A View from the Trenches

Toronto, Thursday, February 21, 2013

This is the first of three articles I will post on the suppression of gold. What drives me to write about the topic? I am tired of seeing endless proof of suppression (i.e. the typical take downs in the price at either 8:20am ET or at 10am-11am ET, with impressive predictability) and at the same time, it is unfair that anyone who voices this suppression be called a conspiracy theorist. Therefore, these three letters will give a rigorous theoretical support to the claim.

The first letter will show that, under mainstream economic theory, the suppression of the gold market is not a conspiracy theory, but a logical necessity, a logical outcome. From the publication of this letter onwards, the onus to prove the contrary will fall upon mainstream economists. The conspiracy theory will actually be the opposite: To claim that suppressing gold is not necessary.

The second letter will show how that suppression takes place. For those familiar with the gold market, this letter will offer nothing new and perhaps, it will even be incomplete. But at the macro level, I will seek to offer an insight.

The third letter will examine the consequences of this suppression and rigorously, prove that the claim of the gold bugs, namely that physical gold will trade at a premium over fiat gold or gold paper is also not a conspiracy theory, but the logical outcome of the current paradigm.

Before I begin, I would like to say that I think proving the logical implication from mainstream economics that gold needs to be suppressed is perhaps comparable to Von Mises demonstration of the impossibility of economic calculation under socialism. Both are very intuitive, of consequence, and a necessary intellectual step. Without further ado, let's start with the **first thesis: The suppression of gold is a logical necessity, under mainstream economics.**

Axioms of mainstream economics

1.-Policy makers believe that there exists a general level of prices, and it can be measured by a price index (Ludwig Von Mises absolutely demolished this notion, but this is outside the scope of this letter. What is relevant is that price indices are "measured" and published by every nation and the market trades on them).

2.-Policy makers believe that in the long term, growth in the supply of money is neutral (Even David Hume laughed at this notion back in 1752)

3.-Policy makers use the general-equilibrium framework introduced by Léon Walras

4.-There exists a gold market and within this market, there are investors who see gold as money, as gold has been money for thousands of year

5.-In global trade, there is no relevant single price index, but relative prices, affected by cross exchange rates.

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Thesis

If axioms 1-5 hold, both a global monetary coordination (as opposed to currency wars) as well as the suppression of the price of gold are required, for the global economic system to remain stable.

Demonstration

Between 1874 and 1877, the works of Léon Walras introduced the notion of general equilibrium in Economics. Considered by Schumpeter as "the greatest economist", in 1874 Walras published "*Éléments d'économie politique pure, ou théorie de la richesse sociale*", as he was teaching in Lausanne. His work examined the conditions necessary to reach equilibrium in an economic system, based on a system of simultaneous equations. To this day, mainstream economists, including those at the helm of central banks, rely on the framework of general equilibrium to work out the theses on which their policies are based.

For obvious reasons, I cannot be exhaustive and therefore fair to M. Walras in this short article. Briefly, general equilibrium in an economic system with (n+1) markets implies that if the first n markets are in equilibrium, the last market, n+1, must be in equilibrium as well. In the same fashion but at an aggregate level, if the n markets show an excess of demand (supply), the (n+1) market must have an excess of supply (demand) large enough to offset the sum of the excesses of the n markets. This conclusion is known as the Walras' Law. It is important to note that it is not necessary that all markets be balanced (i.e. in equilibrium). That is only a particular case of the Walras' Law, where if n markets show no excess of either demand or supply, the last one, market (n+1), is also balanced.

Applied to our context, if we think of the (n+1) market as the global money market and the same is oversupplied because every central bank is monetizing sovereign debt, it must hold that the rest of the markets, on aggregate, must be overdemanded for the world economy to be in equilibrium. That is exactly what policy makers believe they can achieve. To be precise, I shall call here the global money market to the aggregate of fiat currency markets.

Later on, in 1949, another economist, Don Patinkin published a work titled "*The Indeterminacy of Absolute Prices in Classical Economic Theory*", on Econometrica. Patinkin decisively demonstrated that under the Walrasian analysis, the absolute level of prices cannot be determined and that markets clear (i.e. supply meets demand) driven by relative prices. Indeed, the whole notion of a price index is flawed. As Rothbard pointed out:

"…After one commodity, say gold, is chosen to be the medium for all exchanges, every other good except gold will enjoy a unitary price, so that we know that the price of eggs is one dollar a dozen; the price of a hat is ten dollars, and so on. But while every good and service except gold now has a single price in terms of money, money itself has a virtually infinite array of individual prices in terms of every other good and service. To put it another way, the price of any good is the same thing as its purchasing power in terms of other goods and services...(…) In short, the price, or purchasing power, of the money unit will be an array of the quantities of

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alternative goods and services that can be purchased for a dollar. Since the array is heterogeneous and specific, it cannot be summed up in some unitary price- level figure…" The Austrian Theory of Money, 1976

In other words, agents do not bother about a price index, because they only look at relative prices. At this point, one has to make the following observations:

a) We cannot blame Walras. When he wrote, the world was a different place. There was sound money and in 1879, the gold standard would fully blossom. Indeed, with commodity-based money and no aggregate leverage or re-hypothecation the sorts of which we suffer today, imbalances were less pronounced and relative prices were all what mattered (It is necessary to clarify here that the gold standard of 1879 did not enforce a 100% reserve requirement. These two conditions, as far as I know, where only met during the golden time of the Bank of Amsterdam).

b) In the world of fiat money that Patinkin was familiar with, the illusion of the existence of a level of prices was relevant. It was a world of relatively closed economies, that ended with the birth of the likes of Wal-Mart. More than half its population lived under communism, there was relatively little outsourcing, no internet, no Euro zone, no NAFTA or other free-trade blocks.

But if axiom 5 is correct, in a fiat world with the integration which we still enjoy, Walras' implied condition that markets can operate based on relative prices only, namely cross fx rates, should hold. Mainstream economists after all could not point to a global price index which does not exist. Most if not all goods are made with components/inputs produced in different currency zones with different *local* price levels, as measured by mainstream economists. There is no global consumer price index, unless one (like me) measures everything in ounces of gold.

In such a context, it is conceivable and necessary to look at the global economic system as a set of (n+1) markets where the last one, the (n+1) market is the global fiat money market. As long as this market remains balanced, the rest of the markets should not be impacted by global monetary policy.

To obtain the global money market in balance, there must be global monetary policy coordination. Currency wars should be clearly discouraged. Under mainstream economics, there is a benefit in achieving balance at an aggregate level, where the excess of demand in a currency is offset by an excess of supply in another currency. This is what we have observed between the US dollar and Euro currency zones. This is a direct implication of axioms 1-5…But what about the manipulation of the gold market?

When we consider gold as an additional currency, it is clear that its imbalance, for instance, an excess in the demand of it, has to be offset by the opposite imbalance in fiat currencies, if the global money market is to remain in equilibrium. If gold is demanded more than is supplied, fiat currencies will have to be supplied more than demanded. In similar fashion, if there is global coordination to maintain the global fiat money markets balanced at an aggregate level, gold must be also balanced.

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But balance is not what policy makers (i.e. central bankers) are looking for these days. They see an imbalance in the n markets for goods and seek to address it with another imbalance in the global fiat money market. They want to induce an excess of demand on the real side of the economic system through an excess of supply in the global fiat money market. But as money is simply another necessary good, people need sound money; a sound asset as a medium of indirect exchange. If the idea of central bankers is to weaken the liabilities of the banks they lead, people will simply switch to gold. This, of course, is unacceptable to the existing rulers. **Therefore, it is hereby demonstrated that to either keep the status quo (i.e. global fiat money market balanced) or to boost an excess demand in real assets, it is a logical necessity to manipulate the gold market; either to leave it balanced or oversupplied.**

Corollary

Having demonstrated that if axioms 1-5 are true, the manipulation of the gold market is a logical outcome, I want to make a final observation. If global coordination of currencies would leave the global fiat money market balanced, the balance in the rest of the markets would entirely depend of fiscal policy.

But there is an inconsistency here, because the flow and stock of fiat money in most if not all currency zones today are governed by fiscal policy (i.e. by the monetization of fiscal deficits). Therefore, to enforce a balance in the global fiat money market via coordination of central banks is impossible. What may be feasible is to coordinate the expansion in the supply of global fiat money. But if that is the case, we fall back to my proposition: that the manipulation of the gold market to leave it oversupplied is the logical outcome. To pretend it is not…is a conspiracy theory! The onus is on mainstream economists, to prove me wrong.

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