Gold by Alice Roth

Why the price has declined

A hostage deal, Soviet gold sales, and Middle East cash needs are not the main reasons.

Several factors have contributed to the weakness of the gold price in the last two weeks: in my view, the factor of higher interest rates is by far the most important.

The first factor is the belief that the release of the hostages will lead to an easing of international tensions. (In actuality, if Carter were to obtain the release by agreeing to arm the Iranians, the Soviet Union might feel compelled to come into the war on the side of Iraq.) Although wrongheaded, this view is widely held and is helping depress the price.

Last week, Swiss customs statistics were released showing that the Soviets had delivered 25 tons of gold, worth more than $480 million, to Zürich in September, the largest Soviet transfer to the Swiss market in nearly a year. This does not necessarily mean that all the Soviet gold was sold in Zürich last month—some of it could still be sitting in a Soviet bank account—but the figures do seem to indicate that the Soviets are stepping up their sales after a long period of inactivity. Speculation has mounted that the Soviets may need to sell more gold to obtain the hard currency to pay for grain imports.

But Bill Darby, a precious metals trader for ACLI Commodity Services in New York, cautions that the Soviets have only delivered about 43 tons to Switzerland so far this year, compared with 214 in 1979 and 401 in 1978. This level of sales scarcely indicates that they are desperately short of hard currency.

Also tending to depress the market is the fact that some private Middle East investors have been switching out of gold bullion and gold futures into dollar-denominated instruments to capitalize on the strong dollar and higher U.S. rates.

There have also been repeated reports that the Iranian government has been selling gold to raise cash for arms purchases. *EIR* originally dismissed these rumors because we were informed that there was probably no need for Iran to sell its gold since it could obtain gold-collateralized loans from European banks. More recently, we were told by a gold market source that Iran is viewed as too great a credit risk by the banks and that the country was probably having to liquidate some of its gold—perhaps in direct arms-for-gold transactions.

More important than all the above considerations is the surge in U.S. rates. This has a twofold effect: first, it makes short-term, dollar-denominated instruments appear relatively more attractive compared with both other leading currencies and with gold, which yields no interest. Second, it increases costs for holders of commodity futures contracts, who typically invest on margin. At present interest levels, an investor who purchased a gold futures contract at $600 an ounce would have to wait until the gold price reached $690 before he could realize a profit. Our sources indicate that the Carter administration is committed to high rates even in the face of deepening recession. (Reagan's top advisers are also committed to that policy.) This could mean that rates will remain in the double-digit range until the second quarter of 1981, at which point the threat of major bankruptcies could force the Fed to ease up as it did late last spring.

This tight credit regimen may mean that the gold price will remain quite flat for several more weeks or even months to come. Two types of developments could dramatically alter this prognosis: one would be a serious deterioration in East-West relations as a result of the bungling of the hostages issue or a Soviet invasion of Poland. The second would be an international banking crisis triggered by the tight-credit policy itself. Federal Reserve officials have already indicated that they are determined to drive Brazil to the International Monetary Fund, and are even willing to risk a default on its $50 billion foreign debt—an event which could easily topple several major banks. Aside from these worst-case scenarios, gold is unlikely to fall below $600, since this is the level at which European central banks have supported it in the past. The best strategy therefore, would be to maintain a portion of one's portfolio in gold as a hedge and take advantage of the opportunity to augment this "insurance policy" whenever the price dips close to $600. Some of the big players appear to be already following this strategy: last week, when the price fell to $630, substantial buying materialized from European institutional investors and Middle East interests.