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THE DOLLAR: AN AGONIZING REAPPRAISAL

Part One of a New Series

GOLD VANISHING INTO PRIVATE HOARDS

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Introduction. While doing research in the Library of the University of Chicago in the early 1980's I came across the unfinished manuscript of a book with the title: *The Dollar: An Agonizing Reappraisal*. It was written in the year 1965. It has never been published (although it has received private circulation). The author, monetary scientist Melchior Palyi, a native of Hungary, died before he could finish it. Monetary events started to spin out of control in 1965, culminating in the default on the international gold obligations of the United States of America six years later in August, 1971. Palyi had correctly prophesied that event which occurred after he died. He had also correctly diagnosed the malady and prescribed the remedy that could have arrested the train of events that would in all likelihood cause a crash further down the road. As part of the offering of Gold Standard University, I shall publish the manuscript serially in the form of excerpts, along with with my commentary, concentrating on parts that are still timely.

That the title is more timely than ever is a fact that nobody can deny.

Biographical remark. Melchior Palyi (1892-1970), the internationally recognized educator, author, and economist was born and got his early education in Hungary. He was Professor Emeritus of the University of Berlin and also taught at the Universities of Munich, Göttingen, and Kiel. He was the chief economist of the Deutsche Bank of Berlin, the largest on the European continent at the time, and was adviser to the Reichsbank, the central bank of Germany, from 1931 to 1933. He was then guest of the Midland Bank, Ltd., in London, and visiting lecturer of the University College of Oxford.

Palyi moved to the United States in 1933. He was visiting professor and research economist at the University of Chicago, Northwestern University, the University of Wisconsin, and the University of Southern California. He was involved in broad literary and lecture platform activities. The bibliography of his literary output is extensive; let it suffice to mention the titles of some of his books: *Compulsory Medical Care and the Welfare State* (1949; he is credited with the saying „where the Welfare State is on the march, the Police State is not far behind”), *Managed Money at the Crossroads* (1958), *A Lesson in French: Inflation* (1959), and his swan song: *The Twilight of Gold* (1970). Change of font to bold face type indicates quotations from the manuscript.

The Gold Paradox

Nineteen sixty five will be remembered in the modern history of money. For the first time, private buyers absorbed almost the entire supply of new gold coming on the market. „Newly mined gold plus Russian sales amounted to approximately \$1.9 billion”, reported the First National City Bank of New York, but „only some \$250 million worth is believed to have reached officially recorded monetary stocks” (all quantities are stated in gold dollars, reckoned at the gold price of \$35 per Troy oz.) And none whatsoever accrued to U.S. monetary reserves | which has actually declined by a near record amount of \$1.66 billion.

What is happening to all that disappearing gold? Why does it refuse to go to official gold reserves? Why, in particular, is the U.S. Treasury on the losing side year after year, with no sign of terminating this process? And, above all, what does it say about the stability of the dollar, the economic health of the nation, and the future prospects of the Western World?

The central problem is the actual maintenance of the parity. The U.S. Treasury is under obligation, in effect, to assure that on the world's markets 35 dollar means the same value as one ounce of gold. Thereby the value of the dollar is anchored to the solid rock of a fixed quantity of gold. As long as this external convertibility of the dollar appears to be guaranteed, world public opinion will not question the equivalence between the currency unit and a set amount of the yellow metal. That is why to the world at large the dollar is „as good as gold”. In the words of President J. F. Kennedy, speaking in September, 1963, „We are determined... to maintain the firm relationship of gold and the dollar at the present price of \$35 an ounce, and I can assure you we will do just that.”

Gold vanishing into private hoards

1950 is the watershed year marking the start of a new era in the relationship between gold and paper money. In the twelve-year period ending in 1964 the Western World's gold mines and Russian gold sales (about \$1 billion in 1963-64) combined, produced \$16 billion worth of gold, but official gold reserves have grown only by \$7 billion. More than 50 percent, on average, of the new gold bypassed official reserves and vanished in private hoards. On the top of that the prime reserve currency, the U.S. dollar (that is backing many other currencies) had lost close to one-half of its gold reserves. By the end of 1965 our reserves have declined from a peak of \$24.7 billion in September, 1949, to less than \$14 billion| of which \$835 million is a sight deposit of the International Monetary Fund. Not only has the richest country failed to attract any part of the new gold supply; it has actually lost more than \$10 billion's worth. If continued, this process would herald the breakdown of the entire gold-based monetary setup of the West, with incalculable consequences.

To have some idea of the order of magnitude of gold vanishing into private hoards during the period from 1950 through 2007, let us recall some facts and figures.

Output from Western mines plus Russian gold sales before the collapse of the Soviet Union (approximate quantities in gold dollars at \$35/Troy oz.):

1950-51: \$ 2,000m; 1952-65: \$ 21,000m; 1966-68: \$ 3,400m; 1969-2006: \$ 77,500m.

Absorption into private hoards from mine output, gold pool sales plus US/IMF/central bank gold auctions (approximate quantities in gold dollars at \$35/Troy oz.):

1950-51: \$ 100m; 1952-65: \$ 9,000m; 1966-68: \$ 3,200m; 1969-2006: \$ 80,000m.

The crescendo of gold disappearing in private hoards is crying out for an explanation. Gold absorption into private hoards for the 20-year period from 1950 through 1970 was of the same order of magnitude as the entire U.S. gold reserve at its peak in 1949, the largest gold concentration ever in history: just short of \$ 25 billion. It was followed by the greatest dissipation of gold ever. This private absorption of gold is unprecedented, both as to its magnitude and its speed. The total amount of gold absorption for the entire 56-year period 1950-2007 was approximately \$ 90,000m, an amount greater than all the gold produced in history before 1950.

Clearly, something ominous is happening to the dollar. Vanishing gold is trying to tell us something, that is, if we have ears for hearing. More remarkable still than these extraordinary quantities of wealth shifted out of paper assets into physical gold, worth about \$ 1,8 trillion at today's gold price, a process that is still continuing at an accelerating rate, is the fact that *mainstream economists and their paymasters in government are not asking questions about, nor offering explanations for this incredible movement of wealth going into hiding*. The apparent lack of interest about the identity and intentions of the owners of this wealth on the part of the economists' profession is in itself a worthy subject to investigate.

Put it differently, paper wealth in the world is presently being destroyed at the rate greater than that of the annual gold production, approx. \$2.8 billion gold dollars (equivalent to about \$55 billion paper dollars at today's gold price), but this earthquake-style destruction is allowed to go unnoticed by academia and the financial media. They are satisfied that paper wealth so destroyed will not be missed. The U.S. Federal Reserve banks are dutifully replacing these real assets, and more, by printing paper assets. „See no evil, hear no evil.” „What you can't see won't hurt you.” Nobody is pointing out that this newly created paper wealth facing, as it is, an equivalent amount of wealth in solid gold, is quite hollow. Nobody asks whether the large quantities of gold vanishing into private hoards could cause a crisis when its size reaches and exceeds critical mass. Be that as it may, thinking people ought to realize that, the official 'propaganda of silence' notwithstanding, the disappearance of such inordinate quantities of gold cannot help but, in the fullness of time, have an untoward effect on their lives, and on their children's lives.

Fifty percent of all the gold in existence has been produced since 1960. *The same fifty percent has been withdrawn from the public domain during the same period of time* and disappeared in private hoards. There is no way to account for this gold. We do not know the location, the identity of owners, nor their intentions what they wanted to do with it. This is a sea change portending a still greater sea change to come. This is a situation comparable to the disappearance of the gold and silver coinage of ancient Rome portending the fall of the Empire. For this sea change the public is totally unprepared. It is left in complete ignorance, due to the deep silence of the media and academia.

„The most uneconomical medium of circulation”

At this point the reader may raise some pertinent questions. Why is gold essential for a healthy monetary system? Why should anyone want to hoard it?

Is it not a useless gadget, good only for jewelry and dentistry? Why base the currency on such an odd commodity, or on any commodity for that matter? We have eliminated gold from hand-to-hand circulation; why not finish the job and dethrone the „barbarous relic”, as Lord Keynes called it?

Indeed, we seem to be on the way to wipe all traces of gold out of the monetary system. The first (1915) Annual Report of the New York Federal Reserve bank argued that „gold is the most uneconomical medium of hand-to-hand circulation since, when held in bank reserves, it will support a volume of credit equal to four or five times its own volume”. (That was an unintended admission of the inflationary bias indigenous to American money-management.)

Twenty years later, in 1934, we proceeded to 'demonetize' gold, forcibly taking it out of circulation. This was followed, in 1945, by the reduction of the Federal Reserve banks' gold reserve requirements to 25 percent of total liabilities. By 1965 we had abolished gold as a mandatory backing of the deposit liabilities of the Federal Reserve banks altogether.

Rationale of gold

The first thing to know about gold is that there is no alternative to it. Gold is the one and only commodity that has no marketing problem. There is no sales resistance and no competition to overcome. A gold reserve is as important for the nation as a bank account for the firm or individual. You keep part of your funds in idle bank balances in order to be 'liquid' | to be able to pay your bills. Gold is the ultimate and unquestioned world-wide 'liquidity'. It is accepted in payment of claims. Hence it is imperative that a country should possess gold, or to have access to gold, in order to take care of an unfavorable balance of foreign payments that arises when it has to purchase abroad more goods, services, and assets than other countries buy from it. This has been the chronic case for the United States in the post-World War II era, resulting in gold losses and in a huge volume of short-term debt to foreigners.

The gold reserve inspires confidence in the currency at home and abroad. „Even the most prejudiced managed-money advocate cannot deny that no form of paper or arrangement can ever command the confidence and trust inspired by gold, a store of value in itself” (*The Statist*, London, December 25, 1964.)

In addition to the monetary there is also a non-monetary demand for gold. The very promising metallurgical and medical applications of gold are still in their infancy. Its use in the arts is ancient history. In any case, the non-monetary demand provides a substantial part of the value of the yellow metal, and is the root-cause of its use as the Number One store of value. This function loses its importance when the national currency is safely anchored in gold. But it is promptly revived and expanded whenever convertibility comes under a cloud.

Paper money can be multiplied *sine fine*, virtually at no cost. Gold is available only in limited quantity and at a substantial cost of production. This fact is not a negative but a highly positive factor for determining gold's monetary fitness. Gold derives further strength from another circumstance. The annual new production is a very small part of the accumulated total supply, hardly ever more than 3 percent at any given time. In 1965, for example,

the \$1.9 billion new gold reaching the market was less than 3 percent of the total supply of over \$60 billion accumulated in the central banks of the West and in private hoards. (The latter has been 'guesstimated' at \$17 billion.)

No commodity known to man combines as gold does the qualities of durability, unlimited marketability, portability, homogeneity, steady demand, stability of supply growth, fitness for being stored, low cost of storage per unit of value and, last but not least, independence from authoritarian manipulation of the total supply. This is why totalitarians (and their dedicated or subconscious fellow-travellers) are violently opposed to its private ownership that provides the citizen with a large measure of freedom. By having gold he can hedge against arbitrary policies of the Omnipotent State, or even slip out from its clutches.

Explanation of the gold paradox

The paradox of a chronic flight into gold, and out of the U.S. dollar which is tied to gold, is the outstanding symptom of the present critical situation. The pat explanation for the paradox is to blame the recurrent runs on the 'speculators'. This is a characteristic throwback to medieval economics, confusing symptom and cause. In truth, responsibility belongs to the authorities who create opportunities to induce speculators to go short on the dollar or to buy gold on margin. A far more important factor may be the maneuvering of the cautious who do the exact opposite of 'speculating': they are trying to protect their assets and incomes by hedging against a possible devaluation...

Another pat explanation relegates the problem to the fringes of the global economy. In areas where political, legal, or monetary insecurity prevails, there is a compulsive instinct to seek security in hoarding gold. No country can beat India in this regard. The hidden gold of her population has been estimated by India's Reserve Bank at some \$6.4 billion (!), built up over a period of 100 years or longer.

But the less developed economies are altogether too poor to absorb *each year* the huge amount of vanishing gold. And why would they not hoard convertible currencies instead of gold, as they did in the past? Actually, an appreciable fraction of foreign aid dollars has been used by the recipients to acquire gold | another vote of no-confidence for the dollar, as well as for the respective local governments.

Even more significant is the fact that leading European central banks display definite signs of impatience with the dollar. Given the \$13.7 billion holdings of dollar claims by monetary authorities, not counting some \$6 billion held by international organizations, the danger this implies for the American gold reserve and the maintenance of the dollar's convertibility can scarcely be overestimated.

It is more than a problem in monetary management. Our very prosperity, and the integrity of our economic system is at stake!

Explanation, forty years later

In forthcoming parts of this series I shall take the analysis of the gold paradox beyond the point to which Palyi has taken it. I shall ask the question who the hoarders are and what motivates their gold hoarding. My thesis is that gold hoarding is a win-win strategy, the only

valid one as such. (All other win-win strategies are Ponzi schemes.) However, there is a strict condition, one that disqualifies most would-be beneficiaries. The gold hoarder must be prepared to, and mentally capable of, using gold exclusively as his *numeraire* in calculating asset values as well as profit and loss. He must understand that profit/loss accounting in terms of the paper dollar is tantamount to trying to measure length with an elastic measuring-tape. The obvious result is a cover-up for the deficiency of length, akin to the cover-up for the deficiency of wealth and to making losses parade as profit. Watch for the day when people wake up from their delusion.

Admittedly, very few people are able to adapt their thinking to the demand that the dollar be discarded as *numeraire* of wealth. The dollar is far too deeply ingrained in their psyche for that. As a result, very few people see the fragility of wealth under the regime of irredeemable currency. Those who can are not tempted by the spectacular profit opportunities in stock, bond, and real estate speculation. They know full well that yielding to the temptation would be tantamount to be seated in the middle of a crowded auditorium just before the fire alarm was ready to sound. Their chance to reach the fire exit alive would be practically nil.

Apparently, more and more people do accept gold as a valid *numeraire* replacing the dollar, since they have seen the writing on the wall warning about the dollar: „*Mene tekel, upharsin*” (you have been weighed and found wanting).

We can understand the little guy's agonizing watch on a hesitant gold price to go up. He is conditioned by a host of cheerleaders of get-rich-quick schemes. However, the more enlightened hoarders of gold (whom in another paper I have called 'bulls in bear skin') | admittedly a tiny minority | are in no hurry to see the dollar to bite the dust, or the price of gold to go to outer space. They do have the philosopher's stone, gold, well in hand. More importantly they also have the matching wisdom, without which gold is just another dead asset. They know that the most productive use of gold is not to sit on it waiting for the miracle of a gold price in five digits to spring upon the world. They want to derive maximum advantage from their possession of the metal. In particular, they know how to make gold beget gold, something even Aristotle believed was impossible. Most importantly, they need not release control over their gold while deriving an income from it. Mark that, in all other cases, deriving income from an asset involves putting the latter to risk. The fact that gold income is an exception to that rule, in that it can be harvested risk free even while the gold is locked up in one's own vault, is due to the idiosyncracies of irredeemable currency. It is the paradox that, while the irredeemable dollar is gold's sworn enemy, it lends gold the unbeatable advantage whereby it can generate an income *risk free*.

The 'enlightened hoarders of gold' prefer the security of a gold income, that they can enjoy in relative peace, to the insecurity of an exploding gold price. They understand that they could not enjoy their exploding wealth once the gold price escaped from the earth's gravitation, because blood would flow in the streets where the 'have-nots' gave battle to the 'haves' over the only bone of contention that mattered: gold.

The common perception is that commercial traders are selling gold short *naked* in order to drive down the gold price where they can cover their short positions at a huge profit. In this view the bears are sucking the blood of the bulls. This, of course, is a myth. It is a simplistic explanation for a complex puzzle, the gold paradox. In reality commercial traders are mere agents. If they trade for their own account, the amounts are paltry in comparison. Commercial traders act on behalf of principals who do hold the gold and are set upon deriving an income from their holdings. It is understandable that these principals wish to stay anonymous and, in an unexpected reversal of Andersen's tale *The Emperor's Clothes*, they foster the misperception that they are naked!

Historical precedence: vanishing gold in ancient Rome

The last time in history when huge quantities of gold were going into hiding occurred during the twilight of the Roman Empire. It was an ominous portent of bad tidings. People were withdrawing gold coins from circulation. They declined to spend them hoping that saner and safer times would come. As a rule people do not spend their gold coins unless they see that they will be able to get them back on the same terms. As saner and safer times did never come, these ancient hoards were forgotten and remained buried in the ground throughout the Dark Ages. Present day archeologists still keep finding them fifteen hundred years later.

The owners of those ancient gold hoards were helpless. They could not enjoy their gold as they were unable to retard the coming of the evil day when the Roman monetary unit would become worthless, and the Empire would fall. In this respect latter day gold hoarders appear to be better off. They seem to be able to retard the fall of the dollar towards worthlessness and, in the meantime, they could enjoy a gold income in relative security. Of course, this will not ward off the ultimate collapse of the American Empire, although it may materially postpone it. *The fortunes of empires tend to be predicated by the fortunes of their currencies.*

The present episode of gold vanishing into private hoards is no less ominous than the previous one that was followed by the collapse of the Roman Empire, and the lights going out in the civilized world.

As this „agonizing reappraisal” shows, the days of the dollar are numbered. Whether it be a large number or small, the coming Dark Age looms large on the horizon.

May 31, 2007.

Correction. It was incorrectly stated in my article *The Golden Thorn in the Flesh, Part Two*, that a translation of Melchior Palyi's 1968 paper *Gold Standard and Economic Order* from German to English was made by Dr. T. Megalli. In fact, the article appeared in English in the original edition of the Festschrift *Geld, Kapital, und Kredit* (Stuttgart, 1968) honoring Heinrich Rittershausen on the occasion of his 70-th birthday.

Announcement. Session Two of Gold Standard University will take place between August 17 and 29, 2007, at Martineum Academy in Szombathely, Hungary. It will feature a one-week course (13 lectures) entitled *Gold and Interest*, as well as a blue-ribbon panel discussion entitled *The Last Contango | an Early Warning Sign of the Collapse of the International Monetary System*. The second week is reserved for sight-seeing and recreation. Enrolment is limited; first come first served. For more information please contact: GSUL@t-online.hu