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THE FIRST PILLAR OF SOUND MONEY AND CREDIT

THE PRINCIPLE OF THE GOLD STANDARD

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A Chinese Tale

Once upon a time the standard of measuring length, the foot, was defined in China as the length of the foot of the emperor. A change of the standard occurred upon the death of the old emperor, as a proclamation heralding the length of the foot of the new emperor was made. Later emperors discovered to their delight that they did not have to die in order to bring about a change of the standard. Imperial pleasure could proclaim a change in imperial footage at any time.

The ropemakers of the Celestial Empire learned to live with this capricious and whimsical system. They withheld production when they suspected that a shrinkage of the imperial foot was imminent. One day the ropemakers became even smarter. They formed a lobby in the Celestial Court, to persuade the Son of Heaven to have his toes amputated in order to make the imperial foot even shorter. This was thought to have a salutary effect on the ropemaking business. When, however, the people of the Celestial Empire found out what was afoot at their expense, they rose in anger, beheaded the emperor, and made the new emperor declare the length of a platinum rod as the official standard. It was thought that platinum was impervious to changes inspired by minority pressure groups.

How to replenish water in New York City's water reservoir

The basic characteristic of any good standard of measurement is that of fixity. And a nation has no standard of measurement more important than its standard monetary unit, because its money reaches and affects virtually every activity of all its people in domestic commerce as well as in foreign trade.

Changing the standard of value, or the devaluation of a currency is like the amputation of one's arm or leg: it is a great misfortune. Informed people do not engage in either sort of amputation unless it is unavoidable. We pride ourselves on being infinitely more scientific than the Celestial Empire of old. as we define the unit of length in terms of the wavelength of the orange color in the light spectrum. Nowadays, we respect such standards of measurement as the foot, the pound, the gallon, etc.

For example, if the water supply of New York City is depleted, say by one-half, Congress could conceivably change the definition of the gallon to one-half of the original as the easiest way to restore the number of gallons in the reservoir and forestall panic among city dwellers. But Congress knows that such tampering would be unscientific. Changing the definition of the gallon would do nothing to restore the original amount of water in the reservoir, while it would cause havoc at the gas pump. Congress knows that people would see through the mischief and would react unfavorably to the farce.

When best is worst, and worst is best

When it comes to the standard of monetary value, which also serves as the standard of deferred payments such as pensions and life insurance, a peculiar confusion and inconsistency reveals itself. As national profligacy depletes the reservoir of wealth in the country the Congress has found it expedient to resort to tampering with the standard measuring the quantity of wealth in the nation. Congress reduced the value of the monetary standard, the dollar, in order to conceal the alarming news from its constituents. And in 1971, Congress abolished the standard altogether, when it abdicated its Constitutional responsibility by allowing the dollar to float. Today the length of the foot of the incumbent Chairman of the Federal Reserve Board is the effective standard, and it is up to him and his colleagues on the Open Market Committee to say what this length is. The amazing thing is that we accept the alteration of the definition of the dollar when the things it is supposed to measure do not conform to their wishful thinking, although we would not accept the alteration of the definition of the gallon motivated by the same considerations. The explanation of this irrationality cannot apparently be compressed sufficiently for inclusion here. As though struck with a fever or some sort of madness, government officials and powerful groups of industrial and agricultural leaders took the position that a country with weak currency has an advantage over a country with a strong one, and that it is necessary to pull the strong currency down to the level of the weak. The worst currency is really the best, and the best currency really the worst.

Squandering the wealth

In our wild embracing of this madness, we never settled down to state clearly just what is the target of currency depreciation or "goodness" in money The secret of that mystery is ostensibly in the hand of the currency manipulators who perform as though they had a hotline to Heaven. They never can bring themselves to face the logic of their basic position that, if a depreciated currency is better for our country than one based on a fixed monetary standard, the best currency would be the one having no value at all, and that country would gain most which simply gave away its goods and services. The extent to which the nation, and particularly its leaders in Washington, are afflicted by this phantasmagoria that we can maintain prosperity and increase our standard of living by giving away wealth should be apparent from the September 22, 1985 announcement of the plot by the Group of Five industrial nations to beat down the value of the dollar.

The proper monetary standard

The typical currency system has various kinds of moneys in circulation, and it is the proper function of the monetary standard to keep the value of each unit of each kind of money equal to that of each unit of every other kind of money in the system. A standard monetary unit should be something which itself has value. It cannot be an abstraction, a legal fiction. It cannot be a promise to pay let alone an irredeemable promise. It must be material property commanding the most universal acceptability. To serve its purpose best, it should have a relatively high value in small bulk; it must be permanent, resistant to tarnish; it must be homogeneous, divisible without loss of value; and it must be readily recognizable. For these reasons gold has evolved, over thousands of years, as the material of which the monetary standard is made.

Fate of a government prophecy

The value of gold is not derived from its monetary applications. Back in 1967 government economists prophesied that if the U. S. Treasury stopped bidding for gold. the dollar price of gold would drop, perhaps by as much as 50%. On March 15,1968, the U. S. Treasury and the cartel of central banks known as the Gold Pool withdrew their long-standing offer to buy unlimited quantities of gold - and the rest is history Refusing to fall, the dollar price of gold started rising immediately and has followed a checkered path upwards ever since. The government economists were wrong. The monetary economists who maintained that a dollar is a promise to pay a fixed amount of gold on demand, and that the repudiation of that promise cannot enhance the dollar's value, were right. Since March 15.1968, the dollar has lost almost 90% of its gold value - and a commensurate amount of its purchasing power.

Marginal utility of gold

The most important quality of gold as monetary metal is its universal acceptability In technical economic language, the marginal utility of gold is constant in contrast with that of any other good, all of which have more or less declining marginal utilities. In other words, the acceptability of gold in exchange for goods and service does not depend on the amount of gold possessed by the parties to the exchange.

The recent collapse of the price of oil and tin* shows the rapidly declining marginal utility of these resources. Unlike gold. the acceptability of oil and tin depends on the amount in the possession of the market participants: the more they have. the less acceptable these resources become. Gold is the only commodity that can be offered in unlimited quantities in exchange for goods and services across all national boundaries. Without apparently harming its exchange value. Moreover, gold is the only asset that individuals and governments will carry in the balance sheet without any promise of return to capital. Gold is the only asset that can balance a liability without being at the same time a liability of someone else. It is the only financial asset that can survive the consolidation of the balance sheets of any combination of individuals or governments. (*1985)

Most abundant commodity on earth

Economics accounts for this anomalous behavior of gold. not by appealing to psychology or to human weaknesses such as vanity or superstition, but by appealing to logic. Even if we regard the choice of gold as monetary standard as an historical accident, by now gold is so firmly entrenched that its replacement is virtually unthinkable. Almost all the gold that has been produced since the dawn of history is still available in marketable form. The same simply cannot be said of other commodities. They all disappear in consumption. The ratio of stocks of gold to annual production flows is a high multiple, estimated to be between 80 and 100. For other goods, the ratio of stocks to flows is a small fraction, e.g., 1:3 for copper. The latter is an interesting example because copper, like gold. also has a long and rich history including its history of monetary applications. Yet, if copper stocks were to double overnight, raising the stock/flow ratio to 2:3, then the price of copper would collapse and all but the most efficient producers of copper would be ruined. No matter how many marginal applications for copper we may find. the marginal utility of copper would be testing zero. i.e., copper would be a "free" good, like drinking water. By contrast, if the stock/flow ratio of gold went from 100 to 200, hardly anybody would take notice. Gold producers would continue to prosper. The increase in the ratio would be looked upon as another confirmation of the supreme confidence individuals have in gold as a store of value.

In these terms, gold is the *most abundant* commodity known to and produced by man. Gold does not owe its value to its alleged scarcity On the contrary, gold owes its value to the fact that, in spite of its abundance and steady increase of abundance, gold continues to be in universal demand, and it continues to be acceptable in unlimited quantities. No other asset can match the record of gold in this regard. No other commodity can withstand the wear and tear the monetary standard is constantly exposed to.

Like the Chinese platinum foot, gold may not be a perfect standard, but it is the *only conceivable monetary standard we have.*