"Will you lend me your mare to ride a mile?

No, she is lame leaping over a stile.

Alack! And I must go to the fair!

I'll give you good money for lending your mare.

– Oh, oh! Say you so?

Money will make the mare to go."

The old nursery rhyme still holds true today. Money still makes the mare go. The story of money goes even further back. In fact, the tradition of money goes back around 3000 years, before which a barter system was probably used.

Early records (circa 1000 BC) show that the Chinese initially used miniature replicas of tools and weapons as a form of money which later developed into the form of the round coins we know today.

The first manufactured coins occurred in India, China, and in cities around the Aegean Sea between 700 and 500 BC.

Image Source: calgarycoin.com

The Chinese coins had holes in the center allowing for them to be strung together whilst the Indian coins were punched metal discs.
The Aegean coins were completely different, too.
This is a great illustration of how the concept of money developed separately across the world.

Around the 7th century A.D, the Chinese, having grown tired of carrying purses full of heavy coins, invented a form of paper money (see image below) that allowed the notes to be converted to precious commodities like gold and silver. The notes came with a stern warning to counterfeiters about the consequences of their actions if caught.

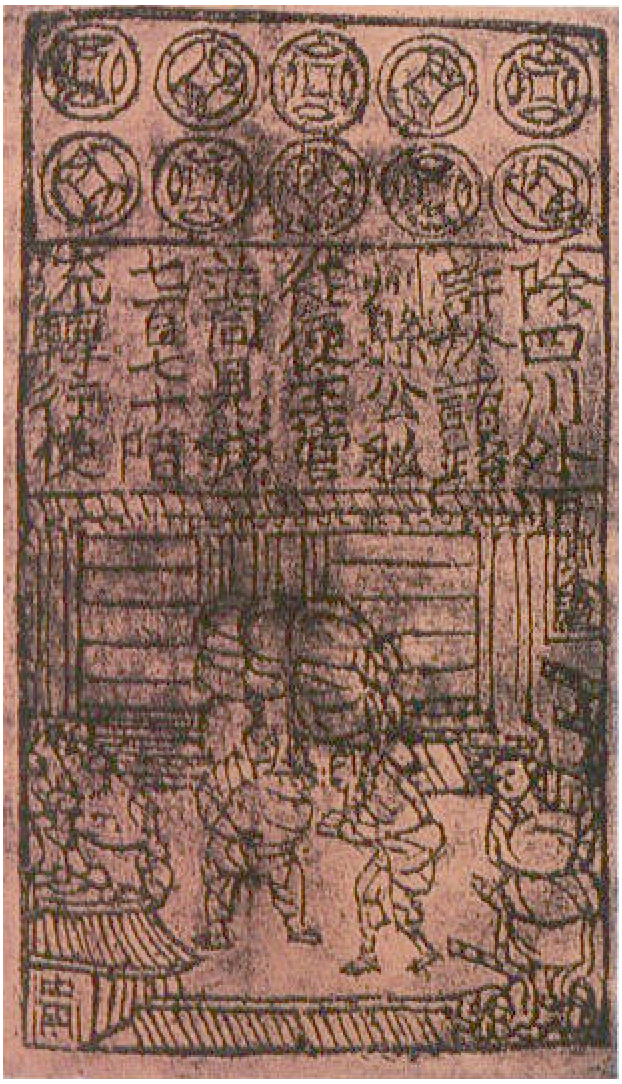


Image Source: Wikipedia

A form of this “commodity money” was used in India, albeit unsuccessfully, by Muhammad bin Tughlaq in the 14th century which was one of the reasons that ultimately led to the downfall of his sultanate.

Image Source: Liveauctiongroup.net

Paper money came to Europe much later after travellers like Marco Polo brought the concept to them in the 13th century. Promissory notes were used during transactions which later developed in to bank notes which could be exchanged for their face value in gold and silver coins. The gold standard system whereby the value of a national currency was based on a fixed weight in gold was in use in one form or another until 1971.

Bank notes further evolved to the form we know today.

Commodity Money vs. Fiat Money

Commodity money is backed by goods which have intrinsic value. In the past, precious metals like gold and silver were the most common items utilized to back currencies. In contrast, fiat money has no intrinsic value and is any money declared by a government to be legal tender. It is usually paper or coinage that is not backed by a valuable commodity.

For example, imagine a government prints a large amount of money to increase the amount of liquidity, most of the money printed would be invested in real estate or the stock market or any other such commodity. Since this fiat money has no intrinsic value of its own, it would only serve in pushing up prices but not actually stimulate an increase in the actual wealth of a country. One of the biggest reasons that can lead to a major financial crisis is the amount of money printed as opposed to actual assets and how quickly the money can be converted to such assets. Failure or delays in converting the money to assets on demand would lead to the failure of the system.

Fiat Currency Collapse: Past History

A notable example is the financial crisis in France (1720) which is believed to have been one of the major causes that led to the French Revolution (1789-1799).

Those who don't learn from history are doomed to repeat it
– George Santayana

In 1640, the French state minted commodity money called Louis d'or (gold coin) and Ecu Blanc (silver coin).

The beginning and early issues

Louis IV of France had waged several wars on foreign territories which had emptied France's coffers. The resultant shortage of precious metals led to a shortage of coins in circulation, which in turn limited the production of new coins. Following poor fiscal condition of the French state, all the money under circulation were withdrawn and re-stamped at higher value. Owing to which, the livre depreciated in terms of gold by 50 per cent between 1696 and 1715.

Gradually paper notes were exchanged for delivered gold coins and were given “temporary currency” status. Following the death of the Louis XIV in 1715, Phillipe of Orleans had inherited an huge state debt of 2 billion livres and an imbalanced budget. As a measure, some debt was “re-examined” which shook the trust in the state. John Law was also permitted to establish the Banque Générale in 1716 with the right rent tobacco trade and create banknotes.

The beginning of the end

The government acquired Banque Générale during Dec-1718. Large payments were limited to banknotes, not gold and silver. Bank notes were also replaced by state “Livre Tournois” notes. The belief was that “Banknotes were not to be affected by devaluations of coins, as the notes were more reliable than gold or silver coins and should be trusted by the public”.

A general economic boom followed, leading to a speculation in company shares.

John Law, now the director of the Banque, also acquired the badly performing companies of East India and China during May 1719, renaming them as Compagnie des Indes. It got rights on coinage for 9 years. John Law also acquired monopoly on tax collections from Paris Brothers, in return offering the regent to repay state pensions. Shares were also issued the regent in exchange of protection. John Law’s companies issued new shares at heightened prices to public to fund for these rights and entitlements..

The end

By late 1720 prices in Paris were nearly twice of what they were compared to a mere two years earlier. This was mainly due the increase in paper currency circulated. Total money supply was four times larger in livre terms than gold and silver coinage previously used. Not surprisingly, people began to lose faith in the paper currency and started conducting payments in gold and silver. The speculators started to sell their shares and invest in real estate and precious metals. The Banque Royale and Compagnie des Indes were united and the buy-back of shares was announced to support stock prices that had declined to 5000 livres by December 1720 compared to their peak at 18000 livres in the January of the same year. During 1721, share price had dropped to 600.

"During Sept-1720, Compagnie des Indes was allowed to make house searches for precious metal and confiscate them. Carrying pearls, diamond and gems was forbidden."

In the following years, the French state was a beneficiary of the crisis. The total debt of 2 billion livres from 1715 remained the same, but most of it was in pensions with a 2% interest rate – a significant improvement of public debt. Most of public's wealth (an estimated 80%) in pensions, company shares, bank notes or bank accounts had been lost.

The cycle continues

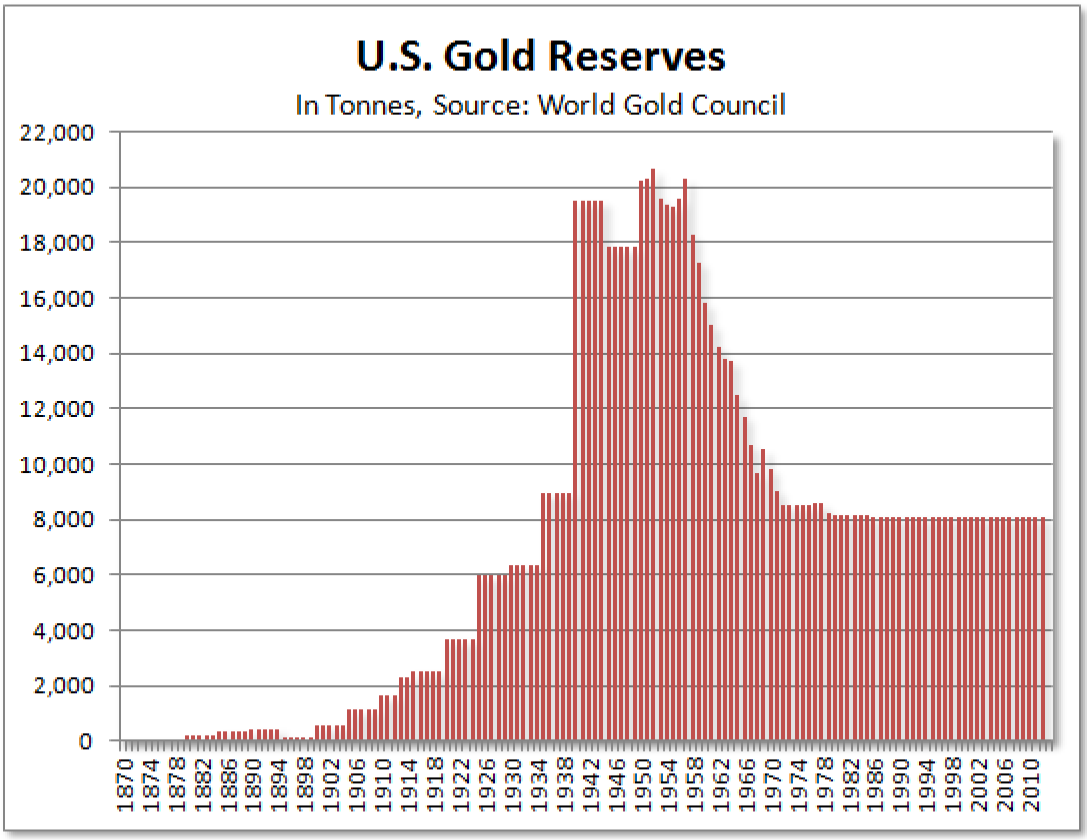
The years between 1721 and 1796 saw usage of different monetary systems as well as experimentation with fiat currencies. By 1795, inflation of assignats (a new form of paper money) was running at approximately 13,000%. By 1796, trade was conducted only in silver, leading to the downfall of the fiat system in France and thereby rendering paper money worthless.

Fiat Currency Collapse: Recent History

The beginning and early issues

A more recent example is the case of the Bretton Woods Agreement. This system was agreed upon in 1944 with 44 countries participating. It established a fixed exchange rate system in order to give international transactions stability. The International Monetary Fund (IMF) was established as a result with an aim to monitor exchange rates and lend reserve currencies to nations. The World Bank Group was also created to provide financial aid to countries necessary after the First World War.

At the time of the Agreement, the United States, who controlled two-thirds of the world's gold, insisted that the Bretton Woods system rest on both gold and the U.S. dollar. The IMF and the World Bank served to initiate the process of internationalization of the dollar across the globe under the guise of foreign aid. Under the agreement, all national currencies were valued in relation to the U.S. dollar which in turn was convertible to gold at a fixed rate of $35



to the ounce.

The Historic rise and fall of U.S. Gold Reserves

As world trade increased rapidly through the 1950s the size of the gold base in the United States increased by only a few percentage points.

During the 1950s, the U.S. balance of payments swung negative. As a first response, the U.S. Government placed import quotas on oil and some other restrictions on trade outflows. Although the design of the Bretton Woods System was such that nations could only enforce gold convertibility on the anchor currency—the United States dollar, nations could forgo converting dollars to gold, and instead hold dollars.

The beginning of the end

Gold had an alternate market as well. Gold price spiked in response to the Cuban Missile Crisis to $40 an ounce during 1960s. A decade long efforts were made to contain the peg at $35 an ounce by way of production and exports encouragements, tax cuts, etc. By 1971, more and more dollars were printed by Washington, then being pumped overseas, to pay for government expenditure on military and social programs. U.S. dollars flooded European currency market and as a response the central banks of Austria, Belgium, Netherlands and Switzerland stopped the currency trading.

The end

By 1971, the United States carried only a third of the gold bullion at Fort Knox necessary to cover the amount of dollars in foreign hands. On August 15, 1971 President Richard Nixon unilaterally terminated convertibility of the US dollar to gold, effectively bringing the Bretton Woods system to an end and rendering the dollar a fiat currency. (Video)

1971 termination of USD convertibility of gold lead to emergence of a new monetary system whereby

This …

$100- In Bretton Woods System

(One Hundred Dollars in Gold Coin Payable to the Bearer on Demand)

changed to this…

(In God We Trust)

Around same time, many fixed currencies (such as the pound sterling, for example), also became free-floating.

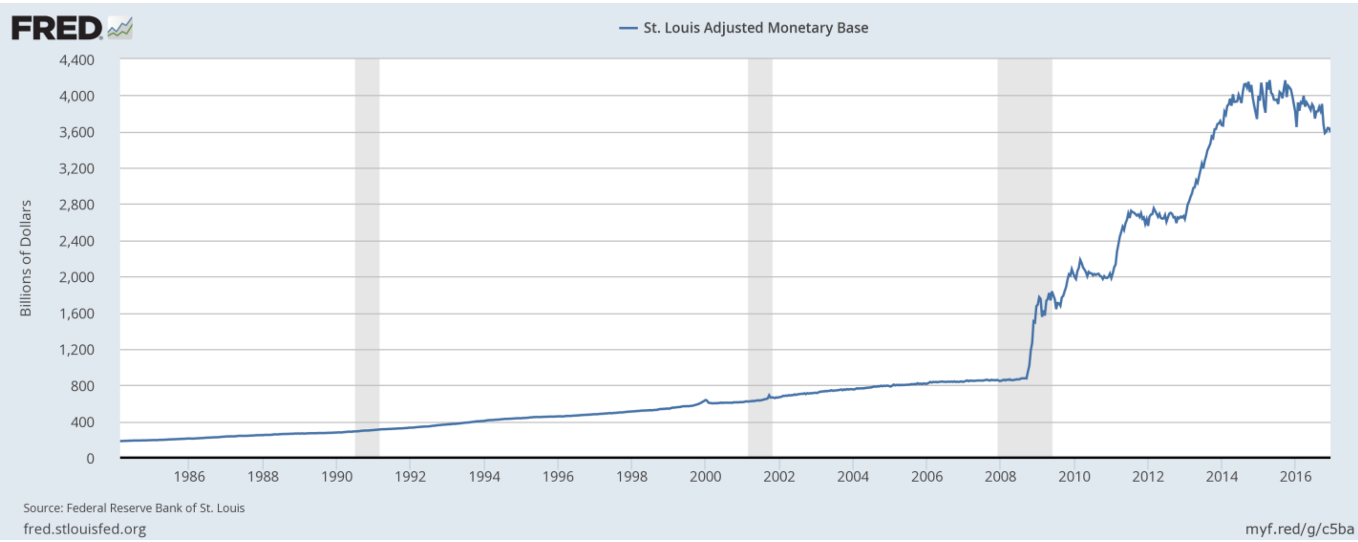
The cycle continues

By 1973, the international currency market lost its formal connection to gold and governments let their currencies float putting an end to the Bretton Woods System. The global financial system thus turned in to a fiat currency or credit driven system as we know it today.

The Fiat System and the Present

Over the years, the U.S. has become a net consumer of goods. However, this rise in consumption has been subsidised by the government by way of deficit funding and ultimately by U.S. Treasury holders. USA has been able to sustain this system only because the world has continued to use the U.S. dollar as a reserve currency for global trade and are willing to purchase the same, in turn funding an entire country's consumption.

Post the 2008 financial crisis, the U.S. government has been trying to revive its economy, however, the Federal Reserve and the government have been unable to achieve any success.



Since the Great Financial Crisis, the U.S. monetary base has expanded from $875 billion to $3,637 billion between September 2008 and November 2016 Thus, currently the U.S. is a country with high debts, low ability to repay those debts with its central bank abusing the reserve currency status and acting like a printing press to fund US government' deficits.

The dollar has lost 92 per cent of its value since its issue in 1913 (since US Fed was created) and the U.S. has currently been increasing the supply of dollars at a rate of 13% per annum. This could be a leading indicator of a currency on the brink.

Every fiat currency has ended in devaluation and eventual collapse, right from the Roman Empire in the 1st century AD to modern times. The domino effect of these collapses has led to large wipe outs of masses' wealth as well as economic hardships for the nations. The above incidents show that it takes years for a bubble to form, as they are built due to the gradual increase in monetary bases over the years. But it takes just about a year (or few) to pop, creating chaos till the time "new order" is adopted.

As these events are "black swan" events, they are often overlooked by investors due to "normalcy bias". But, whenever these events play out again they give little chance to protect wealth. The resultant resets are painful and generally lead to a wipe out of a large proportion of wealth of general population.

"History has shown us that whenever credit worthy people (governments) start abusing their credit worthiness, that whenever a debtor cannot honor the commitments, slowly but surely creditors will change their terms."

When Lessons Are Not Learned History Will Repeat Itself

The examples above serve to show that, historically, fiat systems are arbitrary, unstable and will fail. Presently, monetary policy is not a science – it is based on people's faith in their currency and estimates and predictions. As mentioned earlier, printing more currency does not result in an actual increase in wealth. This 'currency debasement' has been one of the main reasons for financial collapses in the past.

Effective Wealth Management Can Ease the Impact of Fiat Currency Collapse

A good monetary system needs to be based on real wealth creation with a stable asset base. Until such a system is developed and universally accepted, the best possible chance of survival is to invest in 'real' assets like gold, natural resources, land entitlements and sustainable businesses that would survive such economic crises.

Contrary to popular belief, gold is not a depreciating asset. It goes through fluctuations in price as with most other commodities. However, it has historically maintained its value over the long term, making people flock towards it as insurance in hard times. By owning appropriate amount of gold, as highest quality of cash, one can effectively protect their investment in case of hyperinflation (adverse macro environment) or during a financial depression.

"There is no means of avoiding the final collapse of a boom brought about by credit expansion.The alternatives are only whether the crisis should come sooner as the result of

voluntary abandonment of further credit expansion…

Or later as a final and total catastrophe of the currency system involved."

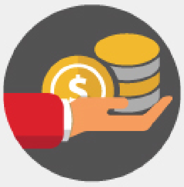
– Ludwig von Mises in Human Action

Economists from the Austrian School of thought have all along predicted that the current system of paper currency, or "fiat-money," is an economically and socially destructive scheme. The current system of money is not backed by gold or any real asset as it was before 1971 and is solely based on the U.S. taxpayer being the ultimate guarantor of all the fiat money in issuance. In other words, our "debt based" monetary system seems like an irrational arrangement which can have a disastrous impact on the global economy.

At Multi-Act, we engage in investment advisory activities as well as provide advisory and Portfolio Management Services. We believe in providing sustenance through long-term goals and prosperity. We are market agnostic and are thus able to provide independent and conflict free research and investment advice. Our analysts follow our in-house Global Rational Analysis Framework (GRAF) that merges all four schools of investment analysis, namely fundamental, technical, quantitative and behavioural analyses that makes it easy to follow the rules of investing increasing the probabilities of making a profit on your investments.

Summary:

STAGES OF FIAT CURRENCY COLLAPSE

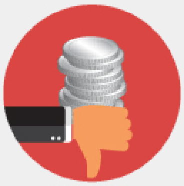


Commodity Money

Commodity money is backed by goods which have intrinsic value. In the past, precious metals like gold and silver were the most common items utilized to back currencies.

Currency Debasement

Currency debasement is the process wherein money's value depreciates. Eventually, the debasement turns strong commodity backed money into a fiat currency (any money declared by a government to be legal tender).



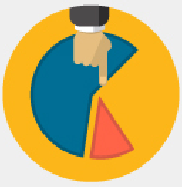
Fiat Currency

Fiat money has no intrinsic value and is any money declared by a government to be legal tender. It is usually paper or coinage that is not backed by a valuable commodity.

Fiat Currency Chaos

In the past some fiat currencies have failed and led to disastrous situations. History had witnessed a state of absolute collapse when empires have been dependent on fiat currencies.

The impact has been severe given the urge of the governments to crank up the printing presses for war, projects, graft, etc.



Loss In Purchasing Power = Loss Of Faith

This stage occurs when the loss in purchasing power of the prolonged currency supply is identified by the population.

Gradually it triggers a loss of faith in the currency and the financial markets.

An End Mass-Movement Out Of The Fiat Currency

This stage often causes a mass turmoil within the society. Nations may go back to commodity monetary system or may come up with a new monetary system only backed by government diktat.

As and when these resets occur, the public loses its capital and savings. However, effective wealth management practices can ease the impact of these resets on one's finances.

Built by Investors for Investors

Read More: https://multi-act.com/fiat-currency-collapse-is-history-repeating-itself/