THE GOLD STANDARD INSTITUTE

An Introduction

According to John Maynard Keynes (1883-1947) the deeper roots of the gold standard are to be found in psycho-pathology. There is something pathological in man's desire to palm the metal. Keynes says that whenever he is digging to find the rational basis for man's wanting gold, he always runs into Virgil's dictum from the *Aeneid*: *Auri sacra fames*, "that accursed hunger for gold", at which point he is forced to give up and "pass on the case to the psycho-pathologist with a shudder".

Keynes' jeremiad pretty well sums up the official position on gold to-day. You may try, as I have, to engage politicians and mainstream economists in a discussion on the subject of the gold standard, and get a polite refusal saying that their plate is full with 'real' problems, leaving no room and time for 'imaginary' ones.

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In spite of Keynes and officialdom, there is a scientific theory of the gold standard. Gold is not wanted because of a bestial instinct in man. Nor is it desired because it is scarce. After all, there are substances even scarcer than gold. Gold is in general demand because its marginal utility is constant (or, at least, it declines more slowly than that of any other substance). This is a technical expression that could be rendered in plainer English by saying that while the satiation point for most substances is not too far, for gold, it is receding farther than for any other.

It is clear that there must be a substance with this property; it just so happens that it is gold that fills the bill. It is also clear why the substance with the fastest receding satiation point is important economically. It is this property that makes gold 'most hoardable' or ‘most marketable in the small’. Man is mortal and subject to the curse of senescence. He needs a substance that can help him to transfer wealth over time, that is, a substance he can hoard in confidence in order to provide for his old age. Or here is another example: man has a need to transfer wealth over time as he wants to provide for the education of his offspring. This is especially important at a time when the credit system breaks down (sounds familiar?), or when no one can trust the currency any more for fear of depreciation or debasement. If the government bans ownership and trading in gold, as it has done in history on certain occasions, another substance will take over the role of the most hoardable commodity.

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We may approach the problem from the other end by posing the following question: what is the ultimate extinguisher of debt? If there is debt, then there must be a way to liquidate it. Granted that one type of debt can often liquidate another type; we still need an ultimate extinguisher of debt. If we weren’t allowed to have one, then debt would sooner or later start its fast-breeding accelerator cycle and toxic debt would ultimately overwhelm the system (sounds familiar?)

The ultimate extinguisher of debt is gold. It is that financial asset that has zero counterparty risk. All other assets do carry such risks since that selfsame asset must also occur as a liability in the balance sheet of someone else.

If you say that the national currency backed by the wealth of the country is the ultimate extinguisher of debt, then you need to be reminded that the writ of the government stops at the border. There is no way to legislate legal tender that is enforceable abroad.

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The theory of interest is a part of economic science that has never achieved a “state of finality” in the sense that the majority of economists would accept it, at least in its broadest outlines, as valid. The theory of interest is still very much at the percolating stage.

Ludwig von Mises (1881-1973), a solid gold standard man, denies that gold has constant marginal utility. He says that this would imply ‘infinite demand’ for gold which is contradictory. Mises is wrong. It is true that for all commodities the obstruction to infinite demand is declining marginal utility. Gold is an exception, the only one there is. For gold, the obstruction to infinite demand is not declining marginal utility but the phenomenon of interest. As the rate of interest is increasing, ever more people will give up their gold in exchange for income in the form of a stream of interest payments.

It is important to note here that the converse is also true. As the rate of interest is falling, ever more people will find the income from interest payments insufficient and will want to hold gold. Yes, they do want to palm gold, as opposed to paper promises to pay gold. There is nothing psycho-pathological about that. If people dissatisfied with the low interest income accepted a wad of paper money in exchange, then they would be jumping from the frying pan into the fire. Their protest against the interest rate being *too low* ended up settling for *zero* interest which was as low as it could go, but it was exactly what they would get on their investment in paper money.

Mises also says that a promise by a credible promissor to pay gold coin to bearer on demand is a full and equal substitute for the gold coin in every conceivable economic transaction as it is accepted in lieu of the gold. He concludes that paper money is a present good just like the gold coin itself. Even if no longer redeemable in gold, according to Mises, paper money is a present good rather than a future good. Mises is wrong again. However you look at it, a gold certificate payable to bearer on demand is no more than a future good, never a present good. Here is the reason why. The marginal bondholder, who has set out to register his protest against the rate of interest being too low by selling his bond, will accept the gold coin in payment but will refuse to take the gold certificate.

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I quote from the great American monetary scientist, Benjamin M. Anderson (1886-1949), who in 1948 wrote under the caption *The Tyranny of Gold* as follows:

“Gold needs no endorsement. It can be tested with scales and acids. The recipient of gold does not have to trust the government stamp upon it, if he does not trust the government that stamped it. No act of faith is called for when gold is used in payments, and no compulsion is required.

"Men everywhere, governments everywhere, and central banks everywhere are glad to get it. When paper is offered instead of gold, it will be accepted on faith if the government or the bank which has issued the paper has proved itself worthy of confidence by a satisfactory record of redeeming the paper in gold on demand.

"Complaints are always made about gold and the behavior of gold when there is irredeemable paper money. Under Gresham's Law, gold is hoarded, or leaves the country. It ceases to circulate, leaving the dishonored promissory note in possession of the field. Gold will stay only in countries which submit to its discipline. Gold is an unimaginative taskmaster. It demands that man and governments and central banks be honest. It demands that they keep their promises on demand or at maturity. It demands that they keep their demand liabilities safely within the limits of their quick assets. It demands that they create no debts without seeing clearly how these debts can be paid. If a country will do these things, gold will stay with it and will come to it from other countries which are not meeting the requirements. But when a country creates debt lightheartedly, when a central bank makes rates of discount low and buys government securities to feed its money market, and permits an expansion of credit that goes into slow and illiquid assets, then gold grows nervous. Mobile capital funds of all kinds grow nervous. There comes a flight of capital out of the country. Foreigners withdraw their funds from it, and its own citizens send their liquid funds away for safety.

"When suspension of gold payments comes, speculators in the foreign exchange market treat paper currency most disrespectfully. They sell it short. They buy it only at a discount. The amount of discount in a free gold market or in a free foreign exchange market will be governed primarily by speculative expectation as to whether and when resumption of gold payments is coming, whether or when the government and the central bank will reverse its unsound policy and work back toward orthodoxy. Gold is blamed, speculators are blamed, "hot money" is blamed…

"The prestige of a great government and a long-established government can go far in upholding the value of its paper money even if rational foundations for the value of paper money have waned…

“A country which is afraid of hot money, money which may suddenly jump to another country, has a very simple way of avoiding this danger. It does not need to control capital movements. It can protect itself against this danger by having a sound currency, firmly anchored to gold at a fixed rate, by keeping control of its money market so that its demand liabilities do not grow excessive in relation to its gold, by keeping a balanced budget – by making a financial environment in which money cools off and wants to stay…

“Gold’s greatest competitor is the confidence men have in the paper promises of governments and central banks to pay gold, and you could use that promise as a substitute for gold. The devaluation of the dollar has shaken that faith…

“There is no need in human life as great as that men should trust one another, and should trust their government, should believe in promises, and should keep promises in order that future promises may be believed in, and in order that confident cooperation may be possible. Good faith – personal, national, and international – is the first prerequisite of decent living, of the steady going on of industry, of governmental financial strength, and of international peace.”

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No other institution has been subjected to more bad-mouthing and verbal abuse than the gold standard. An enormous amount of propaganda was deployed in order to discredit it by governments and banks. This is not surprising if we contemplate that the dishonored promises of banks to pay gold have immediately been promoted to legal tender status upon the suspension of the gold standard. Moreover, academic scribblers could expect handsome stipends and other rewards such as early promotion if they are willing to sell their pen at the bid of governments and central banks.

When governments, strong in gold, broke their promise to pay gold to widows and orphans to whom they have sold government bonds with a pledge to pay gold coin of the present standard of value; and also broke their promise to redeem their paper money in gold coin of the present standard of value, it represented an act of absolute bad faith. It was dishonor.

The dishonor had to be covered up. Thereupon an adventurer, one John Maynard Keynes, comes along with a handy theory suggesting that the gold standard is pure superstition masked as science. He claims that prior saving is not really a prerequisite for spending, provided that you have a pliant central bank with an efficient printing press. He claims that interest could and should be abolished through the “euthanasia of the rentier”. He says he could take care of gold hoarders and eliminate gold from the monetary system, for being such a nuisance as the perennial obstruction to bad faith in high finance. He says he knows how to discredit the gold standard for once and all. Unfortunately for the government, Keynes died before he could reveal his secret.

Governments and their pliant central banks were eager to take the advice of Keynes. They sabotaged the gold standard by feeding the rumor-mills suggesting that the national currency will be presently devalued. When gold disappeared from circulation as a consequence, they threw up their hands in a hypocritical gesture saying: “See? It does not work. Gold does not behave. You can’t run a gold standard, given that accursed hunger for gold.”

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The golden thorn in the flesh is still bothering devaluation-happy governments. The golden corpse still stirs. There is still this unfinished business, to take care of the gold hoarders. During the French Revolution they did it by enlisting the guillotine as an instrument of monetary policy. If they found you with undocumented gold, then your head would be chopped off in summary justice.

But maybe, just maybe, public opinion can force a Great Debate on the merits of the gold standard, a debate that has been resisted during the tenure of Keynesian economics for the past 75 years.

It is time to take stocks. Keynesian economists promised an end to bank runs, to deflations, depressions and lasting economic contractions on condition that they were allowed to demonetize gold. Gold was duly demonetized, but the Keynesians could not deliver. The worst depression of all times has burst upon the world on their watch in 2007, causing the greatest economic contraction, unprecedented economic pain, and untold damage to the social fabric, of which we have seen just a sample so far.

The Gold Standard Institute was established to prepare the worlds for this Great Debate. We are ready for a showdown now; are also the Keynesians?

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One of the tasks the Gold Standard Institute will face is to deal with the views of the deviant friends of the gold standard, and convince them of the errors of their ways. Let me just briefly mention four points at issue for starters.

¶The main excellence of the gold standard is not that it can stabilize prices, which is neither possible nor desirable. The main excellence of the gold standard is that it can stabilize the rate of interest, which is all the stabilization the economy needs. Once this is done, other economic indicators including prices will be imparted as much stability – or flexibility – as is necessary for the smooth operation of a healthy economy.

¶The so-called 100 per-cent gold standard is a pipe-dream that would not survive the first Christmas shopping season. The theory of the gold standard, properly conceived, admits self-liquidating credit. As Adam Smith's Real Bills Doctrine reveals, short-term commercial paper drawn on fast-moving goods to the ultimate gold-paying consumer is the second best thing to the gold coin itself. Its emergence is spontaneous and contemporaneous with the emergence of new merchandise demanded most urgently by the consumers. It is not inflationary because together with the removal of the merchandise from the market the short-term credit is extinguished through the release of the gold coin of the ultimate consumer. It is the best earning asset that a commercial bank can have. In launching a gold standard you cannot ignore self-liquidating credit. If you do, you are inviting a humiliating failure, giving occasion for *schadenfreude* in the enemy camp.

¶The Quantity Theory of Money is a linear model that may be valid only as a first approximation. The real world is far from being linear, however. To the extent this is true, the Quantity Theory of Money is false.

¶The essence of the gold standard is not the fixing of the gold price. It is the taking the power to create money out of the hands of unelected bureaucrats and putting it into the hands of the people themselves, where it belongs according to the U.S. Constitution. It did not establish a central bank; it established the U.S. Mint and opened it to the free coinage of gold (and silver). This gave the power to people: those who felt that there was not enough money in existence could take new gold from the mines, or old gold from jewelry and plate, to the Mint and convert it into the coin of the realm.

Talking about fixing the gold price would be putting the cart before the horse. It is just the other way round: the price of paper instruments is fixed in terms of the gold coin of the realm.

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These are the best of times, and these are the worst of times. Best of times because, for the first time in 75 years, it is possible to come out with a forceful defense for this magnificent institution that no one designed or planned, but that developed spontaneously creating a great harmony in the economy, matching investments with available savings and production with existing demand: the gold standard.

Worst of times, because great damage to the world economy and finance has already been done, and more damage will still be done by the destructive forces of society responsible for exiling gold from the monetary system for the past 35 years. The Gold Standard Institute has a formidable task ahead in carrying the torch to show the way out of the present darkness.

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I send my hearty welcome to the Gold Standard Institute on occasion of its début wishing it a prosperous future. I pledge my support in the task of saving our great monetary heritage: the theory and practice of the gold standard, and in educating the world about the sound principles of money and banking.

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Further Reading

The Gold Standard Manifesto, January 9, 2006

Götterdämmerung: The Twilight of Irredeemable Debt, April 27, 2008

see: www.professorfekete.com