GOLD AND HONEY*

Open letter to Thomas Hoenig, President, Federal Reserve Bank of Kansas City

Dear President Hoenig,

On January 5, 2011, you were quoted on *abc NEWS* as saying that “the gold standard is a very legitimate monetary system”. The quotation went on: “We are not going to have fewer crises necessarily. You will have a longer period of price stability or price level stability, but I don’t know that you will have lower unemployment, and I don’t know that you will have fewer bank failures.”

As a student of the gold standard for the past 50 years I welcome your statement. I would be happy to open my files and archives if the Research Department of the Federal Reserve Bank of Kansas City (that, as far as one can tell, has so far not been interested in gold standard research) invited me. My files may have the answer to some of your queries.

(1) You are right, the gold standard is a necessary but not a sufficient condition for achieving lower unemployment. A necessary and sufficient condition would assume that Adam Smith’s Real Bills doctrine is also rehabilitated along with the gold standard. The bill market is the clearing house, without which the gold standard cannot survive. The explanation why it collapsed in the years 1931-35 is that, when the victorious Entente powers decided to restore the gold standard after World War I, they also decided *not to restore* real bill financing of world trade or world-wide real bill circulation. Thus the gold standard which Britain reestablished in 1925 lacked a vital organ: a clearing house. The Entente wanted bilateral (to the exclusion of multilateral) trade for fear of German supremacy in exports. This decision was a great setback for world trade. In effect, it meant a return to barter. The consequence was: beggaring-thy-neighbor, trade war, the destruction of the *wage fund*, and massive unemployment world-wide.

(2) As pointed out by the German economist Heinrich Rittershausen in his 1930 book *Arbeitslosigkeit und Kapitalbildung* (Unemployment and capital accumulation), before World War I ‘structural unemployment’ was unknown. Part of the ‘float’ of maturing real bills was earmarked for payment of wages to workers producing consumer goods. This float was what Rittershausen called the “wage fund”, out of which wages could be paid up to three months in advance, well before the underlying consumer goods were paid for by the ultimate, gold-paying consumer.

This wage fund was destroyed by the “Guns of August” in 1914 at the start of hostilities. The destruction of the wage fund went unnoticed because the production of war materiel absorbed all slack labor. After the war, a great inflation inflicted on the world by the Fed created not only the T-bond bubble (that burst in 1921), the Florida real estate bubble (that burst in 1925), and the stock market bubble (that burst in 1929), but it also financed a hugely bloated production of consumer goods.

* The German word ‘Honig’ means ‘honey’ in English.

Only after the stock market bubble burst did it become clear that there was no wage fund out of which the workers producing consumer goods could be paid. The workers had to be laid off and the factories had to be closed. Thus did the prohibition on real bills circulation cause the collapse of the gold standard and the Great Depression.

My research suggests that if after World War II *both* the gold standard and real bill circulation had been rehabilitated, there would have been no serial currency turmoils and no Great Financial Crisis. The gold standard and real bills go together like hand and glove.

(3) The purpose of the gold standard is not to stabilize prices or the price level, which is neither possible nor desirable. *Its purpose is to stabilize the interest-rate structure*, which it can do very efficiently, as history shows. There was no bond speculation under the gold standard. Speculation was confined to agricultural commodities, the supply of which is governed by nature rather than bureaucrats in the Treasury and the Central Bank. Changes in commodity prices or in the price level under the gold standard were mild. They reflected changes in marginal productivity, not speculative fever. Virtually all crises after the collapse of the gold standard in the 1930's were caused by volatile changes in interest rates due to bond speculation.

(4) *Gold is the ultimate extinguisher of debt*. The reason is that gold enters the asset column in the balance sheet of banks but, unlike every other asset, it has no corresponding entry in the liability column of the balance sheet of someone else. Gold survives any consolidation of balance sheets. Other assets are wiped out when the balance sheets of debtor and creditor are consolidated, as in default and repossession.

(5) No runaway debt or derivatives tower can develop under a gold standard. Such cancerous growths have occurred in the 21st century because, in the absence of a gold standard, the economy is lacking an ultimate extinguisher of debt. Total debt can only grow. It can *never* contract through normal debt retirement.

(6) Bank failures are a consequence of unbridled escalation of debt. The gold standard acts as a restraining force on banks with a propensity to expand credit even after further expansion becomes detrimental to their capital. Widespread bank failures that presently hit the economy are an indication of destruction of bank capital. Banks were happy to put their capital in jeopardy during the boom as their cash flow from fees was plentiful. However, cash flow is no substitute for capital. When the boom was over, cash flow stopped, but bank capital was gone.

Under the gold standard banks know better. They cannot expand credit with impunity beyond safe capital ratios. If a bank does, it deserves to fail and should not be bailed out.

We can indeed return to a gold standard by going back to Constitutional money. This means opening the U.S. Mint to unlimited free coinage of gold and silver. We can return to financing production and trade in goods demanded most urgently by the consumer through real bills, if the Federal Reserve Banks go back to the legal provisions of the F.R. Act of 1913. That Act confined F.R. credit to real bills arising out of the production and distribution of consumer goods, to the exclusion of anticipation and accommodation bills as well as government debt. The solution to the present crisis will be found in the strict observance of the monetary provisions of the Constitution, and enforcement of the law governing Federal Reserve credit.

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ANNOUNCEMENT

New Austrian School of Economics

Course Two at the Martineum Academy in Szombathely, Hungary,
from March 5 through 13, 2011. Title of the course:

ADAM SMITH'S REAL BILLS DOCTRINE AND SOCIAL CIRCULATING CAPITAL

What makes this course especially topical today is the fact that more and more hints are being dropped about the possible rehabilitation and restoration of the gold standard — following the ignominious collapse of the irredeemable dollar. However, *a gold standard without its clearing house, the bill market,* ***is not viable*** and itself is liable to collapse in short order — as it did in the early 1930's. The level of public ignorance about the necessity of a clearing house is appalling. It is made that much worse by a tottering banking system. We have an urgent message: only gold standard *cum* real bills can restore prosperity to the world, in view of the fact that *we have to write off the world's banking system as a total loss.*

This is the second in a four-course series on Austrian Economics, a branch of economic science based on the work of Carl Menger (1840-1921). It is meant for those, including beginners, who are interested in the theory of money, credit, and banking, with *special emphasis on the current financial and economic crisis.* The complete program consists of four courses (10 days, 20 lectures each). Completion of each course will earn one credit. Participants who have accumulated four credits get a diploma signed by Professor Fekete. Course One that was given in 2010 *is not a prerequisite*. It is available on DVD for purchase.

Scholarships for students are still available.

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