

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**

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Dear Paul:

In 35 years our paths have crossed for the second time. In 1974/75 you and I were Visiting Fellows at Princeton University. Now, in 2009, both you and I are attending the Santa Colomba Conference on the present debt crisis at the invitation of Bob Mundell.

In 1975 you conducted a seminar on the international monetary system and invited me to contribute a paper on gold which I did. Those were halcyon days by comparison. The United States, after the turbulence of 1971, successfully consolidated the international position of the dollar and could confidently lift the 42-year old ban on the ownership and trading in gold. On December 31, 1974, trading of gold futures contracts started in New York and Chicago. It showed a robust contango at full carrying charge, that is to say, the gold basis (the spread between the futures and the cash price) was at its peak. It indicated that monetary gold was available in great abundance to meet any demand for any reason. It showed that the gold futures markets could serve as the fulcrum in seeking out the equilibrium between the supply of and demand for gold. They could act as a safety valve, releasing occasional pressures that, in the absence of paper gold, may be a threat to the monetary system. It looked as if the gold problem has been solved for once and all.

But as I feared, and as the intervening 35 years have proved, rather than moving towards equilibrium we have been constantly moving ever farther away from it, as measured by the gold basis. The secular vanishing of the gold basis is a most ominous danger signal. It indicates that monetary gold is increasingly unavailable, and in case of a crisis it can no longer be relied upon to come to the rescue. Basis started out at 100 percent of the prevailing interest rate, but has been steadily eroding all the way to zero percent today. Permanent gold backwardation (negative gold basis) is staring us in the face. The gold basis is trying to tell you something. It heralds the greatest monetary crisis of all times. It warns about the possible collapse of the international monetary and payments system.

Let me explain. Gold is the only *ultimate* extinguisher of debt. Other extinguishers do, of course, exist but they are not ultimate in that they have a counterpart in the liability column of the balance sheet of someone else. Gold has no such liability attached to it. Gold is where the buck stops. It is this property that makes gold unique as a financial asset. Historically, gold discharged its function as the ultimate extinguisher of debt through the gold clauses written into the bonds of the U.S. government before 1933. Gold could also discharge this function, albeit rather imperfectly, under the gold exchange standard of 1934 with gold redeemability limited to foreign holders. Still more imperfect was the system of fluctuating gold prices

introduced in 1971, thanks to the availability of paper gold. Imperfect as though these stratagems were, they served as a pacifier to the bond market. But as the threat of permanent backwardation indicates, all offers to put monetary gold at the disposal of the international monetary system could be abruptly withdrawn. In that event there would be no ultimate extinguisher of debt. The world is totally unprepared for such a momentous development. I ask you: are there contingency plans in the U.S. Treasury and in the Federal Reserve what to do if backwardation makes monetary gold unavailable for the indirect retirement of debt?

The message to debt holders would be: *suave qui peut*. There would be a rush to the exit doors and people would trample one another to death in trying to get out. The debt crisis of 2008 was a dress rehearsal. It gave the world a foretaste. *This crisis is a gold crisis*. It is a crisis indicating the threat of a shortage of the ultimate extinguisher of debt, without which our runaway debt tower is doomed. When it topples, it will bury the world economy under the rubble, as the Twin Towers buried the people working inside in 2001.

All kinds of *ad hoc* explanations have been offered for the debt crisis. But the real explanation is that under the threat of gold backwardation creditors are scrambling for liquidity. *There will be no recovery unless provision is made for the orderly retirement of debt through a mechanism using gold as the ultimate extinguisher*. The alternative is a Great Depression worse than that of the 1930's. To understand this we have only to contemplate the shock to the world if it was revealed that the debt of the U.S. government was in fact irredeemable. The Emperor is naked. As long as bonds carry a gold clause, or the bond market is supported by the trading of paper gold, bonds are deemed redeemable. But once permanent backwardation makes gold unavailable, debt becomes irredeemable in the eyes of the bondholders. Paying U.S. bonds at maturity in F.R. notes does not establish redeemability. The latter is just evidence of debt secured by the former as collateral revealing that bonds are not really redeemable at all. An interest-bearing bond is replaced by a non-interest-bearing bond, that is, by an inferior instrument. All you do is shuffle various forms of irredeemable debt. When the world wakes up to this prestidigitation, the international monetary system will not be able to survive the shock-waves. The chaos that will engulf the world is appalling.

The solution is relatively simple. The world's monetary gold should be remobilized. This can be accomplished by opening the U.S. Mint to the free and unlimited coinage of gold. There should be no attempt to fix, cap, or otherwise control the dollar price of gold. The gold coins of the United States ought to be made available to bondholders in order to provide for an orderly retirement of debt, if that is what the bondholders want. When they become convinced that this avenue is open to them through the unlimited availability of gold coins of the realm, the scrambling for liquidity will peter out and stability return. If other great nations wanted to join opening their Mints to the free and unlimited coinage of gold, so much the better. It should not be beyond the power and the wit of the U.S. government to rein in this crisis and make a decisive move in the direction of full recovery through opening the U.S. Mint to gold, as demanded by the Constitution.

Gold is a great world resource. It would be foolish if, for parochial or ideological reasons, we failed to enlist it in the cause of economic development — even in the absence of a great crisis. But given the present crisis situation, remobilization of gold is imperative.

Yours very sincerely,
Antal E. Fekete

Santa Colomba, July 10, 2009.