Lecture 3:

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GOLD STANDARD UNIVERSITY

Summer Semester, 2002

Monetary Economics 101: The Real Bills Doctrine of Adam Smith

Lecture 3

CREDIT UNIONS

- The Invisible Vacuum Cleaner -

- The Quantity Theory of Money -

- Destruction of the Gold Standard -

- And Discrediting the Real Bills Doctrine -

- Are Two Sides of the Same Coin -

- The Working Man As the Guardian of Sound Money -

Lending *versus* Clearing

I dedicate this lecture to the memory of Ely Moore, the first union official ever to have been elected to the Congress in 1834. He was a solid gold-standard man who believed, with Daniel Webster, that

"Of all the contrivances for cheating the laboring classes of mankind, none has been more effective than that which deludes them with paper money."

Daniel Webster

In the first two Lectures I dealt with a new blueprint for a gold coin standard for America and the world, designed to avoid two great pitfalls: (1) the pitfall of breakdown of social peace between creditors and debtors, (2) the pitfall of entrusting gold coins that represent the savings of the people to the banks. In this Lecture I shall recommend that the guardianship to preserve the system of sound money should, instead, be entrusted to the laboring classes and their representatives, the Credit Unions, which would be the only financial institutions chartered to carry deposit accounts denominated in Gold Eagle coins, and which would act as clearing houses for the circulation of real bills.

Recall that real bills provide credits to move urgently demanded consumer goods from the producers to the retail outlets. We don't need banks for that. In any event, short term commercial credits arise not through *lending* but through *clearing*. As the supply of consumer goods emerge in production, purchasing media to finance its movement to the consumer emerge simultaneously through the process of clearing. *No lending is involved*. Coin, credit, circulation, clearing - the four C's - are central ideas that economics has ignored. We are going to revive them here in preparation to pave the way to a new gold coin standard.

The Invisible Vacuum Cleaner

Imagine that General Motors has come into the possession of a fantastic contrivance: an invisible vacuum cleaner capable of siphoning out of the pockets of every worker two dollars for every dollar that his union had won for him in wage contracts at the bargaining table. Further imagine that the invisible vacuum cleaner would operate secretly and unobtrusively (just like other contrivances did in the recent accounting scandals of Enron and Westcom) so that the theft or embezzlement could not be detected. What would be the result of the wholesale application of the new device? Well, labor would have to run twice as fast on the treadmill just to stay abreast, while the union could pat itself on the back for having negotiated a good contract. In the meantime the public would be told again that the process of collective bargaining was working fairly and efficiently.

This parable is, of course, far too fanciful to approximate truth. General Motors would find itself in the center of a devastating legal challenge and public relation fiasco if and when the theft eventually came to light. It is doubtful, to say the least, that the existence

of a contrivance of this kind could be kept in secret forever. Another problem with the scheme is the tacit assumption that the workers and their unions is a bunch of illiterate boors unfamiliar with the four rules of arithmetic.

Combating Inflation

Yet the parable is not quite as fanciful as it may appear at first sight. Actually, *there* is an invisible vacuum cleaner. It is called "deliberate currency debasement". Just substitute "government" for "General Motors", and pieces of the jigsaw puzzle immediately fall into place. Unlike General Motors, the government cannot be sued for siphoning off labor's gains fraudulently and surreptitiously. The *modus operandi* of the government's invisible vacuum cleaner is known to and condemned by many a courageous critic, but to no avail. The media ignores the criticism and the public=s ire is not raised. Some monetary experts are blackmailed, and some economists are bribed with fat government contracts and grants. To add insult to injury, the funds used for bribing have come out of the loot. The chorus of servile economists suppresses the voice of the critics. To the former deliberate currency debasement, which they prefer to call "inflation" with a connotation that, far from being man-made, it is a natural phenomenon, is merely a minor irritant. They see no moral dimension to the problem. As long as inflation is barely noticeable, everything is fine. Economists cheer on the government for its valiant efforts to "combat inflation" - as if it weren't the same government that has been both the engineer and the beneficiary of what is being combated.

The invisible vacuum cleaner can only be operated by the government which is free to bend the legal system to its advantage. It can even violate the Constitution with impunity at pleasure. The Constitution of the United States expressly forbids the use of "bills of credit" as legal tender, but this has never inhibited the Treasury from printing the legend on every Federal Reserve note that it is "legal tender for all obligations, public and private". Since the executive arm of the government controls the judiciary (certainly as far as jurors' compensation is concerned), no wonder that the latter condones the fraud of siphoning off labor's wage gains, and no legal challenge to the operation of the invisible vacuum cleaner can ever succeed.

The Pleasure of Being Cheated

Not only does the government bribe the economists' profession, it also uses its control over public education to throw dust into the eyes of every new generation of workers entering the labor force. Docile teachers fail to instruct their pupils about the importance of the virtue of thrift, about honesty in dealings between the government and its subjects,

or between the government and its creditors. Instead, they preach the desirability, nay, the necessity for the government to manage the nation's money supply, which is just as absurd as the idea of the government's managing the nation's soap supply. The citizens are immersed in a barrage of government propaganda from womb to tomb. Small wonder that the workers are confused and their unions are blinded to official duplicity and chicanery.

The invisible vacuum cleaner reaches not only into the pockets and bank accounts of domestic workers: it is equally effective in siphoning off the savings of foreign workers. It is the Moloch of the world. It can reach into the vaults of central banks and the mattresses of poor peasants the world over, wherever dollar bank notes or balances are held. U.S. Treasury bonds in the hand of foreigners are, in effect, irredeemable promises. At maturity the holder of the old issue can only exchange it for another scrap of paper carrying another irredeemable promise. The promisor assumes no responsibility except for the quality of ink and paper to make counterfeiting harder. If at maturity the dollar is worth only a fraction of the value of the dollar with which the bond was purchased 30 years earlier, that's too bad. But it is entirely the problem of the foreign holder of the bond. Why under these circumstances are foreigners so foolish as to buy and hold U.S. Treasury securities?

"Doubtless the pleasure is as great of being cheated as to cheat."
Samuel Butler (1600-1680), *Hudibris, Part 2, Canto III*

Foreign holders try to beat their own central bank. They are proud that they have outsmarted their home-grown looters as the securities of their own government lose value even faster than those of the U.S.

Presidential Lies

Former president Clinton declared from the White House that the dollar's strength was due to the "impeccable record of the U.S. to pay its obligations meticulously". He claimed that "there has never been a case of the U.S. defaulting on its bonds in the entire history of the Republic." This, of course, is an outright lie. Financial annals record two cases of American default, the first under a Democratic, and the second under a Republican president. After the Roosevelt administration devalued the dollar in 1933, it paid bondholders in diluted dollars. It did this in spite of a gold clause written into the bond. Apart from an insignificant number of unimportant cases, Roosevelt failed to make amends after in 1935 the Supreme Court reviewed the case of abrogating the gold clause, and ruled that the government had no power to alter unilaterally the contract embodied by the bond, concluding that bondholders were entitled to the dollar-equivalent of the value reserved by the gold clause.

35 years later, in 1971, the Nixon administration defaulted on the gold obligations of the United States held by foreign governments. It did this in spite of the solemn commitment confirmed by four presidents to honor the gold redeemability of the dollar for foreign governments. The injured parties never sued C presumably as a result of some behind-the-scenes diplomatic arm-twisting. Yet this default was the root cause of the heart-rending depreciation in the value of all the currencies of the world that followed, wiping out 90 percent of the purchasing power of savings denominated in paper currencies. First the dishonored dollar went to a deep discount in terms of gold and foreign exchange. Then other governments, in an effort to protect their export industries, felt obliged to follow suit and debased their currencies to approximate the debasement of the dollar.

It is characteristic of the enormous deterioration in public morality that, while in 1935 workers and savers in the United States could still take the federal government to court charging that property was taken from them without due process of law, and in so doing they could draw attention to the official fraud and duplicity, such challenges were no longer possible in 2001. That year, when the workers' pension funds cashed in their 30-year Treasury bonds issued in 1971, they received 10 cents on the dollar in purchasing power. The missing 90 cents represented wealth stealthily confiscated by the government. But since the law does not allow a distinction between the 1971 and the 2001 dollar (in spite of the hypocrisy that the government's own Labor Department explicitly makes such a distinction for *approved* purposes), the government is unconstitutionally taking from the working and saving public.

Nothing shows the success of official brain-washing through public education and through the activities of economists in the pay of the government more clearly than the fact that the unions are not protesting the progressive and stealthy confiscation of wealth held by their pension funds, and neither the Congress nor the media took Mr. Clinton to task for lying publicly about the dismal history of the dollar.

The Quantity Theory of Money

How could the government, to which the Constitution granted only limited and carefully enumerated powers, grab unlimited power symbolized by the invisible vacuum cleaner? How could the government get away with robbing workers of their wage gains and savers of their savings, not only in this country, but world around? How could we account for the travesty that the government, while doing these things with impunity, earns high praise for "combating inflation?"

The short answer to these difficult questions is that the government has, over a period of time involving several generations, successfully indoctrinated people with a most dangerous and vicious doctrine, the Quantity Theory of Money. According to it the value of money is determined, not by its quality, but solely by its quantity. The obvious

motivation of the Quantity Theory is the a *priori* removal of all moral considerations from the debate on debt-based money. Since regulating the quantity of money involves regulating the banking system, it follows that the task can only be entrusted to the government. Only the government can make the ponderous decisions impartially which are involved in the problem of increasing the quantity of money in uniform doses, year in and year out. The Quantity Theory of Money uses an impressive array of mathematics such as the Equation of Exchange $MV = PQ$ (where M is the stock of money, V is the velocity of money in circulation, P is the price level, and Q is the physical volume of transactions). The purpose of the exercise is to persuade the uninitiated that human action, just like mechanical action, can be reliably predicted via mathematical formulas. However, individuals are not molecules and, therefore, the essence of human action cannot be captured by equations. Human individuals have what molecules have not, namely, free will. You may plug in space, time, mass, force, etc., into your equations. But you can never plug in free will.

The trouble with the Quantity Theory of Money is that it is palpably false. Monetarists have utterly failed to come up with a universally acceptable definition of money. This is evident from the proliferation of the monetary aggregates M1, M2, M3,..., etc., *ad nauseam*. (Milton Friedman tried to get around the problem by confining his version of the Quantity Theory called "monetarism" to "high-powered money" defined as the deposit liabilities of the Federal Reserve banks. Nice try, but has anybody ever used high powered money to buy a loaf of bread?) If we cannot agree on what money is, then how can we expect to regulate its quantity? Monetary scientist Walter E. Spahr had this to say in 1954:

"Apparently no quantity theory of money which has thus far been stated has validity... The evidence alone is sufficient to dispose of such an assumption. But, the reasons for the lack of relationship between the supply of currency and prevailing prices need to be understood. Currency is a two-dimensional entity. Besides supply there is velocity. Often velocity - the rapidity with which the supply of currency is used - is a more important factor than is the supply of currency in affecting prices."

The Federal Reserve Act of 1913

It could be objected that it is hardly fair to blame the government for the outcome of a scientific debate that has ended with the triumph of the Quantity Theory of Money. This triumph, it is alleged, has come about through meticulous statistical research, not through crude government interference with scientific inquiry. Or did it, really? To adjudicate this issue it will be necessary to examine how the competing doctrine, the *Quality* Theory of Money, also known as the Real Bills Doctrine, has been dethroned and ostracized through the crudest interference in science by the strong arm of government. The Real Bills Doctrine, as we know, has the most impressive credentials. Adam Smith made it the corner stone of his *Wealth of Nations* in 1776. It has served as the scientific basis on

which the monetary system of the German Reich was constructed after it adopted the gold standard in the 1870's.

To tell the truth, the Federal Reserve Act of 1913 was also crafted on the scientific basis of the Real Bills Doctrine. The Federal Reserve was conceived as a *commercial-paper based system with the real bill as the only asset category eligible for re-discounting*. In more detail, real bills were the only type of paper the Federal Reserve banks were by law allowed to purchase from their member banks. Treasury bills were ineligible. The Federal Reserve banks were not allowed to monetize government debt. The original Act refused to give the Treasury a free ride. The idea was that government debt ought to be exposed to the vicissitudes of the market, without offering it refuge in the portfolio of the Federal Reserve banks. The only way these banks could come into possession of government securities was through a penalty-provision. Whenever gold reserves fell below the legal limit of 40 percent of note and deposit liabilities, the Federal Reserve bank was assessed a tax penalty on a progressive scale. It had to make up the deficiency by putting government securities in the asset portfolio, but there was a tax penalty on the interest income from those securities amounting to several hundred percent. The Act had a built-in disincentive for the banks to hold government securities in their portfolio.

However, the original Act was never put into effect. It was violated on the very day the Federal Reserve banks opened their doors for business in 1914. There was no way for the U.S. government to finance the war effort of the Allied Powers through a commercial-paper based banking system which made the monetization of government debt impossible. No problem. A subterfuge would do the trick. The Federal Reserve banks deliberately dropped their gold cover below 40 percent of liabilities, and started loading up on government securities, to punish themselves for the violation. Maybe the Treasury will 'forget' to collect the tax penalty. You guessed it: that's just what the Treasury would do. Why should it tax an activity that it liked and wanted by all means to encourage? You scratch my back, and I'll scratch yours.

Ever since 1914 every chairman of the Federal Reserve Board, and every dollar of research money spent by the banks, has served to undermine the original concept. With each amendment of the Act, the dollar was diluted. The amendments cast the net ever wider for eligible paper, with an unmistakable intent to make room for government securities in the portfolio of the Federal Reserve banks. Step-by-step, what was conceived as a commercial-paper system to furnish an elastic currency for the benefit of the people, was converted into a fiat money system to monetize government debt. The beneficiary was no longer the general public, but the federal government itself, transgressing its constitutional limits and assuming unlimited power.

Finally, the amendments to the Federal Reserve Act progressively reduced and ultimately eliminated the gold reserve requirement mandated for Federal Reserve notes and deposits in stages from 40 to 35 and then to 25 percent. On February 21, 1968, the U.S. House of Representatives voted 199 to 190, and on March 14, 1968, the U.S. Senate voted 39 to 37 to repeal all gold reserve requirements against Federal Reserve notes. (Those against deposits had been repealed earlier.) The president signed the bill on March 19, 1968,

thereby converting the dollar into fiat money. Under the original Federal Reserve Act of 1913, the government would have been forced to compete with private borrowers for the savings of the people. By 1968 the government could sell all the debt it wanted. If people wouldn't buy it, there was always a cozy corner in the portfolio of one of the Federal Reserve banks where the Treasury paper could take refuge.

Science by Government

Thus was the Real Bills Doctrine overthrown in the United States between 1914 and 1968, not by a committee of scientists acting in the service of truth, but by the same government that had overthrown the Federal Reserve Act. Scientific justification, so called, came later, to provide the fig leaf to cover up the power grab. This is a shameful chapter in the history of science showing how scientists may go out of their way to do the bidding of the powers-that-be in exchange for material advantage.

The written record of this piecemeal corruption of the banking system and dilution of the U.S. dollar is there for everybody to see, on the pages of the Federal Reserve Bulletins and research publications of the individual Federal Reserve banks, from 1914 to date. In reading these pages one cannot help but observe how the Real Bills Doctrine was gradually discredited, and the Quantity Theory of Money promoted in its place as the supreme fountain of truth and wisdom. Never ever was the question raised whether the dismal results (such as the loss of 99 percent of the purchasing power of the dollar during the 88 years on the Fed's watch) were due to the dethronement of the Real Bills Doctrine. The pseudo-research was most generously funded by the invisible vacuum cleaner. The incestuous relation between the Federal Reserve banks, and academic activities sponsored by them, make it abundantly clear that we are dealing not with bona fide research, but with science by government.

Human Action or Horse Action?

The Real Bills Doctrine, as well as *The Wealth of Nations*, were conceived by their author as merely one chapter in a more complete work on society. This work was to be written in the great tradition of Scottish moral philosophy. In addition to economics, it was to comprise natural theology, ethics, politics, and law. Unfortunately Adam Smith (who was the professor of Moral Philosophy at Glasgow University) could never complete his great project.

By contrast, the theory of money, as it is presented today, is entirely devoid of any ethical considerations, and is completely divorced from moral philosophy. Just as Milton Friedman has described it: "even a clever horse can be trained to tread out the new money supply at a steady pace at the treadmill". But honest money is not the result of *horse action* or mechanical processes symbolized by the treadmill: it is the outcome of *human action*. Honest money cannot be obtained as a solution to the Equation of Exchange. Honest money, that the workers, widows and orphans, and other people of small means can fully trust, comes about as a result of the market process, the natural process of production aiming at satisfying the urgent and demonstrable needs of the consuming public.

Returning the Looted Gold

Milton Friedman and Anna Schwartz in their "Monetary History of the United States, 1867-1960" write that gold was nationalized in order to capture profits for the government that were to accrue later to all holders of gold, after president Roosevelt has devalued the dollar from $20.67 an ounce of gold to $35. When a fellow Democrat of the president, Senator Gore from Oklahoma, described the same sequence of presidential moves of appealing to the patriotic feelings of the citizens to turn in their gold 'temporarily', and then writing up its value, he used a somewhat different language:

"Henry VIII approached total depravity as nearly as the imperfections of human nature would allow. But the vilest thing that Henry ever did was to debase the coin of the realm!"

Earlier, when president Roosevelt asked the Senator for his opinion regarding these measures, he answered: "Why, that's just plain stealing, isn't it, Mr. President?" (As reported in Benjamin M. Anderson's "Economics and the Public Welfare", Indianapolis, 1979, p 317.)

Be that as it may, time has come to return the looted gold. Since there is no way to track down the beneficiaries of the wills of the original owners, the gold should be used for endowing the Credit Unions with capital consisting of gold. It will be the responsibility of the Credit Unions, whose shareholders are the working people of this country, to provide support for the circulation of Gold Eagles and to act as the clearing house for gold credits (real bills) to finance production and trade of consumer goods.

Only Credit Unions that have renounced the practice of borrowing short to lend long, and declared publicly that they were ready to support the new gold coin standard and the financing of the production and trade of urgently needed consumer goods through the circulation of real bills, will benefit from recapitalization in terms of U.S. Treasury gold.

Only real bills, to the exclusion of accommodation bills, anticipation bills, and others of a non-self-liquidating nature, are eligible for investment purposes by the Credit Unions.

Closed Shop or Right to Work

Gold coin circulation is to be spontaneous and voluntary. No legal tender laws will force it, as those laws are presently necessary to force the circulation of the irredeemable dollar. People will be free to continue using the irredeemable dollar in exchange for their goods and services, and for the purpose of saving, if that is what they wish. But they will not be coerced to do so. The legal tender status of the Federal Reserve notes is withdrawn forthwith, effective on M-Day, the day the Mint is opened to gold. Debt contracted before M-Day could be retired either with paper dollars or with gold coins, at the option of the debtor. As far as debt contracted after M-Day is concerned, provisions in the contract apply.

Labor organizations would ask their membership to decide whether they want their wage contracts in Gold Eagle coins or in irredeemable dollars. Where labor is not organized, a committee with labor and management representatives (two labor votes for every management vote), would make that decision. This is a very delicate issue, and we must well understand that a great deal of educational effort is needed to make the labor force see the implications of what is involved, which I now proceed to outline.

Those laborers who want to retain closed shop, fixed minimum-wage rates, unemployment insurance and social security benefits, company pensions, health and other fringe benefits, as well as long-term collective agreements to fix wages, should opt for the irredeemable dollar. The downside for them is that the value of the dollar will continue to fluctuate in terms of gold, and if history is any guide, the dollar-value of those benefits will probably decline. Those laborers, however, who prefer right to work to closed shop, and who would prefer fully funded health insurance and pension benefits defined in gold units to unfunded government health insurance and pensions schemes defined in terms of the irredeemable dollar, should opt for the Gold Eagle coins in which their wages will have to be paid. Gold wage rates may fluctuate but, in return, the threat of unemployment will be removed, and workers would be free to make their own provisions for health care and pensions. Payroll taxes on gold wages (such as Social Security levies) will not be authorized. Laborers who have originally opted for wages payable in irredeemable dollars will be given a chance to opt for wages payable in gold every time their labor contract comes up for renewal (or annually, in case of unorganized labor).

Existing labor legislation to govern collective agreements in dollar terms would not apply to wages payable in Gold Eagles. However, new legislation should provide that gold wages should be at least ten percent higher than comparable dollar wages calculated at

the floating exchange rate for the Gold Eagles, in order to compensate workers who have opted for wages payable in gold for the fringe benefits available only to those workers who have opted for wages payable in irredeemable dollars.

Limited Charter of the Federal Reserve

I cannot condemn the Federal Reserve banks in strong enough terms for their part in the great embezzlement of the wage-gains of the workers for almost a century. The whole edifice of labor legislation involving monetary rewards, including fixed minimum wage rates, escalator clauses to supplement long-term wage contracts, unemployment insurance, etc., comes under what Daniel Webster described as cheating the workers, by deluding them with paper-money magic. The value of all these "achievements" is, in practice, diluted, nullified, or negated by the invisible vacuum cleaner, operated by the Federal Reserve banks. For their role in this travesty, their existing Charter must be revoked and replaced by a new one limited for a ten-year period. After that, it may be renewed for a further period of ten years *only if* demand for irredeemable dollars stays above ten percent of the total demand for currency made up by the gold money component and the irredeemable dollar component, as measured in terms of gold.

Divorce the Mint from the Treasury

It is further understood that the regulation of the gold component of the nation's currency is not the task of the federal government, or central bank created by the federal government. The power to regulate the amount of gold money in circulation is reserved by the Constitution for the people of the United States of America. The symbol of this power is the United States Mint. To give better effect to this Constitutional provision than was done in the past, *the U.S. Mint should be removed from the control of the U.S. Treasury and the Executive Branch, and placed under the sole authority of the Legislative Branch, specifically under the direct control of the U.S. House of Representatives*. This is not only fitting but is also in line with the language and the spirit of the Constitution, which places all money-matters into the hands of the direct representatives of the people. It follows that a simple majority vote of the House of Representatives will suffice to originate this transfer. For the same reason, regulatory power over the Credit Unions must be retained by the U.S. House of Representatives, without the interposition of the U.S. Treasury.

The Vampire

German mark banknotes are tossed into a garbage bin in 1923. At this point money was more valuable as scrap paper than it was in purchasing goods and services.

The above banknote, issued in 1922, was nicknamed by the German people as "The Vampire". Rotate it counter-clockwise through 90 degrees and see the vampire in the shape of an old hag (her pointed nose jutting behind the ear of her victim, and her black cap formed by his collar) as she is sucking blood from the neck of the worker.

Note: This interesting graphic coincidence was not the only reason why the German people nicknamed their irredeemable paper mark "The Vampire".

* * *

"It is Grossly Offensive to Hear Such Ignorant Marxist Rantings Associated with the Name of Ayn Rand"

From time to time I shall answer questions, comments and criticism from my audience related to these Lectures. Mr. Claude Cormier of Ormetal Inc., St-Basil-Le-Grand, Quebec, CANADA J3N 1H2, complains that I have called foreign exchange and bond speculation "parasitic activity". He suggests that foreign exchange and bond speculation are honest market activities making the best out of a possibly bad situation. To call these economic participants 'looters' and 'parasites' is nonsense. He concludes his remarks by adding that "it is grossly offensive to hear such ignorant Marxist rantings associated with the name of Ayn Rand".

I have written about bond speculation in my earlier pieces (Economic Consequences of Mr. Greenspan, www.gold-eagle.com/editorials, January, 2002; Revisionist View of the Great Depression, parts 1-3, www.gold-eagle.com/editorials, March, 2002.) where I stated my views in greater details, and I said, in part:

Bond speculation is a parasitic activity on the body economic. Of course, this is not meant as a smear on the character of any individual. Speculators acting on their own can be, and we may assume that they mostly are, upright people. Like everybody else, they are trying to eke out a living. They are certainly not responsible for the establishment of this vicious system which, by staying the 'invisible hand', victimizes the majority. The blame is entirely on the government which is responsible for the institution of this iniquitous system which, rather than promoting social cooperation, pits one citizen against the other.

I made it clear that the real culprits are the big banks. Small speculators could never create and feed a $100 trillion derivatives monster.

I find it interesting that Mr. Cormier posted the link to my Lecture, 'ignorant Marxist rantings' and all, on his mailing list without giving me the courtesy of prior notice.

Reference

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GOLD STANDARD UNIVERSITY

SUMMER SEMESTER, 2002

Monetary Economics 101: The Real Bills Doctrine of Adam Smith

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FALL SEMESTER, 2002

Monetary Economics 201: Gold and Interest

IN PREPARATION: COURSES TO BE OFFERED IN 2003

Monetary Economics 201: The Bill Market and the Formation of the Discount Rate

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