THE MYTH OF THE NEW AMERICAN GOLD STANDARD

"The Dismal Monetary Science"

by Antal E. Fekete,
Professor, Memorial University of Newfoundland
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Introduction

In 1999 *The New York Times* ran an obituary of the "barbarous relic" from the pen of Floyd Norris under the title "Greenspan Has Become the New American Gold Standard" (op-ed page, *International Herald Tribune*, May 5, 1999). It alleged that the process of removing the glitter from gold has been a gradual but inexorable one and the world was more than happy to accept the greenback backed by Greenspan (no pun intended), just as earlier it had accepted the yellowback backed by the precious yellow. The earmark of the new millennium is people's unshakeable faith in the dollar. My rejoinder suggesting that "rumors about the demise of gold were grossly exaggerated", written over six years ago, is reproduced below. It goes without saying that *The New York Times* refused to publish it. The occasion for publishing it now is the impending historic changeover from the Greenspan standard to the Bernanke standard.

Green cheese factory on the Potomac

There is nothing new about premature obituaries for the gold standard. In 1936 John Maynard Keynes noted in the book that has made his name world-famous (The General Theory of Employment, Interest, and Money; Macmillan, 1967, p 235) that people habitually scramble for gold, which is to say that they crave for the moon. But the government cannot let them have the moon. A good central banker, by definition, is one who can persuade people that green cheese (sic!) is practically the same thing, and will go on to parcel it up and dish it out for their delight and satisfaction. Nomen est omen: Greenspan was destined to be the first (and probably the last) green cheese monger on the Potomac. Mr.Greenspan certainly understands gold and the reasons why people habitually scramble for it. He also understands why the government wants people to take green cheese for gold. It is not my intention to ridicule the deep-rooted yearning in the human psyche for Santa Claus. But to me, instead of cutting a happy figure of Santa Claus, Mr.Greenspan cuts the sorry figure of the Sorcerer's Apprentice. He learned the magic word how to start green cheese production; his tragedy is that he has forgotten to learn the other magic word how to stop it when enough is enough. Apart from that, the problem is that too much green cheese is not good for you. It may cause diarrhea (inflation) and constipation (deflation), although it is impossible to say in which order.

Competition of gold to irredeemable promises is too telling for comfort

According to Norris, gold's reputation as a store of value has been eroded while its price fell by more than two-thirds from $873 in 1980 to $251 in 1999, in contrast with the Dow which at the same time increased more than 12-fold. This is not a new story either. Gold's reputation as a store of value had been eroded many times before, to wit, during such historical episodes as the Tulipomania, the South Seas Bubble, the Mississippi Bubble and, more recently, during the Roaring Twenties of the Twentieth Century.

Norris informs his readers that the IMF is to sell "surplus" gold, a move applauded (ordered?) by the U.S. Treasury, to help finance the laudable program to forgive debts owed by the very poor countries. He explains that money from gold sales is to be invested in U.S. Treasury securities and the income from the investment will pay off the loans. He concludes that "gold, which does not pay interest, is a lousy investment".

Here Norris betrays how badly misinformed he is. As every central banker and gold miner knows, gold can earn interest even in the Twenty-First Century, provided that you can find trustworthy borrowers. It is true that the interest rate on gold loans (euphemistically called the "lease rate") is but a small fraction of what the U.S. Treasury is forced to pay on its debt. Yet this does not make gold a lousy investment. Quite the contrary, it is this very fact that makes gold such a superb investment. Financial writers ought to know that yield varies inversely with quality. By Norris's logic a government bond is a lousy investment in comparison with a junk bond because the yield on it is lower. The reason why the U.S. government is so anxious to push gold out of the international monetary system is that the competition gold offers to irredeemable promises is too telling for comfort. The fact remains that when a central bank or the IMF sells gold, it is replacing the best kind of monetary asset, one that is nobody's liability, with the worst kind: the irredeemable promises of devaluation-happy governments. In selling gold central banks and the IMF make their balance sheet weaker, not stronger.

Why strong central banks fall over themselves to sell gold

Norris gleefully reports that the Swiss National Bank has also joined the "let's junk gold" contest. He mockingly adds that the Swiss defection is not unlike Rome embracing Protestantism. Of course, he fails to mention that the Swiss were put under duress: Paul A. Volcker was dispatched to Zürich to twist their arm. Even so, I concede that an explanation is in order. When a weak central bank is selling gold to meet its maturing liabilities, it is acting logically. It is using gold to maintain its credit standing. That is what gold is for. But when strong central banks, such as the Swiss National Bank and the Bank of England are falling over themselves to sell monetary gold from reserves under the full glare of publicity, knowing that the inevitable result of the fanfare will be the worst sales price for the asset on the block, then logic is turned upside down. The lame explanation that gold sales are designed to raise funds to perform good deeds is for simpletons only. If the motif were really charity, then there would be all the more reason to cut out glare and fanfare, lest the trustees open themselves to charges of unfaithful stewardship. We are fully justified in looking for a hidden agenda. I do not pretend to know the real reason for this "negative gold rush". I can only speculate: central banks are desperately trying to prevent a melt-down threatening the financial system. This crisis is largely unknown to the public, even though it is potentially more damaging than any previous one in the 20th century. It has to do with "naked" selling of call options on gold bullion and other forms of forward sales by banks. This activity has been officially encouraged by government as a way to finance the stock market and real estate bubble, the bursting of which would cause great damage to the world economy. Central bank gold sales are designed to bail out short interest in a futile effort to stave off a corner in gold.

What maintains the value of irredeemable promises

Norris does say that gold has once served as protection against government plunder through deliberate currency debasement. Moreover, he admits that there is still plenty of it going on in the world. But he contends that, with Mr. Greenspan in charge of green cheese production and distribution, the answer to the problem is no longer gold. It is, in the lingo of the day, "dollarization", a sort of gold standard without gold. This is not a new story either. In the 1960's governments were experimenting with what they used to call "paper gold".

In order to appraise the idea of putting the whole world on a dollar standard, we may recall some basic facts. The American dollar is an irredeemable promise, no better and no worse than the Russian ruble. The value of either stands or falls on one thing, and one thing only: the support of currency speculators. It is a fable that the difference between the dollar and the ruble is the difference between the professionalism of the Fed and the dilettantism of its Russian counterpart. Exactly the same knowledge is available to central bankers in Moscow that is available to Mr. Greenspan in Washington. Before currency speculators decide which currencies to support and which ones to dump they look at three factors as follows, in the same order of priority: (1) the balance sheet of the central bank issuing the currency; (2) the trade accounts of the country; (3) the history of the government honoring its promises to pay. On the last two counts the dollar is an unmitigated disaster. The U.S. has been running a horrendous trade deficit for decades which still keeps growing. Twice in the 20th century the U.S. government broke faith with its creditors: in 1933 it defaulted on its domestic and, forty years later, in 1973, on its international obligations. In the latter instance the U.S. government was the perpetrator of the debasement of all the currencies of the world, in wiping out more than 90 percent of the purchasing power of the dollar in less than a decade, including the non-gold reserves of central banks - the greatest monetary destruction on record.

The only count on which the dollar still shines in comparison with the irredeemable promises of other central banks is the balance sheet of the Federal Reserve banks, showing a higher ratio of gold assets to liabilities. In fact, one reason why American officials are pushing other governments to get rid of their gold while they themselves hang on to the "barbarous relic" is that, thanks to Mr. Greenspan's tutorials, they understand the role of gold in the balance sheet. They understand that the moment American gold reserves cease to be second to none speculators will unceremoniously dump the dollar. In the meantime the more other central banks can be pushed around to get rid of their gold the better it will be for the political, economic, and military hegemony of the United States.

Investment or insurance?

The discriminating observer would look at gold not just as an investment the glitter of which can be tarnished by central bank gold sales. He would also look at it as an insurance against disaster caused by recklessness at the helm, whether the boat of the world economy is run onto a reef or whether it is run into an iceberg. For the prudent, gold is an insurance policy the importance of which increases with the dangers and uncertainties growing in the world with the passing of every day. The price of gold is of secondary importance. A low gold price simply means that insurance is momentarily cheap. Why is it cheap? To put it bluntly, it is cheap because foolish people are selling their life-savers while staring at the iceberg which is about to hit the "unsinkable" Titanic. However, as long as some people are willing to hold on to their life savers, gold cannot be demonetized through wishful thinking.

This exposes the myth of the "new American gold standard". It is solely based on the hoard of fraudulently and unconstitutionally confiscated gold which the American government still retains while exhorting other governments to get rid of theirs.

Little needs to be added to update this piece written over six years ago. At the close of the Greenspan Fed the boat of the world economy is still buffeted between Scylla (inflation) and Charybdis (deflation). If it is not smashed to pieces on the rock of Scylla, then it will be sunk on the reef of Charybdis. Part of the myth is that we are having low inflation thanks to the adroitness of helmsman Greenspan. However, as the new helmsman Bernanke has warned, deflation may well be the greater danger of the two. He is getting ready to load the helicopters for the dollar-drop while gearing up the printing presses for a fresh run.

In spite of all the anti-deflationary maneuvers the Bernanke standard is still vulnerable to deflation. This is because Mr. Bernanke, who is a devout believer in the quantity theory of money, sees the essence of deflation in falling prices rather than in collapsing demand and its corollary, vanishing pricing power. Obviously, the printing-press remedy of Mr. Bernanke does not address these. Because of collapsing demand and loss of pricing power, businessmen will remain lethargic regardless how much manna is dropped from Bernanke's helicopters. The dollar bills will be picked up by speculators who thereupon join the Fed's mad spending spree in the bond market offering risk-free bets. The result will be falling interest rates further deepening the deflationary crisis.

This is not to say that Bernanke's helicopters cannot frighten the speculators. They certainly can. If and when they do, speculators will dump bonds, currency, and all. Mr. Bernanke is confident that he can cure deflation through hyper-inflation. He cannot. Under hyper-inflation the currency is losing value faster than can be replaced by printing more of it. That is precisely the difference between inflation and hyper-inflation. It spells further decline of demand and vanishing pricing power, that is, more deflation, not less.

The success of the Greenspan standard was due to Mr. Greenspan's steadfast refusal to authorize plans to sell U.S. gold. The downfall of the Bernanke standard will follow Mr. Bernanke's decision to authorize it when he finds, much to his chagrin, that hyper-inflation is no cure for deflation.