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The Myth of the Gold Standard

Allan Greenspan wrote:

> *If all goods and services were to be paid for in gold, large payments would be difficult to execute, and this would tend to limit the extent of a society's division of labor and specialization. Thus a logical extension of the creation of a medium of exchange, is the development of a banking system and credit instruments (bank notes and deposits) which act as a substitute for, but are convertible into, gold.*

For some reason, the sleight of hand in the above paragraph goes unnoticed by the minds of the advocates of the gold standard. What is the sleight of hand? While the banking system existed for the warehousing and safe keeping of gold, the notes of the bank were convertible into gold. Once the bank makes loans based on other people's deposit, thereby creating new money, not all the notes are convertible into gold, only the notes equivalent to the original deposits of gold can be converted into gold. There is no more gold in the vaults after that.

Once the banking system begins making loans of other people's money, money is no longer based on gold but partly on gold, to the amount of the gold in the vaults, and partly on the good name and trust of the banker. Once money cannot be fully converted into gold, money becomes fiat money, trust money, play money, monkey money, funny money.

This is the reality of fiat money: all money that is not based on real gold in the vault is fiat money. If there are $100 worth of gold deposited at the bank and the bank makes $400 worth of loans then there are 100 gold dollars in circulation and 400 funny dollars in circulation. Of the total of 500 dollars, 100 are real gold and the rest is funny money which can be destroyed at any time by a run on the bank.

How can this problem be solved? By getting rid of the gold standard. By making money worth what the government says it's worth. By making all dollar bills exchangeable for other dollars bills which in turn are also exchangeable for new dollar bills but not for any given amount of gold.

The problem then becomes that people don't trust the government to handle money properly. Either the Fed creates too much money or the Fed shrinks excesively the money supply. The Fed, it seems, never gets it right. Of course not, the system, being a compex system, can never be managed by a single entity. It can only be managed by free agents all acting in their own self interest.

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ajnock wrote:

> *(P.S. I'm still confused about your comments about gold. Historically, people gravitated to a medium of exchange in which ONE of it's positive properties was that it was not easily replicable, therefore, it would hold its value over a longer period of time. Once governments got into the picture, they of course corrupted it for their own self interests. I personally would rather store my value in something of this nature (e.g, gold, silver, etc.) than a piece of cheap paper that anyone can print any denomination they want to on it.)*

I urge you to read *Money, whence it came, where it went* by John Kenneth Galbraith. Money has taken many forms including sea shells and tobacco. What gives money its value is trust. If we agree that one sea shell is worth 10 loaves of bread then that what bread costs, 10 loaves per shell. This agreement will change with the relative abundance of bread and sea shells. Gold is no different. When Spain stared to mine gold in America and to ship it to Spain, it caused great inflation first in Spain and then in the rest of Europe that traded with Spain. Had you been the unlucky owner of some ounces of gold, your net worth would have dropped considerably.

Gold as currency has many problems. You can sweat it, file it, and you can add copper to it. That means that each piece of gold that you receive in payment has to be essayed, a considerable pain in the wallet. If you hold gold you have to take measures to make sure you are not robbed so holding gold has a cost. The Bank of Amsterdam was born to solve all these problems. People deposited their gold at the bank and the bank gave them notes in exchange. The merchants trusted the owners of the bank so they were willing to accept these notes in lieu of gold and their trading costs dropped considerably.

This is why I insist that money is a contract. We agree that we will trust the owners of the Bank of Amsterdam or we will trust the government of a country or we will trust in something else. If trust disappears, money loses its value. The problem of entrusting money to governments is that they love to tax and spend. Printing money -- creating inflation -- is exactly the same as levying a tax, the government removes some of our net worth and spends it on something we probably don't want or need.

Let's suppose you trust gold. That in no way prevents me from creating money. All I need to do is to give you credit, sell you something on credit. That is what credit cards do. That is what banks do when they give loans. The real difference between me and the government is that I will have to pay eventually if I want to keep my credit rating but the government can get away with murder. Like the Social Security SCAM. There is no Social Security fund! The government took the Social Security tax money and spent it. It will pay future expenses with future taxes. So the interest that might have been earned by a real fund does not exist and the Social Security taxpayers are paying more than they should.

But none of this changes the fact that we need to find or build an institution that we can trust. My solution is to close down the Fed, fire Greenspan and let the money changers take care of business. You are not allowed to print money so the only way to get some is to earn some. In each transaction either you get pretty pieces of paper or you get a credit in an electronic account at a bank, a brokerage house or elsewhere. When business is good, banks make loans and the money supply expands. When business is bad, banks recall loans and the money supply shrinks. End of story. All we need is to regulate these private institutions and that's where the difficulty lies.

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MadCapitalist wrote:

> *Interest rates are determined by the interaction between the *demand* for money and the *supply* of money.*

That is entirely correct. **Free market interest rates** are nothing more than the price of money. But, as with all prices, interest rates can be manipulated up or down by the vendor of money, in this case, the Fed.

When the Fed lowers interest rates, making money cheaper, it increases the money supply because banks can borrow more from the Fed and that, in turn, increases the general level of prices. That is how the Fed aided and abetted the technology bubble.

When the Fed increases interest rates, making money dearer, it decreases the money supply because banks can borrow less from the Fed and that, in turn, lowers the general level of prices. That is how the Fed aided and abetted the bursting of the technology bubble and the recession.

Now, if the Fed would just go away, a lot of our problems would go away with it. This whole problem reminds me of what novice helmsmen do on sail boats. Sailboats don't react to the helm as quickly as cars react to the steering wheel. The novice helmsman, not getting instant satisfaction when he applies the helm, tends to over steer. The experienced skipper knows his ship better and gives her a lot more room to let her take care of herself.

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shellfish wrote:

> *At maturity, a promise to pay is merely replaced with another promise to pay - in effect, there is no mechanism by which the market can clear. Because so much of the world (especially central banks) hold the liabilities of others as reserves on their balance sheets, even the most valid attempts to liquidate would place enormous stress on this*

fragile debt structure.

Here you are dealing with the crux of the matter but you are arriving at the wrong conclusion. Have you ever tried to step out of an airplane in flight? Can't be done safely unless you have a parachute. The same sort of problem exists when surgeons try to repair a heart. If they stop the heart the patient dies unless they hook him up to an artificial pump.

The economy has arrived at a level of complexity where the market cannot be cleared without destroying the market the same as you cannot stop an airplane in flight without hitting the ground.

The question then becomes, do we abandon flight because airplanes cannot fly below a certain speed or do we accept that fact and deal with it? In my opinion, gold as currency is no longer workable and we need to deal with the current system which is fiat money. We need to find ways to make fiat money work for us, not against us.

In the last several hundred years it has been clearly demonstrated the world over that complex systems work when left to their own devices, when free agents can act in their own self interest but the opposite did not work. The Soviet Union collapsed. Socialistic governments had to privatize state owned industries. The price of phone calls dropped when Ma Bell lost its monopoly power. There are hundreds of examples to back this argument. Yet when it comes to money most people don't trust the free market. They want a super brain to carefully manage it for us. It does not work. It will never work. Money has to be managed by free agents all acting in their own best self interest.

Some people keep dreading greed. I think they read too much Dickens. Some people keep dreaming of altruism. I think they saw too many reruns of Mary Poppins. The reality is somewhere in between with most of us trying to make a living in an honest manner. And for those that don't, for those who want to abuse the system, we have the legal means to curb them or to punish them.

It's time to bring the monetary system up to date. We are in the 21st century after all.

shellfish wrote:

> *The saver has the right to withdraw his gold coin if he feels that the rate of interest being offered is too low.*

In a system that is not 100% backed by gold that is a myth. If one saver has the right to withdraw so do all others but if all of them try to withdraw they collectively fail because there is not enough to go around.

I really wish people would stop perpetuating this myth about the right to withdraw your gold in a system that is not 100% backed by gold. This the same as being partly pregnant. No way. Either you are or you are not pregnant. Either all have the right **and the ability to withdraw** or that right is mythical.

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