

THE GOLD-DEMONEZIZATION HOAX

Gary North is wrong on gold.

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Introduction

According to official doctrine gold was demonetized in 1971 by the "Group of Seven", governments of the most important trading countries of the world. Demonetization was meted out as a punishment for "bad behavior". In the words of Paul A. Volcker gold has been tolerated as long as it was content to act as a constitutional monarch. No sooner had gold asserted itself as an absolute monarch than it was dethroned. Indeed, by a stroke of the pen the 5000 year old monetary reign of gold was unceremoniously terminated over the entire globe, never again to return.

But was it really? This is the question that Gary North is grappling with in his paper "The Remonetization of Gold" (www.LewRockwell.com, August 14, 2003). North is happy to accept the official doctrine that gold is no longer money. Moreover, he doubts that it ever again will be - short of an economic cataclysm. Even though the world needs gold as money, he contends, the transition costs would be astronomical. "Everybody wants to go to heaven, but nobody wants to die." North blames the consumer, not the government. He asserts that there has been a huge, historically unprecedented collapse of demand for gold since 1914. "Demand for gold today is for industrial and ornamental uses, not monetary uses."

In this rejoinder I take issue with North and show that no combination of governments or consumers has the power to eliminate gold as money, any more than they can eliminate nature. The dictum of Horace applies: "*Naturam expellas furca, tamen usque recurret*" (Expel nature with a club, return how it will). I also reject North's simile that the pill of gold circulation is a pill of suicide. In reality going to heaven would take nothing more drastic than opening the Mint to the unlimited and free coinage of gold, as mandated by Constitution of the United States of America.

What makes gold the monetary metal?

Gold is the monetary metal *par excellence* because it has constant marginal utility. While the marginal utility of every other commodity declines at a more or less rapid rate, gold has over the millennia displayed a rate of decline lower than that of any other. This fact has made gold leap-frog as the substance of preference when it comes to hoarding. Existing gold hoards have a feedback effect on the hoarding decision of individuals and, as a result, gold's marginal utility by now declines so slowly that it is practically constant. Gold hoards are so huge that they constitute a high multiple of annual output at present rates of production. We express this by saying that the stock-to-flow ratio is by far the highest for gold. By contrast, existing hoards of other metals constitute a fraction of annual output. Their stock-to-flow ratio is low. No sooner had a good other than gold been produced than it did disappear in consumption. By contrast, hardly any gold is consumed. When it is, as in jewelry, the monetary form is never too far away and can be restored through relatively inexpensive processes of recycling.

To put the unprecedented hoards of gold into context we must point to the superb confidence that individuals and institutions have placed in its value over the ages. While obviously this fact is

subjective, it has over a long period of time translated itself into the objective fact of a high stock-to-flow ratio. In this sense the value of gold is objective while that of other goods is subjective. If a government really wanted to demonetize gold, then first it would have to dissipate accumulated gold stocks through consumption. Lenin understood this better than our Western leaders. He suggested a most ingenious way to demonetize gold. Under communism, Lenin said, gold would be used to plate the inner surfaces of public urinals - an application for which gold is superbly fitted for reasons of its chemical inertness, surpassing that of any other substance known to man. Note the condition "under communism". Under any other system the gold plates would be picked. Lenin certainly knew how to prevent the picking of public urinals. He had the Cheka.

How to make the value of gold fall

Unlike Lenin, superficial thinkers assumed that demonetization could be effected merely by the issuance of a government edict. Before such an edict was issued in 1971 a number of economists, Ludwig von Mises among them, were thinking aloud what would happen if the unthinkable did indeed happen. They concluded that as monetary demand was cut off the value of gold would fall, and fall it would precipitously since monetary demand constituted the lion's share. Economists cited the example of demonetizing silver a hundred years earlier. When Germany, victor of the Franco-Prussian War did it in 1871 and the United States government, victor in the Civil War followed suit ("The Crime of 1873"), the rest of the governments reluctantly toed the line (with the only exception of China which refused). The price of silver went into a long and steep decline from \$1.29 in 1871 to 25 cents in 1933, less than one fifth of the original value.

Apparently the only time the government of the United States listened to Mises was on August 15, 1971, when Nixon decided to prevent the value of gold from going to outer space by demonetizing it. Subservient governments hastily joined in issuing an edict to the effect that they considered their combined gold reserves as "adequate" and, from then on, they would refuse to buy gold from any outside source, and would ostracize governments that did. Newly mined gold, having lost its biggest customers: governments and central banks, would have to go begging. Those who had speculated that the official gold price would be increased ought to burn their fingers "right to the armpit" in the words of a U.S. Senator. The world must be taught a lesson who is in charge.

Causality versus Teleology

The economists couldn't be more wrong on gold. No sooner had governments embargoed it than the price of gold soared. The economists never answered the question how they could ever make such a colossal blunder. We must do it for them. Doctrinaire belief in the supply/demand equilibrium theory of price has led them astray. Economists reasoned that if the demand for gold is cut abruptly then the value of gold is duty-bound to fall. However, the equilibrium theory of price is a *linear* model having a limited range of applicability. The world is *non-linear*. As long as causality prevails, monetary circulation can be approximated with linear models. But when teleology becomes dominant, as it sometimes does, the world no longer behaves linearly. As teleology replaces causality linear models, including the equilibrium theory of price, fail to be applicable. It is incumbent upon the scientist to examine the range of applicability of his model before applying it. This the economists have forgotten to do in studying the probable effects of gold-demonetization.

If we really wanted to understand the gold-demonetization episode of 1971, then we would have to look for the teleological context. We would find it in the fact that gold-demonetization was just a hoax, designed to cover up the fact of default on gold obligations and so to save the face of the United States. It has never ever happened in history that the paper of a defaulting banker would go to a premium. Yet that is exactly what the economists predicted. They forgot that the dishonored paper would always, without exception, go to a discount. This would happen even if further issues of the paper were drastically curtailed. The circulation of the dishonored paper is

definitely not governed by the laws of causality, the quantity theory of money, or the equilibrium theory of price. Rather, it is governed by the laws of teleology. Frightened holders of the paper would try to get rid of it at whatever price they could, as they expected the discount to widen and, ultimately, to go to 100 percent. Time has nothing to do with it. Depreciation can take days, but it can also take decades to run its full course. It is not possible to forecast how long. The only thing certain is that time will not cure whatever ails the dishonored paper. Once in default, always in default. True, the banker may not be at the end of his rope. He may still have tricks up in his sleeves. He could use bribery, blackmail, and other forms of coercion to keep his dishonored promises in circulation. He may even be able to expand circulation. By hook or crook he might slow the rate of depreciation, or even stall it. Sometimes he might succeed in reversing the trend temporarily through false signals to the market. No matter. The ultimate outcome is inevitable. The value of the dishonored paper will eventually approach the marginal cost of its production, which is greater than zero only by a negligible amount.

It is important to realize that the quantity theory of money has nothing to do with monetary depreciation. Like the equilibrium theory of price, the quantity theory of money is just another linear model that is valid only as a first approximation. But where causality ends, teleology begins and first approximations become useless. More sophisticated models such as the disequilibrium theory of price, and the depreciation theory of dishonored promises are called for. Value is not collapsing because paper money has been "over-issued". It is collapsing in consequence of the original sin, the act of default. Monetarists and quantity theorists of all stripes, please pay attention. Regulating the rate of increase of the stock of high-powered money (e.g., by entrusting it to a "clever horse" on the tread-mill as once suggested by Milton Friedman) may postpone but will not avert the ultimate humiliation of the dollar, which is to join the assignats, mandates, Reichsmarks, and other dishonored promises in the garbage heap of history. From there, as from Hades, no currency has ever returned.

The concept of marketability

North says that gold is no longer money because it is no longer the most marketable commodity. The irredeemable paper dollar is. I challenge this. Back in 1960 I carried out a little experiment. I obtained a \$1000 bill (in those days equivalent purchasing power would be more than \$10,000 in today's money). This was in Canada, and the bill had a light pink color as I recall. The vast majority of people have never seen a bill of such denomination. My experiment consisted in trying to pass on the bill. Retailers flatly refused to touch it. It wasn't that they could not make change. The price of a Volkswagen Beetle was around \$1000 then, but the dealer would still not take my bill. He would be glad to take a personal check, but not the \$1000 bill issued by the Bank of Canada. He suggested that I go to the bank around the corner and come back with ten \$100 bills. The bank would take the bill only on condition that I opened an account. I would have to provide three ID's, one of which would have to be a picture ID. So much for the marketability of paper money.

I followed up with another experiment. I offered a kilobar (1000 grams of fine gold, then worth about \$1200) to a Swiss bank. Without a bat of the eyes the teller paid me at the going rate. No questions asked. No need to call the manager. No need to open a bank account. No need to produce three different ID's. So much for the marketability of gold. I am aware that things have changed since. Swiss banks, as a result of some arm-twisting from Washington, no longer deal in gold over the counter. They don't want to be open to the charge that they facilitate money-laundering. You have to go to a large city where some banks have special departments for dealing in precious metals, and they certainly won't buy from you unless they know you.

The scientific concept of marketability is due to Carl Menger (Absatzfähigkeit). He based it on the distinction between the bid and asked price. Menger pointed out that it is not possible to buy something in a market, then turn around and sell it at the same price. You always buy at the higher asked price and sell at the lower bid price. The difference is the spread. Obviously, the

spread is a function of the quantity of merchandise under negotiation. It is the behavior of the spread that determines marketability. According to the Principle of Declining Marginal Utility the bid price is a decreasing function of quantity. Further insight shows that, by contrast, the asked price is an increasing function. Market-makers are reluctant to deplete their inventory too fast before securing further supplies. If they must quote an asked price for an unusually large quantity, they naturally add a risk premium. The upshot is that the spread is an increasing function of quantity.

Commodity *A* is more marketable than commodity *B* if the rate of increase in the spread for *A* is lower than that for *B* as ever larger quantities are thrown on the market. On that basis gold was, is, and will be, as far in the future as the eye can see, the most marketable commodity available. So much so that the market, when not rigged by the banks or the government, would make the spread practically zero. Thus gold is the only commodity that could, in the absence of official sabotage, be bought and sold back-to-back without losses in any quantity, however large. It is this property that has made gold the monetary metal. Irredeemable currency certainly does not have this property, as a quick check with a foreign exchange dealer will reveal. Please do not be confused by the volatility of gold price. It is not an indication of the uncertain value of gold. Rather, it is an indication of the uncertain value of the dollar in which the gold price is quoted.

Is Gold Money?

This is a semantic issue as the answer depends on how we define money. If you, following North, define money as something Wal-Mart will take in exchange for made-in-China junk then, for you, gold is not money. But if you adopt Carl Menger's more scientific definition according to which money is a commodity for which the spread between the asked and bid price stays small as ever larger quantities are traded, then gold is money. It is not the consumer or the retail market that decides the issue. It is the wholesale market trading as it does unlimited quantities, that is privileged to make that determination.

It also follows that people and institutions are, even today, willing to carry unlimited amounts of gold in the balance sheet *without any promise of return to capital*, in preference to any other asset. There is obviously no contest between gold and the dollar in this regard. Apart from the fact that the dollar is but a dishonored promise to pay, at best it is an asset that also shows up as a liability in the balance sheet of a third party. As the only asset in the balance sheet that is not at the same time the liability of someone else, gold provides the only effective portfolio insurance against default.

The final monetary showdown between gold and the dollar may be close at hand. As dollar-holdings of individuals and institutions not subject to the jurisdiction of the United States grow by leaps and bounds in consequence of increasing American trade deficits, the ultimate test of "moneyness" is being applied to the dollar. Are foreigners really willing to hold unlimited amounts of dollar balances indefinitely? Euro-balances as an alternative are not relevant. After all, the euro is just another irredeemable promise to pay. The contest is not between the dollar and the euro. Ultimately, it is between the dollar and gold. When all is said and done, it turns out that at one point owners of dollar balances will cry "enough!" By contrast, history and logic show that there is no such point for gold. This qualifies gold, and disqualifies the dollar, as money.

Gold and Interest

Yet the strongest argument proving that gold is still money, the best available, is its relation to interest. According to Carl Menger, subsequent units of a commodity are valued less by the economizing individual than units acquired by him earlier. This is known as the Principle of Declining Marginal Utility. If we rank commodities according to the rate of that decline, then we shall find that the marginal utility of one of them declines more slowly than that of any other. The

commodity with this property is none other than gold. In fact, the marginal utility of gold declines so slowly that it is practically constant. It follows that gold hoarding must be limited by something other than declining marginal utility so that demand for it may not become arbitrarily large, and gold coins may stay in circulation. The fact is that demand for gold is limited by the positive rate of interest channeling gold into monetary circulation, away from hoarding. This makes gold the corner-stone of both the theory of money and the theory of interest.

Ludwig von Mises in *Human Action* denies that the marginal utility of gold is constant (second edition, p 404). His reasoning is that constant marginal utility would mean infinite demand which is contradictory. Elsewhere in the book (*op. cit.*, p 205) Mises also denies that it is possible to construct a unit of value because two units of a homogeneous supply are necessarily valued differently, according to the Principle of Declining Marginal Utility. Yet gold has successfully furnished the unit of value for thousands of years to many a flourishing civilization, including our own, and when it was removed it had to be done by travesty, trickery, and police force. Mises failed to grasp the connection between gold and interest. Interest is obstruction to gold hoarding: but for the presence of interest gold hoarding would be unlimited, since gold's marginal utility is constant. It is interest that keeps gold hoarding within bounds. Interest is the opportunity cost of gold hoarding. By contrast, hoarding of a non-monetary commodity is kept within bounds by declining marginal utility. In this sense interest is analogous to a parking meter on a busy street which limits the demand for parking space that would be unlimited otherwise. Be that as it may, interest is specific to gold and no demonetization hoax can change that fact. The gold-rate of interest (disingenuously called "lease rate") is still the benchmark to which the dollar-rate and all other paper-rates of interest are related by the application of a depreciation premium.

Monetary demand for gold

North makes the point that demand for gold today is for industrial and ornamental uses only; there is practically no monetary demand. Thus North, a self-declared gold bug, forgets that his very own demand for gold is nothing more or less than a monetary demand. He refers to gold as an "inflation hedge". The demand for gold as an inflation hedge, too, is a monetary demand. The investment-demand for gold, too, is a monetary demand. If Alan Greenspan owns gold, which seems more than likely, his demand for gold, too, is a monetary demand, like it or not.

By monetary demand is meant demand for medium to circulate as money with whatever velocity, *including zero velocity*. Therefore hoarding demand for gold that originates in protest, whether against low interest rates, or against the banks' loose credit policy, or against the government's fiscal policy, or against the central bank's monetary policy, is part of the monetary demand. Furthermore, hoarding demand that originates in fear, whether fear of devaluations, monetary depreciation, or any other form of embezzlement of private wealth through monetary manipulation, is also part of the monetary demand. Protest- and fear-related demand started burgeoning in 1947, the first year when United States hemorrhaged gold. Some of that gold went to central banks that would keep it in circulation; most of it went to satisfy private demand that would keep it out of circulation. In retrospect, hoarding demand was justified by competitive devaluations triggered by the British pound barely one year later in 1949. It was also justified by unprecedented peace-time budget deficits ran by the United States that forced the debasement of the dollar. The monetary history of the intervening years can be described as a tug-of-war between the two demands for gold: that of central banks and that of private holders of cash balances. Don't be fooled by the rhetoric that central banks no longer need gold and they are anxious to get rid of this barren asset by exchanging it for "earning assets". Central banks, like individuals, need gold for the stronger reason. They need a default-proof asset to balance their monetary liabilities. As gold keeps disappearing from the asset column of the balance sheet of a central bank, so does public trust in the value of the bank's notes in circulation.

Private monetary demand is gradually winning the tug-of-war. It is enormous and it keeps growing: not only does it absorb the entire world production of gold, it also picks up all the gold

dropped by central banks to keep the wolves away from the door. True, the price of gold falls whenever the U.S. Treasury, the IMF, and "me-too" Bank of England announce their gold auction rituals. This fall certainly does not mean that gold is in over-supply. It means that the market is willing to play chicken with the protagonists of the demonetization-hoax. Above all it means that the market exacts a price for foolish market-behavior. If the desire to exchange a non-earning asset for an earning asset were genuine, then gold would not be auctioned with the loudest fanfare and widest publicity designed to suppress the price. Instead, it would be quietly fed into the market in order to fetch the highest possible price. But there is a hidden agenda: to discourage private demand by the threat of a falling price. However, the ploy to manipulate expectations is a failure, as shown by the fact that the gold price always returns to a higher level the day after the official gold-shedding program is completed. This was true for the auctions of the U.S. Treasury, those of the IMF and, most recently, those of the Bag Lady of Threadneedle Street. The exercise of dissipating official gold is a hoax. It misleads simpletons only. Gold disgorged by central banks is quickly absorbed by private monetary demand. In auctioning off monetary gold the managers of irredeemable currency are trying, in vain, to buy time to save their tottering regime.

The First and Second Decline of the West

When the barbarians overran Rome, the government of the Western half of the Roman Empire ceased to function. We may side-step the question whether the policy of deliberate currency debasement which Rome had pursued for centuries was ultimately responsible for the collapse. Be that as it may, after the barbarian invasion there was no authority to re-introduce gold coinage that would circulate. Gold coins of old had long since ceased to circulate in the wake of debasement. They were hoarded or exported to the Eastern half of the Empire, where the supply of gold coins by the Mint of Constantinople continued uninterrupted for another thousand years. The fact remains that the First Decline of the West had been foreshadowed by the disappearance of gold coins from circulation. Only later was it followed by a cataclysmic shrinkage of trade.

The Second Decline of the West, in our days and age, has also been foreshadowed by the disappearance of gold coins from circulation. We may take the year 1914 to mark the beginning of that process. We are worse off than were people during the First Decline, insofar as there is no Eastern half where gold coins would still circulate. The threat is that the disappearance of gold coins from circulation will again be followed by a fatal collapse in world trade and the survivors of wars will be forced to live from hand to mouth. Nobody can deny that competitive currency devaluations and trade wars, not to mention shooting wars, are presently a threat to our survival and welfare. No one knows how long producers will continue to accept irredeemable promises to pay in exchange for real goods and real services. No one knows how long savers will continue to accept a depreciating monetary unit as *numeraire* for their savings. The vanishing of gold coins from circulation have historically been followed by a collapse of trade if not immediately, then certainly in a century or so. If the Second Decline isn't turned around soon by the re-introduction of circulating gold coinage, we may again experience a cataclysmic shrinkage of world trade, similar to that during the First Decline.

Defeatist North considers a return to gold circulation most unlikely, even undesirable. But remember, the First Decline was stopped in its track and reversed by two amazing developments: (1) the opening of the Mint to unlimited coinage of gold by Venice and Florence; (2) the financing of the trade of Italian city-states with one another and with their trading partners overseas through the invention of the gold-redeemable bill of exchange. Corresponding developments could halt and reverse the Second Decline and save our civilization from ruin. *It is not the cost of returning to gold circulation that is astronomical as North suggests, but the cost of not returning.*

Reference

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