THE GOLDBUG, VARIATIONS IV

Part 4 of 5: A Rebuttal of Paul Krugman's Chrysophobic Theories

The Dismal Monetary Science

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Recitativo

Crucially, gold is not a stable standard when measured in goods and services. It is a commodity whose price is constantly buffeted by shifts in supply and demand that have nothing to do with the needs of the world economy — by changes, for example, in dentistry.

Rondo

Is this the best you can do in defense of Dismal Monetary Science, Krugman? Must the Constitution of the United States of America be dishonored, besmirched, and continuously violated because of your conjecture that, under its provisions, changes in dentistry may cause inflation or deflation?

Here is what dishonoring the U.S. Constitution, implicitly endorsed by Krugman, has given us:

1. The irredeemable dollar has been losing at least 90 percent of its purchasing power every 35 years.

2. Interest rates have been destabilized and could reach unprecedented high or low levels.

3. The volatility of commodity prices has increased explosively and continues to do so.

4. We are forced to live under the constant threat of disruptive corners, for example, corner in the crude oil market.

The volatility of the price of crude oil has been as high as 1000 percent per annum (i.e., the price increased eleven-fold within a year). It is blamed on the intrigues of OPEC to corner the market. However, this begs the question, as cartels prosper under the regime of irredeemable currency and wither under the gold standard. At any rate there are many other examples of explosive increases in price volatility. The price of sugar went from 6 cents per lb to 75 in 1975 (forcing Coca Cola to switch to corn syrup) only to fall back to 10 in the following year. The price of coffee underwent comparable gyrations. Nor was volatility confined to imported goods. Soybeans saw wild price movements up and down, as did most cash crops. This type of volatility was simply unheard-of under the gold standard. Also unheard-of was a cartel cornering a commodity such as crude oil, as long as the medium of exchange was gold.

In fact, one of the chief merits of the gold standard is that it eliminates the threat of disruptive corners by reining price volatility back. Suppose that under a gold standard there is an incipient corner in the crude oil market. Arbitrageurs would respond by selling crude oil forward at ever higher prices, and keep doing it until the corner is broken. I use the word "arbitrage" advisedly. A short position in crude oil is balanced by a long position in gold and, as a consequence, the risk of the arbitrageur is limited. Price volatility is reined in through arbitrage long before a corner could materialize. By contrast, under the regime of irredeemable currency a short position in crude oil carries unlimited risk (since there is no obvious limit above which the price may not rise). As a consequence speculators are reluctant to resist price trends and swings. Volatility could become explosive.

Of course, you could resist the uptrend and keep selling forward crude oil at ever higher prices. But this would no longer be arbitrage. It would be pyramiding naked short positions at escalating losses, a most foolish market action. No speculator in his right mind would undertake it. For lack of arbitrage corners have become common, and volatility is left unchecked. Not just in crude oil. Not just in agricultural products. Also in metals: copper, lead, palladium, you name it. Explosive increases in price volatility are in the making as I write this.

It is ridiculous to argue, as Krugman does, that changes in dentistry could adversely affect the monetary role of gold, presumably by causing deflation in case of an increasing, or inflation in case of a decreasing demand for dental gold. Gold is not merely a commodity. Its highest stocks-to-flows ratio, which is not materially affected by changes in dentistry or in any other marginal application, makes gold the monetary metal par excellence.

Interlude

Let me relate my personal experiences concerning gold and dentistry. I can speak with some authority on this matter as a survivor of the Soviet occupation of Hungary in 1945 (which was to last 45 years, until the collapse of the Soviet Union in 1990.) Like most people of the middle classes, my father had gold in his teeth, a relic of more prosperous times. However, gold teeth had not much chewing to do in Soviet-occupied Hungary. The Red Army requisitioned all foodstuff it could lay its hands on for its own use, as well as for shipping it back home — without any regard for the starving local population.

So my father had his gold teeth removed. With the proceeds of the sale of gold he could have false teeth made of cheaper material, and still have money left to buy food for his family. This shows that the demand for gold in dentistry is price-elastic and can even go negative, just as it is in jewelry. Scarcity of money will not cause deflation under a gold standard. Rather, it will attract gold to the Mint, and not only from the mines and jewelry boxes, but also from people's teeth — a further proof of the excellence of gold as monetary metal, contrary to what Krugman thinks.

It is just as silly to suggest that replacing gold in dentistry with other materials could cause the demand for gold decline which translates into inflation under a gold standard. In 1945 dental gold was replaced by cheaper materials in

Hungary, without making the demand for gold decline. I remember very vividly the delicate hands of our dentist as he clipped off an agreed portion of the heavy gold chain that used to hold my grandfather's pocket watch. (I still have the remnants of that chain in my possession. The watch itself has been bartered for food during hard times.) In doing so the dentist was taking his fee for professional services, which he simply refused to provide on any other terms. In particular, he contemptuously declined to take his fee in irredeemable currency, however profusely offered. The dentist did not need the gold in his dental practice as his patients could not afford it. He wanted the gold because he did not trust the value of irredeemable currency. On a more grisly note, high-ranking officials of Nazi Germany as well as of the Soviet Union did not trust it either. They ordered gold teeth to be wrenched from the mouth of the victims they had killed, to be recycled as good-delivery gold bars.

Nicholas Deak, principal of Deak-Perera, a banking firm in New York specializing in precious metals and foreign exchange in the 1970s, was of Hungarian origin. He worked for OSS (predecessor of the CIA) during World War II out of his base in Switzerland. He has told me that agents operating in enemy territory were issued gold coins. Later in the Vietnam War American airmen were also issued gold coins. In each case the idea was that gold might buy them freedom in case they were captured, something that paper money would be decidedly unable to accomplish.

Deak believed that the top brass at the Fed carried part of their personal savings in the form of gold coins. They certainly appear to understand gold better than Krugman. Chairman Alan Greenspan is on record revealing the "shabby little secret of fiat money" as an agent of the Welfare State. It enables politicians to promise pie in the sky to the electorate, something they could not do under a gold standard without being found out in short order as imposters. Greenspan is also on record opposing U.S. Treasury gold auctions for reasons that in war the dollar might be useless, and gold will be needed to purchase war material abroad to support the fighting men and women of the armed forces. What he did not say was that the dollar could become useless in peacetime, too, under his own watch.

Cadenza

In this Cadenza I give a brief refresher course on the subject of speculation versus arbitrage. The two are very different. In a sense they diametrically oppose one another. The speculator is willing to take large risks in the hope of large profits, while the arbitrageur is interested in reducing risks. The speculator is betting on changes in the price, while the arbitrageur is betting on changes in the spread (difference between two prices). The speculator's basic tools are: 1. net long position (commitment to buy), 2. net short position (commitment to sell) at a predetermined price. The arbitrageur's basic tool is the straddle (combination of a net long and a net short position). To every straddle there corresponds a spread, the difference between the prices at which the commitments to buy and sell have been made. Reduction of risk is realized as movement in the spread is often more predictable than that in the price itself.

Unfortunately, the distinction between speculation and arbitrage as a rule is not kept clear, and confusion arises frequently. For example, strictly speaking, under a gold standard there is no speculation, only arbitrage. What looks like an outright position is really a straddle (in case of a long position, long in the commodity and short in gold; in case of a short position, short in the commodity and long in gold). This fundamental fact is ignored by virtually all authors writing on the subject, thereby obscuring the role of the gold standard as a regulator reining price volatility back. In more details, speculation is less risky under a gold standard than under a regime of irredeemable currency in view of the fact that speculators work with straddles rather than net long or net short positions. Because of the smaller risk, they are not reluctant to resist price swings and trends. By contrast, under a regime of irredeemable currency speculators are often weary to enter a long or a short position because of the greater risks involved. Moreover, speculators seek protection in “herd instinct”. That is to say, they prefer to jump on the band-wagon in order to ride an established price trend. This is the exact opposite of what they might do under a gold standard where resisting trends may offer a greater profit opportunity than riding them.

To recapitulate, the gold standard has a built-in mechanism to restrain volatility in commodity prices. This is in contrast with the regime of irredeemable currency which is more likely to encourage volatility, as well as the formation of a price trend. By the same token, it is also far more hospitable to cartels than is the gold standard.

It goes without saying that establishment economists, including practitioners of the dismal monetary science, are simply not interested in these problems. The Federal Reserve banks would never sponsor research investigating the fundamental change in the nature of speculation after the dollar has been made irredeemable. This example alone should make it clear that establishment economics has nothing to do with the search for and dissemination of truth. It has to do with the maintenance and aggrandizement of establishment power.

Interlude

The love of paper money may make Krugman the “modern King Midas in the reverse”. His gods could turn everything he touches, including food and drink, into paper. It is small consolation that the paper he must eat has a long string of zeros following the digit 1 printed on it.

It actually happened, among other places, in Hungary, where bank notes denominated in the billions, trillions, and quadrillions circulated in rapid succession in 1946. I know — I have been there. At one point they ran out of prominent people the image of whom could be printed on the bank notes. Luckily, this is no problem in the United States where the supply of professors of dismal monetary science whose image can be printed on the $1 billion, $1 trillion, or $1 quadrillion FR notes is unlimited, thanks to the foresight of the twelve FR banks in making generous research grants to qualified applicants.

Additionally, the game of “knocking off zeros“ can also be played by any country, big or small, with an equal and fair chance to win. The rules are simple. You could declare one New Peso equivalent to, say, one million old pesos, knocking off 6 zeros right there and then with one mighty swoop, and a crispy one New Peso note could be printed to replace one million of the old variety. In the game of knocking off zeros the current world champion is Yugoslavia, eliminating 22 zeros in 1994. The runner-up is Argentina that has gone through 13 zeros so far. A recent upstart is Romania with 4 zeros. Not bad, considering that Romania is the only former Soviet satellite having started its “free market economy“ in 1991 with no foreign debt whatsoever!

Recitativo

The current world monetary system assigns no special role to gold. Indeed, the Federal Reserve is not obliged to tie the dollar to anything. It can print as much or as little money as it deems appropriate. There are powerful advantages to such an unrestrained system. Above all, the Fed is free to respond to actual or threatened recession by pumping money. To take only one example, that flexibility is the reason that the stock market crash of 1987 — which started out every bit as frightening as that of 1929 — did not cause a slump in the real economy.

Rondo

Rub it in, Krugman, rub it in! To the injury of trampling over their Constitution you now add the insult of telling the American people that it makes judicial and economic sense to give a banking cartel the privilege of issuing liabilities it has neither the means nor the intention to honor!

Your example stinks to high heaven. The stock market crash of 1987, just as the one of 1929 before it, were caused precisely by granting privileges without responsibilities to the banking cartel. For damage control you now advocate putting the fox in charge of the chicken coop. Has it not occurred to you that dirt swept under the rug keeps accumulating until it reaches critical mass, at which point damage control no longer works, but further accumulation will start the chain-reaction of dirt explosion?

Recitativo

While freely floating national money has advantages, however, it also has risks. Countries with a history of runaway inflation often come to the conclusion that monetary independence of the central bank is a poisonous chalice. A system that leaves managers free to do good also leaves them free to be irresponsible and, in some countries, they have been quick to take the opportunity.

Rondo

“Some” should read “all”. First and foremost among those managers were the officers of the Federal Reserve. Children of a lesser god could not make their fiat money command purchasing power abroad. The United States could. Accordingly, managers of the dollar were double-quick to take the opportunity to be irresponsible with the unlimited power they have usurped, as the diluted dollars still found eager takers abroad, especially in the Third World.

The Constitution of the United States was born of the ashes left behind a runaway inflation, that of the Continental Dollar, although it is not considered polite behavior to mention this bit of history in the presence of practitioners of the dismal monetary science. Thus, then, following Krugman’s logic, we may conclude that the United States has gulped down most of the content of the poisonous chalice. It just takes longer for the poison to act in this case than it would in the case of the children of a lesser god. Be that as it may, we can be sure that there is no way to make monetary managers possessing unlimited power to behave responsibly. Indeed, such a behavior even defies definition, as the last Interlude below will show.

You just don't delegate unlimited power to anyone, be they politicians elected with large majorities, civil servants, hired experts, appointed judges, or even altruists and saints. You don't calculate the odds whether unlimited power will be exercised responsibly or irresponsibly. If you are sensible, you will adopt a Constitution based on the principle of delegating limited and enumerated powers only, complemented with checks and balances. Then you keep your fingers crossed lest the powers that be won't trample over it. To keep your Constitution alive and well is going to be an uphill battle still. Professors of dismal monetary science may pop in and chalk up differential equations to prove that great danger will befall the world, in the form of oversaving and overproduction, unless their sponsors are granted unlimited power to pump money in rapid response to recessions, actual or threatened. With that power, the professors say, they will be able to abolish the business cycle and, with a little bit of luck, scarcity, too, and will wipe out the difference between credit and capital to boot.

Interlude

In the comedy masterpiece written in 1673 by the French playwright Molière entitled Le malade imaginaire the protagonist, Argan, is a hypochondriac. No physician can convince him that there is nothing wrong with his health. Finally, in desperation, someone suggests that he himself become a Doctor of Medicine. Then he will be able to find out what is really ailing him and what to do about it. Argan takes the advice, and the M.D. examination, which may go as follows.

> *Examiner:* What therapy do you apply in case of constipation?
>
> *Argan:* I prescribe enema.
>
> *Examiner:* What if it is a stubborn case?
>
> Argan: Definitely more enemas.
>
> *Examiner:* A most excellent answer! What therapy do you apply in case of diarrhea?
>
> *Argan:* I prescribe enema.
>
> *Examiner:* But what if the condition persists?
>
> *Argan:* Definitely more enemas, Your Honor!
>
> *Examiner:* A most excellent answer indeed! Congratulations! You have met the requirements for the Degree of Doctor of Medicine. Welcome to the Club!

Rondo

Exactly as in Le malade imaginaire, dismal monetary science prescribes enemas of new money to be injected into the economy in case of a deflation, actual or threatened, in order to prevent prices from falling. But it also prescribes enemas of new money to be injected into the economy in case of an inflation, actual or threatened, in order to prevent interest rates from rising. In this way money-doctors cannot be held responsible for the treatments they decide on except, perhaps, to suggest that they have failed to administer an adequate number of enemas to their patient.

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