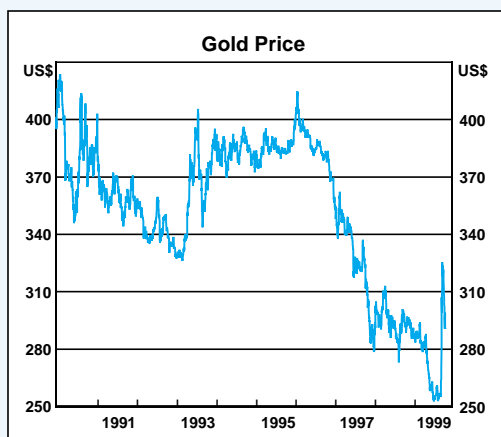


## Box B: Recent Developments in the Gold Market

The past year has seen large movements in the price of gold, falling to 20-year lows in the September quarter – following the commencement of a series of gold auctions by the Bank of England and discussions concerning the possible sale of gold by the IMF – and then rebounding to its late 1997 level, following the announcements by European central banks of a moratorium on further gold sales and loans, and by the IMF of an alternative plan to revalue its gold holdings without sales on the open market. At present, the price is a little over US\$290 per ounce, about 15 per cent above the recent low point but about 30 per cent below the most recent peak of US\$415 per ounce (Graph B1).

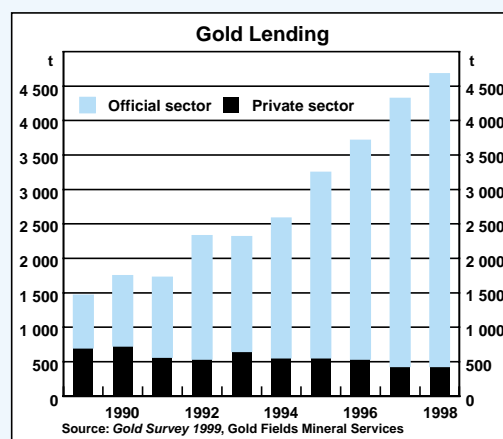
**Graph B1**



The sharp fall in the gold price over 1997 and 1998 seemed to reflect market concerns about possible official sector sales more than the sales themselves. During this period, the amount of gold sold by central banks was broadly in line with earlier years. There was, however, an increasingly prevalent practice of central banks making their gold holdings available for lending. As can be seen in

Graph B2, since 1996 gold lending by central banks increased by a little over 1 000 tonnes to about 4 300 tonnes. Gold lending effectively facilitates additional activity by other market players, including producer hedging activity and short-selling by speculators. The activities of these players have had a significant role in the recent volatility of gold prices.

**Graph B2**



Gold producers often seek to protect themselves against variation in their earnings by hedging future production. This can be done through forward transactions or options, but either way the result is that the gold supply is effectively brought forward through a sale by the counterparty to the forward/option contract. This is because the counterparty to the producers' transactions will need to cover their position in the market, which is typically done by borrowing gold (usually from central banks) and selling it into the market. According to industry sources, producer hedging and the use of gold loans are estimated to have resulted in about 750 tonnes of accelerated supply to the gold market since the start of 1996.

Over the past couple of years, speculators have also used short sales of gold to obtain low cost funds to invest in other assets – for example, by shorting gold (borrowing it and selling it in the spot market), market participants have been able to obtain US dollars at between 1 and 2 per cent, well below the rate of return available on US assets. Selling gold short has therefore been an alternative to the ‘yen-carry’ trade which saw market participants fund investments in various markets by borrowing yen (at almost zero cost due to the low interest rates in Japan) and selling it for other currencies, mostly US dollars. Although short-sellers ran the risk of a rise in the gold price, this risk had been judged to be low in a climate of generally negative sentiment towards gold.

Much of this activity takes place in over-the-counter markets, rather than on exchanges, so figures are difficult to come by. The only indication of the scale of speculative short-selling on these markets comes from statistics on the gold lending market, which short-sellers must use to fund their sales. Since the beginning of 1996, gold loans to speculators are estimated to have increased by about 350 tonnes.

With 25 per cent of all above ground gold stocks held by central banks, any increase in demand for borrowed gold by short-sellers has been easily met by an increase in central bank lending. Whereas in most markets an increase in short-selling puts pressure on the lending market and pushes up the interest rate at which short-sellers can borrow the underlying stock, the ready supply of gold loans from central banks seeking to earn some return on their gold holdings has, until recently, helped to keep lease rates low, generally in the range of 1–2 per cent (Graph B3).

In late September, a group of 15 European central banks (including the Bank of England) announced that:

- They would not sell any gold beyond already decided sales for five years. Such sales were said to be 2 000 tonnes, of which the Bank of England accounts for about 400 tonnes and the Swiss National Bank 1 300 tonnes.
- Sales already decided would be co-ordinated and spread over 5 years so that the amount sold in any one year would not exceed 400 tonnes.
- Gold lending would not be increased.

This caused an important structural change in the gold market. The prospect of reduced central bank sales removed the downward pressure on the gold price, while the proposed cap on gold lending pushed up lease rates. Both factors worked to make the ‘gold-carry’ trade unattractive. As such, the announcement led to extensive buying as speculators rushed to cover short positions. There was also some unwinding of hedges by producers. Lease rates spiked to almost 10 per cent before settling around 2–3 per cent, and the price of gold rose to as high as US\$340 per ounce, before falling back under US\$300 per ounce. ↵

**Graph B3**

