Myths and realities of world gold market

Industry is difficult to understand in good times and bad

***CHRIS THOMPSON** is the former chair of the World Gold Council, an association of the world's major gold producers formed to promote gold, its application and demand. Headquartered in London, the Council has 22 offices globally. Thompson was also chair of Gold Fields Limited, Johannesburg, and from 1998 until 2005, was the company's CEO. Gold Fields is one of the world's largest gold producers with annual production of approximately 4.5 million ounces from operations in South Africa, Ghana and Australia. During Thompson's tenure, Gold Fields had over 50,000 employees and was the world's most profitable gold mining company and the third largest by market capitalization. He is a member of the Global Advisory Board of UC Denver's Institute for International Business.*

Speaking at an International Executive Roundtable presented by the University of Colorado Denver's Institute for International Business and Center for International Business Education and Research, Chris Thompson provided insights into the gold industry and put some prevailing myths under the bright light of reality.

Although gold looms large as a sign of wealth, the industry itself is small. "The world produces about 2400 tons of new gold a year valued at about $86 billion or $390 million per trading day." To put this figure in perspective, Thompson pointed out that the "New York Stock Exchange alone does $100-$150 billion a day in trades."

Total gold ever produced is about 160,000 tons, all of which remain viable in some form or other. However, accurate figures are hard to come by, said Thompson, due to the fact that a large quantity of gold is privately held and privately transacted much the same way that one person might sell personal property to another.

"Total bullion in private hands is estimated at +/- 28,000 tons. Central banks also hold gold, 29,697 tons or less than $1.1 trillion at today's prices (see sidebar next page).

Reality: Gold is a small business, much smaller than most people realize.

Myth: Supply/demand = price

Given the high price of gold today and taken in isolation of other factors, it might be reasonable to conclude that demand-supply economics are at work here. But that is not the case, said Thompson.

"One of the biggest myths in the business is that when demand exceeds supply, prices go up," said Thompson. "That might be true with other commodities but not with gold which is a monetary asset as well as a commodity."

He drew a parallel to the housing market. "Housing prices are not set by supply and demand for new homes alone. The true determinants are construction and other costs, interest rates, employment, and availability of existing homes. So too with gold. The price depends on many factors, especially supply and demand for privately held bullion. Conventional supply/demand analysis is insufficient to draw a realistic picture of the market."

Reality: The price of gold is not all about supply and demand.

Myth: Jewelry drives demand

"Jewelry is the largest source of demand for new gold (2500 tons a year)," said Thompson. "It is one of the world's largest categories of consumer goods. The US is the largest market for gold jewelry in terms of retail value; India is the largest market in terms of volume. About 80 percent of the world's gold is exported to India where religious and cultural traditions stimulate gold purchases; e.g., divorce would leave a woman destitute if not for the gold jewelry she acquired during the marriage. This is true in Mideast countries as well.

"Very little gold goes into Cartier type jewelry which is of low karatage (purity) but high design value. Traditional dowry type jewelry, of high karatage but low design value, contains the most gold."

In 2009 "everything changed," said Thompson. "The recession caused consumers to cut back on jewelry spending and demand dropped 20 percent worldwide. For the first time since 1980, gold investment demand surpassed jewelry buying in 2009."

There are other ways to invest in gold. Buying gold bars and taking physical delivery is an option but then the problem becomes where to keep it? Stashing gold bars under the mattress will not lead to a good night's sleep. Fortunately, investors can buy gold and store it in a bank's locker – for a fee of course, which has to be factored into bottom line gains and losses. There are other ways to invest in gold, just as there are in stocks, among them gold certificates and Exchange Traded Funds (ETFs) which require research and a trusted advisor.

In addition to jewelry and investment demand, industrial, dental and medical uses account for around 11 percent of gold demand (an annual average of more than 440 tons from 2004 to 2008). Other industrial demand includes, but is not limited to, electrical components and biomedical applications.

Reality: Most traditional jewelry purchases are actually investment driven.

Myth: Inflation drives price

The origin of this myth is rooted in recent history.

"In Feb. 1982, during a period of high inflation, gold hit $850, a price the media and the public linked to inflationary times," said Thompson.

"But it wasn't inflation driving up prices; it was rich Saudis who were buying huge amounts of gold as protection against a worst-case scenario: US reprisal for OPEC's oil holdup." There was no reprisal but the Saudis felt more secure knowing their gold purchases would survive any political or financial upheaval in a way that cash in the bank could not. "The Saudis bought gold because it is portable and difficult to trace," said Thompson.

"Today everyone thinks the gold-inflation link is well established and that tends to make it a reality. But if inflation is the cause, which country's inflation? Is it the US? China? Europe? Gold is a global business and gold buying is not limited to a particular country."

So if the price of gold isn't affected solely by supply and demand and inflation is as much perception as reality, what are the pressures that trigger price fluctuations?

Paradoxically, it's not inflation but fear of inflation that drives up the price of gold as investors seek a hedge against rising prices for goods and services. "Financial turmoil, political instability, investment flows, dollar hedging, central bank buying and fear of currency failures are other drivers.

"Fear of currency collapse or devaluation is a concrete reason for buying gold," said Thompson.

The value of the dollar is closely linked to the demand for gold. If you could put

the dollar on one end of a playground seesaw and gold on the other end, it would be easy to see that when the dollar goes down, demand for gold goes up. Outside the US, a weak dollar lowers the price of gold to investors which in turn raises their demand as they look for a safe haven for their money. So as long as the dollar remains weak, the demand for gold will be strong.

Deficits - whether the federal government's or individual US states' or global market leaders' like the UK - also play a role in the price of gold as they tend to weaken currencies and make gold more attractive to investors.

Fear is the motivator behind most gold purchases, whether it's fear of inflation or fear of a financial breakdown such as the global crisis that struck at the end of 2008. Whatever the circumstances, investors like gold because it is impervious to a country's internal turmoils and offers safety in uncertain times.

Reality: Many factors drive the price of gold, not the least of which is fear of currency devaluation.

Myth: A new gold standard is the solution

World War I saw the beginning of the end of an international gold standard. Gold's value as a reserve asset was slowly edged out by the paper money it backed, which was more flexible and better suited to a growing global economy. "In the US, President Nixon formally abolished the gold standard in 1971. Since then central banks have been faced with a dilemma about what to do with their gold reserves.

"Conventional wisdom in the 80s and 90s was to convert gold holdings to currencies. Some countries rushed to sell their holdings: UK, Canada, Australia, Portugal. The US, Germany and France were a lot more sanguine, adopting a wait-and-see approach. Rising gold prices have vindicated the latter and made the big sellers regret their haste," said Thompson.

With the demise of the gold standard came uncertainty about the value of paper money which was, well, paper. "Conspiracy theorists were convinced that the feds were out to destroy the price of gold. Gold fell from the mid-$500s in the 1990s to a low of $252 in 1999 when the UK aggressively sold its gold. This drop in price was not attributable to the end of the gold standard as conspiracy theorists alleged," said Thompson. "It was the gold producers' appetite for hedging that caused most of the decline as their bets on the future of gold prices led to unanticipated losses."

The gold standard worked for two main reasons, said Thompson. "It imposed a discipline that aspiring governments could not avoid which in turn helped control inflation. And it worked because the supply of new gold rose alongside the growth in demand for money. Today, gold production is stagnant or declining while real monetary demand is soaring."

For those who think a new gold standard would fix the economy, Thompson pointed out that "many, many issues cloud the picture:

- Who would set the formal price for gold?
- What formal system should be used to set the price: The Pure Standard? The Bullion Standard? The Bretton Woods System?
- What to do about all the gold in private hands? Confiscate it? (Private ownership of gold was banned in the US from the 1930s to effectively 1979.)
- The price required to achieve 100 percent convertibility for the total money supply would be some multiple of the current price.
- What to do about privately owned gold mines?

Reality: The problems are so insurmountable that we could not go back to a gold standard.

Central Bank gold holdings

Country	Tons	% of Total Currency Reserves
USA	8133	76.5
Germany	3413	64.4
IMF*	3217	——
France	2508	56.7
Italy	2452	61.9
Switzerland	1040	23.8
Japan	756	1.9
Netherlands	621	57.8
China	600	0.9
ECB**	534	——
Others	6423	
Total	**29,697**	
ETF*** holdings	1100	

*International Monetary Fund
**European Central Bank
***Exchange Traded Funds (ETFs). Unlike derivative products, ETF securities are 100% backed by physical gold.

Central banks and gold reserves

Although the gold standard is long gone, the appeal of gold remains strong as evidenced by the amount of gold held by central banks (*see sidebar*). Collectively, the central banks own some 30,000 tons of gold which are more or less equal to their holdings 60 years ago, according to the World Gold Council (WGC). Banks continue to hold gold as part of their reserves for some of the same reasons that individual and institutional investors add gold to their portfolios such as diversification (spreading the risk) and confidence in the metal's enduring value.

"The mere existence of gold in reserve tends to support individual currencies," said Thompson. "Yet, there is a tendency among banks to continue to sell their gold reserves," he added.

In 1999, to protect the value of gold as a monetary asset, "European central bankers signed the First Washington Agreement on Gold which limited the amount of gold that banks collectively could sell each year. The banks understood that they were destroying value for themselves and that 'a rush for the doors' could ensue if unchecked.

"The issue still remains for the banks: What to do with these non formal assets? Attitudes about gold have changed along with the price as systemic financial risk has risen in 2009/2010. For the younger generation it does not hold the same relevance as for people who were adults in 1971 when gold convertibility was abandoned." Thompson see this as "a good omen for the future."

He declined to make predictions. "It is difficult to pin down the market with any certainty because of the unknowns," Thompson said. "Will we really see substantial inflation down the road? Maybe, maybe not. What about the deficits; will they cause the dollar to collapse? And what is an alternative currency should this happen: The euro? Yuan? Rouble? The market is opaque and difficult to understand." ◆