"GOLD STANDARD UNIVERSITY"

THE GOLDEN THORN IN THE FLESH

Concluding Part of a Series of Two

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The topsy-turvy world of central bank gold sales

Here is a passage from my 1998 book entitled *Gold and Interest* that will soon be released as an e-book.

As these pages are written (late 1997), chrysophobes make much of the weak dollar-price of gold and of the fact that more central banks, including the Swiss, join the company of those that have been dumping gold on the market. In addition, self-styled experts on deflation submit that, while under an inflationary spiral gold hoards may have been a reasonable investment, gold is the worst possible place to be under a deflationary spiral.

It is undeniable that the gold market has been highly charged psychologically for the past thirty years. This will likely continue into the 21st century. It is also true that the great bull market in bonds that started in 1980 has so far coincided with the great bear market in gold. From a high of $850 in 1980 gold went to a low of $ 285 in 1985 and is trading near the low end of that range at the time of writing. However, it does not follow from this that the gold bear must march hand-in-hand with the bond bull, or that they must expire together. There are reasons to believe that the gold dumping is orchestrated and is meant as a scarecrow tactic. A central bank advertising its future gold sales stinks: it cannot be sincere about its real intentions. As every student of the market well knows, *selling at low and falling prices is a sign of weakness - never a sign of strength.* Central bank selling of gold is no exception.

Hecatomb of currencies

At this juncture the gold market is a mere side-show. The main show is the foreign exchange market where a clandestine trade war is being waged. Presumably there will be a lot of casualties in the form of fallen currencies before it is all over. The dollar, for the time being, is the obvious refuge for the victims of the *hecatomb* of currencies. This makes it appear strong. But the dollar has its own problems. First, it suffers from exactly the same ills that are plaguing all falling currencies. Second, the American political establishment has a very low tolerance for a strong dollar. Recall that in 1985, under a conservative President, the dollar was diagnosed 'too strong' and was subsequently scuttled - making the price of gold rise from its lows. Rumors of the demise of gold are grossly exaggerated. At the risk of belaboring the obvious I would like to make the following points.

The only financial asset that is nobody's liability

The volatility of the dollar-price of gold is not a reflection of the uncertainty in the value of gold. It is in fact a reflection of the uncertainty in the value of the dollar in which the gold price is quoted. A lower gold price shows a momentary strength of the dollar; not a reluctance on the part of people to hold gold. Nobody is suggesting that the world no longer needs a financial asset that is nobody's liability.

A currency immune to debasement, default, and devaluation

The lower gold price also reflects the reluctance of the people to put the central bankers out of their misery. After all, they could call the bluffing of central bankers at any time if they wanted to. For the time being they don't. Central bank gold dumping may or may not be good politics, but it is certainly poor economics. Gold is the only sound asset in the balance sheet. It is the *only* asset in the balance sheet that is not at the same time a liability in the balance sheet of someone else. For this reason, gold is immune to deliberate debasement, defaults or devaluations. By contrast, dollars in the balance sheet represent irredeemable promises to pay, with the obligor having a history of deliberate debasement, defaults and devaluations. When a central bank discards a sound asset from its balance sheet at a low price, and replaces it with a dubious one at a high price, it makes its own currency weaker, not stronger. It is especially foolish to do this at a time when the world is entering shark-infested waters where the sharks are preying on paper currencies.

Central bankers making themselves the laughing stock of the world

We must distinguish between gold sales by a weak central bank from that by a strong one. A weak central bank prefers to conduct its gold sales in perfect secrecy. It does not want the world to know about the timing and the extent of its selling program lest the market's unfavorable reaction cause the proceeds from the sale to suffer. Even so, the market has an uncanny way of bringing down the gold price ahead of the sale just long enough to accommodate the central bank eager to unload its gold, only to put the price back up once the sale is completed. By contrast, a strong central bank wants to show off that its gold is 'surplus'. All the same, the central banks has to proceed carefully lest it become the laughing stock of the world in selling its patrimony for a pittance. Embarrassing questions might be asked such as this: "why is it that central bankers always sell at the bottom, and never at the top?"

Hidden agenda?

Especially suspicious is a central bank drumming up its proposed sales. It is the height of incompetence and ineptitude to proceed this way - unless the central bank has a hidden agenda. It may want to camouflage its intention *to buy*, so it is bringing down the price to facilitate its purchasing program.

External demand for dollars

The strength of the dollar, such as it is, is entirely due to external demand. This demand is, as it has been since 1971, subject to withdrawal without notice. Internally, there is nothing to justify the strength of the dollar. There is no end in sight to U.S. trade deficits. All the optimistic predictions about eliminating the U.S. budget deficit that have been made in the past turned out to be ill-founded. It remains to be seen whether the latest optimistic prediction is better founded. If the deflationary cancer metastasizes across the Pacific, as appears likely, then the present falling trend in the U.S. budget deficit could make a nasty U-turn. The U.S. is still the greatest debtor in the world and in history. And it is still true that nothing comes from nothing.

Misunderstanding economics and mismanaging public resources

The current rush of central banks to sell their shrinking gold assets in the face of their burgeoning liabilities is just another case of misunderstanding economics and mismanaging public resources as completely as only government bureaucrats can misunderstand and mismanage them.

35 years of Keynesian and Friedmanite agitation for confetti money

The folly of central bankers and Treasury officials managing the patrimony of their countries in the face of gathering storm is unprecedented. This is the result of 35 years of Keynesian and Friedmanite agitation in favor of irredeemable currency, and the systematic badmouthing of sound economics, finance, and debt-management. I am grateful to Dr. Theo Megalli of Germany for translating into English a paper of the late Hungarian monetary economist Melchior Palyi with the title *Gold Standard and Economic Order* that appeared in the book *Geld, Kapital und Kredit* - Festschrift for the seventieth birthday of Heinrich Rittershausen (Stuttgart, 1968) from which the following quotations are taken.

The Gold Standard and economic order

The gold standard was sacrosanct to generations brought up on Adam Smith's ideal of the free market, free, that is, from arbitrary and discriminatory intervention by the powers that be. Indeed, it was an essential instrument of economic freedom. It protected the individual against arbitrary government measures by offering a convenient hedge against confiscatory taxation as well as against currency depreciation and devaluation. Gold provided essential mobility of funds beyond national boundaries. Above all it raised a mighty barrier to authoritarian interference with the economic process. In the words of Adam Smith: "That insidious and crafty animal calling himself 'statesman' whose councils are guided by the momentary fluctuations of affairs" was forced to keep the national budget in good order. Authoritarians of all denominations had to control their inflationary propensities and to refrain from excessive taxation in order to forestall the loss of confidence in the currency on the part of the people. The public purse had to be held tight. The business community had to learn to live with the salutary threat that illiquidity caused by short-sighted over-investment and irrational speculation could be penalized by loss of gold and an automatic tightening of the money-supply.

The gold standard in the classical sense was part and parcel of an economic order. It was the corner-stone of the system of public law, social customs and institutions that Marx pejoratively called "capitalism" - a system that rested on nearly unlimited freedom of consumer choice, of enterprise, and of markets…

Unity of the economic world

The meaning of the gold standard - with unrestrained and uncontrolled private ownership of gold - cannot be appreciated in isolation from the institutional and psychological background that characterized the civilized world in the decades before 1914. The outstanding feature of that period was the unity of the economic world as it has not been achieved before or thereafter.

Quoting from Oscar Morgenstern's *International Financial Transactions and Business Cycles*, New York,1957, pp 17-19: "There was freedom of travel without passports, freedom of migration, no exchange controls or other monetary restrictions. Citizenship was freely granted to immigrants… capital could move unsupervised in any direction, and these movements could take any form… International trade had to overcome tariffs, yes, but… tariffs were exceedingly low. There were hardly any qualitative restrictions on international trade (quotas, import prohibitions, etc.)… It was a world of which recently many… would have been inclined to assert that it could not be created because it would never work…"

It was a world of low wages and lower still prices. Taxes were almost nominal. It was a world in which virtual freedom of enterprise, 'workable' competition and highly flexible wage-price structures prevailed in which private property and contracts were held inviolable. Defaulting governments had to face boycott or worse.

It was a world, by and large, of balanced national budgets. Public debt had to be amortized as a matter of course, just as private debts had to be repaid. Fiat money was anathema. Emergency public expenditures were financed by long-term bonds. There was no monetization of public debt.

A world of steady real growth

Above all, it was a world of steady *real* growth - at an average annual rate of 5 percent during the six decades before 1914 - of steadily rising living standards for the masses, with 'social security' provided by the automatic protection of savings…

The role of the gold standard in unifying the civilized world can scarcely be overestimated. It was the *sine qua non* opening up the world for economic progress, for the diffusion of modern civilisation. Capital flows that were instrumental could allow the gold standard to operate with a minimum of actual gold transfer and with relatively modest gold reserves. The gold standard presupposed a high degree of freedom in foreign trade helping the debtor nations in liquidating their debt through exports to the creditor…

Throughout the 19th century most major central banks remained privately owned commercial institutions and were supposed to conduct themselves as financial enterprises - to earn profits. They were to "suffer" the impact of gold flows, rather than influencing them…

Real Bills - the safest earning asset

In Britain, the Banking School argued that no authoritarian control or discretionary power was needed to sustain the balance between the production of marketable goods and the creation of currency. Enlightened self-interest would compel the central bank to maintain the liquidity of its earning assets that were to consist of "real bills", that is, short-term self-liquidating commercial paper growing out of the actual sale of goods.

The Currency School on the other hand doubted that stability could be guaranteed by asset liquidity rules which, notoriously, could be violated when most needed - at times of business upturn and rising prices. Adherents of this school believed that the money-creating power of the central bank was the crux of the situation and insisted on curtailing this power by requiring 100 percent gold reserve for the note issue. The idea was that the automatism of the gold standard was to be preserved by putting the central bank into a strait-jacket. The volume of the outstanding note issue was to expand and contract in exact proportion with the inflow and outflow of gold.

The Currency School won a Pyrrhic victory in 1844. By the Peel Act the Bank of England was obliged at all times to maintain 100 percent gold reserve behind its note issue beyond a modest amount… But the necessity to suspend limitation on the note issue in the monetary panics of 1846, 1858 and 1867 taught that tying the Bank of England to a formula was a senseless undertaking. Not only did the Peel Act fail to extend the 100 percent reserve requirement to the central bank's deposit liabilities, which grew faster than the note liability, but the tying of the bank's hands behind its back, as it were, left the problems of monetary policy unresolved.

The flame of liberty

Before World War I economic considerations dominated political agenda, not the other way around. Wars could not be waged to the bitter end, bankrupting vanquished and victors alike. Peace following war was genuine, rather than a continuation of hostilities through other, economic means. The vanquished were allowed to recover through hard work and hard saving, thanks to the operation of the gold standard.

All this was to change with the outbreak of World War I. Economic considerations were sacrificed on the altar of political expediency. A new regime, one of prepetual and total war was inaugurated. When the gold standard refused to play along, it was given a bad name, and a dishonorable discharge. People were not consulted. Through a series of confidence tricks they had been weaned from the gold coin. The Warfare State went all out to bribe the electorate with the newly-invented Welfare State. The golden thorn in the flesh of the establishment remains. The Constitution of the United States of America, primarily because of its monetary provisions, was thrown to the winds. The powers that be wanted to unshackle themselves in preparation of enslaving the American people. Confiscation of the gold coin of the people was the necessary first step. Trying to bribe people with an avalanche of confetti money was the second.

If the flame of liberty is to flare up again from the ember barely glowing underneath layers of ashes left behind by a century of total war, it will be thanks to the indelible mark that the gold standard, once the epitomy of unity of the entire civilized world, has left on human affairs as no religion, ideology, literary or scientific movement ever did.

Gold Standard University

Session Two is scheduled for August 15-29, 2007, in Szombathely, Hungary. It will include a blue-ribbon panel discussion under the title *The Last Contango: the First Sign of Disintegration of the International Monetary System*, on the gold/silver basis as a most sensitive market indicator that is being developed by a team of researchers. For further information please contact: GSUL@t-online.hu .

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