

# THE GOLDBUG, VARIATIONS II

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## Recitativo

Gold is just another metal. If it sometimes seems to be more, that is only because society has found it convenient to use gold as a medium of exchange - a bridge between other, truly desirable, objects.

## Rondo

Society has also found it convenient to use gold as a medium of savings. The demand-side theory of money of Keynes has not succeeded, after 70 years of intensive brain-washing and indoctrination, to wean society from the idea that money must unite in itself *two* properties: those of a medium of exchange and a medium of savings. This gold does admirably well, in fact better than anything that has been recommended in its place. Gold is not just another metal. It is the monetary metal *par excellence*.

Money promoted by the dismal monetary science of Krugman is a singular failure in that it loses at least 90 percent of its purchasing power in every generation, or 35 years, and its protagonists can do absolutely nothing about it. Nor is it wear and tear that is responsible for the miserable record of the irredeemable dollar. The loss of purchasing power has not been dissipated in the universe without a trace. Where has it gone? According to the principle of conservation of matter, it must still exist. This is a question Krugman dare not confront. Well, I have asked it and shall answer it, too. What appears as a loss of purchasing power is value that has been embezzled. That's right, embezzled through a deliberate scheme designed to throw dust into the eyes of the victims. It is the check-kiting scheme between the Federal Reserve banks and the Treasury of the United States.

Check-kiting is a conspiracy, generally between two banks. They are issuing checks which they haven't got the means or the intention to cover. That is to say, the checks are issued fraudulently. They issue them with the criminal intent to tap the float, the mass of checks in the process of clearing, and so to defraud the public. The checks issued by Bank *A* are cleared at the clearing house through earmarking the checks issued by Bank *B*, and *vice versa*. In more details, the first unbacked check is "backed" by an infinite string of subsequent unbacked checks.

The gold standard makes check-kiting highly unlikely to succeed. That is one of its chief merits. Every individual using gold substitutes such as checks, bank notes, or bank deposits can apply the "bubble-test" at any time: he can demand payment in specie. It is a basic human right to protect oneself against would-be criminals. To be able to exercise this right there must be an *ultimate* means of payment. Under a gold standard it is the gold coin of the realm. The regime of irredeemable currency has no ultimate means of payment, nor can it have one. Before Krugman interrupts me objecting that the Federal Reserve notes *are* the ultimate means of payment under the monetary system he is pushing, I hasten

to add that the Federal Reserve notes themselves are the product of a cleverly designed and disguised check-kiting scheme. Government coercion can make the Federal Reserve notes legal tender, but it can hardly make them the ultimate means of payment. There is a difference. An ultimate means of payment cannot be legal tender because it must be *voluntarily* accepted in final settlement of debt, while legal tender implies *coercion*.

To the best of my knowledge no one before has pointed out that the origin of Federal Reserve notes and deposits, as they are presently issued, is fraud and conspiracy that goes by the popular name of check-kiting. I want you to know that I am not making this charge frivolously, and I stake my professional reputation in support of it. People in the United States are inclined to believe that it is not possible to cover up theft, fraud, and conspiracy by legislation. But it is. I got my education, including the first university degree, under a Communist regime in Soviet-occupied Hungary, where legislation was routinely used to "justify" the violation of virtually every basic human right. If you think that it cannot happen in your country, then you are kidding yourself.

The original Federal Reserve Act of 1913 nowhere mentions open market operations whereby the central bank can inject new currency into the economy through purchases of government bonds. Monetization of government debt was not authorized. In fact, government paper was explicitly made ineligible for use as a reserve to back Federal Reserve notes and deposits. Those liabilities had to be covered by gold coins to the extent of no less than 40 percent; and the remainder by short-term self-liquidating commercial paper. If a Federal Reserve bank was short of gold or eligible paper to cover its outstanding note and deposit liabilities, and if it used government bonds in its portfolio to make up the shortfall, then a steep and progressive penalty had to be paid. The penalty made it virtually prohibitive to use government paper as cover for the note and deposit liabilities.

Open market operations were introduced clandestinely in violation of the law in the 1920's. It is true that later the Federal Reserve Act was amended to legalize the practice. It is possible that Congress was presented with a *fait accompli* and had little choice in the matter if it wanted to avoid a financial panic in a fragile international monetary environment. Be that as it may, the introduction of open market operations was a serious violation of the law. As it then stood, the law did not authorize it. And for a very good reason, too. If they had leave to do it, then the Federal Reserve banks could conspire with the U.S. Treasury to start a gigantic check-kiting scheme to defraud the public. The Treasury could sell bonds in the open market which it had neither the resources nor the intention to honor. The Federal Reserve banks could then purchase these bonds in the open market paying for them with newly issued currency which, likewise, they had neither the resources nor the intention to honor.

Guess what, this is exactly what happened once gold has been eased out of the system. The proportion of required gold reserves was reduced from 40 to 25 percent of liabilities, first for Federal Reserve deposits, and then for Federal Reserve notes as well. Then gold reserves were eliminated altogether, first for Federal Reserve deposits and then, in 1968 (appropriately enough, on the 35<sup>th</sup> birthday of the irredeemable dollar), for Federal Reserve notes as well. It was done in carefully staggered stages, through four or five separate amendments to the Federal Reserve Act.

There is no valid argument why the Treasury or the Federal Reserve banks should be given the privilege to issue liabilities which they had neither the means nor the intention to honor while the same, if committed by private parties, is treated as a serious crime punishable by severe penalties as specified by the Criminal Code. On the contrary, in jurisprudence the principle of double standard of justice is rejected, not just because it is unfair but, for the stronger reason, because it is self-defeating.

## Rondo

I have said that gold is not just another metal but it is the monetary metal *par excellence*. Nor is this an opinion, subject to dispute. This is an objective fact as I shall presently show. Today gold is still the monetary metal, and as such is immune to efforts by the United States government, or any combination of governments, to "demonetize" it. All that the governments can do is to deprive themselves, and their subjects, of the manifold benefits afforded by gold money.

As money, gold circulates, and circulate it may with various velocities, including the zero velocity. It had happened before, and it has been the case for the past 35 years, that gold "circulates" with zero velocity, meaning that monetary gold has gone into hiding. It typically happens when the Constitutional order breaks down and the administration of justice becomes arbitrary, so that owners of monetary gold have reasons to worry about the safety of their possession. That is what happened during the last decades of the Roman Empire when the government stopped protecting private property against highway robbers. That is what happened during the final stages of the French Revolution when possession of gold coins was made punishable by death. That is what is happening today in the world when private ownership of monetary gold is on a 24-hour basis. When in 1974 the politicians in the United States restored the citizen's right to own and trade gold, they "forgot" to give legislative guarantees that this right will not be disturbed in the future again, using any number of possible excuses, including the fight against terrorism.

Do not be misled by the trading of paper gold on a number of commodity exchanges. Very little monetary gold is involved as compared with the size of the commitments of speculators, and even that is provided by central banks as a way for them to influence the price of gold. In addition, gold miners are driven into the open embrace of the commodity exchanges. Not only are they denied freedom by their creditors, the bullion banks, to market their product as they see fit including withholding it from the markets, they are also forced to sell forward several years of future output, never mind that it is in violation of the laws governing futures trading in general, and the charter of the commodity exchange in particular. I find it hard to lay the blame on the commodity exchanges. They can't very well refuse to honor call options written by a central bank whose balance sheet, showing gold, is supposedly true to fact and open to public scrutiny.

I now come to the proof that gold is still the monetary metal *par excellence* (albeit with zero velocity of circulation). There is one, and only one, fundamental reason for this. It is the fact that *gold has constant marginal utility*. I am not going to quibble whether the marginal utility of gold is indeed constant, or whether it declines at the slowest rate, by far, among all the substances known to man - a fact that even Paul Krugman cannot deny (that is, provided that he is familiar with the concept of marginal utility). For the purposes of this discussion the two formulations amount to the same. At any rate, it is easier to refer to this property

of gold as constant marginal utility, than rattling off the other description, even if it may be more accurate.

The marginal utility of any good used by man declines, with the possible exception of gold. This means that subsequently acquired units of the good in question are earmarked for uses with lower priority than units acquired earlier. Carl Menger, one of the three economists generally credited with formulating this important concept in the late 19<sup>th</sup> century, gives the following example. Suppose an isolated farmer in the rain forests of Brazil brings in five sacks of corn at the end of the harvest. He earmarks the first sack to cover his and his family's need for food until the next harvest. The second sack is seed corn. The third sack he intends to use as animal feed. The fourth sack is for making beer and vodka. The fifth or *marginal sack* he will use to feed the birds around his house whose antics are the only entertainment he and his family have. If he had more sacks available, then they would be surplus that could be used for the purposes of barter. At any rate, the *value* of corn for this farmer would be determined by its marginal utility, that is, the utility of his marginal sack. It follows that if the farmer lost one or more sacks to fire or any other mishap, then the marginal utility of corn to him would go higher. By the same token, if he harvested more sacks, then the marginal utility of corn to him would go lower. The same is true of any other good.

What makes gold coins different is that anyone receiving a number of them will earmark the first and the last coin with the same priority. He can use either one to purchase other goods in the market on exactly the same terms. This property of gold is not due to an accident. It is the result of a long evolution taking several millennia. As gold has been a means of savings in addition to being a means of exchange, and because of its constant marginal utility, the *stock* of gold in existence is huge relative to the *flow* of new gold from the mines (defined as the combined annual output of all the gold mines in the world). The stocks-to-flows ratio for gold is a high multiple, variously estimated between 50 and 80. This means that, at current rates of production, it would take 50 to 80 years to produce the same amount of gold that is now in existence. The stocks-to-flows ratio for all other goods (with the possible exception of silver) is a small fraction. For copper, for example, it is around 0.3 meaning that the available supply of copper is equivalent to about four months' production. If the ratio went higher, the price of copper would most assuredly plummet, because of the relatively fast declining marginal utility of copper, even though it is an industrial metal with lots of uses.

To say that gold is the monetary metal of the world is not an expression of opinion. It is an objective observation justified by the size of the stockpiles of gold, the accumulation of millennia, that are known to exist. They are huge relative to the meager annual flows of new gold from the mines. Indeed, it was an evolution lasting for thousands of years during which the market has made its choice which particular good will have the slowest-declining marginal utility, allowing the accumulation of monetary stocks to take place. By the same token, gold cannot be dumped as the monetary metal by government decree, regardless whether it was countersigned by V.I. Lenin or by F.D. Roosevelt. If gold was really to be demonetized, then the enormous stocks relative to flows would have to be dissipated first through consumption. Literally, you would have to make people eat gold. King Midas couldn't eat it. Lenin and the commander-in-chief of the Cheka with his machine guns could not make people eat it. Not in the 73 years of their control of power in Russia, and not in another hundred years.

It is true that the government can outlaw gold as money, or ban the gold market. It can even forbid or discourage the use of gold in jewelry (as the Indian government may be planning to do according to rumors). None of this will address the crux of the matter: the highest stocks-to-flows ratio for gold, which gives people that superb confidence to entrust their savings to gold, rather than to the gentlemen running the central banks and treasury departments of the world.