Money and Oil

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> *"The problems that exist in the world today cannot be solved by the level of thinking that created them."*
> – Albert Einstein

EVERY DAY WE WAKE UP hoping for good economic news: lower unemployment numbers, more jobs created, stronger growth. But we miss the forest for the trees. Our markets, for the past 100 years, have been engulfed in perennial financial crises.

Many of these crises have been associated with major Federal Reserve credit expansions and contractions. Upon examination, these volatile market episodes almost always lead to major moves in non-durable commodities, primarily oil and food.

But first, some historical background.

How do we mark the onset of the age of financial disorder, or, if you will, the Age of Inflation? The starting point was the volcanic eruption in 1914 at the epicenter of the Western world. World War I brought to an end the preeminence of the classical European states system; it decimated the flower of European youth; it destroyed the European continent's industrial primacy, making Europe a debtor and America a creditor. The classical gold standard was suspended everywhere by the belligerents. The monetary gyroscope of the Industrial Revolution collapsed along with the world trading system into the anarchy of total war.

To interpret the financial events associated with the Great War —and their effect on the ensuing hundred years—let us highlight two crucial occasions of 1913: the establishment of the Federal Reserve system and the publication by the young John Maynard Keynes of his book *Indian Currency and Finance*. Neither event by itself would probably have created a barrier to resumption of the long period of monetary stability and economic growth under the prewar classical gold standard. But the inauguration of the Federal Reserve and the monetary ideas of Keynes, taken together, created the perfect storm.

As originally conceived, the Federal Reserve system, a government-dominated central bank, was designed to strengthen American participation in the classical international gold standard, even while making the U.S. currency and banking system more "elastic," so it would be able to deal with crises like the panic of 1907. As the lender of last resort, the Fed was also tasked with issuing Federal Reserve notes and commercial bank deposits against collateral convertible on demand into gold. (By collateral here, we mean things such as the liquid, short-term, high-quality commercial paper of solvent firms used to finance goods in the process of production.)