

THE DEATH OF MONEY

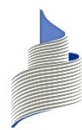
THE COMING COLLAPSE
OF THE INTERNATIONAL
MONETARY SYSTEM



JAMES RICKARDS

BESTSELLING AUTHOR OF *CURRENCY WARS*





THE DEATH OF MONEY

‘A terrifically interesting and useful book . . . fascinating’
Kenneth W. Dam, former deputy secretary of the Treasury
and adviser to three presidents

‘*The Death of Money* contains very big, provocative ideas
clearly explained and delivered in an evenhanded tone that steers
away from the sensational proclamation yet successfully undercuts
conventional market wisdom. Rickards’s insight enables him
to connect the dots in a way that few others can’
John Hathaway, portfolio manager, Tocqueville Gold Fund

‘*The Death of Money* is an engrossing account of the massive
stresses accumulating in the global financial system, especially
since the 2008 financial crisis. Jim Rickards is a natural
teacher. Any serious student of financial crises and their
root causes needs to read this book’
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immediately ahead for a world that remains entirely dependent
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for those who worry about the future of our country’
R. Christopher Whalen, noted bank analyst; author of *Inflated*

‘Rickards’s analysis of the inflation-deflation paradox,
dangerous adversaries to the dollar and the Fed’s strategy
is insightful. Following his bestseller *Currency Wars*, this
book is even better. A great book makes you think differently
about the world – and this one does just that’
Don Young, twenty-five-time Institutional Investor All-Star
Analyst; former board member, Financial Accounting
Standards Board

ABOUT THE AUTHOR

James Rickards is the author of the national bestseller *Currency Wars*, which has been translated into eight languages and won rave reviews from the likes of the *Financial Times*, *Bloomberg* and *Politico*. He is a portfolio manager at West Shore Group and an adviser on international economics and financial threats to the Department of Defense and the US intelligence community. He served as facilitator of the first ever financial war games conducted by the Pentagon. He lives in Connecticut.

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OF THE INTERNATIONAL
MONETARY SYSTEM

JAMES RICKARDS



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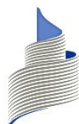
For Glen, Wayne, Keith, Diane, and Eric—all best friends
since the days we were born

Tuan Mahatir,

It was an honor meeting
you in Malaysia. I
hope you find this book
helpful in the years ahead.

Best wishes,
Mark Miller

5047 24, 2015



Write down, therefore, what you have seen, and what is happening, and what will happen afterwards.

Revelation 1:19



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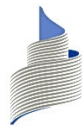
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THE DEATH OF MONEY





PERDANA
LEADERSHIP
FOUNDATION
YAYASAN
KEPIMPINAN
PERDANA

INTRODUCTION

The Death of Money is about the demise of the dollar. By extension, it is also about the potential collapse of the international monetary system because, if confidence in the dollar is lost, no other currency stands ready to take its place as the world's reserve currency. The dollar is the linchpin. If it fails, the entire system fails with it, since the dollar and the system are one and the same. As fearsome a prospect as this dual collapse may be, it looks increasingly inevitable for all the reasons one will find in the pages to come.

A journey to the past is in order first.

Few Americans in our time recall that the dollar nearly ceased to function as the world's reserve currency in 1978. That year the Federal Reserve dollar index declined to a distressingly low level, and the U.S. Treasury was forced to issue government bonds denominated in Swiss francs. Foreign creditors no longer trusted the U.S. dollar as a store of value. The dollar was losing purchasing power, dropping by half from 1977 to 1981; U.S. inflation was over 50 percent during those five years. Starting in 1979, the International Monetary Fund (IMF) had little choice but to mobilize its resources to issue world money (special drawing rights, or SDRs). It flooded the market with 12.1 billion SDRs to provide liquidity as global confidence in the dollar declined.

We would do well to recall those dark days. The price of gold rose 500 percent from 1977 to 1980. What began as a managed dollar devaluation in 1971, with President Richard Nixon's abandonment of gold convertibility, became a full-scale rout by the decade's end. The dollar debacle even seeped into popular culture. The 1981 film *Rollover*, starring Jane Fonda, involved a secret plan by oil-producing nations to dump dollars and buy gold; it ended with a banking collapse, a financial panic, and global riots. That was fiction but indeed was powerful, perhaps prescient



hit an all-time low, over 4 percent below the October 1978 panic level. In August 2009 the IMF once again acted as a monetary first responder and rode to the rescue with a new issuance of SDRs, equivalent to \$310 billion, increasing the SDRs in circulation by 850 percent. In early September gold prices reached an all-time high, near \$1,900 per ounce, up more than 200 percent from the average price in 2006, just before the new depression began. Twenty-first-century popular culture enjoyed its own version of *Rollover*, a televised tale of financial collapse called *Too Big to Fail*.

The parallels between 1978 and recent events are eerie but imperfect. There was an element ravaging the world then that is not apparent today. It is the dog that didn't bark: inflation. But the fact that we aren't hearing the dog doesn't mean it poses no danger. Widely followed U.S. dollar inflation measures such as the consumer price index have barely budged since 2008; indeed, mild *deflation* has emerged in certain months. Inflation has appeared in China, where the government revalued the currency to dampen it, and in Brazil, where price hikes in basic services such as bus fares triggered riots. Food price inflation was also a contributing factor to protests in the Arab Spring's early stages. Still, U.S. dollar inflation has remained subdued.

Looking more closely, we see a veritable cottage industry that computes U.S. price indexes using pre-1990 methodologies, and alternative baskets of goods and services that are said to be more representative of the inflation actually facing Americans. They offer warning signs, as the alternative methods identify U.S. inflation at more like 9 percent annually, instead of the 2 percent readings of official government measures. Anyone shopping for milk, bread, or gasoline would certainly agree with the higher figure. As telling as these shadow statistics may be, they have little impact on international currency markets or Federal Reserve policy. To understand the threats to the dollar, and potential policy responses by the Federal Reserve, it is necessary to see the dollar through the Fed's eyes. From that perspective, inflation is *not* a threat; indeed, higher inflation is both the Fed's answer to the debt crisis and a policy objective.

This pro-inflation policy is an invitation to disaster, even as baffling. Fed critics scratch their heads at the apparent absence of inflation in the face of unprecedented money printing by the Federal Reserve and oth

major central banks. Many ponder how it is that the Fed has increased the base money supply 400 percent since 2008 with practically no inflation. But two explanations are very much at hand—and they foretell the potential for collapse. The first is that the U.S. economy is structurally damaged, so the easy money cannot be put to good use. The second is that the inflation is coming. Both explanations are true—the economy is broken, and inflation is on its way.

The Death of Money examines these events in a distinctive way. The chapters that follow look critically at standard economic tools such as equilibrium models, so-called value-at-risk metrics, and supposed correlations. You will see that the general equilibrium models in widespread use are meaningless in a state of perturbed equilibrium or dual equilibria. The world economy is not yet in the “new normal.” Instead, the world is on a journey from old to new with no compass or chart. Turbulence is now the norm.

Danger comes from within and without. We have a misplaced confidence that central banks can save the day; in fact, they are ruining our markets. The value-at-risk models used by Wall Street and regulators to measure the dangers that derivatives pose are risible; they mask overleveraging, which is shamelessly transformed into grotesque compensation that is throwing our society out of balance. When the hidden costs come home to roost and taxpayers are once again stuck with the bill, the bankers will be comfortably ensconced inside their mansions and aboard their yachts. The titans will explain to credulous reporters and bought-off politicians that the new collapse was nothing they could have foreseen.

While we refuse to face truths about debts and deficits, dozens of countries all over the globe are putting pressure on the dollar. We think the gold standard is a historical relic, but there’s a contemporary scramble for gold around the world, and it may signify a move to return to the gold standard. We greatly underestimate the dangers from a cyberfinancial attack and the risks of a financial world war.

Regression analysis and correlations, so beloved by finance quants and economists, are ineffective for navigating the risks ahead. These analyses assume that the future resembles the past to an extent. History is a great teacher, but the quants’ suppositions contain fatal flaws. The first is that in looking back, they do not look far enough. Most data used on W

Street extend ten, twenty, or thirty years into the past. The more diligent analysts will use hundred-year data series, finding suitable substitutes for instruments that did not exist that far back. But the two greatest civilizational collapses in history, the Bronze Age collapse and the fall of the Roman Empire, occurred sixteen hundred years apart, and the latter was sixteen hundred years ago. This is not to suggest civilization's imminent collapse, merely to point out the severely limited perspective offered by most regressions. The other flaw involves the quants' failures to understand scaling dynamics that place certain risk measurements outside history. Since potential risk is an exponential function of system scale, and since the scale of financial systems measured by derivatives is unprecedented, it follows that the risk too is unprecedented.

While the word *collapse* as applied to the dollar sounds apocalyptic, it has an entirely pragmatic meaning. Collapse is simply the loss of confidence by citizens and central banks in the future purchasing power of the dollar. The result is that holders dump dollars, either through faster spending or through the purchase of hard assets. This rapid behavioral shift leads initially to higher interest rates, higher inflation, and the destruction of capital formation. The end result can be deflation (reminiscent of the 1930s) or inflation (reminiscent of the 1970s), or both.

The coming collapse of the dollar and the international monetary system is entirely foreseeable. This is not a provocative conclusion. The international monetary system has collapsed three times in the past century—in 1914, 1939, and 1971. Each collapse was followed by a tumultuous period. The 1914 collapse was precipitated by the First World War and was followed later by alternating episodes of hyperinflation and depression from 1919 to 1922 before regaining stability in the mid-1920s, albeit with a highly flawed gold standard that contributed to a new collapse in the 1930s. The Second World War caused the 1939 collapse, and stability was restored only with the Bretton Woods system, created in 1944. The 1971 collapse was precipitated by Nixon's abandonment of gold convertibility for the dollar, although this dénouement had been years in the making, and it was followed by confusion, culminating in the near dollar collapse in 1978.

The coming collapse, like those before, may involve war, gold, chaos, or it could involve all three. This book limns the most immin

threats to the dollar, likely to play out in the next few years, which are financial warfare, deflation, hyperinflation, and market collapse. Only nations and individuals who make provision today will survive the maelstrom to come.

In place of fallacious, if popular, methods, this book considers complexity theory to be the best lens for viewing present risks and likely outcomes. Capital markets are complex systems nonpareil. Complexity theory is relatively new in the history of science, but in its sixty years it has been extensively applied to weather, earthquakes, social networks, and other densely connected systems. The application of complexity theory to capital markets is still in its infancy, but it has already yielded insights into risk metrics and price dynamics that possess greater predictive power than conventional methods.

As you will see in the pages that follow, the next financial collapse will resemble nothing in history. But a more clear-eyed view of opaque financial happenings in our world can help investors think through the best strategies. In this book's conclusion you will find some recommendations, but deciding upon the best course to follow will require comprehending a minefield of risks, while poised at a crossroads, pondering the death of the dollar.

Beyond mere market outcomes, consider financial war.

■ Financial War

Are we prepared to fight a financial war? The conduct of financial war is distinct from normal economic competition among nations because it involves intentional malicious acts rather than solely competitive ones. Financial war entails the use of derivatives and the penetration of exchanges to cause havoc, incite panic, and ultimately disable an enemy's economy. Financial war goes well beyond industrial espionage, which has existed at least since the early 1800s, when an American, Francis Cabot Lowell, memorized the design for the English power loom and recreated one in the United States.

The modern financial war arsenal includes covert hedge funds a

cyberattacks that can compromise order-entry systems to mimic a flood of sell orders on stocks like Apple, Google, and IBM. Efficient-market theorists who are skeptical of such tactics fail to fathom the irrational underbelly of markets in full flight. Financial war is not about wealth maximization but victory.

Risks of financial war in the age of dollar hegemony are novel because the United States has never had to coexist in a world where market participants did not depend on it for their national security. Even at the height of dollar flight in 1978, Germany, Japan, and the oil exporters were expected to prop up the dollar because they were utterly dependent on the United States to protect them against Soviet threats. Today powerful nations such as Russia, China, and Iran do not rely on the United States for their national security, and they may even see some benefit in an economically wounded America. Capital markets have moved decisively into the realm of strategic affairs, and Wall Street analysts and Washington policy makers, who most need to understand the implications, are only dimly aware of this new world.

■ Inflation

Critics from Richard Cantillon in the early eighteenth century to V. I. Lenin and John Maynard Keynes in the twentieth have been unanimous in their view that inflation is the stealth destroyer of savings, capital, and economic growth.

Inflation often begins imperceptibly and gains a foothold before it is recognized. This lag in comprehension, important to central banks, is called *money illusion*, a phrase that refers to a perception that real wealth is being created, so that Keynesian “animal spirits” are aroused. Only later is it discovered that bankers and astute investors captured the wealth, and everyday citizens are left with devalued savings, pensions, and life insurance.

The 1960s and 1970s are a good case study in money illusion. From 1961 through 1965, annual U.S. inflation averaged 1.24 percent. In 1966 President Lyndon Johnson began a massive bout of spending and incur-

budget deficits with his “guns and butter” policy of an expanded war in Vietnam and Great Society benefits. The Federal Reserve accommodated this spending, and that accommodation continued through President Nixon’s 1972 reelection. Inflation was gradual at first; it climbed to 2.9 percent in 1966 and 3.1 percent in 1967. Then it spun out of control, reaching 5.7 percent in 1970, finally peaking at 13.5 percent in 1980. It was not until 1986 that inflation returned to the 1.9 percent level more typical of the early 1960s.

Two lessons from the 1960s and 1970s are highly pertinent today. The first is that inflation can gain substantial momentum before the general public notices it. It was not until 1974, nine years into an inflationary cycle, that inflation became a potent political issue and prominent public policy concern. This lag in momentum and perception is the essence of money illusion.

Second, once inflation perceptions shift, they are extremely difficult to reset. In the Vietnam era, it took nine years for everyday Americans to focus on inflation, and an additional eleven years to reanchor expectations. Rolling a rock down a hill is much faster than pushing it back up to the top.

More recently, since 2008 the Federal Reserve has printed over \$3 trillion of new money, but without stoking much inflation in the United States. Still, the Fed has set an inflation target of at least 2.5 percent, possibly higher, and will not relent in printing money until that target is achieved. The Fed sees inflation as a way to dilute the real value of U.S. debt and avoid the specter of deflation.

Therein lies a major risk. History and behavioral psychology both provide reason to believe that once the inflation goal is achieved and expectations are altered, a feedback loop will emerge in which higher inflation leads to higher inflation expectations, to even higher inflation, and so on. The Fed will not be able to arrest this feedback loop because its dynamic is a function not of monetary policy but of human nature.

As the inflation feedback loop gains energy, a repetition of the late 1970s will be in prospect. Skyrocketing gold prices and a crashing dollar, two sides of the same coin, will happen quickly. The difference between the next episode of runaway inflation and the last is that Russia, China and the IMF will stand ready with gold and SDRs, not dollars, to provide

new reserve assets. When the dollar next falls from the high wire, there will be no net.

■ Deflation

There has been no episode of persistent deflation in the United States since the period from 1927 to 1933; as a result, Americans have practically no living memory of deflation. The United States would have experienced severe deflation from 2009 to 2013 but for massive money printing by the Federal Reserve. The U.S. economy's prevailing deflationary drift has not disappeared. It has only been papered over.

Deflation is the Federal Reserve's worst nightmare for many reasons. Real gains from deflation cannot easily be taxed. If a school administrator earns \$100,000 per year, prices are constant, and she receives a 5 percent raise, her real pretax standard of living has increased \$5,000, but the government taxes the increase, leaving less for the individual. But if her earnings are held constant, and prices drop 5 percent, she has the same \$5,000 increase in her standard of living, but the government *cannot tax the gain* because it comes in the form of lower prices rather than higher wages.

Deflation increases the real value of government debt, making it harder to repay. If deflation is not reversed, there will be an outright default on the national debt, rather than the less traumatic outcome of default-by-inflation. Deflation slows nominal GDP growth, while nominal debt rises every year due to budget deficits. This tends to increase the debt-to-GDP ratio, placing the United States on the same path as Greece and making a sovereign debt crisis more likely.

Deflation also increases the real value of private debt, creating a wave of defaults and bankruptcies. These losses then fall on the banks, causing a banking crisis. Since the primary mandate of the Federal Reserve is to prop up the banking system, deflation must be avoided because it induces bad debts that threaten bank solvency.

Finally, deflation feeds on itself and is nearly impossible for the Fed reverse. The Federal Reserve is confident about its ability to control i

flation, although the lessons of the 1970s show that extreme measures may be required. The Fed has no illusions about the difficulty of ending deflation. When cash becomes more valuable by the day, deflation's defining feature, people and businesses hoard it and do not spend or invest. This hoarding crushes aggregate demand and causes GDP to plunge. This is why the Fed has printed over \$3 trillion of new money since 2008—to bar deflation from starting in the first place. The most likely path of Federal Reserve policy in the years ahead is the continuation of massive money printing to fend off deflation. The operative assumption at the Fed is that any inflationary consequences can be dealt with in due course.

In continuing to print money to subdue deflation, the Fed may reach the political limits of printing, perhaps when its balance sheet passes \$5 trillion, or when it is rendered insolvent on a mark-to-market basis. At that point, the Fed governors may choose to take their chances with deflation. In this dance-with-the-Devil scenario, the Fed would rely on fiscal policy to keep aggregate demand afloat. Or deflation may prevail despite money printing. This can occur when the Fed throws money from helicopters, but citizens leave it on the ground because picking it up entails debt. In either scenario, the United States would suddenly be back to 1930 facing outright deflation.

In such a circumstance, the only way to break deflation is for the United States to declare by executive order that gold's price is, say, \$7,000 per ounce, possibly higher. The Federal Reserve could make this price stick by conducting open-market operations on behalf of the Treasury using the gold in Fort Knox. The Fed would be a gold buyer at \$6,900 per ounce and a seller at \$7,100 per ounce in order to maintain a \$7,000-per-ounce price. The purpose would not be to enrich gold holders but to reset general price levels.

Such moves may seem unlikely, but they would be effective. Since nothing moves in isolation, this kind of dollar devaluation against gold would quickly be reflected in higher dollar prices for everything else. The world of \$7,000 gold is also the world of \$400-per-barrel oil and \$100-per-ounce silver. Deflation's back can be broken when the dollar is devalued against gold, as occurred in 1933 when the United States revalued gold from \$20.67 per ounce to \$35.00 per ounce, a 41 percent dollar devaluation. If the United States faces severe deflation again, the antidote of de

devaluation against gold will be the same, because there is no other solution when printing money fails.

■ Market Collapse

The prospect of a market collapse is a function of systemic risk independent of fundamental economic policy. The risk of market collapse is amplified by regulatory incompetence and banker greed. Complexity theory is the proper framework for analyzing this risk.

The starting place in this analysis is the recognition that capital markets exhibit all four of complex systems' defining qualities: diversity of agents, connectedness, interdependence, and adaptive behavior. Concluding that capital markets are complex systems has profound implications for regulation and risk management. The first implication is that the proper measurement of risk is the gross notional value of derivatives, not the net amount. The gross size of all bank derivatives positions now exceeds \$650 trillion, more than nine times global GDP.

A second implication is that the greatest catastrophe that can occur in a complex system is an exponential, nonlinear function of systemic scale. This means that as the system doubles or triples in scale, the risk of catastrophe is increasing by factors of 10 or 100. This is also why stress tests based on historic episodes such as 9/11 or 2008 are of no value, since unprecedented systemic scale presents unprecedented systemic risk.

The solutions to this systemic risk overhang are surprisingly straightforward. The immediate tasks would be to break up large banks and ban most derivatives. Large banks are not necessary to global finance. When large financing is required, a lead bank can organize a syndicate, as was routinely done in the past for massive infrastructure projects such as the Alaska pipeline, the original fleets of supertankers, and the first Boeing 747s. The benefit of breaking up banks would not be that bank failures would be eliminated, but that bank failure would no longer be a threat. The costs of failure would become containable and would not be permitted to metastasize so as to threaten the system. The case for banning derivatives is even more straightforward. Derivatives serve practically

purpose except to enrich bankers through opaque pricing and to deceive investors through off-the-balance-sheet accounting.

Whatever the merits of these strategies, the prospects for dissolving large banks or banning derivatives are nil. This is because regulators use obsolete models or rely on the bankers' own models, leaving them unable to perceive systemic risk. Congress will not act because the members, by and large, are in thrall to bank political contributions.

Banking and derivatives risk will continue to grow, and the next collapse will be of unprecedented scope because the system scale is unprecedented. Since Federal Reserve resources were barely able to prevent complete collapse in 2008, it should be expected that an even larger collapse will overwhelm the Fed's balance sheet. Since the Fed has printed over \$3 trillion in a time of relative calm, it will not be politically feasible to respond in the future by printing another \$3 trillion. The task of re-liquefying the world will fall to the IMF, because the IMF will have the only clean balance sheet left among official institutions. The IMF will rise to the occasion with a towering issuance of SDRs, and this monetary operation will effectively end the dollar's role as the leading reserve currency.

■ A Deluge of Dangers

These threats to the dollar are ubiquitous. The endogenous threats are the Fed's money printing and the specter of galloping inflation. The exogenous threats include the accumulation of gold by Russia and China (about which more in chapter 9) that presages a shift to a new reserve asset.

There are numerous ancillary threats. If inflation does not emerge, it will be because of unstoppable deflation, and the Fed's response will be a radical reflation of gold. Russia and China are hardly alone in their desire to break free from the dollar standard. Iran and India may lead a move to an Asian reserve currency, and Gulf Cooperation Council members may choose to price oil exports in a new regional currency issued by a central bank based in the Persian Gulf. Geopolitical threats to

dollar may not be confined to economic competition but may turn malicious and take the form of financial war. Finally, the global financial system may simply collapse on its own without a frontal assault due to its internal complexities and spillover effects.

For now, the dollar and the international monetary system are synonymous. If the dollar collapses, the international monetary system will collapse as well; it cannot be otherwise. Everyday citizens, savers, and pensioners will be the main victims in the chaos that follows a collapse, although such a collapse does not mean the end of trade, finance, or banking. The major financial players, whether they be nations, banks, or multilateral institutions, will muddle through, while finance ministers, central bankers, and heads of state meet nonstop to patch together new rules of the game. If social unrest emerges before financial elites restore the system, nations are prepared with militarized police, armies, drones, surveillance, and executive orders to suppress discontent.

The future international monetary system will not be based on dollars because China, Russia, oil-producing countries, and other emerging nations will collectively insist on an end to U.S. monetary hegemony and the creation of a new monetary standard. Whether the new monetary standard will be based on gold, SDRs, or a network of regional reserve currencies remains to be seen. Still, the choices are few, and close study of the leading possibilities can give investors an edge and a reasonable prospect for preserving wealth in this new world.

The system has spun out of control; the altered state of the economic world, with new players, shifting allegiances, political ineptitude, and technological change has left investors confused. In *The Death of Money* you will glimpse the dollar's final days and the resultant collapse of the international monetary system, as well as take a prospective look at a new system that will rise from the ashes of the old.

PART ONE

MONEY AND GEOPOLITICS

'THE NEXT FINANCIAL COLLAPSE WILL RESEMBLE NOTHING IN HISTORY'

The international monetary system has collapsed three times in the past hundred years: 1914, 1939 and 1971. Each collapse was followed by a period of war, civil unrest or damage to the stability of the global economy.

Now James Rickards, the acclaimed author of *Currency Wars*, shows why another collapse is rapidly approaching – and why this time, nothing less than the institution of money itself is at risk.

The US dollar has been the global reserve currency since the end of the Second World War. If the dollar fails the entire international monetary system will fail with it. But Washington is gridlocked, and America's biggest competitors – China, Russia and the Middle East – are doing everything possible to end US monetary hegemony.

The potential results: financial warfare. Deflation. Hyperinflation. Market collapse. Chaos.

James Rickards offers a bracing analysis of the fundamental problem: money and wealth have become ever more detached. Money is transitory and ephemeral; wealth is permanent and tangible. While wealth has real value worldwide, money may soon be worthless. The world's big players – governments, banks, institutions – will muddle through by making up new rules. The real victims of the next crisis will be small investors who assumed that what worked for decades will keep working.

Fortunately, it is not too late to prepare for the coming death of money. In this riveting book, James Rickards shows us how.

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