SOURCES AND REMEDIES OF FINANCIAL INSTABILITY*

Gold Bond: Life-Saver for the U.S. and World Economy

Antal E. Fekete

Sources

The financial instability that first surfaced with full force in 2008 is the result of a deteriorating condition in world finance going back 40 years. Worse still, that deterioration is continuing and threatens with an historically unprecedented world-wide credit collapse.

The watershed year was 1971. What made that year outstanding was not just the first-ever introduction of the world-wide floating exchange rate system, but also the disappearance of the most potent and reliable financial instrument that has ever existed. It was little noticed at the time. If ever mentioned, it was being treated as a non-event. Yet the world can only dismiss its significance at its own peril. Academia that is supposed to study problems created by monetary experimentation, rather than alerting the public to the most serious consequences of the omission, has been guilty of ignoring it.

The most potent financial instrument, the disappearance of which we are referring to, is the *gold bond*.

This observation would immediately be objected to by the detractors of gold in the monetary system. They would say that the gold bond had disappeared from world finance much earlier: in the years 1931-35. Its disappearance gave no occasion for any major catastrophe in its wake. Rather, the word economy has gone on from one triumph to another without gold bonds ever since — proving the inconsequential nature of their being phased out. However, this objection is not valid.

The truth of the matter is that the gold bond had survived the collapse of the gold standard in the early 1930's and has played a most important albeit largely unrecognized role in world finance afterwards. Consider the fact that since January, 1934, the dollar has had a fixed value in terms of gold, based on the Treasury price of $35 per ounce of fine gold, and the U.S. government has continued to honor its international dollar obligations in gold at that rate. Moreover, this obligation was solemnly enshrined in several international treaties and confirmed by four sitting presidents. As a result, there is no gainsaying of the fact that U.S. Treasury paper in the hands of foreign governments and central banks directly, and in the hands of banks, financial institutions, and even ordinary citizens not under the jurisdiction of the U.S. indirectly, have continued to exist as gold bonds (or gold bills, as the case may be) after 1934.

The most important role the gold bond has played up until 1971 was this: it was the standard of credit whereby all other debt instruments were gaged. Through disintermediation substandard debt was eliminated, and the rise of the Debt Behemoth prevented.

Ignoring this fact is a major error that Academia has been and still is making. To continue to deny this fact leads to further grievous errors. There used to be a saying on Lombard Street, long since forgotten, that "there is only one thing that is safer and arguably more desirable to hold than gold, namely, *the promise of a government to pay gold*". In that spirit gold bonds were considered an "ultimate form of debt", enforcing quality standards. Moreover, the U.S. Treasury bill in the hands of foreigners was, along with gold, the *ultimate extinguisher of debt.* This instrument was destroyed on August 15, 1971. On that day gold was exiled from the international monetary system. Since that day the world has lacked an ultimate extinguisher of debt.

Any other means of payment, including Federal Reserve credit, however useful in international trade or otherwise, could *not* extinguish debt. It could only shift debt from one debtor to another (ultimately, to the U.S. government). As long as there were gold bonds in existence, a Debt Behemoth could not rise to threaten world finance with destruction. Whenever total debt in the world approached the danger level, safety-conscious governments and banks quietly started converting their holdings of debt into gold bonds, thus squeezing marginal debt out of existence. This also explains the absence of a derivative tower and other unsafe financial constructions, instruments and practices, such as mortgage-based bonds, or bank-loan-backed bonds, prior to 1971.

World trade was financed and regulated by gold to the extent that the great trading houses abroad kept a portfolio of gold bonds in their balance sheet. In effect they were doing arbitrage between the gold bond market and the market for internationally traded merchandise. If the gold rate of interest (the yield of U.S. Treasury bonds) rose, they sold out marginal merchandise from warehouses without reordering them, and invested the proceeds in gold bonds. If subsequently the gold rate of interest rates fell back, then they would sell the gold bond at a profit, and invest the proceeds in marginal merchandise, the trading of which out of the warehouse yielded better profit than that available from holding the gold bond. This arbitrage was real, continuous, and it kept international trade on an even keel. Academia has missed this important arbitrage responsible for regulating world trade after World War II. It has also been guilty of failing to point out that, without gold bonds, world trade is clueless, subject to deterioration and open to manipulation.

In 1971, by a stroke of the pen, gold bonds were stamped out of existence. World trade lost its guiding star. The floodgates of exorbitant debt creation were opened. The fast debt-breeder was turned on. Debt of dubious quality flooded the word, the soundness of which could no longer be gaged in the absence of gold bonds. There was no sink to absorb excess and waste. This explains the origin of the debt tower, and the steady deterioration of the quality of its component parts. This process is still continuing. Worst of all, the series of financial crises in the world also continues. Every one of them will be more devastating than the preceding one — unless something is done about it, *and soon*. In the absence of remedial measures now the momentum of the approaching avalanche will become overwhelming.

Remedies

Having made the correct diagnosis, the remedy readily presents itself. *The gold bond should be brought back.* There is presently a great latent demand for gold bonds in the world, as indicated by the high marketability U.S. Treasury bonds are still enjoying — something that cannot be justified on purely economic grounds in view of the net debt of the U.S. government and the tenaciousness of the American trade and budget deficits. Make no mistake about it: the high marketability of the U.S. Treasury bonds is justified solely by the fact that there is still a residual hope that the U.S. government will, in its own self-interest as well as in the interest of the world economy, make them payable in gold at maturity, and will pay interest on them in gold in the meantime.

Most significantly, there is a convincing precedent in U.S. history for this. During the Civil War and its aftermath, the U.S. government continued to honor its debt, both as to principal and interest, paying them in the gold coin of the realm. To be able to do it, the government continued to levy import duties and excise taxes in gold — to the exclusion of paper. The exchange rate between the gold dollar and the paper dollar (endearingly called the ‘greenback’ by their protagonists) was fluctuating. The government need not embrace a gold standard in order to enjoy the benefits offered by the gold bond.

There is no reason why the U.S. could not emulate the Civil War practice in the present crisis. Admittedly, it would take extensive research to work out the details. For example, the question arises how gold bonds can survive in a fiat paper money system (or how a fiat paper money system can prosper in an environment where gold bonds exist and enjoy the highest prestige). At any rate, the intellectual resources to conduct such research are all at hand. If not residing in Academia, then, at least, they are scattered around in small discussion groups and can be accessed through the Internet. There ought to be such a thing as “shadow research” offering sorely missed competition to mainstream economics on the gold question.

The first obstacle that confronts the present effort by the U.S. government and the Fed to put the great financial crisis behind them is that it runs head on into Triffin’s Dilemma. Already in the early 1960’s Robert Triffin observed that the stated aims of increasing ‘world liquidity’ and those of eliminating the U.S. budget deficit are contradictory. They cannot be simultaneously accomplished.

Likewise, the present effort to rein in the U.S. government deficit and reduce the outstanding government debt, while simultaneously increasing the stock of money through direct sales of government bonds by the Treasury to the Fed (euphemistically called QE 1 & 2) are contradictory. It is like trying to have one’s cake and eat it. On the one hand the Fed wants to inject more Federal Reserve credit into the payments system — while the “other hand”, the government, pretends to choke off the supply of the necessary collateral through eliminating the budget deficit. Politicians, mainstream economists and financial journalists sing the praise of this scheme without realizing that it cannot be done.

The two aims are contradictory, and the market will not be fooled by the prestidigitation.

Most mainstream economists have a vested interest in maintaining their anti-gold stance. Their prestige is committed to Keynes' dictum that the gold standard (and, by implication, gold) is nothing but a 'barbarous relic'. However, if they really believe in a goldless monetary system, then they should have nothing to fear in exposing their fiat paper scheme to competition with the gold bond. Hand-to-hand money will still be irredeemable under the suggested remedial action. The fact that this will cause the managers of fiat money to make their instrument deliver stellar performance so that people shall have no desire to dump paper in favor of gold is an added benefit. The remedial action proposed here ought not to be seen as an attempt to return to the gold standard through the back door. The proposal is to allow the gold bond to discharge its natural function, to wit: weeding out bad debt — something irredeemable debt cannot do.

A great failing of monetary scholarship is the one-sided appraisal of the origin and subsequent evolution of the Federal Reserve System that came about as a result of six years of thorough study and public debate in the wake of the 1907 financial panic. It was not even remotely considered during the debate that the Fed coming off the drawing board ought to be an engine monetizing government debt. Just the opposite is true: the Fed was supposed to be a commercial paper system whereby self-liquidating bills of exchange would acquire ephemeral monetary privileges, facilitating the movement of semi-finished merchandise from the producer to the ultimate consumer. This was not considered inflationary: *pari passu* with the sale of merchandise to the ultimate consumer the expiring bills diminish the money supply dollar for dollar.

Nor was it thought possible during the debate that the monetary unit of the United States could be anything but the Constitutional double eagle gold coin. There was nothing sinister about the study and the debate. There was no conspiracy. It was all in the open. All questions could be openly asked and would be honestly answered.

The outcome, the Federal Reserve Act of 1913 was far from being a perfect document. It had many weak points, errors of commission as well as errors of omission. It had a lot of room for improvement. But it was acceptable for the purpose of putting credit, such as existed within the confines of the United States, on a sound and enduring financial basis.

Mischief occurred *after* the Federal Reserve banks opened their door for business in 1914, about the same time when the war in Europe got started. Without much thinking, and in an obvious violation of the law and the neutrality of the country, the Administration of president Wilson committed the new Federal Reserve banks to the task of financing of the allied war effort in Europe. The idea of self-liquidating credit was discarded; credit was created expressly to finance destruction. You could not get further away from the ideal of self-liquidating credit than putting credit in the service of destroying life and property.

This takes us to the second remedy: *restoration of self-liquidating credit.* The idea that the central bank can calibrate the rate of debasement of the currency by adjusting the speed of the printing press is absurd. It is only surpassed by the absurdity of the notion that the Federal Open Market Committee can divine, pick, and set the optimal interest rate that will make the GDP grow, payrolls swell, prices stabilize, and prosperity endure.

Historically, commercial banks came into existence not to 'create' credit but to 'liquefy' it. Commercial credit takes its origin in the handshake of two businessmen while one saying to the other: "I'll pay you for this shipment in 90 days". The handshake later took the form of a real bill. It had the advantage that it could be endorsed and passed on to a third party in payment for other merchandise.

Thus the formula to solve the present crisis of instability, and to fend off the threatening credit collapse is: Go back to gold bonds and real bills. Adopt the best agents of credit there obtain, in place of intrinsically worthless promises. Substitute the real source of credit, the handshake of two businessmen, for the stroke of the banker's pen.

The hour is late. At stake is the survival of the U.S. and the world economy as we know it. Failure to act now would lead to a disaster comparable only to the collapse of the Roman Empire in the fifth century A.D. that was accompanied with a total breakdown of law and order while, significantly enough, gold was going into hiding.

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* The title of this essay is borrowed from a list of research topics proposed by the *Institute for New Economic Thinking.* The author submitted this essay for consideration, but the Institute declined to entertain it.

Calendar of events

NEW AUSTRIAN SCHOOL OF ECONOMICS

in Munich, Bavaria, Germany

Aug. 20 - 29, 2011

The Austrian Theory of Interest and Discount

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The Last contango in Washington: how many more dress rehearsals?

Corner or permabackwardation in silver?

Gold and Silver Basis and Cobasis: An interpretation.

Lecturer: Prof. Antal E. Fekete

Guest Lecturer: Sandeep Jaitly (United Kingdom)

The school is meant for all students (including beginners) interested in the thought of Carl Menger (1840-1921) and, more generally, in the Austrian theory of money, credit and banking in the spirit of Menger. The school's program plans to cover the whole spectrum of Austrian economics. It is recommended especially for those who have read the papers of Prof. Fekete about the instability of the present monetary system and the danger of a world-wide credit collapse, available on the Internet, see the website www.professorfekete.com .

The complete program consists of four courses (10 days, 20 lectures in all). Completion of each of the four courses will earn one credit. Students with 4 credits will earn a diploma, signed by Professor Fekete. The four courses are as follows:

Course I: Disorder and Coordination in Economics — Has the world reached the ultimate economic and monetary disorder?

Course II: Adam Smith's Real Bills Doctrine and Social Circulating Capital

Course III: The Austrian Theory of Interest and Discount

Course IV: The Austrian Theory of Money, Credit and Banking

Courses I and II have been given in Hungary in 2010 and earlier this year. There are plans to repeat them in Munich next year.

For further information contact: nasoe@kt-solutions.de

or phone: +49-170-380-3948 (please take time-zone difference into account)