

Gold and Economic Freedom

An almost downright hysterical hostility toward the gold standard unites state interventionists of every kind. They seem to sense more clearly and distinctly than even many advocates of the free market economy that gold and economic freedom are indivisible, that the gold standard is an attribute of the free market economy, and that both mutually condition each other and are dependent upon one another.

To grasp the cause of their hostility, it is first necessary to understand the exact role that gold plays in a free society.

Money is the common denominator of all economic transactions. It is the good that is used as a medium of exchange, that is accepted by all participants in an exchange society for the payment of their goods, and that therefore can be used as a measure of market value and for the storage of value, that is, for saving.

The existence of such a good is the prerequisite for a society based on the division of labor. Without a good that serves as an objective standard of value and is generally accepted as money, people would have to content themselves with primitive barter or would even be forced to eke out their lives on autarkic farms and forgo the enormous advantages of the division of labor. If there is no possibility of storing value, that is, of saving, then neither long-term planning nor exchange would be possible.

Which medium of exchange is acceptable to all economic participants cannot be arbitrarily determined. First and foremost, the medium of exchange should be durable. In a primitive society with only little wealth, wheat might be sufficiently “durable” to serve as a medium of exchange, since all exchange transactions would take place only during the harvest or immediately afterward and there would be no necessity to store value surpluses. But as soon as the storage of value becomes significant, as is the case in civilized and richer societies, the medium of exchange must be a durable raw material, usually a metal. A metal is generally chosen because it is homogeneous and divisible. Every unit equals the other and it can be shaped and alloyed in any quantity. Gemstones, for example, are neither homogeneous nor arbitrarily divisible.

Even more important is that, in order to be suitable as a medium of exchange, the good must be a luxury good. The human need for luxury is unlimited, which is why luxury goods are always in demand and also always accepted. Wheat is a luxury good in an undernourished

society, but not in a prosperous society. Cigarettes would normally not be accepted as money, but after the Second World War they were regarded in Europe as a luxury good. The term luxury good implies scarcity and a high value per unit. Since it represents a high value per unit, such a good can easily be transported. For example, one ounce of gold has the same value as half a ton of pig iron.

In the initial phase of a developing money society, several media of exchange are often used, since a whole range of goods can fulfill the described requirements. Over the course of time, however, the exchange good that finds the greatest acceptance will displace all others. For the function as a store of value, demand will concentrate on the most accepted good, which in turn brings it even more acceptance. This development continues to the point at which this good becomes the sole medium of exchange. The use of a single medium of exchange has great advantages, namely for the same reasons that a money economy is superior to a natural barter economy. It enables exchange on a vastly greater scale. Whether this one medium is now gold, silver, shells, cattle, or tobacco varies and depends on the environment and the stage of development of the respective society. In fact, all these goods were used as media of exchange at various times. Even in our century, two significant goods, namely gold and silver, were used as international media of exchange, whereby gold became the dominant one. Gold, which finds both artistic and functional use and is relatively scarce, has always been regarded as a luxury good. It is durable, easily transportable, homogeneous, divisible, and therefore has significant advantages over all other media of exchange. Before the beginning of the First World War, it was practically the only international exchange standard.

If all goods and services had to be paid for in gold, large payments would be difficult to carry out and this in turn would to a certain degree limit the division of labor and specialization in a society. The logical continuation of the development of a medium of exchange is therefore to develop a banking system and credit instruments (banknotes and deposits) that function as representatives but are redeemable in gold. A free, gold-based banking system is capable of granting credit and thereby creating banknotes (currency) and deposits according to the production requirements of the economy. Individual gold owners are induced by interest payments to deposit their gold in a bank, against which they can draw checks. And since in the rarest cases all depositors want to withdraw their gold at the same time, the banker only needs to hold a portion of the total deposit in gold as a reserve. This enables the banker to lend more than his actually physically present gold deposits (i.e., he holds claims on gold instead of actual gold as security for his deposits). But the amounts he can lend are not unlimited. They must stand in a sustainable ratio to his reserves and the current state of his investments.

When banks lend money to finance productive and profitable enterprises, the loans are repaid quickly and bank credit remains generally available. If, however, the businesses financed with

bank credit are less profitable and are repaid only slowly, the banks quickly sense that their outstanding loans are too high in relation to their gold reserves and they begin to be more restrained with new lending, usually by charging higher interest rates. This limits the financing of new undertakings and requires the existing debtors to improve their profit situation before they can receive loans for further expansions. Therefore, under the gold standard a free banking system acts as a guardian of economic stability and balanced growth.

If gold is accepted as a medium of exchange by most or even all nations, an unimpeded free gold standard favors and promotes the worldwide division of labor and international trade. Although the exchange units (dollar, pound, franc etc.) differ from country to country, the economies of the individual countries nevertheless function like a unified economy, insofar as all units are defined in gold and there are no impediments to trade and free capital movements. Credit, interest rates, and prices then behave similarly in all countries. If, for example, the banks in one country grant credit too generously, there is a tendency in that country for interest rates to fall, which induces gold owners to shift their gold to banks in other countries where it yields higher interest. This will immediately lead to a shortage of bank reserves in the country with the loose credit conditions, which in turn leads to stricter credit conditions and a return to competitively higher interest rates.

A completely free banking system and a consistent gold standard have never yet been realized. But before the First World War, the banking system in the United States (and in most of the world) was based on gold, and although there were occasional interventions on the part of the state, banking was nevertheless predominantly free and uncontrolled. Occasionally the banks had, due to too rapid credit expansion, exposed themselves to the lending limits of their gold reserves, whereupon interest rates rose sharply, new credits were not granted, and the economy fell into a sharp but short recession (in comparison to the depressions of 1920 and 1932, the economic downturns before the First World War were mild). It was the limited gold reserves that stopped an uneven expansion of business activity before it could develop into such disasters as then occurred after the First World War. The correction phases were short and the economy quickly found a healthy basis for further expansion.

But the healing process was misinterpreted as a disease: If the lack of bank reserves causes an economic downturn — so the economic interventionists argued — why do we not find a way to make additional reserves available to the banks so that they can never become scarce! If the banks can continue to lend money without limit — it was claimed — there need never again be any economic downturns. And so in 1913 the Federal Reserve System was created. It consisted of 12 regional Federal Reserve Banks, which nominally belonged to private bankers but in reality were promoted, controlled, and supported by the state. Credit created by these banks is in practice (though not legally) backed by the taxing power of the federal government.

Technically speaking, the gold standard remained intact; private individuals were still permitted to own gold and gold was still used as a bank reserve. But now, in addition to gold, credit created by the Federal Reserve Banks (paper money reserves) could also serve as legal tender to pay out depositors.

When the economy in the United States suffered a slight setback in 1927, the Federal Reserve created additional paper money reserves in the hope of forestalling any shortage of bank reserves. Even more disastrous, however, was the attempt by the Federal Reserve to help Great Britain, which had lost gold to the USA because the Bank of England refused to let interest rates rise as the market situation would actually have required (it was politically undesirable). The reasoning of the authorities involved was as follows: If the Federal Reserve were to pump massive paper money reserves into the American banking system, interest rates in the United States would fall to a level comparable with Great Britain. This would cause the English gold outflows to stop and avoid the political inconveniences associated with an interest rate increase.

The “Fed” was successful: It stopped the gold losses, but at the same time it brought the world economy to the brink of the abyss. The excess money quantities that the Fed pumped into the economy flowed into the stock market and triggered a fantastic speculative stock boom. Belatedly, the leadership of the Federal Reserve tried to withdraw the excess reserves from the market and finally succeeded in braking the boom. But it was too late: by 1929 the speculative imbalances were already so massive that this attempt only accelerated the already beginning sharp economic slump. The result was a collapse of the American economy. Great Britain fared even worse and, instead of accepting the full consequences of the previous wrong decisions, abandoned the gold standard completely in 1931 and thereby finally destroyed the remaining network of trust, which led to a worldwide series of bank collapses. The world economy sank into the Great Depression of the 1930s.

Using the same logic they had already employed before, the interventionists now argued that the gold standard was primarily responsible for the debacle that had triggered the Great Depression. If the gold standard had not existed, they claimed, England’s departure from gold payments in 1931 would not have caused the bank collapses throughout the world. (The irony was that since 1913 no gold standard, but at best something that could be called a “mixed gold standard,” had existed in the USA; nevertheless, the blame was placed on gold.)

But the hostility toward the gold standard in any form by a growing number of welfare-state advocates was caused by a completely different insight — namely the realization that the gold standard is incompatible with chronic budget deficits (the hallmark of welfare states). If one once pulls aside the veil of academic phraseology, one recognizes that the welfare state is

nothing more than a mechanism by which the state confiscates the wealth of the productive members of a society in order to finance numerous welfare projects with it. A large part of the wealth confiscation occurs in the form of taxes. But the welfare bureaucrats recognized that the tax burden had to be limited if they wanted to remain in power. Their alternative was massive government indebtedness, i.e., they must borrow money by issuing government bonds in order to finance the enormous welfare expenditures.

Under a gold standard, the amount of credit that an economy can absorb is limited by the real physical assets of the economy, because every credit is ultimately a claim on a real physical asset. But government bonds are not backed by real physical assets, but only by the government's promise to pay from future tax revenues. They therefore cannot so easily be absorbed by the financial markets. A large quantity of new government bonds can only be sold to the public at constantly rising interest rates. Hence the possible government debt under a gold standard is very limited. The abolition of the gold standard enabled the advocates of the welfare state to misuse the banking system for unlimited credit expansion. In the form of government bonds they created paper wealth which the banks, after a complicated procedure, accept as security like real wealth, as it were as a substitute for what was previously a deposit in gold. The holder of a government bond or of a bank deposit based on paper money believes that he has a valid claim on real values. In reality, however, more claims on real values are in circulation than real values exist.

The law of supply and demand cannot be repealed. If the supply of money (claims) increases in relation to the supply of real goods in the economy, prices must inevitably rise. That means that earnings saved by the productive parts of society lose value when expressed in goods. On the bottom line of the balance sheet, it then turns out that this loss exactly corresponds to the goods that were acquired by the government for welfare and other purposes with the money from government bonds financed through the credit expansion of the banks.

Without a gold standard there is no way to protect savings from confiscation through inflation. There is then no longer any safe store of value. If there were, the government would have to declare its possession illegal, as indeed actually happened in the case of gold.* If, for example, everyone decided to exchange all his bank deposits for silver, copper or another good and afterward refused to accept checks as payment for goods, bank deposits would lose their purchasing power and government debts would no longer represent a claim on goods. The fiscal policy of the welfare state makes it necessary that there be no possibility for property

* Gold ownership was prohibited for private individuals in the USA from 1933 to 1975, translator's note.

owners to protect themselves. This is the shabby secret that stands behind the demonization of gold by the advocates of the welfare state. Government debt is simply and plainly a mechanism for the “hidden” confiscation of wealth. Gold prevents this insidious process. It protects property rights. Once one has understood this, the hostility of the welfare-state advocates toward the gold standard is no longer difficult to understand.

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