

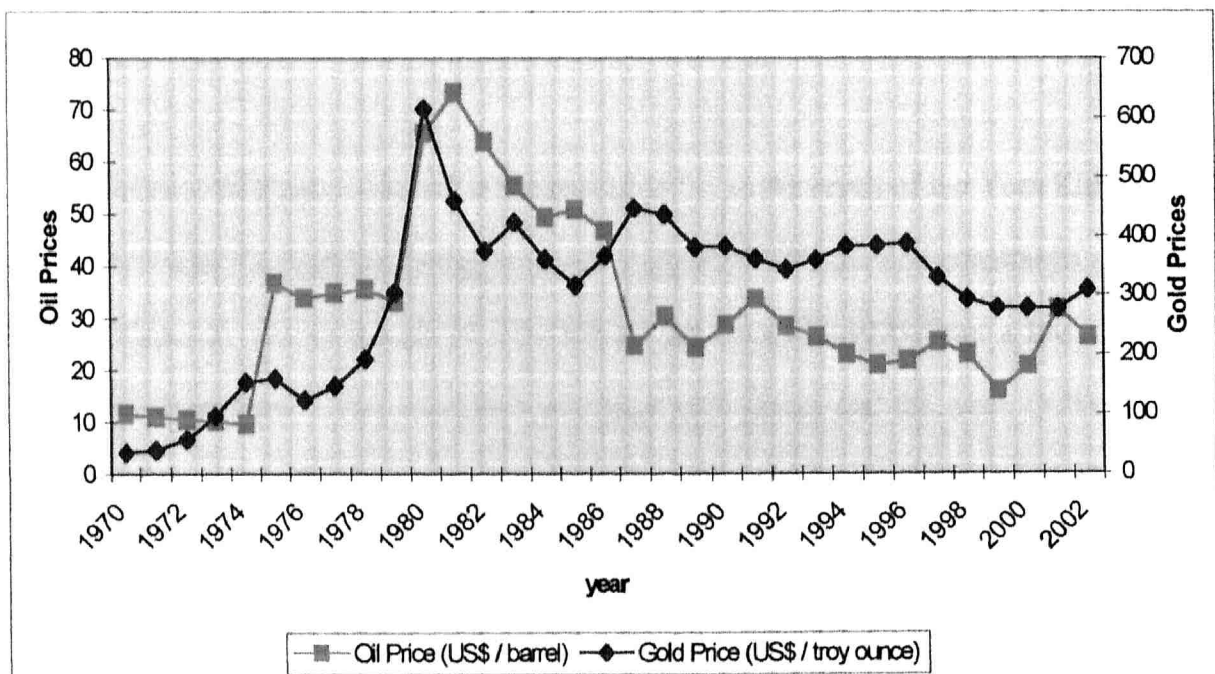
Chapter 3:

Historical Background of Oil and Gold Prices

3.1 The History of Crude Oil and Gold Price Shocks

The analysis of the effects of world oil price¹ shocks and gold price shocks on GDP is not straightforward, it has been complicated by other important events and changing economic conditions during the period in which the oil shocks occurred. Nevertheless, just by looking at the price trends over the period of 1970 to 2002, as can be seen in Figure 3.1, there have been instances whereby the oil and gold prices seems to be moving in the same direction. This is especially apparent in the 1970s and the early 1980s.

Figure 3.1: The Trend in Oil Prices and Gold Prices from 1970 to 2002



Sources: International Monetary Fund website² and Gold Council website³

¹ World Oil prices are derived from the yearly average of three main types of crude oil, namely Brent, WTI and Dubai.

² See <http://ifs.apdi.net>

³ See <http://www.gold.org>

However, towards the end of 1980s, where price shocks was relatively milder than before, the correlation between oil prices and gold prices begins to disappear.

Prior to the period in study, in the period of 1900 to 1933, the gold price was fixed at US\$20.67. In 1934, the price of gold was revised to US\$35 an ounce. The change may be attributed to the recovery of the US economy after the 1929-1933 economic slump. Similar to the gold prices, oil prices were relatively stable prior to 1970. The oil prices before 1970 were between US\$10 to US\$20 per barrel.

Let us scrutinize the price trend of the two commodities. During the 1970s, two important events took place: the “Arab oil shock” and the breakdown of the Bretton Woods international monetary system, as the US, one of the last countries in the world to abandons the gold standard for good and move towards a flexible exchange rate regime. The 1970s also signified the beginning of oil and gold prices instability.

The first oil shock occurred in the end of 1975, as the result of the Yom Kippur War, or also known as the Arab Oil embargo. It was triggered by production constraints agreed by OPEC. Oil prices rose to a high of over \$36.64 per barrel in 1975 from a low of around US\$9-US\$12 per barrel. This coincided with high gold prices and the weak Dollar. At that time, the US was suffering with huge deficits as they had spent a lot on financing the Vietnam War. Gold prices soared to a yearly average of US\$160.86 per ounce in 1975 from a low of US\$36 per ounce in 1970.

The second oil price shocks occurred at the end of 1979, during the outbreak of the Iran-Iraq War, resulting in the fall in Iraq and Iran’s crude oil production. To make matters

worse, OPEC introduced further reduction of oil supply hence triggering the rise in crude oil prices. Prices hit an all time high of US\$73.47 per barrel in 1981. Although real oil prices fell somewhat through the early 1980s, the two oil shocks resulted in a fifteen-year period of historically high oil prices. Coincidentally, the yearly average gold prices also hit an all time high of US\$615 per ounce in 1980.

In October 1987, the stock market crashed, pushing up the yearly average gold prices to US\$447 an ounce. However, there was a slight dip in oil prices as OPEC as Saudi Arabia decided to abandon production constraints after several failed attempts to control prices. They increase supply, resulting in dipping oil prices. There was also a global recession at that period, which caused a reduction in demand and aggravated the fall in crude oil prices.

The third, and very short-lived, spike in oil prices occurred in the second half of 1990 on fears of major supply disruption as a result of the Persian Gulf crisis. As a result, the prices of crude oil rose from a yearly average of US\$24.29 in 1989 to US\$33.75/ barrel in 1991. However, the rise in oil prices was relatively mild compared to the earlier two oil shocks. When the fears of insufficient supply were not realized, prices soon fell back to their pre-crisis level. Again, the oil price shock was not accompanied by increase in gold prices. In 1996, prices touched the US\$400 per ounce level in January and February but failed to sustain in the following months.

3.2 Crude Oil : Introduction

Crude oil is one of the most important commodities in the world, being the main source of energy. Today, more than one third of crude oil supply comes from the Organization of the Petroleum Exporting Countries (OPEC); which consist of eleven

countries namely, Algeria (latest), Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates and Venezuela. Hence, the OPEC has the power to control the prices of crude oil by determining the level of oil supply it to the world market.

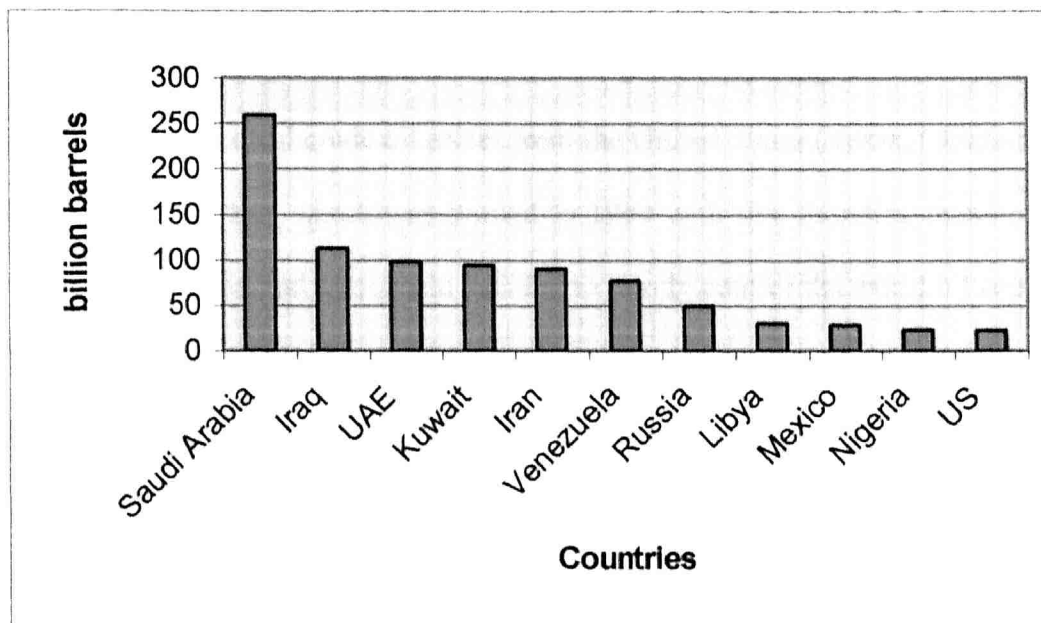
Saudi Arabia is the world's biggest supplier of crude oil and the US is the biggest user of crude oil. Incidentally, Saudi Arabia has also the biggest proven oil reserves in the world (see Figure 3.2a), which is at more than 250 billion barrels. Next to Saudi Arabia, Iraq has the second biggest oil reserves, followed by UAE. When looking at proven reserves by region, the Middle East is by far the leader in oil reserve with almost 700bn barrel of oil in 2001(see Figure 3.2b). Central and South America region has the second highest reserves followed by the Africa region.

3.2.1 Crude Oil Price History and Analysis

Throughout the years, the crude oil commodity has behaved much as any other commodity with wide price swings especially in times of shortage or oversupply. The U.S. petroleum industry's price has been heavily regulated through production or price controls throughout much of the twentieth century. During the post World War II period, crude oil prices were around US\$19 per barrel in 1996 dollars. Through the same period the median price for crude oil was US\$15.3 in 1996 prices. The prices have only exceeded US\$22.00 per barrel in response to war or conflict in the Middle East.

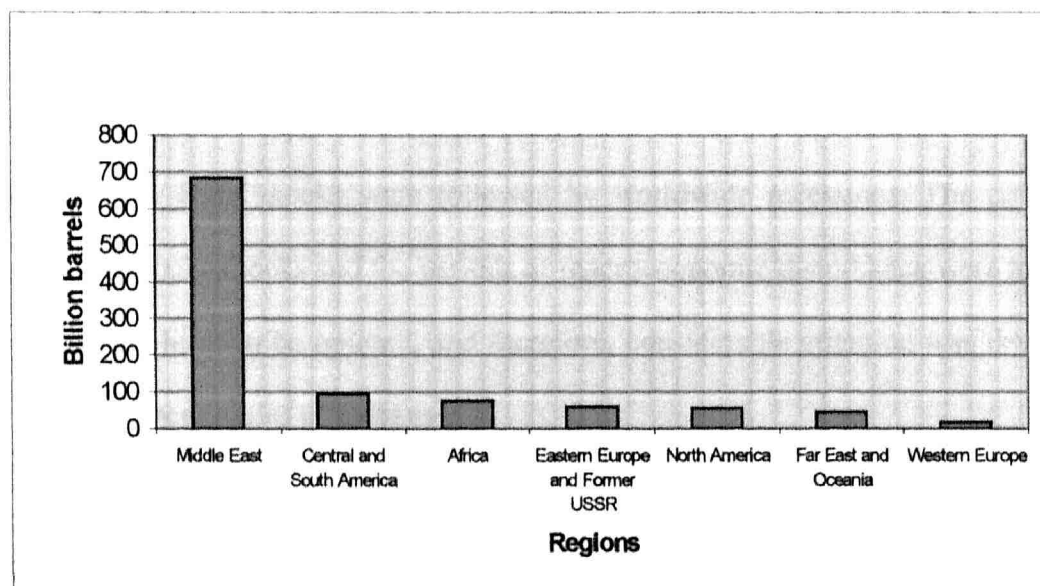
In the past three decades, there have been three main cases of rapid oil prices increases; not including the recent episode caused by the US-Iraq War. The three events were known as the Yom Kippur War in 1973, the Iran Iraq War in 1979 and the Persian Gulf Crisis

Figure 3.2a: Proven Conventional Oil Reserves by Countries (2001)



Source: Fortune, November 12, 2001

Figure 3.2b: Proven Conventional Oil Reserves by Regions (2001)



Source: Fortune, November 12, 2001

in 1990. Apparently, the three oil price shocks were uncannily related to war and political crises.

One significant change worth mentioning during the early oil price shock period was the change of power to control crude oil prices from the United States (Texas, Oklahoma and Louisiana) to OPEC. OPEC, which was formed in 1960 with five founding members Iran, Iraq, Kuwait, Saudi Arabia and Venezuela decided to jointly control the world oil supply. By the end of 1971 six other nations had joined the group: Qatar, Indonesia, Libya, United Arab Emirates, Algeria and Nigeria. OPEC has a target range of price between US\$22-US\$28 per barrel and the members would increase output if prices stayed above the top end of the cartel's US\$22-US\$28 per barrel target range for 20 consecutive working days and vice versa.

Back to the history of oil price shocks, the simultaneous occurrence of inflation and recession in the mid-1970s surprised many macroeconomic policy makers. The oil supply shocks of 1973-74 and 1979-80 were boldly visible events followed by considerable turmoil in various markets. Both shocks were followed by worldwide recessions. The coincident timing of the oil supply shocks and the periods of macroeconomic disturbance were too close for possible causal links to be ignored, and therefore, considerable attention was devoted to studying the macroeconomics of these events.

Many empirical estimates of the effect of the 1973-74 shock have indicated an effect on GDP as high as 7%, other researchers had difficulty reconciling such a magnitude of effect with the small relative share of oil, or even all energy, in GNP (1.5% for oil and 3.5% for all

energy). Cochrane (1994, p. 349) points out that the cost of holding reserves plus cash is the interest cost, which amounts to about 1/10% of GDP.

However on the other hand, the disagreement among OPEC members, which was one of the factors that precipitated a collapse in the price of oil in 1986, notably did not produce an economic boom. The Iraqi invasion of Kuwait in August 1990 effectively removed some 9% of world oil production from the market and caused considerable uncertainty in the oil market. Saudi Arabia and several other OPEC producers increased production so as to nearly fully offset the losses of Iraqi and Kuwaiti supplies. Before the political situation stabilized and the effectiveness of the alternative supply increase proved itself, the oil price rose from around US\$21/barrel to around US\$40/barrel. Within 6 months the price had fallen back to pre-disruption levels. The institutions in the oil market were considerably more mature than in the early 1970s, and official strategic petroleum reserves existed, although their use was minimal. Once again, the price shock was followed by a recession in 1991 and 1992.

All in all, the asymmetry in macroeconomic response to oil price spikes and collapses elicited different responses among researchers regarding the underlying causality of the oil price shocks and the previous recessions. Simply, the study of oil price hikes and collapses did not offer a standard explanation on the effect on the economy.

Some economists concluded that the oil price shocks are more of a political-economic factor: the jump in prices in the 1970s occurred because of a sudden ability of Arab nations to exert cartel-monopoly power that they enforced with an embargo. In other word, the main reason for the "supply shock" oil price increases of the 1970's was the OPEC countries' monopolistic behavior. Another view was that the oil price inflation at that period was due to

wartime disruptions. Wars created uncertainty in supplies as well as supply shortage in the war-affected oil-producing country. The latest oil price surge in 2002 and 2003 is an affirmation of the theory, whereby price shock was very much linked to the US-Iraq war, oil strike in Venezuela and other socio-economic uncertainties which caused worry on supply. However, according to Barsky and Kilian (2000), commodity price increases occurred long before the 1970s War and were too broad-based to reflect supply shocks in individual markets.

3.3 Gold : Introduction

Gold is thought to be one of the first known metals. The word “gold” came from an old English word *geolo*, meaning yellow. The measurement of gold has two dimensions, weight and fineness. The customary measure of weight domestically in the United States is the “avoirdupois pound”⁴ and its sub-units, among which are ounces and grains. (This statement is not true for most of the rest of the world and for international trade, in which the metric system reigns.) However, gold (and other precious metals, as well as gems) are also measured in “Troy pounds” and its sub-units, ounces, pennyweights, and grains⁵. The fineness of gold is the proportion of the gold that is pure (“fine”). For example, pure gold is described as 24-carat gold, 1000 fine, or a fineness of 1, or unitary fineness. Gold of 23 carats $3\frac{1}{2}$ grains (four-grain carat) consists of $233\frac{1}{4}$ parts gold to $\frac{1}{2}$ part alloy, and is equivalent to gold of 23 carats $10\frac{1}{2}$ grains (12-grain carat), is described as gold .9948.

⁴ Under the avoirdupois schemata, 16 “avoirdupois ounces” = 1 avoirdupois pound and 437.5 grains = 1 avoirdupois ounce, yielding 7000 grains = 1 avoirdupois pound.

⁵ In the Troy system, 12 “Troy ounces” = 1 Troy pound, 20 pennyweights = 1 ounce, and 24 grains = 1 pennyweight, whence 480 grains = 1 Troy ounce and 5760 grains = 1 Troy pound. So the Troy pound is almost 18 percent lighter than the avoirdupois pound. Specifically, $1 \text{ Troy pound} = 5760/7000 = 144/175 = 0.822857$ avoirdupois pound. In contrast, the Troy ounce is almost 10 percent heavier than the avoirdupois ounce: $1 \text{ Troy ounce} = 480/437.5 = 117/175 = 1.097143$ avoirdupois ounces.

There are three basic forms of gold: (i) bullion (strict sense), meaning gold in mass, that is not priced, (ii) coin, that historically circulated as money, and (iii) gold bars, that decidedly does not circulate as money but was (and is) a convenient form for international transfer of gold and for speculating or investing in gold. The term “bullion” (loose sense) is also used to designate all non-coin gold, including bars, that is, (i) and (iii) together.

Gold has been a valuable metal throughout the ages because of its scarcity and durability. Gold is also versatile as it can be used in many applications. One of its primary uses is as jewelry and adornment. In Mesopotamia (now Iraq) gold cups and jewelry have been excavated that date back to 3500 B.C. In the Egyptian tombs jewelry and masks made of gold have been discovered. During the Middle Ages a science called “alchemy” evolved as a way to try to artificially create gold.

In 1851 gold was discovered in Australia and that rush saw the population of Australia triple in the following nine years. New Zealand experienced a gold rush in 1861 and their population also grew tremendously. Johannesburg in South Africa was founded as a result of the 1886 gold rush. Canada’s Yukon Territory was developed as result of a gold rush that started in 1897. In the 1900s, gold rush worldwide has led to the development of frontiers. The largest U.S. gold strike occurred in the 1900’s near Carlin, Nevada. In 1965 an open-pit mine began operating there and the Carlin mine added about 10 percent to the annual gold production of the U.S. It appears that gold rushes played an important part in developing territories in many parts of the world.

3.3.1 Gold Price History and Analysis

Between 1880 and the late 1930s a gold standard was the most common monetary arrangement for a country. A gold standard defines a national currency in terms of a fixed weight of gold, and allows a free exchange and trade of gold. The phrase “gold standard” is defined as the use of gold as the standard value for the money of a country. If a country will redeem any of its money in gold it is said to be using the gold standard. This seemingly small act of law turned out to have broad implications for almost every aspect of the domestic and global economy.

For many years up to 1914, most of the world's leading currencies had their exchange rate determined by the gold standard; hence a global fixed exchange rate system reigned. Great Britain, Australia and Canada were amongst the earliest to adopt the gold standard in 1821, 1852 and 1853 respectively. The US adopted the gold standard by 1879 and Asian nations linked up to the gold standard in the early 1900s. Gold dinar was used as a currency in the Muslim world until the collapse of the Ottoman caliphate in 1924.

However, economic disruption resulting from the first World War led the combatants to abandon the link to gold. The UK as well as a few other countries returned to the gold standard in 1925, before quitting it for good in 1931. The widespread use of the gold standard ended during 1930-33 as a result of global depression and large cuts in international lending. The United States left the gold standard in 1933 and partially returned to it in 1934. After the second World War, a limited form of gold standard continued but only directly applied to the dollar; other major currencies had their exchange rates fixed to the dollar under the Bretton Woods arrangements.

The dollar was finally cut loose from the gold standard in 1971; among the reasons given were inter-war instability and the depth and length of the Great Depression of the 1930s. On August 15, 1971, the world entered the first era in its history in which no circulating paper anywhere was redeemable in gold, by anyone. President Richard Nixon of U.S. closed the “gold window” Making it illegal for a U.S. citizen to own gold. This action broke the last tie between gold and circulating currency, resulting in our modern financial system which is called a “floating currency” system.

Nevertheless, holdings of gold are still retained because it is an internationally recognized commodity, which cannot be legislated upon or manipulated by interested countries. In most monetary system today, a country backs its currency with a reserve of gold and allows currency holders to exchange their notes and coins for gold. Currently, the US has the highest reserves in gold.

In recent times however, arguments for a gold standard have re-emerged. Among the reasons given are exchange rate volatility, lower transaction cost of trade, gold standard generates more credibility and other political factors. Some countries in the Middle-east are using gold as a standard of payment for bilateral trade.

Malaysia has also started using the gold in bilateral trade with some countries in the Middle-east. The idea to use of Gold Dinar as a Standard Unit of Currency for trade and financial transactions was first proposed by Malaysia previous Prime Minister, Dr Mahathir in late 2002. The Malaysian proposal is not to revive the gold dinar as a currency to settle day-to-day payments, but to revive it as a means to settle bilateral payment arrangements exclusively in bilateral trade between Islamic countries, and later, non-Islamic countries too.

The reason being the gold is less volatile compared to the US dollar, and has an intrinsic value which paper money does not carry. Malaysia has been working rapidly towards addressing the technical issues of using the gold dinar. There were ongoing discussion between Malaysia and countries such as Iran, Pakistan, Morocco and Bahrain to use the gold dinar in bilateral trade.

The proposal is to denominate external trade in dinar (a standard unit of weight of gold), but the denomination has yet to be set. Exporters would be paid in their respective national currency by their central bank on the due date of exports, based on the gold dinar exchange rate prevailing at the time of the transaction. Meanwhile, central banks would settle the difference in bilateral trade balance every 3 months by transferring gold in their custodian's account at the Bank of England. There would not be physical transfer of gold from one country to another, but a transfer of beneficial ownership in the gold custodian's account.

Some party have raised concerns that the use of the gold dinar could contravene an existing prohibition by the International Monetary Fund on the use of gold as a medium of payment and could be a return to the Bretton Woods policy of a gold-reserve system. Bretton Woods refers to the gold standard used in the Bretton Woods Agreement, which fixed the exchange rate of major trading countries' currencies against gold. Furthermore, using the gold dinar as a means of payment still casts doubts among many countries. For one, its credibility is yet to be proven.

The main challenge lies mainly in developing the mechanism to make it a credible system that was practical to traders the challenge in the adoption. Most important is the need

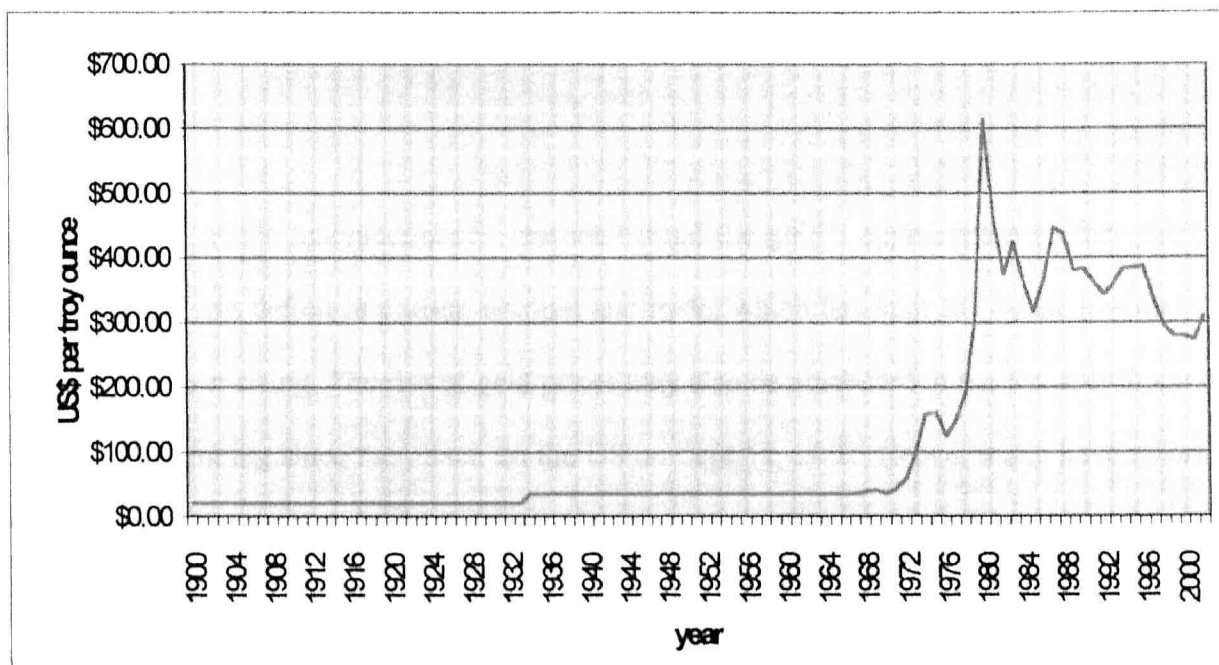
to come up with a system acceptable to the central banks of all the participating countries. In addition, other key issues that needed to be addressed are the establishment of legal frameworks in countries using the gold dinar, matters pertaining to trade surpluses and trade deficits, and interest charges and penalties for late payment and net settlement.

As seen in Figure 3.3, gold prices during the 1900 to 1970 have been relatively flat. After the breakdown of the Bretton Woods 1971, the US refused to continue supplying gold at US\$35 per ounce to other central banks. There was a December 1971 Smithsonian extension of the exchange rate peg system, with the final breakdown of the fixed exchange rates occurring in March 1973 (McCallum, 1999). Gold became the target of price speculation, and therefore the volatile swing in gold prices henceforth.

Between 1996 and 1997, when the Asian Crises manifested, the Indonesian Rupiah dropped seventy-six percent; the South Korean won fell fifty-six percent and both the Malaysian Ringgit and the Philippine peso lost forty percent of their value against the dollar. Since the US dollar was performing well on foreign currency markets, thanks to the Brazilian, Mexican and Japanese devaluations earlier in the decade, a tidal wave of capital made its way to the United States. The increase in the US dollar following the Southeast Asian currency crisis crushed the US dollar-gold price, hence the gold prices decreased tremendously.

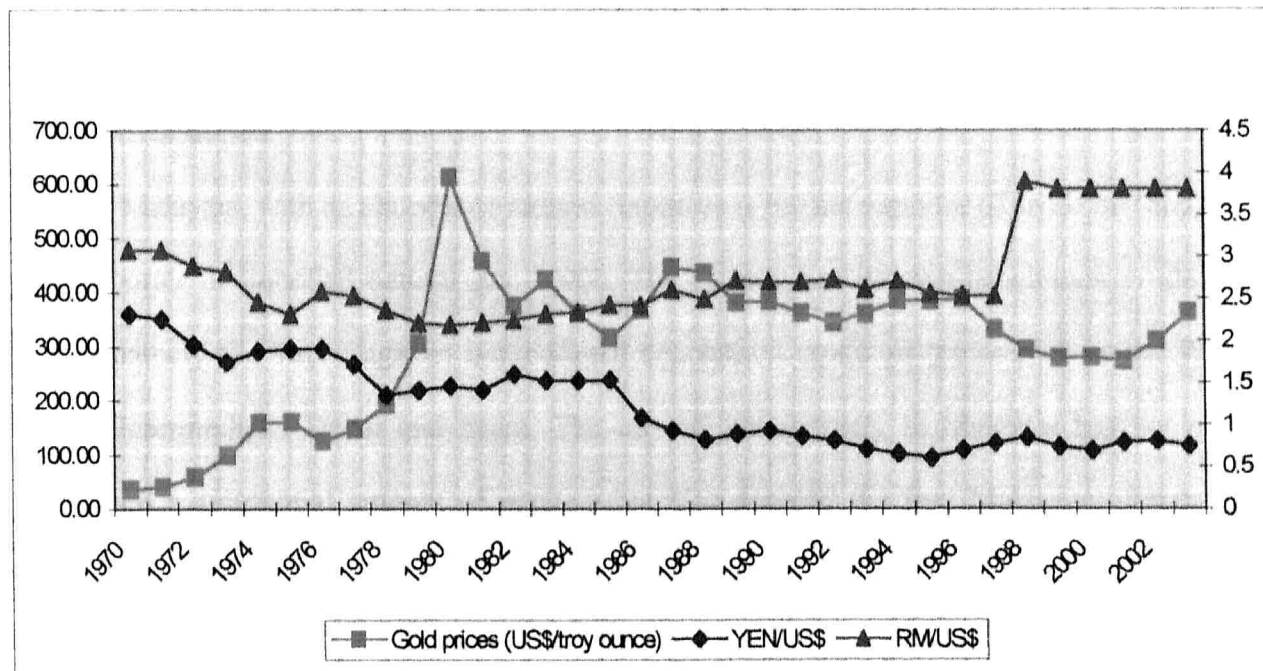
In 2003, we witness the meteoric rise of the gold price amidst global economic uncertainties. In Dec 2003, gold prices have breached the US\$400 per troy ounce limit amidst falling dollar. The rise of gold to highs of more than seven years has coincided with a reduction in forward gold sales by producers, declining production globally and a lack of new

Figure 3.3: The Trend in Gold Prices from 1900 to 2002



Source : Gold Council website

Figure 3.4: Gold Prices, Malaysia and the US Exchange Rate (1970-2003)



Source: Gold Council website, Monthly Statistical Bulletin (various issues) and International Financial Statistics.

discoveries. The sharp climb in the euro, and other currencies, boosting dollar-denominated gold's investment demand and value overseas, was one of the factors of the recent rise in gold prices.

Some of the macroeconomic reasons behind the gold's appreciation include the US government twin deficit in current account and trade, which has kept the dollar low and the gold prices ever rising. The rise of gold prices may also be attributed to the terrorist threat on America beginning since the attack on the US on Sept 11, 2002. Hence, many have resorted to buy gold as safe-haven buying. In addition, the uncertainties due to US-Iraq war, oil price shocks and low interest rates at 1% have further precipitated the rise of gold prices. Waning foreigners' political confidence in the US economy since the Iraq War also did not helped to ease the situation.

3.4 The Malaysian Economy

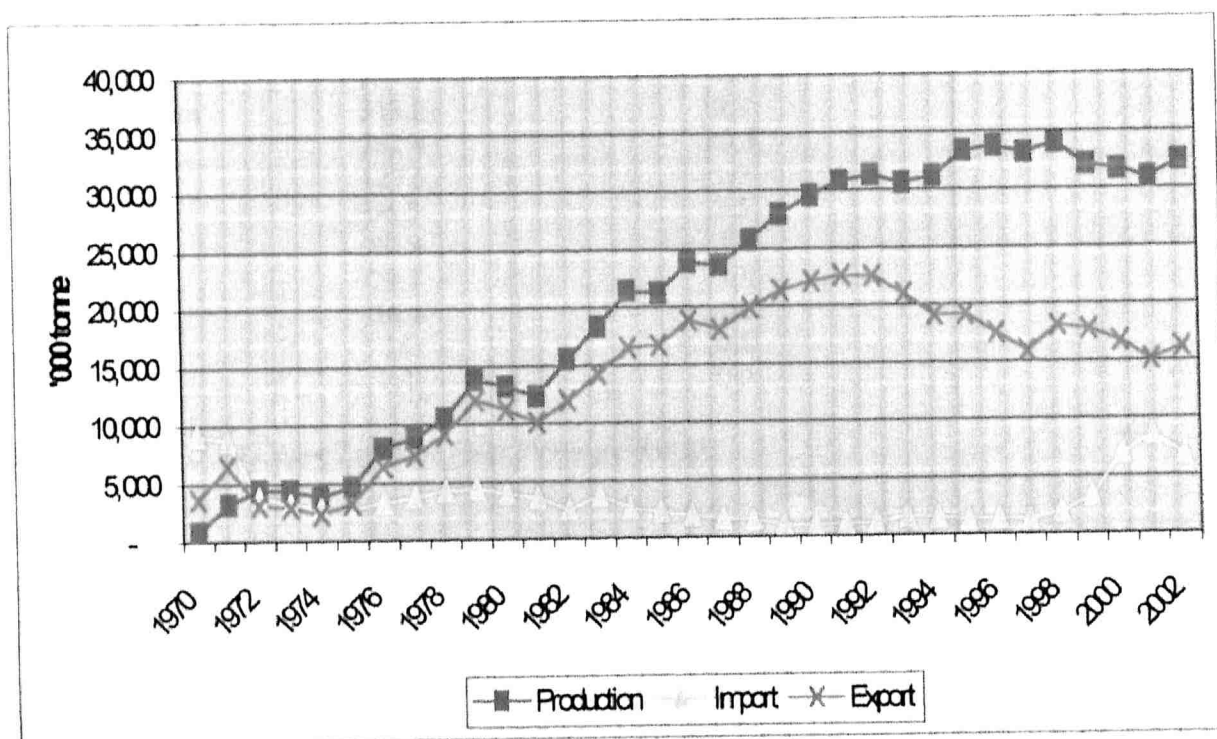
3.4.1 Introduction

Malaysia, with its abundance natural resources is the net exporter of crude oil (and the top exporter of liquefied natural gas; LNG). The country has its own benchmark crude oil price; namely the Tapis; against international benchmark crude oil prices such as the West Texas Intermediate, Dubai and Brent. The oil and gas industry in Malaysia has not only generated a substantial amount of revenue but also enabled the first Malaysian company, Petronas to be ranked amongst Fortune's global 500 companies.

In Figure 3.5, the production of crude oil in Malaysia has been on the rising trend since 1970. Oil is sourced from off the coast of the state of Terengganu, Sabah and Sarawak. The discovery of new oil sources continues to sustain the high production level. On the

external trade side, the export of crude oil rose to the peak of 22.6bn tonnes in 1991 and has been sliding down ever since. Imports on the other hand, continued moving upward, peaking in 1998 but only to decline in the following years. Needless to say, oil consumption has been increasing throughout the years, in tandem with the expansion of the industrial sectors. Although exports have been consistently above imports since breaking even in 1974, there is the possibility a greater reliance on oil imports in the future as natural resources are limited by nature.

Figure 3.5: Production, Import and Export of Crude Oil in Malaysia (1970-2002)



Sources: *Monthly Statistical Bulletin, Bank Negara Malaysia (various issues)*

Figure 3.6 : Malaysia's Production, Import and Export of Gold ('000 grams)

Year	Production	Import	Export	Net (M-X)	% y-o-y
1998	3,352	50,811	6,287	44,524	
1999	3,449	99,556	3,697	95,859	115.3
2000	4,026	101,157	5,042	96,115	0.3
2001	3,965	97,019	4,552	92,467	-3.8
2002	4,289	81,851	12,237	69,614	-24.7

Source: Monthly Statistical Bulletin (various issues)

Figure 3.7: World Official Gold Holdings (Dec 2003)

Selected Countries	Tonnes	% share of Gold to Reserves**
United States	8135.4	58.2
Germany	3217	45.3
France	3024.8	55.2
Italy	2451.8	47.4
Switzerland	800.5	47.3
Japan	765.9	1.5
China	600.3	1.9
Taiwan	423.6	2.7
India	357.7	4.8
United Kingdom	313.2	8.8
Philippines	262.4	20.3
Singapore	127.5	1.7
Indonesia	96.5	3.5
Thailand	80.9	2.5
Australia	79.7	3.1
Malaysia	36.4	1.1
Korea	14	0.1
Hong Kong	2.1	0.0

Source: World Gold Council website (<http://www.gold.org>)

Notes:

This table was updated on December 5th and reports the latest data available on that date. Data are taken from the International Monetary Fund's International Financial Statistics, online December 2003 edition, and other sources where applicable. IFS data are two months in arrears, so holdings are as of October 2003 for most countries, September or earlier for late reporters. For Canada, Eurosystem members and Switzerland data are end-November. The table does not list all gold holders: countries which have not reported their gold holdings to the IMF in the last 6 months are not included, while other countries are known to hold gold but do not report their holdings publicly. Where the WGC knows of movements that are not reported to the IMF or are misprints, updates or other changes have been made.

All countries shown hold some gold. Where data are shown as zero, the figure is less than 0.05.

**The percentage share held in gold of total foreign reserves, as calculated by the World Gold Council. The value of gold holdings uses the IMF's end-October gold price of \$386.25 per troy ounce (there are 32,151 troy ounces in a metric tonne). The value of other reserves is from IFS table 'Foreign Exchange and Total Reserves minus Gold'.

On the other hand, in terms of gold, Malaysia produces gold, albeit at a small amount and the country is a net importer of gold (see Figure 3.6). In 2002, net imports of gold declined by 24.7% year on year, mostly due to the rising gold prices. In Figure 3.7, the US gold reserves stood at 8135.4 tonnes or 58.2% share of total reserves; the highest in the world. Malaysia's gold reserve represented only 1.1% of total reserves. Compared to many of the other Asian countries, the country's percentage of reserves in gold is rather low. Hence, Malaysia is relatively unfazed by gold price shocks as compared to countries with higher proportion of gold holdings in their reserves.

3.4.2 Analysis of Oil and Gold Price Shock in Malaysia

Looking back, during the first oil shock, Malaysia was in the midst of high economic growth. The commodity market was drawing high earnings especially in the export of palm oil and the development of a substantial oil and natural gas industry. There have also been important developments in manufacturing, particularly in electronics and textiles that provided new jobs in the urban sector. In 1974, GDP growth was down to 8.3% compared to 11.7% in 1973. In 1975, world gold price peaked at US\$160.86 per troy ounce after hovering between the range of US\$36-US\$100 per troy ounce in 1970-1973 (see Figure 3.7).

In the past, petroleum income taxes have moved in tandem with crude oil prices. In the Mid-Term Review of the 8th Malaysian Plan, petroleum income tax is expected to decline by an average of 7% per annum in line with the trend in crude oil prices for the remaining period. Therefore, the higher crude oil prices will increase government revenue from direct and indirect petroleum taxes as well as non-tax revenue from petroleum royalty. In 2003, the share of federal government revenue as a percentage of GDP increased to 23% compared to only 18% in 2000.

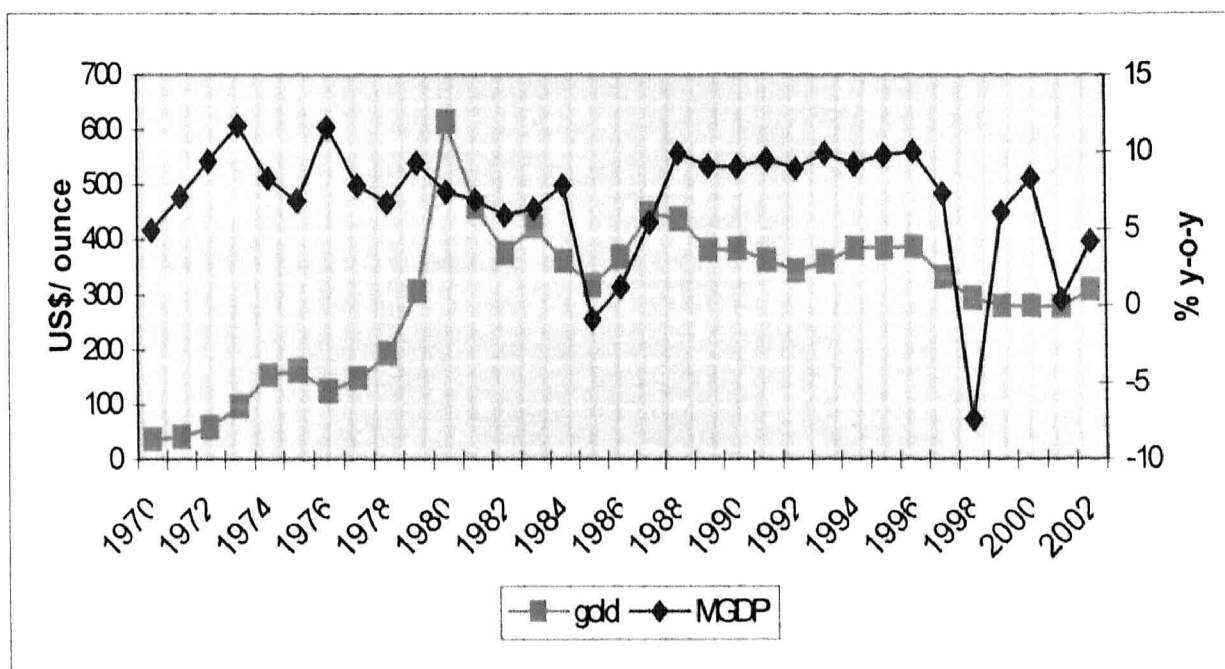
All in all, the 1974-1975 oil shock aftermath caused falling output and rising inflation, which urged many top economies to adopt a generally accommodative policies, as opposed to earlier monetary tightening. The 1979/80 oil price hike was accompanied by higher unemployment and lower capacity utilization as well as high inflation in most countries, especially the US. In the main industrial countries, short-term interest rates, which had already been rising prior to the oil price hike, were increased further in 1980 and 1981. The very short-lived nature of the third oil shock, coupled with the declining role of oil in overall economic activity, also limited the impact on inflation.

Meanwhile, as can be seen in Figure 3.8a and Figure 3.8b, the volatility of gold prices and oil prices do not show a strong correlation with Malaysia's real GDP growth. Gold prices reached a peak of US\$615 per troy ounce in 1980, coinciding with the second oil price shocks and world recession. Growth rates have generally moved within the 6-11% range until the recession in 1985. At that time, the prices of gold and oil was at a relatively low level. Being an export-based economy, Malaysia was badly affected by the downturn, as export demand and commodity prices fell drastically. Nevertheless, the economy picked up and was largely unscathed by the third oil shock as a result of the Gulf War.

Malaysia produces gold albeit not extensively and is a net importer of gold. Therefore, the rise of gold prices has little impact on the economic growth of Malaysia. Three channels have been identified where by the rise in gold prices may be felt: lower purchasing power for buyers of commercial gold (gold used as jewelry, ornament, etc.), investment gains for investors in gold prices and the higher cost to the government when purchasing gold as reserves. Theoretically speaking, higher gold prices accompanied by depreciation in the US

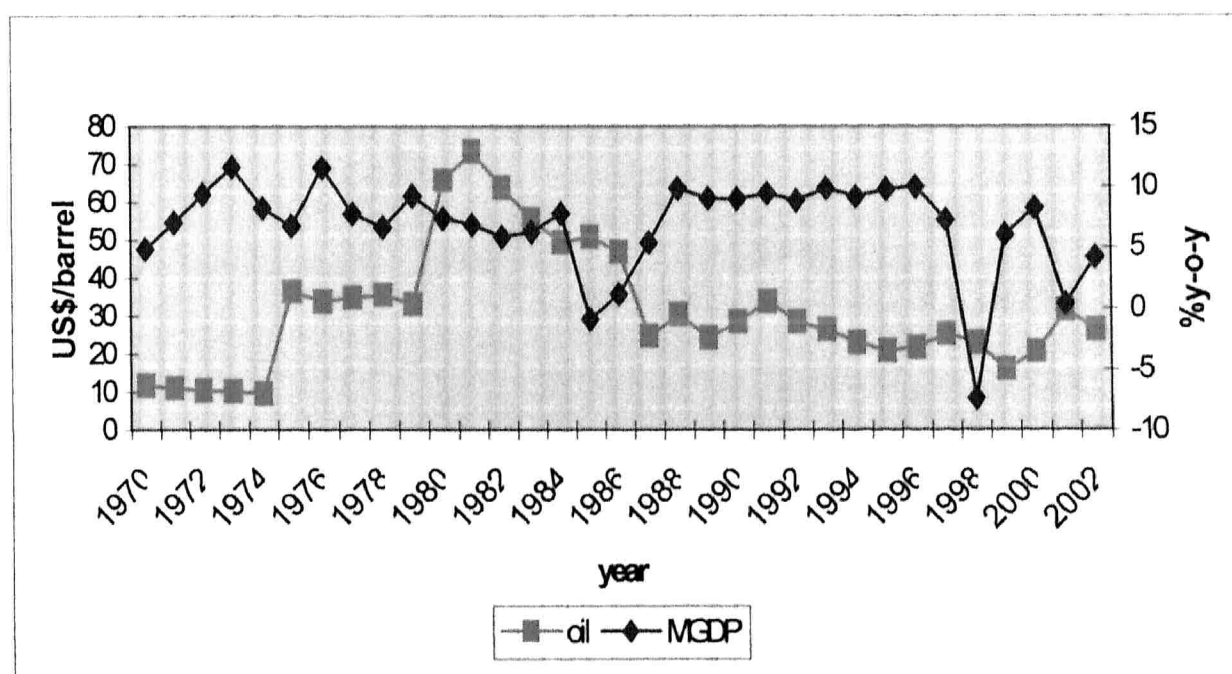
Dollar may also trigger higher demand for gold, as a better means of store of value. Nevertheless, the demand for gold in Malaysia is very elastic; and the hike in gold prices discourages the purchase of gold in Malaysia.

Figure 3.8a: The Trend in Malaysia's GDP and Gold Prices From 1970 to 2002



Sources: *Monthly Statistical Bulletin* (various issues) and *Gold Council website*.

Figure 3.8b: The Trend in Malaysia's GDP and Oil Prices From 1970 to 2002



Sources: *Monthly Statistical Bulletin* (various issues) and *International Monetary Fund (IMF) website*.