TIMING HYPERINFLATION

The Saga of Unraveling Global Fiat Money Issued on the Strength of Irredeemable Promises of Governments

Antal E. Fekete
New Austrian School of Economics

Synopsis

The consensus pushed by mainstream economists almost all of whom are staunch supporters of global fiat money based, as it is, on irredeemable promises of governments, is that the problem of inflation has been disposed of through successful government measures such as QE (quantitive easing), ZIRP (zero interest policy) blowing bubbles in the bond, stock and real estate markets. Governments have also succeded in their war on gold: the precious yellow has been marginalized. Gold has been put where it belongs: in the dog-house.

Thus, inflation is no longer a threat thanks to 'wise' government monetary policy in manipulating the rate of interest. This treatise aims at exploding the myth of government omnipotence by focusing on the weak point of mainstream economics, i.e., Keynesianism, namely, the denigration of capital and dismissing the problem of capital destruction. However, all that these 'wise' government policies have accomplished was to let the capital structure of the world enter an advanced state of

decay. We are witnessing the wholesale progressive destruction of capital. As a result of this, inflation will come back with vengeance and, ultimately, global fiat money will unravel causing hyperinflation.

We shall see that the decay of capital can be put in a time-frame and the coming doomsday can be pinpointed. This will be done through refining our theory of permanent gold backwardation. The theory of *primary gold backwardation* will be augmented by the theory *of secondary gold backwardation.*

Endgame in the gold market

We all know that fiat currency is going to fail. Historically, every experiment with it did sooner or later. The fact that the current experiment survived longer than any previous one proves nothing. In addition, the regime of global fiat currency has become the breeder of irredeemable debt. Logic tells us that the construction of such a Babelian Debt Tower cannot continue forever. It will collapse like its biblical forerunner has, and will bury the conceited builders under the rubble. The problem the monetary scientist must confront is to predict *when.*

I have devoted the greater part of my life to the task of studying hyperinflations throughout the ages. For some six decades I was trying to analyse the problem. I have established the New Austrian School of Economics (NASOE) that attracted brilliant students from all over the world, and conferred several Master's and Ph.Degrees. Some of these doctoral dissertations, written under our program have beaten new paths by using such novel concepts as the gold basis and cobasis. Members of our alumnus contributed important new results to monetary science, for example, proving the important theorem that permanent gold backwardation inevitably brings about hyperinflation in its wake.

Personally, I was motivated by my experience of growing up in a family burdened with the memory that the pension of my grandfather, a government engineer, was wiped out in 1926; followed by the pension of my father, a school principal, being wiped out 20 years later, in 1946. I felt that I was targeted next. The deprivation caused by this experience left an indelible mark on me.

What impressed me most while studying hyperinflations was the fact that virtually all monetary scientists ignored the endgame in the gold markets as the catastrophe of self-destruction of money has been unfolding.

This article consists of excerpts from my book of the same title in which the problem is treated in full. My greatest contribution to monetary science has been the shifting of the focus from the gold *price* to the gold *basis,* the spread between the future and the spot price of gold. Typically it is *positive*. The gold price seismographically picks up a lot of 'noise' while missing false-carding in the gold markets. By contrast, the gold basis is a pristine market indicator filtering out noise while revealing false-carding in the gold market.

* * *

As readers familiar with the card game bridge well know, rules governing endgame are very different from those governing the middle-game and the pre-game auction. In the endgame the knowledge of the distribution of cards yet to be played is all-important. Here false-carding come to the fore. Not surprisingly, in the endgame of the hyperinflationary phase false-carding becomes a frequently applied maneuver. For example, a gold mining concern may be selling gold faster or more slowly than justified by its output. Also, central and bullion banks and hedge funds publish fake statistics on their holdings of bullion and on their maturing gold lease contracts. Forward selling and leasing of gold bullion is also a favorite. When a central bank leases its gold to a bullion bank it assumes the risk that it may never see its leased gold ever again. The latter promptly sells it to silk-road countries. The former, the central bank knows this but it also knows that bank examiners accept paper gold as equivalent to physical, thanks to the relaxing of the standard of bank examination, compromising the process of auditing.

Since 2000 in my lectures and articles I have drawn attention to the unique phenomenon of *permanent gold backwardation* as a foolproof indicator of the progressive scarcity of gold deliverable against maturing futures contracts. The endgame drama features episodes of sporadic backwardation of gold, indicated by the gold basis dipping into negative territory. These episodes, while temporary at first with the gold basis bouncing back into its normal positive range, reestablishing contango in the gold futures markets where the price of gold for more distant future delivery is necessarily higher than that for nearby future delivery. The upshot is that the length of sporadic spells of gold backwardation is getting

progressively ever longer making physical gold ever more scarce, severely squeezing short interest.

The curious thing is that this is not how it played out during the past ten years. The purpose of this article is to explain why.

Waiting for Godot

People bombard me with the question: "How much longer do we have to wait for Godot (read: hyperinflation?)" .

"Why has the prognostication for permanent gold backwardation failed to materialize during the past decade?

The short answer is that the analysis in terms *primary* gold backwardation must be augmented through the introduction of the *secondary* gold backwardation.

The title of this caption calls for an explanation. In 1952 Samuel Beckett wrote a play with the title *En attendantant Godot* that has subsequently become world famous. In his play the author demonstrates with unforgettable force the pre-conscious visceral form of expectation, similar to the Jewish peoples' waiting for the Messiah, or Christendom's waiting for the second coming of Christ. The question arises, in view of the instinctive waiting for hyperinflation in the wake of the "latter-day miraculous proliferation of money". It is motivated by QTM (quantity theory of money), a faulty doctrine. The superficial observer misses the individual's effort to shape the future and the fact that , to this extent, what is happening is caused by teleological forces. The expectation of future always builds on empirical foundations, but exceeds the level of experience. Reasonable monetary policy ought to be able to figure out what consequences follow from government interference.

The gold price is getting irrelevant

To recapitulate, research at NASOE concluded that the gold price is not *per se* a reliable indicator of hyperinflation in the making. More reliable is the *gold basis* and *cobasis*. The negative gold basis makes physical gold progressively scarcer, paving the way towards permanent gold backwardation. Wholesale withdrawal by sellers offers to sell brings

about a situation in which no physical gold is available for purchase *at any price* denominated in irredeemable currency. Sellers do not see how they can replenish their inventory through ordinary trading of gold futures contracts.

In what follows I shall indicate how I propose to refine the theory of permanent gold backwardation to explain the lag between cause and effect.

The Mechanism of Gold Delivery

Strictly speaking gold futures markets are trading warehousing space for gold, and the gold basis is just the price of that warehousing space. We have to familiarize ourselves with the nitty-gritty of delivering on gold futures contracts. We are, of course, talking about warehousing *allocated gold,* in which case the warehouse certificate specifies the exact weight, fineness and the serial number of the gold bar covered. There are well-known risks involved in owning unallocated gold starting with the potential bankruptcy of the warehouse itself.

Even when we limit ourselves to the warehousing of allocated gold, not all gold certificates are created equal. The gold futures exchanges (the largest of which is COMEX in New York) appoint warehouses whose certificates are acceptable in delivery on gold futures contracts.

It may come as a surprise to my readers that delivery on gold futures never involves delivery of physical gold directly. It involves delivery of gold certificates. There are 12 gold futures contracts, as many as there are months in the calendar year; however, only half of them are actively traded: February, April, June, August, October, December.

The procedure of taking delivery on a gold futures contract is as follows. Holders of a maturing long contract who intend to take delivery must give notice of their intention on *first notice day*. At the same time they must capitalize their account with the exchange 100 percent (zero margin). Holders of short contracts, of course, are also subject to the zero margin rule. In addition, they must deposit with the exchange a gold certificate issued by an exchange-approved warehouse.

Now we have come to the crucial point that plays a role in refining our theory of permanent gold backwardation.

Two varieties of warehouse certificates are distinguished:

1. ***gold certificates on registered gold***
2. ***gold certificates of eligible gold.***

THERE IS NO DIFFERENCE BETWEEN GOLD COVERED BY THESE TWO VARIETIES.

THE DIFFERENCE IS BETWEEN THEIR ACCEPTABILITY IN THE DELIVERY PROCESS:

Certificates on registered gold are acceptable; certificates on eligible gold *are not acceptable.* I beg the reader to bear with me while I explain this cumbersome and seemingly superfluous provision that is crucial in understanding secondary gold basis and secondary gold backwardation.

Thus, then, there are two markets for gold certificates, one for those on registered gold, and another, on eligible gold.

Recall that it is arbitrage between the spot gold market and futures gold market that is responsible for *primary* gold backwardation.

Similarly, arbitrage between the market for gold certificates on registered gold and the market for gold certificates on eligible gold is responsible for *secondary* gold backwardation.

The question arises naturally what motivates market participant to carry an inventory of either variety of gold certificates.

The motivation for carrying an inventory of certificates on *registered* gold is to be first in line for getting the physical gold (recall that physical gold may be in short supply and may even be unavailable in case of permanent gold backwardation.) Not surprisingly, the price of certificates on registered gold is higher than

that of certificates on eligible gold, in spite of the fact that exactly the very same physical gold is backing either variety.

The market does not directly quote prices, but they can be extrapolated from data released by the exchange, such as the number of certificates of either variety outstanding.

The motivation for carrying an inventory of certificates on *eligible* gold primarily is speculation on the gold price. Gold certificates moving from the registered to the eligible category reflects the opinion of market participants in the firing line how many gold certificates are in existence for every ounce of physical gold. Clearly, at any given time there is an overissue, just as airlines are known to overbook seats. When it happens, holders of long gold futures contracts who are bumped are typically offered a bribe in the form of a premium on the price of the certificate on registered gold.

The premium may move holders of certificates on registered gold to give up their priority. But it is also possible that they do not want to deliver their certificates because they do not see a chance to replace them through the regular trading of gold futures contracts. They may not want to hold the proverbial bag.

Secondary gold contango manifests itself by the condition whereby certificates on registered gold command a premium. Secondary backwardation means that the price of certificates on eligible gold goes to a premium.

Recall that primary gold backwardation is about the scarcity of spot gold relative to gold futures contracts. Likewise, secondary gold backwardation is about the scarcity of certificates on registered gold relative to those on eligible gold that, for the stronger reason means that the scarcity of spot gold relative to gold futures. Thus secondary gold backwardation implies primary gold backwardation. It indicates the reluctance of the holders of gold certificates to put their registered gold into harm's way (to risk that their registered gold will be called).

Secondary gold basis, as we have seen, is the difference between the price of gold certificates on registered and eligible gold.

I leave it to my students to define *secondary gold cobasis* and study the interplay between the two.

Lest someone think that the emergence of dual gold certificates is due to making arbitrary rules, I point out that it comes about due to the organic development gold futures trading. It is part of the firewall to prevent short interest from engineering a corner. The system of dual gold certificates is the gatekeeper. When the inventory of gold is getting too low in the exchange-approved warehouses and the long interest is approaching critical mass, the clearing house of the exchange shuffles the gold certificates on registered and eligible gold.

A Short Course on the History of the Legal Position of Gold in the U.S.

Under this caption I shall deal with the question why the 'powers that be' allowed gold futures trading to go ahead in the U.S. in 1975.

During the period 1933-1975 the ownership and trading of gold was criminalized in the U.S. pursuant to F.D. Roosevelt's suspension of the monetary clauses of the Constitution. Of course, this was trampling on the rights of the citizens and an abominable restriction of freedom. Change occurred in 1975 when the ban was lifted and futures trading in gold was allowed. What is in the background of this change of heart? First of all, it must be emphasized that – as the executive order made it very clear – the easing was on a 24-hour basis.

Since the writ of the U.S. government stops at the water, in foreign countries gold markets continued to trade gold, invariably quoting premium dollar prices , indicating dollar debasement. This was embarrassing. At first, there was no ban on Americans to own and to trade gold in the overseas markets. Such a ban was imposed later, during the Eisenhower administration.

Mainstream economists (all staunch supporters debt-based fiat money) came to the conclusion that the system leaked like a sieve, and suggested that the way to stop leakage is to allow gold futures trading.

1

They were hoping that the availability of paper gold suppress the appetite for real gold. They were inspired by a metaphor of Keynes:

People want the moon, but, of course, they cannot have the moon. So the government must convince them that blue cheese (*sic!*) is just as good, and order the central bank to produce it galore to make them happy. So why did the U.S. government legalize gold trading? Well, because it saw the proliferation of paper gold an effective (even the only) way to deflect the inevitable hyperinflation.

Such shabby Keynesian musings were used to justify the trampling on the American Constitution.

Secondary Gold Basis Measuring Capital Destruction

We have seen that the primary gold basis is the price of warehousing space for gold. It measures the ratio of paper and physical gold in existence. What does the secondary gold basis measure? Secondary gold basis measures the ratio of gold certificates on registered and eligible gold in existence. In other words, it indicates how many ounces of gold in certificates have been issued on every ounce of physical gold. When this number reaches the critical mass, chain reaction ensues. People start scrambling to get out of paper gold and into physical gold. We shall also describe the secondary gold basis as *the price of insurance against default on paper gold.* In this view, the secondary gold basis is a measure of decay in the capital structure of the world. Recall that **gold is the only form of capital that is no subject to decay or destruction, while all other forms of capital, whether physical or whether financial *are.***

To recapitulate, our refined theory of permanent gold backwardation scrutinizes the endgame in the gold markets: it focuses on the jockeying of people to get into position where

they have control over the only indestructible form of capital: *gold*.

The new element is the importance of the endgame in the gold market that has thus far been ignored. I submit that once we make it part of the theory of permanent gold backwardation, we shall have a handle on the problem of timing hyperinflation.

October 23, 2017.