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Monetary Economics 102: Gold and Interest

EXTRA! SPECIAL!

WHAT GOLD AND SILVER ANALYSTS OVERLOOK

Executive Summary

Analysts keep talking about supply/demand factors, instead of concentrating on the falling basis and looking for other signs of the coming backwardation in the gold and silver markets. They should also answer the question: Whatever happened to the Chinese silver, remnants of China's defunct silver standard?

Phantom Supply and Demand

As his starting point in trying to explain prices Ted Butler, among other analysts, chose the supply of and the demand for gold and silver. This is a mistake. Under the regime of an irredeemable currency the supply and demand of a monetary metal are indeterminate. In other words, they cannot be quantified in any meaningful sense of the word. For example, the supply of gold from official sources is on a 24-hour basis, in spite of the Washington agreement and similar declarations largely drafted in order to obfuscate rather than to enlighten. Supply from private sources, too, can change on a moment's notice together with demand as speculators have no firm commitment either to the long or short side of the market. It is a mistake to assume that the dealers are committed to the short and the tech-funds to the long side. Such commitments, to the extent they exist, are subject to many an overriding consideration such as profit-taking, stop-loss, to say nothing of herd-instinct that may induce a massive stampede from one side of the market to the other based on nothing more substantial than a rumor. It is futile to analyze the gold and silver markets in the same way as one would other commodity markets. It is dangerous to ignore the fact that gold and silver are monetary metals.

Phantom “Free Market”

To call for a free market for gold or silver is calling for the impossible. Once again we must remember that we have irredeemable currency. The gold market could only be free if the official supply were available on demand to the private sector at the official price. This is clearly not the case as a result of the wholesale default of governments to pay their gold obligations in the 20th century. Never mind if governments are shouting from the rooftop that silver and gold as money are *passé* since the former was demonetized in 1871 and the latter a century later. At best, this is wishful thinking, at worst, malicious misinformation. It is not up to the governments to monetize or demonetize a commodity. It is the prerogative of the market. In picking a monetary commodity the market will make its marginal utility decline at a rate more slowly than that of any other. There is always such a commodity, no matter what the government says. It can be recognized by the fact that its above-the-ground supply is a large multiple of annual output, whereas that for a non-monetary commodity is a small fraction. We shall express this by saying that the stocks-to-flows ratio is the largest for the monetary commodity. For this reason, once it has been picked, it is virtually impossible to change. Such a change would involve the dispersion of the large existing hoards of the old, and the accumulation of similarly large hoards of the new monetary commodity. That would take centuries to complete, longer than the week-end declaration of a default-prone government.

What Is the Value of a Broken Promise?

In prehistoric times the market picked the monetary metals: gold and silver. The rest is history, replete with government bluffing. It is easy to see through this. Paper money was originally issued as a promise to pay a definite amount and fineness of gold to bearer on demand. Later the government reneged on its promise, which promptly started losing value in terms of gold. There have been ups following downs, but the downtrend is unmistakable. Why the ups?

Nothing is more natural than for a banker to try to keep his dishonored promises in circulation by hook or crook lest their value go to zero, as it has happened every time in history. It makes no difference whether the banker runs a wildcat bank or whether he runs the most powerful government in history with the most formidable armor and weaponry imaginable at its disposal. The banker may be able to pull new tricks from his sleeves and thereby to fool the public a little longer. But no tricks will turn upside down the natural law that written evidences of broken promises are destined to end up in the garbage bin. Regardless how fine the paper and how beautiful the print is.

Under the regime of irredeemable currency the price has nothing to do with the value of gold. It has to do with the success of the government to fool the public. It has to do with the failure of the people to see through government bluffing. It helps if the government (or central bank) has a large hoard of gold. It can be used to intimidate other holders, bombarding them with propaganda that the supply/demand fundamentals for gold are most unfavorable.

The existence of such hoards will induce speculators to place bets as to the ultimate disposal of the official stocks. Those who bet that these hoards will eventually be used by the government to stabilize paper money will go long. Those who bet that the government will commit *harakiri* in bluffing its way down to the last bar of gold in its coffers will go short. The contest of the longs and shorts will cause the price of gold to fluctuate. As we shall see below, ultimately, the shorts are destined to be the losers but, in the meantime, they can make a lot of mischief. Especially if they are right in assuming that the government really intends to bluff its way down to the last gold bar.

Keynes' Blunders

The *enfant terrible* of British economics John Maynard Keynes assumed that there was inherent symmetry in speculation that was supposed to furnish a natural limit to the size of the markets in derivatives. By derivatives we mean futures contracts (or options thereon) to make or take delivery of a definite quantity and quality of a commodity at the price prevailing at the time of contracting. Those who contract to take delivery are the *longs* (a.k.a. *bulls*) and those who contract to make it are the *shorts* (a.k.a. *bears*). Keynes argued that, since to every long there must correspond a short, the net effect of the derivatives on supply and demand is neutral. According to him derivatives-trading is a *zero-sum game*: the gain of one speculator is the loss of another. *Samizdat* economists* (my term for those publishing on the internet) see it differently. If we depict the underlying cash market as the dog and the corresponding derivatives market as the tail, it is foolhardy to suggest that always the dog wags the tail. The trouble with the regime of irredeemable currency is that under it the tail may often be wagging the dog.

It is patently false to suggest that symmetry prevails in trading derivatives. The risks taken by the longs and shorts fail to be symmetric. In case of commodities the risk of the longs is limited while that of the shorts is unlimited. Nor is it hard to see why. The risk of the longs is that the price will fall. But fall as though it may, it will definitely not fall below zero. This limits the exposure of the longs. Compare this with the risk of the shorts, which is that the price may rise. As there is no obvious limit above which the price may not be allowed to rise, the risk of the shorts is unlimited. The lopsided nature of speculation in commodities is revealed. Another way of expressing this is to assert that the longs can squeeze, and sometimes corner, the shorts. By contrast the shorts cannot squeeze, let alone corner, the longs in the commodity markets (although, of course, they are free to bluff that they can).

Speculation in interest-rate derivatives is no less lopsided, albeit with a switch between the roles played by the longs and the shorts. Here the risk of the shorts is limited while that of the longs is unlimited. Indeed, the risk of the shorts is that the rate of interest may fall (so that bond prices will rise). But fall as though it may, the rate of interest will definitely not fall below zero. Compare this with the risk of the longs, which is that the rate of interest may rise (so that bond prices will fall). As there is no obvious limit above which the rate of interest may not be allowed to rise, the risk of the longs is unlimited (in comparison to that of the shorts). Another way of expressing this is to assert that the shorts can squeeze, and sometimes corner, the longs. By contrast, the longs cannot squeeze, let alone corner, the shorts in the financial markets (although, of course, they are free to bluff that they can). Examples of the bond-bears cornering the bond-bulls are provided by the various historic episodes of hyperinflation.

Keynes was wrong in declaring that the net effect of derivatives on the cash markets is neutral, and thereby the volume of derivatives trading is capped. Just the opposite is true. Derivatives trading in gold and silver has grown beyond rhyme and reason. The growth in trading interest-rate derivatives has been even greater. These cancerous growths are part of the self-destroying mechanism of the regime of irredeemable currency.

It Takes Three to Contango

Keynes' theory of speculation is wrong beyond the possibility of repair. He insisted that the natural condition for the futures markets for commodities is to be in *backwardation*. This is the name for the condition that the market quotes a lower price for a more distant and a higher price for a nearby delivery date. The opposite condition, one that obtains when the market quotes a higher price for a more distant and a lower price fore the nearby delivery date is known as *contango*.

Keynes called what he saw as the natural condition for the futures markets in commodities "normal backwardation". He reasoned that there is a risk involved in carrying a commodity, namely, the risk that the price may fall. The producers and distributors want to unload this risk onto the shoulders of the speculators. However, the speculators will shoulder the price-risk only for a consideration, as manifested by the backwardation. The role of the speculator, according to Keynes, is analogous to that of the insurer who charges a premium for insuring specific risks.

This is a complete misrepresentation of the facts of the markets. The speculator is no insurer shouldering specific risks in return for a premium represented by backwardation. Just the opposite is the case. The speculator is interested in taking small risks in the hope of a large payoff. He will not be bribed with a pittance. The speculator is willing to take a number of small losses because he expects the few bets he will win to be big. Keynes' analogy between the roles of the speculator and the insurer is a colossal blunder.

It is interesting to note that the market for monetary metals seemingly justifies Keynes' theory. The shorts appear to be the master who takes the initiative, while the longs appear to be the servants who take orders. The shorts are the aggressors while the longs are on the defensive, whereas the asymmetry of speculation would justify the opposite cast. This reversion of roles will not ofcourse determine the final outcome that must be the utter defeat of the shorts and the *apotheosis* of the longs. What it suggests is that the road ahead is going to be arduous, full of backtracking that will often raise doubts in the hearts of the longs. In particular, it is not likely that silver will go straight up after one last short squeeze forcing traders to cover all short positions for good, as predicted by some analysts. More likely the market will follow the classical zig-zag pattern of lots of profit-taking and stop-losses on the long side. Meanwhile the shorts will continue to stand guard at the gates of the Underworld in their role of Cerberus, the triple-headed dog. The blow-off is presumably still a long way away.

Contrary to the teachings of Keynes, the normal condition of the futures markets is one of contango, not backwardation. The proper way to view the futures markets is a place where warehousing services are traded. Contango is the premium from which the warehouseman derives the fee for his services. If there is no contango, no warehousing is possible. Accordingly, it takes not two but three to contango: the producer, the speculator, and the warehouseman.

This is especially clear in case of the monetary metals, of which a supply many times larger than annual demand for consumption exists. We have expressed this by saying that the stocks-to-flows ratio for a monetary metal is a large multiple (it is estimated to be greater than 50 for gold), whereas the same number for a non-monetary commodity is a small fraction (it is estimated to be less than 0.25 for copper). The large stocks-to-flows ratio reveals the willingness of people to carry the monetary metal, in spite of carrying charges, and defying government propaganda. The longs have a choice. Either they carry the monetary metal in inventory, or they replace it with a futures contract. In the latter case they sell the metal and invest the proceeds at interest (taking care that maturities match). In the normal situation arbitrage between the two ways of being long in the monetary metal will bring about contango. It tends to equalize the carrying charge with the premium over the cash price. Therefore it is not "normal backwardation" as preached by Keynes. If anything, it is "normal contango". Here a very important question arises: Can contango in a monetary metal turn into backwardation, and if so, under what condition?

Abnormal Backwardation

It appears to be a theoretical impossibility for the gold and silver market to be in backwardation for any extended period of time. Such a situation would guarantee *unlimited and riskless* profits for all those holding gold and silver. They could replace their cash holdings with futures *at a lower price*. When their futures contract matured, they could take delivery and repeat the procedure. The mere possibility of unlimited and riskless profits suggests that there is an error in the calculation. And indeed, there is. The profits are *not riskless*. As the ancient adage says: “A bird in hand is worth a dozen in the bush”. When cash gold or silver is replaced with futures, a risk is created, namely, the risk that it may not be possible to convert the futures contracts back into cash gold or silver at maturity. There is the risk of default in the futures markets. Of course, exchange officials, bullion bankers, and government watchdog agencies vehemently deny the existence of such a risk. But the fact remains that under the regime of irredeemable currency it is possible to corner a monetary metal. It is true that cornering a monetary metal goes by another name: that of *hyperinflation.* There have been any number of hyperinflationary episodes ever since paper was invented by the Chinese. What people don’t generally realize is that every one of these episodes was a corner in gold or silver. It is foolish in the extreme to suggest that in the 21st century we are immune to the threat of a corner in gold and silver, since we have the wisdom of Keynes and Friedman at our disposal. These men were writing for the benefit of their employers, the British and the U.S. governments. They were not committed to the truth any more than the government that had hired them was. Governments are committed only to perpetuating and aggrandizing their own power, if need be, by trampling on the Constitution. Inflicting irredeemable currency on the people is part of this aggrandizement.

The Basis for the Basis

In order to understand how the monetary metals may go to backwardation we need to refine our investigative tools. We need the concept of a *basis*. First we raise the question of how the warehouseman knows what and how much stuff to put into his warehouses. Well, his guiding star is the basis, the term he uses for the difference between the futures and cash prices of the commodity. If the basis for corn is higher than for wheat, then the grain elevator operator will fill his elevator with corn in preference to wheat, regardless of prices. He will cover his need for wheat by purchasing wheat futures rather than cash wheat. It is more profitable for him to carry wheat in the form of futures than cash, in view of the basis.

The basis is the measure of contango. If it is greater than the carrying charge, then the warehouseman will increase his stocks in warehouse and sell an equal amount of futures; if less, then he may sell stocks from his warehouse and buy an equal amount of futures. Note that, once again, a lack of symmetry obtains between these two cases. If the basis is greater than the carrying charge, then the warehouseman is treated to riskless profits. If less, then the warehouseman has a dilemma. On the one hand the already quoted adage: “a bird in hand is worth a dozen in the bush” applies. On the other, he has a powerful incentive to sell the cash commodity and buy the futures. Because of this asymmetry the basis hardly ever goes higher than the carrying charge while it may well go lower. In fact, there is no theoretical limit below which the basis may not go. It may even go negative creating backwardation. The warehouseman will have to be very careful in choosing the point where he sells cash commodity and buys the futures. He must remember that shortages are always heralded by a falling basis. This is called the basis-risk.

The important fact to keep in mind is that a low and falling basis and, in particular, backwardation, are always a warning signal indicating tightness in the cash market. The size of the shortfall of the basis from full contango is an indication of the magnitude of the shortage. In a nutshell, cash prices always appreciate relative to futures prices in case of a shortage, showing that delivery problems exist as the warehouseman is unable to replenish his dwindling supplies fast enough. The basis-risk of the warehouseman who sells the cash commodity against buying the futures is unlimited.

Up and Down the Elevator

All this may be illustrated through the cyclical business of the grain elevator operator. In the harvest season he is buying grain. Selling futures against grain in the elevator is called *hedging*, with the short futures position being the *hedge*. The objective of hedging is to neutralize the price-risk that goes with holding the grain in storage. The elevator operator has only a limited amount of capital available to cover various risks in his business. The amount of grain in the elevator is so huge that even a small decline in the grain price could wipe out his entire capital and bankrupt the grain elevator operator. Hedging highlights the economic significance of the futures markets. They make it possible for the operator to ignore price variations, and concentrate on what he does best, the handling and distribution of grain until the new crop is brought in. He can focus his attention on the basis, from the variation of which he derives his income. As he puts the new crop in his elevators, the basis will go higher. If it didn’t, then the elevator operator would buy the futures instead of the cash grain. As the elevator is filled to capacity, the basis approaches the carrying charge.

During the course of the year grain is gradually consumed, supplies at the elevator are drawn down, and the basis falls. The successful elevator operator anticipates these changes correctly. He will sell grain just before the bounce-back in the basis after every major fall, simultaneously lifting his hedges in the futures market. Moreover, he will sell only so much, as he is trying to sell most of his grain at the end of the season when the basis is the lowest, and there may even be backwardation. It bears repeating that the grain elevator operator must keep it in mind that in selling cash grain against buying futures he is incurring a basis-risk that is unlimited.

Speculation *versus* Gambling

Speculation in grains is legitimate business as it addresses risks given by nature. Both the price-risk and the basis-risk are nature-given. They are influenced by the weather, the possibility of floods and other natural disasters. We have no other means to alleviate market dislocations such as shortages caused by crop failure (hurting the consumer) and price busts caused by bumper crops (hurting the producer) than organized speculation.

By contrast, organized speculation in the monetary metals is an aberration due to irredeemable currency. In fact, to call it speculation is a misnomer. Speculation in gold and silver is of the nature of gambling. The risks it addresses are not nature-given but man-made, like those addressed by foreign exchange and interest-rate speculation. We use the term “man-made” in its broadest sense, to include manipulations by the government and central bank. If we compare the government to the casino owner, then the speculators are the gamblers. The government creates the risks artificially in the gold and silver market for the speculators to place their bets on. Few people today realize that under the gold standard there was no organized speculation in foreign exchange and interest rates, as the variation in these rates were too small rendering speculation unprofitable. And, of course, there was no organized speculation in gold. This, incidentally, is one of the merits of a gold standard. It channels talent and manpower away from gambling and into productive enterprise. The main negative effect of the destruction of the gold standard by the government was the creation of a long list of artificial risks that had not existed before, *e.g.,* the foreign-exchange risk and the interest-rate risk. The regime of irredeemable currency is seen as a most wasteful one. It creates phantom markets, phantom supply and demand, channeling talent and manpower away from socially desirable production into socially undesirable gambling. The derivative markets trading gold, silver, foreign exchange, and interest-rate futures (options) are a monument to government obtuseness and inefficiency. Rather than reducing, as it should, the number of ever-present risks that man has to face in his struggle for survival, the government in embracing irredeemable currency creates new and wholly unnecessary risks, thereby undermining the efficiency of production, distribution, and saving. Worse still, the government also exposes society to unimaginable dangers such as the sudden impoverishment and permanent pauperization of the majority of the people, as it happened in pre-Hitler Germany.

Hedging the monetary metals is also of the nature of gambling. The risks addressed here are all man-made. While exchange officials and government watchdog agencies strictly enforce the rule that the total short position in grains must at no time exceed annual production, they look the other way when gold mining companies sell several years' of future production forward. In no way does hedging by the gold and silver mining industry serve the shareholders. On the contrary, it is a scheme whereby the management dispossesses them.

Having made the point that speculation in monetary metals is of the nature of gambling, we want to understand it as it vitally influences our own well-being and financial security. We wish to study it based on sound economic principles rather than the phony ones pronounced by so-called economists in the hire of the government.

Recall that the normal condition of the markets in the monetary metals is that of contango. Backwardation is abnormal, yet it may occur. When it does, the regime of irredeemable currency will start to crumble. People in trying to save their financial future will take flight to the monetary metals. They will scramble to mop up the dwindling supply that is allowed to trickle down. Then all of a sudden all offers to sell the monetary metals are withdrawn. Supply goes to zero, facing an infinite demand. That such a development is not fanciful but a true description of economic reality as it unfolds is confirmed by history. Supply of the monetary metals went to zero and demand to infinity many times before, in France (the *assignat* and *mandat* inflations), in the United States (the *continental* inflation), in Germany (the *Reichsmark* inflation), to mention but a few of the notable cases.

Analysts of the gold and silver markets make a mistake when they use monetarist models, try to balance a phantom demand with a phantom supply, and cry for a free market. Instead, they should be watching the gold and silver basis as they fall, and look for other signs of the coming backwardation, first in the silver, then in the gold market. For practical purposes the basis for gold and silver is the difference between the two nearest futures prices, in more detail, it is the settlement price for the nearby future month less the settlement price for the current cash month. We shall see that the basis for gold and silver behaves perversely when compared to the basis for agricultural commodities. This fact is quite important as it explains the self-destroying mechanism for the regime of irredeemable currency.

Understanding the Silver Market

By no stretch of the imagination can the silver market be called free at any time since 1871. In that year two powers demonetized silver: Germany and the United States. The governments of both were cashing in on the war-booty from their respective victories. Prussia had just defeated France, and in the United States the North had just defeated the South. These governments were dumping silver in order to raise the gold needed to run a gold standard. The price of silver fell from $1.29 an oz and continued falling for more than 60 years to a low of 0.25 ¢, or less than one-fifth of the old official price (although there was a brief spike back to $1.29 at the end of World War I) as all other countries with the significant exception of China followed suit in abandoning silver and turning to gold. In the meantime the U.S. Treasury was made by law to purchase silver from the Western states at prices *above* market. The silver-purchasing program of the United States remained in effect for over 75 years, after which the Treasury initiated a silver-selling program at prices *below* market. All in all, 6 billion oz of Treasury silver was sold during the past fifty or so years and, by now, the U.S. is allegedly out of silver. Well, maybe out of silver, but not out of the silver business. Holding the line on the silver price, or at least yielding ground to higher prices only gradually, is considered the first line of defense by the U.S. government protecting the dollar. If silver were allowed to be cornered, then gold would follow and that would be the end of the dollar, and the financial domination of the world by the U.S. government.

Ted Butler and other silver analysts have properly noticed the structural deficit for the past twenty years or longer, the draw-down of the visible supply deliverable against futures contracts, all in the face of stable or declining silver prices. They have also noticed what they took to be naked short position of traders that is increasing by leaps and bounds. The analysts say that behind it all there is illegal price manipulation. They contend that silver prices would be much higher by far if it wasn't for the traders' selling of unlimited amounts of silver futures naked illegally. The analysts claim that the naked short position of a few big traders amounts to several years of mine production. At any rate, it is a high multiple of the existing stores of deliverable cash silver in existence. It is a disaster waiting to happen. And happen it will before the last bar of deliverable silver is gone.

In trying to explain these anomalous developments Ted Butler and other silver analysts charge that there is a conspiracy involving the "silver insiders" (namely, the four to eight largest traders), the exchange officials and, possibly, the government watchdog agencies. The insiders have made obscene profits at the expense of the outsider investors and the shareholders of the mines. They could do it as they enjoy special privileges and may get off scot-free with violating both the exchange rules and the laws of the land. Dark hints are dropped about the possibility of kickbacks to officials whose duty it is to enforce the rules and the law. It has also been suggested that silver mine executives have been bribed not to complain about low silver prices but to keep producing at a loss.

Without trying to refute these accusations I should point out that, before charges are made, one ought to make sure that all other possible explanations have been exhausted for the aberration that the price of silver declined significantly in the face of structural deficits and the draw-down of visible supplies. Even if there is no other explanation, the existence of a conspiracy does not logically follow. Without trying to refute the conspiracy theory I should point out that the market behavior of the shorts may find a spontaneous explanation. Speculators may be prompted to congregate on the same side of the market by the idiosyncrasies of the regime of irredeemable currency. It is not an outrageous assumption that all speculators read the mind of government and central bank manipulators in the same way. While uniform behavior would not be possible in the case of speculation in agricultural commodities where the risks are nature-given, it is quite possible in the case of speculation in monetary metals precisely because here the risks are man-made.

Whatever Happened to the Chinese Silver?

The most populous country, China has one of the oldest civilizations on earth. It had been on a silver standard since time immemorial before the Communists overran the mainland. Nobody knows how much silver was involved in running China's monetary system, but the amount must be mind-boggling. In addition, China was forced to absorb enormous amounts of silver (both through legal channels and through smuggling) after silver was demonetized by the rest of the world and the price of silver collapsed. We do know that this addition to the Chinese money supply created an inflation horrible enough to cause the fall of the Kuo-min-tang regime and the ascension of the Communists to power in 1949. We do not know what proportion of the monetary silver the Communist government left in the hands of the people while confiscating the silver in the banks with characteristic ruthlessness. Finally, we do not know whether or not China was buying silver clandestinely during the twenty-year period between 1980 and 2000 when the price was falling.

Be that as it may, the silver left over from the silver-standard days, plus the silver subsequently flowing into China, is largely unaccounted for. The question is: where is this Chinese silver? It appears that China does hold the silver wild card, and hasn't played it yet. We cannot lithely assume that China will play it stupidly. The possibility exists that China will play it intelligently. For all we know, China may already be active, if only clandestinely, in the silver market and has been deriving handsome profits from it. The alleged naked short positions in silver may in fact be genuine hedges for Chinese-owned silver. In other words, China may have decided upon a strategy to derive a steady income from her silver treasure, at least for as long as prices remain low, in preference to the alternative strategy of driving up the price of silver and then cashing in. I haven't examined the evidence and I am not suggesting that this is the case. All I am saying is that there is another possibility that could explain the anomalous market behavior for silver. One reason why I find the theory of inordinate and growing naked speculative short positions unattractive is because it assumes that the insiders are either stupid or suicidal or both. It is dangerous to underestimate one's opponents.

Serial Crimes of 1871, 1933, and 1971

The right of the people to free and unlimited coinage of silver at the Mint is carved into the corner-stone of the U.S. Constitution. This right was abolished with a sleight of hand in 1871. "The Crime of 1871", as William Jennings Brian called the unconstitutional demonetization of silver, may get its just punishment after a 130-year hiatus before our eyes.

It wasn't an isolated crime. It was a serial crime through which politicians deprived the American people of all their Constitutional rights and prerogatives pertaining to money, that started even before 1871. The crime was repeated on a bigger scale in 1933 when a Democratic president tricked the American people out of their gold. The crime was crowned in 1971 when a Republican president tricked the rest of the world out of its gold, while inflicting a regime of irredeemable currency on the American people and everybody else. Although through the betrayal of the economists the people were left in darkness about what has happened to their money, these crimes cry to high heaven for justice.

While I am somewhat doubtful about the theory of conspiring private parties, I find the theory of a secret government plot to suppress the price of silver plausible, even persuasive. This plot may also include collusion between the governments of the United States and China to fend off a price explosion. According to this scenario China would supply cash silver to deliver against futures contracts, in return for the right to collect the income flowing from her short positions in silver.

Even the obvious delivery problems cannot serve as conclusive proof that the insiders (also called "silver managers") have rigged the silver market in an effort to cap the price. After all, the silver to be delivered may have to be brought in from China. That takes time. Silver analysts would do well to compile intelligence as to what percentage of the delayed deliveries to the Central Fund of Canada and other longs has originated in China. If it was a large percentage, then we would have evidence that the silver managers were neither stupid nor suicidal. They merely acted as the agents of the government China.

Understanding the Gold Market

Before the United States defaulted on its obligations in 1968 and subsequently demonetized gold in 1971 all economists, including the arch-conservative Ludwig von Mises, predicted that demonetization would send the price of gold way down. They pointed to the episode of silver demonetization one hundred years earlier, followed by the collapse of the price of silver. They also adduced a pseudo-theoretical argument that the disappearance of the lion's share of demand, namely the monetary demand, cannot help but make inroads into the gold price.

Of course the economists fell on their face when gold was demonetized yet its price, instead of falling, rose more than twenty-fold in less than ten years. Nobody dared to confront the economists with their embarrassing failure. Why did they fail so miserably? I shall now give the answer to this so far unanswered question. The economists fell victim to one of the most elementary fallacies known as *post hoc ergo propter hoc* (after this, therefore because of this). When silver was demonetized in 1871, no government default was involved. Owners could continue to redeem their silver certificates without let or hindrance. Since its price showed a falling trend, a lot of people rushed in to sell silver. Even the silver mines redoubled their efforts to produce all the silver left in the shafts, before they had to be closed down and abandoned for good. Genuine silver mines have all but disappeared. Whatever silver production survived was byproduct from the gold and copper mines. It was not demonetization that caused the price of silver to fall but dumping, official and unofficial, that followed it.

By contrast, the demonetization of gold a hundred years later was a default on the gold obligations of the U.S. government. Nobody has ever seen a dishonored promise to go to a premium. Yet this is exactly what the economists were predicting that would happen to the dollar. The gold obligations of the U.S. were internationally recognized. By the Bretton Woods Treaty of 1944 that was responsible for hatching the IMF, foreign governments could treat their dollar balances as gold-equivalent at the rate of $35 to one oz of gold. These gold obligations were solemnly reconfirmed by three sitting presidents. Browbeaten by Washington, foreign governments wouldn't dare to protest the breach of faith and the unilateral abrogation of international obligations. They meekly swallowed the loss that arose. They pretended that nothing much happened and the dollar was still as good as gold. They ignored the market and continued to count their dollar balances at "the official price at which the U.S. Treasury refused to sell gold". They called it the "two-tier monetary system". Of course, that hare-brained scheme could not endure. The market trumped the governments, as it always does when they do something foolish. It is interesting to note that the financial annals are silent on the biggest default in history. Well, you can get away with it if you are the paymaster of the annalists.

As there was no point in pretending any more that the dollar was as good as gold, the U.S. government put measures in effect designed to drive down the price of gold or, at least, to prevent it from rising further. IMF gold auctions were followed by U.S. Treasury auctions. Both backfired badly. The market obliged in bringing down the price of gold temporarily to allow the IMF and the US Treasury to unload the bothersome surpluses. But no sooner had the auction been completed than the price of gold returned to its pre-auction level to resume its upward march.

It is hard to find another example of such an inane market action in the long catalog of government blunders. If a bank needs to sell an asset, then it does so discretely in order that it may fetch the best possible price. Fanfare and the Dutch auction method were used for their propaganda value in demonstrating how the price falls when gold is put on the block. It is clear that these gold auctions were not an exercise in high finance but one in low propaganda. More recently the Bank of England auctioned off more than half of her gold reserves at record *low* prices, to replace it with U.S. government securities at record *high* prices. In doing so the Bag Lady of Threadneedle Street was replacing her best asset gold, that is nobody's liability, with the worst, obligations of a default-happy government. This made the portfolio of the bank weaker, not stronger. Once again, the completion of the auction gave the green signal to gold that it may resume its upward move.

It should be abundantly clear that in sacrificing their remaining ordnance governments are fighting a desperate rear-guard action in an effort to fool the public. In this situation it is puerile to call for a free market in gold and to go to court accusing the government of price manipulation. Once more without trying to refute the conspiracy theory I wish to point out that, given the idiosyncrasies of the regime of irredeemable currency, the uniform action of the shorts may find a spontaneous explanation. The gold mining executives, the bullion bankers, and other speculators may read the mind of the government and central bank manipulators in the same way.

Self-Destruction of Irredeemable Currency

The explanation of hyperinflation in terms of the quantity theory of money is untenable. You cannot explain non-linear phenomena in terms of a linear model. The proper explanation must be sought in terms of a non-linear model. Such a model can be developed using the concepts of basis and backwardation. If applied to the monetary metals, we shall see the cataclysmic conflict that will bring about the end of the regime of irredeemable currency. No one can predict the future, but science makes it possible for us to find the most likely course of events. It is in this spirit that I offer the following observations.

As the regime of irredeemable currency threatens to crumble under the weight of the inordinate debt tower of Babel, people increasingly take flight to gold. Supplies will get tight and the gold basis will fall. The gold futures market may even go to backwardation briefly at the triple-witching hour, *i.e.,* the hour when gold futures, as well as call and put options on them expire together. Later, flirtation with backwardation may occur even more often, at the end of every month when gold futures expire. Gold will get caught up in a storm.

Backwardation in gold has a perverse effect. In the case of agricultural commodities backwardation provides a most powerful incentive for traders to sell the cash commodity and buy the futures. Not so in the case of gold. Rather than bringing out deliverable supplies of gold, backwardation tends to remove them. The more the gold basis falls the less likely it becomes that owners will exchange their cash gold for futures. Please remember that you have seen it here first. *This perversion of the gold basis constitutes the self-destroying mechanism of the regime of irredeemable currency*. The longs tend to take delivery on their gold futures contracts in ever greater numbers, and refuse to recycle cash gold into futures, regardless how low the gold basis may go. As it is not set up to satisfy demand for delivery on 100 percent of the open interest, the gold futures market will default. Exchange officials will declare a “liquidation only” policy to offset long positions in gold. At that point all offers to sell cash gold will be withdrawn. Gold is not for sale at any price. The shorts are absolved of their failure to deliver on their gold futures contracts.

Previous descriptions of hyperinflation purporting to explain the descent of a currency into the abyss of worthlessness do so in terms of the quantity theory of money. My explanation of the hyperinflation that is staring us in the face is very different. I dismiss the quantity theory of money as a linear model that is not applicable. Every previous episode of hyperinflation took place in the context of a war replete with shortages caused by the destruction of stockpiles and productive facilities. In this situation it is not possible to sort out the effects of an increasing demand (due to a flood of printing-press money) and a decreasing supply (due to the destruction of stockpiles and production facilities). We want to show that prices may also explode in the presence of unsold stockpiles and ongoing production.

Moreover, previous episodes of hyperinflation affected isolated countries which had embraced the regime of irredeemable currency out of desperation, while the rest of the world stayed the course of monetary rectitude. In the present situation the entire world has been inflicted with irredeemable currency. There are no gold standard countries around that could lend a helping hand to countries that want to stabilize their currency. My description of hyperinflation is not in terms of the quantity theory of money, but in terms of a model where the relentlessly declining gold basis leads to backwardation destroying the gold futures market. When all offers to sell cash gold are withdrawn, producers of essential commodities such as grains and crude oil refuse payments in dollars, and demand gold in exchange for their product. The dollar and other irredeemable currencies will go the way of the *assignat*.

Backwardation in gold should therefore be considered the self-destroying mechanism for the regime of irredeemable currency that “only one man in a million may identify and understand” (my thanks to Keynes for the felicitous phrase). This is where supply/demand analysis is utterly useless. The huge stocks of monetary gold are still in existence, yet zero supply confronts infinite demand.

The only way to fend off this outcome is for the government of the U.S. to come up with a credible plan to stabilize the dollar in terms of gold. Presently there is no hint that contingency plans for the rehabilitation of the gold standard exist. It doesn’t matter. Any country, *e.g.*, China, India, Iran, could do it through the back door by opening the Mint to the free and unlimited coinage of gold and silver. The alternative may be mass starvation in the midst of plenty as world trade comes to a halt for want of a universally acceptable medium of exchange.

Here is a question for the U.S. President and Treasury Secretary to contemplate: How many innocent lives are they willing to sacrifice on the altar of doctrinaire purity in defense of their untenable gold policies?

Note. I have taken a pause in my lecture series on Gold Standard University in order to bring you this essay on the failure of gold and silver analysts to include the basis as an instrument of analysis. My lecture series *Gold and Interest* will be resumed in June..

(* Ed: Samizdat' is Russian for "self-printing/publishing")