

GOLD MARKET BOOM

It was anticipated by informed dealers and analysts that at the rate at which gold prices were soaring it would come as no surprise if they scaled US\$ 500 an ounce before the year was out and if the climb continued it could even reach the US\$ 600 per ounce barrier some time in 1980. These were the most feverish and optimistic of dealers' forecasts in a world gold market which has been characterised by a highly volatile movement of prices in recent years.

In 1979 the markets all over the world witnessed a spectacular price boom. The year opened with prices around \$210 an ounce and by mid November were hovering around \$450 an ounce in the London Market. In fact, gold prices had crossed the \$400 barrier in October.

From about US\$ 45 per ounce at the end of 1971, gold prices rose to \$200 at the end of 1974. During the next two years, however, the prices declined in the wake of IMF and US Treasury gold sales and reached a bottom of almost \$100 in August 1976. In the next two years prices rose reaching a level of around \$200 by end 1978. In 1979 the price rises were dramatic—from about \$210 in January the price rose to nearly \$300 in August and to a peak level of \$404 in the first week of October. Most observers believe that although prices may slip back a little in 1980, they are likely to remain at high levels at least in the next few months. The price level in early October was about 90 per cent higher than in January and over 100 per cent more than the level a year ago. When compared with the prices of ten years back, the price rise was more than 700 percent. These price developments led to a severe shortage of gold supplies in world markets, and the excess demand spilled over to other metal markets raising the prices of silver, platinum, and even of copper.

Over the last few years, the monetary role of gold has been largely eroded, and today gold no longer

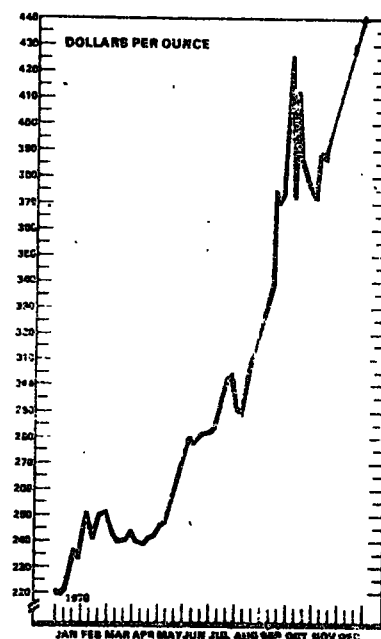
plays a central role in the international monetary system. The separation of the official gold market from the private markets by the adoption of a two-tier market system in 1968; the creation of the SDR as a reserve asset ('paper gold') in 1970; the suspension of the convertibility of the US dollar into gold in 1971 and the gold sales by the IMF and the US Treasury since 1975 constituted the important stages in the systematic erosion of the monetary role of gold. Prior to these developments, crises in balance of payments and foreign exchange markets led to changes in the official stocks of gold—sales and purchases of gold by central banks to maintain the official price of gold and hence the exchange rate parities. Such crises are now reflected in the private market price of gold. The gold market has become very sensitive to the actual and expected changes in currency values, interest rates and the global economic conditions in general.

Industrial and ornamental uses account for about two-third of the gold demand; but the most volatile component in the demand for gold is the *speculative demand*. Gold is not an interest-bearing asset and holders earn a return only if its market price rises. The speculators rush to buy when they expect gold prices to increase more than the anticipated returns on other investments. In recent years, speculators have increasingly used gold as a hedge against inflation—to buy when inflation is expected to increase and to sell when it is expected to decline. The price rises often tend to be self-reinforcing—price rises creating expectations of further price rises. These factors have made gold prices highly volatile.

What has been the cause of this 'gold fever' over the last two years? Generally, five traditional reasons have been put forward for the acquisition of gold: as a long-term asset appreciation, for short-term trading profit, for industrial use, for ornamentation, and as a hedge against inflation. In 1979, however, there has appeared a sixth factor causing

feverish buying and demonstrating gold's strength and staying power as never before. This ominous factor in the view of a leading trader is "People are losing their confidence in currencies, particularly the dollar".

Why the rush for gold in 1979? This phenomenon essentially reflects the growing concern over the economic malaise that has afflicted the global economy—spiralling inflation and the consequent loss of confidence in paper currencies, particularly the US dollar, and a global economy threatened by recession and further rise in oil prices and even interrupted oil supplies. The economies of the leading industrial countries, having recovered from the 'stagflation' (inflation-cum-recession) of 1974-75 are now back again in the situation of serious inflation and slow economic growth. Few expect a world depression; the situation is nevertheless a serious one. The inflation rates in US, France and Britain, in particular, have reached double-digit levels. The increasing restrictive monetary policies have pushed up the interest rates all over the world and many believe that a policy of deliberate slow economic growth is necessary to attack



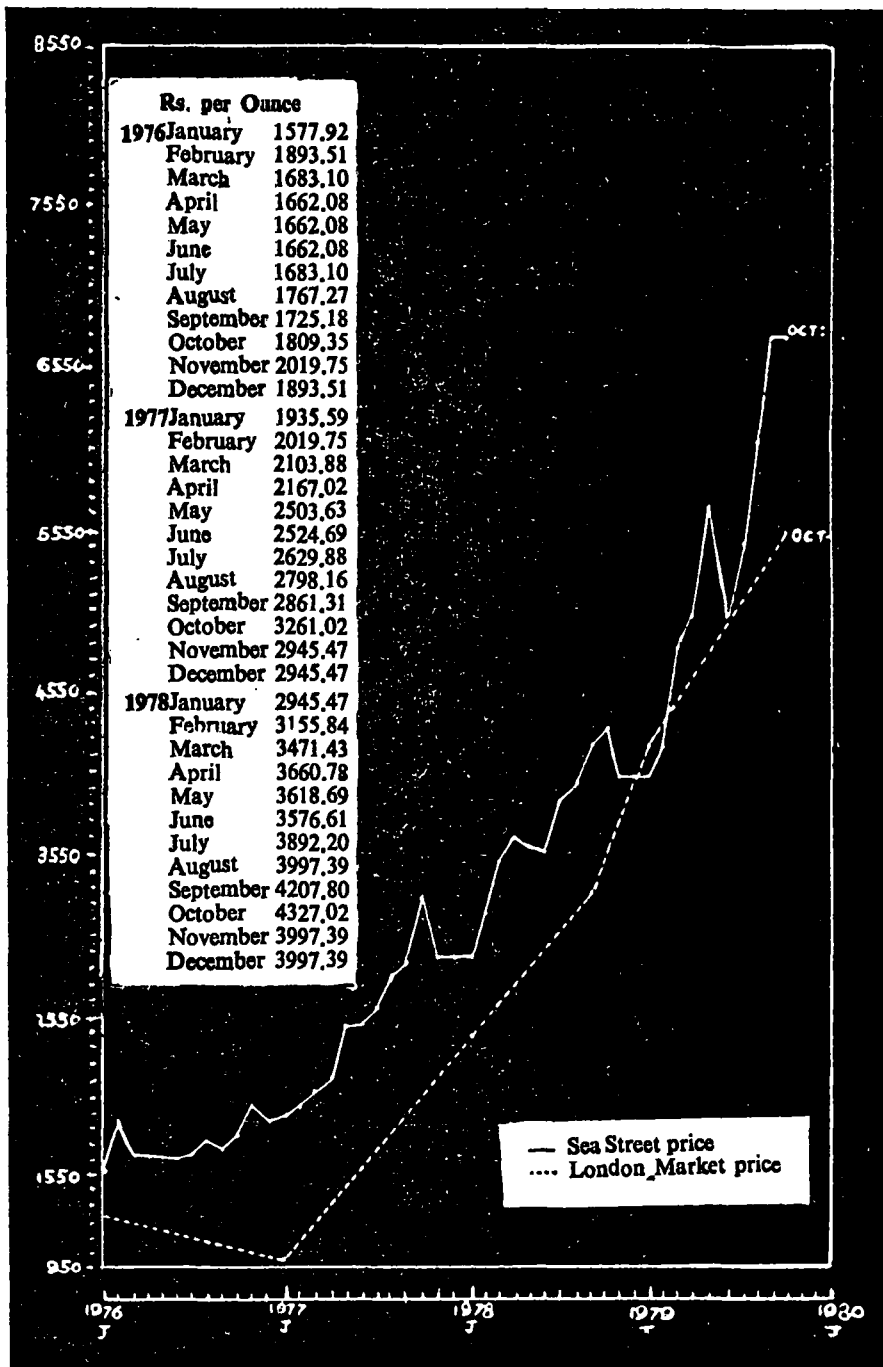
London Gold Prices

inflationary expectations. Another serious concern is the oil situation; the possibility of a new oil shortage (in the context of the political climate in Iran and the recent announcements of cut back in production by some countries) and the expectation of a further price hike after December. All these factors have put intense pressure on currencies, particularly the dollar. The weakening of the dollar has provided a further case for oil price increases, for the oil producers will not stand for a erosion of their purchasing power. Moreover, there is a search for non-dollar assets by oil producers to invest their surplus funds.

Worldwide perception of these problems and the spread of concern over the growing world economic crisis were however not enough in themselves to push up the gold prices so high in a matter of few months. Against the background of the gloomy world economic outlook was the rush by the Arab oil producers to convert part of their massive surplus funds into gold and this, analysts believe, provided the main impetus for the unprecedented gold rush. Surplus funds are being accumulated with Arab oil producers at an estimated annual rate of about US\$ 35.40 million and not all these funds are invested. The share of gold in Arab investment portfolios is estimated to be quite low, probably not more than about 5 per cent. It appears that in recent months, Arab oil producers (monetary authorities as well as individuals) in their attempt to diversify their portfolios have increasingly turned to gold—to increase the share of gold holdings in their portfolios.

It appears then that gold's rise is symptomatic of the serious malaise of the global economy (inflation and recession) but the spectacular price rise was triggered off by the flight to non-dollar assets by the oil producers. The market outlook appears to highly favour the bulls at least for the next few months.

The gold rush in Western markets created similar price booms in Asian



1979			
January	3997.39	May	5680.53
February	4207.80	June	5049.35
March	4838.98	July	5470.12
April	5049.35	August	6106.31
		September	6732.45
		October	6732.45
		November	—
		December	—

gold markets. In Hong Kong—Asia's gold centre—the price movements paralleled the trends in the Western markets and there was an unprecedented increase in gold imports. In Sri Lanka, the gold market

has traditionally been centred in the Sea Street area, Pettah, where the country's leading jewellery merchants are concentrated, and it is here that gold prices are generally

(Continued on page 22)

Gold Boom.... *(continued from p. 17)*

determined for the private trade. The country depends on imports to obtain new gold supplies for industrial and ornamental uses. During the last two decades imports of non-monetary gold have been around Rs. 2 million per annum with the exception of 1975 when the import level rose to Rs. 7 million. Balance of payments statistics do not show any import or export of monetary gold by the Central Bank for recent years. Besides ornamental uses, gold has been traditionally used as a store of value and a means of hoarding wealth by the people.

The local gold prices have closely followed the trends in the London market. The local price which was around Rs. 1600 per ounce at the beginning of 1976 had doubled to reach a level of nearly Rs. 3,200 in February 1978, and at the beginning of 1979 the price was nearly Rs. 4,000. Since then the price rise had been very rapid, a 68 per cent increase during January-October this year. The price stood at Rs. 6,732 in October, and this represents an increase of over 270 per cent above the price level of three years back. In Sri Lanka, however, the prices of other assets, in particular urban and property land values, have recorded much higher increases in the past two years. With gold prices reaching such high levels, pure-gold jewellery will become out of reach for all but the very rich. Other customers will have to turn to jewellery with lower gold contents such as the nine-carat gold commonly used in most Western countries.