COMMENT ON AUSTRALIA'S GOLDEN FUTURE

By D. Mackay-Coghill

It was interesting to discover in the AMPLA invitation to address this Conference that I was asked to take the perspective of a small producer. However, I must point out to you that Gold Corporation is NOT a gold producer in its own right.

So before I respond to Dick Carter's analysis, let me take a moment to quote to you our Group Mission Statement:

> To provide an integrated range of high quality refining, processing, manufacturing and marketing products and services at a profit to the international markets in the overall interest of the Australian gold mining industry.

Today, Gold Corporation operates two principal services to the industry: a processing service, and a value-added precious metals products business. Gross export earnings since formation in October 1986 to June 1989 have been about AUSD 550 million.

But I will deal in depth with these aspects of our activities later, so let me now return to the question of Australia's golden future.

PRICE OUTLOOK

Carter has already mentioned the external factors which will continue to influence the Australian gold mining industry. I would like to focus on one of those factors — price. As 'economic analysts cannot agree on what the future holds for the gold price or exchange rates,' Carter has commented, then 'there is little sense in speculating here beyond acknowledging the impact of these factors on long term production.' Mr. Paul Sarnoff, one of the US's leading gold market commentators, tends to agree with these views. After years of watching the behaviour of international gold markets, Sarnoff had this to say:

— 'A definite conclusion about the direction of the gold market is the place you got tired of thinking;'

— 'if you mention something good about the gold market, it goes immediately away. If it's bad, it happens;' and

— 'a gold optimist believes that the price will go to USD 1000, and a gold pessimist believes the optimist is right'.

Despite these sobering views, I'd like to say something unfashionable about the gold market this afternoon. I want to argue that, yes, Australia will have a golden future, but just how golden that future will be depends on price.

Supply and Demand

Let us take a brief look at the western world supply and demand picture for 1988. The main features of the market were:
On the *supply* side

* B.Ec. (Rand.), LL.B. (Rhodes); C.E.O. Gold Corporation.

1. mine production continued to increase, reaching 1,538 tonnes, the highest level ever recorded;
2. total supply to the non-communist private sector fell by 10 per cent to 1,850 tonnes;
3. central bank purchases increased by a factor of three on the previous year to 270 tonnes.

On the *demand* side

1. total fabrication usage rose by 16 per cent to a record 1,844 tonnes;
2. consumption of newly-mined gold in jewellery was 40 per cent above the 1987 level at 1,233 tonnes, a record volume;
3. identified bar hoarding outside of Europe and North America also increased dramatically to 474 tonnes, up 77 per cent; and
4. total demand exceeded conventional supplies by 468 tonnes, and was essentially met by a surge in gold loan activity and forward selling by producers.

In general terms, the pattern that emerged last year was this:

1. although mine production was at the highest level ever recorded, the increased volume coming onto international markets was easily absorbed by the jewellery sector; and
2. declining gold prices in most east Asian currencies, combined with increased disposable income here, underwrote sustained bar hoarding in the region, while investment interest in the North American and European economies remained subdued.

Price Trends

The striking feature of the market was that these price trends occurred against a background of low inflation in industrialised countries. So gold's price performance, which averaged USD 437 for 1988 or only a mere 2 per cent below that of the previous year, was impressive. Since then, of course, we have seen the price deteriorate to USD 364, a 27 per cent decline since December 1987's five-year high of USD 500 an ounce.

In Australian dollar terms, the decline has been more dramatic, due to the strengthening of the local currency against the USD. From a December 1987 record high of AUSD 686, the gold price contracted by 36 per cent to AUSD 436 in early February this year. Over this period, the AUSD/USD exchange rate strengthened by 24 per cent from 0.71 to 0.88. Since mid-February, this trend has been reversed with the exchange rate weakening to 74 US cents by late May, and the gold price recovering by 13 per cent to AUSD 494.

As you can see, we are dealing with a volatile market. Not only do we have fluctuations in the international gold demand to contend with, but also with the 'exotic' currency perception of the AUSD in foreign exchange dealing rooms.

Major Influences

What has caused this latest decline, and how prolonged is it likely to be? To answer this question, we need to take a look at the two most important influences, in my view, on the gold price, namely:

1. the international economic environment; and
2. the impact of gold loan and forward selling strategies by mining companies.

It is the international economic environment that determines the level of investment demand for physical gold. Here, the inflationary expectations in the major economies is of great importance. It is not, however, the only impetus, as we witnessed last year in East Asia. Japan, for example, purchased 180 tonnes of investment bars in 1988, 38 per cent of the total outside Europe and North America. Taiwan also purchased a record 155 tonnes. The reasons for this buying were not inflationary concerns, which are negligible in both countries. It was simply the result of outstanding GDP growth, combined with the perception that gold in declining current terms was good value, and possibly diversification of investment portfolios away from local stock markets.

Inflationary expectations are nevertheless important influences on the gold price. The OECD average rate of consumer price inflation increased from 3.3 per cent to 3.9 per cent in 1988. Britain, just to remind us how quickly circumstances can change, even in healthy economies, recorded a rate of 7.5 per cent, the result of strong consumer demand last year.

United States Economy

The US economic outlook is also very important. When the US sneezes, the rest of the global economy still tends to catch a cold. US consumer price inflation was 4.8 per cent in February 1989, up from 3.9 per cent in February 1988. The US Consumer Price Index for April was 0.7 per cent, the largest monthly rise in almost two years, and inferring an annual rate of 6.6 per cent. Gold investors have not however, been inspired by the latest figures. The reason is something called Greenspan's First Law: 'there will be no inflation in the US'. The Federal Reserve chairman's policy of unprecedented monetary restraint has curtailed US money growth to its lowest level in twenty years.

In the short term, there is no doubt that a deflationary environment is emerging in the US. US money quantity measure, M1, is identical to what it was a year ago, which in turn is fuelling the current rise in the USD. So far this year the USD has jumped 15 per cent against the yen and the D-Mark. US interest rates are declining because the Federal Reserve is taking such an unprecedented anti-inflationary stance. Commodity markets are also beginning to mirror the declining prices in the precious metal markets. Since the third quarter of 1988, the Barron's index of metal futures prices has contracted by 15 per cent.

The closer we look at the recent performance of the USD, however, the more paradoxical it becomes. The news that the US visible trade deficit was only USD 8.9bn in March, compared with an expected USD 10.5bn, saw the currency soar in value.

> Only one thing is more impressive than the dollar's current strength . . . the ingenuity of economists in explaining its every move, always after the event, of course. In recent weeks some red-faced economists who had previously been forecasting that the dollar was set to fall have lost their nerve, and found reasons why the dollar's rise makes perfect sense from the point of view of economic fundamentals.[1]

While in the short term the firmer dollar may assist in reducing the trade deficit by making imports cheaper, the medium-term danger is that US goods will become less competitive.

There are also other problems. Annual real GNP growth is expected to slow to only 2 per cent, while inflation remains stuck at 5 to 6 per cent because of rapidly rising costs. The twelve-month increase in unit labour costs is now more than 5 per cent compared with 2 per cent the previous year. It seems that inflation may remain a stubborn foe for at least two years, and will be removed only by slow growth, a classic recipe for stagflation.

There is also another ominous problem for the US, which is rather close to home — debt. 'Debt', as Thomas Carlyle once remarked, 'is a bottomless sea', and he could have just as well been talking about the US as Australia. Although the US merchandise–trade deficit is shrinking, increasing interest payments on foreign debt means that the total current account deficit still looms large. This trend will continue for as long as the country's shortage of domestic savings. More than half the total net investment in the US has been financed by a net inflow of foreign savings to finance the current account deficit.

Here is the US dilemma: it needs not only to eliminate its current account deficit, but also to do it while simultaneously boosting investment. As long as its domestic savings remains low, it would appear that the US cannot afford to reduce its current account deficit due to the negative impact on sustainable GNP growth. The US economic malady may therefore be more a case of a prolonged wasting anorexia, rather than a sudden financial heart attack, at least in the medium term. It is a malady that appears to be ignored by today's foreign exchange markets. The jury is still out on the US economy.

As far as the gold price is concerned, I believe we are nearing the bottom of a depressed cycle. The next six to eighteen months will see a clearer resolution of the US situation. Whether a massive deflationery period emerges or a period of stagflation is not clear. What is clear is the chance of a reduction in the Greenspan Law, and an easier monetary policy, together with higher inflation as the US attempts to improve GNP growth rates and turn its economy round. Against this background, we should see an improvement in the USD price.

Gold Loans and Forward Selling

There is another reason why I am unfashionably optimistic about the gold price — gold loans and forward selling. These methods of raising development capital and hedging production had an important impact on bullion supply during 1988. This was for two main reasons:

1. The collapse of global stock markets in October, 1987, prevented equity capital raising.
2. The decline in the USD gold price since December, 1987, encouraged more active forward selling in periods of temporary strength.

1 *The Economist*, 20 May 1989.

Statistical data is scarce, but the following can be stated with confidence:

1. Forward selling strategies often have a compounding effect, particularly in a depressed market when producers commonly share a similar perspective on future prices.
2. Heavy forward selling produces an equivalent amount of spot sales, which may exert a significant downward pressure on the gold price.
3. The impact of forward sales was especially evident in late 1988, as gold broke through the USD 400 an ounce level.
4. A study by Doppler Mineral Research, of Colorado, USA, estimated that since January 1985, 208 tonnes of gold worth over USD 2bn had been lent to international mining companies. Of this total, 101 tonnes or 48.5 per cent had been lent during the first seven months of 1988, and a total of 112 tonnes since October 1987.
5. Consolidated Goldfields GOLD 89 study estimates that at least 150 tonnes of additional gold was released via gold loan financing during calendar 1988, and perhaps considerably more.

Both these methods, then, effectively accelerate the delivery of physical gold to the market, and depress the short-term price.

In addition, it can be argued that as gold loans mature and are repaid, much of the borrowed metal will be returned to central bank vaults, reducing future supplies available to the market from current mine production.

U.S. Dollar Price Outlook

This phenomenon also has two interesting implications for the gold price outlook:

1. With the recent price decline, there is evidence that a peak for this form of project financing has been reached.
2. Given the USD price differential between the loan and the current market price, some companies may choose to repay their gold loans early and take a substantial profit.

For example, Newmont Mining in the US borrowed and sold forward 1 million ounces in January 1988 when the price was USD 450 an ounce. If the company chose to buy back its gold at today's price of USD 360, it could repay the loan and achieve a profit of USD 90 an ounce. With annual repayments of principal around 0.2m ounces, this could mean additional revenue of USD 18m.

The further the gold price falls, and erodes mining company earnings, then the greater will be the temptation to embark on this kind of strategy. Just as the market reaction to gold loan publicity last year was predictably negative, the reverse response could quickly gather momentum if the Newmonts of the mining world announced their intention to take a profit.

To summarise the USD price outlook, I believe that we are approaching the bottom of a cycle at USD 350. During the next six to eighteen months I believe we will see an easier monetary policy in the US, with inflationary implications. This development, combined with the potential impetus from the profitable liquidation of gold loans and further sustained investment buying in East Asia will be sufficient to underwrite an upward price move towards USD 400 within the next year.

Australian Dollar Price Outlook

Exchange rates are about perceptions: perceptions of a country's economic outlook in the international financial markets. While it is true that the AUSD is vulnerable to short-term speculation, there is a growing consensus abroad that the structural problems that have plagued the economy for the past decade are likely to continue for some time to come. Let us look briefly at these key problems:

1. domestic demand-led, unbalanced growth where net exports (exports minus imports) remains zero or negative;
2. high import levels (*e.g.* for every 1 per cent rise in domestic demand during 1988 Australia's imports rose 2 per cent;
3. high current account deficit — Australia has the third largest CAD of the 24 OECD economies, ahead of Iceland, Ireland and Norway;
4. high foreign debt — Australia's gross foreign debt for the fiscal year 1988–89 was AUSD 130bn;

— net debt was AUSD 105bn or 32 per cent of GDP.
— only three major industrial countries, US, Canada and France, have a higher gross foreign debt;
— Australia's debt per capita is the seventh highest in the world;
— over the next decade, about AUSD 9bn of annual export earnings — or 20 to 25 per cent of the total will be required merely to service this debt;
— Australia's current account is not performing well enough, even in a period of high commodity prices, to stabilise the AUSD value of debt. For example, of the AUSD 16.5bn 1988–89 current account deficit (Treasury forecast AUSD 9.5bn), 60 per cent reflects foreign debt interest payments;

5. low productivity growth — labour productivity is expected to rise by only 0.75 per cent in 1988–89, compared with an annual rise of 4 to 5 per cent in East Asia; and
6. a centralised wage system that is preventing urgent microeconomic reform.

Public concern over the economy continues to grow. A recent newspaper editorial summarised the situation like this:

> When the best export prices in five years produce a current account deficit 50% worse than it was five years ago, and exports are falling as a proportion of national output, then something has gone badly wrong. In the three years since Moody's last issued a credit warning, the economy has become no more competitive. Inflation has not fallen, and is still well above the levels of our competitors.[2]

Given this outlook, further deterioration of the AUSD/USD exchange rate is anticipated over the medium term, which should continue to support an AUSD gold price above the AUSD 500 an ounce level.

2 *The Australian*, 30 May 1989.

The Australian gold mining industry will have a golden future, precisely because the outlook for the country's economy is rather more tarnished. Perhaps we should reflect for a moment on the irony of the situation.

THE GOLD TAX

Let me move on to the gold tax issue. I'm afraid I'm unable to be as optimistic on this issue as I have been on the gold price. It seems unlikely that the federal government will back away from the tax.

On 3 November 1988, the Taxation Laws Amendment Bill (No.5) 1988 was introduced into Parliament. It contained the provisions for removal of the gold mining tax exemption, and was virtually identical to the amendments announced by the Treasurer in his May Economic Statement of that year. The main elements of the legislation are:

— that income derived from the sale of gold produced in Australia will be taxable where it is derived after 31 December 1990;

— that gold exploration and prospecting expenditure will be allowable as a deduction after 31 December 1990, where such expenditure was incurred after 25 May 1988;

— that from 1 January 1991, all income and expenditure incurred in deriving gold income will be treated in the same way as other mining activities; and

— that all capital expenditure incurred on gold mining operations after 31 December 1990 will be deductible over the life of the mine or 10 years, whichever is the lesser.

The main implications, will be:

- an effective tax of possibly 35 per cent of pre-tax earnings;
- high grade mining over the next two years;
- reduction of economic cut-off grades for mining, thereby increasing the volume of low grade material left unmined (the Gutman Report estimated that at least 20 per cent of reserves existing in 1986 would be effectively quarantined);
- reduction of exploration by smaller companies, as retained earnings available for this purpose contract; and
- a decline in contract earthmoving activity, as gold miners elect to purchase their own mining fleet for depreciation purposes.

Perhaps the industry can take some solace from the following:

— that a lot can happen to the gold price over a two-year period;

— that the carry forward provision for eligible gold exploration or prospecting expenditure could significantly defer the payment of tax on gold income post-January 1991;

— that an opportunity exists for the industry to ensure that the tax, if inevitable, is as advantageous as possible, by appropriate responses to the draft legislation during the next two years.

GOLD CORPORATION

Carter has already referred to government and industry responsibilities in the mining sector. I would like to take up this issue again here, insofar as it concerns the activities of Gold Corporation. Firstly, let me take you through the brief history of the group.

GoldCorp Australia was established in October 1986 as a wholly-owned trading division of the Western Australian Development Corporation (WADC) to administer the inaugural Australian International Gold Programme (AIGP). The strategic group objectives of the AIGP were:

1. to promote the development and growth of the Australian gold industry; and
2. to maximise the value added to, and export income derived from, Australian gold and precious metals production.

The AIGP had three specific aims:

1. to develop and market value-added precious metals products, initially the Australian nugget gold bullion and proof coin series, as official Australian coinage;
2. to establish banking and bullion services for gold producers, private investors, international banks and precious metals dealers; and
3. to commercially manage and redevelop the Perth Mint, by:
   — establishing a new international gold refinery at the Perth International Airport;
   — refurbishing the Perth Mint as a specialist precious metals mint and manufacturer; and
   — completing the commercial rationalisation of the Western Australian State Battery system, including its transfer to the Western Australian Mint.

The second stage in the corporate growth of GoldCorp Australia came with the Gold Banking Corporation Act of 18 December 1987 (W.A.) (GBCA 1987). The stated aim of this Act was:

> ... to constitute the Gold Banking Corporation and provide for its functions and the conduct of its business, to preserve and continue the Western Australian Mint and constitute GoldCorp Australia as subsidiaries of Gold Banking Corporation and provide for their functions and the conduct of their businesses, to repeal the Western Australian Mint Act 1970 and for related purposes.

On 30 June 1988, Gold Corporation (GC) was established as a fully autonomous consolidated operation, wholly owned and guaranteed by the State Government of Western Australia. GC's strategic objectives were:

1. to provide an integrated range of high quality refining, processing, manufacturing, marketing and banking products and services at a profit to international markets in the overall interest of the Australian gold mining industry; and
2. to act as a catalyst in the long-term development and well being of the Australian gold mining industry and to maximise the profit earned from precious metals sales for the benefit of the country as a whole.

During debate on the Gold Banking Corporation Act in October 1987, the then Premier of Western Australia gave a clear and unequivocal undertaking that the group would not be involved in mining activities.

Three years ago, I recall that there was considerable scepticism from the gold mining industry about Gold Corporation. Despite the

Premier's statement, fears concerning government involvement at the mining level persisted for some time. In addition, the industry was concerned whether Gold Corporation's ambitious plans for marketing and refining would result in additional levies being imposed to fund the proposed expansion. So it gives me particular pleasure to list our achievements to date, which include:

For our marketing division, GoldCorp Australia:

— the successful establishment of the Australian Nugget as the world's third largest selling bullion coin, with a 15 per cent share of the market, in a volatile gold price and highly competitive market environment;

— the successful launching of the Koala platinum bullion coin in late 1988, which has become the largest selling platinum coin in international markets to date. Incidentally, we have donated AUSD 100,000 to the Koala Foundation as part of this programme;

— the development of innovative strategies to obtain market share, such as the successful launching of the Holey Dollar in early November last year as Australia's new legal tender silver coin. The Holey Dollar managed to capture 16 per cent of the international numismatic silver coin market in its first two months of release; and

— the promotion of the Perth Mint as Australia's leading precious metals mint.

For our other divisions involving milling, refining, and minting, within the Western Australian Mint:

— a leading position in the Australian gold refining industry, treating about 65 per cent of the country's production;

— the construction of two new gold refineries, one in Kalgoorlie and one at Perth Airport, with the capability of refining over 100 tonnes a year on a single shift basis, at a capital cost of AUSD 12m;

— the capacity to produce 2.2m ounces annually of 0.9999 purity, with the commissioning of the Perth facility;

— consolidation of the Perth Mint's international reputation for gold refining expertise, by assisting in the establishment of the Fidelity Gold Refinery in Zimbabwe, and refining the first shipment of Saudi Arabian gold produced in recent years;

— consolidation of the Perth Mint's capability to produce internationally acceptable precious metal items of the highest purity and quality; and

— the rationalisation of the State Battery System, which had been costing the Western Australian taxpayer over AUSD 1m annually.

For our embryonic banking division:

— the establishment of a profitable and credible banking business.

On the subject of Gold Corporation's gold banking operations, you may be aware that the R&I Bank made a successful offer to acquire this division last month. There were three reasons for this move. First, the banking business was expanding rapidly, and could no longer be accommodated by the group's restricted capital base. In eight months, gross assets of over AUSD 300m had been generated. A larger and more mature banking environment was required to support further expansion. Secondly, there was a political reason. Government involvement in business ventures after the Rothwells collapse and the recent election was under increasing scrutiny. Consequently, there was increasing pressure on statutory authorities to desist from participating in what were perceived as private enterprise activities. Furthermore, the word 'accountability' had entered the political vocabulary. Thirdly, there was the R&I's strategic objective to provide specialist financial services to niche markets such as the gold sector, to complement its existing customers in the broader personal, retail, and corporate areas.

To quote the Bank's Chairman, Dr. Ross Garnaut,

> Because of the importance of the gold industry to Western Australia, the R&I already held significant gold and gold related business. The acquisition of these banking assets would give the R&I Group a premier position in these markets.
>
> It is anticipated that there would be a significant flow on benefit to the gold mining and related industries through the expansion and development of specialist financial services and investment products which will follow the acquisition.[3]

CONCLUSIONS

To conclude, I believe Gold Corporation has made two very positive contributions to the Australian gold mining industry. First, it has kept pace with the industry's demand for new refining capacity during a period when the country is producing more gold than ever before in its history. The Dickensian refinery at the Perth Mint has been replaced by two superb, modern facilities at Kalgoorlie and Perth Airport, with no increases in refining charges for over two years. Secondly, it has increased dramatically the international profile of Australia as one of the world's leading gold producing countries through its coin programmes. Let me assure you that competing against countries with far greater financial resources for market share has not been easy. But we are there now, we have paid our AUSD 25m entry fee — again at no cost to the industry. We are now in a position to build on our international acceptance as a major player in the value-added bullion products scene. To date, Gold Corporation has exported nearly 25 tonnes of coins of Australian gold, generating gross export earnings of approximately AUSD 550m, and premium income of some AUSD 47.6m.

In the past, the Australian gold industry's focus has traditionally been on discovery, mining and refining. However, when the country is producing a potential 220 tonnes next year, or almost 15 per cent of the western world's newly mined gold, then it has an obligation to promote its product. That is the obligation we have taken on at Gold Corporation. We are working closely with the World Gold Council, the international group formed especially for this purpose and strongly supported by Australian producers, in the constant development of new strategies to encourage gold consumption. In these ways, Gold Corporation hopes to continue to make an important contribution to Australia's golden future.

3 R&I Bank Press Release 5 April 1989.