THE RISE AND FALL OF THE GOLD BASIS

Antal E. Fekete
Professor, Memorial University of Newfoundland
aefekete@hotmail.com

... And God created gold...

And God saw that gold was good, and he ordained it as primordial money. The gold coin was to be the savers' guardian angel and the producers' patron saint, they being the pillars of society. It was also meant to be the protector of the wage-earners, the most vulnerable protagonists of the drama of Human Action. The role of gold in the economy is that of regulator of the quantity and quality of debt. Gold has continued to be money as well as obstruction to the Debt Tower of Babel for over five thousand years. Until man in his infinite conceitedness wanted to be wiser than God. He sought to overthrow the monetary rule ordained by God. He set out to build the Debt Tower of Babel that was to reach to Heaven. Pilfering savers and plundering producers was the inevitable result of the activation of the fast-breeder of debt triggered by the elimination of gold money.

Seven gaunt cows devouring seven fat ones

Not only did man overthrow what he called "the yoke of gold"; he also sought to obliterate whatever wisdom previous generations have accumulated through painstaking research and careful experimentation with the sharp instrument of credit, the cutting edge of progress but which can also hurt its careless wielder. The monetary system of the Brave New World has feet of clay planted in a pile of rotting paper. It is animated by a false doctrine, the Quantity Theory of Money, a.k.a. monetarism, preaching that gold can safely be overthrown provided that it is substituted by a "quantity rule". The fundamental error in this is the assumption that gold is there in the first place to limit the quantity of money. Yet the role of gold is to regulate the quantity, not so much of money, but of debt. In falsifying science man has frustrated the only hope to rectify the error. This brings to mind the old adage that "if God wanted to punish someone, He would make him mad first".

In previous essays of this series I have discussed how speculation and warehousing combine to meet the ever-present challenge of the fickleness and niggardliness of nature. Warehousemen must ration scarce storage space among competing uses. According to the *Genesis* the first warehouseman, Joseph of Egypt, provided for the seven lean years by storing the grain surpluses of the seven fat years, following his interpretation of the Pharaoh's dream: seven gaunt cows devouring seven fat ones.

Supply-shocks

Briefly stated, man is in a continual struggle with supply-shocks in the market. They come in two varieties: bumper crops and crop failures. The former is the Nemesis of producers, the latter that of consumers. Either way, the whole society suffers. However, supply-shocks can be mitigated through foresight, organized speculation, and intelligent warehousing. The fulcrum is the activity of warehousemen who, following the example

of Joseph, allocate scarce storage space in a most efficient manner in order to provide for future contingencies.

Their talisman, enabling them to perform this job successfully, is the basis. It is a seismographically most sensitive instrument to provide information in a most concentrated form. It makes for an early warning system exposing potential supply shocks threatening society. Moreover, the basis also digests information such as the producers' estimate of what is a good price for their product, comparing it with the speculators'. The basis picks up all signals, including producers' forward sales and speculators' purchases of futures contracts, bringing the two into balance. The question arises how this can be accomplished. After all, the basis is the spread between the nearby (rather than distant) futures price and the cash price. The answer is: through arbitrage. Floor traders hedge their sales and purchases of distant futures as they simultaneously do the opposite transaction in nearby futures. The basis registers and harmonizes all signals coming from all markets trading that particular commodity. One cannot help but admire this fine communication system through which potential supply-shocks, ever present due to risks inherent in nature, are mitigated by the "invisible hand"as directed by the basis.

Speculation *versus* gambling

But there are false prophets, in economics no less than anywhere else. They preach that in exactly the same way as speculation can counter the untoward effects of supply-shocks, it can also meet the challenge of demand-shocks. Just as speculation can face risks inherent in nature, it can also face risks artificially created by man. However, in God's own dictionary a fine distinction is made between *speculation* and *gambling*. When man meets risks artificially created by other men (including the government), it is *not* speculation. It is gambling. It is akin to bets placed by the gambler on future events which may appear to be random but aren't: they are rigged artificially by the casino owner for his own benefit. The false prophets, being apologists for government-induced gambling, are anxious to blot out this distinction.

Why is speculation successful in reducing risks inherent in nature, but a miserable failure when used to reduce risks artificially created by men? Why is it that when the government wants the speculative markets to reduce the fluctuation of foreign exchange and interest rates, or that of gold and silver prices -- all caused by foolish policies of the self-same governments -- the result is always contrary to purpose?

To answer this question we need to consider that in the case of risks inherent in nature all speculators start off with an equal chance to be successful. No "inside information" is available to anyone. The playing field is level. Not so in the case of risks artificially created by government in deliberately destabilizing foreign exchange and interest rates. Here speculators pit their wits against that of central bankers. The latter think they can manipulate the former. A *closed* group of men tries to outsmart an *open* group. But the closed group consists of paid hands who don't have to face the music of accumulating losses. All losses have been underwritten in advance by the government and are covered from the public purse. The open group on the other hand consists of speculators who risk

their own capital which, if lost, will force them to quit. Their role is taken over by others with better mental equipment to outsmart the same central bankers. This is how George Soros could single-handedly bust the Bank of England while it was trying to uphold the value of the British pound. The Soros incident was not the first episode of devaluation in the wake of speculative onslaught, following solemn government pledges that the pound would never be devalued. Major landmarks are: 1931, 1948, 1968. Before 1931 a paper pound fetched exactly one gold sovereign. Seventy-five years later, in 2006, it took *one hundred* paper pounds to buy the same sovereign. Apparently, Mr. Soros knows something that Mr. Brown, the Secretary of the Exchequer, does not.

The rise of the gold basis

When in the early 1970's governments in their wisdom discarded gold from the international monetary system, not only did they cut adrift foreign exchange and interest rates. They also let the genie of the gold basis out of the bottle. Treasury officials were confident that they could control it by giving speculators the run of the house. The fundamental feature of the gold market is contango. When threatened to go into backwardation, the falling gold basis would create powerful incentives for people to accept the futures market's offer to absorb all carrying charges and, on the top of it, to pay a handsome bonus. Surely speculators would fall over themselves in trying not to miss this bonanza in gold. In the event Treasury officials have misinterpreted market behavior so completely as only economists imbued with government omnipotence could. The genie has its own agenda. It will at one point refuse to take orders from Aladdin Greenspan or Helicopter Ben (or whoever is put in the Chair at the Federal Reserve Board). The rise of the gold basis will be followed by its fall, bringing about the downfall of the Establishment.

God created basis. He wanted to help men fend off blows from the prodigality or frugality of nature. Like the creatures of Prometheus they would perish without fire. The basis, in the case of agricultural commodities, is just that mythological fire stolen from heaven. It is the Creator's gift to his creatures to help them survive devastating supply-shocks.

Demand-shocks

By contrast, the gold basis is not a gift of God. It is a scourge of God to punish conceited governments pretending to be omnipotent and omniscient. Powerful men want to manipulate their neighbors inducing them to behave in a way prejudicial to their own welfare. They want to enslave them by taking away their ability to protect themselves and to provide for their own happiness and survival, especially in view of the eventuality of disasters caused by foolish government policy. They hire economists who parrot the line that demand-shocks can be met in the same way as supply-shocks: through organized speculation.

Therein lies a great error. The gold basis has risen, but its rise is to be followed by a fall and, later, by the downfall of governments trying to play God as they gamble with the

welfare of their subjects. The fall of the gold basis tells us that God's gold cannot be drowned in a sea of paper gold. The price of the former will tend to infinity while that of the latter will keep falling to zero. The genie of the gold basis will crush the government through demand-shocks waiting in the wings of the gold market.

The fall of the gold basis

As a mental experiment let us arrange all goods in a linear order starting with agricultural commodities exposed to supply-shocks to the greatest extent, reflecting the fickleness of nature. Next in line are base metals and other minerals, as well as energy-carriers which are exposed to supply-shocks to a lesser extent. Finally at the far end of the spectrum we put the monetary commodities virtually immune to supply-shocks. Gold, in particular, has a stocks-to-flows ratio which is a high multiple variously estimated between 50 and 80. An increase in the flows, however large, would hardly cause a ripple, considering the size of stocks. To state the case differently, suppose new gold fields were discovered more prodigious than those of Witwatersrand. Or suppose that processes were developed whereby gold molecules suspended in the infinite oceans could be distilled and gathered economically. Such events could in no wise have an untoward effect on the value of gold, so huge are existing stocks relative to incremental flows. This fact alone shows that it was sheer madness to discard gold from the monetary system. The monetary commodity must be immune to both supply and demand-shocks. God has kept His side of the covenant by helping man control supply-shocks. Governments haven't: they have artificially magnified demand-shocks through foolish monetary policies.

The upshot is that the basis risk is much higher for gold than for non-monetary commodities. The fall in the gold basis, whenever it comes, will have nothing to do with assumed supply-shocks. Even if governments threatened to dump all their remaining monetary gold, the result (after the news wore thin) would be counter-productive. The dumped gold, and more, would be readily absorbed. People would not allow the government to trick them out of their golden life-saver. Rather, they would behave as predicted by the ancient Greek monetary scientist Xenophon. In his treatise entitled *The Revenues of Athens* he wrote that, after people had satisfied all their artistic and industrial needs for it, they would derive just as much pleasure in digging a hole in their own backyard and burying their surplus gold there, rather than entrusting it to public warehouses or, heavens forbid, to government treasuries.

It has always been that way. It will be that way in the future, too. Whenever the government wants to trick people out of their possession of gold, the basis turns negative. It then falls into a pit and no one will hear it to hit bottom. The number of instances of this happening strains the counting ability of monetary historians. Every episode of a hyperinflation in which paper currency has self-immolated furnishes such an example.

Putative gold basis

"Hey, wait a minute", you may interject. "Is this not an anachronism? How could you talk about gold basis under a gold standard?" Well, you are right. Gold basis is a new

concoction, barely 35 years old. There was no gold basis before 1970, as there were no futures markets in gold. The world's first gold futures market opened in the Winnipeg Commodity Exchange in 1970. The contract called for the delivery of the 400 oz. (12.5 kg) international 'good-delivery' gold bar, the one central banks of the world have been using to settle international imbalances with one another in the good old days. I meant the *putative* gold basis in the previous paragraph, that is, whatever the gold basis would have been if there had been a gold futures market at the time of hyperinflation.

In 1971 I went to Winnipeg to be witness to history. I purchased a seat on the exchange. I was interested in studying the variation of the gold basis on the floor first hand. At that time gold ownership and trading was still a crime in the United States pursuant to a Presidential Proclamation dating from 1933. F. D. Roosevelt nationalized (read: confiscated) monetary gold. In Canada gold ownership and trading has always been legal. Canada was chosen as testing grounds by the U.S. Treasury to see how the market would react, in preparation for the legalization of gold ownership in the U.S. four years later. The gold futures market in Winnipeg was a robust carrying-charge market. Its wide basis reflected the popularity of gold futures with gold investors. Buy orders came in a steady stream from all corners of the world. In the absence of gold futures this demand would have shown up as demand for cash gold, the greatest threat to the value of the U.S. dollar. The U.S. Treasury was satisfied that paper gold would do nicely, thank you very much, and gold futures trading in the U.S. was duly allowed to commence in January, 1976.

Bribe money

I have always felt that the gold basis was an anomaly. It certainly did not belong to the same category as the basis of agricultural commodities. It was not a bonus rewarding good husbandry. It was more like the Trojan Horse planted by a bankrupt government that wanted to take through deception what it couldn't by force. I always looked at contango as bribe money, to induce people to take the promise instead of the real thing. It is remarkable and important that under the gold standard there was no need for bribes. People were happy to accept the promise at face value. The credibility of central bankers has in the meantime been reduced to a zero. They are the spinmasters of the "greatest fool" game. The greatest fool is the player who will hold the bag of worthless banknotes when the music stops. Gold futures trading has been introduced in order to make people believe that the possibility of hyperinflation has been eliminated for good.

We may grant that gold futures trading has materially added to the longevity of the regime of irredeemable currency. But while the central bankers are buying time, sand in the hour-glass of the gold basis keeps trickling down. When it runs out, the trickle of cash gold from warehouses will have become an avalanche that could no longer be stopped. The gold futures market will be bankrupt, along with the regime of irredeemable currency. Treasury officials will cry "foul play"and will scurry around looking for "rogue traders" everywhere. That is, everywhere except in the Treasury and in the White House where the real culprits hide. When the present unconstitutional monetary regime of the U.S. comes unstuck, the responsibility for the disaster will have to be assigned to the President and the Secretary of the Treasury. They have betrayed their oath to uphold the

Constitution of the United States of America, as far as its monetary provisions are concerned.

I have never ever wavered in my conviction that such will be the denouement of the drama unfolding before our eyes. Any other outcome, however widely prophesied, whether the inflationary or deflationary variety, appears unlikely to me.

Fools treat promises with greater respect than the issuer himself

I reject the Quantity Theory of Money. It is an essentially linear theory trying to explain an essentially non-linear phenomenon. Consequently, I do not believe that there is a causal relationship between the central bank's inflating the money supply and an increasing price level. No doubt, the newly created money could go into commodities; but it could, and would, also go into bonds, equities, and real estate. It is true that paper currency will ultimately self-immolate. An irredeemable promise to pay, it has been gushing forth in the aftermath of the break of the dam, the 1933 reneging on the promise to redeem the dollar in gold at the rate of slightly over 1/20 oz. It does not matter that hardly anybody alive today has any direct memory of that event. What does matter is that the central bank has neither the intention nor the means to meet this obligation. It simply refuses to give *anything* of value in exchange for its own notes. It should not come as a surprise then that these notes will, at one point, be unacceptable to the producers in exchange for real goods and real services. This is plain logic. There has never been an exception to the truism: *if the issuer treats his own promises with disdain, then it is only a matter of time before the public will do likewise*. Nor does the truth of this syllogism depend on the quantity of promises issued, or on the rate of increase in their issuance. It is still valid even if the rate of increase in the issuance of new promises is declining, or if no new promises are issued. It follows that a quantum increase in prices is not a necessary condition for the imminent self-destruction of the monetary system. Nor can the increase in prices be relied upon to predict the timing of such an event. Then what can?

I am suggesting it to you that the gold basis can.

Aladdin Greenspan whistling in the black hole

Expect the regime of irredeemable currency to put up a desperate and vicious fight for survival. There may be times when the gold basis bounces back. But its decline, on the average, is relentless. The dead-cat-bounce is still to come. I have been a student of the gold basis for 35 years. In the early 1990's I made the pilgrimage to the World Trade Center in New York City to meet the Director of Research at Comex. I asked him what explanation he had for the vanishing contango and for the relentless fall of the gold basis. He cited a couple of *ad hoc* reasons, having to do with the low and falling interest-rate structure, and its effect on the declining carrying charge. But he had to admit that he knew of no theoretical explanation for the phenomenon of continuing erosion even in the face of rising interest rates and increasing carrying charges.

My own explanation is that the shrinking contango and the persistent fall in the gold basis is a measure of the vanishing of gold into private hoards. Monetary gold together with the output of the gold mines is disappearing. Aladdin Greenspan was whistling in the black hole when he testified before a Congressional committee saying that central banks stood ready to sell more gold to quash flare-ups in the gold price. The irrefutable fact is that selling gold makes the central bank's balance sheet weaker, not stronger. The bank would replace its *best* assets for the *worst*. It would exchange an asset that is the liability of no one for the liability of devaluation-happy governments. Central bankers are helpless. They are in a catch-22 situation. Selling gold into a rising market would be the *coup-de-grâce* to their fiat money scheme. They hope against hope that inundating the world with paper gold in the form of gold futures, options, ETF's and other derivatives, existing or yet to be invented, will save their skin. It won't. Not forever, anyhow.

So I advise my audience to ignore the siren song of the Quantity Theory of Money. Focus attention on the falling gold basis. It is a foolproof indication of the disappearance of monetary gold still available to the public as insurance against economic disasters. The fact is that the vast majority of the people lives in a fool's paradise. They haven't given a thought to purchasing such insurance while they are busily building their homes right on the financial fault line.

As a further refinement I call attention to the silver basis which, if my analysis is correct, will fall first. Not because monetary silver has been "consumed", as trumpeted by the cheerleaders of the get-rich-quick crowd. It hasn't. But, as the silver basis shows, silver is going into hiding even faster than gold. Why? Basically because central bankers have less scope for bluffing in the silver market. The cupboard is bare and the kitty is empty when they are looking for more silver.

Sapere aude!

I will not go out on one limb to make predictions about timing beyond repeating what I have already said. The indication for the imminent collapse of the international monetary system will be the "last contango in Washington": the fall of the silver basis. It will be followed by the fall of the gold basis. These events will indicate that the irredeemable dollar has entered its death throes -- regardless what the inflation numbers say. Woe to all fiat currencies whose principal backing is the irredeemable dollar. Controlling their quantity can and will do nothing to save them.

I am fully aware that it is dangerous to question the validity of the prevailing Quantity Theory of Money. I am willing to stake my professional reputation, as Galilei has staked his when he saw no wisdom in the prevailing geocentric cosmology.

I close this series of essays on the basis with Horace: *sapere aude!* (In English translation: dare to be wise; Epist., I. ii .42.)

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Antal E. Fekete
Professor, Memorial University of Newfoundland
St.John's, CANADA A1C 5S7
e-mail address: aefekete@hotmail.com