

CHAPTER 1

THE GREENBACK BOOGIE

*See the money, wanna stay for your meal.
Get another piece of pie, for your wife*

—Ima Robot (*Suits* theme)

Our way in is through “inflation.” Most people think inflation is when things get more expensive. But what if we thought something different? What if we changed our definition of inflation and thought of rising prices as *the result*, not the definition?

It is simple economics, actually. The more that you have of something, the less value it has. Think: if I had the one and only baseball card of Carl Yastrzemeski, it would be worth a lot on the sports memorabilia market. If everyone had a Carl Yastrzemeski card, mine wouldn't matter at all. The analogy fits for me because I grew up in New England. Carl Yastrzemeski was a famous first baseman for the Boston Red Sox when I was a kid. Baseball cards were a thing too. A Yastrzemeski card when you opened the bubble gum pack and got one, euphoria. It was, like, “Whoa, what, seriously? A Yastrzemeski card?!”

One card means a lot. But if there were thousands of them. Billions or trillions of them. You get the point. The same thing goes for the American dollar bill. Substitute the Yastrzemeski card with “the American greenback” and the more dollars you have in the system, the less each dollar is worth. And today, those “dollars” are created by digits.

What this means to the consumer—you and me—is that the dollar doesn't go as far. The items we want to buy feel more expensive. This is because you need more dollars to buy the things you want. But are things really more expensive? Or is the dollar just worth less because there are more of them in the system? It can be confusing! And around and around we go. That's why we call it the "greenback boogie." We're going to explain what that means.

The essential value of the American dollar itself is and has been in question. It's a feature of the economic system in which we live. The dollar is what's in your wallets, so it could present you with a big problem. What if we all start worrying about food on the table, our mortgages, taxes, retirement, tuition, gas for our commutes to work, and the cost of weddings and marriages and vacations, all at the same time? In the end, without what we call "sound money"—money whose value we can rely on—it is really hard to figure out if you have the right amount of money and whether the financial decisions you are making actually work. It doesn't really matter what currency you spend your money in. It's whether you can trust what you earn your money in and whether that money is going to be worth anything when you want to buy something.

In earlier editions of the book, we were forecasting inflation. During the pandemic and now, as the economy begins opening up, inflation—rising prices—is in our face. In 2022, we began to really think about the phenomenon that we call "inflation" and what we can do to manage our money through it.

THAT WHICH IS SEEN

Economists often look to the French philosopher Frédéric Bastiat's "Parable of the Broken Window" for guidance on how to conduct an economic study. He says with all things there is always "that which is seen, and that which is not seen." The idea is very helpful when trying to understand the economy and the stock market at large and, further, the problem of inflation and the effect it has on the money in your wallet. Bastiat writes:

In the department of economy, an act, a habit, an institution, a law, gives birth not only to an effect, but to a series of effects. Of these

effects, the first only is immediate; it manifests itself simultaneously with its cause—it is *seen*. The others unfold in succession—they are *not seen*: it is well for us if they are *foreseen*. Between a good and a bad economist this constitutes the whole difference—the one takes account of the *visible* effect; the other takes account both of the effects which are *seen* and also of those which it is necessary to *foresee*.

What is seen is the chairman of the Federal Reserve—currently Jerome Powell—announcing on television to the American people that he and his Federal Open Markets Committee (FOMC)—the policy-deciding wing of the Fed—are raising interest rates yet again to tackle a so-called “transitory inflation.” Pulses quicken. Mortgage rates go up. Credit cards are harder to pay off.

In 2021–22, we saw a sea change in interest rate hikes. In a very short amount of time, the rate you needed to pay for a mortgage, home equity loan, or tuition payments increased by the quickest pace ever induced by the Federal Reserve. (See Figure 1.1)

Most people don’t know that interest rates determine the rate you have to pay on your credit cards and mortgages. You want to buy a house, you will have to take out a mortgage loan (unless you can pay up front). The interest rate at which you borrow for your mortgage loan is usually around “a point” above the rate decided by the FOMC.

Whether you like it or not, Jerome Powell and his posse are making decisions that directly affect you as an investor and consumer. As the head of the central bank of the United States—colloquially dubbed “the Fed”—Powell announces the collective decision of

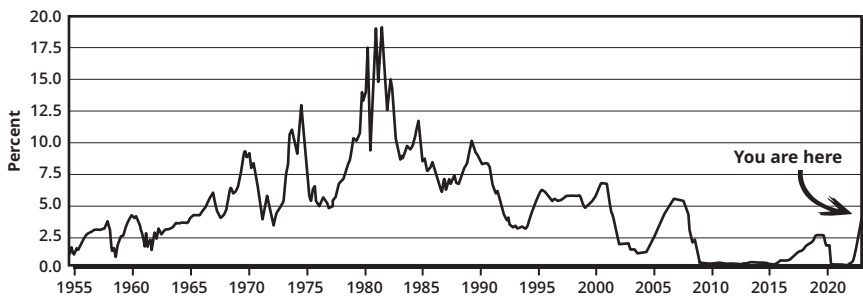


FIGURE 1.1 Federal Funds Effective Rate, 1955–2020

(Source: Board of Governors of the Federal Reserve System (US))

America's seven central bank governors. All together, the committee sets the interest rate for the American banking system. Which, as we all know, is priced in American dollars.

They call it the "overnight Fed funds rate." And the financial media, yours truly included, have taken to "Fed-watching," as we call it, in the last two years. We hang onto every word issued by Powell and the FOMC because it determines the very value of our dollars. Your money.

"What have they decided?" journalists want to know.

"What does it mean?" we ask.

"Can we still buy homes without going bankrupt?" everyone and their mother worries. Then the keyboards get to clacking.

To reiterate: we see the headlines and the analysis of the Fed's every interest rate manipulation. What we don't see: Jerome Powell's actions are actually the culmination of more than three decades of Federal Reserve trials in economic theory.

You might still be thinking: "Why the hell should I care about what the Federal Reserve does to interest rates? I've got better things to do." To which I will respond: In trying to manage the American banking system, the Federal Reserve and the FOMC are directly influencing the value of the money in your wallet. When they tug at strings from up top, you feel it in your wallet.

The Federal Reserve governors think they can manipulate the value of the dollar by lowering and raising rates based on signals from the 12 banks in the American Reserve bank system. This is what we call "the greenback boogie." It's a jazz beat. And it's confusing as it sounds. All the world's a stage to the Fed's two-step. But why? It hasn't always been this way. We haven't always been doing the greenback boogie. In fact, the Federal Reserve didn't always determine the value of the dollar, nor did it always manipulate the dollar in an attempt to regulate its ups and downs.

For 23 years—between 1944 and 1971—the dollar was "pegged to gold." That simply means that the gold price on the world market determined what the dollar could be redeemed for by other countries holding assets priced in dollars. The nation's central bank, the Federal Reserve, did not try to control the value of the dollar through interest rate adjustment as they do today. In 1971, what's

called the “gold standard” for the US dollar was disbanded. Then the story changed, and the boogie began.

In the story of how we got here, there’s a cast of characters. The protagonists are involved in complex discussions about how to organize the global economy and its currency system at the end of World War II, a war that destroyed most of Europe, Western Russia, and the Southeast Pacific. Let’s begin.

WELCOME TO BRETTON WOODS

Our story begins in a little town in New Hampshire on July 1, 1944. For the first time in modern history, an international agreement was reached to govern monetary policy among the world’s nations. It was a chance to create a stable international currency once and for all. In total, 730 delegates from 44 nations met for three weeks at a resort in Bretton Woods.

The conference was held at the Mount Washington Hotel in the shadows of the largest mountain in the Granite State, Mount Washington. Mount Washington is known for some of the most severe weather in the lower 48 contiguous states. Seems all too fitting a location for a conference discussing what to do with the world’s money as the closing battles of World War II raged on in Europe and the South Pacific.

The hotel itself was, and still is, as ostentatious and grand as the aims of the 44 countries who sent their delegates.

The economist John Maynard Keynes led the British delegation—he was something of an economic superstar because of his academic prowess and access to the government ruling class in Great Britain. He was a member of the famous Bloomsbury Group, friends with a hip crowd of writers like Virginia Wolfe and E.M. Forster. He also argued that governments needed to expand their power in typical “Progressive fashion.” Think Steven Pinker or Yuval Noah Harari, but back in the day.

Harry Dexter White led the United States’ efforts. (As a side note to the history we are building for you, in 1948 Harry Dexter White was accused of being a Russian spy during the war and through the conference. Later declassified Russian documents further added to the cloud of suspicion overhanging the formerly high ranking US



(Source: https://en.wikipedia.org/wiki/Mount_Washington_Hotel)

Treasury official.) France, Mexico, and the British Commonwealths like Canada, Australia, and New Zealand also attended. Brazil and 36 other Allied countries sent diplomats and economists. The Soviet Union even joined the conference, although in the end they didn't register a vote.¹

Bretton Woods presented a significant opportunity for the global economic community. But like all diplomatic efforts of this size and scope, it fell short of what could have been achieved. It was, however, a turning point in monetary history.

The intended purpose of the meeting was to discuss ideas both Keynes and White had been working on since early in the Second World War. Without discounting the world's tragic casualties, it was clear early enough in the conflict that the global economy would be destroyed and, after the smoke cleared and the peace treaties were signed, would need to be rebuilt from the ground up, both literally and metaphorically.

In some respects, Bretton Woods was a lot like an economic United Nations. The combination of the Great Depression of the 1930s and

the Second World War required a global economic summit of unprecedented magnitude.

The consensus of the delegates was that trade barriers and high costs had caused the worldwide depression, at least in part. Also, during that time it was common practice to use currency devaluation as a means of affecting neighboring countries' imports and reducing payment deficits. Unfortunately, the practice led to chronic deflation, unemployment, and a reduction in international trade. The situation was summed up well by Cordell Hull, U.S. Secretary of State from 1933 through 1944, who wrote:

Unhampered trade dovetailed with peace; high tariffs, trade barriers, and unfair economic competition, with war. . . . If we could get a freer flow of trade . . . so that one country would not be deadly jealous of another and the living standards of all countries might rise, thereby eliminating the economic dissatisfaction that breeds war, we might have a reasonable chance of lasting peace.

Hull's suggestion that war often has an economic root is reasonable given the position of both Germany and Japan in the 1930s. Many historians believe Japan's sneak attack on Pearl Harbor, "a day that will live in infamy," was forced by a trade embargo imposed by the United States against Japan. Another observer agreed, saying poor economic relations among nations "inevitably result in economic warfare that will be but a prelude and instigator of military warfare on an even vaster scale."

The solution to such crooked manipulation of money? A worldwide agreement. Easier said than done. Keynes preferred establishing a system that would have encouraged economic growth rather than a gold-pegged system. He favored the creation of an international central bank and possibly even a world currency backed by a "basket of commodities" and proposed that the goal of the conference was "to find a common measure, a common standard, a common rule acceptable to each and not irksome to any."

Keynes's ideas were not accepted. The United States preferred the plan offered by its representative, Harry Dexter White. The US position was intended to create and maintain price stability rather than Keynes's supposed economic growth.

At the end of the Second World War, the United States had more gold than anyone else: 70% of the world's gold reserves.² That will be an important detail in 23 years. Due to this perceived economic dominance, the United States held the leadership role at Bretton Woods. And like in many situations, he who holds the gold wins the argument. The amount of gold held in reserve is going to be important when we get to the political reason to end the Bretton Woods Agreement and take the dollar off the gold standard, so keep that in mind.

The official Bretton Woods Agreement laid out a plan for international monetary policy based on a global gold standard. By “pegging” their currencies to the U.S. dollar, which was in turn “pegged” to gold, each country signing the accord promised to maintain its currency at values at or close to the value of gold. In addition, the International Monetary Fund (IMF) was established to facilitate payment imbalances on a temporary basis. The system devised during the conference was bureaucratic in nature; the newly established International Bank for Reconstruction and Development (IBRD, now the World Bank) and the IMF were created and funded, along with a series of infrastructure loans to war-ravaged nations.

In an ominous statement released by President in 1953, it is apparent that the political aims of the IMF began under shoddy leadership. Truman said:

It was originally planned that the United States would support Mr. White for election to the top managerial position in the International Monetary Fund—that of managing director—a more important post than that of a member of the board of executive directors. But following the receipt of the FBI report and the consultations with members of my Cabinet, it was decided that he would be limited to membership on the board of directors. With his duties thus restricted, he would be subject to the supervision of the Secretary of State, and his position would be less important and much less sensitive—if it were sensitive at all—than the position then held by him as Assistant Secretary of the Treasury.

As a consequence, the progress of emerging economies would be achieved through lending and infrastructure investment through the IMF, but without Dexter White at its head. In joining the IMF, each

country was assigned a trade quota to fund the international effort, budgeted originally at \$8.8 billion. Disparity among countries was to be managed through a series of borrowings. A country could borrow from the IMF, which would be acting in fact like a central bank.

The IMF and the World Bank exist right now and appear in the news on a regular basis. They are the pillars of the global economic economy to this day. They are a big piece of the puzzle of inflation and the demise of the dollar, but there's more to the story of Bretton Woods.

WHAT IS "THE GOLD STANDARD"?

Throughout most of the nineteenth century, the "gold standard" dominated currency exchange. The Bretton Woods system attempted to recreate a Victorian-era monetary policy of a similar nature—namely, the British pound being pegged directly to gold. Gold created a fixed exchange rate between nations. Money supply was limited to gold reserves. In this way, the currency was stable and could not be manipulated by central banks. It's what has been referred to since as "sound money."

The gold standard established by the Bretton Woods Agreement worked for 25 years. It's a short amount of time, even when measured against the 234 years the United States has been a country. The peg of the US dollar to gold maintained sensible economic policy based on a nation's gold reserves.

In theory, gold became the method of guaranteeing the value of a currency. A productive nation under this exchange rate system was one that could trade favorably and confidently. Following Bretton Woods, the pegged rate was formalized by agreement among the leading economic powers of the world.

But it was flawed in its underlying assumptions. The concept was a good one. In practice, however, the international currency naturally became the US dollar, and other nations pegged their currencies to the dollar rather than to the value of gold.

So what happened?

The actual outcome of Bretton Woods was to replace the gold standard with a gold standard that depended on the US dollar. The

United States linked the dollar to gold at a value of \$35 per ounce. By pegging international currency to gold at \$35 an ounce, it failed to take into consideration the change in gold's actual value since 1934, when the \$35 level had been set. This disconnect was the beginning of the demise of the dollar.

This problem was described by a senior vice president of the Federal Reserve Bank of New York:

From the very beginning, gold was the vulnerable point of the Bretton Woods system. Yet the open-ended gold commitment assumed by the United States government under the Bretton Woods legislation is readily understandable in view of the extraordinary circumstances of the time.

At the end of the war, our gold stock amounted to \$20 billion, roughly 60 percent of the total of official gold reserves. As late as 1957, United States gold reserves exceeded by a ratio of three to one the total dollar reserves of all the foreign central banks. The dollar bestrode the exchange markets like a colossus.

As well-intentioned as the idea was, the agreements and institutions that grew from Bretton Woods were not adequate for the economic problems of postwar Europe. The United States was experiencing huge trade surplus years while carrying European war debt. US reserves were huge and growing each year.

By 1947, it became clear that the IMF and IBRD were not going to fix Europe's problems after the Second World War. To help address the issue, the United States set up a system to help finance recovery among European countries. The European Recovery Program (better known as the Marshall Plan) was organized to give grants to countries to rebuild. The problems of European nations, according to Secretary of State George Marshall, "are so much greater than her present ability to pay that she must have substantial help or face economic, social, and political deterioration of a very grave character."

Between 1948 and 1954, the United States gave 16 Western European nations \$17 billion in grants. Believing that former enemies Japan and Germany would provide markets for future US exports, policies were enacted to encourage economic growth.

It became increasingly difficult to maintain the peg of the US dollar to \$35-per-ounce gold. An open market in gold continued in London, and crises began to affect the going-value of gold. The conflict between the fixed price of gold between central banks at \$35 per ounce and open market value worsened. During the Cuban Missile Crisis in 1962, for example, the open market value of gold was \$40 per ounce. The mood among US leaders began moving away from belief in the gold standard and straining the Bretton Woods Agreement. President Lyndon B. Johnson argued in 1967:

The world supply of gold is insufficient to make the present system workable—particularly as the use of the dollar as a reserve currency is essential to create the required international liquidity to sustain world trade and growth.³

It became apparent that the idea of progress could not be funded by gold alone. On March 17, 1968, a run on gold closed the London Gold Pool permanently. Maintaining the gold standard under the Bretton Woods configuration was no longer practical for the political agendas of the day. Either the monetary system had to change or the gold standard itself would need to be revised.

In a last ditch effort to keep the Bretton Woods Agreement afloat, the IMF set up Special Drawing Rights (SDRs) for use as trade between countries. The intention was to create a type of paper-gold hybrid system, while taking pressure off the United States to continue serving as central banker to the world. However, this did not solve the problem; the depletion of US gold reserves continued until 1971. The United States held only 22% gold coverage of foreign reserves by that year.

Bretton Woods lacked any effective mechanism for checking reserve growth. Nobody knew who had the actual, physical gold. Only American dollars were considered seriously as reserves, and gold production was lagging. Accordingly, dollar reserves had to expand to make up the difference in lagging gold availability.

Bretton Woods ceased to function as an effective centralized monetary body. In theory, SDRs—used today on a very limited scale of transactions between the IMF and its members—could function as the

beginnings of an international currency. But given the widespread use of the US dollar as the peg for so many currencies worldwide, it is unlikely that such a shift to a new direction will occur before circumstances make it the only choice.

Finally the problem fell on another man's shoulders. In 1971, experiencing rapidly accelerating depletion of its gold reserves, President Richard "Tricky Dick" Nixon and the United States removed its currency from the "gold standard," and the Bretton Woods Agreement was no longer in effect.

He famously blamed it on speculators betting against the US dollar itself, but it was the depletion of gold reserves that really got everyone spooked. If the US dollar was pegged to gold reserves, and those gold reserves were depleting, well, then, the gig would be up.

The only solution at the point would have been to end the peg.