IT'S NOT A DOLLAR CRISIS: IT'S A GOLD CRISIS

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The title is a bow to Peter Schiff for his admirable article *It's Not an Oil Crisis: It's a Dollar Crisis.*

Thirty-five years ago gold, symbol of permanence, was chased out from the Monetary Garden of Eden, replaced by the floating irredeemable dollar as the pillar of the international monetary system. That's right: a floating pillar. The gold demonetization exercise was a farce. It was designed as a fig leaf to cover up the ugly default of the U.S. government on its gold-redeemable sight obligations to foreigners. The word 'default' itself was put under taboo even though it punctured big holes in the balance sheet of every central bank of the world, as its dollar-denominated assets sank in value in terms of anything but the dollar itself. These banks were not even allowed to say 'ouch' as they were looking at the damage to their balance sheets caused by the default. They just had to swallow the loss, obediently and dutifully join the singing of the Hallelujah Chorus of sycophants in Washington praising the irredeemable dollar and the Nirvana of synthetic credit.

For a time it looked like a clever *coup* as America has benefited at the expense of the rest of the world. It could now buy all the goods and services it wanted from foreign countries in exchange for little scraps of paper on which some ink has been sprinkled. More importantly, America could establish military bases and start wars on foreign soil paying for them with dollars created out of thin air. Foreigners had to put up *and* shut up. What used to be "deficits without tears" before, has now become "deficits with laughter".

Few people realized at the time that America, far from giving itself a gift at the expense of foreigners, has fatally shot itself in the foot. At first the wound from this self-inflicted gunshot did not hurt and was quite invisible. Festering and pain came later. The long time-lag makes the causal relationship between the two events fade. Yet the connection exists creating ever more mischief, misdiagnosis, monetary quackery and, ultimately, the greatest credit collapse in history.

America had to foster an anti-gold psychosis in the world to cover up default. Milton Friedman was the high priest of the new paradigm with his monetarism, preaching the unmatched virtues of the floating dollar. It was supposed to eliminate the American current account deficit. It never did, instead, it killed the healthy American trade surplus, as American industry was pushed into an endless decline by the self-mutilation of the dollar.

The worst part of the anti-gold psychosis was its effect on the banking system. American banks were deprived of a chance to hedge their assets, all of it held in the form of irredeemable debt (irredeemable in the sense that at maturity it was payable in irredeemable currency) by holding monetary metals, gold and silver, as a reserve. Those foreign banks that did were made the laughing stock of the banking industry. 'Progressive' banks were free to heap debt upon debt in the asset column of the balance sheet without any regard to reserve ratios, in a mad chase of illusory paper profits. If the balance sheet was not big enough, why, they could simply go 'off balance sheet' to add more debt. Foreign banks chimed in: "Me too, me too!" It was truly an incredible sight watching the Union Bank of Switzerland, a solid and liquid bank before 1973, throwing all caution to the winds in its zeal to embrace hare-brained securitization schemes, and to put a lot of bad debt made in USA on its balance sheet.

We were also treated to another incredible sight: the Bank for International Settlements (BIS), the only sane central bank left after the gold-demonetization farce, committing *hara-kiri*. Since its establishment the BIS carried its books in Swiss gold francs. The implication was clear: the BIS wanted to stay above the hurly-burly of competitive currency devaluations which humiliated even the lofty Swiss franc in 1936. The BIS continued to carry its books in Swiss gold francs, never mind the vicious anti-gold agitation that started in 1973. Ultimately it threw away all good banking sense and caved in. On March 10, 2003, BIS abandoned the Swiss gold franc and embraced the SDR (Special Drawing Rights) as its unit of account. The SDR has the dubious distinction among fiat currencies that *it does not even have an obligor*. It is an out-and-out make-believe currency. It does not arise as an obligation. It arises as a free gift, manna from heaven, brought by Santa Claus *alias* IMF. In want of a definition of an accounting unit, not one bank in the world is subject to any meaningful accounting rules any more. The last central bank with the ability to step into the breach, offering sound credit in case of a world-wide credit collapse, has disappeared from the scene.

Because of the anti-gold psychosis the dollar went into a downward spiral, never to come out of it. The question arises whether gold is just an embellishment, a barbarous relic, a superstitious talisman, or whether gold is a real mooring without which the banking systems cannot safely manage risks in the long run.

To answer this question we must understand the first principles of hedging. Gold and silver, as monetary metals, are the two most important hedges banks can have to offset risks to the asset column of their balance sheets. You cannot hedge these risks through owning more debt — the liability of someone else. A hedge that is subject to exactly the same risks would not diminish but magnify risks. It is a "Texas hedge". For a true hedge, you need and ultimate asset that is not the liability of anyone. Such an asset is furnished by the monetary metals. It is foolish to suggest that gold and silver have lost their value as hedges since their prices fluctuate. The fluctuation of their price does not prove that the value of gold and silver fluctuates. On the contrary, it is the value of the dollar that does fluctuate in which gold and silver prices are quoted.

Because of this fluctuation it is inherently treacherous to trade gold and silver on the variation of price. Proper hedging replaces *price risk* with *basis risk* which is less erratic and more predictable. The basis is the difference between the nearest futures price and the cash price of the monetary metal, gold or silver. There is a long-term trend for the basis to fall, and ultimately to go negative. Traditionally the basis has been positive. The condition when the futures price exceeds the cash price is called *contango*. Permanent contango is a characteristic of the monetary metals indicating large above-ground stores relative to the annual output of the mines. But wear-and-tear causes fiat currencies to lose value. It makes the basis of gold and silver fall, and contango disappear. The opposite condition, when the futures price goes to a discount against the cash price, is called *backwardation*. It is equivalent to a negative basis. It indicates that the monetary metals go into hiding.

The international monetary system is inevitably drifting towards the black hole of backwardation, and will ultimately succumb to its pull. Governments and central banks tell you that they are combating inflation. Their combat is a lonely one. They just cannot escape the pull of the backwardation of monetary metals.

The point is that the only way to measure the slow deterioration of the collective value of irredeemable currencies is the gold and silver basis. It is precisely the change in the basis that provides clues for hedging against the risk of monetary debasement. The outstanding fact is that the basis can be traded with greatly reduced risk, as compared with trading the price.

It should be clear that *some* banks in the world are doing just that. They are trading the gold and silver basis (as opposed to trading the gold and silver price) continuously. This means that they are buying hedged metal when the basis is high, and selling it when the basis is low. This enables them to earn a steady income on their gold and silver reserves in gold and silver. The proof that they indeed engage in this activity is furnished by the inordinate size of the short interest in the gold and silver futures market. It is altogether erroneous to attribute this short interest to the activities Jurassic Park creatures, and to that of the bogeymen of the 'naked' silver commercials. The inordinate size of short interest in gold and silver is just the visible side of the hedges of bullion banks and others, the invisible side of which is their metallic reserves.

Gold Standard University Live is the only organization that advocates paying attention to silver and gold contango, backwardation, and basis. The vocabulary of analysts and other observers of the passing scene does not include these terms. They follow statistics of production and off-take, the commitments of traders in the futures market, and are trying to divine the coming changes in the gold and silver price through supply and demand equilibrium analysis. Their approach is wrong-headed. Supply and demand equilibrium analysis is inapplicable to the monetary metals, both the supply of and the demand for which tend to be unlimited. That's just what makes gold and silver a monetary metal. Nevertheless, the threat of a short squeeze or, if the worse comes to the worst, the threat of a corner, is real. Corner in the precious metals also goes by the other name of *hyperinflation*. Reams and reams of supply/demand statistics and all the COT reports in the world will not predict when it will hit. Only the basis will. It provides an early-warning system indicating, with the precision of a seismograph, the coming shortages in silver and gold. And only Gold Standard University Live is willing to publish the results of research which tell you how to read basis signals.

In summary, the present crisis is far from over. Far from being an oil crisis, it is not even a dollar crisis. *It is a gold crisis.* It is preying on American and other banks for their failure to hedge paper assets with gold. The U.S. government is trying to bail out large multinational banks by stuffing them with more paper assets. The Federal Reserve has made history when it swapped U.S. Treasury bonds for asset-backed securities for which the market refuses to bid. The trick won't work. And it is doubtful that the only meaningful bail-out that would work, namely, opening the U.S. Mint to gold and silver as advocated by presidential candidate Dr. Ron Paul, is in the cards. It would work as it would make U.S. Treasury gold available to American banks to save them from insolvency. What they need is not augmentation of capital in the form of more paper credits. What they need is metallic hedges to prop up the value of paper assets. Opening the U.S. Mint to gold and silver would mobilize the world's metallic reserves, presently in hiding, and put them back into the public domain to assume their traditional role as the foundation of the world's credit system.

References

Peter Schiff, *It's Not an Oil Crisis, It's a Gold Crisis,* May 23, 2008, www.321gold.com

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GOLD STANDARD UNIVERSITY LIVE

Session Four is to take place in Szombathely, Hungary (at Martineum Academy where the first two sessions were held). The subject of the 13-lecture course is *The Bond Market and the Market Process Determining the Rate of Interest* (Monetary Economics 201). It will be followed by a panel discussion on the topic: *The Silver Basis and the Present Banking Crisis: Phony Bond Insurance Schemes and the Lack of Hedging Irredeemable Dollar Debt with Monetary Metals.*

The date is: July 3-6. For more information please see www.professorfekete.com/gsul.asp or contact GSUL@t-online.hu. Registration can be made by e-mail upon payment of the pre-registration fee. The remainder of the registration fee is due 3 weeks prior to the session. Space is limited; first come, first served.

Preliminary announcement: Gold Standard University Live is planning to have its Session Five in Canberra, Australia, in November, 2008. This Session will include a Primer on the gold and silver basis, prerequisite for a Workshop on the basis offered at Session Six (planned to take place in the Spring, 2009).