Part I

GOLD AND THE DOMESTIC ECONOMY

COPYRIGHTED MATERIAL

Chapter 1

Why Gold?

Our infatuation with gold has been around as long as mankind itself. Some call it mystical; others call it a barbaric metal. It is a love-hate relationship that has survived the ages. To some it is blind love. To others it is the object of a great quest. Whatever its role in society, it has never been a benign one. It has never been a metal you ignore. We, to this day, refer to the very best of things as "the gold standard of. . . ." We call a great find a "gold mine" and claim something you can count on to be "as good as gold." We still "go for the gold" and present gold, silver, and bronze medals for achievement. When we hit our prime years, we call them "our golden years." Gold folklore and all of its history is embedded in our culture.

ch001 23 April 2011; 10:21:49

This tradition did not endure because the years of gold as money were tarnished. On the contrary, gold is as American as apple pie. But, among intellectuals, economists, and policy makers today, gold has a more mixed reputation.

Gold has been praised and denounced; called immaterial and impractical. At the same time it has been craved and adored. Governments have adopted gold as their money, denounced it, confiscated it, demonetized it, and hoarded it. Passions run high when it comes to gold. And so they should. One of the most contested and debated of all subjects is not just gold, but gold as money, gold as a standard of value, gold as an investment, and its role within our national and international monetary systems.

Gold: The King of Metals

Gold is a proven successful monetary standard because of its unique properties. Mankind has valued gold for 5,000 years. Through some 2,500 years of formalized monetary systems almost every conceivable commodity has been used as money: stones, tobacco, wheat, pottery, coconuts, beads, and bananas. After years of trial and error individuals selected precious metals as the premier money and gold rose to the top to become the king of metals. Why?

It wasn't an arbitrary choice. Gold is scarce, and in being so it is precious to individuals. It is easily identifiable. Nothing quite jumps out at you like the glitter of gold. Since it is easily recognizable it is easily marketable, which is essential to any medium of exchange. It is accepted by almost anyone anywhere in the world. It has utility. If need be it can be melted and used in various forms as a commodity—such as in the fields of dentistry, medicine, high tech, and others. The fact that it can be melted and utilized in various forms allows it to be made into rings, coins, ingots, or bars and used as money. Or it can be held as gold dust or nuggets. It's small in bulk and therefore portable. Artisans love it for its pliability and beauty. They use it in jewelry and use it in other art forms as well.

Whether as a commodity, money, jewelry, or art, gold has value to most individuals. It has become a way of storing value. It isn't perishable like tobacco or wheat. It doesn't evaporate or disintegrate. All of the gold in the world ever produced still exists. And because the total amount of gold above ground is always substantially greater than the supply that is found yearly, its supply remains stable year after year, century after century, in relation to other goods. Sudden changes of value are possible, but throughout history they are, like gold itself, very rare.

Gold Becomes the Standard of the World

The purchasing power of money under the gold standard, and the silver standard before it, remained fairly constant for over 200 years. Gold's price was fixed at $22.67 per ounce between the years 1792 to 1933, and the value of the dollar during that time was the same as an ounce of gold. During the years 1880 to 1914, the inflation rate was .01 percent. This 34-year period is known as the years of "the classical gold standard," when a dollar remained a dollar, and gave rise to the term "as good as gold." Since we have abandoned the gold standard the value of the dollar has fallen by 97 percent. The case for the gold standard and against the fiat standard is that simple and that strong.

Today, we prefer the virtues of paper. One of my favorite economists, Ludwig von Mises, once said, "Government is the only entity I know of that can take a perfectly good commodity

ch001 23 April 2011; 10:21:49

like paper, slap some ink on it, and make it totally worthless." The same cannot be said for gold. Gold has withstood the test of time. Its virtues have been discovered and rediscovered throughout the years.

Our founding fathers went as far as declaring nothing but gold and silver shall be this nation's money. And in Europe it is common knowledge that "one should always have just enough gold to bribe the border guards." There are a lot of myths and misunderstandings about gold and its credibility as money. But once inspected, the myths pale next to the facts and documented history of gold. We will explore some of them now.

Too Little Gold—Or Too Much Paper?

Usually the first argument given by those that claim returning to a gold standard is impractical is that there isn't enough gold in the world to use for money. This argument makes more sense if you stand it on its head. It's not that there is too little gold—it's that there are too many paper dollars around, too many claims to gold.

First of all, it should be pointed out that during the gold standard there were never complaints of too little gold to use as money, even though both population and the amount of goods and services grew over its 200-year history. Tell people back in the nineteenth century that there was not enough gold to use as money and they would start looking at you sideways. Back then gold had been used as money for generations.

Banks were the major holders of gold. They kept about one quarter to one third of their capital in gold. They made loans based on their capital. A three- or four-to-one capital ratio was commonplace. Today it is closer to 14:1, and Lehman Brothers was said to have leveraged positions that exceeded 40:1. This kind

ch001 23 April 2011; 10:21:49

of excessive leverage and inadequate capital contributed to the panic of 2008. During the gold standard, the amount of gold was leveraged—but only as long as it was redeemable on demand. Redemption placed limits on leverage.

Once the ratio has been determined, the prices of all things adjust and stability prevails. For every new ounce of gold discovered, four new dollars could be created. Throughout our history there has never been a time when there was too little gold to act as a medium of exchange. On the contrary, the gold strike of 1849 was more problematic than any problem arising from a shortage of gold, as the supply of money suddenly increased.

Secondly, other metals have been and can be used alongside gold. Silver, nickel, and copper all served as money during the gold standard. Those metals were also leveraged about four to one. As long as gold, silver, nickel, and copper circulate as coins, there is no reason that paper cannot also circulate as money substitutes, as long as they are at all times convertible on demand. The four to one capital ratio was not arbitrary. It was time tested and was deemed a safe ratio by markets in times of stability as well as times of panics and bank runs throughout the gold standard's existence to protect a bank against insolvency.

Today, the great debate the world is having is, "How much capital should banks maintain to prevent insolvency?" Stress tests are being conducted to determine that ratio. If governments would just look at the years of the gold standard they would have a model to emulate that is proven to have succeeded for centuries. We need not impose the exact same ratios, but an increase in capital and an increase in reserve requirements will do wonders to strengthen the banking system around the world.

The "Gold Prevents Prosperity" Myth

A companion argument to "There's not enough gold to be used for money" is that a gold standard is too rigid and restricts the expansion of business and therefore prosperity. This argument asserts that there is not enough gold to allow enough credit expansion to provide for a vigorous robust economy. This argument can be refuted with one simple historical fact: the industrial revolution. During the two centuries where the gold standard reigned, the world enjoyed the greatest amount of growth in mankind's history. The standard of living for the entire population of those nations tied to the gold standard rose to levels never before dreamed of. The world immersed itself in free trade and there was not a world war fought for a hundred years. And in the United States we transformed ourselves from an agrarian society to an industrial one. Those that claim that gold limits the amount of growth must have somehow missed this fact.

In the words of Nobel Prize winner Robert E. Lucas Jr., "The industrial revolution marks a major turning point in human history; almost every aspect of daily life was eventually influenced in some way. Most notably, average income and population began to exhibit unprecedented sustained growth. In the two centuries following 1800, the world's average per capita income increased over tenfold, while the world's population increased over sixfold. For the first time in history, the living standards of the masses of ordinary people have begun to undergo sustained growth. . . . Nothing remotely like this economic behavior has happened before."

No, gold does not prevent prosperity. It furthers it. For centuries this argument never ever occurred to people. Even though gold became relatively scarcer each year, during the industrial revolution, its value remained stable. There was always enough gold to serve as an effective medium of exchange. Only after we abandoned the gold standard did money claims become abundant rather than scarce and prices begin to rise progressively. The problem became a problem of not too *little* money but too *much* money. A term never heard before among common people emerged in the 20th century: inflation.

Those who argue that the gold standard is impractical because there is too little gold in circulation are overlooking what it means to have too many excess paper dollars in circulation. More paper dollars does not equate necessarily to more wealth. Many times just the opposite is true. I give you Zimbabwe as an example. According to the country's Central Statistic Office, the estimated rate of inflation rose to 11,200,000 percent in August of 2008. The Central bank introduced a new $10 billion note. Everyone had money. Except everyone was broke.

This is the illusion that can come with inflation. This is the illusion of having more money. The argument given that did away with the gold standard was that we needed an expanding monetary unit with less rigidity, one with greater flexibility. Once we did away with limitations on money and credit creation the result was a depreciation of the value of our dollar by 97 percent over the last century compared with the gold standard preserving 100 percent of its value the two centuries before. At the end of a century under the gold standard, one could buy a suit of clothes for approximately the same coins he did at the beginning of the century. Today we would have to drop a zero off our money to buy the same house we could have 40 years ago.

ch001 23 April 2011; 10:21:49

In Gold We Trust

We live in a time of great mistrust—mistrust of our banking system, of our debt, of our money, of our politicians, and our ability to return to a period of growth, prosperity, and stability. We live in a world of reckless government spending, fiscal irresponsibility, and trillions in unfunded liabilities. Until we correct these things, we need to deal with the monetary system as it is.

Interestingly, since the financial credit crisis, most would agree today that an increase in the capital requirements of financial institutions is a good thing and would have perhaps prevented the financial meltdown. A return to gold standard ratios is not out of the question given this realization. Adequate capital requirements and the subsequent decreased leverage they would bring are essential to the solvency of any monetary system.

The best we can hope for today is to improve the present system from within by making it more prudent and more honest. Financial reform would be best achieved by moving toward the operating principles of a gold standard. To build a better financial system we need to know what to aim for—what works, what doesn't, and why. Gold represents a two-century history lesson in which the value of money remained constant. This is something no other monetary system can claim.

The years in which gold, silver, nickel, and copper were used as money represent years of growth, prosperity, and relative stability. The gold standard does not claim to eliminate panics, crises, greed, or irrationality. But it does guarantee that the purchasing power of money will be preserved as long as the rules of the gold standard are adhered to.

ch001 23 April 2011; 10:21:49

The rules of the gold standard come from the natural automatic flows of money and trade between individuals throughout the world; from a government committed to defending the value of its currency; through the certainty of convertibility of paper money to a commodity at a fixed ratio. The rules require both free trade and fiscal discipline. To exist, a gold standard requires a system of limited government, limited spending, limited debt and credit creation, and the protection of individual and property rights under the law.

Why gold? Because gold is a time-honored and time-tested honest currency. It establishes a system based on financial, monetary, and fiscal discipline. Today's fiat standard is barely a century old and may not make it to its hundredth birthday. My guess is that if it does, it will be with the help of gold, or at least by moving toward the principles of sound money and the discipline that a gold standard requires. Without these, financial reform efforts will be meaningless. No paper money system can survive without them. None ever have.

ch001 23 April 2011; 10:21:49