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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

The World Gold Market: A Semiannual Review

International Finance Series No. 22

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
August 1970

INTELLIGENCE MEMORANDUM

The World Gold Market: A Semiannual Review

Introduction

This memorandum, one of a series begun shortly after the two-tier gold market was established in March 1968, reviews developments in both the official and private tiers of the world gold market from January through June 1970.

Highlights

1. The calm pervading international gold and financial markets since realignment of French and German parities in the second half of 1969 continued almost without interruption through June 1970. Free market gold prices fluctuated around $35 per ounce through mid-March then steadily climbed to more than $36 by early May in apparant reaction to renewed Wall Street jitters and US action in Cambodia. By late June, however, free market prices had declined to around $35.50 per ounce.

2. Official gold markets have also been relatively quiet. In the first six months of 1970, the United States experienced a net inflow of $32 million in official gold. During the same period several countries engaged in gold transactions with the International Monetary Fund (IMF), but only a few were in excess of $20 million.

3. The Soviet Union, after a five-year hiatus, is rumored to be considering selling gold later this year. Comments to this effect by a Soviet

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research.

trade official have been played up in the Western financial press. Thus far, although the USSR is running a substantial deficit in its current account transactions with hard currency countries and some of its borrowing is at high interest rates, there is no information to confirm the rumor. However, Soviet sales if they do occur are not likely to be very large.

4. An increase in free market demand for gold could develop during the next six months or so because of growing concern about the United States balance of payments and the Middle East situation. With interest rates still very high, however, and with South Africa selling nearly all its newly mined gold on the free market to finance balance-of-payments deficits, it seems likely that gold prices will remain within the range of $35 to $38 per troy ounce.

5. Demand from industrial users and traditional hoarders probably about equals the supply of newly mined gold. A gap will develop in future years as demand from these sources grows at some 5% annually while production declines about 1% a year. This situation, however, may not soon produce substantial price increases. The shortfall in supply would be very small compared with the vast gold hoards in existence, and, barring major crises, substantial amounts of gold will probably be released from hoards in response to moderate price increases.

The Official Market for Gold

6. At the beginning of 1970 the status of gold as a monetary asset reached a historical point. On 1 January the IMF allocated $3.4 billion in Special Drawing Rights (SDRs) to member nations, and, for the first time since the Fund began operations in March 1947, gold -- including that held by members and international institutions -- accounted for less than half of total monetary reserves.

7. The availability of SDRs in the settlement of international payments transactions plus the relative calm pervading the international currency markets following last October's revaluation of the Deutschemark led to some reduction in official gold movements during the first half of 1970. Should these trends continue through the remainder of the

year, official gold transactions in 1970 will be at the lowest annual level since the IMF began compiling data in 1948.

8. On balance the United States gained $32 million in official gold holdings between January and the end of June 1970. Of the 35 countries involved in gold transactions with the United States, only five bought or sold more than $2 million worth. Kuwait was the largest seller with nearly $25 million, while Malta and Ireland added another $2.5 million and $2.2 million, respectively. The United States acquired $23.7 million more through a purchase from the IMF. The major buyers of US gold were Uruguay ($8.1 million) and Argentina ($5.0 million). Significant non-US gold transactions, many of which involved the IMF as a participant, included purchases by Japan ($59 million), Italy ($24 million), Switzerland ($28 million), the Netherlands ($10 million), and Canada ($8 million); and sales by Iraq ($42 million) and Greece ($10 million).

The Free Market for Gold

9. After declining from a high of more than $42 per ounce in July 1969 to just above $35 per ounce in December, London free market prices remained at or below $35 per ounce for much of the first quarter of 1970; a low of $34.75 was reached in mid-January (see the chart). In mid-March, prices began a steady climb. A spate of bad news from Wall Street, reaction to United States activity in Cambodia, and the usual pre-monsoon season increase in demand from the Indian subcontinent pushed prices to a $36.24 peak in early May. Subsequently, prices drifted lower, ending the second quarter near $35.50.

10. The rather lengthy period of depressed free market prices following the December 1969 Agreement* gave rise to rumors that Swiss bullion dealers

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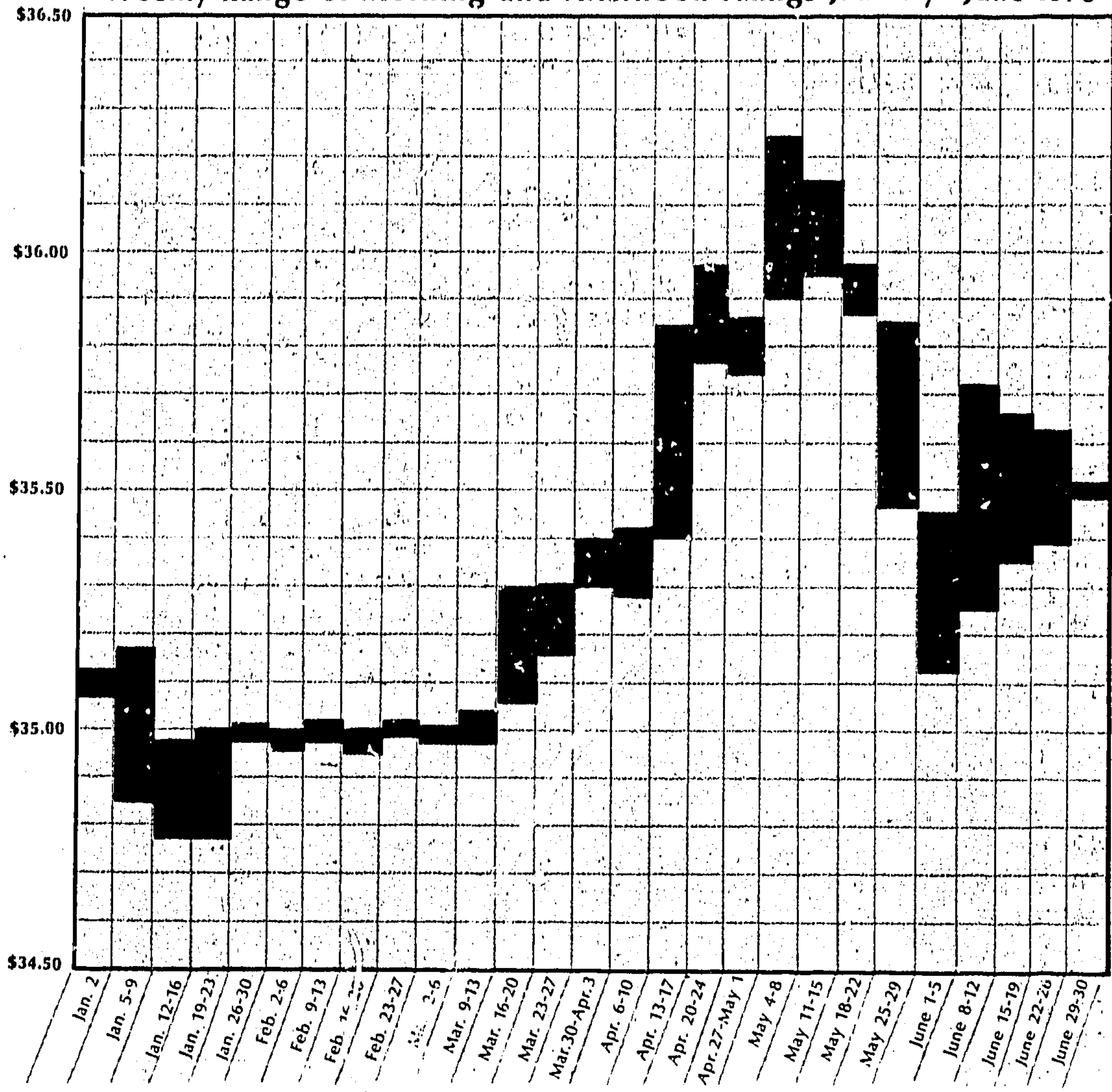
* *This agreement enumerates several conditions under which South Africa may sell gold to monetary authorities, mainly the IMF. One of these clauses allows South Africa to sell to the IMF one-fifth of one week's production for every day that both London fixings are at below* [footnote continued on p. 4]

LONDON FREE MARKET PRICES

Weekly Range of Morning and Afternoon Fixings January - June 1970



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were manipulating the free market to enable South Africa to sell large quantities of its newly mined gold to the IMF. While these rumors cannot be confirmed, it is well known that in mid-1969 the major Zurich banks (the Union Bank of Switzerland in particular) purchased large quantities of gold from South Africa at substantial premiums.

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11. Manipulation of the free market price is suggested by the extremely narrow price range that prevailed for seven consecutive weeks -- from late January through mid-March. During this period, more than 85% of all morning and afternoon fixings fell within the $34.97 to $35.01 range, with nearly 40% of all quotations set at exactly $35.00. Moreover, Swiss bullion dealers are in an excellent position to influence the London free market fixing. At each of some 255 morning fixings a year, the manager of Rothschild's bullion and foreign exchange department suggests an opening price based on a previous half hour of intensive telephone conversations with people at the Bank of England and a host of others, mainly dealers in Switzerland. Representatives of the four other houses are in constant telephone contact with their trading rooms and these in turn are in direct communication with as many as a dozen key clients scattered across Europe. The result is that supply and demand conditions in Zurich are strongly reflected at the London fixings.

South African Gold Sales

12. During the first six months of 1970, South Africa sold $343 million in gold to monetary authorities and another $387 million on the free market. More than one-third ($130 million) of the official sales represented sales to the IMF under the criteria of the December Agreement when the price of gold was below $35 per ounce. The IMF also purchased $177 million of South African gold under two other provisions of the December Agreement and arranged for the Swiss National Bank to obtain $10.5 million of South African gold. Switzerland, although not a member of the IMF, benefits from the December Agreement because its central bank may purchase up to 4% of the gold South Africa sells to the IMF. Of the remaining official sales, $22 million was transferred to France as a result of a French IMF rand drawing.

13. News reports to the contrary, all South African free market sales in the first half of 1970 were apparently made to the Union Bank of Switzerland. Although South Africa continued to ship much of its gold from Johannesburg to Zurich via Balair, a subsidiary of Swissair, a substantial portion apparently was supplied from South African holdings in London.

The Outlook: July 1970 Through June 1971

14. South Africa's balance-of-payments deficit before gold sales in 1970 will be about $1.45 billion.* Receipts from gold sales through the first six months of 1970 totaled $730 million, of which $387 million was obtained from free market transactions. Although this provides a slight surplus for the first six months, South Africa will have to sell another $710 million to $720 million (see Table 1) in order to cover payments needs for the remainder of the year.** There appears to be little likelihood of a substantial improvement in South Africa's payments position during 1971. Another annual deficit before gold sales of perhaps $1.3 billion to $1.4 billion is likely, which would require South Africa to sell at least $650 million (578 metric tons) of gold between January and June 1971.

15. The portion of this gold South Africa is likely to sell to monetary authorities over the coming year will depend to a large degree on whether free market prices remain above $35 per ounce. As early as last summer, several European bullion dealers, perhaps anticipating the coming monetary calm, expressed pessimism regarding the near-term outlook for gold prices. This summer a number of dealers continue bearish. [redacted] 25X1
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Moreover, with interest rates still high (8% to 10%), Eurodollars remain quite attractive as an investment. While short-term interest rates will probably decline over the next year, long-term rates are likely to remain close to their presently high levels for a somewhat longer time as corporations worldwide attempt to shift from a short-term to a long-term debt position. Consequently, to

* *For the purposes of this memorandum, South African deficits are calculated before gold sales. Under a special clause in the December Agreement, however, South African payments deficits exist only after the value of newly mined gold is counted as an export item.*

** *South African payments deficits in the second half of a calendar year frequently exceed those of the first half owing to a seasonal low in foreign earnings during the fourth quarter. Present estimates indicate that 1970 will not prove an exception.*

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Table 1

Estimate of South African Gold Production and Sales a/

	Jan-Jun 1970		Jul-Dec 1970		Jan-Jun 1971	
	Tons	Million US $	Tons	Million US $	Tons	Million US $
New production	490	551	490	551	490	551
Payments deficit before gold sales	632	711	655	737	578	650
Covered by:						
Free market sales	344	387	475	534	480	540
Official sales	305	343	180	203	98	110
Of which:						
Under price criteria	116	130	15	17	10	11
Payments surplus after gold sales	17	19	--	--	--	--

a. Selling price is calculated at $35 per ounce and therefore excludes the small premium on free market sales. Production is always valued at $35 per ounce.

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match alternative investment opportunities over the next year, gold would have to provide a return in excess of 10%. This would require an increase in the free market price to around $39 per ounce. Few dealers believe that the price will rise to this level.

16. Some upward pressure on free market prices could develop during the next 12 months. A growing number of financial experts believe the present relative calm in international financial markets will yield to crisis before the end of the year, because of growing concern about US balance of payments. And increasing tensions in the Middle East could result in greater demand and thus higher prices for gold.

17. On the basis of the experience of the last few years, however, neither disruption of the money markets nor the ebb and flow of Middle East hostilities is likely to have a substantial effect on near-term gold prices. The speculative funds that raced across national frontiers in search of windfall gains during the last two years had relatively little impact on gold markets, and there is little reason to assume that the effect of future speculative flows will be much different. A continuing Middle East crisis has been a permanent feature of the postwar period and, barring all-out war, the Arab-Israeli conflict can be expected to contribute only marginally to any increase in free market gold prices.

18. For the most part, London free market prices through the first half of 1971 probably will range between $35 and $38 per ounce, a range which will not permit much if any newly mined South African gold to enter monetary reserves. South African gold could continue to flow into the IMF coffers to the extent that South African payments deficits exceed output of newly mined gold.

<u>Soviet Gold Sales</u>

19. European financial capitals have been rife with rumors of impending Soviet gold sales. In recent years the USSR has run sizable trade deficits with Western industrial countries and has financed large imports of capital goods by means of medium-term and long-term credits. Sales of diamonds have also helped to pay for growing imports. World

demand for diamonds has slackened, however. Consequently, when a Soviet trade official, Vladimir Alkhimov, in a recent issue of a Soviet foreign trade journal, suggested gold sales as a possible alternative for solving Soviet hard currency problems, the Western press was quick to play up the story.* Although some Soviet gold could reach Western markets this year, the USSR has been in similar financial straits before and decided against selling gold. According to present information, the USSR plans to pay cash for imports of Western wheat and meat this year. Long-term credits are still available, particularly from France and Germany. Moreover, the USSR may well be planning additional diamond sales, knowing that DeBeers, to protect its marketing position, would be willing to purchase all diamonds offered. If the USSR sells any gold, the quantity is likely to be small -- less than $100 million -- and the effect on free market prices is likely to be minor or transitory.

The Longer Term Outlook for Gold

20. The output of newly mined gold is not likely to change appreciably over the next five years. South African production, which accounts for between 75% and 80% of Free World output, is expected to remain relatively stable through 1975. South Africa almost certainly will have to sell most of its newly mined gold on the free market. The December 1969 Agreement effectively limits the amount of newly mined gold South Africa will be able to sell to monetary authorities. Since 1968, progressively larger trade deficits have been financed by selling more gold than its mines have produced. And South African foreign exchange requirements are likely to increase further in the next few years.

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* *One such article presumably based on Alkhimov's statement appeared in the 15 July issue of Green's Commodity Markets Comments. Citing a "well documented rumor," the article stated that between September and November this year, the USSR would sell $1 billion of its gold in the West. This would be the equivalent of nearly one year's South African production placed on the market in about a three-month period.*

21. Demand is more difficult to estimate. Industrial consumption of gold accounts for the largest share of total demand, but few countries publish useful statistics on the subject. Furthermore, in many less developed countries and in a few industrialized nations, a continuing demand exists for gold in various forms -- small bars, coins, jewelry -- which in the broadest sense is defined as hoarded gold. Because much of this gold arrives at its final destination through a complex network of worldwide smuggling organizations, it is exceedingly difficult to gauge the magnitude of demand for hoarding. Speculative demand, such as occurred in late 1967 and early 1968, can also be a substantial and highly unpredictable element in total demand. Beyond these problems are others posed by unpredictable technological, economic, political, and social changes -- any of which could have an important bearing on the future demand for gold.

22. While agreement among the experts is not complete, most believe that basic demand for free market gold is now nearly equal to newly mined output.* Realistically, basic demand can be expected to grow at about 5% a year while gold production will probably decline slowly. Starting in 1972, this demand for gold probably will begin to outpace newly mined production (see Table 2).

23. Beyond these projections of basic demand, it is necessary to consider sales from existing private stocks. Some gold presently held by individual hoarders and Zurich banks, much of it acquired during the 1967-68 "gold rush," could well be unloaded in response to modest free market price increases. Given relative economic and political stability, such sales could keep the free market gold price well below $40 per ounce for several years.

* *Basic demand is defined as the gold requirements of industrial users plus the fairly constant demand from traditional hoarders of the Middle East, the Indian subcontinent, the Far East, and France.*

Table 2

Free World Gold: Supply and Demand

Metric Tons

	1970	1971	1972	1973	1974	1975
Basic demand	1,200	1,260	1,330	1,390	1,460	1,530
Supply (new production)	1,270	1,260	1,250	1,230	1,210	1,190
Excess (shortfall)	70	0	(80)	(160)	(250)	(340)