

# NEWS & VIEWS

May, 2001

## Forecasts, Commentary & Analysis on the Economy and Precious Metals

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"Something's afoot in the gold market. . . ." Ian McAvity, *Deliberations*

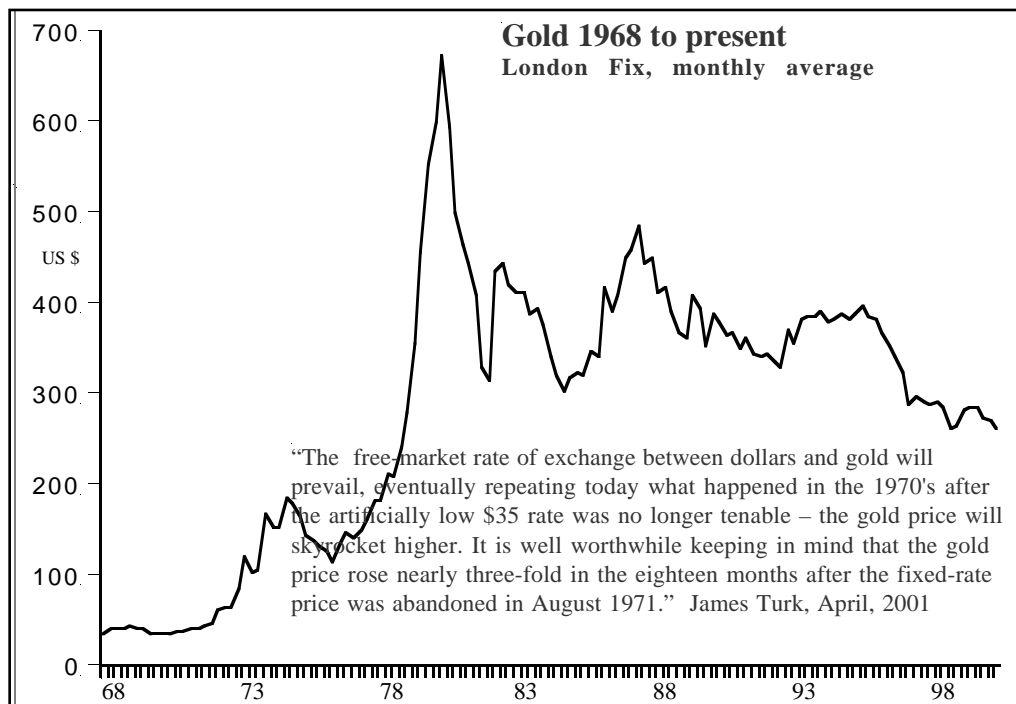
**INTRODUCTION:** As suggested by Mr. McAvity, gold could very well be at a watershed. Evidence continued to build through April that some central bank[s] had decided to pull the plug on the gold carry-trade -- the primary deterrent to higher gold prices since the early 1990s. Some speculated that the Bank of England was recalling gold for its highly publicized gold sales program. Others speculated that a continental central bank was recalling gold as part of a policy change related to the Washington Agreement. Whatever the case, the resulting shortage of metal sent lease rates soaring again and touched off a wave of speculation on gold's future. Three prominent commentators in our May issue suggest that what's "afoot in the gold market" is akin to what happened in the late 1960s when the London Gold Pool broke down, and gold--enthralled at \$35 for the better part of 35 years--was sent on its merry way to first break through the \$200 level in 1974 and then over \$800 by January 1980. Could it be as a prominent American philosopher once put it: "It's *deja vu* all over again?" We invite you to delve into that and other perplexing gold related questions in the pages that follow, starting with a provocative analysis from Mr. James Turk. Our advice remains the same: Continue to add to your gold holdings in a deliberate fashion. But we now add a sense of urgency. If you haven't started your gold diversification, or if your holdings are light, we suggest stepping up the process. As the situation described below unfolds, the small investor could be crowded out of the already thin gold market by scrambling borrowers who try to find metal to pay their loans. The stubbornly high gold interest rate could very well be signalling a very real shortage. MK

### BITS & PIECES. . . .

#### GOLD FUSION

An extremely important fact to remember is that as gold prices rise, short positions will have to be covered. That means leased gold positions will have to be bought in to cut losses and return the gold to its original owners. What is extremely important is not only the upward pressure that will be brought to bear on gold prices, but the withdrawal of liquidity from world markets. Trillions of dollars have been infused into the world financial system by lease gold sales, an event not previously experienced. The covering of these positions will either cause a world liquidity crisis or world central banks will have to create trillions of dollars to keep the world financial system running. That in turn will create tremendous inflation, which in turn will force gold prices ever higher. If they do not create this enormous liquidity, then there will be deflation and depression. Currencies will lose value and there will be a flight to quality, which is gold. As you can see, once the game begins either way gold and other precious metals will be big winners.

--Robert Chapman/*International Forecaster*



#### BEHIND CLOSED DOORS

by James Turk/*Freemarket Gold & Money Report*

This same individual [anonymous] told me several months ago about some astonishing intelligence he had learned from a source in Europe. He told me that the Bundesbank's gold vault was empty, which seemed so preposterous that I found it hard to believe. He also admitted that this news startled him when he learned about it, and that he did not have an adequate explanation for it. He knew that the Bundesbank was an active lender of gold,

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but he had a difficult time accepting the possibility that all 3,400 tonnes that it owned had been loaned. Yet he was confident that his source had provided him with accurate information.

We now know what has happened. The Bundesbank has loaned 1,700 tonnes, one-half of its 3,400

tonnes reserve; the other 1,700 tonnes were swapped for gold in the US reserves, requiring the change in the West Point vault from Gold Bullion Reserve to Custodial Gold. In other words, the Bundesbank's vault is empty because one-half of their gold is stored in West Point not Europe, and the other half has been loaned out. Despite the irrefutable proof that the ESF is involved in the gold market, two questions remain unanswered. First, what's the ESF's motive? Unfortunately, we just don't know for certain.

Many, including me, claim that it is to use gold to provide the liquidity needed to bailout some big banks that have imprudently grown their gold books by recklessly expanding credit and mismatching their asset/liability maturities. These banks are the ones with the unusual – some say abnormal – derivative activities that are named as co-defendants in Reg Howe's suit against the BIS. That this list includes Germany's largest bank may explain why the Bundesbank would agree to participate in this gold swap scheme. It was bailing out one of its own.

Others claim the ESF aims to manipulate the gold price to make inflation numbers look better than they really are by keeping the gold price artificially low. And there are some who argue that the US government, acting at the behest and under the instructions of the big banks, aim to destroy their combined arch enemy – gold, regardless of the fact that the gold mining industry would be destroyed along with it.

This last theory is not outlandish. It has currency because gold is the world's only free-market money. In contrast to national currencies, all of which circulate only because of government fiat, Gold's value derives from everyone who understands that it has usefulness as money. And governments and banks don't like the fact that while they can manipulate gold for a time – and as have we have seen in recent years, even a long time – they cannot in the end control the price of gold anymore than they can control the price of a Picasso painting. The value of a Picasso is determined by the free-market, and so too is gold. In short, you and I give gold its value – not the central banks, not the US government or any other government, either acting alone or together. But the US government either has not yet learned – or refuses to admit – this reality that its power to control gold is limited, which is an inexplicable conclusion

unless you accept the notion that governments have short memories and need to relearn what logic says they should have learned from experience.

If logic prevailed, the US government would have learned from its ill-fated attempt in the 1960's to keep the price of gold abnormally cheap at \$35 per ounce that the market determines gold's value. But instead, the US government is about to learn that it cannot keep a manipulated 'floating-rate' gold price from rising any more than it was able to keep the manipulated 'fixed-rate' gold price from rising thirty years ago. The free-market rate of exchange between dollars and gold will prevail, eventually repeating today what happened in the 1970's after the artificially low \$35 rate was no longer tenable – the gold price will skyrocket higher. It is well

### Dr. MoneyWise says:

When Prosperity is well-mounted, she let go the bridle, and soon came tumbling out the saddle. So gather knowledge, 'tis worth the price. And let those without it, pay the piper. . . And further, it is wisdom that is ground from the hard kernel of truth. And truth is often found where you least expect it.

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worthwhile keeping in mind that the gold price rose nearly three-fold in the eighteen months after the fixed-rate price was abandoned in August 1971.

Then there is the second unanswered question. To what extent is today's exceptionally low gold price the responsibility of certain bullion banks, which have cheapened gold by extending gold credit to such an extreme, and the ESF, by perpetuating this scheme? This question too does not have an answer, at least not yet. But as the truth about the ESF's involvement in the gold market continues to emerge and become more widely known, the price of gold is destined to rise to a more normal level, just like it did after August 1971. The high price that gold eventually achieves will indicate how badly certain bullion banks and the ESF have damaged gold mining companies and the gold industry.

In conclusion, while we don't know whether any of these motives for manipulating the gold price that I ascribed to the US government are accurate, one point is clear and cannot be denied. The US government cannot claim that the ESF is not involved with gold. We now have the irrefutable proof that

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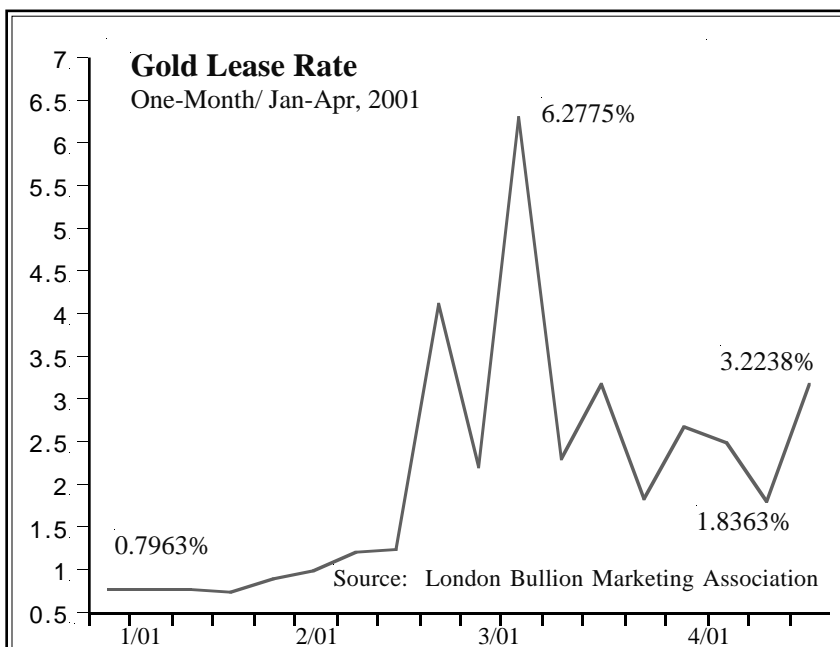
## BITS & PIECES . . . . .CONT'D

establishes beyond any reasonable doubt that the ESF is indeed involved in the gold market. We know this for a fact because of our peek behind closed doors.

[Ed. Note: The above is an excerpt from a more detailed article available in its entirety at the USAGOLD website's GILDED OPINION page.]

### RICHARD RUSSELL IS BULLISH ON GOLD, BEARISH ON STOCKS IN BARRON'S INTERVIEW

The dollar is the wild card here. I'm worried about it. The dollar has remained surprisingly strong in the face of ongoing U.S. trade deficits. When the dollar finally turns down, foreigners could cut back on, or even retreat from, dollar-based financial assets. This would put downward pressure on U.S. bonds and stocks. I'm watching the dollar index that trades on the Cotton Exchange. The June contract recently was 114.90. If it breaks below 114.50, and more importantly 113.50, I'd be reasonably certain the dollar has topped out. Meanwhile, the euro, a major component of the dollar index, is trying to form a head-and-shoulders bottom. This can be seen clearly on



weekly charts and is the first hint of a possible major turn to the upside for the euro. If we start to see a real slide in the dollar, all bets are off. A sliding dollar would put huge foreign holdings of U.S. securities in danger. If foreigners cash in their dollar chips, the dollar could step on the down escalator and all hell could break loose. Gold might even go up.

--Richard Russell (*Dow Theory Letters*) in a *Barron's* Interview (04/14/01)

### SHORT INTRO TO GOLD LEASING FUNDAMENTALS

Gold differs from other commodities (with the possible exception of silver) in that there are substantial above-ground stocks--equal to over 50 years' worth of today's production. About half of these stocks is in the form of jewelry and rather over 10% is in other manufactured applications; the rest is held as an investment or as official reserves traditionally kept in a bullion vault.

Arguably, holders of gold as an investment or official reserve do not have to hold it physically, provided they are confident that they can repossess a comparable quantity (gold being fungible it does not have to be the same gold) if needed. So, starting in the 1980s, certain central banks and other major holders were *persuaded* to lend some of their gold to highly-rated financial institutions (bullion banks), receiving in return a small rate of interest -- the lease rate. Initially, most central banks only lent gold for a very short period -- although the loans were normally rolled over -- but gradually the average time has lengthened.

Like other market interest rates, gold lease rates are essentially determined by the balance between supply and demand.

Since central banks and other lenders have been willing to lend gold to approved intermediaries at only a small interest rate and since there has been a plentiful supply, rates have generally remained low: on average in 1996-2000, 1.5% for the one-month rate and 1.9% for the 12-month rate (both expressed in annual terms). Only on rare and short-lived occasions have they spiked significantly higher.

What do bullion banks do with the gold they borrow? While some is lent to fabricators and jewellers, who borrow gold to defer purchase until they have a buyer, the majority is sold and the proceeds invested on the money market.

--World Gold Council, *Gold in the Official Sector*, April 2001

[ED. NOTE: Though the proceeds from these arbitrage arrangements are invested for the most part in the money markets, it has long been believed by gold market specialists that hedge funds have employed carry-trade funds in much riskier speculations. What's more, unlike the mining companies which will repay their gold loans from production, the hedge funds have no ready source for the metal. They will be forced to go to the open market as gold buyers when the time inevitably arrives to settle their gold loans. Another factor to keep in mind is that as U.S. interest rates drop and gold lease rates rise, the squeeze on returns gets ever tighter. We have warned repeatedly that the benefits of the gold/dollar arbitrage are dwindling. This could

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## BITS & PIECES . . . . .CONT'D

lead to some of the more conservative players unwinding their positions and being forced to buy gold to do so. The gold leased from the central banks, in either case, is sold into the market thus acting to depress the price. I also find it interesting that the Council deftly mentions that the central banks "were persuaded" to lend their gold. The question of who might have been doing the persuading is left unanswered.]

### "DON'T LET GOLD DOLDRUMS FOOL YOU!"

According to latest stats, the amount of gold sold short on the Commodities Exchange in New York remains near a record high of nearly 11 million ounces. It means that more traders and mining companies have committed to gold sales (without owning the metal) than ever before. Problem: When they go to buy the metal needed to deliver on these commitments, it could fuel a move up in gold that perhaps could take back a full month's losses in a single day. The major central banks are in a similar bind. Nearly every one has loaned out gold from their reserves (exactly how much is impossible to figure, but estimates put it at between 150 million to 200 million ounces). Plus, they've sold nearly 70 tonnes of the yellow metal just since November. With central bank supplies declining, and most central banks' gold already loaned out, I believe the price pressure from the central banks will begin to abate. That means the slightest rally in gold could turn into a monster move. Combine these two forces with the fact that demand is holding near record highs, and it's easy to see how gold could turn the corner any minute and blast higher. So I repeat: Don't let gold's doldrums fool you!

-- Larry Edelson/www.safemoneyreport.com (04/16/01)

### FORGET THE YEN. DEVALUE THE DOLLAR

The MPC, the ECB and indeed the Fed itself are now having to deal with the belated reaction to 'irrational exuberance'. Some time ago I used the phrase 'the Greenspan paradox' to

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describe the situation where there was such faith in Greenspan that he could not contrive the adjustment in the stock market that he wanted. In a forthcoming paper the British economist, Marcus Miller, and two colleagues suggest that, if there is not to be an almighty crash, Greenspan needs to avoid declaring that he's not superhuman, but to lose his image gradually.



---William Keegan/*The Observer* (04/8/01)

### GOLD TO EMERGE TRIUMPHANT

If you believe that Treasury Secretary Rubin and Summers after him used "the gold carry trade" to manipulate gold prices lower and lower as part of the strong dollar deception policy of

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Editor: Michael J. Kosares  
Ass't. Editor: George R. Cooper

## BITS & PIECES . . . .CONT'D

the Clinton Administration, then you will begin to understand the significance for the gold markets if the trend in these two interest rates [gold and dollar] continue in their current direction much longer. With interest rates now declining sharply, especially on the short end of the yield curve, and with gold lease rates higher than before--perhaps because of a growing hesitancy on the part of one or two banks to play this short game--the economic incentive for the bullion banks to assist



the Treasury and the overall commercial banking system in its paper money congame may be nearing an end. And when the manipulation of the gold markets come to an end, it is my view we are likely to see an extremely explosive move on the upside for gold that could make the move of the 1960s to 1980 (from \$35 to \$850) look mild by comparison.

Meanwhile, that elderly statesman in the newsletter business and one who has been right on the money concerning the stock market, namely Richard Russell had the following to say about gold in his April 4, 2001 letter.

"The interest in gold is still here, despite a twenty-year bear market. Why? Because a lot of us still believe that gold is the only real money. And just as important, because many of us lived through the great precious metals market of 1975-1980, and we're thinking--'Maybe it will happen again--well, maybe'.

"But there's even another reason and it's that we know that the purchasing power of the dollar is being systematically undermined by the Fed. And ultimately, goes the gold argument, the dollar and all paper currencies will collapse--and gold will emerge triumphant. Anyway, that's the theory. In practice, it hasn't happened yet--to put it mildly."

--- J Taylor's *Gold & Technology Stocks* (04/11/01)

## BE SURE TO TAKE YOUR GOLD BULLION, DEAR.

Right from ancient times until its current use as Auranofin, gold has been used in medicines of various kinds. Many

ancient cultures, such as those in India and Egypt used gold-based medicinal preparations, but China was the earliest to cure sickness with it, and this could date back as far as 2500 BC.

Since the discovery of gold, people have thought of it as having an immortal nature (eg resistance to chemical corrosion) and associated it with longevity. Consequently, gold was used as a medicine to seek longevity. In "On Salt and Iron" (81 BC) written by Huan Kuan of the Western Han Dynasty (202 BC-8 AD) it is stated that "immortals swallow gold and pearls, so that they enjoy eternal life in heaven and earth." Further, in the book "Zhouyi Cangtongqi," written by Wei Boyang of the Eastern Han Dynasty (25-220 AD) it is recorded that "Gold is the most valuable thing in all the world because it is immortal and never gets rotten. Alchemists eat it, and they enjoy longevity". In the Eastern Jin Dynasty (317-420 AD), there was a Ge Hong (281-341 AD) who made it still clearer in his book "Baopuzi: Gold Elixir" that "gold never has any loss despite smelting a hundred times, and it never gets corroded even if deeply buried". He further added that to eat gold "tempers the body of a human being, and he enjoys eternal life."

We can therefore see that although people in ancient times knew very little about the immortal nature of gold from the viewpoint of science, they were led to wonder about the effect of gold on human life. Worse still, the continuous exploration of the application of gold to the treatment of diseases also led to confusion of the two. Consequently, "medicinal gold" (man-made golden alloys and mosaic gold etc), and "potable gold" (the solutions of the sorts having similar colour to gold or containing gold-ion) were developed as elixirs.



This obsession and reckless pursuit by people and alchemists for gold greatly stimulated the development of the use of gold in various medicines. The alchemists' long-term effort was not successful, but it greatly contributed to the development of science and technology as a whole, including that of metals; and the development of gold drugs in ancient China was a notable achievement.

There are many Chinese books dealing with drug development.

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## BITS & PIECES . . . . .CONT'D

The most valuable of all is the "Bencao", a series of important books on Chinese materia medica developed continuously from the Western Han Dynasty (202 BC - 8 AD) to the Qing Dynasty (1636-1911 AD). In all these books, gold is listed in the "mineral medicine" with details of the effects of its use. However, "Compendium of Materia Medica" (6) by Li Shizhen (1515-1593 AD) of the Ming Dynasty (1368-1644 AD) was the greatest masterpiece of all. He made a systematic summary of China's ancient gold drugs and entered it into the "metal and stone category".

---Zhao Huaizhi and Ning Yuantao, *China's Ancient Gold Drugs*

### PRICELESS GOLD TALISMAN

#### FOUND ON EGYPTIAN MUMMY

Over the past few years of publishing these daily ministrations, I have suggested many times that gold should be used as a talisman to ward off the evils of political economy--numerous as they may be. It has been said that there are no new things under the sun. And that apparently stretches to the concept of

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## BITS & PIECES . . . . .CONT'D

golden protection. A tomb of a Pharaoh's wife was discovered in Egypt last week wearing an extensive array of 100 gold amulets and other jewelry--a first in terms of quantity according to a *Reuters* report this morning. Included in the collection of Naas, wife of Gad Khensu Eyuf Ankh (ruler of Bahriya oasis between



589 and 570 BC), is an Osiris pendant, that will be probably be appraised at priceless. Quite often I believe the demand for gold comes more from an intuitive understanding of its value that goes beyond any economic considerations. Perhaps finding a 2600 year old mummy in the Egyptian desert adorned extensively with gold meant to buy passage to the next life reinforces that observation. In the end, we are all linked one generation to the next and going back as far as our beginnings. We carry with us from one generation to the next all that we consider sacred and of value. Through it all, gold has played a role because mankind has always granted it value beyond any other inanimate substance. . . . So it is. So it shall be. --- USAGOLD *Commentary & Review* (04/2/01)

### FINAL NOTE:

Gold demand at Centennial Precious Metals/ USAGOLD remains steady with buyers citing long-term diversification and the historically low constant-dollar price as their primary motivations. They additionally cite the bear stock market, potential utility defaults, and burgeoning inflation as more immediate concerns. Increasingly, investors are mentioning a breakdown in the gold carry-trade (as featured in this issue) which could lead to a spike in gold similar to what occurred in the early 1970s. Over the past weekend, we received a flurry of requests for information packets--which ranks it as one of the top weekends

in USAGOLD/Centennial Precious Metals history. If someone were to ask to what that might be attributed, we would have to answer: all of the above.

As for the overall economy, in talking with a large number of our clients over the past few weeks, our informal polling suggests that investors are concerned about an inflationary, energy- driven recession. When the Gross Domestic Product (+2%) came out unexpectedly strong for the first quarter, it seemed to reinforce that forecast. It is amazing how many investors are aware of "the out-of-the-box money creation" by the Federal Reserve and how that might impact the economy and their dollar-based investments--especially if rates are ratcheted down further as many analysts predict.

We continue to advise aggressive diversification into gold, ranging from 10% to 30% of total assets (sans residence). The level of diversification within that range is a personal commitment based upon your own view of the economic situation. Investor interest continues to be divided between pre-1933 European gold coins and the contemporary bullion coins, with the weighting strongly in favor of the older European low-premium coinage. Interest in silver seems to be picking up among those looking to speculate a bit, but the interest is marginal. Our IRA program has been met with substantial interest. We have ushered



through a number of conversions. Might it be time to capture stock market profits in your IRA with a little, good old-fashioned, historically solid, unencumbered, liability-free yellow gold? At these prices, we can't see how it would hurt. Call George Cooper (1-800-869-5115) to have your questions answered.

That's it for this issue, fellow goldmeisters. We'll see you here next month. Until then, Happy Trails until we meet again.

--- Michael J. Kosares

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--- Donald Hoppe, *How to Invest in Gold Coins*

“I am afraid that one day the government will indeed call gold in. Gold bullion will be subject to confiscation. This is one big advantage to numismatic gold, such as Double Eagles (U.S. \$20 gold pieces). It is an idiosyncrasy of governments that although they may prohibit ownership of gold in any form, they are reluctant to touch collections of numismatic gold coins.”

-- Dr. Franz Pick, *The Triumph of Gold*

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