DRESS REHEARSAL FOR THE LAST CONTANGO

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I have written about "the last contango in Washington" before. The phrase covers the gold crisis that has been brewing under the surface in the world for the past sixty years due to the insane gold policies of the United States Treasury. As a result all newly mined gold, surpassing the quantity of all gold ever mined in the world prior to 1947, has gone into private hoards, from which it will be next to impossible to coax it out. The measure of this act of disappearance of gold is the vanishing of the basis, or the last contango.

In the technical jargon of the futures markets the basis is the spread between the nearest futures price and the cash price in the same location. The gold market has always been a carrying-charge market, a.k.a. contango market, due to the monetary metal status of gold. This means that the gold spread has always reflected the carrying charge, or the opportunity cost of carrying gold, the lion's share of which is foregone interest. But a very strange phenomenon has been manifesting itself during the past thirty-five years, since the inception of gold futures trading. The basis as a percentage of the rate of interest, rather than remaining constant, has been vanishing and, by now, has dropped to zero. At the same time gold holdings registered at the Comex-approved warehouses have been dwindling. Both indicators point towards a developing shortage of monetary gold that appears to be irreversible. The support of the paper gold markets is at stake. Without cash gold backing it up, paper gold trading is not viable.

When the gold basis goes negative, that's the end not only to contango but also to gold futures trading as we know it. Permanent backwardation in gold has never ever been experienced — unless we imagine that there is a gold futures market in Harare. Gold is not available at any price quoted in Zimbabwe dollars. In that sense the last contango has first occurred in Zimbabwe. Whatever paper trading of gold is still going on in the United States, it is at best a 'dress rehearsal' for the Last Contango in Washington that will be followed by the regime of permanent backwardation. The meaning of this is that physical gold cannot be purchased at any price quoted — this time, yes, in U.S. dollars. The U.S. dollar rubbing shoulders with the Zimbabwe dollar?

Mainstream economists and financial journalists shrug: "So what? We are not watching the basis of frozen pork bellies trading either when we make monetary policy". These gentlemen betray a complete lack of comprehension as far as the nature of the present financial and credit crisis is concerned. Make no mistake about it, whatever else it may be, this crisis, first and foremost, is a gold crisis with incubation period measured in scores of years. It is about to reach its climax. The world appears to be totally unprepared for it, witness the complete silence surrounding the gold nexus. Even the so-called sound-money websites misread the situation. They are talking about an imminent break-out of the dollar-price of gold from its holding pattern below $1000 per ounce. Such break-outs have occurred from time to time since 2001, when gold broke through the 'resistance-levels' of $300, $400, etc. The coming break-out is not distinguished by the fact that $1000 is an even rounder figure than the previous round figures that have been successfully scaled. *It is distinguished by the fact that we are confronting a world event the like of which has never happened in all history*. It has never happened that gold was unobtainable at any price. It has never happened that all governments have defaulted on their debt obligations simultaneously.

Still, we have to explain the relevance of this to the present credit crisis. It is no secret that the bonds, notes, bills, and other obligations of the United States government, or any other government for that matter, are irredeemable. That is, they are redeemable in nothing but more of the same. For example, the bonds of the U.S. Treasury are redeemable in Federal Reserve credit, which is itself irredeemable and is 'backed by' the self-same bonds of the U.S. Treasury. Why is it, then, that these Treasury obligations are in demand, where one might think that redeemability is a *sine-qua-non* of issuing them? What makes people participate in this shell-game? How can such a crude check-kiting scheme mesmerize the entire population of our globe? Come to think of it, the sight of this Ponzi scheme would shudder the Founding Fathers of our great Republic.

This is not an easy question to answer. But going through all the alternative explanations one-by-one, we come to the conclusion that the debt of the U.S. government is still redeemable in a sense, however limited or restrictive it may be. The debt of the U.S. government has a liquid market in which it can be exchanged for Federal Reserve credit. In turn, Federal Reserve credit can still be exchanged in liquid markets for physical gold, the *ultimate extinguisher of debt*, albeit at a variable price. But if you break that final link, when gold is no longer for sale at any price quoted in U.S. dollars, then the rug will have been pulled from underneath this house of cards, and the international monetary system will collapse like the twin towers of the World Trade Center. And this is the situation that we are now confronted with.

Look at it this way. There is a casino where the lucky gamblers can gamble risk-free. Their bets are 'on the house'. This casino is the U.S. bond market. There is only one catch. The pile of the winning chips in front of each gambler may become irredeemable at the exit when the hairy godfather waves his magic wand.

As the gold markets enter their phase of permanent backwardation, all rational basis for holding U.S. Treasury debt, or any debt for that matter, will disappear. There will be a mad rush to the exits, and holders of debt will trample one another to death in trying to cash in on their winnings.

In July I attended the Santa Colomba Conference 2009 at the Palazzo Mundell near Siena, Italy. There were 50 people in attendance by invitation of Robert Mundell of Columbia University, recipient of the Nobel Memorial Prize in economics ten years ago. They were mostly officials of various treasuries and central banks, ambassadors, bankers, professors of monetary economics, authors of monographs and editors of financial journals. Paul Volcker, a former U.S. Treasury official and Chairman of the Federal Reserve Board was present. I have circulated several papers prior to the conference among the participants. In these papers I was trying to call attention to the cataclysmic nature of the present credit crisis that could not be understood without trying to understand gold, the ultimate extinguisher of debt. We are all passengers on a runaway train on a down-sloping track, the brakes of which (gold) have been dismantled at the top of the hill. The train is picking up speed beyond any safe limit, and a crash appears inevitable.

Our gracious host and the chairman, Professor Mundell, has made two references to gold during the two-day conference asserting that, apart from wartime, the gold standard has been the most crisis-free monetary system in history. (Of course, *all* monetary system have a habit of breaking down during wars.) Yet not one participant has picked up ball dropped by Mundell, to run with it. They kept talking about green shoots, the recovery of the stock markets, coming bailouts and stimulation packages. As to my papers stating that this crisis is a gold crisis, I got just one feedback, in private. Apparently, the rest of the participants have been turned off by the four-letter word ‘gold’ in the title. It was not worth their while reading the ramblings of this loner on the problem of “putting spent toothpaste back into the tube”.

One of my papers was an open letter addressed to Paul Volcker. In it I asked whether there were contingency plans in the Treasury or in the Federal Reserve to meet the coming crisis of permanent gold backwardation. Volcker declined to answer my question whether in public or in private. I am inclined to think that there are no such contingency plans other than “muddling through”, as they have in all previous monetary crises. None of the policy-makers see the uniqueness of the coming predictable crisis, or the need to confront it with a comprehensive plan. There is an overwhelming unwillingness to admit that the international monetary system as it is presently constituted has been built on quicksand. It is a mere makeshift that took its origin in the last gold crisis of 1971. Cracks have been papered over as they appeared after every subsequent crisis. Every opportunity to sit down and work out a permanent solution was passed up. This seems to have worked well enough in the past. Policy-makers see no reason why it would not work in the future.

Yet the Last Contango in Washington will be different from all previous crises. It will be elemental, devastating, and apocalyptic. It will destroy virtually all paper wealth, and render virtually all physical capital idle. It will involve hordes of unemployed people roaming the streets of the cities, caring for no law and order, pillaging homes and institutions. It will destroy our freedoms. It may destroy our civilization, unless we take protective action.

On the positive side, it will sweep away the complacency of the managers of the regime of irredeemable currency, and fundamentally weaken the sway of Keynesian and Friedmanite economics as it has a stranglehold on the teaching of economic science in the world.

The Last Contango in Washington will eclipse the Great Depression of the 1930's. Be prepared!

References

The Last Contango in Washington, June 25, 2006

The vanishing of the gold basis, and its implications for the international monetary system, June 23, 2009

Remobilize gold to save the world economy! An open letter to Paul Volcker, Chairman of the Board of Governors of the Federal Reserve, 1979-1987; Chairman of President Obama's Economic Recovery Advisory Board;
July 6, 2009

See: www.professorfekete.com

Calendar of Events

University House, Australian National University, Canberra: first week of November, 2009

Peace and Progress through Prosperity: Gold Standard in the 21st Century

This is the first conference organized by the newly formed Gold Standard Institute.

For further information, e-mail: feketeaustralia@gmail.com ,

On the Gold Standard Institute, e-mail philipbarton@goldstandardinstitute.com

Professor Fekete on DVD: Professionally produced DVD recording of the address before the Economic Club of San Francisco on November 4, 2008, entitled *The Revisionist History of the Great Depression: Can It Happen Again?* plus an interview with Professor Fekete. It is available from www.Amazon.com and from the Club www.economicclubsf.com at $14.95 each.

DVD's of the Gold Standard University, Session 3 (Adam Smith's Real Bills Doctrine and Its Relevance Today); Session 4 (The Bond Market and the Markey Process Determining the Rate of Interest); Session 5 (A Primer ont he Gold and Silver Basis) **are now available**. For details, see the announcement on the website
www.professorfekete.com . DVD's of the other Sessions will also be available soon.