RED ALERT: GOLD BACKWARDATION!!!

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December 2, 2008, was a landmark in the saga of the collapsing international monetary system, yet it did not deserve to be reported in the press: *gold went to backwardation for the first time ever in history.* The facts are as follows: on December 2nd, at the Comex in New York, December gold futures (last delivery: December 31) were quoted at 1.98% discount to spot, while February gold futures (last delivery: February 27, 2009) were quoted at 0.14% discount to spot. (All percentages annualized.) The condition got worse on December 3rd, when the corresponding figures were 2% and 0.29%. This means that the gold basis has turned negative, and the condition of backwardation persisted for at least 48 hours. I am writing this in the wee hours of December 4th, when trading of gold futures has not yet started in New York.

According to the December 3rd Comex delivery report, there are 11,759 notices to take delivery. This represents 1.1759 million ounces of gold, while the Comex-approved warehouses hold 2.9 million ounces. Thus 40% of the total amount will have to be delivered by December 31st. Since not all the gold in the warehouses is available for delivery, *Comex supply of gold falls far short of the demand at present rates.* Futures markets in gold are breaking down. Paper gold is progressively being discredited.

Already there was a slight backwardation in gold at the expiry of a previous active contract month, but it never spilled over to the next active contract month, as it does now: backwardation in the December contract is spilling over to the February contract which at last reading was 0.36%. Silver is also in backwardation, with the discount on silver futures being about twice that on gold futures.

As those who attended my seminar on the gold basis in Canberra last month know, the gold basis is a pristine, incorruptible measure of trust, or the lack of it in case it turns negative, in paper money. Of course, it is too early to say whether gold has gone to *permanent* backwardation, or whether the condition will rectify itself (it probably will). Be that as it may, it does not matter. The fact that it has happened is the *coup de grâce* for the regime of irredeemable currency. It will bleed to death, maybe rather slowly, even if no other hits, blows, or shocks are dealt to the system. Very few people realize what is going on and, of course, official sources and the news media won't be helpful to them to explain the significance of all this. I am trying to be helpful to the discriminating reader.

Gold going to permanent backwardation means that *gold is no longer for sale at any price*, whether it is quoted in dollars, yens, euros, or Swiss francs. The situation is exactly the same as it has been for years: gold is not for sale at any price quoted in Zimbabwe currency, however high the quote is. To put it differently, *all offers to sell gold are being withdrawn*, whether it concerns newly mined gold, scrap gold, bullion gold or coined gold. I dubbed this event that has cast its long shadow forward for many a year, *the last contango in Washington* — contango being the name for the condition opposite to backwardation (namely, that of a positive basis), and Washington being the city where the Paper-mill of the Potomac, the Federal Reserve Board, is located. This is a tongue-in-cheek way of saying that the jig in Washington is up. The music has stopped on the players of 'musical chairs'. Those who have no gold in hand are out of luck. They won't get it now through the regular channels. If they want it, they will have to go to the black market.

I founded Gold Standard University Live (GSUL) two years ago and dedicated it to research of monetary issues that are pointedly ignored by universities, government think-tanks, and the financial press, centered around the question of long-term viability of the regime of irredeemable currency. Historical experiments with that type of currency were many but all of them, without exception, have ended in ignominious failure accompanied with great economic pain, unless the experiment was called off in good time and the authorities returned to monetary rectitude, that is, to a metallic monetary standard. It is also worth pointing out that the present experiment is unique in that *all countries of the world indulge in it.* Not one country is on a metallic monetary standard, under which the Treasury and the Central Bank are subject to the same contract law as ordinary citizens. They cannot issue irredeemable promises to pay and keep them in monetary circulation through a conspiracy known as check-kiting. Not one country will be spared from the fire and brimstone that once rained on the cities of Sodom and Gomorrah as a punishment of God for immoral behavior.

In all previous episodes there were some countries around that did not listen to the siren song and stayed on the gold standard. They could give a helping hand to the deviant ones, thus limiting economic pain. Today there are no such countries. If you want to be saved, you must be prepared to save yourself.

You cannot understand the process whereby a fiat money system self-destructs without understanding the gold and silver basis. The Quantity Theory of Money does not provide an explanation, because deflation may well precede hyperinflation, as it appears to be the case right now.

For these reasons I placed the study of the gold and silver basis on the top of the list of research topics for GSUL. These can serve as an early warning system that will signal the beginning of the end. The end is approaching with the inevitability of the climax in a Greek tragedy, as the heroes and heroines are drawn to their own destruction. The present reactionary experiment with paper money is entering its death-throes. GSUL has had five sessions and could have established itself as an important, and even the only, source of information about this cataclysmic event: the confrontation of the Titanic (representing the international monetary system) with the iceberg (representing gold and its vanishing basis) as the latter is emerging from the fog too late to avoid collision.

Unfortunately, this was not meant to be: GSUL has to terminate its operations due to a decision made by Mr. Eric Sprott, of Sprott Asset Management, to terminate sponsoring GSUL, saying that "results do not justify the expense."

I sincerely regret that our activities did not live up to the expectations of Mr. Sprott, but I am very proud of the fact that our research is still the only source of information on the vanishing gold basis and its corollary, the seizing up of the paper money system that threatens the world, as it does, with a Great Depression eclipsing that of the 1930's.

Let me summarize the salient points of discussion during the last two sessions of GSUL for the benefit of those who wanted to attend but couldn't. The *gold basis is the difference between the futures and the cash price of gold*. More precisely it is the price of the nearby active futures contract in the gold futures market minus the cash price of physical gold in the spot market. Historically it has been positive ever since gold futures trading started at the Winnipeg Commodity Exchange in 1972 (except for some rare hiccups at the triple-witching hour. Such deviations have been called 'logistical' in nature, having to do with the simultaneous expiry of gold futures and the put and call option contracts on them. In all these instances the anomaly of a negative basis resolved itself in a matter of a few hours.)

In the commodity futures markets the *terminus technicus* for a positive basis is *contango*; that for a negative one, *backwardation*. Contango implies the existence of a healthy supply of the commodity in the warehouses available for immediate delivery, while backwardation implies shortages and conjures up the scraping of the bottom of the barrel. The basis is limited on the upside by the carrying charges; but *there is no limit on the downside* as it can fall to any negative value (meaning that the cash price may exceed the futures price by any amount, however large).

Contango whereby the futures price of gold is quoted at a premium to the spot price is the normal condition for the gold market, and for a very good reason, too. The supply of monetary gold in the world is very large relatively speaking. Babbling about the 'scarcity of gold' reflects the opinion of uninformed or badly informed people. In terms of the ratio of stocks to flows the supply of gold is far and away greater than that of any commodity. Silver is second only to gold. It is this fact that makes the two of them the only monetary metals. The impact on the gold price of a discovery of an extremely rich gold field, or the coming on stream of an extremely rich gold mine, is minimal — in view of the large existing stocks. Paradoxically, what makes gold valuable is not its *scarcity* but its relative *abundance*, which evokes that superb confidence in the steadiness of the value of gold that will not be decreased by a banner production year, nor can it be increased by withdrawing gold coins from circulation. For this reason there is no better fly-wheel regulator for the value of currency than gold. The same goes, albeit to a lesser degree, for silver.

Here is the fundamental difference between the monetary metal, gold, and other commodities. Backwardation will pull in stocks from the moon as it were, if need be. The cure for the backwardation of any commodity is more backwardation. For gold, *there is no cure*. Backwardation in gold is always and everywhere a monetary phenomenon: it is a reminder of the incurable pathology of paper money. It dramatizes the decay of the regime of irredeemable currency. It can only get worse. As confidence in the value of fiat money is a fragile thing, it will not get better. It depicts the paper dollar as Humpty Dumpty who sat on a wall and had a great fall and, now, "all the king's horses and all the king's men could not put Humpty Dumpty together again." To paraphrase a proverb, give paper currency a bad name, you might as well scrap it.

Once entrenched, backwardation in gold means that the cancer of the dollar has reached its terminal stages. The progressively evaporating trust in the value of the irredeemable dollar can no longer be stopped.

Negative basis (backwardation) means that people controlling the supply of monetary gold cannot be persuaded to part with it, regardless of the bait. These people are no speculators. They are neither Scrooges nor Shylocks. They are highly capable businessmen with a conservative frame of mind. They are determined to preserve their capital come hell or high water, for saner times, so they can re-deploy it under a saner government and a saner monetary system. Their instrument is the ownership of monetary gold. They blithely ignore the siren song promising risk-free profits. Indeed, they could sell their physical gold in the spot market and buy it back at a discount in the futures market for delivery in 30 days. In any other commodity, traders controlling supply would jump at the opportunity. The lure of risk-free profits would be irresistible. Not so in the case of gold. Owners refuse to be coaxed out of their gold holdings, however large the bait may be. Why?

Well, they don't believe that the physical gold will be there and available for delivery in 30 days' time. They don't want to be stuck with paper gold, which is useless for their purposes of capital preservation.

December 2 is a landmark, because before that date the monetary system could have been saved by opening the U.S. Mint to gold. Now, given the fact of gold backwardation, it is too late. The last chance to avoid disaster has been missed. The proverbial last straw has broken the back of the camel.

I have often been told that the U.S. Mint is already open to gold, witness the Eagle and Buffalo gold coins. But these issues were neither unlimited, nor were they coined free of seigniorage. They were sold at a premium over bullion content. They were a red herring, dropped to make people believe that gold coins can always be obtained from the U.S. Mint, and from other government mints of the world. However, as the experience of the past two or three months shows, one mint after another stopped taking orders for gold coins and suspended their gold operations. The reason is that the flow of gold to the mints has become erratic. It may dry up altogether. This shows that the foreboding has been evoked by the looming gold backwardation, way ahead of the event. Now the truth is out: you can no longer coax *gold* out of hiding with *paper* profits.

If the governments of the great trading nations had really wanted to save the world from a catastrophic collapse of world trade, then they should have opened their mints to gold. Now gold backwardation has caught up with us and shut down the free flow of gold in the system. This will have catastrophic consequences. Few people realize that the shutting down of the gold trade, which is what is happening, means the shutting down of world trade. This is a financial earthquake measuring ten on the Greenspan scale, with epicenter at the Comex in New York, where the Twin Towers of the World Trade Center once stood. It is no exaggeration to say that this event will trigger a tsunami wiping out the prosperity of the world.

References

By the same author:

The Rise and Fall of the Gold Basis, June 23, 2006
Monetary and Non-Monetary Commodities, June 25, 2006
The Last Contango in Washington, June 30, 2006
Gold, Interest, Basis, March,7, 2007
Gold Vanishing into private Hoards, May 31, 2007
Opening the Mint to Gold and Silver, February 5, 2008

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

Note: the author is coming out with a follow-up piece:
Has the Curtain Fallen on the Last Contango in Washington?
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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