WOBBLY ANCHOR OR WOBBLY LOGIC?

Remarks made by professor Antal E. Fekete at the Institute of Economic Affairs in London, on March 15, 2012

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According to Reuters (www.reuters.com/assets, February 28, 2012), a team of researchers at Chatham House, the London-based policy institute for international affairs, examined the potential for gold to play a 'more formal' role in the international monetary system. The team concluded that a return to the gold standard would undoubtedly be 'impractical' and even 'damaging' to the financial system – given gold's 'deflationary bias' making gold a wobbly anchor.

"In fact, a serious drawback is that a gold anchor can become particularly unstable precisely when a stabilizing force is needed most. As gold prices stand to rise when inflationary expectations and other risks in the fiat money system increase, the gap between the reference price and the market price is likely to widen at times of uncertainty."

"Although it is far from clear what is the 'right' price for gold, given the large volume of global money in circulation, the disadvantages of using bullion as a monetary anchor are clear: a return to a gold standard could inflate the price of gold significantly, while restrictions on money supply growth could provoke a severe downturn in the growth cycle of global economics."

Assuming that Amanda Cooper, the author of the Reuters article has quoted the Chatham report accurately, the harsh sentence on gold is softened somewhat by the addition of a few patronizing words, such as: "gold may have a role to play as hedge against the declining values of fiat currencies although it also carries inherent risks due to the price volatility of bullion and its lack of a yield". Or: "gold can have some utility in a portfolio of assets by spreading valuation risk but would not be very effective as a sole reserve asset". It is further admitted that gold may play a role as a safe-haven; as collateral; or as a policy indicator – always with a question mark added in the end.

I am not going to analyze the Chatham report. Instead, I am going to discuss some of the results of research done at the New Austrian School of Economics (NASE) on gold in contemporary economy, as well as gold in the 20th century.

(1) **Gold is the only ultimate extinguisher of debt**. Having been exiled from the international monetary system in 1971, gold has not been able to play its God-ordained role as the ultimate extinguisher of debt. As a consequence, total debt in the world can only grow, never shrink. Bad debt can no longer be weeded out. Instead, it is being kicked upstairs to accumulate in the balance sheet of one government or another. Out of sight – out of mind. But you can kick only so much garbage upstairs to the attic before it will start to come crashing down.

We need go no further in trying to understand what the 'sovereign debt problem' is all about, and why all of a sudden it has become a universal threat. It took that long for the level of bad debt in the balance sheet of the government of Greece to reach the tipping point. The same bad debt would have been extinguished long ago, had the U.S. not browbeaten the world to phase out gold from the monetary system. Greece is just the proverbial whipping boy. *Bad debt keeps accumulating in the balance sheet of all governments without exception*. The turn of other countries to become the whipping boy of the future will not be long in coming.

(2) **What gold price?** The gold price is on schedule to cease to exist. When the gold futures markets go into *permanent backwardation* mode, the gold price at which to get gold will be as obsolete as the flint-stone with which to light a fire.

Permanent gold backwardation is a phenomenon bestowing risk free profits galore on speculators. They could sell their gold, and immediately buy it back *at a lower price in unlimited quantities.* The buy-back is in the form of paper gold. But lo and behold, uncharacteristically, speculators refuse to nibble at risk free profits. They do because they are smart enough to sense that wrapped in the bait there lurks a hook. Paper gold that is worth gold today may tomorrow be worth only the paper on which the promise is written. This neat trick, which had routinely been performed on elephants by Houdini, was performed on gold by Franklin Delano Roosevelt. On March 5, 1933, the $20 gold certificates issued by the U.S. Treasury could be exchanged for the double eagle gold coin without hassle. On March 6, pursuant to presidential proclamation, it was exchangeable only for an irredeemable $20 Federal Reserve note. Roosevelt had a better idea what to do with the double eagle gold coin than giving it to its rightful owner as promised. *He was going to keep it and write up its value from $20 to $35*. When the democratic president summoned the democratic senators in the Oval Office to receive their congratulations on his clever ploy, the great

blind senator from Oklahoma, Thomas P. Gore told him in his face: "Why, it is plain stealing, isn't it, Mr. President?"

Permanent backwardation can also be described as the gold basis going negative – never again to return to positive territory. The gold basis is just the difference between the price of the nearby gold futures contract and the price of cash gold. Positive basis is called *contango*; negative basis, backwardation. The two are not symmetric, however. While there is an upper limit to contango, *there is no lower limit to backwardation.* The reason is that the premium on the futures price cannot go higher than the carrying charge, i.e., the total cost of warehousing the good till future delivery. If it did, risk free arbitrage would bring it back into line instantaneously. By contrast, the futures price can go to any discount, however large, up to the full cash price.

When the world's first futures market for gold opened in Winnipeg, Canada, in the early 1970's, gold basis was at its upper extreme: contango was as robust as it could be. The one outstanding feature of gold futures trading that received little attention is fact that *the positive gold contango is constantly eroding and the gold basis is constantly shrinking*, as it has for the past forty years. Attrition of the basis for gold futures as a function of time is a matter of economic law. Paper gold has been withering on the vine. Right now the gold basis is at the brink of going negative. There is an acute and increasing shortage of deliverable gold against futures contracts *in spite of high and rising gold prices.* This can mean but one thing. Those nameless and faceless institutions and individuals who control large quantities of monetary gold are ever more reluctant to relinquish their control. When the basis finally goes negative as it must, the game is up. All offers to sell gold are simultaneously withdrawn all over the world. Gold is no longer for sale at any price. If you want to get it, you have to have recourse to barter. You must give up silver, oil, wheat, and what have you, to get gold in exchange. Dollars are not welcome. This will be an historic event that is approaching with the inevitability of scientific law.

So what? – researchers at Chatham House may shrug. Well, here is what. This event will toll the death knell for the market in U.S. Treasury bonds that, directly or indirectly are backing all currencies in existence. The carpet is yanked from underneath the international monetary system. The only reason why foreigners are still buying U.S. Treasury bonds with a yield not big enough to compensate for currency debasement is that at maturity they fetch dollars that will still buy gold (however little). But the day when permanent backwardation dawns this last incentive will disappear. The credit of the United States will be

gone in a puff of smoke. Like it or hate it, gold still is the cornerstone of the monetary system, pseudo-economists' propaganda notwithstanding.

(3) **Roosevelt's gold confiscation was one of the real cause of the Great Depression of the 1930's.*** A careful analysis of Roosevelt's 1933 gold policies reveals that banning gold coin circulation was a colossal mistake. *It was a major cause of the Great Depression.* Gold was eliminated as the only competition to government bonds. The most conservative savers were forced out of gold and into government bonds. Astute bond speculators saw this as a once-in-a-lifetime opportunity to make a killing. They knew what the extra demand for government bonds was going to do to the bond price. They moved in to pre-empt the savers. They were determined to buy the bonds before the savers on the cheap. Indeed, by the time the savers arrived, the price of bonds was sky high and rising. The rate of interest went into a falling mode. Speculators turned the bond market into a casino, bidding bond prices off the charts.

Tampering with gold coin circulation caused internal hemorrhage in the economy. Falling interest rates increased the burden of all debt contracted earlier. They gobbled up profits beyond the endurance of enterprise, both productive and financial. The unwarranted sudden shift of wealth from debtors to creditors devastated the economic landscape. Business was made prostrate, firms went bankrupt in droves, unemployment snowballed.

There was more. Falling interest rates were translated into falling prices. Easy money from the Fed backfired. It was intercepted by speculators who used it to buy even more bonds. The Fed had wanted them to buy commodities to stem the fall in prices. But the temptation to take the easy money to the casino of the bond market where gains were guaranteed and losses were on the house was irresistible. Instead of buying, speculators were selling commodities short, causing prices to fall further. They knew that the policeman, gold, guarding prices against falling into a bottomless pit, has been fired. A vicious spiral was set in motion: falling prices chased interest rates lower, and falling interest rates chased prices lower still.

Here is how the process would have worked, had gold coins been available. Savers would have taken profits by selling the overpriced bonds. They would have stayed invested in gold coins waiting for the bond price to come back from outer space**. When it did, they would have repurchased the bond at a profit, thus stabilizing the rate of interest at a level consonant with economic reality.

It is a canard due to wobbly logic to say that gold has a deflationary bias. *It was not the gold standard but the fetters put on it – including the confiscation of gold by Roosevelt in 1933 – that was the true cause of the Great Depression.*

The threat of another Great Depression today can be averted only through rehabilitating the gold standard – and through restoring honesty in dealings between government and citizens.

March 4, 2012.

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* The other was the illegal introduction of open market operation by the Federal Reserve in the early 1920's. It released the genie of bond speculation from the bottle, responsible for the prolonged decline of the rate of interest. The ineluctable bull market in bonds siphoned off the capital of productive enterprise, causing wide-spread bankruptcies and unemployment.

** Gold in this role is indispensable: it cannot be substituted by paper money, not even by gold certificates. Substituting paper money yielding zero interest for bonds yielding some, however little, is akin to jumping from the frying pan into the fire. Substituting the gold coin is different. It means substituting a present good for a future good, prompted by time preference.

For further information or in order to register for the course you can get in contact with the organizers Ludwig Karl and Wilhelm Rabenstein via mail (nasoe@kt-solutions.de) or phone (+49 – 170 – 380 39 48 , before calling please consider a possible time lag).
You might also want to take a look at the New Austrian School of Economics on Facebook:
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