Further remarks[1] on the impact of forward sales on the price of gold

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All forward sales are made on the spot market, and are counter productive because they can only lower the price of gold, as one would expect from any additional supply of gold.

Hedging against any further fall in the price of gold can be carried out on one of the World's Futures Exchanges in the same way as other commodities.

FUTURES CONTRACTS

Futures contracts are usually to buy or sell 100 oz of gold on the first business day of some future month. A Futures Exchange will enter into a contract only to **buy or sell** at a specific price on a specific day if a customer seeking a matching contract can be found, i.e. a contract to **sell or buy** under the same conditions. This is relatively easy on a Futures Exchange, with its vast number of potential customers.

If, on the settlement day, the spot price of gold is $\$x$/oz below the contract price and no action is taken, the seller would receive $\$x$/oz less than the futures price and the buyer would pay $\$x$/oz less than the futures price. However, to meet the terms of the contracts, $\$x$/oz would be switched from the buyer to the seller so that the seller would receive the futures price and the buyer would pay the futures price, thus fulfilling the terms of the contracts.

The futures markets require both buyer and seller to make substantial deposits in case the market should turn against one or the other. The interest on these deposits is sufficient to pay the running costs of the Futures Exchange and provide a profit. Both of these items are relatively modest.

It will be obvious that a Futures Exchange needs no gold to be able to carry out its business. Although Futures Exchanges need no gold to conduct their business, in practice they do deal in physical gold as well, but this is for the convenience of a small proportion of their customers.

As explained above, Futures Exchanges, in effect, transfer money from one customer to another in terms of contractual arrangements, but do not alter the value of the sum total of all the gold being dealt with on the exchange. This means that the Futures Exchange cannot directly affect the spot price of gold, which is determined only on the spot market. Prices on the spot market, however, obviously affect futures prices.

VOLUME OF GOLD HANDLED

The annual volume of gold handled on the world's Futures Exchanges, shown in the table at the top of page 64 in *Gold 1992*[2], is about 12 times as great as the annual supply of gold shown in the summary table on page 7 of *Gold 1992*. This means that futures dealings are really paper dealings, since the vast quantities of gold shown in the first-mentioned table simply do not exist. In spite of this, the world's Futures Exchanges provide the best way for mines, financial institutions, and speculators to hedge against falling gold prices. The Futures Exchanges also attract a large number of gamblers. Mines account for only a very small proportion of the futures bought.

Although data are not available, there seems to be no reason to believe that mines, as a body, lose or gain heavily by hedging on the Futures Exchanges. In any case, the purpose of hedging is to avoid losses, rather than to make large profits. However, mines always lose when they sell forward on the spot market, as has already been explained.

SURVEY OF PRODUCERS

There has been a disappointing response[3] to the call for contributions to this paper[1], especially on the contentious subject of forward sales. However, Gold Fields Mineral Services Limited of London recently completed a survey of over 100 producers to establish why they hedged or did not hedge production. This survey provides some vital information, and to some extent makes up for the scarcity of contributions dealing with forward sales.

The survey has revealed two very important facts. One is that about 75 per cent of mines sell forward as long as there is a contango to be earned. The other fact is that producers and bullion banks are almost universal in their belief that hedging results in a lower gold price, through the impact of accelerated supply.

These two facts seem to be contradictory. Why do 75 per cent of mines sell forward if they believe that such sales result in a lower gold price? The only possible explanation is that the producers believe that, although forward selling will lower the price, it increases the total revenue from gold. However, equation [3] in the original paper[1] shows conclusively that total revenue also decreases with increased forward selling. Thus, it appears that the only motivation for forward selling is based on an incorrect assumption. This incorrect assumption has been the root cause of the falling prices and profits in the gold-mining industry world-wide since forward selling became an important factor in the mid-eighties.

REFERENCES

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