EIR Economics

Now that the party's over, bankers make a move on gold

by William Engdahl

The Sept. 26 declaration by 15 European central banks, declaring a five-year policy on gold sales, has underscored again the fundamental reality of the current world financial system: The system is hopelessly bankrupt, the party is over, and some central bankers are asserting the fact that the role of gold, as a crucial component of monetary affairs, must be preserved.

The bankers' move came on the eve of the annual International Monetary Fund (IMF) meeting, which, as it did last year, appears determined to try to paper over the implosion of the world financial system. The crisis being created by the rise of the Japanese yen and collapse of the dollar; the crisis of South Korea; the exploding U.S. trade deficit; the crises throughout Ibero-America; the crisis in Russia—all of these, they were prepared to ignore, as long as the leading international banks could be propped up.

The European central bankers' action goes directly against that taken by British Prime Minister Tony Blair and Bank of England head Eddie George last June, when the British central bank sold off a chunk of its gold cheap, for the benefit of private speculators. The Sept. 26 action also creates the potential for bringing gold back into the financial system as a gold-reserve system, in the fashion of the postwar Bretton Woods system—a system which worked, unlike the floating exchange-rate system that replaced it. In that respect, the latest action creates an opening for the New Bretton Woods policy which has been championed by economist Lyndon LaRouche. LaRouche noted that, in respect to the gold policy statement, the bankers were showing a certain amount of realism in an attempt to keep the world situation from going completely out of control.

The new policy

The European central banks, led by the new European Central Bank, issued their press release late Sunday night during the ongoing IMF talks, just before markets opened in Asia on Monday morning. The text of the statement, read to the press by ECB President Wim Duisenberg, was the essence of brevity. It read: "In the interest of clarifying their intentions with respect to their gold holdings, the undersigned institutions make the following statement:

"1. Gold will remain an important element of global monetary reserves;

"2. The undersigned institutions will not enter the markets as sellers, with the exception of already decided sales;

"3. The gold sales already decided will be achieved through a concerted program of sales over the next five years. Annual sales will not exceed approximately 400 tons and total sales over this period will not exceed 2,000 tons;

"4. The signatories to this agreement have agreed not to expand their gold leasings and their use of gold futures and options over this period;

"5. The agreement will be reviewed after five years."

The statement was signed by the 11 member central banks comprising the European Monetary Union, so-called Euroland, along with their ECB. In addition, notably, it included non-EMU members Sweden, the Bank of England, and the Swiss National Bank. The combined member national central banks together with the new ECB together comprise the world's largest single holder of gold, some 12,574 tons as of Jan. 1 when the euro single European currency was launched.

A move in preparation for months

It is clear that this move to insert gold back into the monetary system had been in preparation for months. An article in the Sept. 30 issue of the French daily *Le Monde* reported that the German Bundesbank and the French central bank had been collaborating to achieve such a new policy. An article

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in the Sept. 30 London *Daily Telegraph* was even more revealing.

The *Daily Telegraph*'s "City Comment" column reported that until this week, the view that gold was "like any other commodity and had seen its day," had driven the price down to just a bit more than $250 an ounce. "Suddenly, being short looks less smart, and the price of cover has shot up: borrowing gold now costs an eye-watering 9%.

"The Bank of England would never actually go short, but it has been selling the country's gold reserves under the Labour *diktat*. The official line is that history is, well, history, and that gold is merely an absurd anachronism which pays no interest to its owner.

"Never mind that it is the only central bank investment which is not a liability on someone else," noted the *Telegraph* ironically. "Never mind that Alan Greenspan, the 74-year-old chairman of the U.S. Federal Reserve, told Congress in May: 'We should hold our gold. Gold still represents the ultimate form of payment in the world. Germany in 1944 could buy materials during the war only with gold. Fiat money *in extremis* is accepted by nobody. Gold is always accepted.'

"Mr Greenspan may not be infallible," comments the *Telegraph,* "(though the markets believe he is), but this philosophy has helped to put a quarter of the world's extracted gold into the vaults of the central banks. They cannot sell it in serious amounts without undermining the price, as Labour has discovered. This is why the pronouncement of no more central bank sales has sent the price up by nearly $30 in less than a week."

Broader implications

The implications of the gold move are broad indeed. In fact, it represents a giant step toward government controls over the international financial markets. The indication that Greenspan is committed to maintaining a role for gold, also denotes that this was not a European move against the United States, but a statement of (belated) institutional sanity.

In the short term, the bankers' action will deal a heavy blow to those speculators who have been betting on the continued fall in the gold price. These speculators who have been involved in what is called the "gold carry trade," were headed for the same kind of losses which speculators in the "yen carry trade" suffered in the fall of 1998.

Within hours of the ECB gold statement, the price of gold began to soar, and what market participants called "panic buying" ensued. By Sept. 28, the gold price in London had broken the $300 barrier—far above the mid-$200 level which it had sustained for months.

Market sources indicate that the rapid rise was attributable, in part, to the fact that speculative hedge funds that were involved in gold, and had borrowed "short," were now rushing to buy gold, to fulfill their contracts before the price rose even higher.

When a speculator does gold carry trade, similar to playing yen carry trade, he borrows gold from a central bank at typically 0.5% interest. He then sells the actual central bank gold, for dollars, which he then puts into speculation in stocks or bonds yielding far more than 0.5%. Because gold for the past several years has been falling and falling, it was a "sure bet" that the borrower could always repay his gold loan in the future, by buying gold three months, or a year later, at the far cheaper price. But now, the situation has shifted.

"A lot of funds are now forced to cover their short positions," commented George Andersen, a senior economist with a major continental European banking group. "Once the market realized they couldn't any longer cover themselves by borrowing central bank gold, panic has been the order of the day. The gold issue was on the agenda of the G-7 for all to see before Sept. 26, but all eyes were on the yen. Some hedge funds and banks are in dire straights as a result of this decision. Blood is flowing, and you will read it soon on the front pages of the London *Financial Times*."

Andersen notes, "The European Central Bank decided, 'enough is enough.' When the euro was launched in January, there was intense debate inside Europe whether to give gold a central role in backing the new euro. That at the time was not done, leaving many to doubt how much the ECB valued its gold reserves. Now they have made it clear for all. Gold, as the ECB stated, 'will remain an important element of global monetary reserves.' "

Bankruptcy reorganization required

No move on gold, by itself, will stabilize the financial system, of course. The speculative floating-rate system, in effect since 1971, has generated hundreds of trillions of dollars in short-term debt obligations, as opposed to approximately $41 billion in real world product. That debt will never be paid, and this fact is being reinforced week by week, as nation after nation goes into bankruptcy crisis. Only a bankruptcy reorganization, followed by a regime of currency and capital controls, and massive long-term credit issuance for major capital infrastructure projects, will reverse the decline.

In addition to the crisis in Ecuador (see article, p. 9), the last week of September featured a showdown between South Korea and its creditors. One of the first nations to get IMF "help" in the 1997 financial crisis in Asia, South Korea remains totally swamped by debt, and unable to pay. The crisis centers on the huge Daewoo conglomerate, which has already been forced into radical cutbacks, at great cost to the Korean nation. But foreign creditor banks are demanding that their debts be paid preferentially, a demand that Korean creditors and institutions have stoutly resisted. Daewoo has $5 billion in foreign debt, of which nearly $3 billion is due by the end of 1999.