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FORWARD THINKING
ON BACKWARDATION

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In an earlier article *Backward Thinking on Backwardation* I explained that backwardation in gold is the flipside of the phenomenon of a drastic contraction of world trade and employment. This brings out the danger in denying the fact of gold backwardation or to belittle its significance, as most observers seem to be doing. I am reminded of the saying of the Swiss educator F.W. Foerster: “if you don’t use your eyes for seeing, later you will use them for weeping.” In this article I want to enumerate the reasons why I believe that permanent backwardation in gold would bring about the descent of our civilization into lawlessness similar to that following the collapse of the Western Roman Empire.

The consensus seems to be that, even if backwardation in gold occurred at one point, it would not be a significant event given the zero-interest environment. Forward thinking on backwardation shows that this is wrong.

Tom Szabo observes (see References below): “If somehow short-term interest rates were to go into significant backwardation, it should be no surprise that gold and silver may go into significant backwardation. THIS WOULD NOT BE A SIGN OF IMMINENT MONETARY COLLAPSE [his emphasis]. In fact, a pretty strong argument could be made for the opposite – that the negative interest rate is a sign of excessive monetary demand (in relation to demand for capital goods and investments). I’ve looked but have been unsuccessful in finding

an historical example of a monetary collapse that occurred while money was actually in high demand. Of course, high demand for money could be extremely deflationary and the only known cure for this is to create a high supply of money, otherwise known as hyperinflation."

While I would disagree with the use of the word "imminent" in describing the coming monetary collapse, I must maintain my stand that a durable backwardation, such as we have experienced for two weeks earlier this month, is a premonition that there will be repeated episodes of the same kind, ever more frequent, ever deeper, ever longer, each episode significantly weakening the monetary system – regardless of the zero or negative short term interest rate. (Let us leave the question aside that zero or negative interest rates in and of themselves show an alarming pathology of the monetary system!)

I have argued that we must carefully distinguish between a fiat money regime with an undisturbed flow of gold to the futures market; and a fiat money regime where the flow of gold to the futures market has been blocked by an unprecedented surge in the demand for cash gold. In the first case confidence in fiat money is high; in the second, it is low and waning fast. In the first case paper gold is an effective substitute for physical gold in most applications; in the second, paper gold has been unmasked as a fraud, and discredited beyond repair. In the first case the economy works pretty well the same way as under a gold standard; in the second, all hell is turned loose as the exchange of goods and services is on the decline and autarky on the rise.

Tom says that "it is incorrect to claim that gold and silver could be in true backwardation without at least some inversion of the futures price curve where the nearer contracts are trading at a higher price than the further out contracts. Well, exactly that's what has happened at Tocom during the first two weeks of this month and is happening still. Tocom publishes its trading summary at the close of trading every day on the Internet: www.tocom.or.jp/souba/gold/index.html. I don't understand how Tom could miss it. Backwardation is jumping off the Internet page covering the standard kilobar contract, even as I write this, on December 19.

Tom is complaining that the spot price for gold is difficult to ascertain: "the spot price for gold is elusive… because they are third-party quotes that suffer from a variety of problems that can make them unreliable and imprecise." I disagree. I have asked my student, Mr. Sandeep Jaitly of Soditic, Ltd., London, U.K., who is tracking the gold basis for me, to explain. Here is what he had to say on December 15: "Tom Szabo comments that spot prices are difficult to obtain. Not true! They are not. You just have to be plugged into the right feeds. My spot price quotes include all the five price fixers at the LBMA, plus everybody else worthy of quoting… The spot gold price I use is the ***best or highest bid*** (and the ***best or lowest offer***) from 300 banks world-wide [list attached, not reproduced here]. The data I use is directly from the exchange, and the prints I see for the carry available are super precise. I can get 90¢ per oz profit on the December contract versus my spot quotes that come from every bank on earth…" Sandeep goes on, dateline December 18: "Everybody of note is inferring that gold is in backwardation because of the zero interest. Let us explore that a little further. One can achieve 0.25% annualized by carrying gold for 190 days till June 26, 2009. 190 days in maturity is about equivalent to a 6-month T-bill with a current yield of 0.18%. The cost of carry for 190 days is 0.25 – 0.18 = 0.07%. If we compare this with the cost of carry for 11 days till December 27, 2008, and, again, for 69 days till February 27, 2009, [calculation included, not reproduced here], then we get that the cost of carrying gold is as follows (all percentages are annualized)

for 11 days:	1.005%
for 69 days:	0.9%
for 190 days:	0.07%

That is pathological without any need of further explanation! It costs more to carry gold for shorter periods of time than for a longer period – according to the futures market. That puts a hole in the zero interest-rate argument, and explodes the explanation that the extra-low contango or outright backwardation in gold is nothing more than "normal backwardation" of a non-monetary commodity!"

Tom says that he does not see things evolving in the same catastrophic manner as I do. For example, he believes that "there will always be willing buyers and sellers of gold in some quantity if the price is right." Buyers – *si*, sellers – *no!* That's just the whole point. The lack of credibility of irredeemable currency will be such that no one in his right mind will accept it in exchange for gold, the ultimate liquidator of debt. Previously, people were willing to trade their gold because they could always replenish their supply from Comex warehouses. That means, in other words, that the irredeemable dollar could still be used as a liquidator of debt (i.e., gold still has a competitor). But let them close the Comex gold warehouses. This is a quantum jump; it means that the irredeemable dollar can no longer be used to liquidate debt, e.g., debt incurred by those holding short positions in gold futures. It is essential not to belittle the import of this observation.

Tom thinks that I am an alarmist in believing that the permanent closing of the gold window at the Comex will mean a cessation in gold mining, loss of segregated metal deposits, and institutionalized theft of ETF holdings.

To answer this I have to go back to the collapse of the Western Roman Empire after the abdication of the emperor Romulus Augustus on September 4, 476 A.D. It was followed by the Dark Ages when the rule of law, personal security, trade of goods against payment in gold and silver could no longer be taken for granted. Gold and silver went into hiding, never to re-emerge during the lifetime of the original holders. It is plausible to see a causal relationship between the fading of the rule of law and the complete disappearance of gold and silver from trade. Virtually all observers say that the first event caused the second.

I may be in a minority of one to say that causation goes in the opposite direction. The disappearance of gold and silver coins as a means of exchange was a long-drawn-out, cumulative event. In the end, no one was willing to exchange gold and silver coins for the debased coinage of the empire. At that point the empire was bankrupt; it could no longer pay the troops that defended its boundaries against the barbarians threatening with invasion. This is not to say that the empire

did not have other weaknesses. It did, plenty of it. But the overriding weakness was the monetary weakness. Centuries after centuries the Mint of the empire could attract less and less gold and silver. Because of this, the empire was forced to debase its coinage and the deterioration continued until the bitter end, when the gold flow to the Mint completely dried up.

Compare this with the Eastern Roman Empire that lasted until the fall of Constantinople to the Ottoman Turks in 1453 A.D., or almost one thousand years longer than the Western half, and during most of this time it could keep its Mint open to gold, producing the gold bezant, which also became the coin of the Muslim world. Is this difference between the two empires trying to tell us something about the importance, from the point of view of political and economic survival, of keeping the Mint open to gold?

The history of the monetary system of the United States shows an ominous parallel to that of the Western Roman Empire. As long as gold and silver was still used in trade at least to some extent, the Western Roman Empire was limping along. The modern equivalent of the disappearance of gold and silver is epitomized by the progressive vanishing of the gold basis.

There is simply no continuous transition from the paper dollar *cum* contango to the paper dollar *cum* gold backwardation, Tom's prayer notwithstanding. The transition will necessarily involve a sudden and fatal weakening of the legal system. Remember, the legal system works only as long as most citizens are law-abiding. It breaks down as soon as the majority of the citizens find that the law protects thieves in high places, but offers next to no protection for the honest hard-working middle class. I am not going to elaborate here on the proposition that irredeemable currency is a system that protects thieves in high places, but robs the little guy by plundering his savings.

Tom notes that it may be technically possible to delay the collapse of the fiat money system by "allowing" gold to appreciate in a hyperinflationary scenario. That is precisely the phase that will end

with the entrenchment of backwardation in gold. Thereafter one can no longer talk about an "appreciating gold price", or any gold price for that matter, as the pricing mechanism will have self-destructed, at least as far as the price of gold is concerned. As Tom himself observes in the same article, local prices in India, China, and in the jungles of Papua are not relevant. Only gold prices in New York and London are, and the arbitrage between the two.

I have nowhere said that the end of the fiat money system will follow the closing of the gold window at the Comex in a matter of days. Sure, finance ministers and central bankers will try to "muddle through". It is not possible to predict how long the death throes of fiat money will continue. Tom may be right in suggesting that it will take many years, and claims of an imminent monetary and economic collapse will again turn out to be wrong.

But where Tom is certainly mistaken is his suggestion that all this agony will take place while the Last Contango in Washington is still going on. You can't have contango and backwardation at the same time. Backwardation is like a black hole, once it grabs a currency, it will swallow it, and gold quoted in that currency will never return to contango.

I think Tom's greatest mistake is to interpret the move into backwardation, or gold to enter the 'fever phase', as "gold's regaining fully-recognized monetary status". Unfortunately, just the opposite is the case. Whether officially recognized or not, gold's monetary status was never in doubt. Gold has always been the monetary commodity *par excellence*, due to the fact that it has constant marginal utility (or, if you will, the fact that the marginal utility of no other commodity declines at a rate slower than that of gold).

What we are witnessing is a transition that deprives gold of its monetary qualities. Gold in hiding cannot and will not act as money. More to the point, absent gold, *nothing else can or will*. The disappearance of money, that can be trusted, fatally undermines the legal system, the sanctity of contracts, *habeas corpus*, any and all provisions of law and order that we take for granted. Under these

conditions nobody can operate a gold mine, nobody can run a gold refinery, nobody can guarantee segregated gold deposits, and nobody can prevent the institutionalized theft of ETF holdings. Welcome to the Madoff economy! (See References below: Paul Krugman's column in *The New York Times*). Jail one Madoff, two others will jump into his shoes.

As a consequence of the permanent backwardation in gold, we shall have a world gone **Mad**off.

References

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These and other articles of the author can be accessed at the website www.professorfekete.com

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Calendar of events

Szombathely, Martineum Academy, Hungary, March 28-29, 2009
Encore Session of Gold Standard University Live.

Topics: *Is There Life after Backwardation?*
Will the Gold Standard Be Released from Quarantine?
The Vaporization of the Derivatives Tower
Labor and the Unfolding Great Depression

San Francisco School of Economics, June-August, 2009
Money and Banking, a ten-week course based on the work of Professor Fekete. The Syllabus of this course is can be seen on the website: www.professorfekete.com

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