive dissonance - and utter uncertainty - continues to stalk the markets. It might seem almost unthinkable to propose a return to a gold standard, in other words. However, the key point is that the last 18 months have already produced a stream of once unimaginable events.

Given that, shell-shocked investors are increasingly reluctant to rule anything out, as they stare at such uncharted waters. So while I would not bet today on a gold standard returning any time soon, I would also not bet that the debate dies away. Nor would I bet that the gold price crashes too far from its current rate of $900, while so much fear continues to stalk the world.

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