The Gold Standard Institute

The vanishing of the gold basis
and its implications for the international monetary system

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The gold basis is defined as the difference between the nearby futures price and the cash price of gold in the same location. A positive basis is called contango; a negative one, backwardation. Since there were no organized futures markets in gold prior to 1971, the history of gold basis is confined to the last 35 or so years.

Gold futures trading started on the Winnipeg Commodity Exchange in Canada in 1971 at a time when ownership and trading of gold was still illegal in the United States. Upon becoming legal the bulk of gold futures trading moved to New York and Chicago.

For all these 35 years the gold markets have been in contango (with minor exceptions due to temporary friction in the delivery mechanism). The basis cannot theoretically exceed the carrying charge (the lion's share of which is interest, usually calculated on the basis of LIBOR). If it did, speculators would be able to pocket risk-free profits in buying the cash gold and selling the futures contract against it. This arbitrage would quickly push the basis back to the level of carrying charge. By contrast, should the market ever go to backwardation, there is no theoretical limit below which a negative basis could not fall. One should see clearly the economic significance of gold backwardation. It is an unmistakable indication of shortages of deliverable supplies.

On the face of it, backwardation in gold would be a rank aberration of the world economy as most of the gold produced throughout the ages is still in existence in marketable form. For this reason profit is to be made by selling cash gold while replacing it through buying the much cheaper futures contract. If people hesitate to do it, there must be a reason. Indeed, the reason is the lack of confidence that paper gold can be exchanged for physical gold at maturity as specified by the futures contract.

The basis for agricultural commodities shows a clear annual cyclical pattern that closely follows the crop year. It starts with contango just after harvest, and ends with backwardation when supplies are drawn down just before the new crop is brought in.

The behavior of the gold basis lacks this cyclical pattern characteristic of the markets for agricultural goods. Contango obviously follows the fluctuations of the interest rate up or down, the adjustment being practically instantaneous. But, in addition, there is a rather curious phenomenon that can be described as the *secular vanishing of the gold basis*. This means that, as a percentage of the carrying charge (interest) the gold basis has been steadily eroding and by now has all but reached zero. Reversals in the trend, if any, are minor and temporary. It is difficult to imagine any combination of circumstances in which there could be a major reversal in the trend of the gold basis, unless there was an explosion of interest rates.

It is incumbent upon economic theorists to explain the peculiarity of the secular vanishing of the gold basis, which is not observed in the case of the basis of other non-agricultural commodities such as the base metals, for example.

The overwhelming fundamental fact about gold during the past half a century is the steady and relentless absorption of new supplies from the mines through individual hoarding demand. *Half a century of gold production at peak rates of output has disappeared without a trace and is by and large unaccounted for*. This is more gold than had ever been produced previously. At the same time also absorbed was whatever monetary gold governments and central banks have in their wisdom dishoarded. It can hardly be doubted that if further supplies of monetary gold were dishoarded, it would be easily absorbed as well, and any setback in the price of gold on that account would be temporary. One should also remember that net dishoarding of gold by governments and central banks is a thing of the past. Countries such as China, Russia, Brazil, to mention but a few, are on record as wanting to buy all the gold they can without unduly disturbing the price. This means that the combined net private and official demand for gold will be insatiable for the foreseeable future. This is in full agreement with the secular vanishing of the gold basis.

The burning question is what happens when gold markets go to permanent backwardation, as is likely if present trends continue. Clearly, the gold futures markets will be no longer viable as they are presently constituted. The main source of gold for investment purposes will be permanently shut, as a negative gold basis means that all offers to sell cash gold have been withdrawn. To see this we have only to remember that paper gold promising future delivery can no longer be trusted under the regime of a negative basis, as explained above.

The huge volume of trade in paper gold would disappear with the advent of permanent backwardation. The demise of the paper market means that governments and central banks have abruptly lost their power to control the price of gold. They would no longer be able to sell unlimited amounts of futures contracts. Paul Volcker has admitted in public that he made a mistake as Chairman of the Federal Reserve in allowing the dollar price of gold to rise as far and as fast as it did in 1979-1980. By implication, he and his successors have learned from his “mistake” and succeeded in subsequently driving down the dollar price of gold during the period 1981-2001, or to contain increases during the period from 2001 onwards. They did it through offering unlimited amounts of paper gold in the futures markets. As we approach the landmark of permanent backwardation, the question arises how will the Federal Reserve control the gold price once the facility of gold futures trading is gone.

Another question is how the gold mining industry will react to the disappearance of the futures market. There is a possibility that they will stop selling gold against dollars altogether until normalcy returns to the market.

However, an announcement to withdraw the offer to sell newly mined gold would make the upheaval in the gold market even worse.

The implications for the international monetary system, in which the U.S. dollar is supposed to play the role of ultimate means of payment and extinguisher of debt, are devastating. The international monetary system is facing its greatest crisis for the past forty years as it confronts the threat of permanent backwardation in gold. Yet there is no sign that the financial press, or academia, let alone the U.S. Treasury and the Federal Reserve, take notice. They appear to think that the futures price of gold has no more relevance to the international monetary system than that of frozen pork bellies. They are under the illusion that gold has been demonetized. It has not. Not by the people anyhow, who had monetized it in the first place.

This crisis is a gold crisis, just as the last one in 1968 was. If anything, this one is the more serious of the two. In 1968 the crisis could be “papered over”, literally, by making the dollar irredeemable. Debt could still be liquidated in paper dollars *because paper gold was still available*. Presently this availability is the residual extinguisher of debt. Without it the debt markets could not function because bonds would, in effect, become irredeemable.

In 1968 policy-makers at the Treasury and the Federal Reserve were granted a “breathing space” during which they could devise a new international monetary system that would provide for orderly liquidation of debt. One hopes that they have used this breathing space fruitfully, and they have by now contingency plans ready for implementation when permanent gold backwardation engulfs the system and paper gold is no longer available, effectively removing the last “pacifier” from the debt markets.

It is not an encouraging sign that the planning, if any, has been done behind closed doors. There should have been an open debate on the debt crisis that threatens the world as gold markets go to backwardation. A blueprint for a new international monetary system should be drawn up publicly, with the participation of economists of all stripes and persuasion.

Monetary reform should not be the exclusive turf of Keynesians and Friedmanites, according to whom there are compelling reasons to dismiss the gold standard out of hand as unfit, both conceptually and in practice, to play any role in a future international monetary system. They argue that its “disciplines” would be politically unacceptable in today’s world.

However, there is no way of telling what is politically acceptable and what is not in the throes of a great depression, with double digit unemployment, past the teens, when law and order is about to break down. *Our debt crisis and the threat of gold backwardation are not unrelated.* Aggregate debt as it exists in the world today is comparable to a runaway train on a down-sloping track. The train started picking up speed back in 1971 when the golden brakes were disabled. By now it is accelerating beyond any safe speed limit, and a crash appears inevitable. In order to slow the train down one needs an ultimate extinguisher of debt that is universally acceptable as a means of payment. The dollar no longer answers this description. Gold does. Everything else has been tried “to paper over” debt, all in vain. Already, the debt crisis wiped out an enormous amount of wealth indiscriminately, causing great economic pain. We ought to remember that if all the remaining paper wealth is wiped out, gold will still survive intact. It is the only financial asset that has no counterpart as a liability in the balance sheet of someone else. That is its main excellence, a property lacking in all other financial assets.

The hour is late. It calls for statesmanship. This is no time for finger-pointing and rancor.
Having recognized the threat of gold backwardation for what it is: the greatest financial crisis in all history, we should act responsibly.

If we do, it will be our “finest hour”.

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