

# War Against Gold: Central Banks Fight For Japan

By  
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In The Golden Sextant, I pointed out that gold is arbitrated like currencies, which is to say on the basis of interest rate differentials. Currencies with higher interest rates are always in backwardation against those with lower rates. To that date, except for six months during the Mississippi Bubble of 1720, gold had never been in backwardation against any major world currency. The reason is that the interest rates on gold (today called "gold libor" or the "gold lease rate") had never been above the interest rates on any currency. Why? Gold had always been considered the soundest money and therefore had always carried the lowest interest rate structure.

## 1. Hidden War Revealed

Today yen interest rates are lower than gold lease rates. Accordingly, gold is in backwardation against the yen. This backwardation may be seen indirectly by multiplying forward gold prices on the COMEX times like maturity forward yen prices against the dollar. Thus today Monex ([www.monex.com](http://www.monex.com)) can offer "Gold below Spot" on the internet. The backwardation of gold against the yen can be seen directly on the Tokyo Commodities Exchange (the "TOCOM") ([www.tocom.or.jp](http://www.tocom.or.jp)), where at the close July 14, spot gold was Y1001/gram and June 2000 gold Y978.

This situation invites the following trade. Sell COMEX gold for dollars; put the proceeds in short-term notes at 5%; and buy an equal amount of gold forward in yen at a lower effective dollar price. Even if the yen exposure is hedged, the cost of the hedge is unlikely to exceed the spread between the short-term dollar interest rate and the gold lease rate. (Note: gold lease rates are rising, but as of July 15 the 1-year lease rate was about 2.2%.) In other words, a holder of gold today can maintain his long gold position (on paper at least) while at the same time earning more than twice the gold lease rate (if he assumes the risk of yen appreciation). Under these conditions, it is not surprising to find most of the open interest on the COMEX in the nearby months (sellers?) and most of the open interest on the TOCOM in the furthest out months (buyers?).

It is even more instructive to view gold's backwardation from a Japanese perspective. Suppose I am Japanese; I earn my living in yen, keep my savings in yen, and think in yen. With yen interest rates at one-half of 1%, and in light of the banking and economic problems in Japan, I begin to think of converting some of my yen savings to gold. But when I check the prices on the TOCOM, I discover that I will pay around 2% less for gold to be delivered to me next summer than today, and I can keep earning my measly half a percent in the interim. That looks like a pretty good deal, as long as I can trust the TOCOM to make good delivery next year.

Judging from the TOCOM's historical volume figures, many are starting to think along these lines. Gold volume for June 1999 exceeded 1.8 million contracts, almost twice that of any preceding month. Is it any wonder? Effectively, Japanese are being paid to defer their urge to convert yen to gold, and the TOCOM is running a huge gold loan by its customers.

But this is not an activity without risk -- a risk not as well-understood today as in the era of free gold banking. Currently the net short gold position of TOCOM members is about 90,000 contracts, or 90 metric tons of gold (each contract representing 1 kilo). The vast bulk of this net short position is held by two companies: Mitsui and Sumitomo. "Net short" means that they do not have an offsetting long contract on the exchange. If they have hedged their exposure, they have done it elsewhere.

What many used to trading commodities often don't appreciate is that in the currency and gold markets, exchange rates (the dollar gold price being an exchange rate) are set at spot. Future exchange rates are simply the product of interest rates (the gold lease rate being an interest rate) and arbitrage. I have \$100; it earns interest at 5%; a year from now I have \$105. I have Y100; it earns interest at one-half of 1%; a year

from now I have Y100.50. Therefore, if today \$1 buys Y120, I can choose now between having \$105 next year or Y12060, which I will have if I convert my \$100 to yen and invest the Y12000 at half a percent. This calculation suggests that one year from now, the exchange rate should be about \$1 to Y114.85. Accordingly, if I wanted today to buy a one year forward contract for yen against the dollar, I would expect to get a rate around this level, which is in fact quite close to that actually quoted on these approximate figures. Were it otherwise, I could make a riskless profit by arbitraging my \$100 against my forward yen contract.

On the other hand, if I want to buy oil, copper or orange juice one year forward, I have no interest rate to use, and without looking up the prices, I do not even know if they will be in contango or backwardation. Put another way, all the judgments that go into setting futures prices in commodities are distilled in the interest rates for currencies and gold.

The Bank of England's gold sale has generated considerable comment, much of it quite wide of the mark. In sum, the BOE's action unmask what before was only suspected by a few goldbugs: that the major central banks have mobilized their nations' gold reserves to support low Japanese interest rates, and thereby (or so they hope) save the Japanese banking system from complete collapse. The timing of the BOE's announcement, the manner in which the BOE is executing the sale, and the purported reasons advanced to justify it leave no other rational explanation. What is more, by pulling away the mask, the BOE has revealed the true motivations for many if not all major central bank gold sales since 1995, some of which at least standing on their own could be plausibly explained.

## 2. Threat from Gold: When and Why the War Began

Gold has been in backwardation against the yen since Japan lowered its interest rates to about their current level in mid-1995. At that time the backwardation was not quite as pronounced as today because gold lease rates were lower. Indeed, gold lease rates to that date had usually been under 1%, with only occasional spikes to the 2% to 3% area. Almost immediately after Japan's action, gold lease rates started moving higher, reaching well over 3% by the end of 1995. At the same time, the gold price began to awaken from its slumber at around the \$380/oz. level. All this was a quite normal market reaction to something that had not been seen in nearly 400 years, a paper currency challenging gold as the world's lowest interest rate money. And the markets were about to award gold the victory. The yen and the Japanese banking system were headed over the cliff, and their fall would have had huge implications for the world economy in general and the international financial system in particular.

It is instructive to review gold's press clippings for 1994-1996. 1994 was a year of relative quiet in the gold market, which did not receive any real discussion by the BIS in its 65th annual report (year ending March 31, 1995). 1995 began in the same manner, with gold continuing to trade in a narrow band around \$380/oz. But toward the end of 1995, gold began a rally that carried it over \$400 in early 1996. Noting "the extraordinary rise in gold lease rates" at the end of 1995, the BIS in its 66th annual report cited "gold lenders follow[ing] their usual practice of reducing their credit exposures at end-year," explaining that "those who needed to borrow gold to sell it short had to offer unusual compensation." So too, a story headlined "Sharp Rise in Gold Lease Rates Revives Market" in The Wall Street Journal on December 5, 1995, noted that lease rates had fallen back the prior two days as "central banks and other investors made more metal available,...in part because of persuasion from the Bank of England, the unofficial custodian of the world's bullion market." And for the first time in several years, gold analysts and investors were showing bullish optimism. At the annual gold roundtable of The Wall Street Transcript in December 1995, not a single one of the six analysts present expressed any serious worry over negative effects on the gold price from unusually high central bank gold sales or gold loans in 1996.

But what a difference a year makes. By the end of 1996, the gold price was in rapid descent, falling to around \$345/oz. in early 1997, and touching well below \$300 by the end of that year. In its 68th annual report (year ending March 31, 1997), the BIS said little about the price of gold but quite a lot about gold leasing. After describing the increasing volume of gold trading in the London market (\$11 billion per day in December 1997), the BIS noted (with accompanying chart): "Although the three-month lease rate shows considerable seasonal variation (with end-year spikes reflecting a reduction in the supply of loans available for loans extending beyond 31st December), a longer-term uptrend can still be discerned." And it added: "In particular, in the early 1980's gold deposits rarely yielded over 1%, while more recently they have rarely yielded less than 1%."

Not until its 68th annual report did the BIS address the falling gold price per se, noting that it had "responded to Asian developments and declining world inflation." And it added: "Observers also cited official gold sales, Germany's decision to lease official gold and a proposal to sell Swiss gold reserves in explaining gold's weakness." In its most recent 69th annual report for the year just ended, the BIS makes no significant mention of gold. But it discusses at length the continuing seriousness of the deflationary problems in Japan, stating: "The worsening of the economic outlook came at a time when the traditional interest rate channel of monetary policy seemed likely to be of limited effectiveness." It added: "Additional relaxations of policy took place in February 1999, when the call money rate was reduced to 0.15% or lower, and in early March, when massive liquidity injections by the Bank of Japan effectively pushed the overnight rate down to zero."

In December 1995, a highly regarded Swiss private banker (today retired), wrote in his monthly market commentary to clients: "The foundation for a gold bull market has been laid; all that is missing is a catalyst which can spark a takeoff in the fascination with the yellow metal and its character as permanent money. A heightening of the banking crisis in Japan could be such a trigger." And that is why four years ago the central banks' started their war on gold, and why they continue it today. It is one front in the larger war to rescue Japan's banking system before its failure brings down the entire international monetary system as it has developed since President Nixon closed the gold window in August 1971, ending the post-World War II system agreed to at Bretton Woods in 1945.

### 3. From the Front: The Battle Rages

It may seem strange that the world's biggest holders of gold are distressed when its price and yield rise. But their real power and influence come not from their gold, but from their power to issue paper currency. Yet they know that gold, as the ultimate money, is also the ultimate judge of their performance. The gold price, then, is a sort of thermometer measuring current inflationary heat and the general level of public confidence in paper currency. Gold lease rates, on the other hand, are more like a barometer, measuring credit pressures in gold banking. But central bankers, unlike weathermen, can often -- at least for a while -- affect the very pressures they are measuring, and thereby even lower the temperature. But they do so at their peril because in a real gold banking crisis, unlike a modern commercial banking crisis, there is no lender of last resort. The Fed will never run out of dollars; the Bank of Japan will never run out of yen; but both -- and all the central banks together -- can most assuredly run out of gold.

Most particulars of the BOE's gold sale have been sufficiently dissected elsewhere. Two, however, require special mention. First, that it was the BOE that acted, and that it acted so publicly, is important because, as already noted, in the cozy world of central bankers, it is the BOE that historically takes principal responsibility for overseeing gold and gold banking. Its brazen action suggests that no other central bank was willing to make further gold sales in the usual covert manner, or that the situation was grave enough to require immediately either a public hit to the gold price or a public reassurance to gold borrowers, i.e., gold shorts, that more gold would be made available for loan rollovers. In this connection, it is worth noting that at the time of the BOE's announcement, not only was gold threatening to break \$300/oz., but also the IMF had just postponed an expected decision formally to ask its members for authority to sell gold.

Second, and perhaps more intriguing, it is possible to read between the lines of the most recent annual report of the BIS a reluctance by that institution to continue to support Japan's insanely low interest rates, particularly if to do so would put at risk the BIS's own gold or balance sheet. Ordinarily, when national central banks cannot for some reason act on their own to address a serious international financial problem, they act collectively through the BIS. But this type of action, of course, requires the support of the BIS's management. In this context, a recent remark attributed to a high BIS official bears repeating. Commenting on the large short position in gold, he observed: "Gold will take no prisoners."

Split or not among the central bankers, the BOE's gold sale has generated huge negative political fallout. It has galvanized strong opposition both to further official gold sales and to the proposed sale of IMF gold to raise funds for debt relief for poor countries. Opponents include: most of the poor countries themselves, many of whom mine gold or depend on receipts from migrant workers in South Africa; the new government in South Africa; the Black Caucus in the U. S. Congress; several powerful members of the House and Senate, some of whom come from important gold-mining states; and most of the world's major gold-mining companies. Indeed, the proposed sale of IMF gold looks to be heading for a brick wall in the U. S. Congress, where under IMF rules it must be approved. Thus stubborn reluctance by the Clinton Administration to dropping this proposal will indicate a high level of concern about something other than simple debt relief for poor countries.

The BOE has also given a huge boost to a relative newcomer to the world of gold: GATA, or the Gold Anti-Trust Action Committee. It seeks to mount an antitrust action against the principal gold bullion banks for manipulating the gold price, all as explained at its website ([www.gata.org](http://www.gata.org)). In essence, GATA alleges that the major bullion banks are in a cabal with the central banks to manipulate the price of gold for the benefit of the bullion banks. GATA has lined up a respected law firm, raised money, and started a hard-hitting investigation of the recent activities of the bullion banks. Besides promoting its cause on the internet at its own site and at [www.lemetropolecafe.com](http://www.lemetropolecafe.com) (see Hot Links), GATA also engages in political lobbying. It has become a force to watch, and potentially a very troublesome one for the central banks and the gold shorts in particular.

From the perspective of a central bank, interventions in the gold market, whether sales or loans, are like interventions in the foreign exchange markets, a tool for carrying out what it perceives as its official mandate. And just as it reaches into the foreign exchange markets through the commercial banks, it reaches into the gold market through the gold banks. When a central bank "loans" gold to a bullion bank, it "deposits" gold to its interest bearing account at that bank. The bullion bank will then "loan" the gold to its customer at a higher interest rate, making the spread, and its customer will generally sell the gold to raise currency. Of course, if the bullion bank knows that central banks are engaged in concerted "interventions" specifically directed at holding down the gold price, it has greater opportunity to profit from the sale or short side of the loan transaction because it has less need to hedge as aggressively as it would in a truly "free" gold market.

GATA is dangerous to the central banks and the bullion banks not just because it threatens to focus the public spotlight on their symbiotic relationship, but also because it does so in a manner that suggests these activities are much more about greed and political corruption than any legitimate public purpose. Both central banking and gold banking are hard to explain to anyone, and more so to a general public that has been trained to think of gold as a commodity rather than money. Scandal, on the other hand, is easy to sell to a public full of distrust for politicians and their wealthy supporters. In any event, whatever the merits of its proposed lawsuit, GATA has performed a valuable function by uncovering much information about the recent workings of the gold market, a large part of which is private and invisible to the public.

#### 4. What to Watch: Physical Demand and Gold Lease Rates

Interventions by the central banks may have denied gold an early TKO against the yen, but gold is a master at the "rope-a-dope" strategy. It bobs and weaves and looks increasingly wobbly, as if it's about to be taken out. All an illusion, for gold is a fighter with explosive hidden power. The two things to watch are physical demand for gold and gold lease rates, particularly when they become inverted.

Today the physical gold market is in deficit, meaning that annual demand for gold exceeds annual new supply. New production now runs about 2500 metric tons per year. Figures vary, but annual offtake of physical gold appears to be running at about 3500 tons. Furthermore, there has been a significant supply deficit for several years. In short, there are still plenty of buyers of physical gold, especially in Asia, where the demand is quite elastic. Accordingly, lower gold prices tend to push up physical demand and drain physical gold from the market. Gold loans by central banks (or others) help to meet this demand without driving the price of gold higher.

Today at about \$260/oz., the price of gold is well below the total cost of production for most gold-mining companies, and below the cash cost for many. New projects are being delayed or cancelled. In sum, the situation in the gold-mining industry is reminiscent of the late 1960's, just before the collapse of the Bretton Woods system with its fixed \$35/oz. gold price. Martin Mayer tells an interesting story about this period in his 1980 book, *The Fate of the Dollar*. Six months before the first upside breakout in the London gold market, George Champion, president of Chase, called a young Paul Volcker into his office to ask whether the then unfolding balance of payments problem might cause the U. S. to start losing gold. Volcker explained that the dollar was healthy and the gold market unimportant. It was, Volcker said later, "one of the most embarrassing moments of my life."

Although today's shortage of physical gold is not yet evident in the gold price, it is quite evident in high gold lease rates, which are now also inverted or partially so. Inverted interest rates are almost always a sign of stress in the banking system. So too, inverted gold lease rates, particularly if they remain inverted for more than a short time, are a warning of problems in the gold banking system. A rise in gold lease rates across the maturity spectrum (lease rates are quoted at [www.kitco.com](http://www.kitco.com) for 1 month, 3 months, 6 months and 1 year) suggests generally increased demand for borrowed gold to sell into the physical market, and is consistent with selling to take advantage of gold's backwardation against the yen. On the other hand, inverted lease rates (nearby gold commanding a higher lease rate than longer maturities) can suggest that existing shorts are having difficulty meeting delivery commitments or rolling over loans as they come due. In recent years inverted lease rates have also been associated with year-end withdrawals of gold from the loan market by central banks anxious to clean up their balance sheets for reporting purposes (i.e., hide the full extent of their exposure to the gold loan market), and with large sales by central banks or others that either remove gold previously on loan or put short-term pressure on the physical supply.

Alan Greenspan twice testified before Congress in 1998 that "central banks stand ready to lease gold in increasing quantities should the price rise." Many have interpreted this remark as suggesting an attempt by the G-7 central banks to thwart gold from signaling any incipient inflation, thereby foreclosing early calls for monetary tightening. But his statement is equally consistent with the view that the G-7 central banks will continue to support the demand for gold loans precipitated by gold's backwardation against the yen. At \$260/oz., the gold price is far from giving a warning of imminent inflation. If the central banks continue in these circumstances to provide gold to the bullion banks, they are worried about something else. And they are continuing to set the stage for a classic gold banking crisis, something not seen since the Great Depression.

## 5. Bubbleland

The war against gold is but one front in the effort of the G-7 nations and their central banks to save Japan's banking system and economy from complete breakdown, the consequences of which are almost too dire to contemplate: calling of Japan's foreign loans; sale of its hoard of U. S. Treasuries; massive depreciation of the yen; in short, the sort of collapse experienced by some of its Asian neighbors but in an economy far larger and far more important to the world. The fundamental strategy has been to try to keep Japan afloat on a sea of liquidity -- liquidity that has gushed out of Japan into other major markets, particularly in the United States and Europe.

Mirroring but on a far larger scale what has been happening in the gold market, the so-called "yen carry trade" -- borrowing yen at low interest rates in order to invest in other higher yielding assets -- has supported stock and bond markets outside Japan even as its own markets struggled. From mid-1995, when Japan sharply lowered its interest rates, to August 1998, when the Long Term Capital Management (LTCM) hedge fund crisis hit, the yen fell from about 90 to the dollar to 145. Borrowing at one-half of 1% a currency depreciating at an annual rate of around 15% is a pretty good deal, not to mention the return earned on the borrowed funds.

When the near bankruptcy of LTCM shook the world last August, the yen began a sharp recovery from 145 to less than 120 to the dollar in a couple of months, largely testimony to effects of leverage as shorts run for cover. More worrisome, however, was the simple fact that a single hedge fund through the use of leverage and derivatives could put itself in a position where its failure could threaten to seize up the entire international financial system. Nor was the gravity of this fact lost on the BIS, which devoted several pages in its most recent annual report to the dangers illustrated by the LTCM incident.

Almost a year later the yen remains relatively strong at around the 120 level despite a continued absence of loan demand in Japan. Now the demand for yen appears to come largely from investors anxious to buy Japanese stocks. But the Bank of Japan, fearful that any rise to much over 120 will choke off Japan's nascent recovery, thwarts any move much above this level by selling yen, thereby inviting more yen borrowing by foreigners.

Meanwhile, particularly in the United States, a financial bubble of historic proportions continues to grow even as it emits an increasing number of danger signs. Their catalogue and analysis is beyond the scope of this article, but the notion that gold is being "demonetised" is as much a part of "new era" thinking as the notions that historic benchmarks of stock valuation are passe or that profits don't matter, at least for internet companies. Yet like the Bank of Japan a decade ago, the Fed seems immobilised by fear of triggering a stock market collapse, and like the Japanese economy then, the U. S. economy now is at the mercy of such a collapse.

Nor can much comfort be found in the apparent absence of consumer price inflation. None of the great stock market bubbles in history -- neither the Nikkei in the 1989, nor Wall Street in 1929, nor the Mississippi Bubble in 1720 -- was accompanied by consumer price inflation. In all those cases, as today in the United States and Europe, the credit inflation went into stocks.

A recent online poll of U. S. college students showed that twice as many expect in their lifetime to see aliens land on Earth than to experience another Great Depression. The beanstalk let Jack capture the hen that layed golden eggs; today's tall trees on Wall Street are providing investors a unique opportunity in gold-mining shares.

## 6. Checkmate: How It Will End

Whether the recent bounce in the Nikkei signals the beginning of a real recovery in Japan or another false start is the question of the hour. But the consequences of either may be grim for the U. S. stock market, now far into bubbleland.

A real recovery in Japan, particularly if it brings the rest of Asia along with it, is almost certain to put upward pressure on prices in the commodities and some consumer markets. That whiff of inflation by itself could be enough to tank the U. S. stock market. In any event, a real recovery in Japan that leads to more normal interest rate levels for the yen should cause both the yen carry trade and gold's backwardation against the yen to reverse, draining the liquidity which they had provided, and quite likely causing upward spikes in both the yen and gold, with concomitant downward pressure on the dollar and upward pressure on U. S. interest rates. None of these events bode well for the U. S. stock or bond markets.

On the other hand, a continued absence of recovery in Japan must at some point adversely impact the yen, a collapse of which against the dollar will export Japan's deflation to the rest of the world. Whichever way Japan falls, the nub of the problem is how to freeze the bubble that the U. S. stock market has become, as have some European stock markets as well. It is a long way from where these markets are today to even normal valuations. The history of bubbles is not one of slow, controlled deflations, but of sudden, sometimes cataclysmic, crashes.

Of course, predicting exactly what pin will provide the fatal prick is almost impossible. Even after the event, there may not be agreement on the immediate cause of the collapse. What is more, the world today presents a number of potential military flashpoints, any one of which could explode sufficiently to puncture overvalued western markets. In truth, the effort to rescue Japan has created a credit bubble bigger than that which caused Japan's troubles in the first place, and this bubble has now left the G-7 countries hostage to events over which they have little or no control.

But there is good news. With their four year war on gold, the central banks have virtually assured that when it arrives, a U. S. stock and bond market collapse will either bring with it a classic gold banking crisis or be the result of one.

What is a gold banking crisis? In essence it is a failure of confidence in the promise of gold banks to deliver gold, i.e., a "bank run" or a "panic" to our grandfathers. The equivalent today would be gold \$1000 bid, none offered, underlining the key point: In a true gold banking crisis, customers demand delivery of physical gold. They want the asset itself, not a promise that is someone else's liability.

And why would a gold banking crisis be good news, other than to the few who had the luck or foresight to profit from it? Because it would force serious rethinking and likely meaningful reform of the international monetary system that caused it, all to the benefit of future generations who would enjoy, as did our forefathers, the blessings of honest money. This happy prospect will be discussed in my next essay: The Golden Millennium: Aftermath of the Gold Banking Crisis of 1999-2000.

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