WHAT YOU ALWAYS WANTED TO KNOW ABOUT GOLD*

Antal E. Fekete

The following is a transcript of an interview given at the request of a gold-friendly hedge fund.

Q.: Professor Fekete, you are known as a staunch advocate of a return to the gold standard. But mainstream economists are saying a gold standard is not practicable and they are fighting the idea with everything they have. How do you answer their criticism?

A.: To say that the gold standard is not practicable is the same as saying that honesty is not practicable. It is the same as saying that Constitutions are made to be blithely ignored whenever convenient. The American Constitution, for example, mandates a metallic monetary standard for the United States in the clearest possible language. Opponents of the gold standard have never been able to muster up the moral fortitude to amend the Constitution so as to formalize the abolishing of the gold standard in 1933. In that year president Roosevelt confiscated the gold of the citizens, gave them irredeemable paper in exchange, and proceeded to write up the value of gold in terms of the paper by 75 per cent. Might makes right: if you cannot do it fairly and legally, then you can use the strong arm of the government to do it through chicanery, backed by the constabulary and the jail cell.

More recently, in our own century, Switzerland changed her Constitution in which the gold standard was also enshrined, through a referendum. Citizens were given a week-end to debate and decide the merits or demerits of the proposed constitutional changes. The indecent haste with which the measures were railroaded through the constitutional process betrayed the bad conscience of the authors.

One of the key principles supporting a gold standard is that jurisprudence does not tolerate a double standard of justice. The government, its departments and agencies ought to be subject to the same law as are the citizens. There are no valid grounds to allow the Treasury and the Central Bank to issue obligations which they have neither the intention nor the means to honor — while everybody else doing it will be dealt with according to the Criminal Code under the heading “fraud”.

To say that the gold standard is not practicable is the same as saying that the government is free to violate the Criminal Code as it sees fit in dealing with its subjects.

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* but were afraid to ask.

Q.: What would be the basic steps involved in reintroducing a gold standard? How to proceed?

A.: Three indispensable steps are involved.

First, the government should open the Mint to gold. This means that everybody who wants to convert his gold into gold coins of the realm should be able to do so at the Mint, free of seigniorage charges, with no limit imposed on the amount. In other words, they would get gold back, ounce for ounce, in coined form, and the cost of minting would be absorbed by the government, the same way as it absorbs the cost of maintaining highways in good repair. Conversely, owners of the gold coins of the realm must have the right to hoard, melt down, or export them. Opening the Mint to gold symbolizes the fact that the power to regulate the money supply is vested in the people, rather than in unelected bureaucrats. Creating money is an *unlimited* power. A republican form of government is one of *limited* powers by definition.

Second, "legal tender protection" of paper money must for once and all be declared unconstitutional. This is necessary to remove coercion whereby labor can be forced to accept irredeemable promises for services rendered.

Such coercion was first legalized in France and Germany in the year 1909, just five years before the outbreak of World War I. These countries wanted to make sure that the military and civil service could be paid in chits. They wanted to put the entire labor force at the disposal of the government — regardless of the state of budget and collection of taxes — in case of war. But governments should not be able to wage undeclared wars, nor should they be able to continue unpopular wars to the point of final exhaustion as could kings of old, but they should go to the electorate for money year after year. World War I would have come to an early end but for the legal tender laws. As soon as treasuries had run out of gold, the belligerents would have been forced to make peace, unless people agreed to pay for the continuing bloodshed and destruction of property, and send more of their sons to die in the trenches.

Third, the "Real Bills Doctrine" of Adam Smith should be rehabilitated. Bills of exchange drawn on fast-moving merchandise in most urgent demand by the consumers, which mature into gold coins within 91 days (the length of a quarter), must be allowed to enter into spontaneous monetary circulation. This would make credit elastic and self-liquidating.

It can be seen that the bill market is the clearing house of the gold standard. In 1918 at the end of World War I the victorious Entente powers, in their wisdom, decided not to allow the world to go back to the multilateral financing of international trade. To be sure, they wanted to go back on the gold standard. In 1925 Great Britain decided to make the pound sterling once more convertible into gold at the pre-war exchange rate at a great cost. But because only bilateral trade was authorized, this meant nothing less than the castration of the gold standard. Once its clearing house was amputated, it could not perform.

The allied powers did this out of spite and vengeance. They wanted to cripple Germany over and above the provisions of the Versailles peace treaty. Forcing bilateral trade upon Germany was equivalent to peacetime blockade whereby the Entente could monitor and control Germany's imports and exports. The measure backfired. The Great Depression and the 1931-1936 collapse of the international gold standard was due to the forcible elimination of multilateral financing of world trade with real bills.

The gold standard did not collapse because of its "contractionist" tendencies — as alleged by Keynes. It collapsed because of its clearing system, the bill market was blocked. Falling prices in 1930 were not the cause of the Great Depression: they were the effect. The cause was falling interest rates.

Incidentally, the cause of falling interest rates was the illegal introduction of "open market operations" by the Federal Reserve of the United States in 1921, whereby the central bank pays bribe money, in the form of risk-free profits, to bond speculators for bidding bond prices sky-high.

Q.: To what extent should money be "covered" by gold?

A.: The Real Bills Doctrine provides the answer to that question. There are on average 75 business days in a quarter. Therefore on each business day, on average, one-seventy-fifth, that is, $1^{1}/_{3}$ percent of the outstanding real bills mature into gold. Sufficient gold must be available at all times to pay the bills at maturity; more if the discount rate is rising, less if it is falling. In normal times the commercial banks should have that much gold flowing to them in the ordinary course of business, with which they can pay the maturing bills. If times are not normal, banks may have to go to the bill market and sell, at discount, a sufficient amount of bills from portfolio to raise the gold. This should be no problem: a maturing real bill is the best earning asset a commercial bank can have. At any given time there are commercial banks somewhere in the world overflowing with gold. They scramble to acquire earning assets. The value of a real bill increases every single day through maturity. Real bills represent "self-liquidating credit". Sale of the underlying merchandise to the ultimate consumer provides the wherewithal for liquidation.

Q.: What happens if a country has no gold in its coffers?

A.: Such a country will experience a rise in the discount rate. The appearance of a positive spread between discount rates improves the terms of trade for the country with the higher, while worsens it for the one with the lower rate.

In effect, cash prices on exports drop for the first, while they rise for the second country, increasing the competitive edge of the firs. Moreover, the first country has the advantage of paying lower prices, 91 days net, for its imports. By contrast, the second country has the disadvantage of having to pay higher prices, 91 days net, for imports, relative to cash prices. In practice this means that the country with the higher discount rate gets the gold for its exports 91 days before bills for its imports fall due. Thus the higher discount rate induces an inflow of short term capital from the second country to the first. We must remember that imports are financed by exports, not by gold. Gold is there for tying the country over through temporary difficulties — not for financing imports.

If this help is not sufficient to ease the gold shortage then consumers, provided they want to eat, keep themselves clad, shod, and warm in winter, will have to dig into their pockets and come up with the gold coin to pay their import bills. It is a mistake to think that the central bank is the best guardian of the country's gold. It is not. The system is viable also in the complete absence of central banks: it may even work better. The best gold reserve a country can have is that managed by the people themselves. The government cannot be the judge of what people think is best for them.

The point is that a shortage of gold need not cause privation in any country because, thanks to the discount-rate mechanism, it is a self-correcting condition.

Q.: You have announced that in August you will start a school, and call it the New Austrian School of Economics, in Budapest, Hungary. Why new? Why Austrian? Why in Hungary?

A.: The Austrian School of Economics was started by Car Menger (1840-1921) of Austria-Hungary who could also deserve the epitaph, carved on the tombstone of Isaac Newton in Westminster Abbey: *humanis generis decus* (pride of the human race). Members of the Austrian school, like Menger himself, were all great monetary scientists who abhorred the idea of irredeemable currency. In the 1930's Keynes introduced the notion that the gold standard was a "barbarous relic" and should be discarded. Through bribe and blackmail academia was enlisted to rally to the new doctrine, while the Austrian School withered. When the intellectual bankruptcy of Keynesianism — which turned things upside down in castigating the virtue of thrift and lionizing the vice of prodigality — has become obvious, the Austrian School has gone through a renaissance, especially in the United States, calling for sanity and the return to the gold standard. However, the "American Austrians" are vehemently against the Real Bills Doctrine of Adam Smith for doctrinaire reasons, as it contradicts their holy of holies, the Quantity Theory of Money. They do not understand that real bill circulation is spontaneous and its suppression is nothing less than unwarranted interfering in the operation of the free market. They do not see the difference between the discount rate (yield on real bills) which is governed by the propensity to consume, and the rate of interest (yield on the gold bond) which is governed by the propensity to save.

There is a great danger ahead, namely, the overkill in adopting the so-called "100 percent gold standard", as clamored for by the "American Austrians". Such a move would ban real bills. It would be a disaster. The financial system would not survive the first Christmas shopping season. Markets would seize up, and the gold standard would be given a bad name for the second time. This danger prompted me to start my school in Hungary where I live. I call it "new" to distinguish it from the school of the "American Austrians".

Austria and Hungary used to be a dual monarchy during the days of Carl Menger, sharing not only the monarch but also their scientific and cultural heritage. I am proud to be part of this heritage.

Q.: Why a gold standard? Why not pick a basket of precious metals, or some other marketable commodities, to serve as the unit of value?

A.: American money doctors take pleasure in ridiculing gold while comparing it to frozen pork bellies. Gold, *horribile dictu*, is trading in the same pit after having been expelled from the Monetary Paradise. This reflects a mindset suggesting that gold, at best, is just one of several marketable commodities, and a basket of wider selection could provide a better monetary reserve, or unit of value, than gold.

This position is false. Gold is no frozen pork bellies — wishful thinking of the American money doctors notwithstanding. The reason is that the marginal utility of gold declines more slowly than that of frozen pork bellies. In fact, *the marginal utility of gold declines more slowly than that of any commodity (or a basket of any commodities) known to man.* That's what makes gold the monetary metal *par excellence*. That's what makes gold the only monetary asset that has no counterpart as a liability in the balance sheet of someone else.

Incidentally, there are only two monetary metals: gold and silver. Other precious metals such as platinum and palladium are not monetary metals. What sets monetary metals apart from other precious metals is their stocks-to-flows ratio. It is a high multiple for the former, but only a small fraction for the latter.

Q.: Critics say that, historically, under the gold standard, the world economy languished, trade was sluggish, technological and therapeutic innovation was unexciting, in a word: the gold standard has never worked well. How do you answer that?

A.: This allegation is just the opposite of the truth. The heyday of the gold standard was the 100-year period between 1815 (the end of the Napoleonic wars) and 1914 (the start of World War I). This was the age of transcontinental railways, intercontinental shipping This was the time when all the key inventions were made that ushered in the age of electricity and electronics, the age of the internal combustion engine, the age of aviation, the age of wireless telecommunication, the age of the X-ray, radium, and the ultrasound, etc. Financing these discoveries and their applications in production, transportation, telecommunication, and therapeutics wouldn't have been possible without the gold standard and the accumulation of capital that it facilitated.

Q.: Introducing a gold standard hardly seems possible today, in view of the gigantic injections of new currency into the economy world-wide. How could the gold standard handle that?

A.: It couldn't and wouldn't. The new gold standard would let the regime of irredeemable currency boil in its own juices of excess fiat money and, finally, run itself aground. When it can no longer handle the task of delivering food and other necessities to the people, when it can no longer provide employment for those who are eager to earn wages, the gold standard will spring back to life spontaneously. People have to eat. They must have work to be able to earn a living.

It will dawn on the world that gold has a place underneath the Sun. Gold is that hard core of capital that can be destroyed neither by inflation nor by deflation, that will survive any consolidation of balance sheets. Gold is at the heart of the healing process of the world economy that makes survival possible when empires are crumbling. Empires come and go according as they can provide law and order or let them disintegrate, but gold remains. It has a greater staying power than tyrannies, or even democracies.

Q.: Is a gold standard the *ultima ratio* to cure the human weakness epitomized by the belief that you can multiply wealth by printing money without limits? We know that no central bank could ever stand up to do-gooder politicians.

A.: Friedrich A. Hayek, the Nobel-laureate Austrian economist thought so. He said that there would be no need for a gold standard but for the propensity of governments to spend beyond their means.

I don't believe that for a moment. I see gold everywhere, independently of governments' spending propensities. It can be shown that quite apart from a gold standard gold has a role to play in forming prices, wages, rents, rates of interest. It helps to find the balance between consumption and saving, as well as between short-term and long-term satisfaction. It determines the marginal productivity of capital and labor. It is like air. We don't see it yet it's there. Without it, there is no life.

We need a yardstick to measure value. Gold is the raw material of which that yardstick is made, whether bigoted governments accept it or not.

Q.: In the past governments also went bankrupt, some repeatedly, e.g., in ancient Athens, Rome, or France in the 17th and 18th centuries. This shows not only that such occurrences are possible under a gold standard, but also that the powers-that-be could always circumvent limitations put on coining money and restrictions on banking whenever the idea of scarcity of gold takes hold. What makes you think that a future gold standard may be more successful, and could endure for a long period of time?

A.: There is no hard-and-fast limit on the amount of self-liquidating credit that can safely be built on a given weight of gold. Improvements in clearing techniques such as those in telecommunication, overnight freight-forwarding, and warehousing will increase the amount of credit outstanding even if there is no corresponding increase in gold bearing that credit. It is this property that makes gold suitable to support credit. It is simply not true that restrictions erected by the gold standard stifle the economy, and that the powers-that-be are justified in breaking those fetters.

Gold is not scarce by ay means. In fact, among the produced goods it is the most abundant. The stocks-to-flows ratio for gold is a high multiple; the same ratio for other produced goods is a small fraction.

For the gold standard to endure the number one requirement is that men must have confidence in the promises of government to pay gold. If this confidence is impaired, gold tends to go into hiding. Then the system breaks down not necessarily immediately, nonetheless, with the force of inevitability. The answer to the problem resides in the governments' keeping faith with their subjects without fail. We must admit that the record in this regard has been miserable, to say the least.

Q.: What is your opinion of the governments' handling the Great Financial Crisis, the Greek debt crisis, the crisis of the Euro, and other currency crises brewing? How long can they contain the "debt-firestorms"? Will they be able to extinguish it with a shower of new debts?

A.: The governments of the industrial countries bear full responsibility for bringing the world to the brink of the present crisis — the greatest financial and economic crisis ever. They should have resigned in admission of their guilt, and let new governments armed with a better economic theory take over and work out the remedy. Instead, they are doggedly clinging to power. Their analysis of the cause of malady is faulty; the remedial actions they have recommended are old nostrums, incredibly inept, nay, outright counter-productive.

Take the example of the runaway growth of the debt tower. The Great Financial Crisis, the Greek debt crisis, and all the other crises still at the brewing stage are part of the same problem, namely, the debt problem. It goes back to the year 1971. On August 15 of that fateful year the U.S. government defaulted on its international gold obligations. By now the debt tower is so huge that it threatens with toppling and burying the world economy under the debris.

The reason for the exponential growth of debt in the world is that in 1971 the world economy was deprived of its *ultimate extinguisher of debt*. As a consequence, total debt in the world can only grow, never contract. We should do well to remember that, since time immemorial, gold has successfully served as the ultimate extinguisher of debt — until it was forcibly and unilaterally removed from the international monetary system by the United States. Since 1971 governments have pretended that paying debt in U.S. dollars extinguished it, too. But in fact it did not. Debt was merely transferred from the debtors to the U.S. government, and kept accumulating. Transferring debt is not the same as extinguishing it. Debt accumulation has a natural limit. This limit has now been reached.

Your description of the debt-tower as a firestorm is apt. Governments of the leading industrial countries will not be able to contain the firestorm they have started. Worse still, what they do is just pouring oil on the fire.

Q.: How will the current situation unfold? Do you think resolution will come in the form of hyper-inflation, or will it come in the form of deflation?

A.: One has to be careful with these terms. Both inflation and deflation mean destruction of wealth through destroying the value of obligations; the former through depreciation, the latter through default. It is also possible to have a mixture of both simultaneously.

If you insist on a straight answer from me, then chalk me up in the deflation column. Signs of deflation are all around us. Torrents of freshly printed money are unable to turn receding prices and interest rates back. Confidence in promises to pay is evaporating. Banks do not trust one another with overnight money. Paper gold is being pushed down the throat of those demanding physical gold. Vanishing confidence has reached the stage of contagion. Paper wealth is disintegrating before our very eyes. The domino-effect is spreading: the collapse of one firm brings down two other. Most frightening is the shrinking of employment. It threatens with leading to a break-down in law-and-order. Governments are completely unprepared for what is coming. They think that it is just a matter of printing more money for which they are so superbly equipped, and sprinkling it from a helicopter as if it were manna, to prevent further contraction. They don’t understand that money could self-destruct faster than it can be printed.

Q.: Your answer to my next question would certainly interest our readers very much. Are you invested in gold, silver, and other precious metals? Would you still buy them at these elevated prices?

A.: I take exception to your use of the word "investing". To my way of thinking holding monetary metals is not investing but more like taking out an insurance policy. I don't think the other precious metals (or stones, for that matter) make good investment for lack of liquidity. As far as the monetary metals, gold and silver, are concerned, you would be well-advised to buy a certain amount, however small, every month routinely, regardless of the price. You should look at these purchases as you do on your insurance premium payments due monthly. The analogy is apt. If you never need to collect on your fire insurance policy, well, so much the better.

At the optimum, you would track the value of your net worth not at its dollar but at its gold equivalent. In other words, you would carry your balance sheet, both on the asset and the liability side, not in dollar or euro units, but in gold units (ounces or grams). A decline in the gold price doesn't mean a decline in your net worth. Conversely, an increase in your investments in real estate or equity may not mean an increase in your net worth. It takes self-discipline to follow this rule, but this is the only way to avoid the pitfall of always looking at your own face in a curved mirror. The torsion of the image may easily translate into the torsion of the mind.

Q.: Let me come to my final question, if I may. What do you think the gold price will be in terms of U.S. dollars or euros in 3 to 5 years' time?

A.: I am often asked to answer questions similar to yours. Whenever I am, I say: I am sorry, but I am not a practitioner of clairvoyance. I would compromise my reputation as a scientist if I ventured to make unwarranted predictions about the future. Besides, I don't think I am very much interested in knowing. Guesses at the future price of gold are dime a dozen.

Furthermore, these questions assume that, as far as the higher the gold price is concerned, the sooner is the better. People tend to ignore the fact that a more slowly advancing gold price would give them the opportunity to shore up their insurance, an opportunity that so many of them obviously need.

A more appropriate — and interesting — question may be whether the dollar and the euro will still be around in 3 to 5 years. I am not sure about the euro, but I think the dollar will definitely be around 3 years from now. In 5 years? — maybe not, but I wouldn't be surprised if the staying power of the dollar extended beyond 5 years.

It is dangerous to underestimate the strength of the poison you are forced to live and work with.

Interviewer: Thank you for your time to talk to us.

Professor Fekete: Thank you for the opportunity to express my views.

May 6, 2010.

Calendar of Events

ANNOUNCING THE ESTABLISHMENT OF THE AUSTRIAN SCHOOL OF ECONOMICS IN BUDAPEST. The first ten-day, 20-lecture course offered is entitled: Disorder and Coordination in Economics — *Has the world reached the ultimate economic and monetary disorder?* The lecturer is Professor Fekete, with the cooperation of Mr. Rudy Fritsch (Canada), Peter van Coppenolle (Belgium), and Mr. Sandeep Jaitly (United Kingdom). It will be held in Budapest, Hungary, from August 9-20, 2010. Participation is limited, early registration is advisable. For more information and registration, contact Dr. Judith Szepesvari at: szepesvari17@gmail.com. Inexpensive dorm-type accommodation is available for students (shared bathroom, shared kitchen); a three-star hotel is next door. Extra-curricular consulting with Professor Fekete can be arranged for an extra fee.

The school is meant for all students (including beginners) interested in the Austrian theory of money, credit, and banking. Its program plans to cover the whole spectrum of Austrian economics, with special emphasis on developments that took place after the death of the greatest 20th century economist, Ludwig von Mises, including the Real Bills doctrine and social circulating capital; the theory of money, credit and banking; and the theory of interest and discount.

Completion of this course will earn participants one credit towards a four-course, four-credit program that has been submitted for accreditation to the Adult Education Accreditation Board of Hungary. Participants will receive a certificate signed by Professor Fekete. The follow-up credit courses will cover these areas:

Adam Smith's Real Bills Doctrine and Social Circulating Capital.

The Austrian Theory of Interest and Discount.

The Austrian Theory of Money, Credit, and Banking.

Some of the future courses may be offered in Martineum Academy in Szombathely, Hungary, where we have had four successful conferences already in the past. A special cordial invitation is extended to all Martineum alumni and their family members and friends!

It is not well-known that Budapest is one of the foremost spas in Central Europe with a dozen or so medicinal thermal springs. Participants of the course could stay on afterwards and savor the superb spa and cultural offerings in the city. Make it a family holiday! Eating and shopping facilities, as well as a swimming pool are nearby. Spectacular excursions can be arranged in the surrounding hills, and boat trips ont he River Danube!

Preliminary announcement: a session in Hong Kong in late October is on the drawing board, followed by some more events in New Zealand in November. Stay tuned.