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Howard Davies focuses on EMU issues



Howard Davies
Deputy Governor, Bank of England

The Deputy Governor of the Bank of England, **Howard Davies**, proposed the health of the London Bullion Market Association at the LBMA's fifth biennial dinner held at the Gibson Hall, London, on 12 September 1996 (writes Chris Elston, LBMA Chief Executive).

In a speech which focused partly on the prospects for the English soccer season, and for one northern first division team in particular, the Deputy Governor had some serious points to make.

First, on the subject of International Monetary Fund (IMF) gold sales, he re-iterated the UK government's support for the sale of up to 10 million ounces so that income on the proceeds could be used to help the poorer countries. If, despite some opposition, such sales were to go ahead, it would be the UK government's aim to ensure that they should be phased so as to minimise any possible disruptive effect on the bullion market.

Secondly, the Deputy Governor broached the thorny issue of Economic and Monetary Union (EMU) and the implications for the bullion market. "The central banks involved in the EMU process are very significant holders of gold," he said, "with around 15,000 tons between them -- a little under half of the total of 35,000 tons owned by all central banks and monetary authorities together. The European Central Bank (ECB) statutes say nothing explicit about gold, but that does not mean it won't play a part in the reserve pool of perhaps around 50 billion ecus which the Treaty requires EMU members to establish in Frankfurt". While no decision has yet been taken on this, the Deputy Governor again stressed that the UK government would be arguing against any measures which could disrupt or unsettle the bullion market.

He referred to discussions that the Bank had already held with the LBMA on how its members could be affected. These were part of a wider exercise aimed at assessing the impact of EMU on the City. Despite not knowing whether the UK would be in or out, he considered it important to think through the potential consequences for London.

In this context he saw it as unwise to talk about the City as if it were a homogeneous entity. In any political development there were bound to be both winners and losers, so it was necessary to look at the impact on the City market by market, he said. Done this way, careful analysis had a hard job to provide a simple conclusion. He could find little support for the proposition that the interests of the City would be irremediably damaged if the UK were to sit out the first dance. Likewise, he thought that those who argued that a position outside EMU was inherently desirable from a financial market point of view and that the UK could be the deregulated offshore centre for the Euro tended to underestimate the determination of the ins. He had little doubt that Frankfurt and Paris would do their utmost to exploit whatever potential EMU gave to gain advantage over financial markets in countries staying outside.

In conclusion, the Deputy Governor stressed the need for individual markets and institutions to take a long hard look at the way in which the competitive dynamics of their operations could be affected by EMU, in both the long and the short terms, and irrespective of whether the UK joined or not. For the bullion market he saw the practical consequences of EMU in the short run at least as modest, but he warned that

the single currency could alter the dynamics of financial markets in ways we could not easily predict today. His serious message, therefore, was that we should all usefully engage in the intellectual exercise of trying to assess those dynamics.

In thanking the Deputy Governor and proposing the health of the guests, **Alan Baker**, Chairman of the LBMA, paid tribute to the Bank's co-operation and support for the market over the years. "This" he said, "has undoubtedly been a major contributing factor in the position of London in the world of bullion and something we look forward to continuing in the years ahead".

Like the Deputy Governor, Alan also touched on the burning topics of IMF gold sales and EMU. On the former he took comfort from the fact that the last occasion when the IMF sold 732 tons over a four-year period in a series of 44 public auctions coincided with a market rally which has since become legend. Perhaps, he suggested, we should just wait for history to repeat itself.

On EMU, Alan reported that the LBMA had become a member of the City of London Joint Working Group on EMU legislation not because he foresaw practical problems of conversion of contract that some markets were having to address but, because it wanted to be involved in discussions on the implications of the introduction of the Euro, whether the UK was in or out. At the same time, he noted, "we have considered the implications for the status of the London Bullion Market if the UK remains outside EMU. Given the standing and experience, combined with the critical mass of the market in London with its representation from all over the world, we really do not envisage any threat, and are sure we can only retain the prominent position in the international market we currently enjoy".

Alan also referred to the gold market's stability. Some people, he admitted, may well be bemoaning its lack of volatility, but was stability really such a bad thing? A market without volatility may limit profitability but, conversely, high volatility is not necessarily a recipe for instant profitability for all.

Still on the subject of volatility, he condemned the continuing indiscretions by the stupid or greedy few who held themselves out to be bigger than the market and damaged the dealing environment in the process. At the end of the day he saw basic honesty, integrity and common sense as the best regulators. "One thing is clear", he said, "the difference between genius and stupidity is that genius has its limits".

Some saw a solution in greater transparency and, while the LBMA was keen to move in this direction, with an enhancement of the Reuters GOFO page and the possible availability of statistics on clearing turnover in the offing, he warned that there was a tightrope to walk in achieving a balance between transparency and confidentiality. And there was the danger that too much information could be used by those manipulating a market to their own ends.

The Top-Table Team



Alan Baker paid tribute to HM Customs & Excise and, in particular, to Stewart Kingaby, whom he welcomed as a guest, for its role in maintaining a close working relationship with the LBMA. This was evidenced by the recent establishment of a liaison group to discuss UK policy on VAT harmonisation in the EU, in which at the top of the agenda was the aim that any changes in VAT arrangements will take place only if they are positive for and in agreement with the London Bullion Market.

Alan also expressed satisfaction at the move towards a closer relationship between the LBMA and the LPPM. A first example of this was the work being done together to include Platinum and Palladium within the ISDA Bullion Definitions. "With so much common ground between our organisations by way of product, market participants and personnel, it would be incongruous if this tendency towards closer co-operation does not continue and, for my part, on behalf of the LBMA I support it wholeheartedly".

Finally, Alan paid tribute to the efforts of his fellow members of the Management Committee, of those serving in the various Sub-Committees and of the Executive. He singled out the Public Affairs Committee, now under Jeff Rhodes, for its work on the new brochure and the *Alchemist*; and the work of the Physical Committee under Peter Smith on updating and refining the Good Delivery List, including the task of bringing into the fold the former Soviet state refineries.

Alan concluded by welcoming the other guests and introducing **Timothy Green** who, he said, "over the years has taught us more about our own market than we know ourselves."

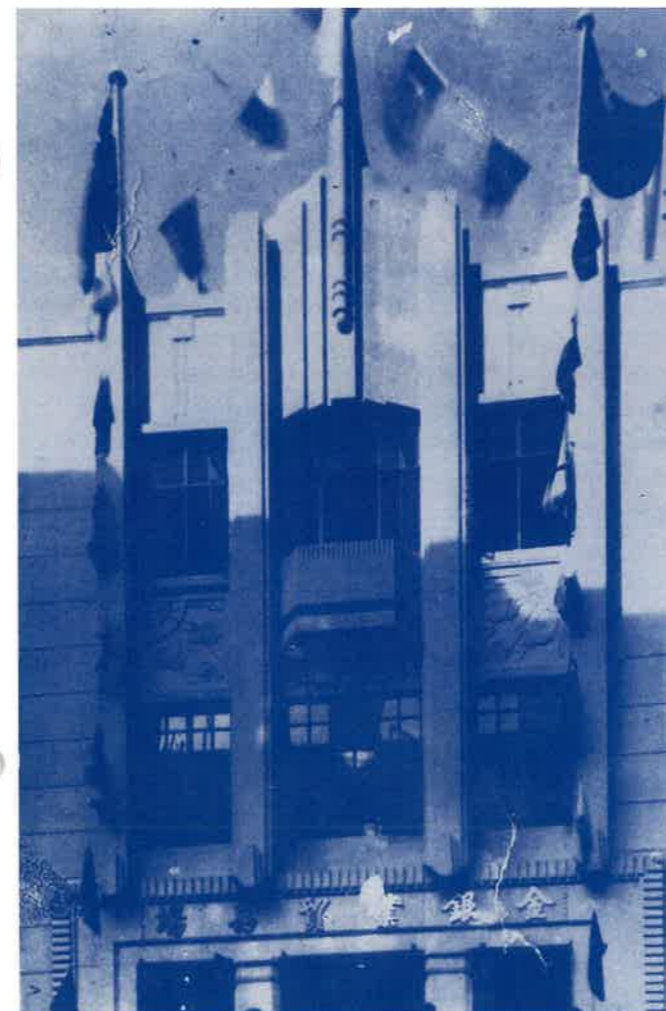
In responding on behalf of the guests, Tim took his audience on an unashamed and entertaining nostalgia trip. He said that he seemed to get into the gold business some 30 years ago by accident by writing about it as a journalist and had somehow stayed with it ever since.

His career, he thought, had covered the most entertaining era in the history of gold (with the possible exception of the Napoleonic wars – when there *was* some volatility). He had seen the transition to today's high-tech paper trading from what was, essentially, a physical market where you had to journey to up-country Laos or downtown Jakarta to meet your clients.

Tim reflected on the long history of the London market as the prime crossroads for both gold and silver and sang the praises of the enduring relationship between the market and the Bank. The market, he pointed out, had pre-dated the Bank by some 20 years but, once the Bank was born, it soon worked hand-in-glove with the market. It was worth acknowledging that inheritance which continues today, despite the immeasurable changes in gold. "The Old Lady is doing a beautiful job for the London market", an envious Swiss gold dealer had told him – and so it should, he thought; it has had three centuries of practice.

The Asia/Pacific Market

by Jonathan Spall, Head of Precious Metals (Asia), Deutsche Morgan Grenfell, Hong Kong



The *Alchemist* approached me to write an article on Asia. So what should it be about? India as the world's largest consuming nation? An analysis of the Chinese physical market and the bulls' great hope for the future? The Asian spot gold market as arguably the biggest in depth and volume? Or Australia's position as the third largest producer and home of

some of the world's most innovative hedgers?

The next question was how qualified am I to handle these subjects? The World Gold Council and Gold Fields Mineral Services devote much of their time to compiling statistics on supply and demand – little new for me to add to their analyses. Market depth?

I could not believe that any of my competitors would be willing to send their turnover figures to Deutsche Bank, even for so worthy a cause. Similarly, the Australian mining community would be unlikely to lay bare their hedging strategies or, perhaps more pertinent, want them published. In the event, I decided that I would adopt a personal approach.

The Asia/Pacific market has trading centres in Hong Kong, Melbourne, Singapore, Sydney and Tokyo (alphabetically ordered). Despite rapid international phone dialling, Reuters dealing machines and computer links, location is still a rough guide as to the niche that each company looks to fill. A Singapore base means physical business, Australia has producers and Tokyo plays host to the Tokyo Commodity Exchange (Tocom) (see pages 6-8). Hong Kong is more rounded than most but does have the greatest concentration of market-makers.

I moved to Asia from London nearly five years ago. When I first arrived, the gold market opened and shut with bewildering frequency. Tokyo opened an hour ahead of Hong Kong, market-makers in Hong Kong would quote the Japanese trading houses during this period but refused to quote each other. Once the Hong Kong tael market had opened,

the Japanese were only an hour away from going to lunch. When they returned two hours later, it was only 30 minutes before Hong Kong was off to enjoy dim sum for two hours and, by the time we had returned, both the Australians and the Japanese had closed. So, out of the entire trading day these three centres were only open at the same time for 90 minutes. No wonder that "Asian liquidity" was seen as something of an oxymoron.

Things have altered greatly in the intervening period. The Australians still pick up the baton after Comex closes, but are now joined by Hong Kong, Singapore and Tokyo at 8am Hong Kong time (0000 GMT). No longer are traders "waiting for the opening" or "at lunch", quotes are available from every centre, bar Tokyo, throughout the trading day. Although Tocom does close for a two-hour lunch, liquidity remains high with aggressive market-makers located in the other three centres.

Conventional wisdom may be that the narrow ranges seen in Asia are indicative of a market where little happens. However, I am not alone in my belief that Asia rivals Europe as the world's largest spot market. We have some of the world's largest consuming nations, coupled with one of the world's biggest producers, and once Tocom is added into the equation, it is

easy to see that large volume can easily be absorbed. The narrow ranges encourage day traders to hold sizeable positions, thus holding the market within tight bands.

So much for a quick overview of Asia, past and present. However, what about Hong Kong and Asia's future?

I recently travelled in Europe and North America and in every meeting I was asked, "What is going to happen to Hong Kong next year?" As most of you will be aware, at midnight on 30 June 1997, Hong Kong will become a Special Administrative Region of the People's Republic

of China. The Basic Law, Hong Kong's mini constitution after the handover, guarantees no change for 50 years. However, the media, both domestically and internationally, have no consensus on how events will unfold. It is unsurprising then, that people are curious as to, first, where Deutsche Bank will site its Asian precious metals team in July next year, secondly, how many market-makers will move out of Hong Kong and, thirdly, where I think the new centre of trading will be.

Ignoring that some banks may switch location as they alter their target market, then the answers to these questions are

relatively simple: first, Hong Kong, secondly none, and thirdly Hong Kong. Events next year are unlikely to alter any bank's decision on where to base their trading room. For example, and I doubt whether Deutsche Bank is alone in this, the bank's dealing room in Hong Kong has increased from 20 positions to 76 in the last nine months. Although not all on precious metals!

As the GNP of Asian nations continues to grow, so will the potential for the physical market. However, there will be competition from a plethora of other investment opportunities and the World Gold Council

will have to keep devising new and imaginative strategies to let gold keep its share in the incomes of these rapidly developing nations. Likewise, the Australian producers will be prospecting fresh resources and new technology will allow them to bring down the economically viable ore grade.

The future for the Asia/Pacific region remains bright for its economies and for the precious metals markets. If anyone has doubts about the efficiency and depth of the markets here then I can only encourage them to trade and see for themselves, whether it be in spot, forwards or options.

(pronounced tail and weighing 37.429 grams). Each contract is of 100 taels.

Trading Style: although prices are open outcry like Comex, members have to touch one another to signify that a deal has been struck.

Delivery: Comex is a futures exchange with set months; the Chinese Gold and Silver Exchange Society is for deferred delivery (closeout basis only).

Price Fixing: twice daily during the week at 11.30am and 4pm; on Saturdays at 10.30am. This is a mechanism for the brokers to avoid the accumulation of large unsettled positions between themselves.

Interest Fixing: the carried over charge is fixed once a day, at 11am during the week and 10am on Saturdays. This allows the rolling over of positions – in much the same way that the "tom/next" market operates for loco London gold.

Membership: Hong Kong registered companies only.

So much for the key differences but what does it mean? The Exchange's page on Reuters is HKGG where the updated prices, carry over charge (interest fixing) and price fixing are displayed. To convert the price shown to one that is a little more recognisable, apply the following formula (the TT rate is the USD/HKD exchange rate):

$\text{Tael price} / 1.1913 / \text{TT} = \text{US\$ price per 995 troy ounce (loco Hong Kong)}$
For example: $3580 / 1.1913 / 7.7380 = \$388.35 \text{ loco Hong Kong}$

If the US dollar price loco Hong Kong is at a premium/discount to the US dollar loco London price, this suggests that there may be arbitrage possibilities – shipping the gold to Hong Kong if the local price is at a premium and shipping out of Hong Kong if it is at a discount. The relative premium/discount is sometimes taken as a barometer for regional physical demand although that is not strictly the case as other factors also influence the price – such as the TT rate.

Turnover on the Exchange has waned over the years with the loco London market now dominant in Hong Kong. The Chinese Gold and Silver Exchange Society is addressing this issue and examining ways to increase turnover. Among the ideas under consideration are to lengthen trading hours so that they overlap with New York's Comex market and to establish a system whereby nominated floor members become market-makers and undertake to quote in 2,000 taels at a time. Re-introducing silver trading is also being discussed.

The author is grateful to The Chinese Gold and Silver Exchange Society for supplying the photographs which accompany this article.

The Chinese Gold and Silver Exchange Society

The Exchange is the oldest gold trading exchange in the world and is celebrating its 86th anniversary this year. It began life as an informal meeting place for money changers and gold/silver traders in 1904. In 1910, it was decided to adopt the name "Gold and Silver Exchange Company" and in 1918 the name changed to the current one of "The Chinese Gold and Silver Exchange Society". This is now something of a misnomer as silver is not transacted on the Exchange any more.



There are a number of key factors that distinguish the Exchange from other futures markets. These are:

Trading Hours: open from 9am until 12.30pm and 2.30pm until 4.30pm five days a week and from 9.30am till noon on a Saturday (Hong Kong is constantly on Greenwich Mean Time plus 8 hours).

Trading Unit: most people are used to seeing prices in US dollars per 995 fine troy ounce and then making a premium/discount adjustment for location. However, the Exchange quotes prices in HK dollars per 99 fine tael

The precious metals market in Luxembourg

by Ralf Kreikenbaum, Senior Vice President,
Commerzbank International S.A., Luxembourg

Luxembourg, located geographically and politically at the heart of Europe, was a founding member of the European Community and hosts many of its most important institutions including the European Court of Justice, the Secretariat of the European Parliament, the Court of Auditors and the European Investment Bank. Luxembourg is also a member of the United Nations, the International Monetary Fund, the World Bank and NATO. This small country, with its population of about 400,000, has repeatedly demonstrated its ability to adapt to the flow of history. It has moved from being a basically agrarian economy in the 19th century, to become one of the major steel-producing regions of Europe in the early 20th century and, since the early 1960s, it has developed into one of the top 10 international financial centres. Today, more than 200 banks from roughly 25 different countries are established in Luxembourg. Most of them are wholly-owned subsidiaries of top-ranking international banks which offer a wide range of services, from traditional banking products to sophisticated financial engineering to private as well as corporate and institutional customers. Professional expertise and high quality standards are well-known hallmarks of Luxembourg as a financial centre.

The development of precious metals transactions in Luxembourg has benefited as a result of various regulations, the first of which was the lifting of a Grand-Ducal decree in December 1955, which made the trading of gold and its exportation subject to an authorisation from the Minister of the Treasury. The introduction of VAT followed in 1969, when gold deliveries inside the country and the importation of gold became liable to taxation. In 1979, gold trading investments were exempted from VAT. On 17 March 1981, Luxembourg created an official "fixing" system for the price of gold in the Grand Duchy. During the 1980s, Luxembourg, which levies no tax on such transactions, became a convenient "off-shore" centre for investors wishing to buy gold bars and coins. Significant gold dealers in the Grand Duchy are Commerzbank International S.A., Kredietbank and Banque Internationale à Luxembourg.

The organisation of the Luxembourg gold market
The daily Luxembourg fixing at 10.30am constitutes the first official quotation in Europe. Admission to the market is restricted to the members of the Luxembourg Stock Exchange, each of whom must possess resources amounting to the equivalent of LUF 50,000,000 (= about USD 1.6 m). The members act on their own behalves as principals and issue their own contracts. The fixing is made for ingots weighing 1,000 grams/fineness of 999.9/1,000; in standard quantities of 400 troy ounces of fine gold. Prices are quoted in terms of LUF per kilogram or USD per troy ounce

(USD1 = about LUF30.60), and the price spread for fixing purposes is LUF 50.00 per kilogram bar or USD per troy ounce. The prices established during the fixing session are published in the Luxembourg Stock Exchange Official List and distributed to various press organisations. In principle, the settlement of transactions is made "loco Luxembourg" through the clearing intermediary for the system, CEDEL, which has organised a central depository for this purpose with the Caisse d'Epargne de l'Etat in Luxembourg. But, given agreement between two contracting parties, settlement or delivery may also be carried out by other means or in another location.

Following the developments in the international gold market during the past 10 years, private investors in Luxembourg, as elsewhere, are no longer interested in precious metal assets. If and how the conditions for private investment in gold in Europe generally and Luxembourg in particular will change with the advent of European Monetary Union remains to be seen.



Luxembourg, the "European Heart of Gold"

The Tokyo Commodity Exchange (Tocom)

by Yuichi (Bruce) Ikemizu, Manager/Chief Trader, Metal Trading Section, Commodity Trading and Risk Management Division, Mitsui & Co. Ltd., Tokyo

Tocom is one of only two surviving and thriving futures markets in precious metals in the world. It has now become the source of liquidity for the Far East market. Tocom platinum has long been the world's biggest platinum market, about 1.5 to 2.5 times larger in volume than Nymex over the past five years. Gold, though not as dominant as platinum, has also become a major market, about half to 1/3 the trading volume and the same level of open interest as Nymex gold contracts (see charts). Yet it is still very much a local, ambiguous and mysterious gold market to many people in other parts of the world. I hope my commentary will help those people to understand Tocom a little better.

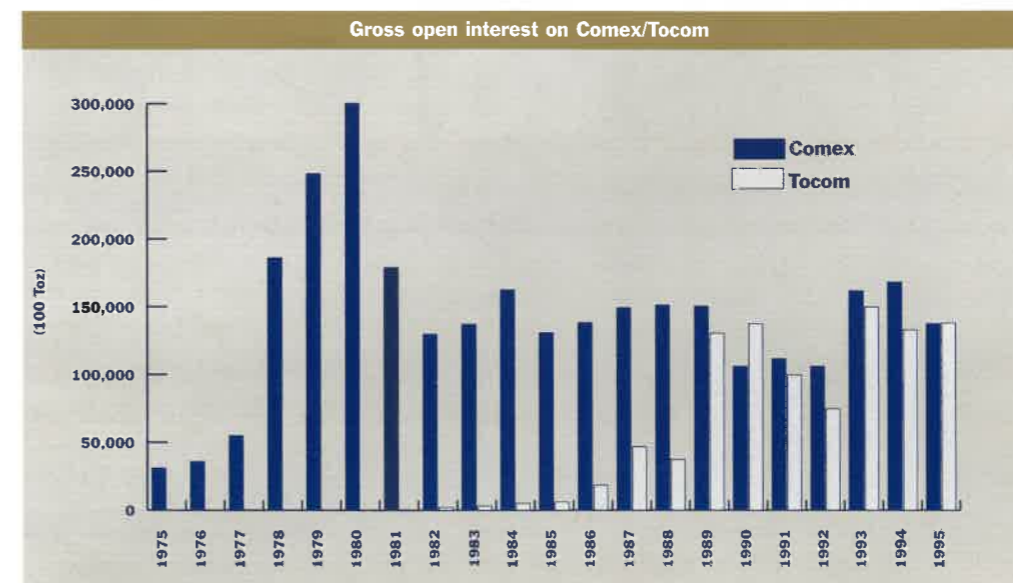
History Tocom started a gold contract in 1982. It has grown so rapidly in the past 14 years that the open interest is now 10 times larger than at the first year-end. It started its trading in a fixing style, where we had six fixings a day in the Tocom ring, doing future months' fixing at each fixing time, and

there was no trading between the fixings. However, the whole picture changed when the new computer trading system was introduced in April 1991. The fixing style trading was replaced by a computerised open and continuous market. Now there is no ring in the Tocom building, but just a computer

sitting in a small room, through which tens of thousands of contracts change hands daily.

Trading In many respects, Tocom is very different from its counterpart in New York. Every general member and FCM (Tocom broker) has at least one terminal from which

he or she can enter orders to the Tocom host computer. The orders are matched and executed by price and in chronological order. Tocom starts receiving orders at 8.20am Tokyo time every morning and it starts trading at 9.00am, fixing prices for the next month at two-minute



intervals; for example, the Aug 96 contract will start fixing at 9.00am, then Sep 96 fixes at 9.02, Oct 96 at 9.04 and so on. Finally, the furthest month fixes at 9.12. After the fixing, each month goes as an open market, where you can just buy or sell at offer or bid or put new orders. Tocom finishes its morning session at 11.00am in almost the same fixing manner as the opening, but all months at the same time. It repeats the same procedure again in the afternoon, receiving orders from 12.30pm, starting fixing at 1.00pm and finishing the day at 3.30pm.

Contracts Tocom contracts are traded on a yen per gram basis. One contract is one kilo for gold, 30 kilos for silver, 500 grams for platinum and 1.5 kilos for palladium. Deliveries are 99.99%up kilo bars for gold, 99.99%up 30 kilo bars for silver (6% weight allowance), 99.9%up 500 gram bars for platinum (2% weight allowance) and 99.95%up bars in bunches of three kilos (which could be three kilo bars or two 1.5 kilo bars, 15% weight allowance) for palladium.

Seven future months are traded separately. (There is no official EFP or switch system.) Trading months are basically even months (Feb, Apr, June, Aug, Oct and Dec) during every year

plus one immediate odd month. For example, if it is August 1996 now, the trading months will be Aug 96, Sep 96, Oct 96, Dec 96, Feb 97, Apr 97 and June 97. Basically, the value date for each contract is the last business day of the month. The last trading day is three business days prior to the value date.

Tocom does not have an EFP or switch system. This means people must trade directly in the Tocom months or spot if anyone wants to do such a trade. (This may be an area for improvement in the Tocom trading system if they want to encourage more overseas interest.) It is unique to Tocom that the further

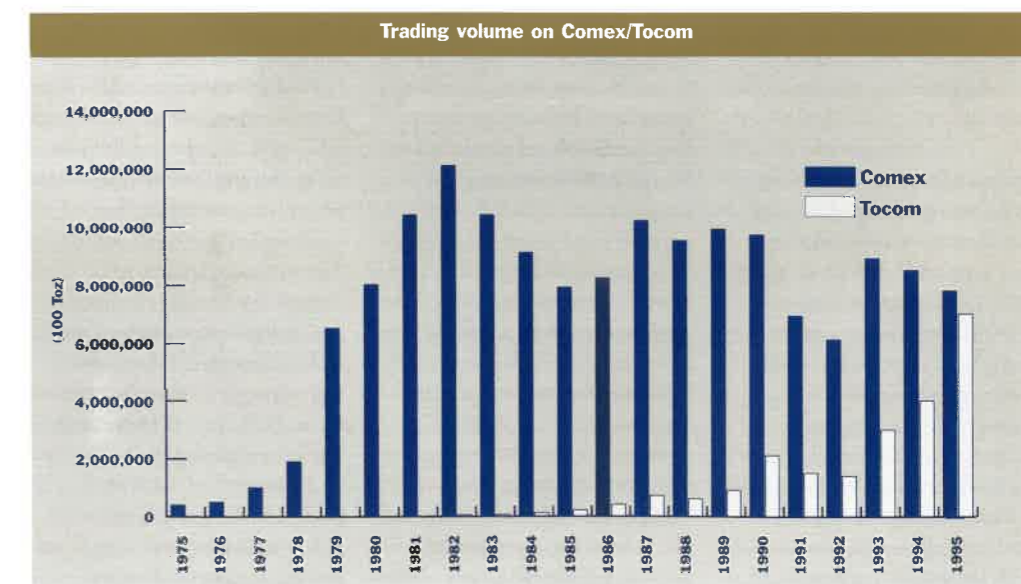
months are more active than the near months. So the volume traded is much bigger in the further months than in other nearer months — as Japanese speculators tend to think they have more time to speculate on one-year contracts rather than the ones which end in three months' time.

One more striking contrast with Nymex is the volume of physical deliveries which is being done. In every even monthly settlement, there are at least 5,000 to 10,000 contracts (5 to 10 tons) gold physical deliveries. Actually, if one thinks about the very high margins on the Japanese domestic retail gold price,

one can buy gold kilo bars contracts in Tocom with much narrower margins and take deliveries. So, in a sense, Tocom is really a physically driven market as well.

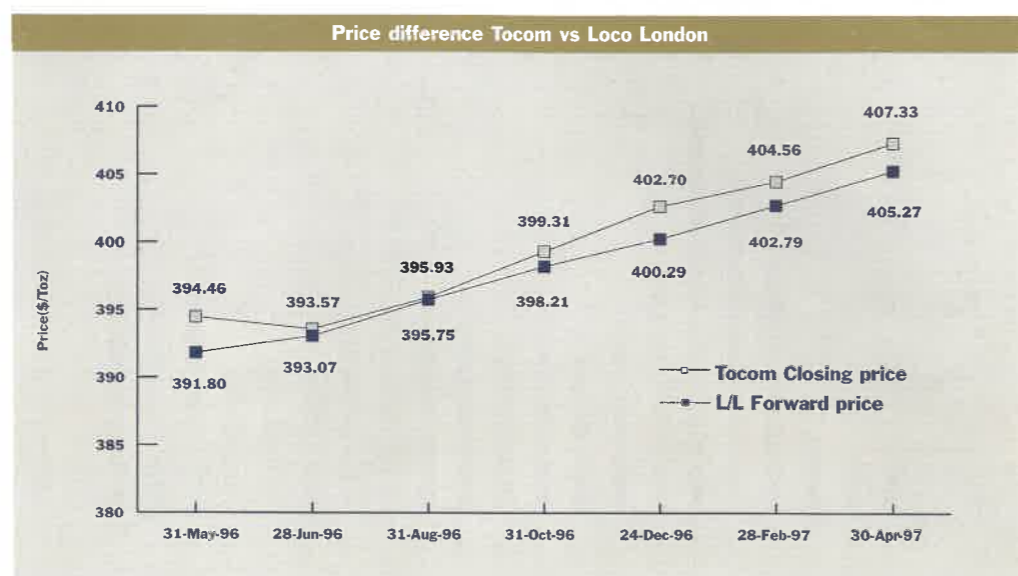
Participants There are roughly three kinds of participants in the Tocom market. They are speculators (general public), arbitrage traders (trading houses and overseas bullion traders) and locals (FCM brokers' in-house trading). These players provide the market with liquidity. Usually there are more than two to three tons of liquidity at any one price, offered and bid in one yen spread (= about 30 US cents/toz) in the most active furthest month. With all the trading months combined, there are usually around 5 tons of immediate offers and bids — a very good market if you need to do some volume.

With these unique features, Tocom has long been a very local market especially as it is denominated in yen. This has acted as a disincentive to overseas traders and funds — so far. But, in reality, there are plenty of trading opportunities: just think about all those gold moves and dollar yen moves mingled together!



You cannot talk about the Far East market without referring to what is happening in Tocom. And you cannot talk about gold without mentioning Tocom.

Yuichi (Bruce) Ikemizu started his career in gold trading in 1986 in Sumitomo Corporation. He established Credit Suisse Bullion Japan in 1990 and, since November 1992, he has headed Mitsui & Co. Ltd.'s bullion trading operation in Tokyo.



The FT World Gold Conference

by Chris Elston, Chief Executive, LBMA

The Financial Times kindly invited me to its World Gold Conference in Venice last June and I am grateful for its hospitality. It was my first Gold Conference so I have no benchmark by which to judge it.

However, I can say that the venue was great; the Excelsior Hotel on the Venice Lido in June is not to be sneezed at and must have had something to do with the record turn-out of nearly 500 participants. Sadly, the weather was not at its best: St Mark's Square was under water for part of the time and floods in the Friuli region to the north prevented the grower from putting in an appearance at JP Morgan's excellent wine-tasting on the island of Torcello

(but not to worry, the wine arrived and we went ahead with the tasting anyway).

Even so, a conference that attracts nearly 500 eager attenders must have something going for it: it was significant that most of them turned up for the second morning's presentations, which from my experience of other conferences does not happen that often. However, the success of a conference hinges as much, if not more, on attracting the right people, which means the ones you want to talk to, as on its subject matter. Here the *FT* may have a problem: plenty of bankers, of both the commercial and central persuasions, and a good sprinkling of miners and refiners, but investors were

outnumbered by a factor of plenty.

Nevertheless, organisation, content and presentation are obviously also vital. So far as I could tell the organisation was faultless, though I daresay those who were doing it would own up to swan-like tendencies – all serenity on the surface, working like hell underneath. The subject matter was comprehensive and the format – individual presentations with slides, some panel discussion and some good contributions from the floor – conventional. The chairmanship, shared by **Robert Guy of NM Rothschild** and **James Riley of Aron**, was suave, professional and entertaining in roughly equal proportions.

If I had a thought to offer to the organisers, it would be that they might explore the scope for getting away from waterfront coverage in favour of highlighting and examining in greater depth a smaller number of themes. Easy to suggest; perhaps difficult to put into practice.

Even so, some issues clearly featured more prominently than others and I shall report on two of the more obvious of these – the great hedging debate and the role of central banks.

On the level of hedging, past and future, **Ted Reeve of Scotia Capital Markets** took the view that it was likely to rise and to go longer. In North

America, despite the well-publicised partial liquidation of forward sales by two major producers (subsequently – and with rather less fanfare – partly reversed), two others had increased their hedging activities. At the same time, hedging by Australian producers, in proportional terms the largest hedgers, was also on the rise, as was that by the South Africans, who at present had a considerably smaller proportion of their output hedged.

Why this trend was likely to continue was made clear by **Mark Keatley of Ashanti** who pointed out that hedging made a substantial contribution to the cash flow that mining companies needed to carry on their business. They tend to spend about \$5bn a year – \$2bn on developing existing mines, \$0.5bn on exploring for new ones and \$2.5bn on buying other mines. So they have been spending more on buying each other than getting the stuff out of the ground. Where was this money coming from? It was gratifying, said Keatley, that \$2.9bn was coming from internal sources. This represented \$40 per ounce of gold sold. The rest came from gold loans, shares and convertibles.

Hedging, therefore, had become a source of finance in its own right, providing a significant enhancement to the producers' income stream. It had been decisive in underpinning the financing of some of the biggest projects currently being undertaken and, therefore, done in an appropriate way, underwrote the growth of the industry.

This was **Mark Keatley's** answer to the question put by **Geoffrey Campbell of Mercury Asset Management**: Do Shareholders Matter? His answer, of course, was yes, because they provide large amounts of capital. Hedging, in his view, gave the wrong

signals: in preferring cash to gold a company was suggesting it lacked confidence in the future of the very metal that provided its life-blood. In addition, hedging tended to conceal the signposts and remove the discipline of fragile economics from mine managers.

Turning to the activities of central banks, **James Cross of Crosswords Research and Consulting** gave a detailed analysis of the role of central banks in providing the market with liquidity. While total central bank gold holdings had fallen slightly in the 1990s, from 35,792 tonnes in 1990 to 34,585 tonnes in 1995, with the drop more than accounted for by developed countries, the number of central banks participating in the lending market had almost trebled and the volume of the market had more than doubled. Even so, the volume of 2,100 tonnes still represented well under a third of the 7,900 tonnes of gold held by the active central banks (and obviously only a small proportion of the total of 35,000 tonnes held by all central banks). For the future, **James Cross** considered it likely that central banks would be more active in managing their reserves, including use of the

gold deposit market. They were also likely to be more responsive to price and interest rate changes.

In an entertaining and colourful analysis on the Differing Impact of Higher Leasing Rates on All Market Participants, **Andy Smith of UBS** reached the same conclusion. Central banks were likely to respond to higher lease rates with more lending, so there was no need to be worried by the prospects of a gold famine.

Finally, **Robert Rubin of AIG Trading Group** speculated on the implications of EMU if and when it happened – and he thought it would, albeit with a limited number of participants. He saw confusion in the market which needed clarifying, and a number of myths which he sought to dispel.

He also threw in IMF gold auctions and put the view that they would become part of the landscape despite current opposition by some countries.

By contrast, however, he saw the birth of the European Central Bank (ECB) and what it all meant for gold as having everyone rattled for the next few years, but that there was probably less

than meets the eye for gold in all the ECB machinations.

There were many other excellent presentations. **Tom Main of the Chamber of Mines of South Africa** claimed that the demise of the South African mining industry had been greatly exaggerated and that it could be in for a renaissance. The growing Asian market featured in presentations by **Michael Kile of the Gold Corporation of Australia** and **Raymond Chan Fat Chu**, the newly elected President of the Chinese Gold and Silver Exchange Society. Asia also featured in **Philip Klapwijk's (Gold Fields Mineral Services)** presentation on the Gold/Silver Relationship, warning that there were dangers in the short term of excessive market reliance on Asian jewellery demand.

A report such as this could hardly omit mention of **Alan Baker's (Deutsche Morgan Grenfell and LBMA Chairman)** contribution on How the Market is Responding to New Forces. Although he admitted to some difficulty, in current market conditions, in identifying those new forces, his analysis of the development of the market led him to the conclusion that the market had grown in depth, sophistication and stability.

Producers, he maintained, could only be grateful for a market which over the past three decades had absorbed a steadily increasing level of supply. Consumers had enjoyed a price stability in which their businesses had flourished. And central banks could only be happy, as they sat on their golden eggs, with a market which caused them no sleepless nights – for the moment!

This brief survey hardly does justice to the range of topics covered. But my guess is the same issues will be the live ones at the same time next year. We look forward to Prague!



NEXT THE "QUEST FOR GOLD" ARIA FROM PUCCINI'S "GIRL OF THE GOLDEN WEST"

Mind the Gap

Comment by Helen B. Junz, Director, Gold Economics Service,
World Gold Council

Mrs Junz challenges CPM Group's analysis of the demand/supply gap in *The Mine Production Shortfall – The Reality behind the Myth* in the third issue of the *Alchemist*.

In the *Alchemist* issue number 3 CPM Group sought to rewrite basic economic demand/supply analysis. The Myth, in their view, was the alleged conclusion that the gap between gold fabrication demand and new mining output heralds price increases. In a more recent note* Ted Arnold of Merrill Lynch took up this point as well.

Rather than wait for strike three, I thought it useful to start putting these views into a better context. First, no serious observer of the gold scene would formulate a view about relative demand/supply pressures based simply on the new mine production/fabrication demand gap. Anyone putting such a one-dimensional view would, indeed, be creating a credibility gap. Any proper demand/supply analysis needs to take account of swing elements such as investment and inventories. Obviously for gold, with its unique level of above-ground stocks, this is a given. Within that context, the strength of underlying demand and its relation to new supply indicates how much inventory release, or

absorption, would be necessary to clear the market at any particular price. All this is basic market analysis. In what determines demand trends and decisions about retention or release of gold held above ground, price is only one element. And even the effect of changes in that one element cannot be gauged properly in a one-dimensional fashion.

Demand and supply responses to changes in the price of gold depend upon particular circumstances. First, if prices rise gradually and there is a conviction that this rise is there to stay, demand will adjust rapidly and may even react positively; conversely, price spikes that are not credible will trigger profit-taking and postponement of normal demand. Second, reactions to price changes depend crucially on local circumstances and habits in individual gold-consuming markets; thus consumers will react differently to price rises induced by internal conditions vs. those triggered externally, or to those that stem from cyclical vs. structural causes.

In terms of habit, reactions will differ on the basis of whether gold holdings are motivated mainly by store of value or adornment considerations. For example, credit squeezes or cyclically low income growth will cut into demand and/or motivate distress sales and, in high gold affinity countries, such motivations generally tend to be stronger than the profit-taking motive.

On the motivation side, Mr Arnold argues that the overriding factor determining the demand/supply balance is the increasing mobility of above-ground stocks, largely because of the rising share of price sensitive markets (read: Far East markets) in overall demand. Ignoring the points made above, he predicts that, at US\$425 per ounce, the market would be deluged with recycled material. An important point here is that a high price elasticity ought to elicit responses to price changes from any price level, and it is interesting that we did not see a deluge of scrap sales when prices rose from \$365/oz to \$385, nor when they rose

further to \$395 and topped \$400 early this year.

Demand and supply decisions are not just reactive, they are pro-active as well and reflect market expectations as much as market developments.

Thus, the lack of price volatility in 1995 – despite strong underlying demand – owed much to hedging decisions by producers, which in turn reflected expectations about exchange rate movements, interest rate developments and the gold price itself.

Similarly, price expectations pulled in investment demand once the gold price broke through its long-established ceiling of \$395/oz.

Overall, the proof of the pudding is in the eating, and that of any "gap" between myth and reality in its credibility! And the reality surely is that strong underlying demand, outrunning new supply, is good news for the gold community at large.

*Merrill Lynch, *Precious Metals Special*, 22 July 1996

Jeffrey M. Christian, CPM Group, responds to Helen Junz

We are saddened that Helen Junz, of the WGC, agrees with CPM Group that it is improper to expect gold prices to rise solely based on the existence of a "gap" between mine production and fabrication demand. We have written for decades that one must indeed include investment demand, other supply, inventories and central bank activities in one's gold model, a point she makes in her comment.

The WGC's own advisors have pointed out that the gap actually widens as prices fall. It is not that a widening gap pushes prices higher but, rather, that lower prices reduce mine production and boost demand, expanding the shortfall.

Given that Mrs. Junz agrees with our contention, we find it inexplicable that she begin her response to our article with the vitriolic accusation that CPM Group has sought to "rewrite basic economic" tenets.

Regarding Mrs. Junz's comments concerning the relationship between gold prices and demand trends, she is making no statements that conflict with CPM Group's oft-stated analysis of these factors. It seems she may have concluded, incorrectly, that CPM Group was stating that demand did not have a positive effect on prices. That, of course, would be ludicrous. In fact, in October 1986, CPM Group was one of the first groups of precious metals economists to utter the dictum that gold is a "demand driven" commodity, in response to concerns at that time that the flood of new gold mines coming into production would reduce gold prices.

LBMA News compiled by Chris Elston, Chief Executive

Committee Business

Management Committee

Major topics under discussion are:

•Bullion Addendum to ISDA Master Agreement – progress has slowed on this of late, but we are into a third draft and hope to have it tied up by the end of the year.

•HM Customs & Excise has set up a VAT Gold Trade Liaison Group, which held its first meeting on 29 August with nine LBMA members present. The purpose of the Group is to facilitate liaison on VAT matters and to provide a forum for interested parties to bring forward and discuss issues of concern. The main issue for discussion at the first meeting was the EC Directive on a VAT regime for gold.

•A discussion has been held with the Bank of England on the potential implications for the bullion market of the introduction of EMU. Whether or not it comes about and whoever is in or out, the Bank's concern is that the necessary infrastructure is in place and that relevant information is disseminated. To this end, the Bank is producing periodical papers on the practical issues arising from the introduction of the Euro. Initial thoughts, at least, are that the direct impact on the bullion market is likely to be limited since the market is wholly US dollar-based. But the Bank's papers will be circulated and members are asked to ensure that relevant parts of their organisations are kept informed.

•We are aiming to expand the GOFO page on Reuters to show implied middle gold rates and other more general LBMA information.

Physical Committee

•Changes to Good Delivery Lists:

Additions: Gold

Italy, Chimet SpA, from 27.7.96
Kazakhstan, Ust-Kamenogorsk Lead Zinc Combine from 20.6.96

Deletions and transfer to Former List: Silver

Australia, The Electrolytic Refining & Smelting Company of Australia Ltd., currently on a care and maintenance basis under the name Southern Copper Limited, which ceased operation on 5.2.95

Japan, Furukawa Metals Company Limited, which no longer refines silver, on 16.9.96

•Former Assayers: the Good Delivery List for gold contains three companies who were accredited the status of "Assayers only" on the listing previously issued by the London Gold Market before 1987. In the light of recent enquiries it may be worth pointing out that access to the LBMA's Good Delivery Lists is, under the rules of the Association, no longer available to "Assayers only".

•New criteria for silver Good Delivery applications: testing procedures are being standardised with those already pertaining to gold.

•Questionnaire to Good Delivery List refiners: good progress is being made in sending our questionnaire to all those companies on the Good Delivery Lists. We expect to have completed the exercise by the end of the year or soon after and are grateful to all those who have taken the trouble to return the questionnaires. If after one reminder we receive no response to a questionnaire, we will be considering transfer of the addressee to the Former List.

•Visitors: The LBMA has received visits recently from representatives of:

The Russian Federation Committee on Precious Metals & Precious Stones

Central Bank of the Russian Federation

Kumtor Operating Company, Kyrgyz Republic

Kara-Balta Mining Combine, Kyrgyz Republic

LBMA News continued

Discussions are under way with the first two organisations about regularising the position of the former Russian State refineries in the Good Delivery Lists; while the last two are exploring the possibility of applying at the appropriate time for Good Delivery status.

•Disaster contingency: a sub-committee has been considering the procedures that would need to be put into operation to facilitate the clearing in the event of a disaster affecting one or more clearing members.

Public Affairs Committee

•At its meeting on 13 June, Willie Lamarque of NM Rothschild stepped down as Chairman of the Committee owing to pressure of other commitments. Jeffrey Rhodes of Standard Bank London Limited took over as Chairman and immediately put on record the Committee's debt of gratitude owed to Willie for his dedicated efforts over the previous year. Willie remains as a member of the Committee. To enhance the Committee's efficiency, Jeffrey Rhodes asked James Dobell of Sumitomo Corporation (UK) Ltd., to act as Deputy Chairman, which James happily agreed to do.

•As can be seen from the front page of this issue, the LBMA's fifth Biennial Dinner was held at the Gibson Hall, Bishopsgate on 12 September. It was a highly enjoyable occasion with nearly 200 guests. Our thanks are due to John Coley of Deutsche Morgan Grenfell, ably assisted by Stella Thompson of the LBMA Executive, who took on the main organisational task. Their efforts were crowned with success.

•The reprint of the LBMA's brochure has been completed and circulated. In particular, it received its first airing at the FT's World Gold Conference in Venice and was snapped up by the assembled multitude. The same was true of the bumper June edition of the *Alchemist*. Five hundred copies of each were shipped to Venice and to his great relief – and with the helpful co-operation of the FT organisers – your Chief Executive brought only about five copies of each back home in his briefcase.

•The Committee is continuing to look at the issues, which are connected, of greater market transparency and relations with the press.

Name Changes

•From 1 July 1996, Deutsche Bank Sharps Pixley became Deutsche Morgan Grenfell, following the integration of the Sharps Pixley bullion business into Deutsche Bank and the inclusion of bullion worldwide in the Global Markets Division of Deutsche Morgan Grenfell. The Sharps Pixley name, however, which can be traced back to around 1740, is retained in Deutsche Sharps Pixley Metals Limited, the non-ferrous metals trading subsidiary of the Deutsche Bank Group.

•From 1 October 1996, Prudential-Bache (Futures) Limited became Prudential-Bache International Limited.

People

Life in the fast lane

Congratulations to **Martin König**, now of UBS, who has achieved a long-held ambition to drive at the famous Daytona Beach race-track while taking a break from the heady excitement of bullion trading. Martin took part in one of the world's toughest motor races – the Daytona Rolex 24-hour race – as part of the First Union Porsche team. With Martin one of two drivers making their debut at Daytona, their team did exceptionally well to finish a creditable 15th overall and 8th in its class, out of 78 starters, completing 598 laps and finishing ahead of 60 other cars.

Into Parliament?

Bob Guy (NM Rothschild & Sons), founding father and first Chairman of the LBMA, has been selected as the prospective parliamentary candidate for the Conservative party for Hove (Conservative majority at the last election: 12,268).

Retirement

Phil Wilson has retired from his full-time role with Mocatta. But, to capitalise on his many years' experience of the bullion market, Mocatta is wisely retaining his services on a consultancy basis. Likewise, Phil remains as a member of the LBMA's Finance Committee.

DIARY OF EVENTS

27-29 October

China Metals Conference, Metal Bulletin, Great Wall Sheraton Hotel, Beijing

19 November

Fifth City of London Central Banking Conference, Skinners' Hall, 8 Dowgate Hill, London EC4

27-28 November

First International Conference on the Mining and Processing of Gold and Diamonds in the CIS, Adam Smith Institute, Le Meridien Hotel, London

8-10 December

Second Southern African Mining & Metals Conference, Metal Bulletin, Park Hyatt Hotel, Johannesburg

11 December

LBMA Christmas Disco, Elizabeth Suite, 34 Wood Street, London EC2

16-21 February 1997

Frankel Pollak Vinderline 20th Annual Investment Conference, Johannesburg and Cape Town

21 May 1997

London Platinum and Palladium Market Annual Dinner, The Savoy Hotel, London

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