Gold's plunge: how far, how long?

A paradox: The same factors that traditionally argue for gold have broken its price.

The price of gold fell to its lowest point in almost two years, at $338, on Friday July 6, surprising many sophisticated investors in Western Europe. On the same day, Continental Illinois Bank's share price fell drastically to only $4, a quarter of its May 15 level, when wire services reported that the near-bankrupt institution had to draw an additional $4 billion from the Federal Reserve and the lifeboat consortium of commercial banks which, so far, have prevented Conti from shutting its doors.

According to banking sources, the troubled bank has nearly doubled the amount of its borrowings from the Federal Reserve bank. The Dow-Jones service reported, "Unconfirmed reports say Continental Illinois upped its borrowing from the Federal Reserve to about $4 billion a day on Tuesday and Thursday from about $2.25 billion daily previously. . . . On Tuesday, Federal regulators said Continental Illinois was also drawing about $8 billion a day from a credit line supported by 28 banks. They said that was about $2 billion more than previously."

London banking sources say that Conti's $5 billion sale of assets during the last month involved a major write-down of the value of those assets, further compromising the bank's underlying capital. The continued flight of funds from Continental and other banks has produced a severe credit crunch on the international markets, forcing the price of gold down $23 on July 6 to $338, its almost two-year low.

Manufacturers Hanover Trust's stock, meanwhile, fell to only $22½, against $38 on May 15 and $26 per share after the reports of trouble at the New York bank.

Also mentioned ominously by British banking sources was Crocker National Bank, which announced months ago that it would try to sell off its new San Francisco headquarters building to raise $700 million in cash. The British sources argue that Crocker will only be able to raise half that amount from the sale, leaving the bank still short of funds.

Britain's large international banks have not been exempted; Midland Bank, one of the most heavily engaged in South America, lost 8% of its share price in a single trading day at the end of June.

Gold has become the victim of a generalized liquidity crisis infecting the entire world banking system, with especially ugly consequences for banking shares.

Deposits continue to run out of American (and some other) banks' foreign branches; Eurodollar deposit rates continue to rise as a result; ordinary loans become difficult to obtain; many Europeans convert their own currencies into dollars to meet dollar expenses, rather than borrow as in the past, and the dollar rises on the foreign exchanges.

Under these circumstances, it becomes possible for the Soviet-Swiss combine on the gold markets to break through the previous so-called support level of $360, a true "bear raid."

The old European financial interests who believe themselves to be the future satraps of the Russian empire are delighted to see gold at the lower price; it means they can accumulate more physical metal in return for dollars.

In this sense, it is both lawful and paradoxical that gold should decline in the midst of a banking crisis; the same conditions that produce a momentary shortage of liquidity, indeed an extremely painful shortage, will force the hands of the American monetary authorities in the other direction.

An acquaintance well-placed in the City of London said this week that "the debtors"cartel is now a functioning entity; the debtors have only one way to go: Radicalize, and they will. None of the solutions we had tried or are envisioning—interest rate capping, interest capitalization, secondary market for bank claims, debt for equity—are liable to work. The only way left to us is to do like in 1982, a massive, mammoth bailout of the banks, printing money to plug the gaping holes in bank balance sheets."

My own view of gold has not changed in the meantime. Gold is not an appropriate vehicle for short-term investment, principally because the market is more heavily manipulated than any other. Nonetheless, a dollar trading at perhaps 40% more than its relative purchasing power, denominating $700 billion in unpayable developing-sector debt, is a problematic investment at the outbreak of a generalized banking crisis.

To the extent that the U.S. monetary authorities continue to pretend that nothing is amiss, gold's weakness can continue indefinitely, i.e., for some weeks or months, and no one can tell with precision when this will change; it is only possible to indicate certain future points of perspective, e.g., the September meeting of the debtor countries in Buenos Aires, as indications of when the rope will run out.