EXPLODING THE MYTH OF SILVER SHORTAGE

What does the negative silver lease rate really mean?

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On Thursday, September 20, 2007, the lease rate of silver suddenly dipped into negative territory. It fell to minus 0.1 percent per annum. I wish Ted Butler stopped bitching about silver manipulation, and telling fairy tales about raptors and dinosaurs, and instead explain the behavior of silver lease rates and the silver basis to his readers. In particular, explain negative lease rates and basis. It may be more helpful in promoting an understanding of the silver market.

I have a long-standing disagreement with silver analyst Ted Butler. I hold the view that silver is a monetary metal, second only to gold in importance. Supply-demand analysis of price is not applicable to silver, still less to gold. The reason is that supply and demand are undefinable in case of a monetary metal. There is no way to quantify speculative supply and demand, Speculators make split-second decisions to become a seller from a buyer or the other way round.

Making price predictions for the silver price on the basis that it is allegedly scarcer than gold does not make sense. Silver has been, is, and will continue to be cheaper than gold for a monetary reason that is just the opposite of the scarcity argument. The monetary stockpiles of gold are much larger than that of silver. Therefore there is less of a threat for the value to drop on account of new additions to the stockpile in the case of gold than in the case of silver. It is not the *absolute* change in mine output, for example, that has an impact on the value of a monetary metal, but the *relative* change as a percentage of existing stockpiles. For this reason gold is more valuable than silver: the huge stockpiles of gold make the impact of a change smaller. *Ergo* the value of gold is more stable. In technical language, the marginal utility of gold declines more slowly than that of silver.

As a consequence, the specific value of gold is higher. This means that the value of unit weight of gold is higher than that of the same weight of silver. Once this fact has been firmly by the markets, it is not likely to change for the following simple reason. The monetary metal with the higher specific value is more portable, both in space and time. In more details, the cost of transporting the unit of value as represented by gold is lower. For example, if the bimetallic ratio is 15, then the cost of transporting the unit of value as represented by silver is about 15 times higher. Roughly the same rule applies to the cost of storage as well. This makes gold the superior monetary metal, as it is more suitable for the purposes of transferring value in space as well as in time than silver.

But silver is still a monetary metal, and for certain application, such as parcelling out value in ever smaller bits, for example, silver could be superior to gold. And, of course, when it comes to industrial applications, silver has a very impressive array of those. In many cases there is no substitution for silver. However, do not make the mistake to think that gold has no industrial applications. It does but, because of its high specific value, these applications are mostly submarginal and as such they are ignored. In 1922 Lenin gave a textbook example of such a submarginal application of gold that became famous. He told a meeting of Communist party activists that, after the final victory of Communism world-wide, gold will be used for the purpose for which it is so superbly fitted, namely, to plate the walls of public urinals. He did not say that his plan could not be realized in the worker's paradise because workers would pick the gold plate of urinals just as fast as the government was installing them.

Another common mistake people make when comparing gold and silver is to say that gold is „not consumed" and therefore practically all the gold produced is still available while silver is „consumed" and, hence, is getting scarcer relative to gold all the time. The truth is that both gold and silver are consumed, for example, in the arts (including jewelry). The difference is in the cost of recovery and refining, relative to the underlying value. Precisely because the specific value of gold is higher, the cost of recovery for gold is lower, so much so that gold in the form of jewelry is often lumped together with monetary gold for statistical purposes. By contrast, silver plate could not be lumped together with monetary silver. By the same token, the cost of refining gold is lower than the corresponding cost for silver expressed as a percentage of the underlying value.

Returning to the silver lease rate, this is not the first time it dipped into negative territory. happened. The 30-day lease rate was pretty consistently negative between May 25 and August 4, when it shot up and reached a high of plus 0.4 percent on August 31. The fact that negative silver lease rates are not impossible but a well-observed fact of the silver market has exploded the myth of a world-wide shortage of silver. Come to think of it: lessors of silver were willing to pay lessees a premium to borrow the metal. Before you rush over to ask lessors for free silver, you had better come to a correct understanding what negative lease rate means. The collapse of the silver lease rate on September 20 to negative territory meant panic short covering in silver. The shorts anticipated an imminent and substantial rise in the price of silver and were running for cover.

How did they know that the silver price was poised to rise? They were not led by crystal balls. They acted on the historic correlation between gold and silver prices which customarily move „in sympathy" with one another. On September 10 the gold price was getting ready to break the resistance level at $700, while the silver price lagged far behind in relative terms. The peak price of gold for the past 27 years, $730 an ounce, was well within earshot. The corresponding peak silver price for silver, $15, established in July, 2006, was not within earshot. Gold had a fair chance to make a new high soon, while silver, selling at $12.75, didn't. Nevertheless, if gold moved, it was reasonable to assume that silver would play catch-up. In the event the price of silver moved some (on Friday, September 21, it closed at $13.50) and, according to analyst Clive Maund, „was set to go through the roof" (www.321gold.com, September 20, 2007).

The point is that if this happens, the price move will not have been caused by any kind of shortage of silver. The notion that we have a silver shortage is preposterous. Most of the silver produced by the mines and sold by the U.S. Treasury during the past 60 or so years still exists in monetary form. Monetary silver is owned by private individuals, who entrust it to commercials skilled in making monetary silver yield a return. This is the reason why silver and gold are monetary metals: they can yield a (more or less consistent) return to their holder if traded adroitly and professionally. This fact may not be too well known, but it is true nevertheless: „damonetization" has done nothing to destroy the unique ability of monetary metals to earn a return. Without a doubt, the best way of making this happen is through playing the short side of the market. To sit on a long position of silver will not hatch the silver egg and is not a very intelligent way to make silver yield a return. A better way is covered short selling which to the uninitiated appears to be naked short selling. It is not.

The commercials are neither stupid nor suicidal. They are professionals who make it their business to call the tops and bottoms in the price moves of monetary metals. It is well-known that they have an excellent track record in calling the market. This is not because they are vicious people who manipulate the market to their own advantage enticing the poor bulls to enter the slaughter-house. They use methods that are well-known, pretty standard among professionals, and can be learned from textbooks. Using these methods they can turn the variable silver price to their advantage (or to the advantage of their clients on whose behalf they trade). You can join their ranks if you are willing to study those methods and go through the training which may be too rigorous to your taste.

If you are envious, or have moral objections against other people being able to make money consistently by trading the monetary metals, then you should lodge your complaint with the government which is responsible for „demonetizing" first silver (1873) and, a hundred years later, gold (1973). Before „demonetization" there were no commercials, speculators, and scalpers who made money by betting on the variation in the price of monetary metals. If they had tried to make a living that way, they would have starved to death. The prices of monetary metals were stable.

Whenever the price of silver significantly lags the rising price of gold, then there will be panic short covering and the leased silver will be returned to the lessors in a hurry. If the lessors were not prepared for this avalanche of silver (because they expected that the leases would be rolled over), then they may not be able to absorb the silver flowing back to them. In this case the silver lease rate drops dramatically and may even dip into negative territory.

It is important to be able to interpret this correctly. As I said, silver is delivered faster by the lessees than the lessors are able or willing to absorb it. Admittedly it is a market aberration, but whatever it means, *it does not mean a shortage of silver. Far from it. It indicates a relative redundance of silver that momentarily cannot find lessors in view of an impending rise in the silver price.*

Rumor-mongering about present or future silver shortages do not bring credit to the analyst. He should go back to his textbooks and study the market in greater depth. Above all, he should learn the elementary differences between monetary metals and non-monetary commodities.

At Gold Standard University we study paraphernalia such as the gold and silver basis, the gold and silver lease rates and their variation. In addition we look at changes in the NAV (net asset value) of gold and silver ETF’s (exchange traded funds). We think the best way to make a profit consistently on silver and gold holdings in troubled times is bimetallic arbitrage At its crudest, this means selling silver to buy gold when the bimetallic ratio (gold price divided by silver price) falls, selling gold to buy silver when it rises. However, as a consequence of concentrated propaganda gold sales by central banks and governments, not only the gold price but also the bimetallic ratio is falsified. Therefore there is need for refinement and for other clues in addition to the bimetallic ratio. We believe that such more refined clues can be derived from the variation in the basis, the lease rate, the NAV of ETF’S, and the like.

As a preliminary announcement I mention that Session Three of Gold Standard University Live will have a feature discussion with the title GOLD PROFITS IN TROUBLED TIMES in February, 2008. As plans get finalized, further annouincements will be made.