# CUT THE GORDIAN KNOT:

## Resurrect the Latin Monetary Union



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The sovereign debt problem, especially as it threatens Greece, Italy, Spain and through them the entire European Monetary System, is like the Gordian knot. Moreover, the solution is similar to that of Alexander the Great. He thought of doing something nobody before him did, and nobody after him could: he drew his sword and cut the knot. The solution of the Gordian knot of the European Monetary System is very similar, except there is a little extra secret. *It would not work unless the sword was made of gold*.

During the recent protracted debate about raising the debt-ceiling in the United States not once was the word 'gold' uttered. That is an indication of the I.Q. of American politicians. Are their European counterparts any better? Possibly. They at least understand that gold and debt go hand in hand. Debt within reason, that is.

A proper diagnosis of the debt crisis reveals that *the world's payments system as it is presently constituted lacks an ultimate extinguisher of debt*. The pipe dream that the fiat dollar or the fiat Euro could serve as such was shattered as the Great Financial Crisis unfolded. When paying debt with dollars, the debt is *not* extinguished. It is merely transferred from the debtor to the U.S. Treasury. Transferring debt is not the same as extinguishing it. There is a saturation point which, when reached, will cause the welcome-mat for the dollar withdrawn. This is nothing new: the world was treated to the dress rehearsal already forty years ago: in 1971. At that time finance ministers and central bankers succeeded in convincing people that the secret of turning the dollar into an ultimate extinguisher of debt is Milton Friedman's formula: the stock of dollars must not be increased faster than the cabalistic rate of 3% per annum.

Then they did some fancy footwork in redefining money supply to make 7% look more like 3%. When that did not work, they tried heroically to push interest rates down all the way to 0, following the script of John M. Keynes. That worked for a time, until it bankrupted weaker countries such as Portugal, Ireland, Italy, Greece and Spain that could no longer sell their debt in competition to U.S. Treasury debt the value of which has been increasing for the past 30 years.

No matter how you look at it: there is only one ultimate extinguisher of debt that always works, rain or shine, war or peace, and that is gold.

But gold could not perform its ordained function of discharging debt if it is locked up in central bank vaults, while debt keeps piling up in the world economy in want of an ultimate extinguisher. What's going on? Well, doctrinaire economists prevent gold from entering the monetary bloodstream. Governments are brow-beaten if they as much as uttered the word 'gold'. Their knee-jerk reaction is to follow the Keynesian-Friedmanite script.

Greece, Italy, Spain are great nations. They have talented and hard-working people, first-rate institutions, they have some exquisite natural resources, including sunshine and the best tourist-destinations in the world. They've also got gold. What they don't have is a *gold income* − but that's through their own fault.

My message to them is: don’t let doctrinaires blind your vision and steer you away from your unique opportunity to save and restore the credit of your nation. You can do it in two easy steps, neither of which involves bailouts. Both of them involve your great European traditions, such as the Latin Monetary Union and its great gold and silver coinage.



## STEP ONE: GOLD INCOME FOR THE GOVERNMENT.

The credit of a government depends, for the most part, on its ability to secure a gold income. In order to have one, the government must open the Mint to gold and keep it open to the unlimited coinage of gold and silver for the account of anyone bringing the metal for coining. It will not be free, but a seigniorage charge as low at 5 percent applies. It will be a monopoly income initially. As your monopoly erodes because other countries will play copycat, it will get smaller. But you have made a head-start. Further gold and silver income could be derived from custom duties, excise and real estate taxes. We have an historical example showing how that works in practice. In 1862 during the American Civil War the North introduced irredeemable currency, endearingly called ‘greenbacks’. The Union did not close the Mint to gold and silver; nor did it make the greenback unlimited legal tender. Certain taxes such as custom duties and excise taxes continued to be payable in gold coin. The Union did have a gold income.

To this you could add real estate taxes payable in silver. The gold revenue of your country could be used to eliminate government debt in irredeemable Euros, as will be discussed below. The silver revenue from real estate taxes should be collected by local governments and it could be used to finance public works. That would extend the employment base locally. Unemployment insurance, so called, ought to be abolished altogether. In this world you get what you pay for. You get unemployment if that’s what you pay for. But you get clean streets, pleasant public parks, great infrastructure, and happily employed people if you pay those who are willing to work and, if necessary, relocate away from big cities.

Mintage could start with the two great standard coins of the now defunct Latin Monetary Union − to which all three countries used to belong − : the standard 20-franc gold piece and the standard silver piece formerly called 5 franc but now has to be renamed since the tie between the values of the gold franc and the silver franc has been cut. Let’s call the former 5-franc silver piece *thaler*. Fractional gold and silver coins would also be struck in order to facilitate the payment of these levies. There must be no rigid ratio set between the value of the 20-franc gold cold coin and the silver thaler. Neither must the Euro price of gold and the Euro price of silver, nor must their ratio be fixed: they must all be determined by the market.

Please note that what I recommend here is not a metallic monetary standard. That would be far too controversial, and it would put the success of the reform in jeopardy. The Euro bank notes and coins would continue to circulate as before, except they would no longer be legal tender for the payment of certain taxes. What I describe here is *a scheme to mobilize gold and silver to help finance government.*

## STEP TWO: REFINANCING GOVERNMENT DEBT WITH GOLD.

The governments of Greece, Italy and Spain should offer 30-year gold bonds and 10-year silver bonds in exchange for their outstanding Euro-bond obligations. This would be the first gold bond issue in the world since 1935. There is a great pent-up demand in the world for gold bonds. In taking the initiative and making them available once more, Greece, Italy and Spain would show the way for the United States and other European countries how to harness gold-bond financing to avoid bankruptcy. All the over-indebted country needs to do is to mobilize its gold reserves.

Why does gold-financing of government work?

(1) It adds new resources, heretofore idle, namely, government-owned gold, to the liquid wealth of the nation.



(2) Privately owned gold may be coaxed out of hiding, further increasing the liquid wealth of the nation.

(3) One ounce of gold 'on the go' is worth ten ounces idled, just like one acre of cultivated land is worth ten acres left fallow.

(4) Circulating gold inspires confidence; gold kept under lock indicates lack of confidence.

(5) Gold is a great stabilizer. Fiat money has never succeeded in stabilizing foreign exchange rates; gold is doing it routinely if given the chance.

(6) Fiat money has never succeeded in stabilizing interest rates. Gold can do it. Stabilization of interest rates is extremely important: volatile interest rates spell capital erosion or even destruction. Stabilization of prices is neither possible, nor desirable. Variation of prices is a market signal that could be suppressed only at your peril. Stabilization of interest rates is both possible and desirable.

(7) Gold has always been used as money directly or indirectly throughout history, for thousands of years. In 1971 gold was forcibly removed from the monetary system and was replaced by 'synthetic credit'. The result was: disaster. Now, a mere forty years later, we are facing a complete credit collapse, due to the Debt Tower ready to topple. The conceit of the managers of the international monetary system exceeds the conceit of the builders of the biblical Tower of Babel.

(8) Under an irredeemable currency system bonds are irredeemable as well. This removes the logical basis supporting lending, including lending to the government. One day the world will wake up and realize that the enormous paper wealth it thought it had has just disappeared. The shock and the suffering that is bound to follow would be devastating. Yet no one can say that it came unexpected. Tried innumerable times, experiments with irredeemable currency have always ended in disaster.

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A gold bond promises to pay interest and principal in standard gold francs; a silver bond, in standard silver thalers. This promise should be stated on the face of the bond, together with a declaration that the country issuing the bond considers repudiation unconstitutional, immoral and reprehensible, and would not allow to happen again.

The coupon rate on the gold bonds should be fixed at fifty basis points above the one-year gold lease rate, and the coupon rate on the silver bonds at five basis points above the one-year silver lease rate, both averaged for the past ten-year period.

Three sinking funds should be maintained by these countries: the first to keep the value of the gold bond on a par, the second to keep the value of the silver bond on a par; and a third one, a Euro-fund, to support the price of the country's outstanding Euro-bonds, should it be necessary. The expectation is that the market will have a preference for the gold and silver bonds. Therefore these countries will be able to retire the outstanding public debt on favorable terms over a ten-year period. A residual gold-bonded and silver-bonded debt would remain.

However, these are needed in order to support the operation of insurance companies, pension funds and other financial institutions.

The gold and silver bonds would be highly liquid in view of the sinking-fund protection. The interest rate on them could be used as the benchmark in bank lending and in issuing corporate bonds, gold backed.



The plan to mobilize the gold resources of Greece, Italy and Spain, if adopted, will stabilize government finances in these countries. The rate of interest on gold and silver bonds is the lowest possible. These countries will refinance their public debt in making them gold-bonded or silver-bonded. The sword of Damocles, the threat of a violent increase of the rate of interest on the public debt, needlessly haunting a lot of countries under the regime of irredeemable currency, will be permanently removed.

The example of these pioneer countries will probably be contagious. If adopted world-wide, the system of financing government through gold and silver would inject new liquidity into the international monetary system sufficient not only to fend off a threatening world depression, but also to imbue the domestic and world economy with great optimism concerning future prosperity. Domestic economies, as well as the world economy would start growing again.

There could be no better way to pay homage to the ancient Greeks and Romans to whom we owe most of the values of our civilization than letting these three countries: Greece, Italy and Spain lead the world back to monetary and fiscal rectitude.

## Notes on the Latin Monetary Union

By a convention dated December 23, 1865, four charter members: France, Belgium, Italy and Switzerland formed the Latin Monetary Union (LMU). They adopted a common bimetallic currency, in France, Belgium and Switzerland called the franc, in Italy called the lira, defined as 4.5 grams of silver or 0.290322 gram of gold, 900 fine (a bimetallic ratio of 15½:1). The design, although not the size, of coins minted by different countries were different. The idea was to facilitate trade between different countries by making their coins perfectly interchangeable.

The agreement came into force on August 1, 1866. The four nations were joined by Greece with its drachma, and Spain with its peseta in 1868. In 1889 four more European and a South American country, Venezuela (the only fully-fledged non-European member in the history of the LMU) with its bolívar joined.

The basic cause of failure of the LMU was its adherence to bimetallism, in spite of evidence that it was not a stable monetary system. It pretended that the gold/silver market price ratio was constant when, in fact, it was variable. Sometimes the market undervalued gold at the Mint, at other times it undervalued silver. As a consequence, bimetallism was in reality a flip-flop between silver monometallism (when the market ratio undervalued gold at the Mint) and gold monometallism (when the market ratio undervalued silver). This had the wasteful consequence that silver and gold were flowing back-and-forth between the Mint and the refinery. When gold was undervalued at the Mint, gold coins moved to the refinery to be melted down; when silver was undervalued at the Mint, silver coins moved to the refinery to be melted down. In either case, the other metal was moving to the Mint to be coined. This arbitrage meant risk free profits for the arbitrageur at the expense of the Treasury. The solution to the problem would have been a dual monetary system using both gold and silver coins, but without a fixed official bimetallic ratio. It is most unfortunate that the LMU did not make a recommendation along these lines. Bimetallism consequently 'self-destructed', as it were. Germany made a fateful step in demonetizing silver and making gold monometallism official, at the same time selling very large quantities of silver from melted coins in the world market. The world price of silver went into a tailspin, taking the gold/silver price ratio from a low of 15½:1 in 1874 to a high of 85:1 in 1932. The LMU closed its Mints to silver in 1878; to gold, in 1936. Subsidiary silver coins made according to the standards of the LMU were discontinued in member countries other than Switzerland during World War I. In Switzerland they continued until well after World War II; the last ones were made in 1967.



Having lost its purpose, the LMU disbanded in 1927.

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The resurrection of the LMU would add a great deal of liquid wealth to the world's financial resources. I have admitted above that a rapid change back to the gold standard at this juncture is not feasible or, at least, is not realistic. On the other hand it appears insane to quarantine monetary gold for no better reason than that it offers an unwelcome competition to the regime of irredeemable currency, when there is such a great need for it in order to stabilize debt in the world economy. Thus the resurrection of the LMU may be the happy compromise, bringing about a hybrid monetary system in the world, paper and metallic, with a variable exchange rate between them. "Let the people choose."

Central bankers of the world show themselves superbly confident that with their expertise and skills the regime of irredeemable currency can be made a durable and stable monetary system. Whatever one may think about their self-confidence, it might take a revolution to remove central bankers from power in spite of the fact that their hold on power is apparently getting ever more wobbly as time goes on. The reason for this is the fast breeder of debt that irredeemable currency set into motion, and the lack of an ultimate extinguisher of debt that could stabilize the system.

But to have an open mind about it, let us not exclude the possibility that the hybrid monetary system may work. The resurrection of LMU would solve the problem of runaway debt, since the mobilization of monetary gold in the European economy could make an orderly debt-reduction possible. This seems to be the only chance for the regime of irredeemable currency to "save its hide." Central bankers may see the writing on the wall. Be that as it may, it is up to the central bankers to prove that the monetary system they manage is able to compete with gold and silver.

In closing I shall answer the question: where will people get the gold and silver to be able to pay the taxes that will give the gold and silver income to the government? I admit that this question goes to the heart of the matter. Some retrenching on the part of consumers may be necessary. Let me look at two typical cases.

(1) Some cutback in imports may be necessary because a part of the final price paid at the cashier includes gold taxes that not everybody may be prepared to pay. Fine, so domestic industry has to reinvent itself to satisfy the demand of those who opt out of paying the import tax. This in itself may be a good thing, as it will contribute to 'job creation'. But obviously there will be enough people who want the imported goods, do have the gold and are willing to pay it out in the form of custom duty and excise tax to have them. Their spending "will prime the pump" and put gold coins into circulation.

(2) Some cutback in owner-occupied housing may be necessary because not every home-owner has the silver to pay the real estate taxes involved in home-ownership.

Fine, so the rental-property industry has to reinvent itself and satisfy the demand for housing of those who want to opt out paying the real estate tax. This in itself may be a good thing because not every bread-winner is able to handle the financing of such a major purchase as a home. But obviously there will be enough people who want to own their home, do have the silver and are willing to pay it out in the form of real estate taxes to have it. Their spending, again, "will prime the pump" and put silver coins into circulation.

In this way, starting with the purchases of luxury and big-ticket items, the purchasers will have to dig into their gold or silver hoard, and take their metals to the Mint for coining. As we have seen, this in itself will have help easing the debt problem of the government, and start the process of 'dishoarding' the monetary metals, gold and silver.

So whatever people decide to do, whether to pay the gold and silver taxes or not, some benefits will accrue to society, and that's the way it should be.

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The resurrection of the Latin Monetary Union will, of course, be a challenge to central bankers. They may not like the idea of having to compete with gold and silver coins. For this reason, there is a conflict of interest which dictates that the Mint must be *completely independent* of the Central Bank.

It would be wonderful if Greece, Italy and Spain turned defeat into victory and resurrected the Latin Monetary Union with a new series of silver and gold coins that would actually circulate domestically and across national boundaries. While the exchange rate between domestic paper money and the gold and silver coins would fluctuate, foreign exchange (consisting of gold and silver coins) rates within the LMU would not. And that would be a great blessing to the world economy, facilitating an increase in world trade, ultimately benefiting everybody.

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