Research Department
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Why Silver?

Volatility has been the hallmark of the silver market ever since the U.S. Government ended its prolonged price-stabilization efforts in mid-1967. Against the background of a strong long-term uptrend, short-run price movements have been exceedingly erratic, largely because of the dominant influence of speculative factors rather than industrial supply/demand considerations. During the period in question, trading increased dramatically on the New York, Chicago and London exchanges. From the original base of $1.29 an ounce, prices doubled between mid-1967 and mid-1968, only to lose all of that gain by late 1971. Prices then soared to a stratospheric $6.70 an ounce in the speculative orgy of early 1974 before retreating to the present level of $4.64 an ounce.

Over the years, investment analysts have formulated careful analyses of expected market trends, only to watch their forecasts rendered invalid by unforeseen political and financial developments. During one especially perverse period (1968-71), speculators sustained severe losses when prices headed downward in the face of earlier bullish predictions. Yet this cautionary lesson was all but forgotten during the recent speculative outburst, when silver fever reached a higher pitch than at any time since the discovery of the Comstock lode.

Initial price surge

Massive price fluctuations began to develop in July 1967, when the U.S. Treasury halted unlimited sales to domestic industrial users at the old monetary value of $1.29 an ounce, and announced that it would sell its remaining silver stocks in small weekly amounts at the going market price. Within a year, prices in New York jumped to $2.56 an ounce, largely because of the reaction of consumers and speculators to the widely-heralded gap between new mine production and industrial demand, but also because of the speculation generated by worldwide monetary uncertainties.

Throughout the preceding decade, world mine production had lagged far behind industrial demand, so that the difference had to be covered mainly by sales of silver from the U.S. Treasury—roughly 2 billion ounces in all. As these supplies dwindled and the Treasury's eventual withdrawal from the market became increasingly certain, silver users and investors concluded that a silver shortage would be almost inevitable. Their belief was supported by the effects of new silver legislation, which set off a rush by silver-certificate holders to turn in their paper money for silver by a mid-1968 deadline, and by the effects of a nine-month-long copper strike, which forced the shutdown of nonferrous metals refineries and seriously reduced the normal refinery supplies of silver.

Upward pressures on prices were exacerbated by the worldwide currency turmoil of 1967-68, which culminated in a flight from the devalued British pound and the weak-

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ening American dollar into precious metals. British and American citizens could not legally own gold, but they could hold silver, so many turned to the gleaming white metal as a safe store of value.

Slump—then speculative boom

Surprisingly, however, prices then turned around and declined for the next 3½ years, in the face of continued production deficits, prolonged worldwide inflation, and the continued weakness of the dollar. Indeed, prices continued to decline even after the cessation of Treasury silver sales in November 1970 and the devaluation of the dollar in August 1971. At the low point (November 1971), prices were only slightly above the $1.25 floor at which the Treasury would have had to buy newly mined domestic metal under the terms of the Coinage Act of 1965.

A sluggish economy contributed to this market weakness, as U.S. industrial demand fell almost 5 percent annually (to 129 million ounces) between 1969 and 1971. More importantly, market participants belatedly began to realize that the Treasury's withdrawal from the market would not necessarily create a physical shortage of the metal. Industrial and investor stocks had grown rapidly as the Treasury's stocks had run off, and these private holdings as well as an expanded supply of scrap metal were available to meet industrial needs at relatively low prices.

These and other factors helped create a wave of speculative liquidation which fed upon itself with each new failure of the market to live up to price expectations. Many silver-market speculators, like their counterparts in the stock market, had bought on margin during the earlier boom, sometimes with margins as low as 20 percent. Frequently, during the 1970 stock-market plunge, stockholders were forced to sell their silver holdings as well as other assets to meet margin calls, and the resultant decline in silver prices then led to margin calls in **that** market.

The 1972-73 economic boom led to a brisk recovery in the silver market. Prices soared to $3.28 an ounce by late 1973, largely on the basis of a 23-percent annual increase in U.S. consumption over the 1971-73 period. But the price rise also was fueled by the heavy demands of speculators seeking protection against an assortment of fears—of universal commodity inflation, of dollar devaluation, and finally, of the Arab oil embargo. The embargo and the related upsurge in oil-import prices pushed prices upward even in the face of the rising strength of the dollar. Silver prices soared nonetheless, because the petroleum-crisis impact on worldwide inflation and balance-of-payments problems created a distrust

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of currencies which sent speculators fleeing towards precious metals.

The result was a speculative bubble which brought about a peak quotation of $6.70 an ounce in late February 1974. But with the suspension of the embargo, prices slumped within several weeks' time from $6.70 to $4.98, and after a brief recovery, dropped further this week to $4.64 an ounce.

Bubble bursting?

Is the bubble again bursting, as it did during the 1968-71 period? Certainly the fundamentals—industrial consumption and mine production—do not appear to support the recent stratospheric level of prices. Total industrial consumption in the non-Communist world, which rose about 15 percent annually (to 463 million ounces) between 1971 and 1973, should decline moderately this year as a consequence of both a sluggish world economy and soaring prices. But silver mine production, which grew only 2 percent annually over the 1971-73 period (to 249 million ounces) should now rise at a somewhat faster pace, as the higher prices prevailing for both silver and other nonferrous metals stimulate increased production from mines producing silver either directly or as a byproduct.

Even more importantly, higher prices should stimulate an increased supply from secondary sources—melted coin and scrap, private hoards and government stocks. The melting of 90-percent silver coins is now increasing, in view of the faster rise in silver prices than in coin futures. (Earlier, silver coins could be sold at a premium on the futures market, thus acting as a deterrent to coin melting.) Scrap recovery is responding to higher prices in the same fashion; for example, leading to a greater use of microfilm for X-ray negatives as a means of conserving expensive silver.

Higher prices, along with economic difficulties, may entice India to part with some of its legendary hoard of perhaps 3 billion ounces of silver. The Indian government has recently lifted its silver export ban, so the flow of metal from private holdings should rise well above the estimated 26 million ounces smuggled out of that country last year. Another possible source of supply is the U.S. strategic stockpile, should Congress authorize the sale of 117 million ounces from that source.

All of these factors suggest a downturn in silver prices this year. But as in the past, their impact could be offset by monetary uncertainties, worldwide inflationary pressures, and other influences favoring an upsurge in speculative demand. After all, silver's past history has shown that psychology is often a more potent influence on prices than basic supply and demand factors.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/27/74	Change from 3/20/74	Change from year ago Dollar	Change from year ago Percent
Loan gross adjusted and investments*	80,138	+ 539	+8,386	+ 11.69
Loans gross adjusted—	61,195	+ 726	+7,304	+ 13.55
Securities loans	1,051	− 82	− 332	− 24.01
Commercial and industrial	21,774	+ 236	+2,212	+ 11.31
Real estate	18,698	+ 12	+3,064	+ 19.60
Consumer instalment	9,121	+ 4	+ 977	+ 12.00
U.S. Treasury securities	5,817	− 154	− 531	− 8.36
Other Securities	13,126	− 33	+1,613	+ 14.01
Deposits (less cash items)—total*	75,022	+ 522	+5,155	+ 7.38
Demand deposits adjusted	21,633	+ 197	+ 810	+ 3.89
U.S. Government deposits	701	− 57	− 650	− 48.11
Time deposits—total*	51,502	+ 405	+4,831	+ 10.35
Savings	18,141	+ 177	− 193	− 1.05
Other time I.P.C.	24,671	+ 267	+5,394	+ 27.98
State and political subdivisions	6,303	− 44	− 216	− 3.31
(Large negotiable CD's)	11,559	+ 241	+3,210	+ 38.45

Weekly Averages of Daily Figures	Week ended 3/27/74	Week ended 3/20/74	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	65	19	16
Borrowings	309	175	−108
Net free (+) / Net borrowed (−)	− 244	− 156	− 92
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (−)	+1,884	+2,026	− 91
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (−)	− 7	+ 3	+ 24

*Includes items not shown separately.

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