

Gold and Silver “Leasing” Examined

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I recently made some controversial and incorrect statements about metal “leasing” as part of my “Today in Silver” commentary at www.silveraxis.com. The following is an attempt to correct some of the errors as well as to provide more background information to demonstrate that the overall message wasn’t as crazy as it might sound.

First, I would like to go back to the very beginning. Before lending or "leasing" of gold became common in the 1990's, there were gold swaps. A gold swap is simply an exchange of gold for a currency such as U.S. dollars under a legal contract that requires the transaction to be reversed at a fixed future date. For example, assume that Bank A, a central bank that owns gold bullion but is desperately in need of cash to provide liquidity to its banking system, were to arrange the following transaction with Bank B, another bank with "extra" cash:

On January 1, Bank A delivers 100 tons of gold to Bank B in exchange for US\$1.6 billion. So far, this looks like a sale of 100 tons of gold, but the important difference is that Bank A wishes to have this gold returned at a later date. If Bank A simply sold the gold and bought it back in the future, there is a risk that gold prices will be much higher and thus Bank A will not be able to afford to repurchase the gold. The transaction with Bank B, on the other hand, guarantees that the 100 tons of gold can be repurchased by Bank A at a fixed U.S. dollar amount. That is what makes this a "swap" instead of a "sale". In this example, let's assume the maturity date of this "gold swap" for U.S. dollars is in 6 months. Thus, on July 1, Bank B would deliver 100 tons of gold to Bank A in exchange for US\$1.6 billion.

Now the intervening question is, are both sides in this transaction happy to simply return the same amount of gold and cash to each other, or should one side or the other be compensated? Well, to answer that, let's look at the transaction in greater detail. Bank A receives \$1.6 billion, which it can invest in a money market fund and earn interest. Bank B, on the other hand, receives gold which cannot normally be "invested" to earn income. Bank B can do one of three things with this gold: (1) keep it in the vault until it is time return it under the gold swap, (2) sell the gold for cash and temporarily invest the proceeds in the same manner as Bank A, buying the gold back in 6 months when it needs to be returned, or (3) attempt to earn some type of "income" on the gold. We can easily see that alternative #2 is not really an option, since Bank B could have invested the \$1.6 billion in the first place without bothering to do a gold swap.

We will get to alternative #3 in a bit (warning: actually it is a long bit), but first let's take a look at what would happen if Bank B simply holds the gold for 6 months, which is arguably the safest thing for Bank B to do. In effect, this would then be simply a cash loan with gold as collateral. Under such a scenario, if Bank A were to repurchase the 100 tons of gold for \$1.6 billion at maturity, Bank B would have essentially made an interest-

free loan. Clearly that is not going to happen, so we should suspect that Bank A will need to compensate Bank B for the use of \$1.6 billion cash for 6 months.

The question now becomes, what is the rate at which Bank A must pay Bank B for the use of \$1.6 billion? The first thing we might assume is that Bank A must pay the going rate of interest for borrowings between banks, because that is what this gold swap really is: a borrowing between banks. There is, in fact, a rate called the LIBOR (London Interbank Offered Rate) which is just such a rate. In other words, we are talking about an interest rate. So it would make sense that a gold swap would result in the bank that lends gold and borrows cash to pay LIBOR to the bank that borrows gold and lends cash. After all, cash earns interest but gold does not.

But alas, things are a little more complicated than this. You see, Bank A can actually accomplish the same thing as a gold swap using a different approach. For example, Bank A can sell its gold outright and obtain a guarantee that it can later repurchase the gold at a fixed price. This is accomplished using a so-called gold forward purchase contract, which is simply an agreement to buy and sell gold at a particular price at a future date. The flip side of this, of course, is a gold forward sale, which many mining companies have utilized to "hedge" their gold production by attempting to guarantee a future minimum--and presumably profitable--price for the gold output at their mines.

Thus, what Bank A could do to replicate a gold swap is to sell its 100 tons of gold for \$1.6 billion and simultaneously enter into an agreement with some party (typically a bullion bank) that provides for Bank A's repurchase of the gold in 6 months at some future gold price. And just what is this future gold price? Well, it is published every day by the LBMA as the Gold Forward Offered rate, or GOFO, representing the difference between the cash price and the forward price of gold expressed as an annual percentage. For example, a GOFO of 5% would mean that the forward price of gold to be bought or sold in one year is \$525 when the cash price today is \$500 (or $\$500 \times 1.05$). In our example, this would mean that Bank A would pay Bank B not \$1.6 billion but \$1.64 billion ($\$1.6 \text{ billion} \times 5\% \times 1/2 \text{ year}$ is equal to \$.04 billion, plus the original principal of \$1.6 billion). The future price is also published for silver as the Silver Forward Offered rate or SIFO and for several other metals as well. These GOFO and SIFO "rates" are determined by polling several large bullion banks that are active in the unregulated (so called "over the counter") gold forward contract market and have agreed to provide their pricing data for public dissemination.

Importantly, the Gold Forward Offered rates made available by bullion banks are not determined in a vacuum. You see, there is actually an organized, regulated market where gold is regularly traded on a forward basis: the COMEX division of the New York Mercantile Exchange. This means that the Gold Forward Offered rates of the bullion banks are somewhat consistent with the trading prices of COMEX futures contracts, for otherwise there would be no over-the-counter transactions involving the Gold Forward Offered rates (since the COMEX futures contracts would be a better alternative).

Now, you should hopefully understand at this point that the basis as I and Prof. Fekete have described it, meaning the difference between the cash price of gold and the futures price of gold on the COMEX, is very close to the same thing as the Gold Forward Offered rate. The relationship isn't perfect, but over time it is closely correlated.

Okay, let's get back to Bank A/B to finish our example. We have seen that Bank A should pay Bank B some compensation for the use of cash since Bank B will normally just hold Bank A's gold as collateral. In the alternative, Bank B could have loaned the \$1.6 billion cash to another bank, earning interest at LIBOR, but in that case Bank B would have received no gold as collateral. Of course, having gold as collateral can be both a curse and a blessing. Yes, there is an asset of substantial value and unparalleled liquidity in case Bank A defaults by failing to repay the \$1.6 billion, but Bank B must also now store and insure the gold. In addition, Bank B has the alternative of selling the gold and locking in a future price to repurchase it by entering into a forward gold contract. Bank B would have to pay the difference between the current gold price and the forward gold price in the form of the Gold Forward Offered (GOFO) rate, which in this instance would essentially represent the rate of interest on the \$1.6 billion (recall that GOFO is actually expressed as an annual percentage: 5% in the above example). But as mentioned previously, there would be little point for Bank B to do this when it had already had \$1.6 billion in cash before entering into the gold swap. We'll get to an important exception in just a moment.

There is one final piece to this puzzle, and it has to do with the favorable accounting rules promulgated by the International Monetary Fund, which allow a gold swap to be reflected as if the gold remained on the books of Bank A, even though Bank B is in actual possession of the gold during the term of the gold swap. This treatment is due to the observation that I made before, in that Bank B is free to do with Bank A's gold as it wishes, but usually Bank B would presumably hold on to the gold as collateral because there are no better alternatives. In actuality, we will see when we finally get to alternative #3 that Bank B does have alternatives, but for now we need to build the base case. For the moment, what's important is that the favorable accounting treatment allows Bank A to continue reporting the "swapped" gold as if it was still owned and held by Bank A. This is an instance where form takes precedence over substance, as an outright gold sale and forward repurchase, even if negotiated with the same counterparty at the same time, would not allow Bank A to get away with such sleight of hand . . . even though the "gold swap" is really just a gold sale and forward repurchase combined into one transaction.

The bottom line is that Bank A has an added incentive to do a "gold swap" instead of a gold sale and forward repurchase because of the accounting treatment. But the incentive isn't so big that Bank A would be willing to pay significantly more under a gold swap than what it would pay to acquire cash under a gold sale and forward repurchase (the cost is based on the Gold Forward Offered rate).

On the other side of the equation, Bank B has offsetting costs (storing and insuring the gold) and advantages (the gold serves as collateral in case of default) when utilizing a gold swap vs. simply making a cash loan to another bank at market interest rates

(LIBOR), but again not to the extent that Bank B would be willing to accept significantly less income under the gold swap (earning the Gold Forward Offered rate) than it could otherwise get for loaning cash (earning LIBOR). The net result is that Bank A should be willing to pay Bank B equal to or more than the Gold Forward Offered rate and Bank B should be willing to accept equal to or less than LIBOR. All things being equal, this means the GOFO rate and LIBOR would tend to converge when the dominant transactions in the gold market consist of gold swaps.

I would note at this point that "Bank A" has traditionally been a central bank in need of foreign currency reserves, but Bank A could just as well be any bank or bullion bank, or even a private investment fund or hedge fund for that matter. For example, we know that the liquidity crisis last month has forced hedge funds to raise cash, and it has been assumed by many market observers that gold was sold in large quantities to accomplish this. I would argue, however, that the close proximity of the GOFO rates with LIBOR throughout this liquidity crisis might actually indicate that gold swaps (or something equivalent) may have been the dominant source of liquidity instead of outright gold sales. If so, this is a bullish development to the extent the original owners of the gold, just like Bank A in the example above, were not willing to officially part with their gold holdings.

Now what about the situation where gold swaps are not the dominant transactions in the gold market? What would that look like? And what would these other transactions be? I would suggest that these other transactions would be Bank B's "alternative #3" that I noted above. As you recall, alternative #3 is Bank B doing something other than holding or selling the gold it acquired from Bank A under the gold swap. So, what could this 3rd alternative be? Although it seems like Bank B could do quite a bit with the swapped gold, such as various derivative and hedging strategies, this is actually not the case because the gold swap is already a perfect hedge. What I mean by this is that Bank B is on the hook to return the gold at maturity of the swap, so it already has a neutral position regarding the gold price if it simply holds on to the gold as collateral. Virtually every strategy other than holding the gold would expose Bank B to loss either from rising or falling gold prices. The intention of Bank B, however, is not to speculate on the gold price but to merely earn a good return on its cash. In fact, it is already doing so without doing anything because the return it earns on the gold swap is, under normal circumstances, very close to both the Gold Forward Offered rate and LIBOR (since the two rates usually have just a small gap between them).

So what is the only thing left at Bank B's disposal, assuming it is not satisfied with "good" returns? I would suggest that the only option is for Bank B to lend out swapped gold to a third party. What I mean by this is that Bank B could give the gold to someone who promises to return the gold at a future date plus pay a fee for use of the gold. Note that such a transaction would not involve an exchange of cash unlike the gold swap between Bank A and Bank B where cash was exchanged for gold. Under alternative #3, Bank B would instead loan the gold to a third party with the only thing received up front in exchange being a promise to return the gold at a future date plus to pay a "loan fee". It didn't escape the banks' notice for long that such a transaction looks a lot like property leasing where the "lessor" receives future payments from the "lessee" for the right to use

the property over the term of the lease. For this and another reason to be described shortly, the transaction that I just described where Bank B loans gold to a third party in exchange for a promise to return the gold plus to pay a loan fee, has come to be called gold "leasing" and the associated fee paid by the gold borrower as a gold "lease rate".

In reality, this is a gold loan, and the fee paid for borrowing the gold is a "gold interest rate". The "lease" nomenclature has stuck, however, due in large part to the fact that the accounting rules lend favorable treatment to this characterization. You see, "leasing" applies to producing assets such as rental real estate, factories, equipment and the like, which is differentiated under the banking regulations from financial assets such as government securities and stocks. Financial assets are "loaned" or "repo'd" and the income generated from the loan is called "interest" or "investment income". As such, a repo'd financial asset is no longer the financial asset itself but rather a repo. On the other hand, producing assets are "leased" or "intermediated" and the income generated is called "leasing fee" or "service fee". Producing assets continue to be carried on the books in original form even when "leased" to a third party. The intent here is basic and obvious: treating gold as a producing instead of financial asset (whereas to most of us it is obviously the latter) supposedly justifies continuing to carry the "leased" gold on the central banks' books as if it were still bullion in the vault. In reality, the gold has been transferred to a third party who, as we shall see, has more than likely sold the gold into the spot market. The gold has been "repo'd" and should probably be shown on the banks' books as a gold "repo" instead of gold "bullion" (or simply "gold").

Okay, let's get back to our example. We were talking about Bank B trying to generate returns above and beyond what it receives from Bank A under a gold swap. Remember, we have seen that the income generated by Bank B under a gold swap is likely to lie somewhere between the Gold Forward Offered rate and LIBOR, and that the gap between these two rates is normally very small. As we shall see in a moment, however, gold "leasing" can create an abnormal situation. What's not "normal" is simply this: gold which would have been kept in the vault by Bank B under a gold swap is now sold into the spot market under a gold "lease". To see why Bank B would do this, we'll need to take a look at how the gold "lease" actually works.

But first, let's back up a bit and talk about a development that occurred in the early 1990's, namely the perceived need by a number of central banks to secure additional sources of operational funding as international currency competition intensified in a rapidly developing and complex financial system. During this period, central banks began to look at the gold sitting in their vaults and saw that the gold not only generated no income but required upkeep in the form of storage and insurance costs. True, the central banks had taken the opportunity to put this gold to work using gold swaps for almost 20 years as a way to shift reserve assets and manage currencies, but up to this point they had earned very little return on any of this gold (recall that the central banks actually pay the Gold Forward Offer rate when swapping their gold for cash and could normally earn no more than LIBOR on the proceeds). Those who tried to "monetize" their gold reserves found out that the spread between the Gold Forward Offered rate and LIBOR was small enough that it wasn't really worth the effort. To the central banks of the 1980's and early

1990's, it didn't appear that the gold swap, or alternatively the gold sale and forward repurchase, could put any extra income into their pockets.

It was in this environment that an "enterprising Bank B" came along and had a bright idea. What if, the bank reasoned, we sold the gold acquired under the gold swap into the spot market and used the cash proceeds to invest in high-yield instruments? The "all-in" cost would simply be the amount paid to hedge the resulting short position in gold (equal to the Gold Forward Offered rate) which would allow Bank B to repurchase the gold at a fixed price on a future date. The cost of this hedge, the Gold Forward Offered rate, would be offset by the amount Bank A was already paying to Bank B under the gold swap. Bank B could in effect earn a higher yield than the Gold Forward Offered rate, higher still than LIBOR. And even if Bank B merely managed to earn just LIBOR, this would still be better than what it could earn with the plain gold swap, since the Gold Forward Offered rate is "normally" lower than LIBOR. Thus, in the worst case, Bank B merely had to invest the proceeds of the gold sale at LIBOR in order to generate a superior return compared to holding the gold as collateral until the maturity of the gold swap. By using complex financial strategies and assuming a bit of risk, however, Bank B could easily do better than LIBOR. And as new strategies and investment options became common in the 1990's, all of a sudden it now seemed to Bank B like the effort was worth it. Especially since Bank B would still be able to end up with the gold if Bank A defaulted on the swap, yet Bank B would no longer have to worry about storing and insuring the gold.

Unfortunately, as Bank B and others got more and more into the business of selling the gold they had obtained under gold swaps, more and more gold appeared on the spot market at the same time as Bank B went long into the futures market to hedge its short position on the gold swap. Perhaps Bank B might have feared that this action would depress the cash price of gold at the same time as it raised the futures price of gold, thus driving the Gold Forward Offered rate much higher. If this had in fact happened, it would have created an automatic restraint to the selling of gold by Bank B under gold swaps since at some point the cost of hedging (represented by the Gold Forward Offered rate) would exceed the yield that could be earned on the cash proceeds from selling the gold. Indeed, an excessive amount of gold selling under gold swaps, all things being equal, would eventually result in the Gold Forward Offered rate exceeding LIBOR. At such point, Bank A would no longer engage in gold swaps as either straight borrowing of cash or a gold sale and forward repurchase would be better alternatives, leaving Bank B out in the cold.

Alas, this is not what happened -- although Bank B was left out in the cold anyway. The spot price of gold did become depressed as a result of Bank B selling the gold it acquired under gold swaps, but this eventually prompted gold mining companies to try fixing a profitable price for their future gold production, lest the falling gold price drive them out of business. Over time, this well-intended but excessive "hedging" of gold production resulted in numerous gold mining companies piling on the short side of the futures and forward markets as they sold forward their gold production. This forward supply in effect satiated the artificial demand for gold forwards and futures created by Bank B as a function of its need to hedge its short position in gold swaps (remember that Bank B has

sold the gold collateral and will need to repurchase it at a later date so that it can return the gold to Bank A). The outcome was predictable: spot selling of gold drove the gold price down while the futures and forward markets were largely in balance between mines "hedging" on the supply (short) side and gold swappers hedging on the (long) demand side. Not so predictable was the fact that the spread between the Gold Forward Offered rate and LIBOR started to increase. This was because the artificial level of gold selling caused a disconnect between the relationship of gold swaps, the Gold Forward Offered rate and LIBOR. In effect, the Gold Forward Offered rate could not maintain its near parity with LIBOR in the face of so much gold selling in the spot market.

As the gap between the Gold Forward Offered rate and LIBOR increased, Bank A started to notice that Bank B was earning excess returns on the gold swaps. This soon led to the demise of Bank B's role in the gold market because Bank A (the original owner of the gold) decided to lend gold directly for income (which is what Bank B was doing) instead of using gold swaps to acquire income-generating cash reserves. As a result Bank B, an unnecessary middleman, was mercilessly cut of the action. As you will recall, the 1990's were a period when central banks were feeling pressure to generate more returns as their frequent interventions in the foreign currency markets caused operating budgets to balloon. Bank A had found what seemed like a good source of returns. When combined with outright sales of gold, the central banks were tapping into what they thought was a golden fountain of free money.

So thus began the gold lending or "leasing" market in earnest. Gold swaps were sidelined, which was actually quite bearish for gold prices because, as we have seen, gold swaps did not normally result in gold being incessantly sold in the spot market. Indeed, without the desire of Bank A or the gold miners to get into the act, even the selling of swapped gold by Bank B into the spot market would probably have been neutral to gold prices in the long run as this activity would have been self-limiting. Why? The Gold Forward Offered rate would simply have increased to the point where it would have become too expensive to hedge the short gold swap position and therefore Bank B would have returned to simply holding the gold as collateral. This is because Bank B would sell gold into the spot market, suppressing spot prices, and simultaneously buy gold futures to hedge against rising prices (remember that the gold would need to be returned to Bank A at some point). Instead, what we got was a marriage of convenience between gold miners and Bank A. Far from being, however, a conspiracy to suppress gold prices, this was a predictable outcome that is relatively easy to decipher in retrospect. In fact, my own criticism of conspiracy theories in the gold market stems from this discernable relationship between gold producers and central banks.

Okay, with this long but necessary background out of the way, let's finally take a closer look at these gold and silver "lease rates". As I've stated before, it turns out that the "lease rate" provided by the LBMA and republished by Kitco, TheBullionBank and others is simply the difference between the Gold Forward Offered rate and LIBOR. This sort of makes sense when we consider what happened when Bank A consolidated the traditional role of Bank B as the counterparty in a gold swap. You see, with Bank B out of the picture, Bank A no longer receives cash up front as it did under a gold swap.

Instead, it simply receives a net amount of cash -- a small fee -- for lending out its gold. This lending income, or "lease rate", is greatly influenced by the fact that Bank A still has an alternative: it could sell the gold, invest the proceeds in LIBOR, and obtain a guarantee to repurchase the gold at a fixed future price by paying the Gold Forward Offered rate. The net result is that Bank A's gold sale and forward repurchase will generate income equal to the spread between LIBOR and the Gold Forward Offered rate. But that is a lot of trouble to go through when the bank can simply "lease" its gold, especially if Bank A could still receive the same or similar net return. Furthermore, the gold "lease" will not be treated for accounting purposes under IMF rules as a gold sale but rather as a temporary exchange of one form of gold (bullion) for another (paper promise). As such, Bank A gets to continue showing the gold on its books since the "lease" involves producing assets, not financial ones. What's not to like?

Now I would like to point out that "leasing" gold does not achieve Bank A's original goal of boosting liquidity, since unlike with a gold swap, Bank A does not actually receive up front cash. That left Bank A still needing cash for liquidity purposes, which was accomplished with outright sales of gold. Such sales continue to this day, although by agreement the central banks active in selling gold have limited their aggregate sales to no more than 500 tons per year. These central banks have also agreed to not exceed the amount of gold "leased" at the beginning of the agreement, which still leaves a lot of room as the "leases" are rolled forward.

Just as importantly, there continues to be every incentive to sell "leased" gold into the spot market. Yet there is still just as strong an incentive to keep "swapped" gold as collateral, which will become a very important consideration to the gold market when gold "leasing" is discontinued and gold swaps become commonplace once again.

The following 13 points will attempt to build a foundation for analyzing silver and gold "lease rates" using the above understanding of the gold market. These points will also provide the needed structure so that I can refer back to this subject in future commentaries.

(1) Gold swaps are bullish for gold prices at best and neutral for gold prices at worst since they contain a self-correcting mechanism that ensures the spread between LIBOR and the Gold Forward Offered rate remains small, thereby limiting the amount of gold sales in the spot market. This is because counterparties to the gold swap need to hedge all of the gold they might sell, which will tend to increase the Gold Forward Offered rate and reduce any spread against LIBOR. This keeps the spread perpetually small and as a result parties to a gold swap are normally satisfied with merely using gold to generate liquidity on the one hand and a normal rate of return on the other hand. In contract, parties who enter into gold "leases" (gold loans, really) where gold is exchanged for a paper promise but no cash have an inherent need to sell the gold acquired via the "lease" so as to be able to invest the cash proceeds in high-yielding instruments that generate excess returns. One way to achieve yields above LIBOR in the case of gold "leases" is by hedging less than 100%, which creates exposure to movements in gold prices (the hope being that gold prices are going down). Under a gold swap, such risk would be

unacceptable. As a result, gold "leasing" creates an artificial supply of gold in the spot market without an equal and offsetting demand in the futures market. The outcome is that Gold Forward Offered rates do not act as a brake on "leasing" activity as they do with gold sold under gold swaps; gold prices are depressed by active gold "leasing".

(2) The domination of the gold market by gold swaps is an ideal condition in a system where fiat currencies coexist with, but are considered superior to, gold. This condition is marked by low, positive and stable gold "lease rates".

(3) Gold mining companies can upset the gold swap market and create conditions that make it lucrative for banks to engage in gold "leases" and other transactions as a result of mining company hedging activities that create an artificial short supply of futures and forward contracts, thus depressing the Gold Forward Offered rate.

(4) When Gold Forward Offered rates drop significantly below LIBOR due to factors such as excessive hedging by gold miners, central banks can add fuel to the fire by trying to take advantage of the artificially high "lease rate" to increase their "leasing" activities. And vice versa, creating a vicious cycle.

(5) Gradually rising gold "lease rates" are therefore typically a sign that gold is in, or approaching, bear market conditions. "Lease rates" in other markets such as silver and platinum have a similar, but less exact, relationship. The main difference is that central banks are not direct participants in the silver or platinum markets and therefore these "lease rates" reflect a smaller and less liquid market, explaining the correspondingly larger spread between the Silver Forward Offered rate and LIBOR as compared to gold, and the Platinum Forward Offered rate as compared to silver. In effect, the "lease rates" reflect liquidity, and not necessarily scarcity.

(6) Conversely, gradually falling gold "lease rates" are typically a sign that gold is in, or approaching, bull market conditions. The easiest way to prove this is to point out that gold swaps dominate under such conditions, and as noted at (1) above, gold swaps are normally bullish (or at worst neutral) to gold prices.

(7) A positive Gold Forward Offered rate indicates that the gold market is in contango because forward/futures gold prices are higher than the spot gold price. Conversely, a negative Gold Forward Offered rate indicates that the gold market is in backwardation because the spot gold price is higher than the forward/futures gold price.

(8) A spike higher in the gold "lease rate" could result from the gold market moving from contango toward backwardation, but it could just as well result from a jump in market interest rates (LIBOR). The former case is usually bullish for gold while the latter may be bearish. Thus, a move in the gold "lease rate" is meaningless without an understanding of the underling moves in both the Gold Forward Offered rate and LIBOR.

(9) A rise in the Gold Forward Offered rate, representing an increase in contango, could result from a rise in LIBOR, or from increased speculative demand for gold

futures/forwards compared to gold bullion. Under most circumstances, LIBOR, as a proxy for general market interest rates, has a significant influence on the Gold Forward Offered rate because gold swaps act to bridge any gaps between the two rates. At certain times, this linkage is broken.

(10) A break in the linkage between interest rates and gold prices can result in bearish conditions, as it did throughout the 1990's, when gold swaps were supplanted by gold "leases". At that time, the rapid growth in gold "leases" should have resulted in negative "lease rates" and an end to falling gold prices, but excess hedging by gold mines and the failure to hedge all gold "leases" combined to keep "lease rates" higher than they should have been. Since then, most gold mines have become unhedged but most gold "leases" have probably not been unwound, which has created artificial demand for gold futures and forwards. As a result, gold "lease rates" have fallen and gold prices have rallied. Had gold "leases" been unwound at the same time, the "lease rates" would have likely remained higher. Importantly, when it comes time to unwind most of the gold "leases", there will be an artificially supply of gold futures and forwards at the same time as an increase in demand in the spot market, and this could create the conditions for temporary (or perhaps permanent) backwardation. The gold "lease rate" would rise, perhaps substantially higher than during the 1990's when gold mine "hedging" and gold "leasing" were increasing concurrently. The key takeaway here is that back in the 1990's the two types of "hedges" tended to cancel each other out whereas the recent unilateral closure of most mine "hedges" has left gold "leases" high and dry.

(11) A break in the linkage between interest rates and gold prices can also happen if and when the Gold Forward Offered rate exceeds LIBOR. This could occur if deflationary pressures drive general market interest rates lower at the same time that significant gold demand fails to find an outlet in the spot market due to limited physical supplies. The result could be negative gold "lease rates" as gold price expectations may create an entirely new phenomenon: cash borrowed to buy gold for future delivery (what I call "gold bonds"). In effect, this is the equivalent of gold owners forward selling their gold at higher and higher prices, and receiving cash up front to be used for current liquidity needs. The difference from gold swaps is that the gold would not change hands until a future date. Gold bonds, in effect, represent an unlimited short position in cash. I note that such a situation would not actually be sustainable ad infinitum because it requires a certain level of confidence in the paper markets -- confidence that erodes by definition as gold demand accelerates. Stated another way, the escape of gold bonds from the genie's bottle -- as evidenced by gold "lease rates" turning negative -- will spell certain doom to all fiat currencies -- as evidenced by gold "lease rates" turning positive and accelerating toward infinity.

(12) Thus, gold's ultimate ascendance may be heralded by a bottoming and reversal of negative gold "lease rates". I would expect this reversal to accelerate as the Gold Forward Offered rate starts to reach parity with LIBOR (which itself could be exploding higher) while the spot price of gold races ahead of the futures/forward price due to physical demand for bullion increasing exponentially. One contributing factor to this scenario might be the desperate attempt to unwind gold "leases" en masse. The end of the road

would be gold reaching permanent backwardation as predicted by Prof. Fekete. With cash gold exceeding gold for future delivery, gold would then have its own "monetary interest rate". Gold "lease rates" and Gold Forward Offered rates would become meaningless. Until then, it may be appropriate to refer to the gold "lease rate" as the "gold interest rate" so long as we realize that it is actually inverted right now. By "inverted", I mean gold prices should normally be in backwardation if gold was universally treated as money, whereas gold is currently in contango and reflects the common view that it is merely an asset class. Of course, backwardation and contango won't really mean anything when gold is money since the distant value of gold will simply be expressed in terms of interest and present value -- money in hand always being more valuable than a distant promise of money -- just like the distant value of a fiat currency is lower than its present value under the current fiat system (which is why interest is charged on borrowed money).

(13) The most important and ultimate point about gold "lease rates" is that people should perhaps be first looking for a zig ("lease rates" shrinking and then going negative) instead of a zag (spiking "lease rates") as they assess the health of the gold market.