A View from the Trenches

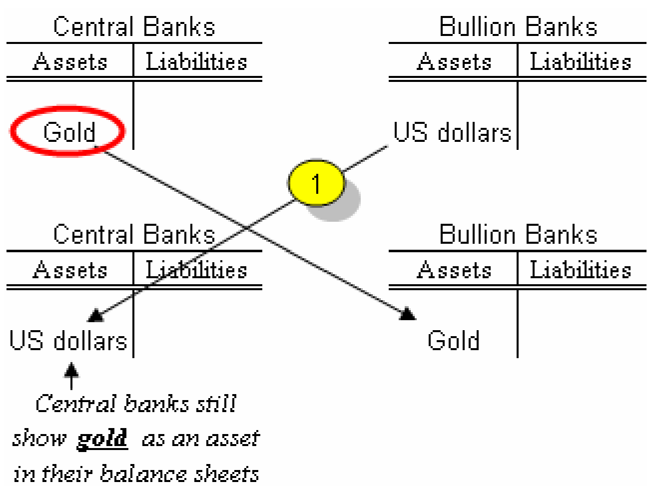
Toronto, Saturday, March 16, 2013

This is the third and last of three articles I am posting on the price 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.** Mainstream economics, framed by the Walras' Law, believes in global monetary coordination which, to be achieved, necessitates that gold, if considered money, be oversupplied. The second article showed, at a very high (not exhaustive) level, how that suppression takes place and how to hedge it (if my thesis is correct, of course)**.** Today's article will examine the systemic impact of this suppression and test the claim of the gold bugs, namely that physical gold will trade at a premium over fiat/paper gold, commensurate with the credit multiplier created by the bullion banks.

I see two complementary ways to approach the systemic impact of gold manipulation. The first one would be to examine how the same affects the relevant prices. The second one would be to analyze the flows involved in the manipulation. With both ways, we should be able to reach a final conclusion on the sustainability of the manipulation. I will not keep the suspense: It is not sustainable. But if it isn't, what is the end game? Without further ado…

Relevant prices involved in the manipulation

From the second article, we know that 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…"* The graph is reproduced below:



Note: Since my last article, Zerohedge raised the possibility that a bullion bank may have its vault adjacent to another one owned by a central bank. In such particular case, the graph above should be revised as follows:

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Central Bank + Bullion Bank with vault adjacent to central bank	
Assets	Liabilities
Gold	

Humor aside and returning to our first graph, we can see that **<u>the swap obtains liquidity in exchange of collateral</u>**. Any profit maximizing agent would weigh placing gold as collateral for cash versus the cost of raising funds in the unsecured market. After all, anyone long gold could sell it, obtain the cash and buy it later, with a gold forward contract. Therefore, the liquidity cost facing (in this example) a central bank seeking to monetize its gold holdings, without selling, is expressed:

Cost of liquidity to a central bank = Min (gold swap rate, gold forward rate)

The gold forward rate is published by the London Bullion Market Association as the Gold Forward Offered Rate (GOFO). This rate represents the difference, in annual percentage terms, between the cash price and forward price of gold. Of course, the expression above implies that the central bank maximizes profit (i.e. minimizes cost). Just like a central bank does when it purchases bankrupt sovereign debt, to stabilize the liquidity in the system… (Temporarily, obviously).

On the other side of the swap, the Bullion Bank that receives gold as collateral must consider the transaction vis-à-vis providing liquidity in the unsecured US dollar market. The price for the latter market is Libor (London Inter-bank Offered rate), which is not really a price (because it doesn't in itself clear anything), but a benchmark (The proof of this statement is simple: If Libor was indeed a price, the aggregate sum of the credit risk –as quoted in the credit default swaps market- of the panel banks that determine Libor should approximate zero. However, this sum is a positive number and far from zero). **Indeed, the collateralized (with gold) lending should not be compared with lending in the unsecured US dollar market.** Here, we have gold as collateral, which at the same time has storage and insurance costs. The benefit for a Bullion Bank for entering a gold swap is therefore expressed:

Benefit of gold swap = Max (gold swap rate, Libor)

When the swap occurs, both the central bank and the Bullion Bank agree on a price, the gold swap rate. Therefore:

Min (gold swap rate, gold forward rate) = gold swap rate = Max (gold swap rate, Libor)

Therefore, for the transaction to take place: Gold forward rate > gold swap rate > Libor

This implies that the GOFO should approximate Libor. Unlike what mainstream economics tells us, exchange does not take place at indifference points along so-called utility curves. The Bullion Bank will either lend in the unsecured US dollar market or through a swap. Choice will happen and will have a cost. Therefore, if it lends via swaps, it has to be more profitable than earning Libor. The question is….what makes collateralized lending more profitable?

The answer is simple: **the Bullion Bank not only earns the gold swap rate, but also a gold interest rate, as it uses the gold it receives to make gold loans. Hence, there is an extra benefit in swapping cash for gold, as the gold is loaned and earns a spread.** As in the case of fiat money, where cash held by banks is used to expand credit, gold held by bullion banks is used to expand fiat gold:

The case of fiat money
with 10% reserve ratio
Bank A

Assets	Liabilities
Cash: $1MM	Demand deposits: $10MM
Loans $9MM	

The case of fiat gold
with x reserve ratio
Bullion banks

Assets	Liabilities
Bullion: $1MM	Gold deposits: $1MM/ x
Gold Loans $1MM* (1-x)/x	

The gold interest rate earned on fiat gold is commonly referred as the gold "lease" rate. This implies that the gold loan is not a loan, but a lease. The terminology is not coincidental. It allows the "leased" gold to be carried on the central banks' books, as if the bullion was still in the vault. But this may certainly not be the case, because while I show gold in the asset side of the ***aggregate*** balance sheet of bullion bank***S*** , this will not necessarily be the case at an individual level. For instance, let's assume that the gold is loaned by what I will call Western bullion banks, but it ends up deposited in Eastern bullion banks. The aggregate position of the Bullion banks can be now shown as below:

The case of fiat gold
with x reserve ratio
Bullion banks

Assets	Liabilities
Bullion: $1MM	Gold deposits: $1MM/ x
Gold Loans $1MM* (1-x)/x	

=

z reserve ratio
Eastern Bullion banks

Assets	Liabilities
Bullion: $800M	Gold deposits: $800M/ z
Gold Loans $800M* (1-z)/z	

+

y reserve ratio
Western Bullion banks

Assets	Liabilities
Bullion: $200M	Gold deposits: $200M/ y
Gold Loans $200M* (1-y)/y	

Where z > y AND $800M/z + $200M/y = $1MM / x

At this time, it is important to understand the difference between gold swaps and gold loans. The graph below should help visualize it:

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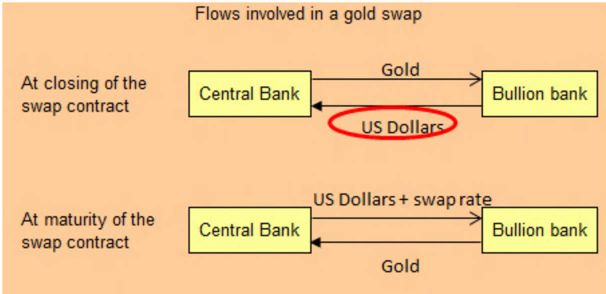
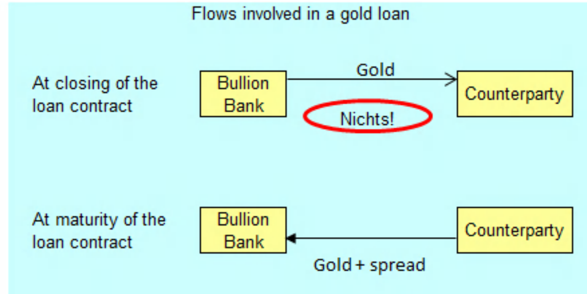
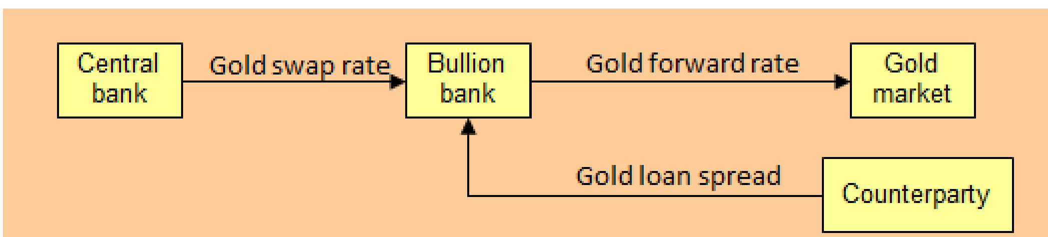




As can be seen, in a swap, the party that facilitates the bullion receives cash upfront. That cash is absent in a loan. This may be a reason for central banks to prefer swaps over loans: The swaps can become a liquidity management tool. They can be used for sterilization. As long as the gold swapped does not end up being sold in the spot market, gold swaps should be neutral to the price of gold.

From the perspective of a bullion bank, the gold loan leaves it "short bullion" vis-à-vis the gold swap obligation entered into with central banks. To hedge this risk, the bullion bank can use the gold swap rate received from the central bank to buy gold on a forward basis:



For the bullion bank to profit from a gold loan without the risk of being short bullion:

(Gold swap rate – Gold forward rate) + Gold loan spread > 0

In practice, Bullion banks quote these loans as: Cost of funds + x bps, where the cost of funds is defined as (Libor – Gold forward rate), for the applicable tenor (i.e. 3 months). **This cost of funds is what is popularly called the Gold lease rate.**

As bullion banks seek to hedge their gold loan counterparty risk, their demand for gold on a forward basis should raise the gold forward rate to the point where it is no longer profitable to expand the credit multiplier on fiat gold. That point can be expressed below as:

(Gold loan spread + Gold swap rate) < Gold forward rate

The pressure on the futures market for gold should therefore be the stabilizing mechanism that limits the expansion of fiat gold. However, this is only so under a static perspective. The dynamics of the process also involves gold miners. If, for instance, due to the expansion of fiat gold, the spot price of gold fell

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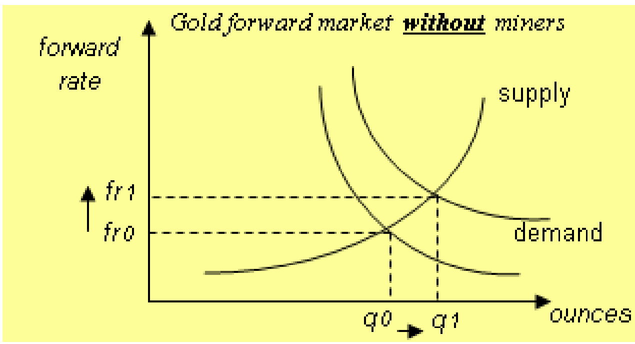
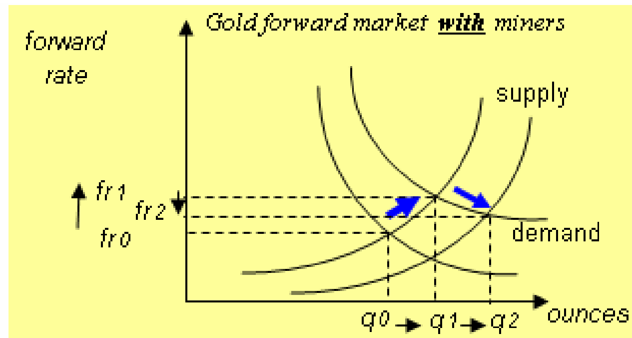
significantly, affecting the margins of miners, we could see consolidation in the industry via leveraged mergers in the current context of ultra-low interest rates. In this case, the same banks that led junior miners to become insolvent as they drove the price of gold down could be now selling their investment banking services to merge them with bigger players. In the process, the banks would demand that the new companies hedge their production, against further future gold price declines. This supply of future gold could offset the initial demand of the bullion banks, leaving room for a further expansion of gold loans…longer than most would believe.





As I wrote above, the collateralized lending rate (gold swap rate) should not be directly compared with the unsecured lending Libo rate. However, if a bullion bank loans gold and at the same time hedges with a gold forward contract, the resulting position can be comparable with unsecured lending.

If the gold lease rate is negative, it is expensive -ceteris paribus- to hedge the short bullion position, and **the incentive to expand fiat gold decreases. This is supportive of the spot price of gold. If the gold lease rate is positive, it is relatively cheap to hedge the short bullion position and to continue expanding fiat gold. This is negative for gold.** When fiat gold expands, we are likely to see a simultaneous bid for gold on a forward basis, to hedge. This should steepen the gold term curve, raising the gold forward rate. When fiat gold contracts relative to bullion, the gold forward rate should fall, flattening the term curve. If spot gold is more expensive than forward gold, in other words, if there is a bid for storage of gold: Gold enters backwardation. **In backwardation, the term structure is that of money. There is an inter-temporal rate that discounts future vs. present purchasing power.**

Why we can say that this is manipulation

At this point, we must ask ourselves what is wrong with all this. After all, **why should the morphing of gold reserves into fiat gold (via gold loans) be called a manipulation? There is nothing different between the creation of fiat gold out of bullion and the creation of US dollars out US Treasuries.**

The answer is simple: **There should be nothing wrong with it, if it was not hidden**. Let me explain myself: **If the central banks did not show the bullion swapped as gold in their possession and if the bullion banks showed the reserve ratio of fiat gold-to-bullion, just like banks do with fiat money, this could not be**

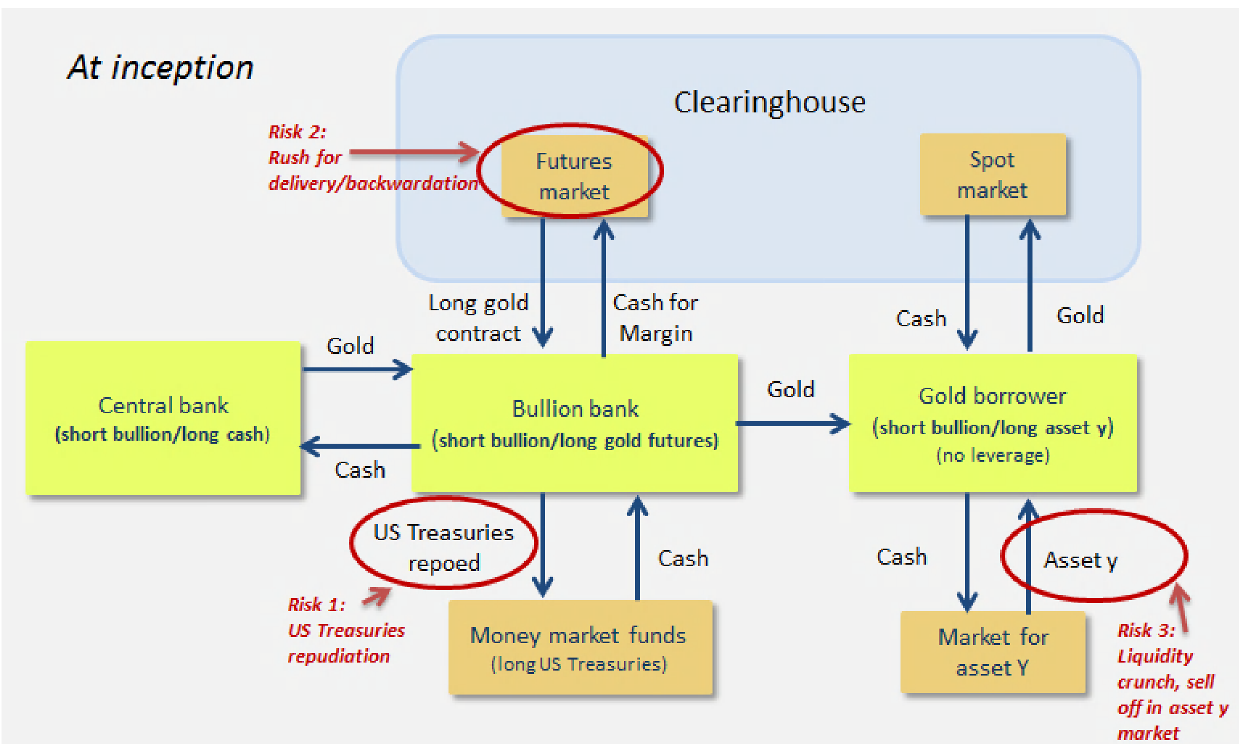
called a manipulation. **Even with consistent sell offs at 8:20am ET or 4am ET, we would still not be able to call this a manipulation (**I challenge readers to do their own research and find out the credit multiplier of fiat gold and the equity ratio of the bullion banks).

How would the market react therefore if there was full disclosure? Physical gold would trade at a premium. As an example, at the verge of the collapse of the currency board in Argentina, the premium of holding USD bills under the mattress vs. USD in the bank (i.e. paper USD), was expressed in terms of an opportunity cost: Banks were offering 20% per annum to retain USD deposits in savings accounts! In other words, those holding to their USD under the mattress, were foregoing a 20% return rate, for not taking risks….Now, let me ask you this: *Do you see gold ETFs paying a dividend?* There you go!

Finally, if there was full disclosure, gold would have to enter into backwardation, which is exactly what mainstream economics seeks to discourage, because the backwardation would once and for all bring to light the fact that gold is money.

The systemic risk of the manipulation: A flow analysis

The manipulation is also not without risk. The graphs below should illustrate this point:



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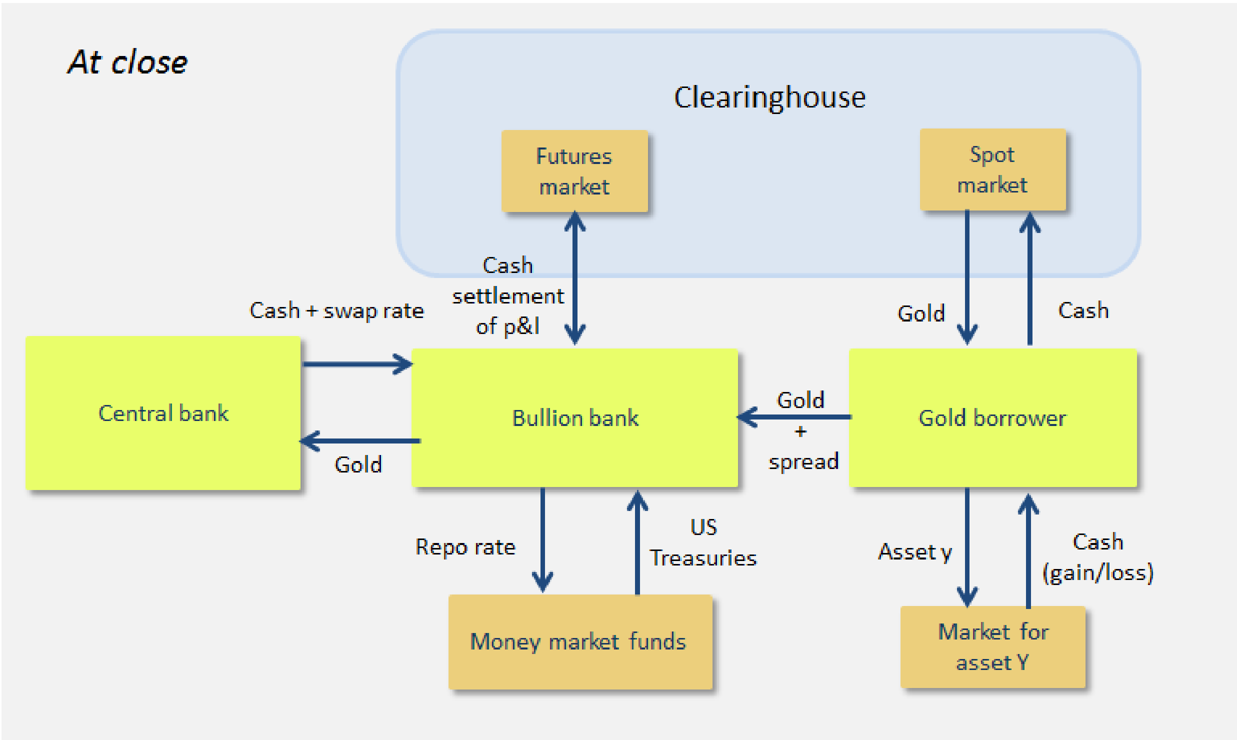

The graphs above show the flows involved in the manipulation and the positions taken by the players. At inception of the conversion of bullion into fiat gold, the central bank assumes a short bullion/long cash position. The Bullion bank enters into a short bullion/long gold futures position, partly or fully financed via Treasuries repoed with money market funds, to cover the swap with the central bank as well as the margin for its long futures position. The gold borrower that sells the gold in the spot market to fund the purchase of asset y is therefore short bullion/long asset y. **There are three main risks to this scheme that give the manipulation a systemic dimension. The systemic implication is tangible and should not be ignored, because we have proof of its actual costs.** A clear example was the loss that UK taxpayers suffered when Mr. Gordon Brown, as Chancellor of the Exchequer, sold 400 metric tons belonging to the UK government. The sale was on purpose pre-announced, driving the price of gold down, to bail out those who had been profiting from the manipulation. Member of Parliament Nigel Farage had something to say about this (click here (minute 2:09))

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Is this ever going to end?

The first graph above shows three events/risks that would crush the manipulation, possibly unleashing a systemic crisis, which should be enough ground to forbid the manipulation altogether. I will then proceed to elaborate on them and seek to reach a conclusion as to which one of them is the most likely to occur.

Event 1: Repudiation of US Treasuries

Description: This is a risk to the money market funds that are long US Treasuries through repurchase agreements. The repurchase agreements provide cash to the bullion banks who use it to either swap for gold or establish margins for their long gold futures position. In our example above and to keep things simple, I assumed that the gold borrower does not use leverage. **This would be unusual** and it is to be expected that the counterparties to the bullion banks also use leverage from repoeing US Treasuries. If there was a sell off, a repudiation of US Treasuries, bullion banks and their counterparties would have to unwind their positions and rush to purchase back the bullion they sold multiple times.

What could trigger it?: The repudiation of US Treasuries could be triggered by a ratings downgrade, or an outright sell off by the market, forcing the Fed to acknowledge their role as the only buyer regardless of the unemployment rate, caused by political instability in the US.

Mitigants: The current degree of financial repression would rise exponentially. Already Standard & Poors is under pressure and Egan Jones was banned from rating US Treasuries. Margin requirements could be lowered, shorting of US Treasuries could be forbidden and ultimately, the Fed could intervene bailing out the money market funds, as I explained before.

Likelihood: This event is unlikely to be triggered in the near term.

Event 2: Rush for delivery of physical gold

Description: This is a risk to all those who are short bullion. As the expansion of fiat vs. physical gold grows, the risk to a rush for delivery rises. In this case, gold futures would trade at a discount vs. bullion. Those short bullion could quickly face insolvency causing an exponential rise in counterparty risk within the market and eventually the crash of the clearinghouse. The clearinghouse would then have to be bailed out by a central bank(s) and bullion could be outlawed and confiscated.

What could trigger it?: As I write, there is already a rotation going on, from paper gold to bullion. I may even venture to suggest that stop losses are increasingly absent, as the manipulation renders price signals irrelevant. During the first week of March, the $1,570/oz level was broken twice on bearish news, only to find minimal sensitivity, forcing the shorts to cover. This behaviour is **typical from segmented, broken markets, where price is no longer the relevant signal and volume becomes the guideline**. Having said this, an event that

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could trigger the rush for delivery could be an "accident", just like the one the world witnessed in 1972, when Russia announced it had purchased 440 million bushels of wheat. The purchase surpassed the total U.S. commercial wheat exports for that year. In similar fashion, we could see the disclosure of an upwards revision in the gold reserves held by a central bank in the East that would seriously challenge the integrity of the reports issued by central banks in the West with respect to their bullion holdings.

Mitigant: In 1972, the world was divided. Today, all central banks are on the same expansionary program and the systemic impact of a rush for delivery in gold would likely affect all currency zones. I would therefore not expect emerging central banks to report their actual gold purchases and holdings. They have more to benefit from keeping these in secret, profiting from the cheap prices the manipulation causes.

Likelihood: This event is unlikely to be triggered in the near term.

Event 3: Liquidity crunch

Description: This is a widespread, macro risk. Its scope surpasses that of the gold market. For this reason, mitigating it is impossible, when all central banks are engaged in the monetization of sovereign debts. This is the risk of having malinvestments surface their ugly heads and causing a wave of defaults. Central banks would once more, but with a very publicly low marginal efficiency, flood markets with liquidity. And this liquidity would quickly find its way into bullion, triggering the events no.1 and 2 above.

What could trigger it?: In my view, political and social unrest in Europe would cause a selloff in European risk, compromising the balance sheet of the Fed, which is coupled indirectly via USD swaps and directly via funding of European banks. These banks also raise funds from US money market funds.

Mitigant: The mitigant here is only political. It depends on how longer the status quo can force the Euro zone to live under high unemployment, taxes and austerity.

Likelihood: I see this event as the most likely to put an end to the manipulation, although I do not see it occurring in the near term.

Is Eric Sprott's prophecy valid?

In recent interviews, Mr. Sprott has made the point that as the manipulation comes to end, **the premium on physical precious metals vs. fiat precious metals will be as high as the leverage (i.e. credit multiplier) that suppressed it.**

The manipulation just described somehow resembles the suppression of the value of the US dollar in Argentina during the convertibility of the peso, after the 1994 Mexican peso crisis. Officially, the Argentine peso was convertible to US dollars at a 1:1 ratio. But the credit multiplier for US dollar deposits was legally capped at 3x in March 1995 (this was a simple calculation, because Argentina lacks any sophisticated shadow banking system). As it became evident that this situation was unsustainable and the public began a run on US dollar deposits, US dollar bills (under the mattress) began to trade at a premium against US dollars in bank accounts, as I explained above. First, limits on withdrawals were established at the end of 2001 and eventually a bank holiday was declared. When the holiday was lifted and the system imploded, the US dollar overshot to 3.80 pesos, but after a few months, it settled back to around $3.00…exactly the ratio implied by the credit multiplier that caused the crash. This simple and real example tells me that Eric Sprott's claim spot on. The chart below (source: Bloomberg) on the USD in terms of ARG peso, makes my point very clear:

However, I expect a financial repression like never seen before unleashed before the prophecy finally becomes reality. Something to keep in mind: **The repression of the price of the USD in Argentina lasted seven years in a context with (a) no shadow banking system, (b) full disclosure of the credit multiplier and (c) a market price for the opportunity cost of holding USD bills under the mattress. Seven years, folks! This suggests two things: (1) It will take a period far longer than most are willing to accept until the day of reckoning comes, and (2) when that day comes, the crash will be far more formidable than anyone can imagine.**

Conclusions

This extensive letter was the third of a series on the manipulation of the price of gold. I am confident that through them, I established the following conclusions:

-According to mainstream economics, the manipulation is a necessary policy tool, to achieve the global monetization of sovereign deficits. Without manipulation, inflation expectations would be shaped by the gold market, causing the fall of fiat money.

-The manipulation consists in inventing a new fiat currency, fiat gold, with a credit multiplier.

-To hedge the manipulation, one can trade the expansion or contraction of the credit multiplier in gold

-The creation of fiat gold, per se, is not manipulation. The manipulation consists in keeping the credit multiplier undisclosed and misrepresenting reserves of bullion.

-The manipulation of gold engenders serious systemic risks that could eventually lead to the crash of a clearinghouse. The costs are tangible.

-The most likely event to put an end to the manipulation is a wave of corporate defaults.

-When the manipulation ends, the premium in physical gold vs. fiat gold will approximate the credit multiplier.

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