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Financial crisis dynamics, the 'shadow' gold demand, and Menē

The study of financial crises is as old as the economics discipline itself. One of the most prominent theorists of financial crises ever to hold a senior Federal Reserve policy position was John Exter, vice-president of the New York Federal Reserve during the 1950s. Several years ago I co-wrote a series of essays on Exter's theories together with his son-in-law, Barry Downs. In this paper, building on Exter's work, including his eponymous 'pyramid', I introduce a new 'hourglass' framework for understanding the role that gold plays in helping to resolve severe financial crises, in particular the concept of the 'shadow gold supply'. I conclude with some observations about how Goldmoney's new 24k jewelry initiative, Menē, brings essential liquidity to this potentially vital if largely unseen sector of the global gold market.

FINANCIAL CRISIS DYNAMICS

As with numerous economic phenomena, financial crises are much misunderstood. The economic mainstream tends to interpret crises as the result of one or more forms of 'market failure' and thus, in response, tends to recommend increased financial market regulation and oversight. In the US specifically, this has been the case for over a century. The Federal Reserve System was initially proposed by a group of senators with deep familial connections to the Wall Street executives of the day in response

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to the panic of 1907. That panic exposed the highly leveraged, fractionally-reserved and hence unstable nature of the money center Wall Street banks. The Federal Reserve System thus was designed to act, if necessary, as a 'lender of last resort' to any systemically significant financial institution, the disorderly failure of which could conceivably bring down their counterparties and, potentially, the broader financial system.[1]

Initiating operations in 1913, the Federal Reserve System was fully in place during the Roaring 20's, when US financial assets soared in value, in part because the Federal Reserve eased monetary conditions in 1927 at the request of the Bank of England, struggling at the time to fight a deep, deflationary depression. One effect of that depression was a huge outflow of gold from the UK to the US, as higher US interest rates drew money – gold – from abroad. While the inflow of gold continued following US the stock market crash in late 1929, curiously the Federal Reserve refused to allow the US monetary base to expand naturally in response. Eminent economic historians Milton Friedman and Anna Schwarz cited this curious, arbitrary and in their opinion highly unfortunate policy decision as a primary cause of the severe US economic depression which began around that time. Within months, banks began to fail. By 1932, failures numbered in the hundreds and even more failures would occur in 1933, the year most historians identify as the trough of the downturn, although a full recovery would not occur until the 1940s.

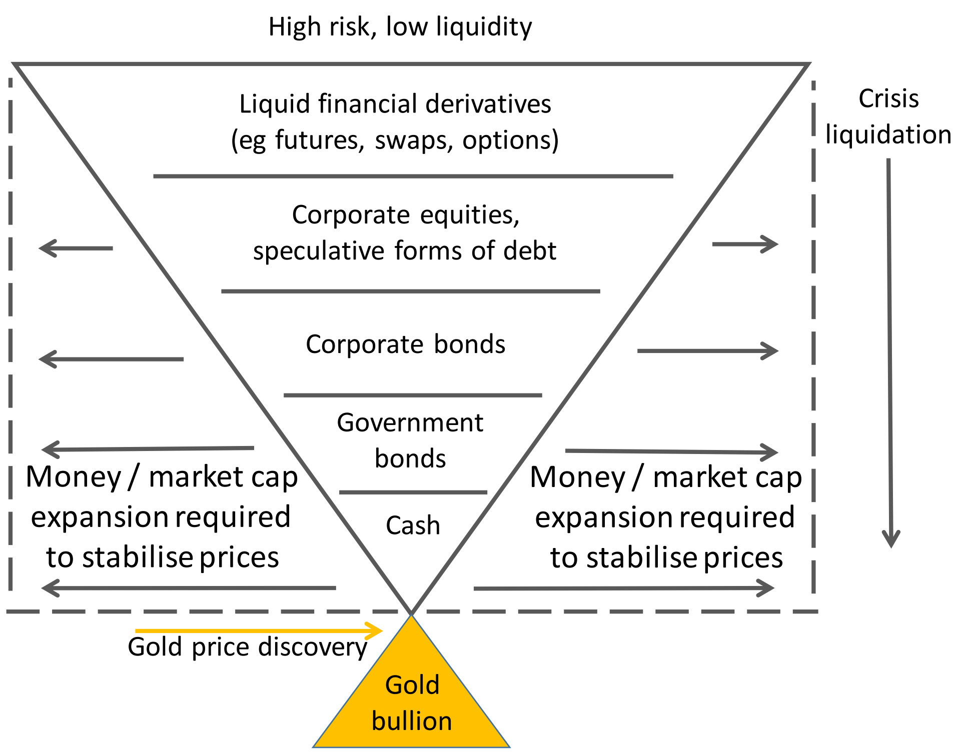
Whether caused primarily by monetary policy failure or mostly market dynamics, however, the Great Depression and other financial crises share certain characteristics in common. As financial market liquidity tends to scale with market size, as asset prices begin to fall, so liquidity can evaporate quickly and unexpectedly. This leads, at least temporarily, to a vicious cycle, in which those who seek to raise liquidity face a 'Hobson's choice' of sorts, that is, either to sell at any price, however distressed, in order to raise liquidity; or not to sell at all and face potentially fatal margin calls on existing liquidity facilities.

Having experienced the Great Depression and the associated crisis dynamics first-hand and having received an economics degree from Harvard, John Exter subsequently created a powerful monetary framework to explain financial crises. This was his eponymous 'pyramid' of money and money substitutes and of various securities and other financial instruments, the values of which either comprise or depend on some other form of collateral.

1 The proposal also included the creation of regional Federal Reserve banks to act in a similar capacity for smaller commercial banks across the country. However, the regional Reserve banks have insufficient voting power either to outvote or to veto the Board of Governors in Washington, DC and the president of the NY Fed, who by law always has a permanent vote.

As the various forms of money, money substitutes and financial assets in the economy expand, so the pyramid grows. Each level of the pyramid depends for support on the collateral values of those beneath; yet in nominal value terms, due to the fractionally-reserved nature of the financial and banking system, market capitalizations tend to shrink rather than grow as one moves down the pyramid to the most solid forms of collateral. Such a structure is, by nature, potentially unstable in the event the demand function for money (or collateral) shifts.

At the inverted tip, the pyramid rests on reserves of physical gold, the only monetary asset that cannot default in the way financial assets can or, in the case of bank deposits, are exposed to the risk of bank failure. Physical cash, as frequently demonstrated by history, can be arbitrarily devalued, officially repudiated, or some combination of the two. Gold cannot.[2]



Source: John Exter, Goldmoney

The pyramid is thus useful in illustrating not only why financial crises can occur, but also why relative price moves can be so large. The only way to stabilize the pyramid against a general shift in risk/liquidity preferences is for the lower levels to re-rate

2 While not subject to default or devaluation risk, as with all property, gold can be confiscated. While property confiscation historically tends to be associated with revolution and war, FDR would nevertheless confiscate a sizeable portion of the US gold stock in 1933-4, when the US faced neither.

in market capitalization terms vis-à-vis the higher ones, thereby providing sufficient support. While this can be accomplished in theory by central bank money-printing to purchase and thus drive up the value of essentially default-risk-free government bonds—and was accomplished in practice through quantitative easing (QE) by the US and most other major economies beginning in 2008—this implies an inflation of the money supply versus that of gold and thus a relative re-rating of the latter versus the former. (In a more traditional Keynesian policy framework the government would simply have run deficits financed by bonds, thereby expanding the supply of default risk-free government bond collateral, rather than increasing its value via lower interest rates.)

The substantial rise in the price of gold leading into the 2008 global financial crisis and further rise notwithstanding a general asset price deflation as various QE programs were announced can be understood easily with reference to Exter's pyramid: Monetary expansion and official asset purchases can stabilize asset prices but this expands the overall nominal size and weight of the pyramid, which nevertheless ultimately rests on a foundation of gold. As the gold price is continuously discovered where the two meet, artificial money or financial collateral expansions thus imply a rising gold price. On the other hand, material increases in available bullion could naturally have the opposite effect.

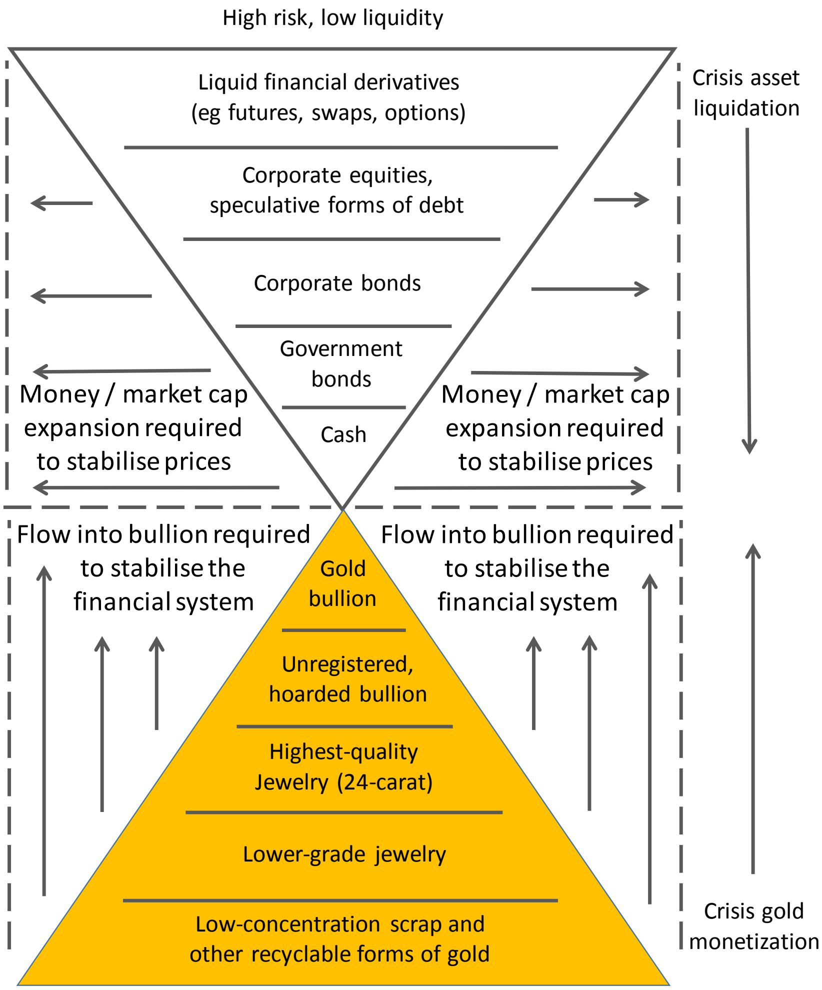
Note, however, that the amount of gold as depicted in the graphic above is tiny by comparison with the overall size of the financial asset pyramid. Monetary gold reserves are held in bullion form. Liquid bullion holdings are highly concentrated, by the so-called bullion banks, other London Bullion Market Association (LBMA) members and large buyers and sellers, including of course major central banks. The gold price discovery process is thereby dependent primarily on the available supply and demand for LBMA-registered and eligible liquid bullion only vis-à-vis that for money eg dollars, euros, etc. Various other exchanges in Asia and North America also play a role and, as it happens, the structure of the global bullion market is evolving rapidly at present as various players, in particular China and India, modernize their infrastructure and improve their liquidity.

However, as with Exter's inverted money, credit and financial asset pyramid, there is in fact a much larger gold pyramid expanding downward from the tip and one that is not inverted but rests on a solid foundation of various forms of gold not available for immediate delivery into the bullion market but nevertheless theoretically fungible.

Gold, after all, is gold. It is an element created by the universe and, due to its highly unique chemical nature, is essentially non-reactive and thus not subject to decay, or physical entropy if you prefer. Yes, it can be combined with other metals rather easily but, for the same reasons, can be just as easily separated again and recycled into concentrated bullion. Indeed, this process of gold finding its way from mined ore, to refined bullion, into jewelry or art, and back into bullion again, is not dissimilar from how terrestrial molecules of water exist briefly as vapor from time to time before falling to earth as rain or snow, flowing down rivers into lakes or oceans and, occasionally, freezing into either of the polar icecaps or a glacier for a prolonged period of possibly many thousands of years.

This frozen water, however, is still part of the available global supply. Subject to sufficient warming, a portion of this ice is subsequently re-liquified as water and, as it evaporates as vapor and falls as rain, can contribute to the re-cooling of the planet, thereby helping to stabilize the climate. (This is not to dispute mainstream Anthropocentric Global Warming Theory, which may or may not be true. Indeed, robust AGWT models take the dynamic role of earth's water into account when making specific predictions for future atmospheric temperatures, sea levels, etc. This same evaporation/convection/condensation effect is utilized in power generation, among other industrial applications.)

Now, to stretch this analogy further, imagine that the 'heat' of a financial crisis releases gold 'frozen' in jewelry as consumers trade in one or more of their family heirlooms for possibly much-needed official cash at what are perceived as relatively high gold prices. As the jewelry is melted down the recovered gold 'flows' up to the bullion tip of the gold pyramid and, voila, in an entirely self-regulating way, helps to support the inverted, unstable financial asset pyramid balancing precariously above.



Source: Goldmoney

This 'shadow gold supply' is potentially vast. While much of it no doubt exists in India, China and elsewhere in Asia, where jewelry and other forms of heirloom gold are particularly widely held, even amongst the relatively less affluent, there are few families in Europe or North America who do not own at least a few items with some gold content. Sure, some of these may be low-quality, perhaps 14-carat or much less. But that is beside the point when it comes to the concept of shadow gold. 14-carat gold is 7/12 pure, or about 58%. And so 100 troy ounces of 14k gold will yield 58 troy ounces of pure gold. Calculating (and extracting) the amount of pure gold from low-quality jewelry is not particularly difficult, expensive or time-consuming.

That said, gold recyclers nevertheless expect to extract a fee for their services. While premiums can vary a great deal, it is not uncommon for generic jewelry to receive only about two-thirds of its bullion value at point of resale.

Losing one-third of gold's marketable value is something gold jewelry owners should no doubt want to avoid. But just as the owners of relatively high-risk/low-liquidity assets may have to liquidate at any available price to remain solvent in a crisis, so might some households, in a severe economic downturn, discover they must pay hefty premiums to monetize their generic, low-quality gold jewelry.

Now it is indeed the case that some jewelry contains the equivalent of a rare, collectible bullion coin's numismatic value in that it might have been sold by one of the more established high-street jewelry retailers and/or have been owned by a famous personality or family. Several jewelry retailers' names are the stuff of luxury cultural lore in the West: Tiffany's say in the US; Cartier in Paris; Faberge in St Petersburg or Moscow. Yes, such 'collectible' jewelry might be beautiful indeed and fetch a price far in excess of its gold content with the assistance of Christie's or Sotheby's or another venerable auction house. However, this cumbersome, potentially high-commission process is unlikely to be able to assist the original purchaser of such items in avoiding the high premiums associated with more generic forms of low-quality jewelry. Indeed, the up-front premiums charged by the better-known luxury retailers can run extremely high, essentially guaranteeing at point-of-sale that the real, inflation-adjusted value of the actual gold contained will never be recovered under almost any conditions at all.

24-carat gold jewelry, however, need not suffer from these drawbacks. Rather, as a bullion substitute, it can be purchased and then re-sold at a far tighter bid/ask spread. Visit a Middle Eastern souk, any Indian gold dealer or Indonesian pawnbroker and this vital point will be clear as day. In these countries, and indeed throughout most of Asia, 24-carat gold functions as an unofficial money with a strong track record of holding its value over time, unlike official monies which depreciate in value at varying, sometimes rapid rates. 24-carat jewelry is also beautiful, a nice bonus for the owner thereof.

It is precisely the potential, practical benefits of this ancient and, in much of the world commonplace, liquid market for 24-carat gold that the new, online gold jewelry business Menē seeks to bring to the developed western world. All Menē products are 24-carat, without exception. Product design varies from traditional to avant-garde, from wearable to playful, from relatively large and expensive to smaller and thus more affordable pieces. With Menē, all product prices are determined by weight only; and with earth's gravity and the mass of gold terrestrial and universal constants, respectively, Menē gold is truly an international product with international liquidity.

Menē goes one step further however: Unlike traditional western jewelry retailers, Menē will buy back any product at only a 10% discount to its 24-carat gold value, at the global market price, at any time. In this way, Menē restores to jewelry's original properties something that has been lost to the western world through its arguably unhealthy obsession with fashionable branding, celebrity advertising and short-term trend-following.

Yet where Menē restores, it also disrupts: In much the way that technology firms Amazon, AirBnB and Uber have brought tremendous cost efficiencies to their respective markets, Menē is now doing so with what is, for all intents and purposes, a gold bullion substitute which is, as we have seen, also a superior money to anything produced or officially approved by any government, east or west. Menē is a form of ultimate money that keeps its value. Money accepted the world over. Money that is, without question or doubt, simply beautiful to behold.

There may be many ways in which investors, large or small, can protect their wealth against financial crises, which as we know occur with some regularity. Menē may be the newest of these but it might just win the store-of-wealth beauty contest, crisis or no. For more information about Menē, please visit www.mene.com.