A brief history of the gold standard

As evidence mounts that the major western economies are heading into a banking and monetary crisis due to contracting credit, we face the consequences of unsound money. The era of fiat is drawing to a close and its death will be painful for the highly indebted advanced economies in North America, Europe, and Japan. History and legal precedent tell us that fiat will die and gold will return to provide an anchor to credit system values.

As always, there are lessons to be learned from monetary history, particularly in the context of credit-dependent post-feudal economies, when a gold standard was expected to support mountains of credit in the forms of bank notes and commercial bank deposits.

In this article, I look at lessons from nineteenth century gold standards and the mistakes made. Mostly, they could have been easily avoided.

The debate over the return of gold backing for credit is becoming urgent, not just because the fiat currency system has run its course, but because it is increasingly in the developing world's interests to embrace it. And unless Russia moves urgently towards backing its rouble with gold, her economy will almost certainly suffer from increasing instability, which explains why she is so keen to do so.

Introduction

We know that from the dawn of monetary history, money is gold, silver, or copper and everything else is credit. And the relationship between money and credit was codified in a series of Roman law pronouncements dating back to Rome's Twelve Tables in 449 BC. It was the successor nations of the Roman Empire, stretching from the Atlantic seaboard to the Urals which colonised the world, apart from China and Japan. But coincidentally with the Twelve Tables, it was the era of Confucius, who had died only thirty years before, and the flowering of Chinese philosophy which confirmed similar conclusions about money. But since the end of barter, there have been numerous attempts by rulers to fraudulently misrepresent or confiscate money, usually to finance wars or disguise their debts.

The transition from agricultural feudalism to industrialisation was facilitated by the expansion of credit, not money, though above-ground stocks of gold and silver available for coining did continue to accumulate. And with its expansion, banking systems evolved to deal in credit, creating it as demanded. Rudimentary banking dealing in credit had existed in Roman times, which is why jurors such as Ulpian, Paul, and Gaius in the early Christian era ruled on the differences between money and credit.

In his 1751 treatise *Della Moneta* [On Money], the Italian economist Ferdinando Galiani confirmed the origins of Italian banking which spread throughout Europe:

> "Notably, the first banks were in the hands of private persons with whom people deposited money and from whom they received bills of credit and who were governed by the same rules as the public banks are now. And thus, the Italians have not only been the fathers, the masters, and the arbiters of commerce so that in all Europe they have been the depositories of money and are called bankers."

Banking as we know it today was developed in England by London's goldsmiths, who began to receive the gold and silver coin of the merchants in deposit. They not only agreed to repay it on demand, but to pay 6% interest per annum for the use of it. Consequently, in order to enable them to pay the interest promised it necessarily became their property to trade with as they wished. They were not the trustees of the money, but its proprietors. And it was not placed with them as a *depositum* to be restored in specie, but it became the goldsmiths' property as a *mutuum* to be restored to the merchant on demand. This business flourished after the Restoration in 1660, and expanded significantly under William of Orange, following the Glorious Revolution when the Catholic James II was banished.

When the goldsmith bankers received this money in deposit, in exchange it was agreed that a credit or right of action be given in favour of the merchant for an equal amount of money to be restored to him on demand. It is this banker's obligation to the depositor which in banking language today is termed a deposit.

As this business became mainstream, experience showed that if some of a banker's customers demanded payment of their deposits or credits from day-to-day, others would probably pay in about an equal amount, so that at the end of the day they would not be much difference in his cash balance. In practice, it was found that ordinarily the bank's balance in cash would seldom differ by more than 1/36th of total deposits from day-to-day. Therefore, if a banker retained 1/10th of his cash to meet any demands for payments that may be made, it would be ample cover for deposit outflows in ordinary conditions.

This allowed the banker to buy commercial and other bills in far larger quantities at a discount in return for a deposit credited in favour of the sellers. The sellers of these bills could draw upon their credits at the bank at will. By dealing in credit this way, the leverage the banker could apply to his own balance sheet was safely up to ten times on the assumptions above. And with the rate of discount on commercial bills typically 8% or more, the banker was able to pay 6% to depositors and retain a good profit.

Clearly, the value of a banker's credit had to be expressed in money. That is to say, a deposit was expected to be encashable for specie. But with the evolution of the goldsmiths' business and the mountains of credit created by their activities, the relationship between gold and silver on the one hand and legal obligations to pay on the other would also evolve.

The gold standard as our nineteenth century forbears knew it was basically a child of the British government and its bank in London, the Bank of England. The Bank itself opened for business on 1 August 1694 with a staff of nineteen. For most of the period between 1717 to 1931, Britain operated either a formal or de facto gold standard. The gold standard commenced after Sir Isaac Newton, as Master of the Mint, valued the gold guinea at 21 silver shillings, marking an important shift from sterling silver towards a gold standard. After a period of bimetallism, gold gradually became to be regarded as the measure of value in preference to silver. And in 1816, gold was declared to be the only legal measure of value in England and the pound became the equivalent in gold of 20 silver shillings.

By the 1816 Regulations of the Mint, forty pounds weight of standard gold bullion are cut into £1,869 in sovereigns, fixing the mint price of gold at £3/17/6d. In modern measures, a sovereign weighs 7.99 grammes with a gold content of 7.32 grammes.

In the United States, before the War of Independence English law prevailed and in the late 1700s Blackstone's *Commentaries* was the standard legal treatise among Americans. Blackstone was clear on what constituted money:

> "Money is the medium of commerce. It is the King's prerogative as the arbiter of domestic commerce to give it all authority or make it current. Money is a universal

medium or common standard by comparison with which the value of all merchandise may be ascertained: a sign which represents the respective values of all commodities…

"The coining of money is in all states the act of the sovereign power that its value may be known on inspection. And with respect to coinage in general there are three things to be considered therein: the materials, the impression, and the denomination. With respect to the materials Sir Edward Coke lays it down that the money of England must be either of gold or silver..."[i]

The framers of the Constitution adapted Blackstone to replace the King's prerogative with the new Congress, giving the federal government the power to coin money. And that money could only be coined. To get around this restriction, which is every spendthrift politician's desire, the government would have to have a tame commercial bank to produce gold substitutes in the form of bank notes. But even that course was controversial.

In 1790, Alexander Hamilton as the first secretary of the Treasury submitted a report to Congress in which he outlined his proposal to establish a government-owned bank, the Bank of the United States, using the charter of the Bank of England as the basis for his plan. It was passed and a 20-year charter was signed into law by President Washington the following February. As well as acting as the government's fiscal agent and making loans to the government, it also operated as a commercial bank, issuing banknotes. In 1811, Hamilton was dead, the Republican Party had taken control from the Federalists, and the charter was not renewed.[ii]

Just five years after Hamilton's proposal, the Bank of England began experiencing a significant drain on its bullion reserve, due to the government's need for gold to finance the war with France and also to pay for imported grain after a succession of bad harvests. In 1797, the Bank suspended payments in cash (i.e. gold and silver coin). The suspension continued through the Napoleonic Wars, during which the Bank inflated its note issue causing the price of gold to rise against the Bank's paper currency. In 1810, this led to the appointment of a Select Committee "to enquire into the high price of bullion", which concluded that the depreciation of the currency was due to the excessive issue of bank notes. The following which is extracted from its report to Parliament is the most relevant passage:

"…there is at present an excess of paper in circulation in this Country, of which the most unequivocal symptom is the very high price of Bullion, and next to that, the low state of the Continental Exchanges; that this excess is to be ascribed to the want of a sufficient check and control in the issues of paper from the Bank of England; and originally, to the suspension of cash payments, which removed the natural and true control. For upon a general view of the subject, Your Committee are of opinion, that no safe, certain, and constantly adequate provision against an excess of paper currency, either occasional or permanent, can be found, except in the convertibility of all such paper into specie. Your Committee cannot, therefore, but see reason to regret, that the suspension of cash payments, which, in the most favourable light in which it can be viewed, was only a temporary measure, has been continued so long; and particularly, that by the manner in which the present continuing Act is framed, the character should have been given to it of a permanent war measure.

The Committee recommended to Parliament that placing numerical restrictions on the note issue would be impossible to judge and that in the absence of an exchange facility between notes and coin the only sure criterion was to be found in monitoring the price of bullion and the state of the foreign exchanges. It was a conclusion which has stood the test of time because ever since all attempts to manage the note issue and other forms of central bank credit to achieve price stability have failed.

Perhaps the implication that Parliament was unable to control monetary matters was unacceptable, because the Select Committee's report was rejected. Consequently, being unrestrained the Bank of England was free to increase its note issue without restriction, reducing the gold value of the Bank's paper pound even further.

In an inflationary free-for-all, bank notes were also being issued in increasing numbers by country banks outside London, in what would turn out to be a classic cycle of bank credit expansion. The consequence of the note expansion was rising prices: between 1808 and 1813, the general level of consumer prices is estimated to have risen 25%. Inevitably, a credit squeeze followed and between 1814—1816 half of the country banks failed in the subsequent slump, reducing the total volume of paper currency circulating substantially. The shortage of bank notes led to the value of the Bank's notes increasing accordingly, proving that the Bullion Report was correct in its analysis: that it was impossible to judge what restrictions to put on the note issue, and the best solution was to be found in a firm relationship with specie.

Though Parliament had rejected the Bullion Report, it became the subject of much debate with the result that businessmen and traders were won over by the report. It also converted Robert Peel, who later became the first Prime Minister with a business background. Peel also became Chairman of the Bullion Committee in 1819, and he pushed through an Act initially introducing a gold bullion standard to be followed by a resumption in 1823 of the previous sovereign coin standard. But the Bank had accumulated enough gold to press for the Act to be amended so that they could resume coin payments in May 1821.

However, a run on the bank's reserves began only three years later, taking the bullion reserves from £13 million in January 1824 down to a little over a million in December 1825. A credit crisis developed on the back of the note issue contracting, which was only arrested by the bank issuing yet more bank notes. At last, the directors of the Bank became convinced there was something in the Bullion Report after all, and from 1827 endeavoured to ensure its balance sheet assets were split two-thirds in favour of government debt and one-third in coin and bullion.

From time to time the Bank had great difficulty maintaining this position, and in 1839 was forced to obtain loans from Paris and Hamburg of £3,500,000 in gold to stave off bankruptcy. The ups and downs of the Bank acting as an issuer of bank notes and operating as a commercial bank led to a debate between two schools of thought: the currency and banking schools. From experience and some would claim self-interest, the banking school was against the rules-based approach of the currency school, preferring demand for bank credit to be left to the markets, echoing the conclusions of the Bullion Committee.

The currency school argued that the issuing of bank notes should be separated from banking activities. It was a rules-based approach imposed by law, based on David Ricardo's analysis of 1824 from which the following extract is relevant:

> "The Bank of England performs two operations of banking, which are quite distinct, and have no necessary connection with each other: it issues a paper currency as a substitute for metallic one; and it advances money in the way of a loan, to merchants and others. That these two operations of banking have no necessary connection, will appear obvious from this — that they might be carried on by two separate bodies, without the slightest loss of advantage, either to the country, or to the merchants who receive accommodation from such loans."

Accordingly, under the Bank Charter Act of 1844, the Bank of England was split into two departments: the Issue Department and the Banking Department. The Directors were to transfer to the Issue Department £14,000,000 of securities (mostly government stock) and all gold coin and gold and silver bullion not required by the Banking Department for its immediate purposes. Under Orders in Council the level of securities was subsequently increased to £15,000,000 to compensate for the private banks who ceased to issue banknotes after the introduction of the Act. The increase in the Issuing department's balance sheet allowed it to increase its note issue.

The framers of the 1844 Act assumed that if there was a contraction of the note issue due to notes being submitted for coin, the lower quantity of notes in circulation would support their value, so that the arrangement would always ensure that a potential run on the Issue Dept would be self-correcting. But crucially, a number of errors in the framing of the act transpired.

In effect, the Act attempted to set up the Issue Dept as a bank of deposit, issuing banknotes as tokens for bullion held on the asset side of its balance sheet. It was forbidden from dealing in credit. But by allowing the balance sheet to record assets of £15m in debt securities, this principle was abused, because those securities had to be bought by the issue of credit. Furthermore, it was apparent that there are irrecoverable costs in converting coin into notes and vice-versa. Presumably, the framers in the currency school thought that these could be offset by the income on securities.

The second error was more serious. The framers of the Act had assumed that only banknotes would be submitted to the Bank in exchange for coin. They had omitted to understand that cheques encashed in the Banking Department could equally be exchanged for coin or bullion, so that when there was a run on the Issue Dept it came from cheques being encashed, not notes presented for payment in gold. This refuted the hope that the submission of notes for bullion would support their value through scarcity. This error led to the temporary suspensions of the Act in 1847, 1857, and 1865.

An extension of the second error was a third. When there were a number of currencies on gold standards (which were always the case de facto or de jure), a run on the Issuing Department's gold reserves would occur if the Bank kept its discount rate too low. To illustrate this point, in 1799 there was a banking crisis in Hamburg and the discount rate there rose to 15%, drawing bullion out of London.

To understand why this is so, be it understood that both principal and interest are payable in gold or gold substitutes. Therefore, irrespective of trade imbalances and other factors which might be ascribed to the risks relative between one centre and another, when the rate of discount between two places differs by more than the cost of transmitting bullion between them, bullion will flow from where the discount is lower to where it is higher.

The Act could have worked, despite the lack of the Issue Department not being a proper bank of deposit, if as well as the powers given to it by the Act it was also given the power to set the discount rate purely with the intention of maintaining the bullion reserve. On each of the three failures above, it was this power being in the hands of the Banking Department that led to runs on the Bank's gold reserves and the suspensions of the Act in 1847, 1857, and 1866.

The underlying point is that you cannot have a note issuing function exchangeable for gold on demand as part of a wider banking business, as the Americans clearly understood when Congress did not renew the 20-year charter of the Bank of the United States in 1811.

Before 1834, the United States was on a bimetallic (gold and silver) standard, switching to gold in 1834 at a rate of $20.67 to the ounce, confirmed by the Gold Standard Act in 1900 and which continued at that rate until 1933 when by Executive Order President Roosevelt rescinded it for US citizens. That America's gold standard stood for nearly a century without alteration or compromise through cycles of bank credit is proof that a central bank, even split into departments of issue and banking, is so conflicted in its objectives as to be incapable of securing monetary stability. It only was the establishment of the Fed in 1913 and its post-war meddling in credit markets, which led to the devaluation of the dollar.

The future of gold standards

We know from the long history of the division of labour that money and credit, however defined, have progressed the human condition following the restrictions of barter. And we also know that credit must take its value from a higher form of credit for which there is no counterparty risk. Both in practice, and in law for nearly 2,500 years that higher form of credit has been metallic money.

Therefore, the current situation whereby commercial bank credit takes its value from a government's credit is an aberration. Indeed, every time the state has tried to take ultimate control over commercial credit, it has always failed. Our current monetary system, which has been in place since the suspension of the Bretton Woods Agreement in 1971 is now showing signs of having run its course. There can be little doubt that however long its ending is resisted, the legal and historical precedents will reassert themselves eventually. Gold will then return as the ultimate backstop for all credit, and therefore the values of all commercial activities and wealth.

There is no doubt that the return to a gold standard will face fierce resistance from western governments, which have come to depend on the expansion of their credit to finance excess spending. As we saw when the British Parliament rejected the Bullion Report of 1810, the political class has a fundamental belief that money and credit is something that can be controlled, and any evidence to the contrary is disregarded. The failure of free market economics to gain intellectual traction against statist interests has many examples in history. Germany's historical school adopted Georg Knapp's 1905 *State Theory of Money* while dismissing the Viennese free market intellectuals as a bunch of (Austrian) country hicks.

So it was that despite the collapse of the European paper currencies in the wake of the First World War, the lessons that should have been learned from the detachment of state credit from specie were not. We can always prevent a monetary problem by managing it better, was the common statist cry. And when the roaring twenties, stoked by credit expansion under Benjamin Strong's Fed ended with the Wall Street crisis in 1929—1932 causing the following depression, free market economics were blamed instead. It must never be allowed to happen again, the statists said. Economists had free markets and sound money educated out of them to be replaced by macroeconomics and statistical modelling.

The establishment is simply not equipped to face the challenges of returning to monetary stability. Its experts cannot even diagnose the problems in advance, only reacting to events with an overriding motive to preserve the status quo. All we can say is in the aftermath of Waterloo that Britain's leadership of Liverpool, Castlemaine, Beresford, and Wellington were sound money men, understanding the importance of free markets, imbued with Adam Smith, and the importance of a gold standard, sadly absent in our leadership today.

Following Waterloo, they set in motion an economy which expanded in real terms on the basis of non-intervention, allowing the government's debt to fall from 172% of estimated 1819 GDP to 21% in 1914. According to the Bank of England's own research, this debt declined from a total of £893 million to £706 million between those dates. An additional benefit to government funding was the use of undated consolidated loan stock, which never had to be refinanced of redeemed.

This is the other essential policy behind sound money: government discipline over its own spending. In 1820, once war-time spending had ended government spending was just 13% of GDP, leaving businesses and individuals with 87% of their own money with which to go about their business. Today, government spending is far higher, even exceeding half their economies in some European nations. Unless these excesses are dramatically reduced, there is no chance of a gold standard lasting.

It is for this reason that Russian proposals for a new trade settlement currency between BRICS members acting as a gold substitute should be causing widespread interest. By being a trade settlement currency, it does not interfere with individual nations' prerogatives to manage their own currencies, thereby making its introduction politically feasible.

For now, these proposals have been put on ice, in favour of using national currencies in place of the dollar. But since these national currencies have a history of losing value measured in goods and services, in some cases extremely rapidly, it is not a solution. It is likely that energy and commodity exporters in the group will turn to the historical and legal relationship between credit and gold, in accordance with Russian wishes.

From our analysis of the errors from the past, the establishment of a banking entity to manage the relationship between gold and credit would be a mistake. The Shanghai based BRICS equivalent of the IMF, the New Development Bank must not act as the issuer, and a new entity distanced from it and all governments should be established solely for that purpose. This entity will have a single purpose, and that is to take in gold from any central bank, to be deposited and earmarked for it in a list of approved vaults (which may be under individual central banks' control). Against this gold, it issues the new trade settlement currency which must be denominated in gold by weight. The currency will operate as a gold substitute. If the currency is backed by Sir Isaac Newton's formula of 40% bullion, that uplifts a central bank's gold reserves by 250% to the extent of gold submitted to the issuing entity. This alone makes the scheme attractive to participating central banks.

The history of the Bank of England's failures in the nineteenth century would be avoided if the new issuing entity is prohibited from intervening in the markets as a clearing agent or lender of last resort. And it must be constitutionally independent from all political influences.

Against their reserves of the new gold substitute currency, national central banks can act as lenders of credit denominated in it to the commercial banks in their own networks. This is a secondary pool of credit, only linked to the gold substitute currency by the creditworthiness of the national central bank. In practice, for commercial banks which maintain accounts with a participating central bank, there would be no difference in value between their pool of circulating credit denominated in the new gold substitute and the gold substitute itself.

This credit derivative constitutes the wholesale credit pool, equipped with an interbank money market in which central banks can also deal. Note that the credit created by commercial banks takes its value from the new BRICS gold substitute, but only central banks actually have access to the substitute. And it will be the commercial banks which provide trade finance and settlement for cross-border transactions, putting it in the hands of merchants, businesses and the wider public. This constitutes a third pool, to which the public has access.

This is possibly where the greatest resistance to the Russian proposal lies. While we cannot be sure that Sergei Glazyev, who almost certainly has had a hand in the design of the intended BRICS trade settlement currency, will follow the design outlined herein, it would be the preference ordinary people will have for hoarding the new currency and disposing of government fiat that is sure to concern the BRICS governments considering the scheme. A further concern will be the discipline forced upon the political class to ensure balanced budgets and therefore to maintain a balance of trade, taking into consideration their national propensities to save.

But maintaining fiscal discipline should not be too difficult for the BRICS nations, which are not burdened by extensive welfare commitments. And with infrastructural improvements planned in partnership with China, they have enormous economic potential to unleash. Unlike the welfare-driven advanced nations, emerging nations have a ssimilar economic potential which Britain and America had in the early nineteenth century. And importantly, politicians in Africa, South America, and Asia now suspect it, understanding that the days of development aid ending up in politician's back pockets are an impediment to progress. And there will be no better driver towards the reintroduction of gold into their monetary systems than the developing crises in the highly indebted major western economies.

Russia should also embrace a gold standard for the rouble, as argued by Sergei Glazyev, Putin's chief economic adviser in his 27 December article for *Vedomosti*, the Moscow based business paper.

The rouble has weakened considerably in recent months, M0 money supply has increased by about 21% in a year, and the 10-year government bond now yields 12%. This is the stuff of crisis. In other respects, the Russian economy enjoys low income taxes, and would benefit hugely from normalised interest rates, which would come with a credible gold standard. Furthermore, if the rouble was put on a gold standard, capital flight can be expected to reverse, supporting the rouble, and driving down price inflation.

From Glazyev's statements, he appears to believe that the Russian Central Bank has been infected with western central banking groupthink, and it is reasonable to assume that this view is shared by Putin. Putin is also in military and economic conflict with American-led

NATO, and it is in his interests to undermine US finances. A plan to stabilise the rouble and protect it from monetary and economic attack, while undermining the US dollar's credibility makes enormous sense. These objectives could be quickly achieved by putting the rouble on a credible gold standard.

Putin's problem is his partnership with China, and their joint plans to wean emerging nations and others away from the western alliance. Precipitative action to undermine the dollar and the fiat euro goes against China's trade interests at a time when she is managing her own crisis in residential property development, which threatens to widen into other areas. Furthermore, India in particular has come under considerable pressure from America to not continue its trade with Russian oil and is treading carefully.

But Saudi Arabia is perhaps more prepared to accept a new gold substitute for trade settlement. And in Iran, it has a new ally in this respect. The BRICS trade settlement currency scheme is far from dead. And anyway, there will come a point when the collapse of the dollar-based western currency system forces China to accept that it must protect its currency, its partnership with Russia, and its hegemonic ambitions by accepting gold as the basis of its own currency values.

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[i] As quoted from *Pieces of Eight,* Book 1 by Edwin Vieira Jr.

[ii] For a fuller description of monetary developments in the US after Independence, see James Turk's *Money and Liberty* Chapter 9 (woodlanebooks.co.uk)