THE FALL AND RISE OF THE GOLD STANDARD

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ABSTRACT

Our revisionist theory of the gold standard takes the bill market and the discount rate into full account. Greater availability of gold is no cause for inflation. The new gold flows to the bill market lowering the discount rate, which quickly puts a greater variety of consumer goods on the shelves of retail shops, thus preventing prices from rising. Nor is reduced availability of gold a cause for deflation. The gold is withdrawn from the bill market raising the discount rate, which quickly eliminates marginal merchandise from the shelves, thus preventing prices from falling. Rising prices are never the result of an abundance of gold. They are always the result of scarcity of goods, such as that caused by misguided credit policies of banks discounting financial bills not backed by maturing consumer goods. Falling prices are never the result of a scarcity of gold. They are always the result of an overabundance of goods, such as that caused by misguided government policies creating unemployment.

UNEVENLY ROTATING ECONOMY

The gold standard can only be understood in the context of its clearing system, the bill market, trading real bills that move in a direction opposite to the flow of maturing goods to the final gold-paying consumer. Authors looking at the gold standard in isolation got a cock-eyed perspective. They have to invoke the quantity theory of money. The trouble is that, although it could explain linear changes, the quantity theory is helpless to explain non-linear phenomena such as dynamic changes. Whenever Mises talked about an “evenly rotating economy,” he was careful to rule out dynamics. To this extent his opus is incomplete and can only be finished by extending it to the “unevenly rotating” or dynamic economy wherein the quantity theory of money no longer applies. The evenly rotating economy is strictly an abstraction that, by Mises’ own admission, nowhere exists in reality, not even as a first approximation.

CLASSICAL THEORY OF THE GOLD STANDARD

There is a natural tendency to minimize gold flows across international boundaries. Typically, balances are settled, not through gold remittances but through arbitrage in real bills. Arbitrageurs buy bills in a country running a deficit and sell an equivalent amount in a country running a surplus, to take advantage of the favorable spread in the discount rate. It is particularly effective if one country acts as a clearing house, as England has done prior to World War I.

This observation invites the following critique of the classical theory of the international gold standard according to which gold flows from a deficit to a surplus country, inducing changes in the relative price levels. According to the quantity theory of money prices are falling in the deficit country and rising in the surplus country. Higher prices are supposed to have the effect of discouraging exports while encouraging imports, with the opposite effect for lower prices. This purports to explain the adjustment mechanism of foreign trade. However, this pernicious theory has never worked in practice but it caused a lot of monetary mischief in the world after Milton Friedman persuaded governments to “float” their currencies in the early 1970's. Friedman’s theory of trade adjustments through currency devaluation, a variant of the classical theory of the international gold standard, was an unmitigated failure, although this was never publicly admitted.

If not corrected soon, it will destroy the international monetary and payments system through competitive currency devaluations and trade wars, or worse.

REVISIONIST THEORY OF THE GOLD STANDARD

In reality, the price level hardly ever reacts to trade imbalances. Economists have been at a loss to explain persistent trade deficits and blamed the gold standard for the anomaly. They should have blamed themselves and their flawed theories.

As our more sophisticated theory shows, if the supply of gold increases in one country, then the new gold first flows to the bill market where it will bid up the price of real bills. This makes the discount rate fall. Shopkeepers respond by filling their empty shelf-space with marginal merchandise. By the time new gold trickles down to the rest of the economy in the form of higher wages and greater dividend income, the extra merchandise will be in place waiting for the increased consumer-spending to materialize. Social circulating capital expands and soaks up extra demand for consumer goods. There is no inflation.

Conversely, if the supply of gold decreases in a country, then the gold is withdrawn from the bill market against selling real bills. Bill prices fall. The discount rate jumps. Shopkeepers respond by eliminating marginal merchandise form their shelves. Neither gold outflow nor increased gold hoarding will squeeze prices. Instead, they cause social circulating capital to contract and propensity to consume decline. Marginal merchandise is no longer available in every grocery store. The consumer who still wants it must search for it in speciality shops and be prepared to pay a higher price for it since moving these items can no longer be financed at the low discount rate; it must be financed through a loan at the higher interest rate. There is no deflation.

Karl Marx talked about the “anarchy of the market” under the capitalist mode of production, suggesting that producers act blindly and they inevitably glut the market through overproduction. But as our analysis shows, assuming that the discount rate is not distorted by the banks and the government, producers and distributors have a sensitive inner communication system, the bill market. They know that by the time the new product reaches the shelves of the shopkeeper the sovereign consumer will be looking for it. Producers and distributors get their signals, not from the rate of interest or prices that are far too sluggish, but from the nimble discount rate. Its fall is heralding an increase, and its rise a decrease, in consumer demand.

FUNDAMENTAL PRINCIPLE OF RETAIL TRADE

This, then, is the fundamental principle of the retail trade. *The adjustment mechanism which brings into balance the amount of gold in circulation with the supply of consumer goods works, not on prices but on the discount rate*. The law of supply and demand is inoperative. An autonomous increase in demand has no inevitable effect on the prices of consumer goods but will, instead, lower the rate of marginal productivity of social circulating capital, i.e., the discount rate. The lower discount rate automatically makes the supply of consumer goods expand.

By the same token, an autonomous decrease in demand will raise the rate of marginal productivity of social circulating capital, a.k.a. the discount rate. A higher discount rate automatically makes the supply of consumer goods shrink. There is no such a thing as an autonomous change of supply in the retail trade. Supply is closely regulated by demand through the mechanism of the bill market and the discount rate.

The vulgar supply/demand equilibrium analysis fails to describe the process of supplying the consumer with urgently needed goods. It could not explain why prices were stable under the gold standard even in the face of great changes in demand. In a previous article I have explained this phenomenon in terms of increasing economic entropy.

COPING WITH NATURAL DISASTERS

If a country is stricken with bad harvest or by some other natural calamity destroying property and consumer goods, then there will be an immediate increase in the discount rate. Retail prices of consumer goods will not rise inevitably. The stricken country, thanks to its high discount rate, is an attractive place on which to draw bills. This translates into an immediate influx of short-term credit from abroad in the form of the most urgently needed consumer goods. In comparison, the present system of politically motivated trade privileges bungles foreign aid hopelessly. By the time the amount and kind of aid is agreed upon by the negotiators, the need may have shifted. The gold standard is by far the best system for international division of labor, in good times as well as in bad. Governments have exposed their subjects to unnecessary deprivations when they first sabotaged the clearing system of the gold standard, the international bill market, and then destroyed the standard itself. Peoples of various countries will help one another to the fullest possible extent under the international gold standard, provided that its clearing system, the bill market, is not sabotaged by the governments, as it was in 1909 when bank notes were made legal tender in Germany and France. In the absence of a gold standard peoples are pitted against one another in a bitter competition and trade wars, often escalating into shooting wars.

COPING WITH A GOLD AVALANCHE

By the same token, the international gold standard and its clearing system the bill market allows nations to share the windfall of a sudden increase in the world's stock of monetary gold in a way that rewards the industrious and penalizes the inept. Let's assume that the output of gold mines increases by leaps and bounds, or that foreign gold invades one particular country. It need not cause an increase in prices, as predicted by the vulgar theory. Instead, it will benefit all countries adhering to the international gold standard, through a general lowering of the discount rate. It will first drop in the country hit by the gold avalanche. Suppliers will start drawing bills on foreign countries with a higher discount rate. Increased imports will repel the invasion of foreign gold and expel excess domestic gold. Social circulating capital expands with the lowering of the discount rate. The spinoff from higher incomes due to the greater availability of gold will be met by an expanded offering on the shelves of shopkeepers who are now able to display a greater variety of goods, thanks to the lower marginal productivity of social circulating capital. As excess gold is expelled, other countries will also participate in the windfall. Benefits are by no means confined to the country where the gold fields are located.

Now suppose that all countries except one close their Mints to gold, and all the monetary gold in the world descends upon that country. Even in this extreme case there is no need for the prices to rise. The rate of marginal productivity of social circulating capital will be approaching zero. Retail stores will run out of shelf space and start using the side-walks to display marginal merchandise. The greater availability of gold will, in this case as in any other, call out an even greater abundance of merchandise. Price rises are always the result of a scarcity of goods, never of a greater availability of gold.

A bumper crop is often considered a disaster by producers who blame it for the collapse of prices. But prices need not collapse under a gold standard. The cash crop is part of social circulating capital and, when available in great abundance, marginal productivity will be lowered and the discount rate fall. New products made of the same old ingredient will appear on the shelves. Furthermore, exporters will take advantage of the lower discount rate. They draw bills on the bumper crop in shipping it to foreign destinations. Far from slashing prices, the gold standard will increase market share through slashing the discount rate. Everybody benefits.

LEGAL TENDER BANK NOTES

Scarcity of goods is usually brought about by the banks and the government through their interference with the free flow of gold to the bill market and with the free flow of merchandise across international boundaries. An example of the former is the world-wide inflation of 1896-1914, mistakenly blamed on the increase in gold production after the opening of the mines in the Transvaal. The prodigious increase in gold production did not cause price increases *per se.* The new gold should have been allowed to flow to the bill market. It wasn't. Banks intercepted it in order to construct a credit pyramid upon their greatly expanded gold reserves.

The bank credit, however, was not healthy. It was not of the self-liquidating kind, as it would have if it had been based on real bills drawn on goods moving fast enough to the final gold-paying consumer. Worse still, governments discouraged gold coin circulation instead of encouraging it. They drove gold coins into the banks. Laws originally barring the bank of issue from discounting financial and treasury bills were changed. The note issue was made legal tender. This event was the salvo heralding the destruction of the bill market. Within five years, by the time the war broke out, the portfolio of the banks of issue consisted of financial and treasury bills, where previously only real bills were eligible as reserves for the note issue. The bill market was paralyzed. It has never been allowed to make a recovery.

A direct consequence of the unhealthy credit expansion was inflation world-wide, even before the war. It was conveniently explained away by the quantity theory of money, using gold as the whipping boy. Nobody pointed out that the expansion of bank credit has far outstripped the increase in the stock of monetary gold. Still more serious was the undermining of the international bill market. It could no longer prevent price rises through the discount rate mechanism, since bank reserves have been diluted through the discounting of fiduciary and treasury bills that, unlike real bills, would not mature into consumer goods. The fact remains that, in spite of government propaganda, it was not the inflow of new gold but the subversion of the bill market that caused the 1896-1914 inflation and price rises.

Economists are guilty of failing to point out that making bank notes legal tender has been tantamount to dethroning the sovereign consumer. It was a destructive act. The gold coin cannot be substituted, the dictum of Mises notwithstanding, by legal tender bank notes in its role as the regulator whereby consumers direct production. Legal tender confers absolute and unlimited power on the bank of issue. It is a great error indeed to classify, as Mises does, legal tender bank notes a present good with which consumers allegedly continue to guide production even after the recall of gold coins from circulation. Legal tender means that the power of consumers to decide which items to produce and which ones to discontinue is fatally compromised. This power is now usurped by the bank of issue. Only one economist, Professor Heinrich Rittershausen of Germany, realized the destructive nature of the 1909 decision to make bank notes legal tender. Unfortunately, his cry has remained, to this day, a cry in the wilderness.

PLUNDER, THE REAL CAUSE OF INFLATION

We have seen that the 1896-1914 inflation was not due to the sudden increase in gold production, but to the hijacking of gold on its way to the bill market by banks hell-bent to build unsound credit on their greatly expanded gold reserves. The point is that this credit expansion was not matched by emerging consumer goods because it was the result of discounting financial and treasury bills, rather than real bills. Had it been, no inflation would have ensued. In the actual case credit expansion made consumer goods scarce. Prices rose as a consequence.

Going further back in time we may observe that the great historic tides of prices, originally blamed on gold, were really caused by military conquest and plunder as they made goods scarce. This was true of the sack of Persepolis by Alexander the Great in 331 B.C., as well as the sack of Cuzco by Pizzaro in 1533 A.D. The fact that looted gold was the instrument whereby goods were made scarce in other parts of the world does not change the validity of this observation. It was not

the greater availability of gold *per se*, but the scarcity of goods due to plunder, that has made prices to rise.

FALL OF THE GOLD STANDARD

The fall of the gold standard can only be understood in the context of the deliberate destruction of the bill market. After World War I the victorious governments in redrawing international boundaries would not allow the free circulation of real bills and consumer goods to resume. They did not want free trade. They wanted autarky. They also wanted to deny the gold coin to "man's greedy little palms", to use the cherished phrase of Lord Keynes. The bill market was scuttled. Governments assumed control of foreign trade in consumer goods, which was thereafter animated by political rather than economic considerations.

This turned out to be the most disastrous public decision in peacetime. In an earlier article of this series I related how it led to the collapse of the gold standard and to unprecedented unemployment world-wide, as predicted by Rittershausen in 1930. It is a shameless lie that the gold standard collapsed because of its inner contradictions, after spreading unemployment in the world. The truth is that the gold standard was destroyed through deliberate sabotage. Legal tender bank notes made the bill market brain-dead. Bills drawn on maturing goods no longer reflected the will of the consumers. They reflected the will of the bank of issue that could print bank notes *ad libitum* to meet payments on real bills. We should not be fooled by the fact that a few gold coins lingered on during and after the war, as they did in the United States. The clearing system of the gold standard, the bill market, has been effectively destroyed. The international gold standard was bound to fall, too. In the *post mortem* it was falsely stated that the cause of death was exhaustion due to old age. No mention of the stab wound in the back was made, namely, the 1909 decision declaring bank notes legal tender.

The theory and history of the gold standard has been distorted and falsified by traitors such as Lord Keynes who was happy to take the thirty pieces of silver offered as reward for the betrayal. It is time to set the record straight and state the truth: mass unemployment in the 1930's was caused by the governments themselves. They destroyed the wage fund, however inadvertently, along with the bill market. Detractors of real bills at the Mises Institute must logically applaud the government hatchet job. They look at the government decision to scuttle the international bill market with satisfaction, as a needed "purification" purging the gold standard from its alleged imperfections. Advocates of the 100 percent gold standard are intellectual accomplices of the greatest job destruction of history. They approve of the abolition of the wage fund in the consumer goods sector, a corollary of the destruction of the bill market. You cannot have it both ways. If you deny self-liquidating credit, then you also deny jobs financed thereby.

IN PRAISE OF GOLD HOARDING

The most serious charge against the gold standard, made by Lord Keynes, is that it is "contractionist." It encourages gold hoarding thus contracting the stock of money, the chief cause of unemployment. The truth, however, is that gold hoarding in the early 1930's was maliciously instigated by the enemies of the gold standard, first and foremost among them Lord Keynes himself. They started a whispering campaign that the national currency should be devalued to help the export industry. This was nothing short of advocating sabotage. The disingenuousness and hypocrisy of Keynes reminds one of the thief crying: "Thief! Thief!"

As an economic phenomenon, gold hoarding and dishoarding are natural and healthy. In fact, gold hoarding is part of the mechanism that regulates the (floor of the) rate of interest. The only way the public can prevent banks from expanding credit is through the withdrawal of bank reserves in the form of gold coins. Contraction of reserves is the only signal banks understand. Jaw-boning is an exercise in futility. Banks should be prepared to pay out their bank reserves to

note holders and depositors on demand. That is what bank reserves are for. Control over changes in the stock of money is, by the Constitution, reserved to the people. They exercise this power through their right to withdraw bank reserves in the form of gold coins. Gold hoarding of the marginal bondholder sets a limit to falling interest rates. Once this right to withdraw reserves was taken away from the people banks could, and would, drive interest rates down below the rate of marginal time preference, taking entrepreneurs into temptation to expand production facilities. This would lead to overinvesting and the boom-bust cycle as explained by Mises and Rothbard.
If the government tries to stop gold hoarding by confiscating the monetary metal, then the propensity to hoard, instead of working through the natural conduit of gold, would find outlet in the hoarding of other marketable merchandise, an unnatural conduit, which is fraught with great dangers. In more details, there is the danger of generating a runaway vibrator through resonance between price fluctuations and interest-rate fluctuations. Therein is the explanation for the phenomenon known as Kondratiev's long-wave inflation/deflation cycle to be found.

RISE OF THE GOLD STANDARD

The gold standard shall, like the mythological bird Phoenix, rise from its ashes when the regime of irredeemable currency foisted upon the peoples of the world will self-destruct, as it must, after the time-bomb of ever-increasing unpaid and unpayable debt, having reached critical mass, goes off. The born-again international gold standard will be complete with its natural clearing system, the international bill market.

Advocates of the so-called 100 percent gold standard display a most profound ignorance of monetary science when they naively think that the clearing system of the new gold standard will consist of fleets of cargo planes flying gold around the world to satisfy their taste for purity. There is a great urgency to have a national debate on the burning questions how to prepare for the cataclysmic collapse of the regime of irredeemable currency that presently threatens the world. The government has betrayed people in keeping them in ignorance. It is inexcusable that some self-styled advocates of sound money try to smuggle in their own petty agenda, derailing the orderly discussion of the main issue, the study of the operation of the gold standard in depth, including its clearing system the bill market, and its signaling system the discount rate (as distinct from the rate of interest).

The second coming of the gold standard and the bill market is inevitable, despite the charlatanism of the opponents of real bills. Their 100 percent gold standard will be rejected 100 percent by events as they unfold.

References

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