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# Credit

Antal Fekete refers to wisdom previous generations have accumulated through painstaking research into, and careful experimentation with, the sharp instrument of *credit*, the cutting edge of progress but which can also hurt its careless wielder”.

# Assets

The asset classes are:

* Companies/LLCs/Corporations
* Real Estate
* Art
* Bonds
* Commodities
* Goods
* Services

Each is identifiable as endurant, as continuant, or both.

# The Value Added Model

Finished or semi-finished goods moving from the producer to the consumer requires circulating capital. Every new division of labor, and every new twist in the roundaboutness of production, brings with it new demands for additional circulating capital. This need not take gold coins out of circulation if real bills are used.

## The Principle of Clearing and the Real Bill

What we describe here is the *real* bill, in contradistinction to the many other instruments which may be called bills. A 3-month US Treasury note is not a real bill.

The following material derives mainly from [writings of Antal Fekete](http://www.financialsense.com/editorials/fekete/main.html), in particular, his *REAL BILLS: "WAGGON-WAY IN THE AIR"* [1](http://www.financialsense.com/editorials/fekete/2006/0807.html) [2](../../MacroEconomics/Money/Antal%20Fekete%20-%20writings/20060626%20The%20Principle%20of%20Clearing,%20and%20Real%20Bills+++.html)

Money is needed as a medium of exchange ………….

We use an example example of Ludwig von Mises to demonstrate that real bills involve neither funding nor financing. They involve the Principle of Clearing which states that each tradesman is paid for value added, but ***after the sale of the finished product***, from the proceeds.

1. spinner
2. weaver
3. clothier
4. customer (end user)

The spinner is spinning cotton and wool into yarn that he delivers to the weaver who, in turn, weaves the yarn into cloth to be delivered to the clothier. The latter runs a store selling the cloth to the ultimate cash-paying consumer. Following merchant custom, the weaver does not expect to be paid in cash at the time of the delivery of cloth (a good of the first order). So the weaver bills the clothier for the cloth delivered, who endorses the bill in writing across its face: "I accept". The bill stays with the weaver. When the spinner delivers (the *subsequent)* consignment of yarn (a good of the second order), the weaver endorses the bill drawn on the clothier on the back and passes it on to the spinner (adjustment may be made in coin.) The bill is now in the possession of the spinner who keeps it as evidence of receivables pending settlement, by which time the consumer will have bought the underlying first-order good, and the wherewithal for payment will be on hand.

A decreasing fraction of the gold given up by the final consumer is passed backward toward the first order producer liquidate all the claims, whether the production process had four, fourteen, or forty stages.

"Neither a borrower, nor a lender be" (*Shakespeare*)

It is important to see that the spinner is not a lender, and the weaver is not a borrower. *No funding or financing is involved*. The bill is not a collateral security. It is simply a receipt for goods of a stated quantity and quality that has been delivered. It evidences receivables. The face value of the bill is payable on settlement day.

Tradesmen follow a long-established merchant custom in allowing for the time it takes to sell the underlying merchandise. Producers of semi-finished goods rarely quote or charge cash prices. They quote and charge *discounted* prices, payable at a later date specified on the face of the bill. The usual term is "three months net". This is based on the fact that goods will reach the ultimate gold-paying customer in less than 91 days. This number, 13x7, is simply the length of a season of the year.

Abstractly, a *real* bill:

* has no lender and borrower
* is not capital/money. Rather, it is a receipt: it documents an exchange which is only half-complete.
* has no rate of interest, even zero.
* involves neither funding nor financing. It involves the *Principle of Clearing* which states that each tradesman is paid for value added, ***after the sale of the finished product***, from the proceeds.

One day the banker calls on the spinner. He offers to purchase (he uses the word "to discount") maturing bills in the spinner’s possession. The banker explains that he will shoulder the cost and the burden of collection at maturity. In the meantime the spinner can put the cash to immediate use. The spinner cannot resist the temptation. He endorses the bills on the back, thereby transferring his rights to the banker. Again, it is important to see that there is no lending or borrowing involved, nor is financing or funding. None of the previous arrangements has been disturbed by the transfer.

The banker applied a "discount" equal to the number of days to maturity times the "discount rate" to the face value of the maturing bill when he purchased it from the spinner. It is of utmost importance to distinguish the discount rate from the rate of interest. The discount rate is always the lower of the two. Moreover, the discount rate tends to be low if consumer confidence is high, and high if consumer confidence is low. To discount a real bill is not a lending function of the bank. It is a clearing function. The bank could never get into trouble on account of its clearing, although it can on account of its lending activities. This is because, to repay the lending bank, a borrower must invade the pool of circulating gold coins and withdraw an equivalent amount from a bank to repay the loan at maturity. If too many loans mature at the same time, there is a problem. Some borrowers may find it difficult or impossible to withdraw gold, and defaults may cascade. It is not the contraction of the money supply that causes prices to fall, but the financing of circulating capital through bank loans rather than real bills.

The real bill is a self-liquidating paper. The obligation is liquidated with the gold coin of the final consumer, not with a gold coin withdrawn from circulation by the borrower.

# The Producer/Warehouser/Speculator Commodity Model

Of all the assets with a futures market, not all are commodities. Of all the commodities with a futures market, not all are warehousable. Lettuce, for example. Those commodities, such as grain, or gold since 1970, which can be warehoused, have a basis. (Before 1970, there was no futures market in gold.

## Basis

The following material derives mainly from [writings of Antal Fekete](http://www.financialsense.com/editorials/fekete/main.html), in particular, his *The Rise and Fall of the Gold Basis* [1](http://www.financialsense.com/editorials/fekete/2006/0623.html) [2](../../MacroEconomics/Money/Antal%20Fekete%20-%20writings/20060623%20THE%20RISE%20AND%20FALL%20OF%20THE%20GOLD%20BASIS%20-%20Fekete++.html).

***Basis is the spread between the nearby (rather than distant) futures price and the cash price***.

Basis = (Spot - NearFuture(time)) = - SwapRate    in $/troy ounce/year . But, [regrettably, there is confusion about its sign](../../Macroeconomics/Money/Antal%20Fekete%20-%20writings/BASIS_and_the_negative_thereof.html)! [[1]](#footnote-1)  
             (NearFuture should relate closely to the gold lease rate minus the eurdollar rate.)

There must be a futures market, and it must be possible to warehouse the commodity -- for basis to be defined.

When NearFuture is more costly the commodity is in *contango*.

When NearFuture is less costly, the commodity is in *backwardation*.

#### Items affecting the Basis

The principal considerations affecting basis are:

|  |  |
| --- | --- |
| Interest rate on borrowed money |  |
| Storage Costs | To store nitrogen, grain, water, oil, each has its costs. |
| Risk of loss | Stored material can be stolen, can rot, can require atmospheric conditioning, … |
| Supply Shock |  |
| Demand Shock |  |
| Risk of War or Natural Disaster |  |
| Risk of Arson |  |

#### Basis for Specific Commodities

Normally a commodities market would be in backwardation due to the interest costs and risks on money over the 3 months the buyer had to wait for the goods to arrive.  A commodities market would be in contango when the interest and storage costs and predominate. It might go into contango for seasonal and/or market shortage.

|  |  |
| --- | --- |
| **Commodity** | **Basis** |
| Gold | Gold is expected to be in backwardation.[[2]](#footnote-2) |
| Silver | positive = in backwardation = the future is at a discount i.e.  (Spot > NearFuture)  However, [it was](http://www.silveraxis.com/basis.html) briefly negative in Nov 2006 and Feb 2007. |
| Oil | positive = in backwardation = = the future is at a discount i.e.  (Spot > NearFuture) |
| New World or Orient spices in Europe in 1650 | positive = in backwardation = = the future is at a discount i.e.  (Spot > NearFuture) |

Realtime basis data is hard to find. [Here](http://www.silveraxis.com/basis.html) it is for Silver. See section on lease rates.

### Supply-shocks

Speculation and warehousing combine to meet the ever-present challenge of the fickleness and niggardliness of nature. Warehousemen must ration scarce storage space among competing uses.[[3]](#footnote-3)

Briefly stated, man is in a continual struggle with supply-shocks in the market. They come in two varieties: *bumper crops and crop failures*. The former is the Nemesis of producers, the latter that of consumers. Either way, the whole society suffers. However, supply-shocks can be mitigated through foresight, organized speculation, and intelligent warehousing. The fulcrum is the activity of **warehousemen** who, following the example of Joseph, allocate scarce storage space in a most efficient manner in order to provide for future contingencies.

Their talisman, enabling them to perform this job successfully, is the *basis*. It is a seismographically most sensitive instrument to provide information in a most concentrated form. It makes for an early warning system exposing potential supply shocks threatening society. Moreover, the basis also digests information such as the producers’ estimate of what is a good price for their product, comparing it with the speculators’. The basis picks up all signals, including producers’ forward sales and speculators’ purchases of futures contracts, bringing the two into balance. The question arises how this can be accomplished.

The answer is: through arbitrage. Floor traders hedge their sales and purchases of distant futures as they simultaneously do the opposite transaction in nearby futures. The basis registers and harmonizes all signals coming from all markets trading that particular commodity. One cannot help but admire this fine communication system through which potential supply-shocks, ever present due to risks inherent in nature, are mitigated by the “invisible hand”as directed by the basis.

### Stocks to Flows Ratio

As a mental experiment let us arrange all goods in a linear order starting with

1. **agricultural commodities** exposed to supply-shocks to the greatest extent, reflecting the fickleness of nature. Next in line are
2. **base metals and other minerals**, as well as energy-carriers which are exposed to supply-shocks to a lesser extent. Finally at the far end of the spectrum we put
3. **the monetary commodities** virtually immune to supply-shocks.

Gold, in particular, has a stocks-to-flows ratio which is a high multiple variously estimated between 50 and 80.

### Demand-shocks

One might assume that, as speculation can counter the untoward effects of nature’s *supply-shocks*, it can also meet the challenge of man’s *demand-shocks*.

But in the case of risks inherent in nature, all speculators start off with an equal chance to be successful. *No “inside information” is available to anyone.* In the case of risks artificially created by government in deliberately destabilizing foreign exchange and interest rates, speculators pit their wits against that of central bankers.

## Lease Rates

Xxx <http://www.kitco.com/market/lfrate.html>

# Monetary Metals

Monetary commodities have several desiderata:

* A
* B
* C
* As indicated above, monetary commodities should be immune to supply-shocks.

xxx

1. See [web](http://chasegalleryconnect.org/FNC_C/Data/Personal%20Finance,%20Investing,%20Estates,%20Retirement/MacroEconomics/Money/Antal%20Fekete%20-%20writings/BASIS_and_the_negative_thereof.html). [↑](#footnote-ref-1)
2. Fekete: I always looked at gold contango as bribe money, to induce people to take the promise instead of the real thing. [↑](#footnote-ref-2)
3. According to *Genesis* the first warehouseman, Joseph of Egypt, provided for the seven lean years by storing the grain surpluses of the seven fat years, following his interpretation of the Pharaoh’s dream: seven gaunt cows devouring seven fat ones. [↑](#footnote-ref-3)