THE GOLD STANDARD STRIKES BACK…

…*WITH A 36-YEAR LAG*

(Part 1 of 2)

Antal E. Fekete
Gold Standard University Live

"Two legs bad, four legs good!"

There were two main direct assaults on the gold standard by the American government: the first on the watch of a Democratic president, Franklin D. Roosevelt, when the U.S. defaulted on its *domestic* gold obligations in 1933; the second on the watch of a Republican president, Richard Nixon, when the U.S. defaulted on its *international* gold obligations in 1971. In each case, the gold standard struck back. Uncannily, in each case there was a lag of 36 years, signifying the fact that it takes that long for a new generation to acquiesce in the slogan "two legs bad, four legs good!" as in George Orwell's *Animal Farm*, a parody of the Soviet Union and the Bolshevik revolution. It will be recalled that the pigs have overthrown the farmer and took over the farm, trying to run it under this revolutionary slogan.

The run on the dollar in the wake of the 1933 default started in 1969, wiping out more than one half of the value of the currency in a few years, the worst episode of monetary destruction in history of the dollar up to that point. The second run on the dollar in the wake of the 1971 default started in 2007, when American banks faltered as bond insurance premiums they were paying on their assets skyrocketed. The second run still continues as foreign dollar account holders have not been heard from. Make no mistake about it: the present financial crisis is a gold crisis, even though this fact is vehemently denied by the Establishment.

Cause and effect

Causality may be camouflaged by lags, and the longer the lag, the more perfect the camouflage is. This is confirmed in the case of the government sabotaging the gold standard. From the point of view of the Establishment, the causality nexus must be covered up by hook or crook. The propaganda line is that gold has long since outlived its usefulness and it was necessary for the government to make some housekeeping changes in order to get rid of this useless and annoying appendage. Note that this is exactly what you would expect to hear from a banker defaulting on his gold obligations: he would badmouth gold and promote his own dishonored paper. But if gold is really so useless, and so entangled with superstition, then why not pay it out as honor demands, and avoid the stigma of national dishonor?

The 36-year long lag is explained, in part, by the servility of academia and media in parroting government propaganda — betraying their sacred mission to inform without fear and favor. The general public, even if indignant at the time of the default, gets desensitized to the enormity of gold confiscation and the government's declaring default fraudulently. As Hitler said, propaganda does work, provided that it is diligently repeated year after year. Nazi Germany just was not given 36 years for its propaganda to sink in. The Soviet Union was; that's why the tenets of international socialism are still treated as holy writ, and those of national socialism as garbage, regardless of the close similarity.

"Four legs good, two legs better!"

Animal Farm could just as well be a parody of the regime of irredeemable currency. The pigs have overthrown the gold standard. They started to mimic its operation, prodded by the chief of pigs, Alan Greenspan. Their revolutionary slogan later gave way to a new one: "four legs good, two legs better!", when the pigs tried to walk on their hind legs instead of all four, to the endless amusement of the other four-legged creatures on the farm. Unfortunately for them, their new manner of walking could not help the fact that they remained just as pig-headed and ham-handed as ever.

Kill the Constitution to make it a "living document"

The role of gold in the monetary system is anchored in the U.S. Constitution. The Founding Fathers were no fools. They knew exactly what they were talking about when they insisted on a blanket denial of power for the government to monetize its own debt, or any debt for that matter. They knew perfectly well that a metallic monetary standard is the only effective prophylactic that can deny that power. The fact that the U.S. government never considered proposing an amendment to the Constitution to legalize fiat money is a telltale. Policy-makers could not muster the necessary moral courage to face counter-arguments in an open debate. Irredeemable currency has no integrity: the issuer is given privileges with no countervailing responsibilities. He is granted *unlimited* power in a republic based on the principle of *limited* and enumerated powers. The principle of checks and balances is thrown to the winds. These features are all alien to the spirit of the Constitution, not just to its letter. Rather than facing a public debate, the government prefers to live with the odium that it is the destroyer of the Constitution.

The legislative branch usurped powers denied to it by the Constitution. The executive branch conspired with the legislative branch to pull it off. All presidents, starting with Franklin D. Roosevelt, have perjured themselves when they swore to uphold the U.S. Constitution, and then turned around and signed bills into law to keep raising the limit on government debt payable in irredeemable currency, i.e., monetized government debt. The judiciary branch of the government, rather than exposing the conspiracy, has joined it, on the basis of the spurious doctrine that the Constitution "is a living document" which does not say what it says, but what the judiciary say it says. In other words, you have to kill the Constitution to make it a "living" document.

Regulator of debt

To expect that the gold standard can be destroyed with impunity is a pipedream. The Establishment will never admit that the present monetary and financial crisis is a gold crisis, or that the day of reckoning has dawned. It will find any number of *ad hoc* explanations, such as too little regulation, too relaxed lending standards, naked short selling of financial stocks, etc., etc. The big picture is blackened out. For this reason, it is necessary to state the cause-effect nexus between ousting gold from the monetary system and the credit collapse that is now unfolding before our eyes, after a 36-year lag, in the clearest possible terms.

Gold has the same role to play in the monetary system as the fly-wheel regulator does in an engine, the brake does in a train, and circuit-breakers do in an electrical network. Gold is the regulator of the *quantity* of debt in the economy that can be safely created and carried. It is also safeguarding *quality* by rejecting toxic debt before it can start metastasis. Debt-based currency utterly lacks safeguards limiting quantity and vouching for quality of debt. Debt-based currency is an invitation to disaster, that of the toppling of the Tower of Babel. Its effects are far from being instantaneous. There is a threshold and there is a critical mass involved. We have long since crossed that threshold and passed that critical mass. By no rational calculus can the outstanding debt be expected to be repaid without inflationary or deflationary adventures, even if further increase were stopped dead in its track. The discussion of the present financial crisis by academia and media avoids all reference to this fact. Under the gold standard a fast-breeder of debt was unthinkable, and debt was retired in an orderly manner.

Destabilizing interest rates

The significance of gold in the monetary system is not that it can stabilize prices, which is neither possible nor desirable. It is the fact that *gold can stabilize interest rates*. No debt-based currency can do it, because the value of the unit of account is left undefined and is subject to political manipulation by the pressure groups. The discussion of the present financial crisis by academia and media avoids reference to this fact as well. Under the gold standard interest and foreign exchange rates were so stable that there was no bond speculation — for lack of volatility would make it unprofitable. There was no Debt Tower of Babel to threaten with burying the economy underneath. Under the gold standard there were no credit-default swaps. There was no need for them.

Barbarous relic or accounting tool?

The gold standard has been called a “barbarous relic”. However, the unpleasant truth, one that government propagandists have ‘forgotten’ to consider, is that the gold standard is merely a tool for sound accounting and, yes, for sound moral principles. Book-keeping under the regime of irredeemable currency is an exercise in prestidigitation. The gold standard is the only conceivable early warning system to indicate erosion of capital. It was not the gold standard *per se* that politicians and adventurers wanted to overthrow. Above all, they wanted to get rid of certain accounting and moral principles, especially those applicable to banking, that had become a fetter upon their ambition for aggrandizement and perpetuation of power. Historically, sound accounting and moral principles had been singled out for discard before the gold standard was given the *coup de grâce*. Just how monetization of debt has led to unprecedented and previously unthinkable corruption of accounting and moral standards, this is a question that has never been addressed by impartial scholarship before.

In order to see the connection we must recall that any durable change of the rate of interest has a direct and immediate effect on the value of financial assets. Rising interest rates make the value of bonds fall, and falling interest rates make it rise. As a result of this inverse relationship the Wealth of Nations flows and ebbs together with the variation of the rate of interest.

Capital destruction

Indeed, rising interest rates destroy wealth as they render the productivity of capital submarginal. Establishment economists and financial journalists preach the false doctrine that, conversely, when the government and its central bank suppress interest rates, new wealth is being created. This is the gravest error of all! Falling interest rates destroy capital in a most devious way, as they increase the liquidation-value of debt contracted earlier at higher rates. *All observers miss the point that as interest rates fall, the burden of servicing outstanding debt is increased. They blithely assume that all debt is automatically refinanced at the lower rate.* This is definitely not the case. The issuer must continue to redeem the maturing coupons of fixed nominal value, regardless how far the rate of interest may have fallen after selling the bond. To that extent all issuers of bonds (along with other borrowers) are subject to impairment on capital account in a falling interest rate environment. If the impairment is ignored, the outcome is wholesale bankruptcies in due course.

Enterprises should make up for losses of capital due to falling interest rates whenever they occur. The trouble is that they don't. As a result they report losses as profits. There is a negative feedback. Capital is eroded further. When the truth dawns upon them, it is already too late. I shall argue that this is the essence of the present banking crisis in America, and it was caused by the destabilization of the interest rate structure, the ultimate cause of which was the overthrow of the gold standard in 1971.

Interest rates have been falling for the past 28 years with the result that the liquidation-value of outstanding debt has reached the tipping point, where capital is plunged into negative territory. Capital dissipation stops as there is nothing more to dissipate. This is sudden death for the enterprise. Producing firms fold tent and look for greener pastures in Asia where wage rates are lower, while financial firms and banks start falling like dominoes.

No commentator is able to explain how American banks could run out of capital in spite of obscene profits they have been making. My explanation is simple. Capital destruction has been going on stealthily for 28 years but the banks were not paying attention. The magnitude of the decline in interest rates, if not its length, is historically unprecedented. The banks have been paying out phantom profits in dividends and in compensation, in the belief that their capital accounts were in good shape. They were not. They were insidiously eroded by the falling interest rate structure, as it inevitably increased the cost of servicing capital already deployed. The banks were unwilling or unable to raise new capital to cover the shortfall. Under these circumstances they should have reduced their own exposure to borrowing. Instead, they were vastly expanding it. By the time they woke up, capital was gone and they were in the grips of bankruptcy.

This puts the importance of the gold standard into high relief. Both rising and falling interest rates are extremely harmful to enterprises, banks not excepted. The plight of General Motors is no different from that of Morgan Stanley. The environment in which they can safely prosper is that of *stable* interest rates, that only a gold standard can provide.

Not all risks can be effectively insured against

Academia has failed to study and expose the untoward consequences of ousting gold from the monetary system. It dismissed the problem of fluctuating — nay, gyrating — interest rates by saying that insurance against those risks is available, just like insurance against the risk of fluctuating foreign exchange rates is, through the derivatives markets. If academia had done its job to research the problem properly, it would have discovered that there are risks against which no effective insurance is available. For example, there is no effective insurance against risks artificially created at the gaming tables in a gambling casino. Likewise, risks represented by fluctuating interest and foreign exchange rates have been artificially created by the government in ousting gold from the monetary system. Under the gold standard, there was no risk of fluctuating interest and foreign exchange rates. Bond values were stable.

Bond values are no longer stable, but there is no effective insurance against diminishing bond values. If you were to offer insurance against losses due to declining bond values or bond default, then you would have to look for second-round insurance to cover your assumed risk. Second-round insurers would need third-round insurance, and so on and so forth. This means an infinite chain of insurers, in effect, a Tower of Babel growing ever taller ever faster. Such a tower is not a figment of the imagination. It is real; it exists even though the earth is quaking under its foundations. This Tower of Babel is the derivatives market. At each level the instrument of insurance is a credit-default swap. *The amazing thing is that there are far more credit-default swaps outstanding than there are bonds in existence that they are supposed to be insuring.*

Observers make wild guesses in trying to explain this strange phenomenon. They suggest that most are "dry swaps", that is, they have been created solely for speculative purposes. In this way speculators can gamble with almost no money down. This is the position, for example, of Floyd Norris of *The New York Times* (Reckless? You are in luck! September 19, 2008.)

I reject this explanation. In reality all credit-default swaps were created to insure actual risks directly or indirectly connected with bond-holdings in the balance sheets of financial institutions. First-round insurance is usually the purchase of a bond futures contract; second-round insurance is the purchase or sale of a put or a call options on bond futures. Third- and fourth-round insurance can also be negotiated in the form of a credit-default swap in the derivatives market. I submit that all the credit-default swaps were negotiated by actual insurers to cover risks they have actually assumed in writing insurance at a lower round. They were *not* negotiated for speculative purposes. However, at bottom, these risks are artificial, as they have been created by the government in overthrowing the gold standard. This is the true explanation of the exploding derivatives market that doubles in size every second year, and has already surpassed the one-half *quadrillion* dollar ($500,000,000,000,000) mark.

The derivatives market is the nemesis of government dishonesty and incompetence. The gold standard is striking back — with a lag of 36 years.

Conclusion

The present credit crisis is the greatest ever in history. It burst upon the world in February, 2007, when insurance premiums on bonds in the banks' portfolio shot up. However, the roots of the crisis go much farther back. They go back all the way to the ousting of gold from the monetary system 36 years earlier. Gold is an indispensable tool for the banks to manage risk. The Federal Reserve can print its notes *ad nauseam*, and Helicopter Ben can air-drop them to the banks and bond insurers. It will not address the risks of declining or evaporating bond values. To do that you need something more substantial than irredeemable promises to pay. In Part 2 of this article I shall look at the present crisis in greater detail from the distinctive perspective of the gold standard as an early warning system indicating capital erosion.

Gold Standard University is closing down

Gold Standard University Live had its mission cut out for it: to do the research that academia refused or was forbidden to do: find out the consequences of ousting gold from the monetary system by the U.S. government. Unfortunately our sponsor, Mr. Eric Sprott of Sprott Asset

Management, Inc., has withdrawn his financial support saying that our "results do not justify the expenditure". I am forced to terminate the sessions. The last one will be Session Five to be held in Canberra, Australia, November 11-14, 2008.

In view of the extraordinary events unfolding in world finance and the American banking scene, I shall put on extra meetings in Canberra where I can answer the questions of participants. I shall show that this is not a sub-prime crisis, not a real estate crisis, not even a dollar crisis. *This is a gold crisis: the chickens of 1933 and 1971 are coming home to roost.* I invite you to come and contribute to the success of Gold Standard University Live with your questions and comments. At any rate, the sessions will be taped and the DVD's made available to the public, along with the conference proceedings.

September 25, 2008.

References

It is not a dollar crisis: it is a gold crisis
June 4, 2008
Is our accounting system flawed? — It may be insensitive to capital destruction
May 23, 2008
Forgotten anniversary haunts the nation
March 25, 2008,
These and other articles of the author can be accessed at the website
www.professorfekete.com

Calendar of events

New York City, October 16, 2008
Committee for Monetary Research and Education, Inc., Annual Fall Dinner.
Professor Fekete is an invited speaker. The title of his talk is:
The Mechanism of Capital Destruction.
Inquiries: cmre@bellsouth.net

Santa Clara, California, November 3, 2008
Santa Clara University, hosted by the **Civil Society Institute**
Professor Fekete is the invited speaker. The title of his talk is:
*Monetary Reform: Gold **and** Bills of Exchange.*
Inquiries: ffoldvary@scu.edu

San Francisco, California, November 4, 2008
Economic Club of San Francisco
Professor Fekete is the invited speaker. The title of his talk is:
The Revisionist Theory and History of the Great Depression — Can It Happen Again?
Inquiries: ifkbischoff@yahoo.com

Canberra, Australia, November 11-14, 2008
Gold Standard University Live, Session Five. (This is the last session of GSUL since our sponsor, Mr. Eric Sprott of Sprott Asset Management, Inc., has

withdrawn his support saying that in his opinion the results do not justify the expenditure. Come along and judge for yourself.) This 4-day seminar is a *Primer on the Gold Basis — Trading Tool for Gold Investors, Marketing Tool for Gold Miners, and Early Warning System for Everybody Else.*

In view of the extraordinary events unfolding in world finance and the American banking scene right now, there will be extra meetings to answer questions from participants and to have a discussion, from our distinctive point of view, namely, that this is not a sub-prime crisis, not even a dollar crisis. *This is a gold crisis: the chickens of 1933 and 1971 are coming home to roost.*

Address inquiries to: feketeaustralia@yahoo.com.

A more detailed description of this seminar is found at the end of my article *Cut Off Your Tail to Save My Face!* September 1, www.professorfekete.com