Gold and Government

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Something has gone terribly wrong with the world's monetary system. It's evident that some kind of fundamental reform needs to be implemented. The question is: Can governments be trusted to issue sound money, or is money too important to be left to the politicians?

Is it reasonable to expect governments to abide by the discipline required to maintain sound money? Or have we set up an irresistible temptation by empowering governments to control both fiscal and monetary policy? Would it make more sense to return money to markets by privatizing money issuance?

In this article, I propose a reform that would bring the power of market forces and competition to bear on the challenge of providing sound money while still giving government a principled role in the monetary system.

My recommendation is to introduce a special class of medium-term U.S. government debt obligations to be designated "Treasury Trust Bonds (TTBs)." These zero coupon bonds would grant the holder the right to redeem in either gold or dollars. This article provides details on how TTBs would be structured and how they might spur a transition toward new global monetary arrangements.

The issuance of TTBs would fit into a pro-growth economic agenda based on limited government, low taxes, rule of law, and global free trade. Linking the dollar to gold through TTBs would be a bold step toward completing the original economic agenda laid

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Cato Journal, Vol. 32, No. 2 (Spring/Summer 2012).

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out by President Ronald Reagan, which called for a stable dollar. Consider it a "trust-but-verify" approach to sound money.

A Gold Standard or Competing Currencies?

Most citizens would be hard-pressed to imagine a world wherein money was furnished by private issuers, and where consumers had a choice in deciding which brand of money to use for any given transaction at any given time. We live in nation states, after all, and have grown accustomed to seeing iconic symbols and the familiar visages of prominent national heroes on our currency.

Yet the dismal failure of central banks to furnish a product that successfully fulfills the three basic functions of money prompts the search for new solutions. Money is meant to provide (1) a medium of exchange, (2) a meaningful unit of account, and (3) a reliable store of value. It seems straightforward enough; indeed, given that money has such useful purposes, one would think that people engaged in commerce would demand only the highest quality.

We have settled instead for a mishmash of exchange-rate regimes around the world dominated by two failing currencies, the dollar and the euro. The dollar comes closest to being a global medium of exchange, though its efficiency is greatly reduced because its value constantly fluctuates. Those resulting distortions from minute-to-minute trading also wreak havoc on the dollar's unit-of-account function. How can a global economy function optimally when the foremost monetary unit of account for measuring value shifts unpredictably across borders and through time? And with regard to time: Why are we required to use money that is destined to lose value? The Federal Reserve and other central banks embrace targeted rates of inflation that may seem low (normally 2 percent inflation), but they inevitably erode the purchasing power of currency over time—so much for the notion that money should provide a store of value. Beware when a central banker refers nonchalantly to "benign" inflation.

In short, our monetary system is broken because it rests on the uncertain anchor of pure fiat money. We have just gone through a financial crisis that has traumatized whole economies and undermined global confidence in the existing political order—including support for democratic capitalism. It is rooted in our worldwide monetary dissonance. We need to fix the present discretionary government fiat money regime.

It's more than an economic prescription; it's a matter of ideals and principles. Without sound money, free trade and free markets will always be subject to the whims of government. When money becomes an instrument of government policy, market prices are distorted and resources misallocated. Government expands and economic freedom contracts. Interest rates are manipulated to serve the financing needs of cash-strapped governments rather than the private sector. As a result, the calculations of buyers and sellers, borrowers and savers, are thrown off by false price signals that draw productive resources and financial capital into misguided pursuits of profit.

Monetary reform is crucial in the wake of the global financial crisis. If we are to emerge from this prolonged disaster, we must establish a foundation for genuine economic recovery. The world desperately needs sound money to restore the foundation for sustainable growth versus the artificial stimulus of paper profits unrelated to productivity.

Sound money means a convertible currency such as existed during the classical gold standard. As Austrian economist Ludwig von Mises (1980: 185) noted:

> The gold standard alone makes the determination of money's purchasing power independent of the ambitions and machinations of governments, of dictators, of political parties, and of pressure groups. The gold standard alone is what the nineteenth-century freedom-loving leaders (who championed representative government, civil liberties and prosperity for all) called "sound money."

For Mises, the automatic restrictions imposed by gold could be relied on to prevent the government from indulging in fiscal irresponsibility. "If, under the gold standard, a government is asked to spend money for something new," Mises (1979: 65) observed, "the minister of finance can say: 'And where do I get the money? Tell me, first, how I will find the money for this additional expenditure.'"

But even if Mises believed that going on a gold standard would successfully deter government from budgetary malfeasance—even if he thought political ambitions would be stymied by the realization that money could not be compromised to accommodate chronic deficit spending—his compatriot from the Austrian school, Friedrich Hayek, did not.

Indeed, Hayek believed it had become impossible to subject government to outside discipline through the imposition of a commodity standard. He did not even trust government to run an honest gold standard. According to Hayek (1979: 1–2):

> I am afraid I am convinced that the hope of ever again placing this discipline on government is gone. The public at large has learned to accept, and I am afraid a whole generation of economists has been teaching, that government has the power in the short run to relieve all kinds of economic evils, especially unemployment, by monetary stimulus. Experience has shown, however, that rapid increases in the quantity of money—although they may temporarily reduce unemployment—become in the long run the cause of much greater unemployment. Yet, what politician can possibly care about long-run effects if in the short run he buys support?

Hayek feared that government officials would always find a way to wriggle out of fiscal constraints; there would always be some compelling reason to abandon the monetary rules. He recognized that politicians are innately receptive to the views of Keynesian economists who prescribe easy money to stave off recession.

Still, while Hayek saw government officials as being predisposed to abuse whatever sovereign monetary authority might be granted to them, he did not abandon the search for sound money. Instead, Hayek (1979: 1) suggested that a superior alternative might be achieved by engaging private sector competitive forces:

> I am more convinced than ever that if we ever again are going to have a decent money, it will not come from government: it will be issued by private enterprise, because providing the public with good money which it can trust and use can not only be an extremely profitable business; it imposes on the issuer a discipline to which the government has never been and cannot be subject. It is a business which competing enterprise can maintain only if it gives the public as good a money as anybody else.

According to Mises and Hayek, then, if you want sound money you should choose: (1) a gold standard administered by government or (2) a private market solution based on competing currencies. But which is the better solution? When two such respected voices in Austrian economics seem to diverge when it comes to preventing monetary abuse and delivering a good form of money, we need to tread carefully. Hayek seems justified in his suspicions of monetary mischief by politicians and his preference for private competition. But Mises's identification of the gold standard as being consistent with the concept of limited government and individual freedom also strikes a chord. It's tempting to side with Mises, whose ideas dovetail with those of our nation's Founders, in believing that monetary tyranny can be prevented through gold convertibility of government-issued currency.[1]

In that hope, the Treasury Trust Bond approach is presented in this article as a way to test the feasibility of having the U.S. government subject itself to the monetary rigors of gold convertibility. If this new Treasury debt instrument were to be well received by the public, my vision is that it could be broadly replicated by private issuers to meet investor demand. Furthermore, I find it reasonable to assume that other nations and regional money issuers, such as the European Central Bank, might likewise find it advantageous to emulate America's example by issuing their own sovereign debt instruments with a gold-redemption privilege. To the extent they do, true monetary reform begins to take shape on a broader scale. The issuance of TTBs could initiate a transition to new global monetary arrangements linked by gold-convertible financial instruments—sovereign debt obligations disciplined by market forces.

Treasury Trust Bonds

This first step toward sound money could be implemented either through congressional legislation or as an initiative by the Department of the Treasury in response to an administration's directive aimed at reconciling fiscal and monetary policy. It would authorize the limited issuance of Treasury obligations redeemable for a

[1]Lawrence H. White (2011) argues that a gold standard along with free banking would have constrainted the boom-bust cycle, and would help prevent future financial crises.

fixed amount of dollars equal to the face value of the bond, or for a specified amount of gold, at the option of the bondholder at time of maturity.

TTBs would incorporate financial instruments already familiar to investors— Treasury debt securities and gold futures contracts—and should be presented to potential purchasers in straightforward terms. For example: Imagine you have the opportunity today to purchase a debt instrument from the Treasury with a principal amount of $2,400 and a five-year maturity date; at the end of five years, you will have the option to receive either $2,400 or one troy ounce of gold. How much would you be willing to pay for that instrument?

Investors who think the dollar price of gold will be considerably higher than the promised amount five years from now—because they suspect too many dollars will be printed in the meantime—will pay a substantial premium for TTBs. They would readily recognize that they are purchasing a U.S. government obligation priced similarly to a conventional Treasury bill, on which the rate of interest is inherent in the difference between the purchase price and the face amount received at maturity.[2] At the same time, they are also purchasing a call option on gold, so if the dollar price for a troy ounce of gold in five years' time is higher than $2,400, they can choose to exercise the option of receiving payment in the form of physical gold (one troy ounce) versus the principal amount of $2,400 at time of redemption. The difference in the higher price of gold versus the nominal amount of dollars stipulated on the face value of the bond would provide compensation for the dollar's diminished purchasing power in terms of gold.

For potential purchasers of TTBs, it would be comparable to buying a variation of Treasury Inflation-Protected Securities, which the U.S. government has made available to investors since January 1997. The TIPS program was launched during the Clinton administration at the initiative of former treasury secretary Robert Rubin; the incentive for offering an inflation-linked bond was to provide investors with the ability to protect against inflation while providing a certain real return over the investment period. A normal or "nominal" bond pays its interest on a fixed principal amount, which is

[2]Treasury bills are short-term government securities with maturities ranging from a few days to 52 weeks. Bills are sold at a discount from their face value.

repaid at maturity. Inflation is a major risk to a nominal bondholder, since increasing inflation means reduced purchasing power in the face of increasing prices.

With the creation of TIPS, those willing to lend money to the U.S. government were able to ensure—for the first time—that no loss of purchasing power in dollar terms would diminish the value of the investment over the time to maturity. In the same way, the introduction of TTBs would protect investors in U.S. government debt against loss of purchasing power in terms of gold. Whereas TIPS reimburse the bondholder for the impact of inflation as measured by the Consumer Price Index (CPI), TTBs would reimburse the bondholder for the impact of inflation as measured by the dollar price of gold.[3]

Here it is important to clarify that the term "inflation" as commonly used measures only changes in the price level of consumer goods and services typically purchased by households. Yet the most damaging aspect of excessive issuance of money is arguably manifested in ominous asset bubbles—which can suddenly burst—rather than perpetual low-grade inflation over a long period of time. While chronic inflation at seemingly harmless rates is seldom viewed as posing an imminent threat, it eventually results in seriously distorted price signals, leading to severe misallocations of financial capital. Ultimately, a breakdown in credit markets sets off the sort of financial panic that proves most debilitating to economic functionality. An unanticipated meltdown often stems from overinvestment in a specific type of financial instrument, such as mortgage-backed securities or derivatives, or in a particular asset market where inflationary excesses have pooled. To the extent that gold is a surrogate for an array of commodities traded worldwide, changes in the dollar price of gold can provide an early warning that overly expansionary U.S. monetary policy is fueling asset bubbles.

The introduction of TTBs should be presented so as to ensure that the public recognizes it constitutes a meaningful self-policing constraint on government. It should be seen as having major implications for both fiscal and monetary policy—and for America's future, both politically and economically.

[3]This description of Treasury Trust Bonds is drawn from Shelton (2011a: 45–52).

Considerations for issuing the first series of gold-backed U.S. debt obligations should include:

- Whether to initially restrict the purchase of these instruments to U.S. citizens and in limited amounts. They might be offered under the same conditions as Series EE Savings Bonds are currently made available—that is, subject to a maximum purchase of $5,000 per calendar year per entity. In addition, to own U.S. Savings Bonds, an investor must be a U.S. resident or U.S. citizen living abroad (with a U.S. address of record) and have been issued a Social Security number.
- Whether to require that a portion of U.S. official gold holdings presently carried as Treasury assets and pledged to the Federal Reserve as "gold certificates" on its balance sheet be set aside as collateral to provide adequate cover for outstanding redemption obligations engendered by the issuance of TTBs. If an initial offering were to encumber 12 million ounces of gold that could potentially be called, it would represent less than 4.6 percent of U.S. official gold reserves of 261.5 million ounces (8,133.5 tonnes). If subsequent annual offerings over the next three years, each maturing in five years, likewise allocated 12 million ounces of gold, it would mean a total commitment of 48 million ounces devoted to the four-year pilot program for TTBs. Total exposure to potential gold redemption would thus equal 18.4 percent of U.S. government holdings at the maximum, less than one-fifth of total amounts held. Both the Treasury and Federal Reserve carry these official gold reserves at a value of $42.22 versus their current market value.[4]
- How to most transparently conduct auction bidding for initial and subsequent annual issuances of gold-backed TTBs so that the level of public confidence in fiat dollar obligations relative to gold is clearly observable. Pricing relative to ounces of gold, instead of more traditional $1,000 increments for Treasury securities priced in dollars, will enable more direct comparisons. Yield spreads should clearly reflect aggregate

[4]The official price of gold in dollars was raised from $38.02 in December 1971 to $42.22 in February 1973. The U.S. government holds 261,498,899.316 fine troy ounces of gold for a total book value of $11,041,058,821.09 based on book value per troy ounce calculated at $42.2222 official price (U.S. Department of the Treasury 2011).

expectations of their relative medium-term values. If market expectations anticipate dollar inflation (i.e., a decline in the future purchasing power of the dollar), the bonds will sell at a premium over their face value. If inflationary concerns have been stemmed by fiscal adjustments to reduce budget deficits, thus mitigating fears of monetary accommodation through expansionary policies, holders of TTBs will have little incentive to redeem in gold. The bonds will sell at close to par value if the dollar is expected to remain stable against the value of gold.

- How to ensure that the Federal Reserve utilizes information inherent in the yields of TTBs to evaluate investor expectations. The Fed has much to gain by measuring the comparative yields on gold-backed U.S. government obligations with conventional Treasury bonds of the same maturity. Just as inflation-indexed bonds (TIPS) provide an indication of inflation expectations as measured by the CPI, gold-backed TTBs would provide Fed policymakers with valuable feedback regarding aggregate estimates of the dollar's future value as measured by a widely recognized monetary surrogate for purchasing power. It would also be appropriate to provide assurances that neither the Federal Reserve nor other central banks are engaging in gold purchases or sales that might be seen as manipulation of gold prices relative to currencies (see Tett 2011).

TTBs would provide security to investors who are willing to hold U.S. debt obligations but do not wish to have the value of their investment reduced through debasement of the monetary unit of account in which its contractual terms are denominated. An instrument that embodies a commitment to maintain the value of the dollar in terms of constant purchasing power will help restore confidence to financial markets; it will function as a barometer on the credibility of the Fed's eventual exit strategy from its lengthy and large-scale quantitative easing operations.

Global Ramifications

By offering gold-backed TTBs, the U.S. government signals its commitment to preserve the integrity of the dollar as a meaningful standard of value. It would be the opening salvo in a drive toward achieving sound finances and sound money—a concrete act toward restoring the Constitution's guarantee of stable money through dollar issuance constrained by convertibility into a precise weight of gold.

For the first time in four decades, the U.S. government would be holding itself accountable for fiscal and monetary policies that debase the value of the dollar. On the global stage, the issuance of TTBs would be viewed as an act of bold economic leadership, providing a clear indication of American resolve to stabilize the dollar in terms of the universal monetary surrogate, gold.

The introduction of gold-convertible sovereign bonds (TTBs) would establish an American beachhead for establishing coherent international monetary arrangements more suitable to our widely professed commitment to global free trade. Gold has served as a widely accepted form of money throughout history, gaining renewed popularity in recent years as the credibility of currencies has been called into question. It was cited by World Bank chief Robert Zoellick (2010) as potentially offering a reference point for cross-border monetary relations that might help to alleviate the threat of currency wars.

But if America proceeded to institute a program of gold-convertible Treasury instruments—what could we expect from other nations and regional monetary authorities? Would other central banks be willing to subject their own currency to such consumer scrutiny by having opt-out gold provisions on sovereign debt securities under the same terms as those offered by TTBs? Instead of lamenting the lack of a multipolar reserve currency or complaining about the dollar's poor performance, other nations need to likewise step up to the problem of restoring monetary integrity.

China would likely be the first major nation to follow the U.S. lead by issuing its own series of gold-backed bonds; it should be encouraged to do so by U.S. officials. The yuan largely tracks the dollar, so the proposition is presumably no more risky for China than for America. Indeed, given that China is the largest foreign holder of debt securities issued by the U.S. government, that nation might welcome the opportunity to reinforce a new American commitment to fiscal discipline. Moreover, current pressure from the U.S. Congress is directed at China's presumed manipulation of its currency; by offering its own gold-backed sovereign debt obligations, China demonstrates its willingness to abide by market assessments of the future value of its national currency relative to a neutral global monetary unit of account.

Other major nations with large holdings of gold reserves (Japan, Russia, India, and Saudi Arabia) should be urged to demonstrate their own commitment to monetary stability through the issuance of gold-backed bonds. The structure of the bonds would ideally be the same for every issuer, with the instrument representing a government obligation to redeem the face value of the coupon at maturity in gold (with the precise weight stipulated in advance) or else to pay the amount of currency fixed at the outset as the principal amount. The rate of convertibility remains fixed throughout the life of the bond; it effectively defines the gold value of the currency which denominates the instrument. The more these commitments can be reasonably compared, the more rapidly private investors can ascertain appropriate exchange rates among the currencies of various issuers.

For countries belonging to the eurozone, the interesting question is whether individual governments would be willing to pledge their proprietary gold reserves to the cause of sound money. Germany, Italy, and France have substantial gold holdings. Would they turn over physical gold to the European Central Bank to hold as collateral, or perhaps designate some portion of ECB official holdings now held as common reserves? In a sense, they would be lashing their own political actors to the masthead of fiscal discipline while being tempest-tossed on broader seas of monetary turmoil. Yet it's conceivable that a joint issuance of gold-linked financial contracts by Europe's leading nations—particularly in response to a U.S. initiative guaranteeing the same—could provide the far-reaching jolt needed to rebuild confidence in a more functional global monetary order.[5]

An increasingly broader group of countries and successively larger issuances of gold-linked offerings should foster greater monetary stability. The transition process would utilize the aggregate wisdom of private markets to bring about fixed exchange rates among participating currencies. At the beginning, governments of sovereign nations would elect to participate on a voluntary basis. Eventually, however, governments might even be removed from the business of producing money. A Universal Gold Reserve Bank could evolve toward the end of the transition process, bundling contracts into gold-linked securities that equate payment at maturity with the

[5]This discussion of transitional implications for global monetary reform is drawn from Shelton (2011b: 25–30).

pre-established fixed value of a specific currency, or basket of currencies, relative to gold.

The Universal Gold Reserve Bank (UGRB) would have the potential to become a sort of global monetary authority. It would function as a central bank, not in a regulatory sense, but as the initiator of open market operations based on the global reserve asset. To the extent a wide array of nations opted to combine their currencies into mutually binding gold-linked contracts (likely in accordance with contributed collateral or private market swap arrangements), a new means of providing base money would be introduced. The UGRB would stand ready to buy or sell its own financial obligation—an instrument pegging the value of the "uni," let's call it, to a specific weight of gold. The central banks of participating countries would essentially serve as primary dealers for UGRB securities.

The new international monetary system would be self-correcting, harnessing the inherent market assessments of bid-and-ask pricing to expand or contract the base money supply. These assessments would be informed by market expectations regarding the prospect of continued stability between the value of the base money and the price of gold. If investors believe gold will be worth more than the nominal amount of base money at maturity (expecting inflation), they will purchase the UGRB instruments; doing so will automatically contract the money supply as funds are withdrawn from the system. If investors believe gold will be worth *less* than the nominal amount of base money at maturity (expecting deflation), they will sell the UGRB instruments; doing so will automatically expand the money supply by injecting additional funds into the system.

Conclusion

Of course, the evolution toward new global monetary arrangements is difficult to predict. It may be going too far afield to suggest that the issuance of gold-linked debt securities by the U.S. government could mark the beginning of a new era of free trade—a new approach based on honest competition anchored by a gold-based monetary system.

Yet it also seems difficult to imagine that any nation other than the United States could assert leadership toward that worthwhile goal. Or that a more pressing situation with regard to fiscal and monetary challenges could spur the search for new economic solutions with greater urgency. The current mood among Americans for less government intervention hearkens back to founding principles; our nation's earliest architects well understood the potential for government abuse of monetary powers. By restricting government monetary authority to the rigors of gold convertibility, we can confidently allow Congress to retain its responsibilities as defined in the Constitution (Article 1, Section 8). But empowering private issuers to link gold convertibility with national currencies also brings the parallel force of aggregate market expectations into the mix.

Seeking to win the presidential election in 1980, Ronald Reagan produced a campaign advertisement that focused on America's need for monetary reform. In the ad, Reagan asserts:

> In the 1960s, the federal government decided to stop tying the value of the dollar to gold. This permitted them to print as much money as they wanted to spend. And that's why we've had this crippling inflation. We'll never regain price stability until we restore some form of gold backing to the dollar. As President, my first priority will be to make the dollar the most trusted currency in the world.

For reasons not fully known, the ad was not aired on national television as intended. Perhaps it was due to the heightened level of academic debate over the relative merits of a gold standard versus monetarism and central bank policy as espoused by Milton Friedman. Nevertheless, Reagan convened a Gold Commission in 1981 to study the issue more closely. Was it possible for America to return to some kind of gold standard? Was it advisable? The commission officially rejected the notion, but with vehement opposition expressed as a minority report authored by Congressman Ron Paul and investment banker Lewis Lehrman (1982).

In September 1981, future chairman of the Federal Reserve Alan Greenspan wrote an opinion essay published in the *Wall Street Journal* entitled: "Can the U.S. Return to a Gold Standard?" Noting that "growing disillusionment with politically controlled monetary policies has produced an increasing number of advocates for a return to the gold standard—including at times President Reagan," Greenspan (1981) elaborated:

> In years past a desire to return to a monetary system based on gold was perceived as nostalgia for an era when times were

> simpler, problems less complex and the world not threatened with nuclear annihilation. But after a decade of destabilizing inflation and economic stagnation, the restoration of a gold standard has become an issue that is clearly rising on the economic policy agenda.

Greenspan (1981) advocated the issuance of five-year Treasury notes with interest and principal payable in gold to examine the feasibility of gold convertibility while helping to curb financial profligacy. "The degree of success of restoring long-term fiscal confidence will show up clearly in the yield spreads between gold and fiat dollar obligations of the same maturities," he observed. "Full convertibility would require that the yield spread for all maturities virtually disappear." Acknowledging the link between restored fiscal confidence and the discipline imposed by gold convertibility, Greenspan explained: "The redemption of dollars for gold in response to excess federal government-induced credit creation would be a strong political signal."

The proposal for Treasury Trust Bonds, as presented here, clearly finds its antecedents in Greenspan's recommendation some three decades ago. We can only speculate how things might have turned out differently had the U.S. adopted such a proposal during Reagan's tenure from January 1981 to January 1989. Our monetary compass might well have been locked onto a more stable course.

But it is not too late to get back on course. The essential task now is to place limits on discretionary monetary authority to prevent currency from being further compromised by government through irresponsible fiscal policy and accommodative monetary policy. We need to begin the transition toward a new economic system dedicated to free trade based on honest money guaranteed by gold convertibility. By issuing TTBs, America takes the first step toward fulfilling Reagan's commitment to make the dollar the most trusted currency in the world.

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