GOLD, INTEREST, BASIS

Antal E. Fekete
Gold Standard University
aefekete@hotmail.com

Introduction

The Inaugural Session of Gold Standard University was successfully completed at the Martineum Academy in Szombathely, Hungary, in February, 2007. By unanimous request the original program *Gold and Interest* was extended to include *Basis* as well. As those who follow my writings on the Internet well know, basis is the difference between the nearest futures price and the spot price. The gold basis is one of the most sensitive economic indicators with a seismographic predictive power. In particular, if taken in conjunction with other indicators such as the silver basis, volume, open interest, and the lease rates for the monetary metals, it is capable of predicting the beginning of the disintegration of the world's payments system. No other scientific method can provide early warning. Moreover, basis could also be used as the guiding star of bimetallic arbitrage between the gold and silver market. If you have a program to accumulate gold and silver, and wish to get rid of a certain amount of irredeemable dollars regularly at every dip in the price of the monetary metals, then the basis will tell you whether at that moment in time it is more efficient to add to your gold or to your silver account. You always go after the metal with the *wider* basis.

It is nothing short of amazing that all the websites which concern themselves with the analysis of gold and silver, with the remarkable exception of www.silveraxis.com, ignore the basis in spite of my repeated prodding to start tracking and reporting it. I have now proof that this is not due to lack of demand. Accordingly, I have made the announcement that at the next session of Gold Standard University scheduled at the Martineum for August 15-31, 2007, we present a blue-ribbon panel discussion with the title *Last Contango: First Sign of Disintegration of the World's Payments System*. The present essay is a primer for prospective participants.

The Janus-face of marketability

Gold, interest, and basis are strongly inter-related. At the Inaugural Session we have covered the concept of *marketability*. Gold and silver have become money through an evolution as the most marketable goods. In more details, gold is most marketable *in the large*. This can also expressed by saying that gold is more *saleable* than any other commodity. Silver is most marketable *in the small*. This can also be expressed by saying that silver, along with gold, is more *hoardable* than any other commodity. The Janus-face of marketability can be observed if we contemplate that gold is the preferred agent when one has to transfer value over *space*. The preferred agent in transferring value over *time* is silver followed by gold. We may clearly recognize the dual nature of money throughout history. In the ancient world money was cattle and salt. Cattle was most marketable in the large, while salt was most marketable in the small. Later two other commodities, far more similar to one another, took over these functions, but the dual nature of money has been maintained to this day, in spite of the silver and gold demonetization farce. This is no accident. Duality has to do with the paramount fact that space and time are absolute categories of human thought.

A new theory of interest

Hoardability leads directly to the concept of *interest*, which arises out of the desideratum to optimize conversion of income into wealth and wealth into income. In choosing the conversion problem as our point of departure to develop a new theory of interest we have deliberately discarded the old-line theory based on the exchange of present for future goods that assumes, wrongly, that *without exception* a present good is valued more highly than an equivalent quantity and quality of future good. A more careful analysis shows that this is true only if the delivery of the various factors to the site of production or consumption is dove-tailed. Early delivery may result in a loss.

The solution to our optimization problem answers two of the greatest of human needs: providing for one's old age, and planning for the education of one's offspring. If the conversion of income into wealth is done through hoarding, and the reverse conversion through dishoarding — a process also known as *direct conversion,* — then optimum is achieved by choosing the most hoardable commodity as the agent of conversion. However, direct conversion can be further improved upon, by passing to *indirect conversion,* through the agency of exchange. Typically, a younger man will give up part of his income in exchange for part of the wealth of an older, as the former is anxious to go into business for himself for which the latter puts up the capital. Then interest appears as the value of improvement in efficiency through the exchange over direct conversion. In particular, direct conversion means zero interest. By contrast, interest becomes positive if social arrangements admit indirect conversion.

The following point is important. The nexus between gold and interest is established by the fact that if indirect conversion is hampered by secular or canonical proscriptions (e.g., usury laws), the economizing individual is not helpless. He can still achieve his goals by falling back on direct conversion through hoarding or dishoarding gold. He will do that even in the absence of proscription. In case interest is suppressed by the banks or the government, he will hoard gold in protest, and dishoard it as the rate of interest is subsequently allowed to rise. Thus gold is the agent to validate one's *time preference*. This aspect of gold is almost always ignored by authors, including Ludwig von Mises to whom gold hoarding is a *"deus ex machina"*. He failed to see that time preference would hardly amount to more than a pious wish if gold hoarding did not give it teeth. Moreover, this is true whether *on* a gold standard or *off*. When on, gold hoarding means withdrawal of bank reserves whereby the individual forces the banks to adjust their lending rate to the rate of marginal time preference. Thus the gold standard makes the adjustment crisis-free. That is its main excellence. When off, hoarding makes the gold price soar, leading to a monetary crisis. The upshot is the same: higher interest rates. The difference is that it is achieved in a crisis-prone environment. Moreover, it generates a swinging interest rate structure, most damaging to savers and producers. Gold hoarding provides escape from the harsh consequences of the predatory monetary and credit policies of the banks and the government, as they plunge society into debt slavery. In the absence of the safeguards of a gold standard, debt slavery is inevitable for all those who fail to use the only prophylactic available against bank and government preying on the individual saver and producer, gold.

Paper boat on uncharted waters

Let us turn from the nexus between gold and interest to the nexus between interest and basis. Mainstream economics made a fatal mistake when it failed to study the consequences of the emergence of the futures markets in monetary metals. It was not a spontaneous failure. It was inspired by the banks and the government that have taken upon themselves the ”burden” of financing research. They have a hidden agenda: to keep the public in deep ignorance and stupor.

Recall that there are no futures markets in monetary metals under a gold standard for lack of volatility, without which speculation cannot be profitable. But no sooner had volatility appeared than futures markets in silver and gold sprang up. As they did, a whole new field of tantalizing research opened up for investigation. Unfortunately, what it shows is an appalling and scary prospect for the Brave New World of global irredeemable currency. It shows dissipation and destruction of capital on a large scale through *falling* interest rates, and the drying up of new savings through *rising* interest rates. Recall that it is the first time ever in history that irredeemable currency has been foisted upon the *entire* world, causing gyration of the rate of interest. Humanity was herded aboard a paper boat named ”Dollar” and tossed onto a stormy sea with no anchor on hand. No wonder that the powers that be are anxious to put research under taboo. It is in their interest that the public stay in blissful ignorance about the fact that the captain of their paper boat has no navigational instruments while sailing on uncharted waters. Gold Standard University was started in defiance of that taboo.

Primer on basis

The condition that obtains when the futures price is above the spot, or the more distant futures price is above the nearby, is called *contango* and, the opposite, *backwardation*. Thus the basis is positive or negative according as the market is in contango or in backwardation. The prevalence of contango is a necessary condition for the warehousing business. Unless there is an expectation for contango to return after sporadic and temporary backwardation, warehousemen would go out of business and supplies for future delivery would be all but unavailable.

The question arises what determines the basis. On the upside it is limited by carrying charges including freight, storage, insurance, and interest. In the case of gold and silver the lion’s share is interest. On the downside *there is no limit*: theoretically the basis can go negative and keep falling indefinitely. It indicates that a tightening supply is facing increasing demand. Ever larger number of sellers withdraw their offer to sell. This is the *basis risk*: the risk of hedging inventory in the futures market. The cash price may start going up faster than futures prices forcing hedgers to take an opportunity loss on inventory. A contemporary example is *Barrick Gold Company* with a phony hedge plan losing tons of shareholder money. Note that *price risk* behaves the other way round. It is limited in the downside (as the price cannot fall below zero) but is unlimited in the upside (as there is no theoretical limit above which the price may not rise).

Interest and marginal utility

The monetary metals are characterized by great stores above ground. The stock-to-flows ratio is a large multiple for gold. Silver analysts deny that the same holds for silver. They are at a loss to account for the disappearance of huge stockpiles of U.S. official silver in any other way but assuming that it has been dissipated through consumption. There is no hard evidence that this is indeed the case. We can account for the disappearance of monetary silver through a more plausible hypothesis, namely, that most of it has gone into hiding. It shall resurface at the right time and right price, as indeed some of it already has after the silver price hit a high of 15 dollars per ounce.

The case is different for non-monetary commodities. Here the stock-to-flows ratio is a small fraction. The reason is *declining marginal utility* in contrast with monetary metals with near-constant marginal utility. Mises argues that constant marginal utility is contradictory because it implies infinite demand. He is plainly in the wrong. He ignores the nexus between gold and interest. In more details, interest acts as obstruction to gold hoarding. In case of non-monetary commodities obstruction to hoarding is precisely declining marginal utility. Demand for monetary commodities can only become arbitrarily large if interest is suppressed by the banks and the government. Thus interest is an exclusive characteristic of monetary commodities. John Maynard Keynes made a colossal blunder when he kept talking about the ”wheat-rate of interest”, ”coal-rate of interest”, etc. Interest can only exist in relation to a monetary metal with constant marginal utility. The marginal utility of wheat and coal declines very fast indeed.

”It takes three to contango”

Keynes made another terrible blunder when he talked about what he called *normal backwardation*. To him backwardation was the natural state of the markets, and contango, the aberration. He argued that speculators ”charge an insurance premium” for shouldering the price risk while carrying the commodity for future delivery. It is this premium that shows up in the futures price as backwardation. This shallow theorizing faithfully reflects the Keynesian mindset that is haunted by visions of overproduction, market gluts, deflations, depressions, and unemployment, in one word: the ”curse of capitalism”. The fact, however, is that ours is a world of scarce resources. Man is engaged in a constant struggle to overcome the niggardliness of nature. In particular, he has to have foresight to provide for future needs. If he succeeds, then future goods will be available to meet future demand in adequate quantities at the right time. This would not be possible without the services of the warehouseman and without contango in the futures market. We express this by saying that ”it takes three to contango”: the producer, the warehouseman, and the speculator. Keynes got it all wrong when he blithely ignored the second member of the troika.

Hoarding is not a dirty word, least of all gold hoarding, in spite of dark hints to that effect dropped by Keynes. The essential services of the warehouseman must be studied seriously and without prejudice on the same footing as those of the producer. The marginal bondholder who decides to sell his bonds in protest against low interest rates, and to invest the proceeds in gold, must not be depicted as Scrooge. He is a legitimate warehouseman who carries social savings at a time when banks behave like drunken sailors on leave at the waterfront, and governments engage in compulsive overspending as if there was no tomorrow. The resulting capital destruction is appalling. After Armageddon no one but the warehouseman, *alias* gold investor, will be in the position to supply capital for reconstruction. Thank heaven for goldbugs. Without them we would have to go back and start from scratch as cavemen.

Backwardation can certainly occur, in particular, when supplies are drawn down just before the new crop of agricultural goods is ready to be brought in. However, backwardation for monetary metals is a gross anomaly, a red alert. It indicates cumulative mismanagement of the monetary and credit system in the past, and potential breakdown in the not-too-distant future. Gold Standard University has championed the cause of doing pioneering research to refine this tool, to take it in conjunction with other market indicators such as lease rates, or the yield curve and its various types of inversion. It is hoped that this research will help people to escape the worst when catastrophe strikes. Forewarned is forearmed.

Lysenkoism ─ American style

The reason why mainstream economics is silent on the subject of gold, interest, and basis is that the interplay of these reveals the incredible mismanagement of the economy in the twentieth century, as well as the corruption of the monetary and credit system by the banks and by the government in the twenty-first. Universities no longer serve the cause of search for and dissemination of truth. Instead, they provide refuge for a reactionary conspiracy trying to cover up mismanagement and corruption reinforced by seventy years of Keynesian and thirty-five years of Friedmanite brainwashing. No university in the entire world, save Gold Standard University, is prepared to study in a detached manner the subject of gold, interest, basis, and the theory of warehousing as it applies to the hoarding of monetary metals. Universities no longer serve the interest of the people anxious to secure their economic survival in the face of untold dangers, as indicated by the Babeldom of runaway debt and exploding derivatives markets. Rather, they are serving the interest of their paymasters.

History will not be kind to mainstream economists. Keynes, Friedman, and their followers will be lumped together with Soviet biologist Lysenko, stooge and sycophant of Stalin. Lysenko sent his fellow biologists to the Gulag for opposing his hare-brained theories, never to be heard from again. Lysenko betrayed science as he betrayed humanity. He was, no less than Stalin, a monster.

The Quantity Theory of Money

I have never subscribed to the Quantity Theory of Money, nor have I ever believed that the downfall of the regime of irredeemable currency must necessarily take the form of hyperinflation. It could, of course, in the wake of wars and revolutions destroying supplies of goods and facilities of production. But the Quantity Theory of Money is a linear model that is wholly inapplicable to our highly non-linear world, now at the peak of its productive powers. The dénouement of the present global experiment with irredeemable currency is not likely to involve hyperinflation (assuming that the world will not be plunged into another World War). Unfortunately, a lot of innocent people will be led astray and ruined financially by the nearly unanimous propaganda predicated upon the Quantity Theory prophesying hyperinflation.

In order to see what is happening to our money a more sophisticated theory is needed. The new theory must assume a thorough understanding of *both* monetary metals, warehousing, futures markets, basis. We must also have a new theory of interest that takes gold fully into account. We must develop a non-linear model for the global world economy. This is what the Gold Standard University has set out to do. It will expose the central fallacy of mainstrean economics in assuming that producers will forever put up with the plundering of their capital accounts through driving interest rates *down* or will meekly keep accepting irredeemable promises to pay in exchange for real goods and real services, and that savers will forever put up with the pilfering of their savings accounts through driving interest rates *up* or will meekly turn over their right pocket when the banks and the government h ave picked clean the left.

In the same order of ideas, it is a grave mistake to explain rising gold and silver prices in terms of the supply/demand equilibrium model. There is simply no scientific way to define the speculative supply of and the speculative demand for monetary commodities, without which the model becomes meaningless. Speculators can jump back and forth between the supply and demand side of the market on a moment's notice and, when they do, they are likely to act *en bloc*. The only thing that the supply/demand equilibrium model can predict is the ever increasing volatility of the price of monetary metals.

Bull in bear's skin

We must also exorcise the boogeyman of silver analysts: the naked short seller of monetary metals. The inordinate short interest in the futures markets is better explained in terms of the activities of a market maker whom I call ”bull in bear's skin”. Typically, he is a super-wealthy individual who has learned the trick how to derive an income *in gold on gold* — even while retaining physical control over his holdings. He is not a naked seller by any stretch of the imagination. He does have the gold and silver, but keeps them at a safe distance from the commodity exchange and its predatory policies favoring the shorts at the expense of the longs. To his mind it pays to pose as a short. He hides his full armour underneath a mask showing him naked.

The proposition that it is possible to earn an income in silver on silver without relinquishing physical control of the stuff may sound like gaining something out of nothing, contradicting the Principle of Conservation of Matter and Energy. Yet we should not be too hasty in dismissing this possibility. It is true that income and risk go hand-in-hand. Income is the reward for consistently successful risk-taking. Show me a man who can generate an income without taking risks, and I show you one who has invented perpetual motion.

Yet there is no contradiction here. Paradoxically, it was mainstream economists themselves who made this black art possible. They promoted the regime of irredeemable currency with the result that the gold price fluctuates. If you keep your book in terms of gold units rather than units representing irredeemable promises, then it is indeed possible to earn an income *in gold on gold*, even without relinquishing your gold and thereby incurring the risk of losing it. To understand this we only need to refer to the possibility of harnessing the energy represented by the flow and ebb of water in the oceans. Likewise, it is possible to harness the energy represented by the fluctuating price of gold and silver. The best way of doing this is to buy on dips whichever monetary metal can be stored more efficiently at the going price. But how to determine the relative efficiency of warehousing different goods? This is the same dilemma facing the elevator operator when he is buying grain at harvest time. Should he buy more wheat or more corn? The price could easily mislead him. The basis would not. He solves the problem by always buying the grain with the wider basis. In this way he maximizes the efficiency of his warehousing operation.

What appears as naked short selling to silver analysts is more likely the activities of the ”bull in bear's skin”. It is the tip of the iceberg, that can be seen. What is not seen, the bulk of the iceberg, is dynamic hedging of ever increasing gold and silver hoards, and covered option writing, where the principal wants to stay anonymous. He is actually very happy that analyts believe, and spread the belief, that he is naked short. The longer he can keep his ”cover” as being ”naked”, the better it is for his operations.

It is futile and puerile to wait for the naked short to cover in a panic, sending the price through the roof. This, of course, does not mean that the price may not go through the roof, but if it does, then it is also likely to go through the floor next time around when the pendulum swings back. It means that volatility is increasing. The get-rich-quick crowd waiting for the miracle of the silver price going to four digits overnight will be frustrated. Rewards will go to the patient and industrious observer taking pains to study the market, and who has the right strategy that can handle increasing swings in the price of monetary metals. He doesn't subscribe to linear models. His guiding star is the non-linear model of the variation of basis.

Gold Standard University is working out a strategy following these principles. It will be unveiled during the next session in August, 2007. At this point let's just say that the strategy is essentially bimetallic arbitrage, but it uses the basis rather than the bimetallic ratio for clues.

Conservation of matter and energy

But how do we answer the objection that our proposed scheme contradicts the Principle of Conservation of Matter and Energy? Simple. We don't. We might as well admit up front that the contradiction is real. Chalk it up as an unintended gift from the managers of the regime of irredeemable currency. Helicopter Ben has air-dropped manna to the enemy camp by mistake. Nor can he help but keep doing it. His navigation system is all screwed up.

The gold standard, when in force, is an instant reward/penalty system that rules out income generated without risk. Were our schools allowed to teach economics properly, the electorate would know this and it would demand the immediate scrapping of irredeemable currency as the most wasteful and iniquitous monetary system imaginable. It would also demand the immediate reinstatement of the gold standard as the only monetary system serving even-handed economic justice. Under a gold standard foreign exchange and interest rates are stable. So is the price of monetary commodities. There is no profit in gold, silver, and bond speculation. Interest rate derivatives and bond futures are unknown. Debt is reined in by the ability to service it. Banks cannot lend long while borrowing short with impunity. When they lend short, they are limited by the size of their quick assets. Under the gold standard all economic risks are created by nature, none by man. Helicopter Ben belongs to fairy tales, not to banking, let alone central banking.

As the regime of irredeemable currency defies natural law, it is digging its own grave. This is the true explanation of the coming crack-up boom, not the "overissuing" of the currency. The currency was overissued already a hundred years ago. What needs to be explained is the *lag*.

References

A.E.Fekete, *What Gold and Silver Analysts Overlook*, May 4, 2004
Bull in Bear's Skin? May 4, 2006
Ultracrepidarian Musings, May 11, 2006
The Rise and Fall of the Gold Basis, June 23, 2006
Monetary versus *Non-Monetary Commodities,* June 25, 2006
The Last Contango in Washington, June 30, 2006
Tom Szabo, *The Silver Basis,* www.silveraxis.com/explain_basis.html

Further information on Gold Standard University can be obtained by writing to:

GSUL@t-online.hu

March 7, 2007.