Research Department
Federal Reserve
Bank of
San Francisco

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Not-So-Precious Metal

The recent cycle of inflationary boom and disinflationary recession has been accompanied (as always) by a massive boom-and-bust cycle in world commodity markets. The silver market in particular has witnessed severe price swings in this period. These movements have reflected, first, a major cyclical expansion in the world economy, aggravated by the attempt of some traders to dominate the silver market in late 1979 and early 1980—and then the economic recession and speculative liquidation of stocks during the past two years. By early this week, therefore, the New York producer price had dropped to $6.02 per troy ounce—back to the 1979 low and far below the peak of $48.00 reached in January 1980.

Congress decreed a $1.29-per-ounce monetary value of silver in 1792, and maintained that value until the mid-1960s, when market forces and burgeoning inflation forced the demonetization of the noble white metal. But silver's market price generally lagged far below the monetary value throughout most of the nation's history. After World War II, the market value of $0.90 per ounce was kept there only by a massive Treasury-purchase program, which led to the accumulation of 3.2 billion ounces of metal over a quarter-century.

But with the Vietnam inflation, the market price almost tripled to $2.56 in 1968—and then reached $6.70 at the 1974 speculative peak. This price upsurge reflected a worldwide industrial boom and heavy speculative demand associated with a series of international financial crises. But in addition, it reflected the widening gap between worldwide consumption and current production, as well as the increasing need to rely on Treasury and other stockpiles. The white metal's impressive physical characteristics contributed to a substantial increase in consumption until recent years. It is foremost in electrical and thermal conductivity, highest in optical reflectivity, and second only to gold in ductility. By the early 1970's, therefore, silver had gained new luster among dentists as well as debutantes, and among spacemen as well as shutterbugs. Although consumption then began to weaken in response to rising prices, speculative forces took over in the late 1970's to drive prices to unprecedented heights.

No longer money
The nation's silver problems can be traced back several decades, to the time when a substantial gap first developed between U.S. (and world) consumption and current production. (The U.S. generally accounts for more than one-third of the non-Communist world's total demand.) The U.S. met the challenge in the early 1960s by exhausting almost all of the Treasury's stockpile, most of which disappeared in a futile effort to retain silver's monetary role. Eventually, Congress passed legislation to withdraw all silver-backed currency from circulation (1963), and then to replace silver with other metals in the nation's coinage (1965). But by that time, practically all of the Treasury's original 3.2-billion-ounce stockpile had gone.

Industrial consumption of silver reached all-time highs in the 1973 boom, but then began to decline as a reflection of the rising price trend. U.S. consumption in 1981 just about equalled the 1971 figure, but fell one-third below the 1973 peak figure—see chart. Total world production meanwhile increased 11 percent between 1971 and 1981—but production in 1981, at 264 million ounces, fell far below world industrial usage of 363 million ounces. To fill this continuing gap meant drawing down, year after year, the stockpiles built up over the centuries for coinage, investment and speculative purposes.

Speculative bubble
Amidst the inflationary flight into goods which characterized the late 1970s, silver's

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unique supply-demand situation led many speculators to invest even more heavily in that specific commodity. Most of the headlines at the time were garnered by the activities of two investment groups—one centered around the Hunt family of Dallas, and another centered around several foreign traders acting through the Conti-Commodity commission houses. Their activities contributed significantly to a 675-percent rise in silver prices between January 1979 and January 1980, and then to a subsequent collapse. According to the Commodity Futures Trading Commission, in December 1979 the two groups owned outright (or controlled through futures contracts) more than 250 million ounces of silver. In the words of the House Government Operations Committee, "Although a number of political and economic factors contributed to silver price movements during 1979-80, the primary cause of the abrupt rise in price and the resulting disorderly markets, both cash and futures, was the millions of ounces of physical silver taken off the markets by the major speculators, the Hunt and Conti groups."

The bubble burst in January 1980, and the price slide accelerated in March when buyers of futures contracts on the commodity exchanges had trouble meeting margin calls. In the process, silver dropped in price to $11.10 from the January peak of $48.00 an ounce. (The silver debacle reflected, in exaggerated form, the price decline then occurring in all commodity markets.) The Hunt brothers' role ended when their Placid Oil Co. obtained a $1.1-billion loan (renegotiated this March) from a consortium of 20 foreign and U.S. banks, on the understanding that they would expeditiously dispose of their 60-million-ounce silver holdings and refrain from future commodity speculation. On the regulatory side, the episode ended with new government and commodity-exchange controls on trading in contracts for silver futures.

Stronger prices?

With the spread of a worldwide recession, the silver market has now seen prices drop even further, to only about half of the lowpoint reached during the March 1980 market collapse. In the process, the ratio of gold to silver prices has risen to about 50-1, compared to a 32-1 ratio prevailing throughout most of the 1970s and a 5-1 ratio that the Hunt brothers reportedly considered reasonable. Still, amid all of the bearish factors now dominating the market, several influences—in addition to the usual cyclical upturn in business activity—could help boost silver prices.

Prices could rise again if inflation resurfaces, especially in view of silver's traditional role as an inflation hedge. Inflation and monetary uncertainties have historically generated interest in silver, and this will continue to be true. Indeed, speculative factors generally have dominated price movements during periods of rapid inflation.

Weaker prices?

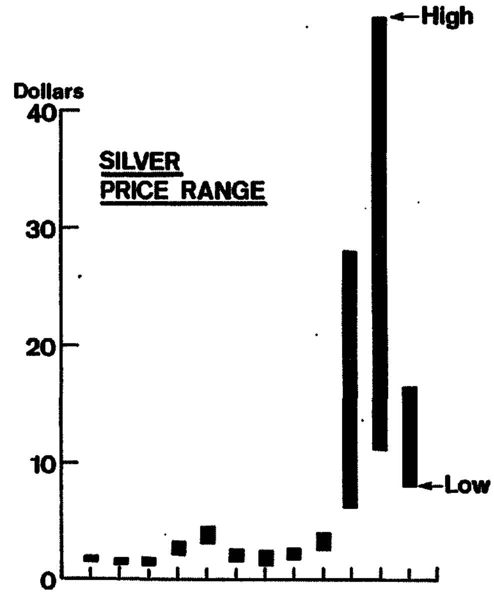
Most other factors, however, point in the direction of further price weakness. The declining trend in U.S. industrial consumption is a crucial factor in this regard. Between 1978 and 1981, for example, use of silver in photographic materials declined 22 percent, and use in sterling and electroplated ware dropped 51 percent, reflecting the attractiveness of silver substitutes and increased recycling of materials, plus technological breakthroughs occurring in photography and other fields.

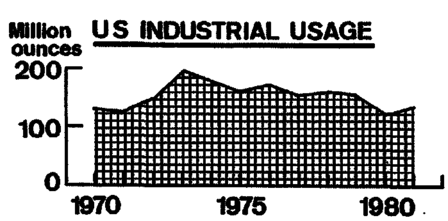
A potential increase in supplies is also a possibility. According to the Handy and Harman processing firm, some 500 million ounces have come out of India in the past 15 years, and more seems to be available—although of course the stock is not inexhaustible. This flow appears to react quickly to price changes, although the liquidation rate has held up even at the relatively low prices of the past two years. In addition, some supplies could become available from the U.S. strategic stockpile of 138 million ounces. Actually, the General Services Administration held several sales of stockpile silver last fall, but suspended sales after opposition arose from domestic and foreign producers. But that stockpiled metal still could be sold at some later time, thereby depressing market prices.

Even greater supplies potentially overhang the market, however, in the form of the 350 million ounces held by investors and speculators throughout the world (Handy and Harman estimate). The Hunt brothers' estimated 60-million-ounce holdings are only the most obvious portion of that supply. Future price levels will depend to a considerable extent on the speed with which such stocks are liquidated. And an even larger supply consists of the 90-percent-silver U.S. coins that have practically disappeared from circulation. Large quantities of these old coins—which total an estimated 655 million ounces—could come into the market, especially in the light of today's high interest charges for carrying silver inventories. Indeed, many holders of coins (or other forms of silver) might be strongly tempted to dump their supplies on the market.

Altogether, silver as a commodity could be expected to rise in price over the long term, in view of the fundamental gap between worldwide industrial demand and new mine production. Indeed, futures-market developments recently have indicated some strengthening of prices. But the near-term future probably will be dominated by the actions of speculators and investors, as has been the case for the past several years. In the absence of another inflationary upsurge, with another massive flight into goods, the large silver stocks now overhanging the markets could keep prices near current levels for some time to come.

William Burke





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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 5/19/82	Change from 5/12/82	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	159,405	51	10,834	7.3
Loans (gross, adjusted) — total #	138,591	126	12,042	9.5
Commercial and industrial	43,598	297	6,295	16.9
Real estate	57,159	– 7	4,858	9.3
Loans to individuals	23,335	6	413	1.8
Securities loans	1,791	– 257	284	18.8
U.S. Treasury securities*	6,042	– 7	– 360	– 5.6
Other securities*	14,772	– 68	– 827	– 5.3
Demand deposits — total#	37,784	– 601	– 2,097	– 5.3
Demand deposits — adjusted	26,232	– 365	– 1,226	– 4.5
Savings deposits — total	30,611	– 39	434	1.4
Time deposits — total#	93,133	118	13,011	16.2
Individuals, part. & corp.	83,448	153	13,086	18.6
(Large negotiable CD's)	34,002	– 122	2,420	7.7

Weekly Averages of Daily Figures	Week ended 5/19/82	Week ended 5/12/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	46	104	– 2
Borrowings	20	20	121
Net free reserves (+)/Net borrowed(–)	25	84	– 123

* Excludes trading account securities.
\# Includes items not shown separately.

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