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The day the greenback divorced gold

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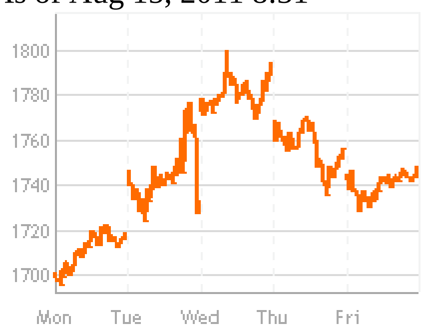
It was mid-August of 1971 when U.S. President Richard Nixon took to the airwaves in a televised address to drop a bombshell on the international financial system: He was severing the final link of the U.S. dollar to gold.

Monday, August 15 will mark the 40th anniversary of Mr. Nixon's historic announcement that the U.S. would no longer honour a pledge to foreign governments to redeem U.S. dollars for gold, which was then trading on the open market for what now seems like the ridiculously low price of about $40 (U.S.) a troy ounce.

Gold (GC-FT)
1,741.10 -1.50 -0.09%
As of Aug 15, 2011 8:31



His decision ushered in the modern era of floating exchange rates and paper-money currencies that today dominate the global marketplace. It also initiated an incredible bull market in gold itself.

"It was a watershed event," says Lacy Hunt, economist at Hoisington Investment Management, an Austin-based money manager, who at the time of the announcement was a senior financial economist at the Dallas Federal Reserve Bank.

The decision to cut the bond between the dollar and gold marked the end of the road for the global monetary system that had been set up in the closing days of the Second World

War. Under terms of the agreement reached at Bretton Woods, New Hampshire, in 1944, the United States had agreed to redeem dollars for bullion at the rate of $35 an ounce, but only for the central banks of other countries. These countries, in turn, pegged the value of their currencies to the U.S. dollar.

The system worked well until the mid-1960s, when it started to fray after the U.S. flooded the world with too many dollars to help finance its domestic social programs, the Vietnam War, and its global military spending.

The U.S. was facing a chronic trade deficit. Investors and other governments began to worry that the United States wasn't as good as its word to redeem dollars for gold at $35, causing a run on the U.S. gold reserve, a flight out of dollars and the eventual collapse of the arrangement.

"[The Nixon announcement is] an important piece of history," observed Gary Shilling, president of Gary Shilling & Co. Inc., a New Jersey money manager and economic consulting firm.

Mr. Nixon's presidency later went down in flames over the Watergate scandal, but analysts say he shouldn't be blamed for driving the final spike through the heart of the gold standard. Much like the current occupant of the White House, who has been grappling with a huge, inherited deficit problem and the fallout from the 2008-09 financial panic, Mr. Nixon was in office when long-running pressures against the dollar finally became overwhelming.

The collapse of the gold standard "was inevitable," says Mr. Shilling. "[President Nixon] really didn't have any choice."

But his actions have prompted intense debate ever since. Some economists of a conservative bent lament that the formal end of the gold standard placed the world in uncharted territory with paper currencies that have no intrinsic value. Governments are now free to print up these so-called fiat currencies at will.

The critics contend that the lack of a gold standard, with its tighter control on the amount of new money in circulation, has led to greater financial instability, more inflation and persistent imbalances in trade accounts.

"It is the lack of any credible monetary rule, the loss of a gold anchor, and the growing discretion of central banks issuing pure fiat monies that have wreaked havoc on the global monetary order," said James Dorn, monetary analyst at the Cato Institute, a conservative think tank in Washington, D.C., in an e-mail.

Mr. Dorn, a critic of Mr. Nixon's move, says the lack of a gold link has meant the dollar has constantly lost value as the price level as drifted upward through high inflation since 1971. Another drawback, in his view, is that governments and central banks can intervene more in the economy than they could have under a gold standard that imposes more discipline on the amount of currency that can circulate.

There has, however, been at least one major benefit from Mr. Nixon’s move.

Since August, 1971, most major exchange rates have floated, meaning that market forces determine the value of currencies on a day-to-day basis, eliminating the frequent devaluation crises that used to occur.

On a short-term basis, the decision to end the role of gold in the monetary system was cheered by investors, as was Mr. Nixon’s simultaneous announcement of import tariffs and wage and price controls. The Dow Jones Industrial Average surged nearly 4 per cent when trading started on the Monday after the announcement.

Despite the move to reduce gold’s role in the monetary system, it’s been onward and upward for the barbarous relic since 1971. By the end of 1974, gold had risen to $183.85 an ounce, a fourfold gain. Recently, it’s done even better, reaching a new record high this week of more than $1,800.