Copyright ©2008
by A. E. Fekete

GOLD: HOW HIGH IS HIGH?

Antal E. Fekete
Gold Standard University
e-mail: aefekete@hotmail.com

Now that the sound of cork-popping and other signs of celebrating the New Year, and the new record highs in the price of gold, are dying down, some questions arise the answering of which brooks no delay. How high is high? Is it the nominal price or the so-called 'real' price of gold that gives us a valid reading of whence we came, where we are, and whither we go? Chrysophobes have already started their dissonant chorus reminding gold bugs that the last time gold was trading at these levels, in January, 1980, it was a sign marking the onset of a bear market taking the price down by more than 75 percent, lasting over twenty years. Goldbugs take comfort in the thought that the previous peak in the price of gold was much higher in "real terms", so that the current price is not so high after all. However, this begs the question. The previous peak was the result of a blow-off, and further rise from here may make a new blow-off loom large on the horizon, with all the unpleasant consequences.

The chorus of chrysophobes will obviously get much louder as we may see fresh record prices in four digits. Just how serious is the danger that a blow-off could trigger another bear market lasting for decades?

Gold Standard University offers a unique perspective on the gold price issue, a perspective which is deliberately ignored, even denigrated, by virtually all investment advisory services. Ours is the perspective of monetary science as it existed prior to 1936, before Keynes and other charlatans gained academic recognition and prominence for peddling their pet monetary nostrums. Let's review some of the principles that are indispensable in separating grain from chaff.

THE VALUE OF GOLD

Gold is the senior monetary metal (silver being the junior). This has nothing to do with the denials, declarations, and desires of devaluation-happy governments. It has to do with the fact that the value of gold, unlike the value of other earthly wares, depends far less on scarcity, and is threatened far less by increasing supply. One may even say that the value of gold is exempt from the effect of the law of supply and demand. Often the rising price of gold causes a contraction of supply. A blow-off may indeed cause a withdrawal of all offers to sell. After that happens, gold is not for sale at any price. But again, a blow-off may bring out an avalanche of supply. The essence of the gold price is *volatility*. The essence of the value of gold, however, is *stability*. We conclude that the price of gold has nothing to do with the value of gold.

WHAT MAKES A MONETARY COMMODITY?

Monetary economics is the science of monetary commodities, which are necessarily quite different from the non-monetary variety. The latter are produced in order to satisfy consumption demand. The former are produced to satisfy demand for the ultimate asset that has no counterpart in the liability column of the balance sheet of someone else. *The only default-proof asset is a holding of monetary metals.*

The value of gold is more stable than the value of any non-monetary commodity, although this fact is deliberately obscured by the managers of global irredeemable currency, anxious to confuse the issue. They have the power to engineer temporary surges in the value of their product, irredeemable promises to pay, in order to put gold into the worst light. What makes a monetary commodity? It is the fact that existing supplies are very large relative to the flows of new metal from the mines. A discovery of new gold fields makes little impact as its effect on supply is small. On this basis gold has been far and away the leading monetary metal for most of the Modern Age. It still is.

GOLD IS GOLD AND PAPER IS PAPER

The managers of the global fiat currency system are helpless in facing the challenge of gold. They can have their high-profile auctions, trying to demonstrate that gold is scrap and is being sold as such. But what these gentlemen accomplish is only to undermine the value of their fiat currency through the dilution of the assets backing it. Those who can read balance sheets understand that selling a monetary asset that is nobody's liability such as gold, and replacing it with the irredeemable promises of coin-clipping governments, makes the balance sheet of the central bank weaker, not stronger. After all is said and done, gold is gold and paper is paper.

A paper promise cannot be better than the good faith behind it. This good faith is not a consequence of a quantity-rule advocated by the monetarists. It is a consequence of the promise being redeemable in something other than another promise. Gold is not a promise: it is the *fulfillment* of promise. You need not trust gold if you don't trust the issuer who stamped it. The weight and purity of gold can be readily tested with scales and acids.

The history of good faith behind monetary promises could hardly be more dismal, as the monetary annals of the twentieth century reveal. There is not a single currency without at least one instance of breach of faith during the twentieth century. The Swiss defaulted on the Swiss franc once, in 1936. The U.S. defaulted on the dollar twice: in 1933 and in 1971. The British defaulted on the pound sterling at least three times: in 1931, 1948, and in 1968.

By 1971 it looked so bad that the world's governments agreed to make the deciphering of their monetary record difficult through the stratagem of "floating". The word is a misnomer designed to camouflage "sinking". Floating obscures the underlying fact of competitive currency devaluations. The dam burst and the world's stock of money started on an exponential track. Prices of consumer goods took flight. Interest rates were destabilized. Derivatives markets proliferated.

MONETARY DEBAUCHERY HAS ITS OWN DYNAMICS

But it was in the twenty-first century that monetary debauchery started in earnest. The scope of monetary destruction that goes on right now makes earlier episodes pale in comparison. Worse still, monetary debauchery has its own momentum and is not responsive to monetary brakes. Everybody talks about the unprecedented rate of new money creation. *Nobody is*

talking about the equally unprecedented rate at which money is being destroyed. No sooner had new money been printed than its value depreciated. The point has been reached that the more new money is created, the more its value declines; and the more it declines, the more new money has to be created. What you have is an irresistible spiral into the abyss.

As I was saying, the price of gold has nothing to do with the value of gold. It has to do with the disappearing value of fiat currencies in which the gold price is quoted. A falling price of gold ought to be interpreted correctly, like the fall of a piece of rock. Is that rock pulling the earth, or is it the earth that is pulling the rock until the latter crashes into the former, through the mutual attraction of masses?

A falling gold price is the market's reaction in anticipating large-scale dumping of gold on official account. The dumping is politically motivated: it is designed to misinform and mislead. Naturally, the market obliges: it brings down the price to facilitate central bank unloading. But once dumping stops, as it obviously has to at one point, the market immediately adjusts the gold price back to its pre-dumping level or higher. Only ignoramuses swallow the propaganda line that gold is *passé*, and the millennium of global irredeemable currency is here.

GOLD AS INSURANCE

Selling gold after a surge in the gold price is akin to canceling fire insurance after surviving unscathed a devastating fire destroying homes and property in the neighborhood. It can be confidently predicted that higher gold prices will bring out a lot of selling by woolly-thinking people, as if insurance against the danger of collapse of the international monetary system were no longer necessary after an initial tumble in the gold value of paper currencies.

The reason for this illogical behavior is greed that is often greater than the desire for security. A large part of the gold bug population is motivated by „get-rich-quick" mentality more than by the mentality of insurance policy holders. This type of behavior should not detain us here. We do know that there were passengers aboard the sinking Titanic willing to sell their life-savers for cash. "Profit-taking", so-called, will ultimately dry up as the collateral risk (what I euphemistically call the dead-cat bounce of the dollar) will become clear even to people ignorant of the difference between monetary and non-monetary commodities.

SUPPLY-DEMAND EQUILIBRIUM PRICE OF GOLD

One of the most controversial propositions that we here at Gold Standard University have to face, and the idea that appears to die hardest, is the supply-demand equilibrium price of gold. The price of monetary metals is not governed by supply-demand considerations. Such a supposed equilibrium is just the figment of the imagination, lacking any scientific merit. The fact is that supply and demand in the case of monetary metals is indefinable. By their very nature the monetary metals are subject to the most intense and most concentrated speculative attacks, both from the long and short side of the market. Speculators in gold are not poring over production and exploration results. Rather, they are trying to divine how the largest holders of gold are going to react to a surge in the gold price. Accordingly, from sellers they become buyers and *vice versa* on a moment's notice, moving the price as they do.

There are no scientific principles to support predictions about human behavior. There are only statistical laws, and we might as well admit up front that they are very imperfect. A statistical law is the more valid the larger is the number of cases it can catch within the net of sampling. It follows at once that when it comes to predicting the consequences of a single isolated, non-repeatable event, such as gold scoring a certain new record, statistical analysis is useless. As any upright scientist will admit statistical analysis has a congenital weakness: its

validity and usefulness diminish in proportion with a decrease in the number of samples. There is simply nothing science can do to eliminate or to assuage this weakness. Of course, quacks are ready to exploit our incurable ignorance and will try to impress the gullible public with mathematical hocus-pocus. They will pretend to make "scientific" predictions about the consequences of isolated, non-repeatable single events in the realm of human behavior.

I am a professional mathematician. Here I stand as a new Luther and bear witness that mathematics has not been in the past, is not at present, nor will it ever in the future be able to make predictions about human behavior based on minimal samples. I am fully aware of the significance of my statement and I am willing to stake my professional reputation on it. It is not possible to predict whether a surge in the gold price will bring out more sellers than buyers, or whether it will bring out more buyers than sellers.

Proliferation of mathematical symbols and studied gestures by pseudo-mathematicians do not science make.

THE SIREN CALL OF PROFIT-TAKING

However, monetary economics is able to predict that the ranks of so-called 'profit-takers' in the gold market will be drastically thinned out by persistent losses they stand to suffer (as have the ranks of naked short sellers in the gold mining industry). Ultimately, when a certain threshold in the price of gold is passed, profit-taking will dry up altogether (as short selling by gold mines has A.D. 2007).

I say 'so-called profit-taking' because we are dealing with an oxymoron. Can one really take profits in the gold market by taking paper currency, destined to lose whatever value they may still have?

The call to take profit is a siren song. To neutralize it, you had better follow the example of Odysseus who had himself chained to the mast, and had the ears of his oarsmen plugged with wax.

SILVER AND GOLD BASIS

When the profit-taking mentality is thoroughly defeated and discredited by the market, gold will go to permanent backwardation making the gulf between cash gold and paper gold unbridgeable. The gold basis will go negative, burning the bridge leading back to contango. From then on gold is not for sale at any price. Just when this will happen is impossible to predict. There are a few clues nevertheless. One is the silver basis that acts as a precursor of the gold basis. Whatever little information we may glean from the markets, it all has to do with the basis. It is therefore all the more surprising that investment advisers cavalierly ignore the basis as an analytic tool, just as they ignore the coming backwardation.

Likewise it is impossible to pinpoint where the threshold price, past which the supply of gold will dry up completely, is located. History and theory confirm that there is such a threshold, but we are left to guessing how high it may be.

BRIBE AND BLACKMAIL IN ECONOMICS

Governments have forcibly removed gold not only from the banks, but from academia as well. As a result, the level of ignorance in the world about gold is appalling. Gold has been relegated from economics to superstition, witchcraft, and soothsaying. It is treated like a narcotic agent. "Gold is addictive. Gold ought to be taken away from man's greedy little palms by a paternalistic government", as advocated by Lord Keynes' New Economics. The advice is disingenuous. It is not given in the interest of people. It is given in the interest of the

pilferers and plunderers of people. Here is how one author, Howard Katz, describes economics as it has transformed, nay, corrupted, American institutes of higher learning.

"Something is rotten in the state of economics. In the middle of the 20th century a group of bankers bribed some of the nation's top colleges to peddle a reactionary economic theory (which was to make bankers a lot of money). This theory swept American higher education with the result that pretty well everybody who has graduated with a degree in economics no longer has the slightest idea of what he is talking about… There is nothing wrong with the science of economics, but there is something terribly wrong with the kind of trash handed out by our nation's colleges today. It is people dumb enough to imbibe such trash who are the reporters and columnists in most of the media, and these are the people giving most Americans economic advice."

THE AFTERMATH OF THE NEXT BLOW-OFF

Gold Standard University is fighting back. It is not motivated by the lure of making a fortune in gold speculation. Not as if it condemned efforts to salvage capital from the crumbling old monetary regime to transfer it to a new one. But salvaging won't be a bed of roses as the idea of making a fortune in gold speculation seems to suggest. Gold Standard University is motivated by values held in the highest esteem. It is motivated by truth, the cause of which has been so pitifully betrayed by economists in taking bribe money from banks; and the dissemination of which has been so miserably compromised by economics departments in reacting to blackmail (namely the threat to discontinue grants and to purge truculent economists).

Making statements about the future course of the gold price is a most treacherous undertaking. Gold Standard University is committed to tell you all that can be supported scientifically. Making predictions about the timing of price moves up or down is beyond the pale. However, I am willing and happy to share with you my insight, for whatever it is worth, on the gold price issue as well as on the burning question how long the agony of watching the death throes of global fiat currency will take. I promise that I will always carefully delineate facts from opinion.

We can dismiss the suggestion out of hand that the next blow-off, if and when it comes, will ring in a new bear market in gold. At any rate, it will be very different from that witnessed in 1980. The credit of the United States was immensely stronger then. There was room for drastic increases in the rate of interest that helped restoring the dollar to strength. Higher interest rate is a very strong and very effective medicine — that is, if the patient has a constitution that it can be administered. If the patient is too weak, strong medicine would be lethal.

BANK CAPITAL AND THE DERIVATIVES MONSTER

The dominant fact to understand is that yield varies inversely with the value of the underlying asset. Therefore *increasing the rate of interest would further erode the capital structure of the American banking system*, already badly shattered by the subprime crisis. It is out of the question that the Fed could follow the Volcker-recipe, 1980 vintage, of letting interest rates go double-digit. Contrariwise, if the Fed were able to lower interest rates by hook or crook, that would be a reprieve for the banks with melting capital. It is my considered opinion that the Fed is doing what it does because the *effect of a falling interest rate on bank capital is instantaneous*. By contrast, pumping money into the banking system works by way of trickle-down. Talk about "stimulating the economy" is for the birds. The real reason why the Fed has

to lower interest rates in a hurry when logic would call for increasing them is the emergency to stave off an implosion of bank capital.

How can the Fed engineer a falling trend in interest rates? This is the point where my own analysis diverges from that of others. Interest rates will fall because bond speculation in which the banks engage is risk-free, on the strength of the open market operations of the Federal Reserve. The banks preempt the Fed in buying the bonds. The consensus is that the ailing dollar can be bailed out only through a regimen of rising interest rates. But the banks bet at the roulette table that interest rates will fall, against everybody else betting that they will rise. Why, the $500 trillion strong derivatives monster serves one purpose and one only, that the bull market in bonds may continue indefinitely. In other words, the infinitely elastic supply of interest rate derivatives is there to make sure that the shorts in the bond market will burn their fingers right to the armpit. Interest-rate derivatives did not come about by accident. Like the original Tower of Babel, the Tower of Derivatives is being built deliberately. It was conceived and nurtured by megalomaniacs, in this instance the managers of the global fiat money system. They understand that bank capital hangs precariously on the cliff of vanishing confidence. They are confident that they can patch up even the largest holes in the balance sheet of banks on capital account, provided that the derivatives monster will not unravel in the meantime. The big unknown is whether the escalation of counterparty risk will trigger the self-destruction of derivatives before the managers are through.

Here is the strategy. The Fed will keep halving the rate interest as many times as necessary. Each halving nearly doubles bank capital. It worked in Japan where the authorities have kept the brain-dead banks in business through thick and thin. The Japanese merry-go-round has been supported by the yen-carry trade; the American merry-go-round will be supported by the derivatives farce.

Both represent a game of musical chairs. It is a matter of opinion how long the music can go on. I am reminded of the sinking Titanic aboard which the orchestra continued playing even after all lights went out. I don’t see that the music would stop this year even if the lights go out and industrial production starts to sputter. The conundrum of a weak dollar *cum* strong bonds will continue to baffle all the experts, and lead a lot of gold bugs astray.

IS ANOTHER DECADES-LONG BEAR MARKET IN GOLD POSSIBLE?

The 1980-2000 bear market in gold was made possible by the Volcker-*coup* in pushing interest rates past 20 percent. It was designed to trick people out of their gold position. The Volcker-*coup* was an expensive gamble that succeeded, because the economy was fairly strong in 1980, a condition completely lacking today. If Bernanke tried to mount the Volcker-*coup* now, the economy would go into a tailspin. We may conclude that another bear market in gold is well-nigh impossible.

GOLD STANDARD UNIVERSITY LIVE

To summarize, in my opinion a blow-off in the gold market is not imminent. The dollar, however weak, is not yet a pushover. It will fight back, supported by a strong bond market. The bag of tricks of the managers of global fiat currency is not empty. They haven’t yet played the Amero card, for example.

I advocate a new approach to investing in gold. This approach rules out profit-taking, but involves arbitrage between the two monetary metals. Cues must be taken from the silver and gold basis, not from the gold/silver ratio which is rigged.

Come to Session Three of Gold Standard University Live to be held in Dallas, Texas, from February 11 through 17. I will conduct the course and the seminars in person. Bring

your questions with you. Details about the session can be found on the website www.professorfekete.com/GSUL.asp

Be part of the uplifting undertaking to resurrect monetary science. Discover the truth about money as the giants of monetary science, Adam Smith, Carl Menger and others have handed it down to us, before bribe and blackmail have overtaken the search for and dissemination of knowledge in economics.

The world's finance capital is on its way to total annihilation. The essence of the subprime crisis was not the slack in lending standards. The essence is that the worm of doubt is eating confidence away. Banks no longer trust the promises of other banks. Under a gold standard trust could quickly be restored by paying out gold. That's what gold is for, to restore trust whenever doubt arises. But gold has been removed from the banking system. Now irredeemable promises can only be redeemed by issuing more irredeemable promises. In such a system the erosion of confidence cannot be checked. Lack of confidence becomes cumulative. It is like kicking garbage upstairs. When the attic can take no more, the day of reckoning has dawned, and the garbage comes crashing down.

What can the individual do under these circumstances? He can salvage the pieces of his capital from the moribund international monetary system through the Yellow Brick Road. When you invest in gold, you transfer your capital, bit by bit, from Sodom and Gomorrah where it is doomed by the coming rain of fire and brimstone, to Emerald City of the New Gold Age.

See you in Dallas!

January 18, 2008.