THE GOLDBUG, VARIATIONS V

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

The Dismal Monetary Science

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Recitativo

The United States abandoned its policy of stabilizing gold prices back in 1971. Since then the price of gold has increased about 1000 percent while consumer prices have increased only about 250 percent or, roughly, a quarter of the increase in the gold price. If we had tried to keep the price of gold from rising, this would have required a massive *decline* in the prices of practically everything else — deflation on a scale not seen since the Depression. This does not sound like a particularly good idea.

Rondo

What the United States did in 1971 was defaulting on its gold obligations to foreign creditors, the biggest act of bad faith in history theretofore. This default, and the making of the dishonored debt money, was the cause of the destabilization of interest rates, as well as the explosive growth in the volatility of prices that have been plaguing the world ever since and causing ever greater economic distress. Krugman's euphemism in calling the greatest default ever "the abandoning of the stabilization policy of the gold price", and calling the promotion of the dishonored paper as money "a measure designed to prevent deflation and the decline of prices" is doublespeak, the hallmark of dismal monetary science. Krugman suggests that an equilibrium now obtains that didn't before. What we have is not an equilibrium; rather, it is a burgeoning disequilibrium, one that will continue its devastating course.

We must remember that the financial annals do not record a single case in which a default has not been followed by a progressive increase in the discount on the paper of the defaulting banker, until it reached 100 percent — possibly several years or even decades later. Obviously, the defaulting banker would try to slow down the process by hook or crook. However, ultimately economic law was to prevail and the remaining value of the dishonored paper would be wiped out.

There is no reason to believe that the dollar default will end differently. Suppose that the price of gold is $420. Let us calculate the discount on the dollar.The gold value of the dollar has been reduced from 1/35 to 1/420 = 1/12×35. Therefore the loss is

$$(1/35)(1\ \ 1/12) = (1/35)(11/12) = (1/35)0.9166...!$$

In percentage terms the loss, also known as discount, is 91.66 percent. Not yet 100, but close enough. Small comfort, as the last 8.33 percent of the loss, coincident with the death-throes of the dollar, is likely to be most violent and painful, revealing the full extent of the devastation. Remember, the loss affects not only cash holdings, but *all* dollar-denominated assets, including bonds, annuities, pensions, insurances, endowments, etc. As the discount on the dollar approaches 100 percent, the dollar price of gold will approach infinity. To assert that the dollar is going to escape this fate is tantamount to asserting that the laws of economics and logic have been turned upside down, and the penalty for default has been replaced by reward in perpetuity.

Rondo

The discount as calculated above in terms of the price of gold is the leading indicator of the depreciation of the dollar. It is pretty accurate in registering the loss of purchasing power in terms of a wide array of other goods as well. However, it is important to note that the discount on irredeemable currency, although obviously going to 100 percent, is *never* doing it along a straight line. It goes through fits and starts, sprinkled with ever more violent reversals.

Therein lies a great danger. Reversal confuses people and lulls them into believing that the currency has reached the end of skid-row, and is now entering respectable neighborhood. The explosive growth in the volatility of interest rates and prices is finally over. More astute observers will, however, realize that low interest rates and subsiding volatility won’t cure the malady the cause of which, default, has not been acknowledged, still less removed. Nor will asset bubbles cure it. Volatility is bound to return with a vengeance. Like the wrecker’s ball, it will keep swinging until the whole financial structure is reduced to rubble.

A reliable measure of destruction is the so-called “notional” size of the derivatives market trading interest-rate futures, options, and swaps. It now stands at a quarter of a *quadrillion* dollars and is increasing at an accelerating pace. The word “notional” is a euphemism suggesting that there is nothing to fear about it. As if it were a kind of financial mirage. Well, there is plenty to fear about. It is real enough as it measures the commitments of bond speculators, most of whom are betting that the rate of interest will keep falling in the U.S., too, as it has been in Japan. The bets are well-grounded. They reflect expectation that interest rates will be driven by the Fed into the bargain basement. This is what the Fed did in the 1930's, causing the First Great Depression. This is what it is doing now, causing the second. The Fed *buys* bonds in the open market when it wants to combat deflation and falling prices, and also *buys* them when it wants to combat inflation and rising interest rates. If the Fed ever *sells* bonds, the occasion is few and far in between and it is for window-dressing purposes only. Speculators know this and think that they can’t go wrong if they try to preempt or emulate the Fed in *buying* the bonds.

This raises the question: if the deflationary danger caused by the Fed’s open market operations is so great, because it makes bull speculation in bonds risk free, then why don’t economists warn us about it? The answer is that dismal monetary science blocks the free flow of information and an impartial scientific debate of the threat (which is caused by the regime of irredeemable currency alternating, as it does, between inflationary followed by deflationary excesses). During the inflationary excess commodity speculation, and during the deflationary excess bond speculation is bleeding the economy white, but you are not supposed to know.

Recitativo

It is true that a freely floating national money can create uncertainties for international traders and investors. Over a period of five years between 1991 and 1996 the dollar has been worth as much as 120 yen and as little as 80. The costs of this volatility is hard to measure but they must be significant.

Rondo

It is disingenuous to say that in 1971 the United States made the dollar "freely floating". What the United States did was nothing less than throwing away the yardstick measuring value.

It is truly unbelievable that, in our scientific day and age when the material and therapeutic well-being of billions of people depends on the increasing accuracy of measurement in physics and chemistry, dismal monetary science has been allowed to push the world into the Dark Ages by abolishing the possibility of accurate measurement of value. We no longer have a reliable yardstick to measure value. There was no open debate of the wisdom, or the lack of it, to run the economy without such a yardstick.

To throw away gold, a rigid yardstick, and to replace it with a shrinking and elastic yardstick, the dollar, idiotic as though it is, does nevertheless have a rationale as well as a precedent. In less enlightened times the length of the "foot", as the name of this particular yardstick suggests, was adjusted every time the king died. If the new king's foot was smaller, then the new official unit of length was made shorter. This allowed rope-makers, spinners, and weavers to sell a smaller amount of merchandise for the same amount of money. In this way inefficient producers were favored at the expense of the consumers who were legally short-changed.

The floating dollar does exactly the same. It shelters the inefficient producer who is enabled to sell the same quantity of products at progressively higher prices, to the detriment of the consumer at large.

Interlude

During the course of his travels to many strange lands Gulliver also visited the Country of the Mad Scientists. A government spokesman took him on a guided tour in order to acquaint him with the marvelous achievements and great projects of that land. Among others Gulliver was shown a new procedure under development whereby the erection of buildings would start with the construction of the roof rather than the foundations and proceed from top down. In this way shelter was provided for construction workers in inclement weather.

In another part of Science City, the capital, Gulliver visited an experimental farm where research scientists were simultaneously breeding woolless sheep and milkless cows. They were motivated by the idea that the output of sheep milk could be increased greatly through the elimination of wool growing, thus making cow's milk redundant. Wool for clothing could then be replaced by the sturdier cows' hair, that could also be shorn more efficiently.

There was one invention in particular that fascinated Gulliver more than any other. They called it "floating time". At the Institute of Horology the director explained that the idea of fixity of time is old-fashioned, even reactionary. In this respect musicians have been more progressive than scientists. They had long ago overthrown constant time, leaving its variation to the discretion of the conductor. Now he could set free the emotive energy implicitly present in the music, the release of which was forbidden by an earlier narrow-minded and reactionary age.

Floating time was implemented by connecting Big Ben in one tower of Parliament Building to Big Barb, the weather vane, in the other. Every time the direction of the wind changed, turning Big Barb one way or another, so did time, as indicated by a slow or a fast Big Ben. The director proudly pointed out that in this way their timepiece was imbued with cosmic power present in the universe, including sun spots and sun flares that have so far been foolishly ignored by clockmakers, but not by the wind.

The director was going to let Gulliver inspect the ingenious mechanism that made floating time possible. It would allow the Chairman of the Board of Time Reserve to overrule the prevailing wind whenever justified. At the Parliament Building they ran into the picket line of workers demanding higher wages. At that moment the town clerk announced that the direction of the wind has just turned Westerly, meaning that Big Ben would run fast, cutting the hour down from 60 minutes to 50. The workers burst into joyous cheering. They understood that the working day has been instantaneously shortened 16 percent by the change of the wind, without reduction in pay. The strike was called off. The director turned to Gulliver and winked: “See what I mean? Floating time is helpful even in settling labor disputes!”

Finale

The great 20th century economist Ludwig von Mises famously predicted, shortly after the consolidation of Bolshevik power that, unless private ownership of the means of production was reestablished, the economy of Russia would collapse. Without valid market prices for the means of production businessmen could not do the necessary economic calculations as to what, when, and where to produce, and how much to invest in production facilities, so rational allocation of scarce resources was no longer possible. For a while the economy could limp along but, eventually, the compounding of bad economic decisions would lead to so great an economic distortion that sudden death would become inevitable. Well, it took three and a half score of years to reach the threshold beyond which economic abuse caused by bad decisions could no longer be tolerated, and the prophecy was duly fulfilled.

Mises made another famous prediction. If the United States left the gold standard, and failed to stabilize the dollar in terms of gold soon thereafter, then a “crack-up boom” would follow and the dollar would lose all its purchasing power, first internationally, then domestically. This prophecy has not yet been fulfilled but, as the Soviet example shows, sometimes you have to be patient when waiting for Mises’ predictions to come true.

Unfortunately, Mises justified his prophecy about the dollar in terms of the Quantity Theory of Money, which is a linear model and is not applicable in a non-linear world such as ours. He should have argued in exactly the same way as he did in predicting the demise of the Soviet Union. If the United States threw away the yardstick measuring value, namely the gold dollar, then businessmen could not do the necessary economic calculations as to what, when, and where to produce, and how much to invest in production facilities, so rational allocation of scarce resources would no longer be possible. For a while the economy could limp along but, eventually, the compounding of bad decisions would lead to so great an economic distortion that sudden death would, in the fullness of time, become inevitable. We don't know where the threshold is beyond which the economic abuse caused by bad decisions can no longer be tolerated. What we do know, however, is that economic abuse cannot continue indefinitely, as the Soviet example so convincingly demonstrates.

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The trouble with Krugman's dismal monetary science is not that it can err. The trouble with it is that it functions as a "thought police". It intimidates people in their pursuit of searching for and disseminating truth, and it bribes others to push propaganda as science.

Over a month ago I issued a challenge that Krugman open the columns of *The New York Times* to an impartial discussion of the future of the irredeemable dollar. I have evidence that the challenge has reached his desk.

It only remains for me to report that I have received no answer to my challenge.

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