The Sept. 26 surprise announcement by 15 European central banks reaffirming the monetary role of gold, has set off a chain of defaults, margin calls, and looming bankruptcies which could soon exceed the seismic shocks of the October 1998 crisis triggered by the collapse of the Long Term Capital Management (LTCM) hedge fund. The statement by the European Central Bank and 14 other European central banks, declaring a five-year freeze on their gold sales at 400 tons per year, or a maximum of 2,000 tons, as well as a freeze on the amount of gold the central banks would provide bullion banks via leasing, has begun a classical “short squeeze” process, sometimes referred to as reverse leverage.

The sudden reversal of the expectation of huge future central bank gold sales has caught many major international banks and investment firms, as well as hedge funds, on the wrong side of the game. Ironically, the move by central banks to reaffirm the traditional monetary role of gold as a store of value, especially in times of financial and currency crisis, may turn out to be the bar that breaks the camel’s back.

The ‘gold carry trade’

Some prominent international banks had speculated heavily in what is called the “gold carry trade.” Much as the same speculators earlier had played the “yen carry trade,” the banks stood to reap huge profits by borrowing or leasing central bank gold. Central banks, without surrendering title to their gold in reserve, had in recent years increasingly leased their gold to select international banks, so-called bullion banks. Because gold in the vaults of central banks, unlike U.S. Treasuries or German government bonds, earned no interest, the leasing process gave central banks a small return on otherwise idle assets. Their risk was small, as the leases were typically for three-month periods.

The bullion banks, in turn, loaned the leased central bank gold—gold which, of course the banks did not own—to either speculative hedge funds, or to gold mining companies faced with a falling world gold price. The hedge fund or gold mine would then sell the physical gold for dollars, deutschmarks, or other major currencies, giving them cash which could be used to buy government bonds often yielding 5-7%. In turn, many used these “safe” government bonds as collateral to buy more speculative stocks, on margin. In the United States, brokers will lend up to 50% of a stock price on margin, a process known as the “golden pyramid.”

As the price of gold had fallen over the past four to five years, from near $400 an ounce steadily lower, the “gold carry trade,” usually combined with exotic “customized” derivatives sold by the bullion banks to their hedge fund or mining clients, appeared to be one of the world’s few “one-way bets.” As long as gold fell, or, at worst, did not rise in price, the players of this lucrative “gold carry trade” could repay with gold bought in the market at a later date, at a cheaper price. They scored on the fall in gold price as well as the use of almost interest-free money from the sale of the leased gold.

However, just as in the case of the “yen carry trade” bets taken by banks and hedge funds speculating that the Japanese yen would never again rise against the dollar, when market events suddenly reversed when the rules of the “gold carry trade” game were torn up by the 15 major European central banks on Sept. 26, those gamblers found themselves facing catastrophic losses. Unlike with the yen, however, it is proving far more difficult for mines and speculators to come up with the physical gold to repay the banks and, ultimately, the central banks which leased the gold in the first place.

The question which everyone is now asking, is, just how much gold have central banks loaned, and at what price did bullion banks structure their derivatives contracts?
The central banks behind the gold decision are well aware of how much central bank gold has been loaned in this “gold carry trade.” After all, it is their gold. The sharp rise in gold from $255-262 in the week of Sept. 23 to more than $323 by Oct. 14, reflects the first phase of reportedly frantic efforts by gold mines and banks with exposed “short” positions, i.e., bets that gold would decline below $255, to buy physical gold to close their exposed positions before losses become catastrophic.

According to reliable gold market sources, the scramble to close these short exposures in gold has only begun. The total of gold loaned by central banks to hedge funds and other speculators is reportedly as much as 10,000 tons, and some estimate as much as 14,000 tons—the equivalent of four to five years of total world gold mine output. The total value, at the current gold price, is $100-140 billion.

But that is just for starters. Most of the $100 billion worth of gold has been loaned by banks on the basis of traditional bank fractional reserve lending. That is, a bank is required to hold 8% of total loans in terms of equity or other assets. It can lend 12 times the initial value of the gold in this situation. That would imply, conservatively, a $1.2 trillion total credit pyramid constructed by these international bullion banks on the back of their borrowed central bank gold.

This now begins to assume the dimensions of the October 1998 crisis surrounding the collapse of the LTCM hedge fund. When that fund went to the Federal Reserve on Sept. 23 to beg for emergency help, it came to light that it stood at the center of a global network of derivatives contracts nominally exceeding $3 trillion.

**Bullion banks are in trouble**

It should not surprise seasoned financial market observers that the banks which lent LTCM billions to leverage its speculative bets, are the same banks today behind the “gold carry trade,” including the giant Swiss bank UBS, Crédit Suisse (the inventor of the Russian GKO bond scam), Germany’s Deutsche Bank, J.P. Morgan, Goldman Sachs, and Chase Bank.

If the price of gold rises above $340-350 per ounce, that will trigger panic gold buying by the banks, hedge funds, and other speculators that either must come up with physical gold to repay their leased or borrowed gold before the price rises even higher, or face financial disaster.

Already this price jump has begun to claim its first victims. On Oct. 2, the Karachi, Pakistan gold association stopped trading for a week because many dealers had become insolvent with the gold price soaring. On Oct. 7, the third-largest African gold producer, Ashanti Goldfields of Ghana, asked for a freeze from its banks on margin calls on its gold derivatives. The banks included UBS, Société Générale, Crédit Suisse, Goldman Sachs, Chase, and the large AIG insurance group. According to the *Wall Street Journal*, these banks had a total exposure to Ashanti of some $500 million, enough to threaten Ashanti with bankruptcy. The banks had demanded an added $230 million collateral on Ashanti’s gold loans as the price rose above $320. Ashanti was short 40 million tons of gold owed its bankers, and it likely will be bailed out by a minority shareholder, the London mining group Lonmin Plc, which has bid to take control of the company.

In Canada, Cambior Mining of Montreal reportedly is facing devastating derivatives losses at the higher gold price, and in Australia, Acacia Mines, also facing insolvency, has been taken over by the world’s largest mining company, the London-based AngloGold, originally of South Africa.

Under such conditions, a brief rise in the price of gold to $400-600 per ounce is not impossible. If prices rise rapidly, say to $400 in the next few weeks, forced liquidation by the hedge funds and banks holding these “gold carry trade” exposures of investments in other assets such as stocks and bonds, could be sufficient, according to some knowledgeable banking sources, to trigger a global market meltdown. Already in the first two weeks of October, the bank computer risk models, ironically based on the mathematical model of former LTCM partner Myron Scholes, have reportedly broken down as the wild volatility of gold’s price has broken all historical trends used to model gold price risk by the banks.

The decision of the 15 European central banks, with the apparent tacit support of the U.S. Federal Reserve, to restore gold to a central monetary role, reflect the desire of those central bankers to have gold currency backing, in the face of expected storms in global financial markets. Hong Kong-based financial manager Marc Faber has pointed to this role of gold in times of financial and currency crisis. In a recent press statement, Faber forecast that “we are going to get the global bust, triggered by a Wall Street crash.” In that case, Faber predicted that the gold price would soar. “If there is a bust, Americans will do what they have done when there has been a problem in the past, that is, let the dollar depreciate by printing money.”

Indeed, the Federal Reserve did just that last October to prevent the LTCM crisis from triggering a systemic meltdown. At that time, gold played no role in financial markets, its price barely moving. Now, since Sept. 26, the situation is radically different. Gold has once more become regarded by investors as a safe haven in times of crisis. Faber notes that, in the face of an imminent global crash, “there is only one currency that is attractive, and that is gold.”

Now, reports have begun to surface that certain central banks, alarmed at the price of gold rising too fast for their comfort, have begun to intervene covertly with gold derivatives in an attempt to hold the price down to the $315-325 range, allowing the banks with huge “gold carry trade” exposures to avert disaster. If that’s true, it hardly inspires confidence that central bank officials, or Group of Seven governments, have learned any lessons from the leveraged, derivatives-driven speculative excesses of the past several years.