Gold, Redeemability, Bitcoin, and Backwardation

April 3, 2013 | Author Keith Weiner

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I recently released a video about the Internet-based currency, Bitcoin. I asked the question: is Bitcoin money? **In brief, I said no it's an irredeemable currency.** This generated some controversy in the Bitcoin community. I took it for granted that everyone would agree that money had to be a tangible good, but it turns out that requirement is not obvious.This prompted me to write further about these concepts.

A human being has a physical body with physical needs, and lives in a physical world. He produces that he may eat and clothe and shelter himself. Once civilization develops beyond subsistence, men specialize to increase their production. Each relies on others, who specialize in other fields. Each trades his products for the goods produced by others.

A problem arises, called the *coincidence of wants*. One man produces food and another produces leather moccasins. When the moccasin producer is hungry, the food grower may not need new shoes. Mr.Moccasin must discover that some goods are more *marketable* than others. He can trade less-marketable moccasins for more-marketable salt, for example. He may not need the salt (though he can always use it) but he knows it is accepted in trade for food and other goods.

Eventually, a market process finds the most marketable good. It becomes even more marketable due to its increasing use as money (but it does not lose the attributes that made it useful in the first place).

People accept the monetary good in trade because it fills one of three needs. They will exchange it for something else later. They may want it for its own sake. Or they may accumulate a hoard during their working years so that in retirement, they can dishoard to pay their bills.

Modern civilization layers a complex financial system on top of the monetary good. It has bills, bonds, and savings accounts, etc. Most people do not want to redeem most paper credit instruments, for reasons of convenience and the preference for an income. However, it is important to keep in mind that the possibility of redemption is necessary and essential to a working financial system. Everyone must choose for himself the right balance between holding the monetary commodity directly and various earning assets that promise to be redeemed in a quantity of the monetary commodity in the future.

Only this balancing process can perform one particular and critical function. **Hoarding, also known as managing risk, has played a vitally important role throughout human history (and which is almost unappreciated by the economics field).** Hoarding and investing are balanced by risk tolerance. In a free market without central banking and bailouts, everyone must think of risk.

To the economist, redemption of paper and hoarding of the monetary good, serve to police and clean the system, force the write-offs of bad credit (as opposed to letting them accumulate), and of course empower the saver to enforce his interest-rate preference. This last, is a point that I have not seen anyone make prior to Professor Antal Fekete, and which is under-appreciated today.[1]

Addendum, by PT:

To the hoarder himself, hoarding looks and feels very different. He is thinking of having something tangible in hand. A coin in his pocket does not have a risk, it can be carried anywhere, and can be accumulated in a safe place. **To anyone aware that he is living in the physical world, there is no substitute to having a physical, tangible commodity.**

Today, of course, legal tender laws obscure most of the above. The monetary commodity is not allowed to do its job, and we're lucky that after they removed it from the monetary system they at least once again legalized its ownership for American citizens. **Even so, most people regard owning gold as a risky speculation because its dollar price is volatile. It's madness.**

Returning to the question of Bitcoin, we have a conundrum. Bitcoin is not debt. In that sense, it is like gold—there is nothing to redeem **because the thing is the final good.** Unlike gold, it is not a tangible good. You cannot hold it or stack it in a safe in the floor. Other than the value you hope it has in trade, it has no utility by itself.

Bitcoin in this context is like an attempt to reverse cause and effect. **Gold is money because people strongly desired it for its physical properties and then, subsequently, discovered that it was the most marketable good and thus useful as money.** Bitcoin bypasses this and attempts to go straight to being money. Should hackers break its cryptography, the Internet go down for a few months, or any number of other scenarios occur, the above logic will reassert itself.

Bitcoin has recently gone bonkers. This is to say, even more so than previously. [Last time we wrote about it, it was at $70]; evidently, it was still a buy at that level. See for yourself:

Bitcoin continues to go parabolic – via bitcoinchart. And there we thought that last year's rally was spectacular, but it was really nothing compared to what has happened in 2013 so far – click for better resolution.

As trading sardines go, this has to be one of the best trades of the past few years, **but certainly it is a bit eerie that mere code is becoming such a bubble** (even if the amounts traded are relatively small).

Owning Bitcoin is to be in a partially completed transaction. **Until it is exchanged for a tangible good in another trade, the owner of the Bitcoin is in the position of having given up something tangible for nothing in return.**

I made the point, in a previous video that redemption is not the same thing as purchasing the monetary commodity. Prior to 1933, one could go to any branch bank of the Federal Reserve and exchange dollars for gold. This was not "buying" gold, but redeeming the dollars. One accepted the dollar bill in trade, with the sure and certain knowledge of the terms (e.g. gold value) of redemption. Unlike then, today the dollar can be used to buy gold. But there is no way to know the terms—or indeed if one can even make the purchase at all—until one attempts the transaction.

It is the same with Bitcoin.

Now that I have used Bitcoin as the foil to establish several points, let's look at the dollar and its ability to buy gold. Consider the following points that I discussed at greater length in this video:

1. irredeemable debt-based currency provides no way to extinguish a debt
2. the dollar itself is a debt instrument
3. payment in dollars merely transfers the debt
4. all debt is borrowed at interest
5. eventually, the interest cannot be paid out of income
6. the only way to pay the interest in aggregate is further borrowing
7. total debt in the system grows exponentially until it cannot

The system is designed to drive all participants to bankruptcy! "This is," as they say in technology industries, "a feature, not a bug".

In this light, the problem is not the rising quantity of dollars per se (though endless issuance by the Fed is certainly not good) but its falling quality. It is all headed to default when the debtors cannot borrow any more. This point was reached in Greece, but it is years away in the United States.

One might be tempted to ask why the banks and financial institutions don't recognize this and refuse to do business in dollars. The answer is that they are regulated, they ultimately answer to investors who believe in dollars, and they are given perverse incentives to continue to play the game. For example, they can borrow short at near zero from the Fed, and lend long at near 2% to the Treasury. This transaction creates no wealth, but the banks engaging in it earn "profits". They are fat, dumb, and happy to make this spread and many others like it.

So who understands it? The lowly gold hoarder does. His challenge is that he is sometimes distracted by the mainstream message that gold is a risky commodity that cannot be used to buy bread. He is often distracted by the gold bug message that the rising gold price is a "profit" (and the falling price is a conspiracy). If he can see through these two mirages, then he can see that all the credit in the system must inevitably and inexorably crash to earth like too many rocks impossibly kept aloft for a while by a juggler who exceeds his limited skill.

"Money is gold and nothing else," as JP Morgan famously said in testimony before Congress. When bad credit eventually is repudiated, gold will still endure.

This is the context to my argument: permanent gold backwardation is a late symptom of the terminal monetary disease. Like jaundice in a cancer patient, signaling to the doctor that the patient is in immediate risk of death by liver failure, permanent backwardation signals to the economist that the monetary system is in immediate risk of death by gold withdrawal.

The dollar is not strictly redeemable, but it can still be used to buy gold. This provides an "escape valve". Those who wish to convert their irredeemable paper into the monetary commodity, to complete the transaction of trading their product for dollars and dollars for the monetary commodity, can still do so.

Backwardation is when the price of a commodity in the futures market is lower than the price in the spot market. Anyone who has the commodity can make a profit by simultaneously selling the commodity in the spot market and buying a future to recover his position. This trade has no price risk, credit risk, or even spread risk. The only risk is default. Permanent backwardation is when all futures contracts fall below the spot price, and the gap keeps widening no matter how much the price rises.

The existence of now-chronic temporary backwardation, is proof that gold owners are starting to become reluctant to trust the dollar system, and the lure of profit is insufficient. If they do not trust the delivery of a future, then they have to question if they will be able to buy gold on any terms. In an environment of collapsing credit and bankruptcies, this lack of trust will be quite well founded.

The final stage is brought on by the complete withdrawal of offers to sell gold for dollars (i.e. the gold bid on the dollar). Collapse will come swiftly because of asymmetry. While no gold holder will then want dollars, some dollar holders will desperately want gold. They will buy any goods that have a gold bid. The trade of dollarsàcommoditiesàgold will drive the prices of commodities up to any arbitrary level in dollar terms, and down nearly to zero in gold terms. Oil could become $1,000,000 per barrel and 0.0001 gold grams per barrel at the same time. This process will continue until sellers of commodities will no longer accept dollars.

The dollar is fiat, which means imposed by force. It is debt-based, which means its value derives from the efforts of the debtors to continue to pay. And it is irredeemable which means there is no way for debtors, in aggregate, to get out of debt, and no way for creditors to know the terms by which they can get gold. The government uses force to impose the contradiction of a debt-based currency that cannot extinguish debt. People would not accept it otherwise!

The final resolution of such a contradiction is total collapse.

For those interested in tracking the backwardation occurring in both gold and silver right now, Monetary Metals publishes The Last Contango Gold Basis Report (free registration required).

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One Response to "Gold, Redeemability, Bitcoin, and Backwardation"

- *georgew:*

  April 3, 2013 at 16:47

  I always enjoy your articles Keith. I have some questions:
  1. When von Mises asked the question, why Gold?, the only answer needed is "because the market chooses it". One could observe that the gold stock is quite large compared to

yearly production, and that may be useful to consider, the salient point is that the market chooses it, not trying to theorize (even if probably correctly), why.
2. "To the economist, redemption of paper and hoarding of the monetary good, serve to police and clean the system, force the write-offs of bad credit (as opposed to letting them accumulate), and of course empower the saver to enforce his interest-rate preference."
It doesn't seem to me, though certainly I may be mistaken, that this is relevant to the free market. For example, if I have a bad debt, I can choose to recognize that whenever I want, but the capitalized loss has already occurred. If I am, or to the degree that I am correct, I'd say advocating something to partially mitigate the nefarious and insidious practices legalized by our Govt is in fact advocating those policies.
3. I am not sure (haven't thought about it enough or seen all arguments) if I agree or not with your opinion on bit coin. My initial impression is that it is like bank notes, and the market will value them to the degree the reputation of the provider is trusted. If we ignore the current problems of the monetary system, which impacts everything but hard assets, it would seem it is identical to bank notes. Perhaps it is the current monetary system which clouds the issue.

Log in to Reply

In a Gold Standard, How Are Interest Rates Set?

By **Keith Weiner** on January 1, 2013 in **Gold**

Today, short-term interest rates are set by the diktats of the central bank. And long-term interest rates are set in a "market" in which the central bank is obliged to keep coming back to buy ever more bonds, and speculators front-run the central banks to buy ahead of them. The result has been that, for 30 years and counting, the bond price has been rising, which is the same as to say that the rate of interest has been spiraling into the black hole of zero. When it gets there (and probably sooner) the entire monetary system will collapse.

This is the terminal stage of the disease of irredeemable paper currency. They have banished money (gold) from the monetary system, and the result is a positive-feedback-loop that destabilizes the rate of interest. The rate of interest has a propensity to fall, just like the value of the paper currency itself.

This leads to the question of how interest rates are set by a free market under a gold standard. This is a non-trivial question, and the answer is profoundly important as we debate what sort of role gold ought to play and evaluate the various gold standards being proposed.

If people are free to own gold coins directly, then the mechanics of setting the rate of interest are simple. Let's define a term. The marginal saver is the saver who could go either way, either holding a bond or a gold coin. If the rate of interest ticks downward, he will sell the bond (or withdraw his money from the bank, thus forcing the bank to sell the bond) and buy the gold coin. He would rather hold the gold than commit to the time and risk for such a low interest rate. If the rate of interest ticks upward, he will buy the bond (or deposit his coin in the bank).

The marginal saver sets the floor under the rate of interest. It cannot fall below his preference or else he will vote with his gold. His preference has real teeth (unlike today).

Now let's define one more term. The marginal entrepreneur is the entrepreneur whose rate of profit is the lowest possible, while still being viable. If his profit falls for any reason, such as due to a rise in costs, he will shut down his enterprise. One cost is the cost of capital, i.e. the rate of interest. No entrepreneur can borrow at a rate higher than his rate of profit, and the marginal entrepreneur is the first to buy the bond and sell his capital stock at an uptick in the rate of interest. He is the first to sell a bond and buy capital stock at a downtick in the rate.

The marginal entrepreneur sets the ceiling over the rate of interest. It cannot rise above his ability to pay, or else he will vote with his capital stock. He also has teeth.

Under a proper gold standard, the rate of interest is kept in a band that is not only narrow, but which is also stable over long periods of time. This is the principle virtue of the gold standard. It does not fix the level of prices, which would be neither possible nor desirable. It keeps the rate of interest consistent, which serves the interests of wage earners, pensioners, and other savers, and of entrepreneurs whose work provides the goods, services, jobs, and interest payments that on which everyone else depends (and which they take for granted).

When evaluating any proposed gold standard, one should ask the question: how will it determine the rate of interest?

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The Precise Definition of Inflation

By **Keith Weiner** on February 22, 2013 in **Core Economic Concepts**

Communicating about money and finance in today's culture is a real challenge; you want to inform and enlighten your audience on their level of knowledge—but this makes the use of terms extremely difficult. Ayn Rand Institute President Yaron Brook's recent video about deflation demonstrates why.

In the video clip, Dr. Brook makes two key points. First, there is nothing bad about rising productivity and the consequence of falling prices. Second, there are no big credit collapses in a free market. I agree. These are important ideas that people need to hear, especially those receptive to free markets.

However, I have a concern regarding the word deflation.

When it comes to this type of communication—a presentation about a specific concept—clear thinking and precise language are essential. Using one word to describe both rising productivity in a free market and defaulting bad credit in a mixed economy does not advance our understanding of monetary science. Ayn Rand called this a package deal, which is basically taking two dissimilar things that have a superficial similarity and putting them into the same word.

Similarly, people often use the term inflation to mean rising prices, and then hold this up as the worst problem of the dollar system. Rising prices is not the main flaw with the dollar (it isn't even in the top five list).

The root problem with the dollar is that it is irredeemable. It's a promise to pay—a debt instrument—that can never be called, and will never be honored. Dollar-denominated debt can never be extinguished. Using a debt instrument to pay off a debt merely transfers the debt.

Let's suppose that John owes money to Sue. So he pays her $1,000. John is now out of debt, but the debt does not disappear. The Federal Reserve now owes Sue $1,000. Next, she deposits it in a bank. Then the bank owes her and the Federal Reserve owes the bank. The lump can be moved around under the rug, but it's still under the rug.

Every dollar was borrowed into existence. Borrowing always comes at interest. The catch is that, like all debts, accrued interest cannot be paid off. It is necessary to borrow more to make the payment.

This is why total debt must rise exponentially. What happens when the interest cannot be paid out of income? In the current phase, the debtor must sell new bonds to pay the interest and principal due on every bond as it matures. What happens when the last and biggest bond market, the U.S. Treasury bond market, fails? We don't want to find out.

Taking a step back, we do not concede the definition of important concepts such as selfish to cater to a populist view. We point out that lying and stealing—which many wrongly describe as selfish—ultimately serve to destroy, not advance, one's self-interest and are therefore selfless. **Though genuine self-interest does include the desire for money, self-interest is about productiveness.** Stealing is only superficially similar to being productive. Both are ostensibly undertaken to obtain money. But they are really opposites.

Similarly, the word deflation does not mean falling prices. As Dr. Brook explains in his video, there are at least two reasons why prices may fall; one is that productivity always rises in a free economy (and nothing needs to be done about rising productivity, as Dr. Brook notes). Another is when the central bank in a mixed economy forces a credit expansion, soon enough loans begin to default and credit contracts. These are two distinctly different phenomena that should not be bundled into one word.

I propose that inflation be defined as an expansion of counterfeit credit. Legitimate credit is when the saver is willing and the borrower has the means and intent to repay. If a loan is made when any of these elements is missing—which can only happen with the initiation of force or fraud—then what we have is counterfeit credit. Sooner or later, counterfeit credit always leads to defaults. **I propose that the word deflation be used to denote forcible (i.e., involuntary) contraction of credit: a default.**

By now, everyone should realize that the dollar is failing. **Defining inflation and deflation in terms of issuance and default of bad loans makes the reason clear.** Defining these terms as rising and falling prices confuses the issue.

This raises another, related issue. In the video, Dr. Brook says: "Today, you have this massive credit contraction … these deflationary pressures where money leaves the system, the amount of money in the system is contracting because banks on systemic scale are contracting the amount of loans that they are providing…"

This conflates money and credit. Testifying before Congress, J.P. Morgan famously said, **"Money is gold, and nothing else."** Obviously, **gold is neither created nor destroyed in the banking system.**

Banks create credit. This is why banks exist. If loan defaults are rising, then banks are unable to expand credit and instead total credit in the system is contracting. This occurs whenever new loans are less than defaulted loans, which are written off. Credit, not money, is leaving the system.

Today, money is excluded from the system by law. **The system is supposed to function on credit only. This makes it easy to confuse these different concepts and I think one could make a strong case that this confusion is deliberate.**

The distinction between money and credit is not necessarily important to every discussion, but it is vitally important in a discussion of our monetary system. Credit cannot perform the job that must be done by money—**to extinguish debt. Credit**—especially counterfeit credit—can be created by the stroke of a pen and it can go out of existence when a debtor fails to pay for any reason.

We are fighting for nothing less than the survival of civilization. The irredeemable dollar is in the process of collapsing. If gold and silver do not begin circulating prior to the dollar's terminal impact, we risk plunging into a new dark age. Our food production and distribution industries depend on credit, and deliver the goods just in time. A credit collapse could result in massive food shortages.

Many have tried and failed to promote the gold standard before now. There are a multitude of reasons why the gold standard has not been adopted, **but the focus on prices is not a winning strategy to advance the cause of gold as money.** Prices have been rising for decades. People accept this. Whether or not they are happy about it, they see no cause for alarm. We urgently need the gold standard, not because of rising prices, but because of an impending collapse of credit.

The Curious Case of Falling Gold and Silver Prices. Part II

Basis Report – February 23, 2013

> Oops, the link to the video was omitted. It is here:
> https://www.youtube.com/watch?feature=player_embedded&v=IYJQJAU-YxE#!

1. **JR**February 25, 2013 at 1:46 pm#

   Inflation is the quality of bank credit declining.

   Deflation is the quality of bank credit declining.

   They are the same thing, hence the total confusion. It depends on which banks' credit you are taking as the measure.

   It is analogous to saying a piece of wood is one metre long & a metre is one piece of wood long.

   Reply

   - **Keith Weiner**February 25, 2013 at 3:03 pm#

     JR: That's good, they are both declining credit quality–of different banks!

     Reply

     - **JR**February 25, 2013 at 11:47 pm#

       Yes, you can't make an objective measure of value with a subjective measure of value. Value is given by quality, so only a standard of quality can make an objective measure of value.

       Inflation of say, the stock market, in $ terms IS deflation of the $ in terms of stocks. The stock market crash in '08 was a hyperinflationary nightmare for those who had been eyeing off that sleek yacht at the marina, based on their stock portfolio, in '07.

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Guest Post: Dollar Backwardation

By *Tyler Durden*
Created *05/23/2012 - 13:51*

 [1]

Submitted by Tyler Durden [1] on 05/23/2012 13:51 -0400

Submitted and © by Keith Weiner of the New Austrian School of Economics

Dollar Backwardation

The current financial crisis, may progress to a phase where people demand and hoard dollar bills but take electronic deposit credits only at a discount which increases until electronic deposit credits are repudiated entirely. The Federal Reserve would be powerless to solve the problem, because while they can create unlimited electronic deposit credits they can't create unlimited paper dollar bills, "money you can fold" as Professor Antal Fekete calls it. There would be a glut of electronic deposits, but a shortage of dollar bills.

Before the financial crisis metastasized in 2008, Fekete wrote a paper that I think is underappreciated and under-discussed. "Can We Have Inflation and Deflation at the Same Time?" (http://www.safehaven.com/article/8507/can-we-have-inflation-and-deflatio... [9]) In his paper, he discussed the "tectonic rift" between paper Federal Reserve Notes (i.e. dollar bills) and electronic deposits. By statute, the Federal Reserve cannot print dollar bills without collateral (e.g. Treasury bonds). Also, they have limited printing press capacity that is insufficient to keep up with a catastrophic crisis.

He discussed the inverted pyramid of John Exter. Gold is the triangle at the bottom, and then above is silver, dollar bills, and then the various kinds of electronic deposits, stocks, real estate, etc. In a crisis, people want to move from top to bottom of the pyramid, but of course there isn't enough of the stuff at the bottom.

In a scenario in which desperate, panicky people are trying to cope with the enormity of a collapse that they don't and can't understand, I think this split between "physical" dollars and "electronic" dollars is very plausible.

Just as there is nothing to be accomplished by selling an underlying security as it becomes worthless, only to buy a derivative of it, selling Treasury bonds and buying dollars is equally nonsensical. The dollar is the Federal Reserve's liability, backed by the Treasury bond as the asset. If you believe the Treasury bond is worthless, then you ascribe no value to the dollar either. This is why gold will go into permanent backwardation. Holders of dollars will provide an unlimited bid for gold that will not be reciprocated by holders of gold. The latter own the only safe asset, and the only monetary asset that is not ultimately backed by the Treasury bond or the dollar, and they will have no desire to give it up.

The concept of backwardation is simple. It is when people accept a future promise to deliver only at a discount to physical stuff handed over right now. This could be when there is a shortage, such as wheat before the harvest. Or in the case of gold, backwardation signifies a collapse in trust. But isn't this the same phenomenon of a tectonic rift between paper dollars and electronic deposits?

In a certain sense, the "money you can fold" behaves like a physical commodity, a present good (I realize I am stretching the concept here more than a bit). The electronic deposit credit is most definitely a future promise. In my gold backwardation thesis, the action begins with the offer on the futures contract falling below the bid on spot gold. The bid-ask spread on spot gold widens, as the offer is relentlessly advancing, pulling the bid behind it. The bid-ask spread on the futures contract also widens, as the offer remains stubbornly high, but the bid withdraws and retreats as gold buyers don't trust futures and buy physical gold instead. Eventually, there are no more sellers of physical gold and that is that (except for the dollar-commodities-gold arbitrage, a backdoor way for dollar holders to get a little gold before the end of the game).

If this split occurs in the dollar, I think it will play out the same way. At first, sellers of real goods may accept electronic credit money, but demand a higher price. The spread on the electronic dollar widens, with the bid from real goods falling. At the same time, virtually unlimited demand for the "real" paper you can fold causes the bid on the paper dollar to rise.

Who knows how long it could last? People could go on accepting paper dollars out of long habit. Obviously, this is an unstable situation that must necessarily collapse. Unlike gold, the paper dollar has no value other than the broken promises that back it.

I dub this "dollar backwardation".

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The Chaos in Real Estate: http://www.acting-man.com/?p=22500#more-22500