BACKWARD THINKING ON BACKWARDATION

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On Monday, December 15, backwardation on gold was still in force at an annualized discount rate that narrowed to 1.55% in the December contract, but widened to 0.36% in the February contract. 12,673 contracts remain for tender in December, including an additional 37 contracts since last Friday. The discount on the December futures was 50¢ offered to those owners of physical gold who would transfer the carry to the market for the remaining 14 in December, or 60¢ for the 72 days deferred delivery for the February contract.

By Wednesday, December 17, backwardation on gold disappeared both in the December and February contracts, on an upwards spike in the price of gold worth $50. At this point in time it appears unlikely that the December contract will default, although the threat to registered gold in Comex warehouses remains very disturbing.

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The father of backward thinking on backwardation is undoubtedly John Maynard Keynes. In his 2-volume *Treatise on Money* published in 1930 he developed a theory of the futures markets and introduced the concept of *normal backwardation*. As the name suggests, backwardation is considered as the normal condition of the futures market so that, by implication, contango is ‘abnormal’. According to

Keynes backwardation, or discount on the futures price as compared to the spot price, is a necessary incentive that is supposed to persuade speculators to buy forward. In his view the discount is just the 'insurance premium', as it were, that speculators collect for shouldering the risk that the price of the commodity may fall during the time-span to delivery.

It would be hard to misconstrue the meaning of backwardation in a way worse than Keynes' "normal backwardation" does. His theory turns reality upside down. The truth is that the normal condition of the futures markets is that of contango whereby the futures price is at a premium compared to the spot price. The premium accrues to the warehouseman who carries the physical commodity while hedging it by selling an equal amount of futures.

The basis, or difference between the futures price and the spot price, is the signal telling the warehouseman about the state of demand for warehouse space. One may even say that the (positive) basis is the market price of available space in the warehouses. It tends to be low when warehouses have a lot of vacant space to fill, and high when they are close to full. Not only does it help to allocate scarce warehouse space between competing uses; the basis also guides the warehouseman telling him how fast he should fill his vacant warehouse space, or how fast he should make space available for alternative and more urgent uses; in other words, to decide which commodity to buy and which to sell. Other things being the same the warehouseman should buy the commodity with the higher and sell the one with the lower basis. Without the signal from the basis and the variable contango he would be in the dark shooting from the hip.

At any rate, backwardation is always indicating an abnormal condition: that of a shortage, whether it is due to insufficient production or prodigal consumption, or whether it indicates lack of foresight to carry sufficient supplies to cover future needs.

Keynes' celebrated *faux pas* in introducing the misnomer 'normal backwardation' is second only to that of Karl Marx. As is known, Marx has made the worst blunder in the history of economic thought when he created his theory of value. According to him, labor is the exclusive source of value, so the value of merchandise is directly proportional to labor content. Thus, then, the government can create value by having bottle-caps buried in deep holes and let people prospect for them and dig them up at great cost in labor – as has in fact been suggested by Keynes. This shows the common thread in the thinking of these two ‘defunct’ economists.

The Keynesian mindset is obsessed with the idea of overproduction and with the need to fight it by all available means. At the same time it dismisses the idea that in the real world scarcity is the basic human problem one should worry about.

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Keynesian economists never quote their mentor’s theory of the futures market as it is a major embarrassment. Still, it is hard not to agree with James Turk (see References) that much of what has been written on the Internet about backwardation “is total rubbish”.

The high level of ignorance about the basis and backwardation was the chief cause of the fiasco -- and Turk is silent on this -- of the gold mining industry falling into the trap laid by the government. It was the trap of ‘hedging’, more precisely, the selling of mine output forward up to fifteen years in advance. It was an insane collective hara-kiri of a major industry. It failed miserably because it left the reaction of speculators out of the equation. Yet it was perfectly predictable that the reaction would be negative -- from the point of view of the industry itself. Speculators would abandon their traditional perch on the long side of the market, and they would hop over to the short side. Gold mines and speculators would fall over themselves in competing for the privilege of being the first in selling gold short.

The net result was that the gold price was clubbed down every time it was trying to climb out of the hole. Gold prospecting was stifled. In addition, the grip on the world of the regime of irredeemable currency was reinforced -- just as wished by the governments. Other results included the premature depletion of the ore reserves of the mines, the looting of shareholders by management, the insanity and waste involved in producing gold at peak rates of output only to squander it at $250 an ounce, as recently as six years ago!

Had gold mining executives educated themselves about the gold basis and the threat of backwardation in gold, the disaster would have been avoided. Based on the correct principles of bilateral hedging, the mines would have developed a marketing strategy motivated by the trading of the gold basis -- instead of trading the gold price. The vanishing of the gold basis would have prevented these executives from making the worst blunder: selling (borrowed) gold and buying the futures. They would have saved a bundle for their shareholders to whom the losses caused by the vanishing basis were charged. They could have maximized the useful life-span of their mines, instead of maximizing short-term paper profits of dubious value. Gold mining executives, just like the American bankers, are very good at paying themselves huge salaries and bonuses. They are not nearly as good at admitting their mistakes and learning from them.

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According to Turk there have been three episodes of backwardation in gold as follows:

> (1) The first occurrence was November 29, 1995. That backwardation lasted for a day and was probably the result of a hedge buy-back by Barrick Gold.
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> (2) The next occurrence lasted for two days, September 29-30, 1999. It was caused by a mad rush for physical gold to cover short positions in the wake of the Washingtin Agreement on central bank gold sales.
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> (3) The third occurrence happened last month, and continued for three business days, November 20, 21 and 24. Turk says that no special event triggered this latest backwardation.

Turk does not consider the possibility that the November episode could have been a premonition of a more durable backwardation on the way. He does not recognize the backwardation at the Comex that started on December 2 and lasted for two weeks, in spite of the fact that it has been confirmed by the Tokyo Commodity Exchange where backwardation was in force, not only between spot and nearby but between more distant futures as well.

The key to understanding the present upheaval in the world economy and the relevance of backwardation to it is that, regardless of official propaganda, gold circulation (such as it is) never ceased to be an important part of the world's trading system. Backwardation means that gold circulation is stopped in its tracks, which is *deflationary in the extreme*, greatly contributing to the contraction of world trade.

Backwardation in gold causes, and is caused by, the cascading contraction of world trade. It is preposterous to suggest that no special event triggered the backwardation in gold last November. The special event was the onset of Great Depression II, just as sabotaging the gold standard by Britain on September 1, 1931, heralded the onset of Great Depression I.

The problem with Turk's analysis is that he considers backwardation in gold in isolation, taken out of the context of the vanishing of the gold basis that has been going on for at least three decades. This is like trying to understand the eruption of a volcano while deliberately ignoring prior rumblings. Given the secular decline of the gold basis, it should be easy to interpret the backwardation episode last month as a warning of the crisis caused by the realization that the world was walking into a gold trap. The gold basis was bound to enter negative territory, because its relentless decline indicated that ever more gold was going into hiding, while it became ever more difficult to coax it out of hiding.

This is not a crisis of Comex. This is a crisis of the international monetary and payments system trying, as it is, to reduce global debt with irredeemable promises issued by central banks. This is a crisis caused by mainstream economics in putting monetary science beyond the pale, and cheering on the government for driving gold, the ultimate extinguisher of debt, out of the monetary system.

Borrowing Carl Menger's admirable phrase 'police science,' *alias* Keynesian economics, *must bear full responsibility for conceiving, giving birth to, and raising to maturity Great Depression II.*

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These and other articles of the author can be accessed at the website www.professorfekete.com

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Acknowledgement

The author wishes to express his thanks to Mr. Sandeep Jaitly of Soditic Ltd., London, England, (e-mail: Sandeep.Jaitly@soditic.co.uk) for tracking the gold basis for him.

Calendar of events

Szombathely, Martineum Academy, Hungary, March 28-29, 2009
Encore Session of Gold Standard University Live.

Topics: *When Will the Gold Standard Be Released from Quarantine?*
The Vaporization of the Derivatives Tower
Labor and the Unfolding Great Depression
Is There Life after Backwardation?

San Francisco School of Economics, June-August, 2009
Money and Banking, a ten-week course based on the work of Professor Fekete. The Syllabus of this course is can be seen on the website: www.professorfekete.com

December 18, 2008