What Went Down When Silver Went Up

By R.W. Bradford

IT IS EARLY 1980. The nation's economy is in a recession. Inflation is continuing to rise. And the prices of gold and silver are skyrocketing.

With silver in alloy form widely held by Americans, who are hurting from the recession and squeezed by the chronic inflation, hordes of people are descending upon silver dealers, bringing with them their silver coins, tea services, baby spoons, and anything else with silver in it. They are getting in on the action, selling while the price is high.

But what they find at the silver dealer is that the price they are getting for their coins and scrap is substantially lower than the price of pure, refined silver bullion making the news. At the height of the bull market, with silver having soared to 715 percent above its price at the start of 1979, US silver coins are being bought at discounts of as much as 25 percent below melt value. But then the price of silver crashes, and in the aftermath silver coins come to command a *premium* of more than 70 percent over melt value.

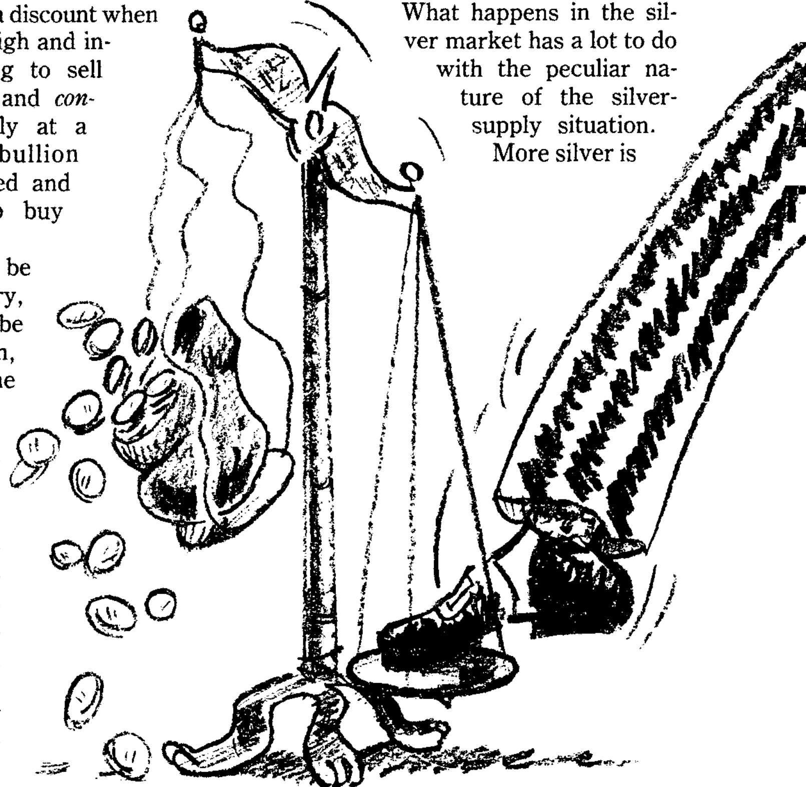
In contrast to the wild gyrations in silver premiums, gold coin markets are remarkably orderly during this tumultuous period. The price of gold bullion has surged to a level 269 percent above its 1979 open, but the major bullion coins—the Austrian 100 Corona, the South *African Krugerrand*, the Mexican 50 Peso, and the Canadian Maple Leaf—are trading at relatively stable premiums in relation to the price of gold bullion on world markets.

Seeing the stability of the gold market and experiencing the swing in silver alloy prices from discount to premium, some upset investors suspect a plot among silver coin dealers. They must be *conspiring* to buy at a discount when bullion prices are high and investors are seeking to sell their silver coins, and *conspiring* to sell only at a premium when bullion prices have dropped and investors want to buy coins.

If fingers are to be pointed in this story, however, it must be toward Washington, D.C. It was not the corner coin dealers who cleaned up in the market in early 1980 but big-time, well-heeled multinational firms—aided by the commodities futures markets and government intervention that kept dealers from responding quickly to consumers' and small investors' desire to get in on the action. The true story of the silver market in early 1980 provides a case study of how government meddling in markets prevents temporary dislocations from smoothing themselves out.

BEHIND THE SCENES

What happens in the silver market has a lot to do with the peculiar nature of the silver-supply situation. More silver is



consumed each year than is produced. The difference is made up from aboveground supplies, most of which are in the form of alloys. The most common form of silver alloy is coins. Under normal conditions, when supplies of silver decline, the price will rise. Higher prices encourage holders of silver coins to sell them to take a profit. The coins are melted and refined into bullion, which relieves the situation.

Because so many Americans hold silver alloys, it is not surprising to find in this country a well-developed silver-recycling industry. Of course, it takes time and money to refine silver coins into bullion. Normally, brokers pay a price for the coins sufficiently below their melt value to cover the cost of refining and of financing the transaction. And, to protect themselves in case the price of silver bullion falls between the purchase of the coins and the sale of the bullion, the brokers sell equivalent quantities of bullion for future delivery on the commodity exchanges.

But during the boom, silver brokers had only severely limited access to that avenue. In a measure ostensibly designed to protect speculators from major losses in active markets, the commodity exchanges impose daily limits on the price changes of contracts for future delivery of the commodity. No trades are allowed at prices above the upper limit or below the lower limit. (No limits are set for contracts for the current month's delivery). Contrary to their stated purpose, however, these limits offer little protection to the speculator; when their effect is to halt trading, they actually prevent losing speculators from liquidating their positions.

Normally, these limits are sufficiently large that they only rarely come into play. But in extremely active markets—such as the 1980 silver market—they do sometimes completely halt trading in a commodity for future delivery. In this case, with silver moving so rapidly, the limits prevented trading in all but spot month contracts. With the spot price gyrating as much as $5 and $10 per day, futures' trading was locked out day after day. Silver brokers could not use the futures market to hedge against the possibility of silver's price falling while their coins were tied up in refining.

Furthermore, under pressure from the US Treasury, the exchanges imposed new rules requiring that 35 percent—rather than the usual 25 percent—of the value of contracts be deposited before a trade could be made. And, crucial to what was to follow, the Treasury issued a "request" to domestic banks to refuse to lend money against gold and silver. (Requests from governmental authorities of highly regulated businesses like banks take on the character of threats; they are nearly always met.) So dealers could not take bank loans, either, to finance their inventories.

The combination of these actions made it impossible for the silver broker/refiner to do business in the normal fashion. Unless he had access to unlimited funds from private sources, the willingness to take on substantial risk, or the capacity to hedge on foreign markets, he was shut off from normal hedging procedures. Almost no dealer had these resources at his command. In fact, the only ones who did were certain multinational firms that could obtain financing from foreign banks (or domestic banks willing to ignore the Fed's directives out of respect for the firm's size) and could sell on the London futures market, which trades huge-sized contracts.

The few well-financed and well-connected firms soon found that they could make almost unfathomable profits.

CHAIN REACTIONS

So what happened? Silver dealers were swamped with public interest. Retail dealers (those who deal primarily with the public) continued to purchase coin and scrap and attempted to move it through conventional wholesale channels. But with credit cut off and no means to hedge, wholesalers were in trouble. Many found out that their refiners could not handle the quantities they had been offered. Refiners began to drop prices (in relation to melt value), hoping that the declining prices would limit the amount of coin and scrap offered. But the refiners soon were filled up.

By this point, many dealers and small refiners were overextended. Some had all their capital tied up in scrap in the process of being refined and had no cash at all. They simply had to close their doors temporarily. When the refiners stopped buying, the wholesalers had to stop. And when the wholesalers stopped, the retailers had to stop.

Some refiners resorted to writing checks against their receivables. Checks from some small refiners bounced. Wholesalers who had deposited the bounced checks from the refiners could not then stop their own checks from bouncing.

Meanwhile, the public—still anxious to take advantage of the record prices—swamped the dealers. Long lines formed outside their places of business. Fights broke out among those waiting in line. Dealers who managed to find means of reselling silver and who could keep their cash flow going hired additional personnel and extended their hours. Telephone calls to dealers increased to the point that dealers took their phones off the hook. One dealer discovered that his competitors had been closed by lack of operating cash for more than a week; but he had not known it, because every time he tried to call them, their lines had been busy from unanswered incoming calls.

More and more dealers (both at the retail and the wholesale level) had to turn to those few firms sufficiently well financed and connected to find financing and to use the London futures market. These firms, few and far between, realized that they were in an exceptionally good position: they were the only ultimate buyers of any consequence left. Very quickly, then, they discovered that they could buy from dealers at larger and larger discounts below bullion value. They made almost unfathomable profits.

When the squeeze was broken and the price of silver plummeted, dealers no longer faced long lines of customers wanting to sell their silver coins. Instead, they faced lines of people wanting to *purchase* at the new lower prices. Those who had significant amounts of silver coin in inventory quickly sold out. But the lines of eager buyers remained. Dealers began to raise their bids to wholesalers on silver coin, but they could still not buy significant quantities.

Gradually, the higher quotes encouraged some to sell and discouraged some of those seeking to buy, and the market settled down. Within a few weeks premiums had dropped back into the 10-15 percent range.

RAKING IT IN

It appears that a substantial portion of the silver coin that was ultimately sold during the boom to a few major multinational firms was never melted at all. The firms simply sold bullion on the London futures market when they purchased the coin. When the market went bust, they repurchased silver bullion to cover their shorts. They then sold the silver

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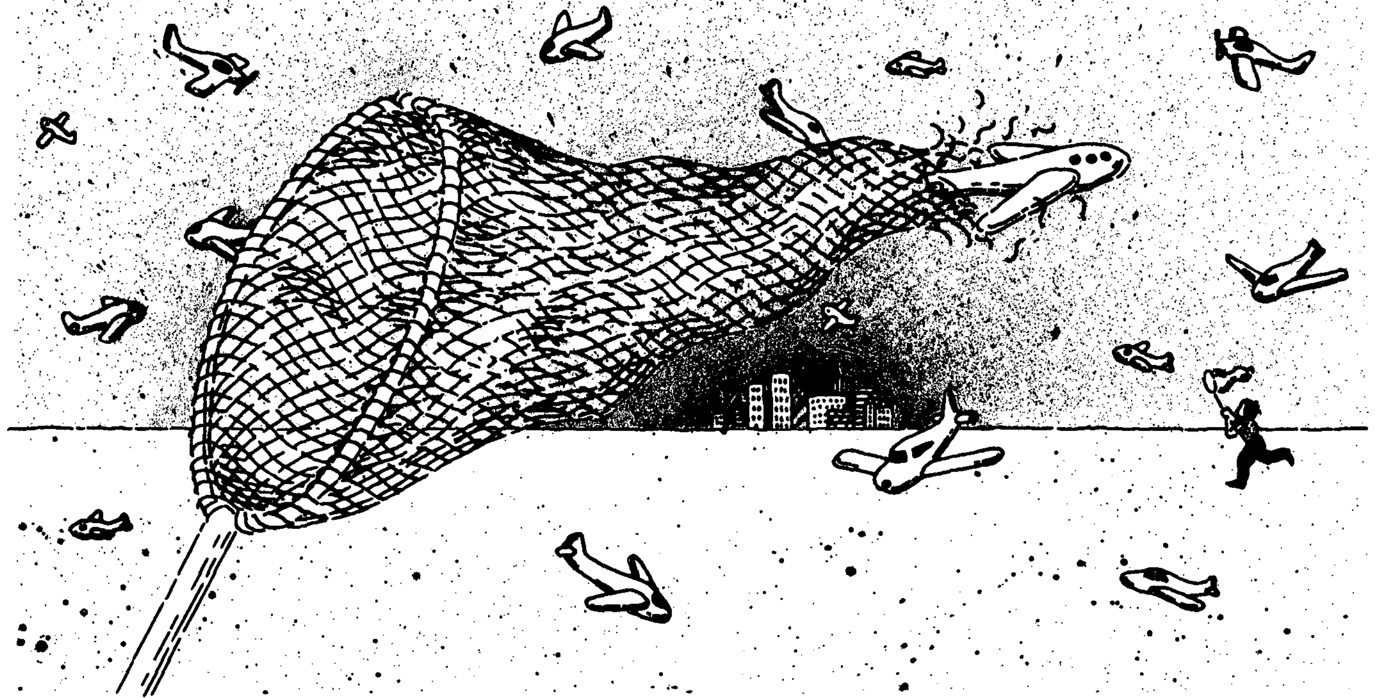

Spreading Wings Across America

Thanks to airline deregulation, small towns have more air service than ever before.

BY PETER SAMUEL

ELLIOT "BUCKY" BUCKINGHAM, an engineer (and, via his wife, Marianne, a distant relative of mine), lives on 40 acres of gorgeous rolling countryside in Vermont. Commercial dairying has died out there, but people keep a few animals as a small income supplement or as a hobby, or just to keep the verdant grass under control. The rainfall feeds fresh, bubbling brooks and is sufficient to support magnificent beech and oaks as well as the maples common to the whole northeast United States.

Bucky, as everyone calls him, is one of America's leading designers of gears—not automotive gears, but gears for all other kinds of machines. His father wrote the basic manuals on gear design in the 1920s, and Bucky has taken them over, modernizing the manuals in line with changing metal alloys and needs. He lives just outside Springfield (population 10,000), which has two quite substantial machine and tool factories, but his work as a free-lance gear consultant comes from all over America. Equipped with an Apple II computer, drafting tables, typewriter, and telephone, he works in an office that, overlooking the woods, covers the whole top floor of a second house he built for renting.

Until two years ago the Buckinghams *used to have* two cars. One of them spent a lot of time 100 miles south of Springfield, in the parking lot of the airport at Hartford, Connecticut, when Bucky was in Chicago or St. Louis or San Diego or wherever new gear designs were needed. Now he has sold his second car.

With airline deregulation, the commuter air service out of Springfield has dramatically improved. There are now one-hour flights four times a day to and from Boston. From Hartford, where he used to drive, Bucky could not fly direct to anywhere west of the Mississippi. From Boston, which was too far to drive to—but which now is an excellent quick commuter flight—Bucky can fly direct to anywhere in the United States.

Bucky's experience seems to be typical. A study by the Civil Aeronautics Board (CAB), "Developments in the Deregulated Airlines Industry," by David Graham and Daniel Kaplan, shows conclusively that service to small communities has greatly improved in the United States with the abandonment of CAB controls over airline routes and charges. Some 132 communities are recorded as having lost regular jet airline service since deregulation, but, says the report, as these "airlines have moved out, the commuter (airlines) have moved in with the small aircraft suited to these markets. On average the commuter airlines are supplying these communities more service with lower subsidy costs than was provided by the certificated airlines." Flight frequency has improved overall. Commuter traffic grew 20 percent in 1978 and 29 percent in 1979—the small planes are definitely accepted by travelers.

Airline routing has changed significantly since the days of license controls over flight routes. The routing that has emerged under free competition, the CAB report notes, has accommodated travelers' needs better than the planning process involved in licensing ever managed to do. Under competition, travelers have fewer connections to

Illustration by Byron Glaser