MY CRUSADE TO FEND OFF

PERMANENT GOLD BACKWARDATION

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I have declined to answer the challenge of an opponent of mine to debate the semantics of the word “arbitrage”. He keeps referring to me by name and to my work through innuendoes. He puts words into my mouth which I have never uttered, and so completely misrepresents my views that I cannot escape the conclusion that he never read or properly digested my theory of permanent gold backwardation.

The threat of permanent gold backwardation is one that, in my view, casts a dark shadow on the future of our civilization much the same way as the disappearance of gold from commerce cast one in 476 A.D., the year when the Western half of the Roman Empire collapsed, world trade succumbed to barter, law and order broke down, and centuries of Dark Age descended upon Western Europe.
For this reason the subject should be treated responsibly and with the humility it deserves. This I cannot discover even in traces in the self-indulgent tirades of my opponent. I fail to see how his broadsides could be treated with respect. However, I do see the need for restating my theory clearly for the benefit of those who have an open mind and are desirous of learning.

There are three broad explanations justifying the existence of futures markets:

(1) Insurance offered to producers and consumers to cover the risk of extreme price swings.
(2) Outlet for human gambling instincts whereby gamblers can place their bets on the course of future price movements in the hope of large leveraged gains.
(3) Market for warehousing services.

The first (1) is the pat explanation offered by Keynes and the Keynesians. Keynes himself coined the expression "normal backwardation", suggesting that the normal condition of the futures markets is backwardation, i.e., when the basis (spread between the price for delivery in the nearby future and the price for delivery on the spot) is *negative*. Contango, when the basis is *positive*, is an aberration. Keynes unambiguously stated that the negative basis is the "insurance premium" collected by the insurers for their service from the producers and consumers. They unloaded their price risk to the insurers against the payment of this insurance premium. In more detail, the producer can *sell forward* if he is concerned that the price will fall; the consumer can *buy forward* if he is concerned that the price will rise. According to Keynes' argument it stands to reason that the producer will get paid *less* for his goods to be delivered in the future, because the insurer has taken his cut in the form of a negative basis. Likewise, according to the rest of his argument, the consumer will have to pay *more* for delivery on the spot, because the spot price incorporates the insurance premium in the form of a negative basis.

I shall not enter the debate whether or not there is a grain of truth in this explanation. It is clear that Keynes did not understand, nay, he completely misrepresented the essence of speculation in commodity futures trading. He has blithely wiped out the distinction between the action of a gambler shooting helter-skelter from the hip and the business of a professional insurer who scientifically studies his markets, charges a variable insurance premium in a way that diminishes his risks while guarantees reliable profits and the survival of their trade even in the greatest adversity − provided only that the monetary system is sound (which ours is not based, as it is, on irredeemable promises). Thus Keynes' theory of the futures markets may appear as a joke to practitioners of the trade. This is confirmed by the necessity to change the signature of the basis. If backwardation were really "normal", it should have a positive basis, rather than a negative one! (Perhaps this bothersome change of signature was the reason why Keynes never mentions the basis in his 1930 work *Treatise on Money*.)

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The second explanation (2) appears a notch more serious. It would be hard to deny the fact that the commodity futures markets, no less than the equity markets attract speculators like a honey-pot attracts the bees. It may also be that speculation is the necessary catalyst to provide liquidity without which these markets could not function. Having said that, we must admit that there is a clear difference between organized commodity exchanges on the one hand and the casino − or futures markets dealing in financial futures − on the other.

The difference is this: the risks involved in the former are created by nature. By contrast, risks involved in the latter are artificial in that they are created by man, as in the case of the casino that rigs the chances to win at the roulette wheel or at the blackjack table; or by the government that discards the gold anchor in the monetary system and the gold leash in the fiscal system to create artificial risks where none existed before, in the foreign exchange market and the bond market.
Risks are rigged in favor of the casino or the government, and to the prejudice of every other participant. Of course the government keeps pretending, mendaciously, that such risks as exist are inherent in the foreign exchange and bond market; they are natural, and bad government cannot be blamed for the economic damage and human suffering they routinely cause. The fact remains, however, that futures markets for foreign exchange or for bonds were conspicuous only by their absence under the gold standard. Not that they were outlawed. You could start one any time of your choice. But variations in foreign exchange rates and in bond prices were so minuscule under the gold standard that speculation simply would not pay.

Of course, mainstream economists fail to make a distinction between risks created by nature and risks created by man. They have a hidden agenda: to exempt the government from responsibility for rising prices, for unstable foreign exchange and interest rates. All untoward economic phenomena must be blamed on Mother Nature even when they are direct consequences of government interference.

The apostle of the false creed that the price of gold has been artificially fixed under the gold standard was Milton Friedman. This Mephistopheles gave the evil advice to the Emperor that issuing irredeemable paper dollars would solve the perennial problem of a bare treasury for once and all. After a hiatus of forty years we can now see the chickens, hatched by Friedman, coming home to roost. Friedman maliciously misrepresented the essence of a gold standard. Far from being a scheme of fixing the value of gold in terms of paper, the gold standard is a scheme of fixing the value of paper in gold. *That's what needs to be fixed, not the other way round!* The essence of the gold standard is that it denies the power of regulating the money supply to the government and the banking system. It is motivated by the desire that whenever people think that there are not enough gold coins in circulation, they should be able to do something about it. They will take new gold from the mines, or old gold (jewelry) from the refinery to the Mint and exchange it, ounce for ounce, for spanking new coins of the realm containing exactly the same amount of gold.

The Constitution did not set up a Central Bank for the United States, as Friedman well knew. *It established the United States Mint* instead. The purpose of the Mint was not the striking of base metal coins, that is, fake money imitating coins earlier struck in silver, to fool the people. *The constitutionally mandated Mint was the very means of putting the power to regulate the amount of money in circulation firmly into the hands of the people where it belonged.* This power had thus been explicitly denied to the government and to the banks by the Constitution. They could not create money, except on exactly on the same terms as the humblest of subjects could: by taking panned gold to the Mint, or gold that was obtained abroad as payment for exports.

Whether Friedman was too dumb to understand this or he was just a devious intellectual with a hidden agenda to overthrow the Constitution stealthily without even trying to amend it, is a question left to historiography to decide. Had he been an upright man and an honest economist true to his discipline, he would have recommended a Constitutional Amendment to the effect that the irredeemable paper dollar be henceforth recognized as Constitutional money. He would not have stooped to the chicanery of putting through a pocket-amendment in order to fool the public. After all, the Founding Fathers have made provision for amending the Constitution.

Whatever Friedman did, we have to suffer the consequences, which are fearsome.

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Thus we are left with explanation (3). Mainstream economics has badly neglected the study of commodity futures markets and can offer no guidance in this regard. The reason for the neglect is abundantly clear. Such a study cannot be based on the assumption that the regime of irredeemable currency is legitimate. In the absence of a gold standard people are forced to hoard commodities for the purpose of saving. Only simpletons would on their own free will choose to save in the form of hoarding irredeemable promises, whether the promise has been issued by a bank or directly by the Treasury. The financial annals fail to mention a single instance of dishonored promises to pay going to a premium. They have always gone to a discount. They are utterly unsuitable for saving because they are destined to lose all their value, down to the last farthing.

In other words, under our present monetary arrangements the commodity market is called upon to satisfy an exogenous demand, namely, demand for commodities needed as a substitute for irredeemable promises pushed down the throat of the saving public. As a consequence, the commodity market cannot help but ultimately turn itself into a gambling casino. Commodity futures trading as it was originally conceived for the purpose of price-discovery and hedging, is badly distorted.

I have taken the task upon myself to find a definitive answer to the question how to explain and justify the existence and legitimacy of futures markets. Here is my answer. Legitimate futures markets include all those trading agricultural commodities where supply is unpredictable for reasons of their dependence upon nature, sometimes giving us bumper crops, at other times crop failures. Futures markets trading non-agricultural commodities are also legitimate.

By contrast, all future markets trading so-called financial futures are illegitimate. The reason is that risks involved in holding financial futures are made artificially by the government and are rigged to the prejudice of the subjects. For example, the foreign exchange market used to be stable and risk-free under the gold standard. Now it belongs to the category of gambling casinos, even if outwardly it resembles commodity exchange markets. The resemblance is a deliberate deception. The government, academia, and the financial press try to lump the foreign exchange markets, bond markets and other derivative markets together with the commodity market to create the impression that the risks they tackle have also been created by nature. This effort is subordinated to the task of perpetuating the regime of irredeemable currency and to prop up the market for government bonds. The latter is in constant danger of collapsing. It has a captive clientele: banks, insurance companies, pension funds, government agencies such as deposit insurance, unemployment insurance, old age security administration funds, and the like. They are under duress to hold government bonds as reserves in their portfolio. In consequence these funds are perfectly useless for the purpose they allegedly serve, namely, to make funds available for payout. In case of real need for selling government bonds, bids are withdrawn and the bonds can only be sold at a deep discount, if at all. The only purpose the government bond market serves is to make the bond appear sound and negotiable, which it is not (save a handful of countries with negligible government debt such as Norway and Singapore, for example).

The commodity markets trading agricultural goods show a regular cyclical pattern for the basis (defined above as the difference between the nearby futures price and the spot price). From backwardation (negative basis) just before harvest the market goes to contango (positive basis) just after harvest. This reflects the fact that warehouses (grain elevators in the case of grains) are nearly empty just before the harvest but they are full when the harvest is brought in. For the rest of the crop year the contango holds sway that slowly fades into backwardation as the basis goes from positive to zero, from zero to negative just before the next harvest, when the cycle is repeated. Vanishing contango reflects the drawdown of supplies. The cyclical pattern of the basis follows the seasons of the year. It justifies the existence of futures markets making hedging and price-discovery possible. There can be no doubt that the futures market for agricultural commodities is in effect a market for warehousing services. Producers can choose basically between two ways to carry inventory. The first one is less efficient: producers provide their own warehousing and carry the goods themselves. The second is far more efficient. Producers sell their crop *en bloc* after harvesting at the prevailing price and replace it with futures contracts which they plan to sell piecemeal during the rest of the year as contango returns and the spot price improves. They may be handsomely rewarded for their strategy just before the next harvest when it turns out that the warehouses underestimated annual demand (as it frequently happens). Clearly, this is arbitrage between the cash market and the futures market. It is manifested by the buying and selling of warehousing services. Sales and marketing need not be simultaneous. It is possible to do sales first and marketing afterwards.

Note that the producer's buying (as opposed to selling) futures contracts *is no speculation.* There is a joke about a Texas rancher who is madly bullish on the price of cattle. So much so that he routinely sells live cattle from his ranch and puts the proceeds into buying cattle futures. He lovingly refers to these long futures contracts as "me straddles". When it is pointed out to him that they are not, properly speaking, straddles, the rancher retorts "mine are *Texas straddles*". That joke is just that, a joke. The rancher, in spite of appearances, is not speculating. Quite properly, he is doing arbitrage between the spot market and the futures market, as many grain farmers do. He is buying and selling warehousing services.

Most of the grain grown in North America is marketed through the grain futures markets. In this way the most modern and most efficient, professionally managed warehousing facilities are made available to small growers who otherwise would be unable to avail themselves to the state-of-art technology. It is a marvelous system that works for the benefit of all.

Another use of the commodity futures markets is hedging, namely, selling the crop forward while it is still at the growing stage. A favorable price may be available presently when the crop is still in the ground, but which may well disappear by the time the harvest is brought in. For example, there could be a crop failure somewhere half-way around the world. No problem. The farmer sells futures contracts against his growing crop at the favorable futures price now, and will cover his short position later, after he has brought in and sold his harvest at the then prevailing price. Everybody benefits: the growers at home get the better price; the hungry people half-way around the world, victims of the crop failure get cheaper imported grain than they would in the absence of futures trading.

Nor is this all. Further benefits are available. If there is a crop failure and an unexpected shortage, it will immediately show up in the form of backwardation in the futures market. The basis goes negative. There is a premium on the price of the cash commodity over that of the futures. This is a threat to the consumer who may be forced to spend more than the usual outlay for his regular supply. The marginal consumer may even have to do without. However, arbitrage comes to the rescue. Arbitrageurs will sell the cash commodity and buy the futures. As a result those who can afford it will postpone consumption. The shortage is eased, and the marginal consumer spared.

Or suppose that there is a bumper crop and an unexpected glut. The basis immediately goes to its maximum called the *carrying charge*. This time it is the producer who is threatened as he may not be able to recover the cost of his production. The marginal producer may even be forced out of business. Again, arbitrage comes to the rescue. Arbitrageurs will buy the cash and sell the futures. As a result the economic pain accompanying the glut is eased and the marginal producer is spared.

We have seen that the futures market for soft commodities (those produced by the agricultural sector) is cyclical. For hard commodities (those produced by the resources sector) the cyclical feature may be partially or entirely missing. The energy sector, for example, is characterized by a futures market swinging back and forth between longer periods of backwardation and shorter periods of contango. This is explained by the costly and danger-wrought warehousing, having to do with inflammable nature of energy-carriers and the fact that demand changes dramatically with the arrival of the winter heating season. For other hard commodities such as base metals warehousing and marketing reveals a different pattern again that I shall not discuss here for reasons of space limitation.

It should be clear from the foregoing that "normal backwardation" is a misnomer. Keynes was as wrong as an economist with a messianic message can be. Keynes needed a justification for his absurd theories of overproduction and under-consumption. Backwardation is *not* normal. The "normal" state of futures markets is contango. Commodity trading assumes warehouses. No one will construct one in order to keep it empty. If anything, one could talk about "normal contango".

We can also observe that commodity futures markets try to shake off backwardation whenever it occurs. This is clear from the fact that the basis has no lower limit. Since it can have any negative value, however large in absolute value, we can be sure that backwardation will "cure itself". At one point the falling basis will start moving commodities into the warehouses. The ancient wisdom holds: "*Natura vacuum abhorret*".

In the same order of ideas I note that the behavior of the basis is highly asymmetric. While it has no lower limit, it does have a strict upper limit. The upper limit of the basis is the carrying charge mentioned above. As the name suggests, it is the total cost of warehousing. In order to establish the fact that the basis can never exceed the carrying charge we argue by contradiction. Suppose that for some commodity *X* the futures market is in contango and the basis exceeds the carrying charge. Then the warehouseman starts selling *X* forward and buys the physical, pocketing the excess of the basis over carrying charge as profit. In other words, he is *doing risk-free arbitrage* from the cash market to the futures market for *X*. The excess disappears, and disappear it will almost instantaneously. Risk-free arbitrage has the habit of devouring its parent right after parturition.

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Gold futures trading has only a brief history of about forty years. It was totally unknown under the gold standard. It started in the early 1970's at the Winnipeg Commodity Exchange in Canada, when the ban on Americans to own and trade monetary gold was still in force. In 1975 the ban was lifted and trading gold futures shifted to COMEX in New York.

A mystery in the gold futures markets soon presented itself. The gold basis, initially as robust as it can be (bumping against the carrying charge) started weakening gradually over the decades. Nobody could explain the phenomenon; it cost the chief economist of COMEX his job. By now the gold basis has become so rickety that the gold futures market indecisively vacillates between contango and backwardation. Some people conjecture that the gold basis will ultimately settle down for a cyclical pattern like the basis for soft commodities, even though these so-called observers never fail to add that "you can't eat gold". No deeper analysis was offered or sought.

For the past twelve years I have in my talks and articles spread the word that, far from being cyclical, the gold basis exhibits a clear vanishing pattern. Moreover, it will necessarily culminate in permanent gold backwardation in the fullness of time. In suggesting this I am fully alive to the fact that *permanent backwardation is not possible for any other commodity futures market* because the persistently falling basis is going to bring out fresh supplies sooner or later.

The solution to the mystery is found in the fact that gold is no ordinary commodity. It is a monetary metal. It fails to obey the Law of Supply and Demand. Rising prices may fail to bring out fresh supplies. Quite to the contrary: it may make the existing supply disappear altogether. There is impeccable logic behind this prognostication. In any futures market basis dropping to zero and showing a tendency to dip into negative territory is an incontrovertible sign of an increasing shortage of deliverable material. That has been the case for gold, too, for the past couple of years. The signs are all around us. Central banks first limited, then suspended their gold-dumping campaign. The brave ones among them even started buying gold in open defiance of the wrath of the U.S. Treasury. Right now there is a run to exchange paper gold for physicals. China leads the pack with her unlimited appetite for ever more gold. The only exception is the Western "democracies", where the worshipping of the paper Moloch has been the strongest.

There is no obvious source where the monetary gold will come from to feed the backwardation monster. Gold in Fort Knox is heavily hypothecated through multiple leasing arrangements. When the last registered gold bar leaves the warehouse, COMEX will become insolvent and a massive default on its gold futures contracts will follow. It matters little that they will call it by some other fancy name, such as "liquidation only policy", "standstill agreement", "cash settlement preference", or any other that comes to mind. Default is default, by whatever name it goes.

As I have repeatedly said, the threat of permanent gold backwardation is a most serious one. It threatens all of us, regardless whether we participate in gold futures trading or we don't. It is incumbent on the government to fend it off at all hazards, just as it should take preventive measures in case the Grand Coulee Dam was about to give way. Nevertheless, my warnings have fallen upon deaf ears. Ben Bernanke has on occasion even boasted that he does not understand gold. It sounds to this observer that the captain of the boat is boasting that he does not know the first thing about navigation.

But why must one see the disappearance of gold as a sign of public danger? Well, the COMEX default will be no ordinary default. It will be cataclysmic. It will, for the first time, reveal that the U.S. Treasury paper is not only irredeemable, but it is outright worthless. Right now, you could still get *some* gold for it, however little. To the extent you could, the dollar is still a monetary instrument, in fact, one of the most potent. *After* the onset of permanent gold backwardation it will cease to be that. The dollar will fetch no more gold. Not one grain. From one day to the next. That will be the day when Ben Bernanke or his successor on the way to Damascus will come to see the light. They will come to understand gold. That will be the day when all banks in the Western World will become insolvent. Bank reserves held in the form of U.S. Treasury paper will go up in a puff of smoke.

F. D. Roosevelt took the insane advice of Judas Iscariot Keynes to make the dollar irredeemable domestically 1933. R. M. Nixon took the evil advice of Milton Mephistopheles to make the dollar irredeemable internationally, i.e., declare it "the ultimate extinguisher of debt" in 1971. Neither measure, however forceful, was sufficient to administer the *coup de grâce* to the dollar. All respectable monetary scientists were most incredulous at the time. They had all been predicting that the dollar, once made irredeemable, was ready to succumb to the sudden death syndrome. Well, it didn't. Their failure to appreciate the fact that you could still buy gold with dollars cost these upright scientists their credibility. Everybody became convinced that the dollar was invincible. The rear-guard of the gold standard was ridiculed as a bunch of superstitious old foggy-bottoms. Today I find myself in a minority of one in suggesting that the dollar will not collapse as long as it can still buy *some* gold. Everybody believes the day will never dawn when the dollar can no longer buy even one grain of gold − just like everybody believes that the day will never dawn when the Sun fails to rise. Why, it is *a contradiction in* *terms*. Yet such a day that the dollar won't fetch one grain of golf *is* going to dawn. And you won't have to wait for it till doomsday. *It is around the corner.*

I leave the challenge to debate the semantics of the word "arbitrage" unanswered. I will continue my crusade trying to fend off permanent gold backwardation. The American government could do it overnight by opening the U.S. Mint to gold. *It is not too late to do it.* I continue to sound the alarm that the present insane gold policy of our political and economic leadership shall land us in the black-hole of permanent gold backwardation, with a ticket to the next Dark Age of Western civilization.

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