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HAS THE CURTAIN FALLEN ON THE LAST CONTANGO IN WASHINGTON?

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Here is an update on the backwardation in gold that started on December 2. It continued and worsened on December 3, 4, and 5. So far this is the most serious signal of the economic crisis: the world is rushing headlong into a Great Depression, possibly worse than that of the 1930's. Please remember the following analogy: the serial devaluation of currencies starting with that of the British pound in 1931 meant a drastic drop in the velocity of gold circulation. This spelled a contraction in world trade that proved catastrophic to employment and economic health in general. The gold confiscation in America in 1933 only made things worse, in particular, it was the direct cause of the decline in interest rates that, in its turn, was the chief cause of the widespread destruction of capital and bankruptcies. I have discussed this correlation elsewhere.

Right now the backwardation in gold also means another drastic drop in the velocity of gold circulation, and it will also cause a tragic contraction in world trade. It will also be catastrophic to employment and economic health in general. Interest rates will continue to fall with a deleterious effect on capital. I don't see that confiscation of gold is in the cards this time. It could not be enforced. People would not comply. Gold confiscation is a trick that can only be pulled off once. A con-game won't work for the second time.

What I see coming is that gold will be declared 'extralegal' by the U.S. government to prevent gold from becoming a world currency, by withholding legal protection from contracts made in terms of gold. For example, if crude oil was bought for gold and the supertanker carrying it was hijacked, and if the U.S. Navy captured the boat from the pirates, then the U.S. government would confiscate the oil as ‘contraband’, arguing that it was paid for in gold. No court in the world would give relief to the rightful owners.

I have received several inquiries how to explain the simultaneous occurrence of gold backwardation and a further fall in the price of gold. Here is my answer. Comex is at the verge of bankruptcy, at least as far as its gold trading is concerned. The trouble is twofold.

<u>First</u>, Comex has a problem that the shorts are overextended opening themselves to a squeeze or, ultimately, to a corner. These are attempts on the part of gold bulls to buy up the gold certificates, instruments of delivery against gold futures contracts. These certificates give you legal title to the metal deposited in Comex-approved warehouses. Such a squeeze would cripple the operation of the exchange and make Comex lose its credibility as a viable market. When the cupboard is empty, the game is up.

<u>Second</u>, Comex can no longer attract sufficient quantities of gold from investors to its warehouses which, in consequence, get more and more depleted. Such a gold flow is the lifeblood not only of Comex, but of the irredeemable dollar as well. There is a world of a difference between the irredeemable dollar with the gold window of Comex *open*, and the irredeemable dollar with the gold window of Comex *closed*. The institute of the gold futures market is the prop keeping the global game of musical chairs of fiat money going. The music stops when Comex closes its gold window.

But Comex will eventually have to declare “liquidation only” policy, effectively closing its gold window. The phrase means revoking the right of holders of contracts to demand delivery on their expiring gold futures under certain circumstances. Clients have to accept settlement on their contracts in cash. This has happened in the past, e.g., in silver and palladium, although it has never happened in gold. It is not widely known that Comex would not go bankrupt *de jure* if it declared “liquidation only”. Small print in the contract makes allowance for this option in case of *force majeure*. Nevertheless, Comex would be considered bankrupt *de facto* in the eyes of the public if it declared “liquidation only” on its gold futures contracts. Comex is the residual source of the world’s only currency that is not the liability of some government, gold.

Moreover, by implication, it would also be the end of the irredeemable dollar as we know it. I am convinced that the managers of the irredeemable dollar are not afraid that their prodigious dollar proliferation policy endangers the value of the currency, Quantity Theory of Money notwithstanding. What they are afraid of is that the gold bulls will force Comex to close its gold window by cornering the supply of gold certificates. When that happens, it will be not only “gold is not for sale at any price” but also “oil is for sale only against payment in gold”.

We have to understand that what has kept up the paper dollar’s value through thick and thin, through war and peace, and through the burgeoning trade deficits and budget deficits since 1975, is Comex. This is the reason why the Chinese still take the irredeemable dollar in payment for real goods and services, and large quantities of food can still be purchased against payment in irredeemable dollars. But once Comex is forced to close the gold window, the dollar will lose its main prop and bearings and, with them, its purchasing power, even if miraculously the U.S. could cut its trade and budget deficit to zero.

The Quantity Theory of Money is no science. It is a model, a didactic tool. It is applicable to an imaginary *linear* world. This world of ours, however, is highly *non-linear*.

I am convinced that the clearing members of Comex are desperately trying to avoid permanent backwardation in gold. Not only is the gold futures market extremely profitable for them, but their bets have been backed by central banks gold sales and leases. All the central banks have a vested interest in maintaining the global regime of irredeemable currency. The clearing members want to have their cake and eat it: they are the consistent short sellers who keep the gold price from breaking out on the upside. But this makes gold cheap causing mass withdrawals of gold from the warehouses, gold which they want to keep in the warehouses for window-dressing purposes.

Please note that these are not naked short sales. The clearing members are convinced of gold's upside potential, no less than you are. Their game plan is that, instead of gambling with their own gold, they want to gamble with yours and mine, and with the gold of the tech-funds. They let us buy gold futures; they let us make money occasionally. But they know that we have to take profit from time to time because we are undercapitalized. They know that we have to use stop loss orders to avoid bankruptcy. What is worse, our stop loss orders are an open book to them. We are sitting ducks which they shoot at for fun. So we have to sell.

But whether we buy or sell, we buy into strength and sell into weakness, which is exactly the wrong way to do business. The clearing members' advantage is that they always buy into weakness and sell into strength, as they take the other side of the trade we have initiated. They don't worry about being undercapitalized, because they can change the rules of the exchange capriciously, and they enjoy a back-wind due to central bank policy. So far they have succeeded.

But something ominous is happening. Most recently central banks have changed their policy. They have stopped selling and leasing gold. Their commitment to bail out the clearing members with *gold* has been changed to a commitment to bail them out with *paper*. This is not the same thing. *Central banks have stopped feeding the market with gold sales and leases.* Here is the proof.

Take Mr. Gordon Brown, the prime minister of Britain. As the Chancellor of the Exchequer he ordered the Bank of England to sell *one half* of the nation's gold reserve in one fell swoop. He even overruled the Governor of the Bank who first refused. The sale took place at the average price of $250 in 2000, a major multi-year bottom. Nice shot, Mr. Brown! The Chancellor has earned the name of *the bottom-picker of the century*.

Now, as prime minister, he could order the Bag Lady of Threadneedle Street to sell *the other half*. If she did, it would be a sale fetching *a* *price three times higher*. Better still, she could buy back the gold in 30 days *at a discount*. (This is the meaning of backwardation in gold.)

But look who isn't selling on these unbeatable terms? Why, Me-too Gordy isn't, that's who. He has learnt that *a bird in hand is worth a dozen in the bush*. He knows that if he falls to the temptation of 'risk-free profits', he may never see his gold again. It would disappear in the black hole of irredeemable currency, where the other half did. Gordy has made himself the laughing stock of the world once as the bottom-fisher of the century. He does not want to do it again. Who can blame him? If he did, he could earn a second nickname: *the sweetest-singing crow of the century*, and he doesn't want that.

As you may recall, Aesop in one of his fables relates the story of the crow perched on a tree holding one big loaf of cheese in his beak. The fox beneath is hungry and salivating. He decided to get the cheese by hook or crook. He knew he could not get it by brute force, but he might get it through flattery, by massaging the bird's vanity. The fox calls the crow his friend. He is telling his friend that of all the singing birds he loves the sweet singing of the crow best. Would his friend be kind enough to sing for him?

After a bit of coaxing the crow started crowing, but the fox did not stay to listen. He made off with the cheese as fast as his legs would take him.

Mr. Brown can print pounds galore, and even swap them for dollars. But he cannot print gold. Neither can his colleague, Helicopter Ben. That's why he is willing to airdrop an unlimited amount of paper, but would not airdrop even one grain of gold to alleviate the economic crisis of his own making. These gentlemen still think that the present crisis is a subprime crisis and it can be tackled by flooding the system with newly created money. Scarcely do they see that, instead of being a real estate crisis, a stock market crisis, or a banking crisis, this is a *gold crisis*. It can only be resolved by involving gold, in particular, by remobilizing the world's gold reserves. The most straightforward way of doing this would be to open the U.S. Mint to gold (more precisely, to the seigniorage-free and unlimited coinage of gold on private account), as Sir Isaac Newton, Master of the Royal Mint of London had done in the year 1717. Unfortunately, this option is no longer available because the trust in the irredeemable dollar has been fatally undermined by the backwardation in gold. No longer will people be coaxed out of their physical gold by the promise of risk-free profits, however large, payable in paper.

One possible explanation of the backwardation in gold is that the clearing members of Comex, who could have prevented it from happening by allowing gold to break out on the upside, have changed tactics and decided to step aside and let backwardation do the job. They hoped that it would pull in gold from the moon. The risk-free profits that backwardation promises to yield would tempt holders to swap cash gold for paper gold.

Well, so far it is not happening. Fewer than 10,000 ounces of new gold was registered at the warehouses during this episode of backwardation so far, not enough to deliver on even 100 contracts. By contrast, an extra 132 December contracts were presented for delivery by their holders.

A second possible explanation of the backwardation in gold and the decline of the gold price to $740 on Friday, December 5, is that the clearing members in desperation attempted to demoralize the bulls by their persistent selling of cash gold and December futures. Hefty margin calls went out to intimidate holders of the December contract. But the tactic seems to have backfired: while both the cash price and the December futures price fell, *the futures price fell more*. Backwardation was the result. The bulls refused to swap their cash gold for the December futures, in spite of further decline in the basis (making the swap more tempting still). The contest between the good guys (longs standing for delivery) and the bad guys (the clearing members) may not be resolved until December 31, the last day when the latter must deliver, or declare ‘liquidation only’. Right now it looks as if the longs are quite prepared to call the bluff. They are willing to face further decline in the gold price to force the issue. They know full well that the last thing the clearing members want is to declare *force majeure*, because that would kill the goose laying the golden eggs for them.

Please remember that the bad guys have another secret weapon. They can *raise the margin requirement to any level higher than the value of the underlying contract*. Nasty, isn't it? The idea is to force the longs to sell their contracts and, in doing so, give up their right to take delivery. Such a measure, however, would betray the utter helplessness of the clearing members. It would be oil on the fire, triggering a world-wide rush into cash gold, ruining other paper gold markets (including ETF's) in the process.

A third possible outcome is that all the gold demanded will be delivered in December, and the deterioration in the warehouses' holdings will be papered over in January. No matter, the battle is already shaping up for the February confrontation when the bad guys will be in an even weaker position.

To sum up, the gold price is not the issue right now. The low gold price is a side show trying to scare the longs out of their cash gold positions. Here the iron rule of the commodity markets applies: *you can squeeze the bears, but you can never squeeze the bulls*. The reason is that the best you can do to shake the bulls out of their position is to tempt them with risk-free profits to give up physical gold against future gold. That is happening right now. But it appears that, for the first time, cash gold can no longer be coaxed out with paper profits. After all, gold is gold, and paper is paper.

This is why this battle is so crucial: it is the first real confrontation between physical gold and the paper dollar. Paper gold is marginalized. We know that, in the long run, the paper dollar cannot stand up to physical gold. However, as Keynes has warned us, in the long run we are all dead. This time it's different. *The long run ends on December 31, 2008.*

The "last contango in Washington" refers to the end of the hegemony of the irredeemable dollar that is in no position to throw its weight around any more. The advent of backwardation means that a writing has appeared on the wall: "*Mene tekel, upharsin*": the dollar has been weighed and found wanting. On the last day of this year of economic and financial surprises we shall know whether the backwardation in gold is permanent, or whether it will become permanent only after the inauguration of the new president, at the expiration of the next active gold futures contract in February.

Either way, this is a contest the bad guys cannot win. They are at the end of their rope. The low gold price means that they are left with just enough rope to hang themselves.

References

The Last Contango in Washington, June 30, 2006

Red Alert: Gold Backwardation!!! December 4, 2008

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

Note: the author is writing a follow-up piece:
There's No Fever Like Gold Fever
Stay tuned.

Calendar of events

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

Topics: *When Will the Gold Standard Be Released from Quarantine?*
The Vaporization of the Derivatives Tower
Labor and the Unfolding Great Depression
Gold and Silver in Backwardation: What Does It All Mean?

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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