A View from the Trenches

Toronto, Tuesday, February 26, 2013

This is the second of three articles I am posting on the suppression of gold. In the first article I showed that, **under mainstream economic theory, the suppression of the gold market is not a conspiracy theory, but a logical necessity, a logical outcome.** This second article will show how that suppression takes place**.** Those familiar with the gold market will likely find nothing new. **The third article will examine the implications of this suppression and support the claim of the gold bugs, namely that physical gold will trade at a premium over fiat gold or gold paper is also not a conspiracy theory, but the logical outcome of the current paradigm.**

How they do it: The concept

The popular notion, which central bankers would love to destroy, is that gold is a good hedge against inflation. In its simplest form, gold cannot be printed and, as its supply remains anchored, its price should spike if the supply of fiat money increases. The implicit math behind can be represented as follows:

Given a constant demand for money…

$$\frac{\text{1 Au oz}}{\text{1 USD}} = f\left(\frac{\text{Monetary base } \mathbf{usd} \times \text{Credit multiplier } \mathbf{usd} \text{ (includes shadow banking)}}{\text{Stock of Au ounces outstanding}}\right)$$

The equation above shows the price of gold, in terms of a fiat currency (in this case, the US dollar) as a function of the relative supplies of gold and the US dollar. In the case of a fiat currency, its supply is the product of two factors: the monetary base created by the respective central bank and the corresponding credit multiplier. This multiplier reflects every single mean by which the original base is expanded, through the banking system and the shadow banking system.

If the equation above was indeed representative of the state of affairs we're in, there would be no room for manipulation. The supply of gold, in terms of ounces available, could be perhaps capped or confiscated, but not expanded. The price of gold, therefore, could not be suppressed.

Now that we know what cannot be, let's understand what really is happening. To suppress the price of gold. central bankers, simply, have invented a new currency: Fiat gold. The math involved in it now is:

Given a constant demand for money…

$$\frac{\text{1 Au oz}}{\text{1 USD}} = f\left(\frac{\text{Monetary base } \mathbf{usd} \times \text{Credit multiplier } \mathbf{usd} \text{ (includes shadow banking)}}{\text{Stock of Au ounces outstanding} \times \text{Credit multiplier } \mathbf{Au}}\right)$$

As you can see from the second equation above, the genius of central bankers was not to forbid gold but to morph it into another fiat currency, by adding a credit multiplier to it. With this, it only takes to proportionally expand this credit multiplier faster than the numerator (of the equation) and the price of gold will fall regardless of fundamentals. If they

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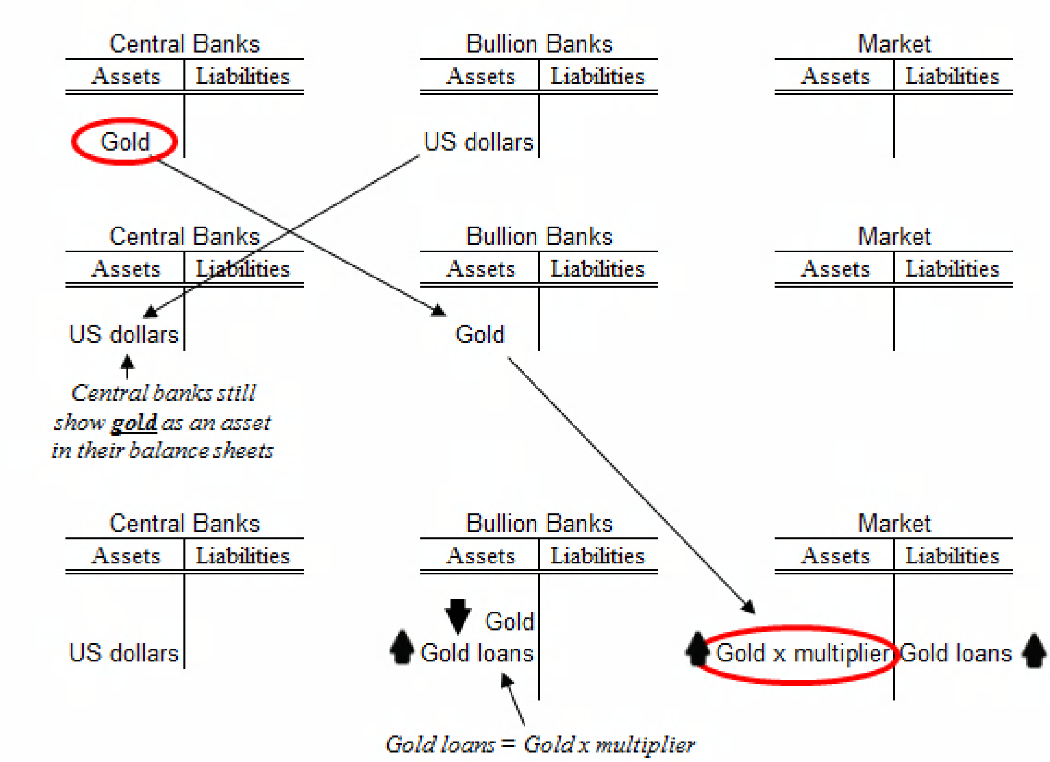
want to go one step further and signal to the public that they can do this with complete impunity and for as long as they please, they then proceed to expand the credit multiplier predictably at specific times of the day (i.e. 8:20am ET).

How they do it: The details

Below, I will describe how the supply of this new currency, fiat gold, is expanded. The motivation for this expansion was already explained in the previous article. Below, I present the steps included in the expansion of the supply of fiat gold. In the next article, I will elaborate on the graph below, addressing its implications and consequences. But today, let's just look at the mechanics:



The above graph shows the aggregate balance sheets of the central banks, bullion banks and the gold market. Bullion banks handle transactions in precious metals and, in this case, in gold. As you can see, central banks hold gold as part of their assets. However, they can swap their gold holdings for liquidity, for US dollars. This swap is a mere exchange and is shown as step 1, in the graph. The official explanation is that such swaps would have temporary liquidity management purposes, because they remove US dollars from the market (i.e. from the Bullion banks). At a later date, not shown in the graph, the Bullion banks should return the gold to the central banks, and receive US dollars back (including an interest). For this reason, because the swap contract implies the return of the gold at a later stage, central banks are allowed to continue showing the gold they swapped in their balance sheets, as an asset.

Once the physical gold is in the hands (i.e. balance sheet) of the Bullion banks, these banks can create loans against it, supplying the market with fiat gold. This is shown in step 2. Gold is debited and Gold loans are credited. The ultimate

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amount of gold loans outstanding is obviously a factor of the credit multiplier in fiat gold. The higher the multiplier, the higher the supply of fiat gold in the market and the pressure on the price to come down.

The anxiety around this issue is noticeable and the big questions are: *How far can central banks go with this manipulation? How long can it last? Is there a mechanism by which the market should revert to fundamentals?* **I will devote the next letter to the last question**. With respect to the first ones, all I can say is that central banks can go very, very far with the manipulation and can last longer than you or I are willing to believe. Why? Because unlike the case of other currencies and their respective credit multipliers, in fiat gold**, the players that demand gold loans are also the ones who transact in gold (i.e. Bullion banks) and dominate the repo market to provide funding (to those ultimately speculating with gold). They are all the same and only a handful. They play a cooperative game among themselves and with the central banks.** The public that holds physical gold or the central banks that accumulate physical gold but do not enter into swaps with the Bullion banks cannot force a contraction in the credit multiplier. By their actions (i.e. hoarding of physical gold), all they can do is to force the rest of the central banks and Bullion banks involved to take a higher risk in the expansion of the multiplier. But they cannot force a rush for delivery. They are, by definition, outside of the system.

How can we protect ourselves from the manipulation?

One way to protect ourselves from the manipulation described above is to simply trade the expansion of the credit multiplier for fiat gold. *At this point, I remind the reader to read my disclaimer. (My comments are not intended to provide personal investment advice and they do not take into account the specific investment objectives, financial situation and the particular needs of any specific person).*

If the supply of fiat gold is a factor of the monetary base in fiat gold and its credit multiplier, one can think of proxies for these factors. In my view, the monetary base is represented not only by the stock of physical gold outstanding, but also by the stock that is to be mined: By the gold miners, collectively. Fiat gold, on the other hand is represented by either futures or gold certificates.

When the manipulation succeeds, the credit multiplier expands. In this case, if I am correct, it should be profitable to be **long the promise to deliver gold and short the monetary base of fiat gold**. **When the manipulation is not successful** or a rush for delivery is triggered, the credit multiplier contracts. Here, if I am correct again, it should be profitable to be **short the promise to deliver gold and to be long the monetary base of fiat gold**. There are many ways to express this trading thesis, but I'd rather leave these speculations to the reader.

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