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What's the colour of money, Part II

"Don't Get Caught Up in Optimism."

- Headline from CNBC.com which you couldn't really make up.

"Fund managers reconsider their holdings in gold" is a recent headline from TheWealthNet. It cites a report from Standard & Poor's Fund Services, whom one hopes are more accurate in their assessments of managed fund quality than their colleagues in the credit ratings business. High prices for the metal have apparently if not unsurprisingly led some fund managers to reduce their gold holdings. A team at Barings is mentioned for being disappointed that the gold price has been highly correlated to that of other risk assets, as if investment management were somehow an exercise in the choreography of statistical waltzes rather than an exercise involving the defence and growth of capital. Managers at Union Investment are mentioned for having considered investing in gold but having concluded that "the recent rise of the gold price is not backed by solid fundamentals" (what form of universal currency depreciation *would* incline them to buy ?). A team at Legal & General apparently believe that gold price appreciation has been driven primarily by low interest rates and ample liquidity, and that "on some technical indicators it looks overbought" (compared to what ? – for more on which, see below).

While we discuss gold fully aware that simply mentioning the stuff catapults us into presumed gold-bug territory, trying to understand what gold represents is not necessarily intuitively obvious. For some it hearkens back to what Keynes called a barbarous relic, a throwback to a financially unsophisticated and therefore stupid age in which nobody knew anything, and the rise into universal use of fiat money had made all other complementary stores of value obsolete. For others it represents jewellery whose price has been temporarily overwhelmed by an outbreak of speculators displaying greater fool theory (are there any who don't ?). But to some, gold is "sound money" that, unlike modern fiat currency, is not destined to be perennially depreciated until it is inevitably replaced or, more realistically, rebranded. As the managers of the Edelweiss fund point out, at the time of World War I, a quarter of an ounce of gold was worth £1. Now a quarter of an ounce of gold is worth roughly £200. In terms of gold, the Pound Sterling has undergone a depreciation since that time equivalent to 97.5% of its original value. As they suggest, maybe the question is not whether gold is over- or under-valued, but whether the fiat currency used to measure it is overvalued (or, by extension, whether it really has any real value at all – the question most often and ironically hurled at those seeking refuge in bullion in the first instance). To the so-called Austrian school, fiat currency is not "sound money" but dishonest money, money produced through the violation of property rights; fiat credit 'coined' into being by commercial banks or issued by central banking authorities.

The relative (or indeed absolute) soundness of money is relevant because as at the time of writing, rumours were circulating that the beleaguered Obama administration was on the verge of ordering the insolvent government-controlled lenders Fannie Mae and Freddie Mac to forgive some of the mortgage debt of millions of Americans currently in negative equity. A note discussing this plan was being circulated by staff at JP Morgan; brokers Goldman Sachs and Mizuho Securities were mentioned debating the proposals in the original Reuters article; and brokers Morgan Stanley were cited as recommending a mortgage relief plan directly to Congress. The plan does not appear to be just the fanciful creation of a bored blogosphere during the summer doldrums.

Whether the plan is fanciful or not, and indeed whether its actual announcement is confirmed before this commentary is distributed, it shows the extent to which the US administration is determined to do anything and everything it can to sacrifice long term domestic solvency and any form of fiscal stability at the altar of short term political expediency and mid-term vote-grubbing. The inflationary (also read: currency devaluing) implications should be apparent. But there comes a point at which a succession of ever more desperate variations on the Greenspan 'put' have an effect on the body economic that is no longer healthy (if they ever were) but actively destructive, leading a credulous but increasingly financially vulnerable electorate down the path towards what Ludwig von Mises called the flight to real (as opposed to wholly illusory) values and the "crack-up boom" – and the complete breakdown of the monetary system. Of course none of this is in the public interest; it merely serves to redirect short term wealth towards the most voluble lobbyists. As Mises said,

"By committing itself to an inflationary or deflationary policy a government does not promote the public welfare, the commonwealth, or the interests of the whole nation. It merely favours one or several groups of the population at the expense of other groups."

By committing itself to an inflationary policy (the results of which are not yet certain) to bail out the malinvestments of the banking sector, the US administration has thus far showered its favours onto bankers at the expense of taxpayers. In time-honoured political fashion, the reckoning is being deferred to future taxpayers which, in the context of the politician of today, effectively makes that reckoning essentially invisible.

The late Austrian scholar and historian Murray Rothbard wrote an intriguing study of the US' last *really* major brush with financial crisis, "America's Great Depression" (The Ludwig von Mises Institute, Fifth Edition, 2008). Depending on the economic slant of your schooling, Rothbard's account may turn your opinion of the 1930s experience on its head. Conventional and comparatively recent accounts had it that Herbert Hoover oversaw a stupendous crash in the US stock market; the economy entered a profound slump; and it was only the practically manic intervention of Franklin D. Roosevelt that pulled it back out.

But Rothbard's conclusions are exactly opposite to this. President Hoover, by Rothbard's telling, threw all kinds of government resources at the problem, long before Roosevelt's own alphabet soup litany of state agencies. And his viewpoint on banks is instructive:

"Banks are 'inherently bankrupt' because they issue far more warehouse receipts to cash (nowadays in the form of 'deposits' redeemable in cash on demand) than they have cash available. Hence, they are always vulnerable to bank runs. These runs are not like any other business failures, because they simply consist of depositors claiming their own rightful property, which the banks do not have. 'Inherent bankruptcy', then, is an essential feature of any fractional reserve banking system."

Rothbard goes on to quote Frank D. Graham from "Partial Reserve Money and the 100% Proposal" (American Economic Review, September 1936):

"The attempt of the banks to realize the inconsistent aims of lending cash, or merely multiplied claims to cash, and still to represent that cash is available on demand is even more preposterous than.. eating one's cake and counting on it for future consumption.. The alleged convertibility is a delusion dependent upon the rights not being unduly exercised."

One of the primary reasons that Rothbard and fellow Austrians see gold as a fundamental store of value is that it restricts the ability of bankers (not least central bankers) to indulge in uncontrolled credit creation.

Under Rothbard's analysis, bank (and central bank) credit expansion causes an inflationary boom, which is marked by an expansion in the money supply and by what he calls malinvestment, by bankers and entrepreneurs. The crisis comes about when credit expansion halts abruptly and those malinvestments are revealed in all their horror. What he then calls the "depression recovery" starts the necessary adjustment process "by which the economy returns to the most efficient ways of satisfying consumer desires." Note that Rothbard conjoins depression and recovery: they are one and the same thing. You cannot have economic recovery without a cleansing depression:

"Wasteful projects.. must either be abandoned or used as best they can be. Inefficient firms, buoyed up by the artificial boom, must be liquidated or have their debts scaled down or be turned over to their creditors. Prices of producers' goods must fall, particularly in the higher orders of production – this includes capital goods, lands, and wage rates.. Not only prices of particular machines must fall, but also the prices of whole aggregates of capital, e.g. stock market and real estate values. In fact these values must fall more than the earnings from the assets.."

US Treasury Secretary Andrew Mellon is alleged to have said in response to the growing Depression:

"Liquidate labour, liquidate stocks, liquidate the farmers, liquidate real estate."

He may not have said it. The only apparent source for the quote is Herbert Hoover. Whether he indeed said it or not, in the vernacular of the time, as Anthony Herrey recently suggested, it simply meant "sell" and did not carry the darker meaning given it by Stalin's purge trials later in the decade.

But if Mellon did give that advice, he suggested that the economic severity of the Depression would "purge the rottenness out of the system".

As the scale of government support for today's ailing Anglo-Saxon economies continues to swell, in constant and perpetual pursuit of somehow sacred "expansion", one might well ask whether the presumed interventionist cure, now increasingly desperately being sought, is worse than the disease. The Hippocratic Oath that doctors swear begins with an admonition: first, do no harm. That lesson does not seem to have gained any traction within government.

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