April 29, 1997

TO: Members of the Board

FROM: Ted Truman

Subject: Gold and Foreign Exchange Market Discussion on the Gold Market

RESTRICTED-CONTROLLED

Attached for your information is a copy of notes by Dino Kos (FRBNY) on the discussion of the gold market at the meeting of the Gold and Foreign Exchange Committee of the G-10 Governors a the BIS on April 7.

The discussion anticipated the preparation of a paper by the BIS staff as background for a discussion of the issue of official gold sales by the G-10 Governors in July.

Attachment

cc: Messrs. Kohn and Prell

RESTRICTED-CONTROLLED

Gold and Foreign Exchange Committee
Discussion on Gold Market
April 7, 1997

Dino Kos

Plenderleith (Chairman, United Kingdom), welcomed everyone and asked Smeeton to start off the discussion on recent developments in the gold market.

Smeeton (United Kingdom) noted that the gold market is not as depressed as the price would suggest. Gold itself is not in a bear market. Physical demand is high. Mining activity is also quite high. The Bank of England recently released, for the first time, statistics that it has collected for many years, on trading volume in the London market. In May 1996, the market traded the equivalent of $3 billion of gold daily. Swap deals accounted for 75 percent of the volume. London also serves as a settlement point for gold. Last year London settled 950 tonnes of gold daily -- or roughly $10 billion -- giving some scope for the volume of trading outside of London as well. He noted that gold had traditionally been a secretive market and some dealers had even resisted releasing this information, but most thought release was helpful in demonstrating the market's resilience even though the price has been sluggish.

Smeeton, however, was bearish on the near-term prospects for the price of gold. Central banks were running low inflation policies that made gold less attractive to investors. A second worry surrounded the EMU process, and the expectation that European central banks would sell gold to help meet Maastrict debt targets. The recent Dutch sale had only aggravated this worry. The ongoing rumors of selling by the Dutch and Belgian central banks, and the change in attitude toward gold by the Swiss National Bank, had created an environment where hedge funds and others found it attractive to play gold from the short side.

Gold leasing was also a prominent piece of the market, whose growth central banks were very much a part of. The central banks, in turn, had been responding to pressures that they turn a non-earning asset into one that generates at least some positive return. Smeeton estimated that roughly one year's worth of production had already been sold forward. Central banks mostly lent gold at maturities of 3-6 months, but some central banks sought to enhance returns by lending at longer tenors. Smeeton noted that central banks had some responsibility for the gold leasing market since it was their activity which made that market possible to begin with. He added that gold does have a role as a war chest and in the international monetary system.

Gehrig (Switzerland) noted that the Governors would be discussing gold -- including whether central banks could come up with some coordinated approach to the gold market -- at their July meeting. Gehrig thought it was appropriate that the question be raised, though he was skeptical whether in fact such coordination could be achieved in practice, especially given the risks that central banks could lose control of the process.

Plenderleith did not want to have a discussion on the core philosophical question of whether such coordination should be sought. That was up to the Governors. Instead he thought the Gold and Foreign Exchange Committee could develop factual aspects of the market that may prove useful to the Governors in their upcoming discussion. The BIS could then write a paper that would help set the background for the Governors discussions.

He asked Gehrig whether the SNB could share some of its experience in the gold market, particularly regarding the demand side of the market.

Gehrig said the SNB knew very little about that question. The SNB had not sold any gold and was not engaged in leasing.

Gill (Bank for International Settlements), said that the BIS had not sold any gold in many years. The BIS did some leasing, but kept its participation moderate because it did not want to become "too big" in that business and be seen as the liquidity provider of last resort. He agreed with Smeeton that the market was worried about central bank selling. He noted that central banks own 30 percent of the gold ever mined, and that 25 percent of their reserves were in gold. He posed several questions that now perplexed the market: What was the posture of central banks toward gold? Would they continue selling "at will"? Was it possible for central banks to coordinate their sales programs? Perhaps a pooling of sales? Given the difficulty of finding buyers in this market, would other central banks be willing to step in and absorb any oncoming supply?

Fisher (United States), agreeing with Plenderleith that the broader questions should be left for the Governors, made three observations. First, he noted that some market cynics viewed central bank activity as a contrary indicator and therefore one had to be conscious of possible feedback effects. Second, he noted that the price of gold, unlike other commodities, had historically not trended toward the cost of production. This seemed to suggest an ongoing supply/demand imbalance. Third, he had the sense that the gold leasing market was an important component in this puzzle, though he did not understand enough about that market, particularly the credit risk aspects of gold lending.

White (BIS), asked whether anyone had an analytical model for gold price determination?

Truman (United States) said that some work done at the Board by Henderson and others from an academic perspective suggested that demand for gold was rather elastic -- more so than thought. Much of the new supply went into private hand (service demands). Henderson's paper was likely to be released fairly soon and may be of interest to this Committee.

Mainert (Germany) asked how a big sale would affect the market? What would happen if, say, the central banks sold 2,500 tonnes -- equivalent to one year's production.

Nobody took up Mainert's challenge. Smeeton noted only that he would certainly expect such a sale to affect the price. Mainert thought that this question [i.e., scale of any coordinated sales] and hence, what the impact would be on price, was precisely at the heart of the issue.

Stephenson (Canada) asked whether the data on this market could be trusted. Central banks were both sellers and buyers. Do we know much about the buyers?

Smeeton said that the Gold Fields survey is thought to be very thorough and meticulous. It was probably the best piece of research about this market. Regarding Stephenson's other question, he agreed with Gill's earlier comment that it was difficult finding central bank buyers. Certainly if some central banks were interested in building up gold reserves, they were likely to wait because the price was "coming their way".

Gill thought it would be helpful for the market to know how much was coming onto the market.

Mainert agreed, but quickly pointed out that the first central bank would get the best price, while later sellers would not.

Plenderleith, again pulling the discussion back, said he did not want to jump the gun and discuss the possibility of coordinated sales.

Fisher asked what the institutional arrangements were in each country with respect to gold? He pointed out that in the U.S. the Treasury was fully responsible for gold, while in Switzerland the central bank had full responsibility. Where were others on that spectrum?

Patat (France) said that the prospect of coordinated sales was a political issue. He thought such a prospect would worry the market. His impression was that currently central bank sales were few and far between. Regarding Fisher's question, in France gold belongs to the state. But gold and foreign exchange are both on the balance sheet of the Banque de France. Gold transactions could not be carried out without consultation with the Finance Ministry. At the same time, he did not think the Ministry could force the Banque de France to do something it did not wish to do.

Heikensten (Sweden) suggested that the BIS prepare not only some factual material, but also a list of alternatives for the Governors to consider. Plenderleith again resisted this suggestion.

Saccomanni (Italy) said that Italy was about to end the state monopoly on gold ownership. Italian banks were considering whether they should set up a bullion market in Italy. Right now they were cautious because of costs. Regarding Fisher's question, gold was held by the Bank of Italy and Foreign Exchange Office -- a sister entity of the central bank. He did not think the central bank could buy/sell without Finance Ministry approval, and vice versa. Finally, echoing Patat, Sacommanni noted that besides the Belgian and Dutch cases, there did not appear to be rush of sales because of EMU. With respect to any rumors that Italy might become a seller, he did not think this was in the cards.

White noted the political complications several had mentioned. However, if one central bank starts selling aggressively, there may be a quick spill-over effect.

Truman, referring to a more academic perspective, thought it was more helpful to view the situation in terms of the stock of gold, rather than the flow. Thus, if there were a program to sell "X" ounces of gold per year, the market would adjust immediately to that news. On a related point, gold leasing was very much a part of the behavior of mining companies and other private participants. One implication was that if there were an understanding among central bank re: gold sales, then leasing would also need to be part of the same understanding.

Bussers (Belgium) defended Belgium's periodic sales, saying they were intended to bring Belgium's ratio of gold/reserves to levels comparable in other G10 countries. Each time Belgium sold, it picked a counterparty that would carry out the sales over a 3 to 6 month horizon. The intermediary bank was then free to carry out its program based on its execution skills. Gold prices did not move appreciably during these periods. The market absorbed the sales -- 300 tonnes over a 3-6 month period was not a problem for the market. The Belgian National Bank did not know many of the ultimate counterparties. Proceeds were used to repay debt to help get levels down as part of the Maastrict process. Decisions to sell were made by the central bank, backed by the government.

Heuvelman (Netherlands) said that the Dutch operations were carried out much the same way as Belgium's. At times during these programs the price was steady; other times, the price fell. Some of the sales were outside London, so he was skeptical about the comprehensiveness of the London numbers. As with other countries, the Dutch central bank cannot take decisions about gold unilaterally -- it must consult with the government. He agreed with Fisher's earlier point: there was credit risk in gold leasing deals. Compensation for taking on that risk was reflected in the spread between the gold deposit rate and the [U.S.] t-bill rate. De Nederlandshe Bank had been surprised by the demand for gold leasing -- it was very large. In response to a question from Kos, Heuvelman said that during selling periods, the lease rate rises as the intermediary sells forward, and then covers his short position by borrowing in the lease market, thus forcing up rates.

Stephenson said that Canadian gold belongs to the government. The Bank of Canada acts strictly in an agency capacity.

Nagashima (Japan) explained that the MOF had sold all its gold to the Bank of Japan some years back. However, any decisions to change the BOJ's gold holdings would require consultations with the Ministry of Finance.

Smeeton said that the government owns the U.K.'s gold and decides how it is used.

Mainert said that the Bundesbank owns German gold, but it is also a political question.

Fisher explained that U.S. gold belongs to the Treasury. However, the Treasury had issued gold certificates to the Reserve Banks, and so gold (by these means) also appears on the Federal Reserve balance sheet. If there were to be a revaluation of gold, the certificates would also be revalued upwards; however [to prevent the Fed's balance sheet from expanding] this would lead to sales of government securities. So the net benefit to Treasury would need to be carefully calculated, since sales of government securities would expand the public portfolio of government securities and hence also expand the Treasury's debt servicing burden.

Plenderleith suggested the BIS assemble a paper on the more factual aspects of this market, not ignoring the leasing market, and for this paper to serve as background for the Governors discussion in July.

Smeeton pointed out that the next Gold Fields survey would be available in mid-May, and should be of interest to the BIS.

Fisher and Stephenson both asked for a fax procedure so that the Committee can comment on the BIS paper before it is presented to Governors.

Plenderleith asked the BIS to circulate a draft of the paper prior to the July meeting, asking that it not veer into the policy discussions that is more rightly the domain of the Governors.

* * * * * * *

The short time remaining was used for a quick tour-de-table on exchange market developments.