MONETARY *versus* NON-MONETARY COMMODITIES

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Sorting out wheat from chaff?

In my last two articles (*Bull in Bear's Skin?* and *Ultracrepidarian Musings*) I emphasized that gold and silver analysts make a blunder when they dismiss the monetary aspect of these metals. Some of them even brag that they deliberately ignore it lest their vision be blurred by considerations other than supply and demand which alone determine price. To my criticism that supply and demand in case of a monetary metal are indeterminate because of the huge speculative following as it switches its loyalty back and forth between the long and the short side of the market, they mumble something to the effect that they have a unique ability to sort out the wheat from the chaff. Such a claim is preposterous. Speculation is anything but predictable. It is downright scandalous that these analysts doggedly ignore the basis and its variation as an analytic tool. Is it sheer ignorance? Or do they perhaps have a hidden agenda, such as the desire to keep the public in the dark? – I can't say which answer is worse for them.

A monetary commodity is one that can, in most applications, be substituted by a promise to deliver it. Once endorsed, the promise can be passed on to a third party. The promise itself may take a variety of forms from a warehouse certificate through standard futures or option contracts to an *ad hoc* forward sales or swaps agreement. On a strict application of this definition there are only two monetary commodities: the senior one is gold, the junior one is silver. Sorry to disappoint platinum and palladium addicts: theirs are not monetary metals

Armored cars in the streets of Geneva

The willingness to accept promise in lieu of the monetary metal itself evaporates if a commodity exchange goes into liquidation-only mode, meaning that the shorts are exempted from their obligation to deliver the monetary metal as contracted, and the longs can realize their gains only through cash settlement. A notorious example was the decision of COMEX in January 1980 to relieve what looked like an incipient corner in silver, by declaring that only liquidation orders for silver contracts would be entertained. As if by magic short squeeze disappeared. The longs were falling over themselves in trying to liquidate positions before their profits went up in smoke. This was a highly visible effect. But there was another, if you like even more highly visible effect, the import of which only one in a million could see. As luck would have it, I was given the opportunity to see it with my own eyes. It left a deep impression on my mind. I take this opportunity to share that experience with you.

In January, 1980, I happened to be in Geneva, Switzerland. I was visiting a private bank in the banking district. An unlikely number of banks were lining either side of the river Rhone. The office of my banker was on the first floor with a view of the river and several bridges spanning it. He looked out: "See those uniform trucks crossing the bridge underneath?" I said: "Yes, but I also see trucks crossing the river in the opposite direction through the next bridge. They are similar to those ugly armored vans of Brink's which are ubiquitous in the streets of New York and other large American cities." My banker continued: "That's exactly what they are, making bank-to-bank deliveries. But you don't often see *two* convoys simultaneously moving in both directions! After all, bankers have learned how to cross out liabilities at the clearing house a long time ago. It doesn't take more than *one* convoy to settle the difference." I innocently asked: "Actually what is it that those vans carry?" My man smiled: "I knew you would ask that. They carry *silver.*"

Bring home the bacon and the steak

It took some time before the message sank in. COMEX had just declared “liquidation-only” on its silver contract. This had the immediate effect around the world that banks, traditionally accepting each others’ promise to deliver, refused to honor them and went into cash-and-carry mode. The finely woven fabric of credit, at least as far as the silken metal was concerned, had been blown away in Genev and elsewhere by a local storm brewing in New York. The laconic pronouncement at COMEX paralyzed the normal workings of finance. In less time than the blink of an eye promises to deliver have become worthless. The bulk of trading instruments disappeared, leaving cash silver to do work cut out for a widely-based credit system. Exchanges do not often have recourse to such an extreme measure, because it dilutes the potency of their paper instruments. It has not been used for twenty-six years. Watch out for a dress-rehearsal.

The big unknown is how the crisis will be resolved when it happens again. In 1980 the longs’ knee-jerk reaction of “cut and run” resolved it quickly. Had they stayed the course, the outcome could have been different, with far-reaching implications for the health of the dollar. In that case the shorts might have had to do the cutting and running.

For a non-monetary commodity substitution of promises for the real thing is hardly possible. A live cattle futures contract cannot be slaughtered and served as steak at the dinner-table; a frozen pork belly contract cannot be thawed out, made into bacon, and served at the breakfast-table. You have to bring home the bacon to eat it. Paper bacon won’t do (although Keynesian economists are still working overtime to finish the grand design in alchemy of their master, to turn the stone into bread, thereby making GDP edible for humans.) A breakdown of the delivery mechanism for a non-monetary commodity is no big deal. It is a local affair barely noticed even by other exchanges trading the same commodity in default.

But for a monetary commodity, it is a different story. A breakdown cannot be localized. It triggers a domino-effect. Trading of the monetary commodity at all other exchanges will also come to a screeching halt. Banks go into cash-and-carry mode without delay. No statistics are available showing the volume of credit instruments in use involving a monetary metal but, in view of the derivatives, it must be enormous. All this credit freezes up at the same time, with incalculable consequences as far as world finance is concerned. It is true that derivatives directly linked to gold and silver form but a minor part of the total. Nevertheless, the entire derivatives Tower of Babel is in danger of toppling. Why? Because gold and silver, whether demonetizing governments like it or not, are still part of the foundation of credit. If the credit financing gold derivatives goes, so will soon the credit financing interest-rate derivatives. The domino-effect will knock down all the other pillars supporting the credit structure.

Big Lie Number One

The fact that monetary metals can readily be substituted by promises implies that the stocks-to-flows ratio is a high multiple. Monetary metals are the most hoardable among all the commodities. People want to hold the metal because it is the philosopher’s stone the possession of which allows them to “print their own money”. They don’t have to wait for Helicopter Ben and his air-drop.

For non-monetary commodities the ratio is a small fraction. The price-risk involved in hoarding them is unacceptably high. Supplies are hand-to-mouth. The phenomenon of interest, an exclusive feature of monetary metals, is explained by the observation that interest is the obstruction that checks the hoarding of a monetary metal. It is remarkable and important that this is true regardless whether the country is on a gold standard or not. It is none of the business of governments and central banks to set the rate of interest. Interest is intrinsic. It is inherent in gold and silver.

How does it work today when no country in the world is on a gold standard? Because of the high stocks-to-flows ratio for the monetary metal, contango develops in the futures market. People are willing to pay a premium for future gold up to a limit determined by the carrying charge. In other words, you can earn a return on your gold in gold. It accrues as you sell gold forward at a premium price and buy it back at the lower spot price at maturity. Most significantly, this has absolutely nothing to do with the dollar price of gold which can gyrate up or down in the meantime. Your return in gold is guaranteed. For this reason, the smartest of the smart will discard the dollar as *numeraire* and adopt a gold unit to gauge wealth.

Of course, contango occurs in case of non-monetary commodities as well, but this should not fool us. The point is that for non-monetary commodities contango is a sporadic occurrence. It can in no way be relied upon as a source of income. There is the basis risk. You may not be able to buy back your holdings at a cheaper price. In case of backwardation you take a loss at maturity. For gold, this danger is non-existent.

Here you have the Big Lie Number One about gold and interest. Mainstream economists mendaciously bad-mouth gold as a “barren” asset, incapable of generating an income. Just the opposite is true. Interest income *in gold, on gold* is a natural phenomenon while interest income *in paper, on paper* is an artifact, and there’s many a slip between cup’n lip. The mainstream economist is the stereotype of an ignoramus when it comes to gold. He appeals to the authority of Aristotle who declared: *pecunia pecuniam parere non potest* (in free translation: gold cannot beget gold). What Aristotle meant was that if you hang on to your gold, then you have to forgo income. Lending and investing, however, is another matter. *Then* there is a yield. Of course, lending and investing involve risks. For starters, your gold may not be returned to you at the end of the loan period. Be that as it may, there has never been a time in recorded history when it was not possible to lend out or invest gold at a positive rate of interest, whether on the gold standard or off. And it is still true today!

Mainstream economists disingenuously refer to the interest rate on gold loans as the *lease rate*. Let the “useful fools” fall for the obfuscation. But a yield is a yield, by whatever name you may call it. You can’t overthrow economic law by tinkering with terminology.

Big Lie Number Two

Mainstream economists further assert that you can never derive an income from an asset by sitting on it. Income accrues only to those who dare release control temporarily, i.e., assume risk. We must admit that there is a certain intuitive appeal in all this. It sounds like the Principle of Conservation of Energy. Income and risk go hand-in-hand. Income is the reward for risk-taking. If you can really derive an income without shouldering risk, then you have invented Perpetual Motion. It is tantamount to gaining energy out of nothing.

Even so, this claim is a lie, at least under fiat currency. Paradoxically, it was mainstream economists themselves who created this exception to the rule when they promoted irredeemable currency without examining the question whether it would be in conflict with natural law. They pretend that we have arrived at Cockaigne, the country where fences are woven of sausages and dollar bills, like manna, fall from heaven (thanks to puppet-master Helicopter Ben making himself busy behind the scenes).

Oh, sweet dreams of a hungry pig! But it is no dream that *you can derive an income in gold without releasing control over your gold holdings, including the physical possession of it!* In other words, if you keep your books in gold units, then you can make gold yield an income in gold *without incurring any economic risk whatsoever!* This is a well-guarded secret still. Please remember that you heard about it here first.

Bulls in bear's skin are practitioners of this black art. They keep writing covered options. Here is how it works. They buy gold whenever the gold price dips. They write covered out-of-the-money call options (nearest maturity) on their holdings whenever the gold price rallies. They set up stop-buy orders at every point where the option is called, should the gold price fall. (If they control a gold mine as well, then they reduce the stop-buy order by output). Then the bear puts his market position on auto-pilot and goes into hibernation. No sweat, no fret. He always buys into weakness and sells into strength. Pity poor bulls who buy into strength and sell into weakness. In addition they can hardly sleep at night, and have to have their diapers changed several times during the day. The bulls have what they think is a great device, the stop-sell, a.k.a. stop-loss order. Stop-loss is the worst misnomer ever invented. It certainly does not stop the loss on a limit-down day! Even if it does, it kicks in several ticks below where it has been set. Stop-loss orders are ferreted out by the bulls in bear's skin. Thereafter it is a game of cat-and-mouse. Guess who the mouse is.

"Stop-loss" is not just a misnomer, it is an oxymoron, a contradiction in terms. Gosh, if you gotta sell, as you do since no bull market is straight up, then at least have the intelligence and the strategy to sell into strength, not into weakness! If Warren Buffett had asked me to manage his silver position, I would have done as spelled out above. True, he would have lost the friendship of Ted Butler. But, as a consolation prize, he could have kept his silver. And he would have made a bundle to boot. Warren Buffett is a genius, but he is getting rotten advice. His advisors cannot tell a monetary commodity apart from a non-monetary commodity.

You can be sure that lots of other well-heeled investors and gold mining concerns are getting better advice, and they happily keep drawing an income on their assets held in the form of monetary metals. The income is higher the greater the volatility. Just take a peek at the option premiums. The unmistakable beauty of the scheme is that *at no time must they give up control over, or physical possession of, their assets.* So there is no risk involved. Butler mislabels the activity of these bulls in bear's skin as the "illegal naked short selling of the silver managers". How they love that mislabeling! They don't want to be identified. They don't want to be imitated. They don't want you to learn the secret how to earn risk-free income on silver in silver. It may spoil their free lunch.

But how do we account for the objection that this scheme contradicts the Principle of Conservation of Energy? We don't. We might as well admit that the contradiction is real. Put the blame squarely on the regime of irredeemable currency. The gold standard, when in force, is an instant reward/penalty system. Were our schools allowed to teach economics properly, the electorate would know it, and would demand its immediate restoration as the only monetary system serving even-handed economic justice. Under a gold standard foreign exchange and interest rates are stable. Interest rate derivatives and bond speculation are unknown. Debt is reined in by the ability to service it. Under a gold standard all economic risks are created by nature, none by man. Helicopter Ben belongs to fairy tales, not to central banking. The gold standard is the only monetary system that rules out risk-free income. It also rules out free lunch.

As the regime of irredeemable currency defies natural law, it is the digger of its own grave. It is this that explains the crack-up boom, not the overissuing of the currency.

Silver Jewelry and Cutlery

In summary, none of this makes sense unless you are able to distinguish between monetary and non-monetary commodities. You may ignore the teachings of monetary science only at your own peril. Supply/demand equilibrium analysis is not appropriate to gold and silver. The most you can say is that the supply of promises to deliver gold will grow to infinity, as will the demand for gold. Under these circumstances the price of gold may approach any figure, including infinity for cash gold, and zero for the promise.

The big open question is what happens after COMEX goes into liquidation-only mode on its silver contract once more, after one last huge spike in the price. Will it lead to another bear market, as it did in 1980? Or will the bull market keep roaring until it turns itself into a crack-up boom?

Teddy and Izzy suggest that people will learn to love silver prices in four digits. They will gladly pay it if that's the price of showing off. They will start bedecking, themselves with silver jewelry, their tables with silver cutlery.

This is puerile. Rather than displaying it, people will want to hide their silver lest small time pilferers and big time plunderers (read: governments) take it from them.

This question cannot be answered without a careful analysis of the basis and its variation. This I intend to do in a forthcoming article.