Making Sense of the Gold Price
by
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Introduction

The gold price in U.S. dollars is not necessarily the same as the gold price in euros or South African rands. When we talk about the gold price in U.S. dollars, we are by definition also talking about the U.S. dollar exchange rate.

Even though the gold price in U.S. dollars has declined by over 30% since January 1990, the average gold price in the world has increased by over 20% during the same time. This not only reinforces the concept that talking about the gold price is currency specific but more importantly, it shows that the average gold price in the world is stable and in fact steadily increasing.

This in turn is a strong indication that gold is still a safe haven for capital. Gold has not lost its value as a store of wealth. We will briefly look at a few examples that illustrate specifically how gold has acted as a safe haven for capital during financial crises.

Then we will focus our attention back to the dollar to try and understand why the dollar got so strong and what may lie in store for us over the next five to ten years. We will briefly look at events leading up to the financial crisis of the 1970’s and then examine our current situation in the United States with respect to the economy, the stock market and the dollar.

The gold price is currency specific

They say a picture is worth a thousand words. I promise not to write a thousand words about the following chart but I do think that this is one of the most enlightening pieces of information for anyone interested in gold.

The gold price and exchange rates
The top line on the chart is the U.S. dollar exchange rate and the bottom line is the gold price in U.S. dollars. The line in the middle of the chart shows the average gold price in the world as measured by a basket of currencies weighted by the countries’ relative GDP. An explanation of how the dollar exchange rate and the average gold price were calculated can be found at the end of the paper.

Discussion
From January 1990 to September 1992 the dollar exchange rate was essentially flat. There was a gradual 15% decline in both the U.S. dollar-gold price and the average gold price during the same time with very little divergence between the two gold prices.

In the latter part of 1992 the Brazilian real crisis was underway and the dollar strengthened 15% by January 1994 as capital left Brazil. The average gold price responded to the crisis by rising 24% while the U.S. dollar-gold price rose only 13%. The lag in the U.S. dollar-gold price being due to the strength in the dollar.

From November 1994 to February 1996 the dollar rose another 5% as the Mexican peso fell. The average gold price rose by 10% while the U.S. dollar-gold price rose only 6%, again as a result of the dollar’s strength. By now the dollar-gold price, which was at parity with the average gold price just four years ago, was almost 11% lower than the average gold price.

By July 1997, when the Southeast Asian crisis exploded, the dollar had already gained another 10%. The average gold price meanwhile had declined by 10% and the dollar-gold price by 20%. Yes, the difference was due to the increase in the U.S. dollar exchange rate.

In response to the Southeast Asian crisis, the dollar gained 15% from July 1997 to July 1998. Disregarding some volatility, the average gold price remained essentially flat while the dollar-gold price lost 10% as a result of the strong dollar.

In August 1998 Russia defaulted on its debt and devalued the ruble. By December of that year the dollar had gained yet another 10% as did the average gold price. The two offset each other exactly and the dollar-gold price remained unchanged.

As you can see from the above examples, even though the dollar-gold price did not necessarily respond to crises, the average gold price certainly did. But the world had become fixated on the dollar-gold price and it has become generally accepted that gold had lost its value as a store of wealth. From the above examples however, it should be clear that nothing is further from the truth. Later on we shall emphasize that point again with additional, explicit examples.

In January 1999 the euro was launched at 1.17 euros to the dollar. With all the momentum behind the dollar the euro promptly fell 25% against the dollar as the dollar gained an average of 21%, which brings us to the present. During the same time the average gold price increased by 13% while the dollar-gold price remained essentially unchanged.

Overall, the dollar increased by 105% from January 1990 to the present, the average gold price increased by 20% and the dollar-gold price decreased by 30%. Were it not for the increase in the
dollar exchange rate, the U.S. dollar-gold price should today have been in excess of $500 an ounce. And were it not for the 20% increase in the average gold price, the U.S. dollar-gold price would today have been under $200 an ounce.

One more item needs clarification and that it is the decline in the average gold price from February 1996 to August 1998.

Ever since the U.S. dollar was declared the world’s official reserve currency, and especially during the days when the dollar was convertible into gold at a fixed rate of $35 an ounce, central banks have consistently sold off gold reserves in favor of interest bearing dollars. After the acceptance of gold derivates however, central banks had a way to earn income on their gold reserves without selling it. They could lend the gold out to bullion banks, which in turn made gold loans to mining companies and hedge funds. The borrowers of the gold would sell it and reinvest the proceeds of the gold sales in U.S. government treasuries. The gold-carry trade, as these transactions are called, is risk free as long as the gold price does not appreciate against the dollar. Given the recent increases in the dollar and the extremely robust U.S. economy, it seemed like a very low-risk trade.

All went well from 1996 to mid-1998 and a vast amount of gold was mobilized in the gold-carry trade. Central banks earned interest on their gold reserves, bullion banks made lots of fees and the hedge funds made fat profits. Until the Russians defaulted on their debt and devalued the ruble.

One of the victims of the Russian default and concomitant ruble devaluation was Long Term Capital Management. LTCM was a very active hedge fund managed by the ultimate dream team. After the collapse of LTCM, central banks seriously reevaluated counter-party risk in their gold transactions and gold-lease rates dropped by 25% to an annual rate of barely 1.5%. Ignoring the brief surge in gold-lease rates between the time the Bank of England announced their gold auctions and when the Washington agreement was announced, gold-lease rates have continued to languish. The gold-carry trade had lost its luster and the average gold price started its ascent, rising more than 20%.

Gold as a store of wealth
The easiest way to demonstrate gold’s value as a safe haven for capital is to look at the gold price in terms of currencies that have recently been the subject of financial turmoil. It will immediately become evident that during times of financial crisis those investors who had gold in their portfolios were substantially better off than investors without gold.
**Mexico 1995**

Mexican investors with assets in gold saw the gold price rise by 107% in less than three months.

**Indonesia 1997**

Indonesian investors saw the gold price rise by 375% in seven months. For the sake of redundancy I won’t show the charts of any other Southeast Asian countries. Suffice to say the gold price in South Korean won increased by over 100% in five months; gold in Malaysian ringgit increased by 80% in six months and gold in Philippine pesos increased by 67% during the same six months.
Russia 1998

Russian investors saw the price of gold rise by 307% in eight months and it has continued to increase ever since.

South Africa 1992

South African investors have seen the price of gold rise consistently since 1992, increasing by 180% over the past nine years. In fact, this is one of the main reasons why South African gold mining companies have done so well. While everyone was crying about a terrible bear market in gold, South Africa was experiencing a raging bull market in gold.

From the foregoing charts, as well as the first composite chart that we looked at, it should by now be clear that gold has definitely not lost its value as a store of wealth nor as protection for financial assets in times of turmoil.
We have not yet experienced an increase in the gold price in the United States because of its robust economy and extremely strong stock market of late. However, now that the “New Era” has been discredited, the economy is stalling, corporate earnings are falling, bankruptcies are at record levels and the stock market is shaky – shouldn’t you be thinking about some financial insurance and a safe place to put some of your capital?

**What is in store for the dollar?**
The current strength in the U.S. dollar is not an isolated occurrence. It is merely the most recent development in a sequence of events that began in New Hampshire during the last years of World War II, in a small ski resort called Bretton Woods.

The Bretton Woods agreement gave birth to two institutions: the World Bank and the IMF. But the main thrust of the Bretton Woods agreement was the establishment of fixed exchange rates between the members of the IMF, which soon included most non-soviet block countries. The British pound and the U.S. dollar became the official reserve currencies of the world and reserve assets were held in a combination of pounds, dollars and gold. Only the U.S. dollar was convertible into gold.

At the end of the War the United States owned approximately 60% of all the gold in the world and by 1946 it had almost 80% of all the gold. It did not take long for dollar denominated transactions to drown out the British pound and the U.S. dollar became the de facto reserve currency of the world.

Reserve assets were now essentially a combination of dollars and gold. Gradually the central banks adjusted their portfolios to emphasize dollars instead of gold. This was a logical development since the dollar was convertible into gold and the central banks could earn interest on their dollar assets but did not get any return on their gold assets. The current spate of central bank gold sales is actually nothing more than a continuation of portfolio adjustments that started soon after World War II.

In order for the system of fixed exchange rates to work, as agreed to at Bretton Woods, there had to be coordinated economic and monetary policies throughout the world, particularly among the largest economic powers. Furthermore, since the U.S. dollar was by far the most important reserve asset in the world, and because the dollar was convertible into gold at a constant price of $35 an ounce, there could be no inflation (devaluation) of the dollar. These two requirements eventually led to the breakdown of the Bretton Woods system.

From the end of World War II until about 1965, U.S. domestic monetary and fiscal policies were conducted in such a way as to be non-inflationary. As world trade expanded, the relative importance of Germany and Japan grew so that by the end of the 1960’s it became unreasonable to expect any system of international finance to endure without consensus at least among the United States, Germany and Japan. But after 1965, U.S. economic policy began to conflict with policies desired by Germany and Japan. In particular, the United States began a strong expansion, and moderate inflation of the dollar, in order to finance the Vietnam War and the Great Society Program, the domestic social programs of the Johnson administration.
When it became obvious that the U.S. dollar was overvalued relative to the German mark and the Japanese yen, the U.S. urged these two countries to revalue their currencies upwards. Germany and Japan argued that the United States should revise its economic policy to be consistent with those in Germany and Japan, as well as with previous U.S. policy. Specifically, they wanted the U.S. to curb money supply, tighten credit and cut government spending. The U.S. decided to continue its expansion program and both Germany and Japan were forced to intervene in the currency markets in order to try and maintain their respective currencies’ exchange rates.

In April 1971, the Bundesbank took in $3 billion through foreign exchange intervention. On May the 4th 1971 it bought $1 billion in the course of one day and on the next day the Bundesbank took in $1 billion during the first hour of trading. Intervention in the foreign exchange market was suspended and the German mark was allowed to float upwards against the dollar.

Recall that in 1946 the United States owned approximately 80% of all the gold in the world. By 1963 the U.S. gold reserve barely covered liabilities to foreign central banks and by 1970 the gold coverage had fallen to 55%. By 1971 it was a measly 22%. Thus, from 1963 onwards, had foreign central banks tried to convert their dollars into gold, the U.S. would have had to abandon gold convertibility.

On August 15, 1971, President Richard Nixon halted gold convertibility in response to a massive flight out of the dollar. The last vestige of a gold standard was gone.

The stage was set for the inflationary seventies. The gold price rose from $35 an ounce to over $700 an ounce before settling into a trading range around $400 an ounce where it remained essentially until February 1996, which brings us back to the present.

**Making the same mistakes again**

More than a generation has passed since the “Great Devaluation” of the seventies. The current powers that be, although they are intimately familiar with the events of the seventies, would very much like to experience the thrill of defeat for themselves. Portfolio adjustments among central banks continue to replace gold with dollars but this time the inflation of the dollar, which should lead to a new round of devaluations, is much more severe than it was in the seventies. The U.S. dollar has never been as prevalent in the world as it is today. The stage is set.

While the financial crisis of the 1970’s was very different from what I think is in store for us now, there are certain similarities. The inflation of the dollar that started in 1965 eventually led to the closing of the gold window and the problems were for most part associated with attempts to adhere to the Bretton Woods agreement of fixed exchange rates. We do not have that situation today and so the same stresses are not present in our foreign exchange markets.

However, the crisis of the 70’s was precipitated by a run on the dollar when it was realized that the world’s reserve currency had been grossly devalued and that the devaluation had not been priced into exchange rates. I believe that a similar situation to that exists today.

During the seven years leading up to August 15, 1971, the U.S. was inflating the dollar and yet the dollar was artificially strong relative to other currencies due to the system of fixed exchange
rates. During the past seven years the dollar has been artificially strong due to foreign currency crises that started with Brazil in the early 1990’s followed by Mexico in 1995, Southeast Asia in 1996, Russia in 1998 and the precipitous decline in the euro, which was launched in 1999. Due to the relative declines of all these currencies vis-à-vis the dollar, and continuing with Argentina’s problems and the precarious situation in Turkey, the dollar is trading at an unsustainable level in spite of the fact that the U.S. has embarked on a policy of domestic monetary expansion and the U.S. trade deficit has increased the foreign supply of dollars at an unprecedented pace and to historical levels.

Whenever the issue of the dollar’s strength is discussed, analysts cite the size and strength of the U.S. economy as the main reason why foreign investment in the U.S. is justified and should continue. But consider that:

- From 1965* to 1971, M3 grew at an approximate average annual rate of 7.5% and from 1995 to 2001 M3 growth has been 8.4%.
- The yield on the 10-year Government bond rose from 4.19% in 1965 to 6.73% in 1971 while it dropped from 7.78% in 1995 to 5.24% in 2001.
- GDP growth from 1965 to 1971 and GDP growth from 1995 to 2001 were almost equal at approximately 3.3% per annum.

In spite of similar economic growth leading up to 1971, higher interest rates and less debt, the bottom fell out of the dollar during following ten years. Could a similar surprise be in store for us?

Unlike the forced dollar exchange rate of pre-1971, the faith in the dollar today is based on faith in the U.S. economy. We already know that recent economic growth has not been as spectacular as what some would like us to believe and that a similar economy preceded the catastrophic devaluation of the dollar during the seventies, but let’s look at today’s economy in a bit more detail to see whether the world’s faith in the U.S. miracle is justified.

**The U.S. economy today**

Even with more rapid growth in the money supply and declining interest rates (more stimulus) from 1995 to 2001, the economy expanded at the same pace as it did from 1965 to 1971. Never before in the history of the Federal Reserve have interest rates been cut ten times in a row.

The “New Era” concept has by now been fully refuted, just like the “New Era” of the 1920’s was eventually refuted. Remember, the crash of 1929 didn’t really hit until almost the middle of 1930. Our own version of the Great Depression, the “Greater Depression” may, quite literally, be upon us.

Industrial Production in October 2001 fell for the 13th month in a row, the longest string of declines in manufacturing since the Great Depression. But the biggest risk to the U.S. economy is debt.

* All dates are from January 1965 to July 1971 and from January 1995 to July 2001.
During the stock market bubble of the 90’s, U.S. corporations issued debt in lieu of equity in an attempt to minimize equity dilution and drive share prices higher. Leveraged balance sheets were used to increase earnings per share and if such earnings could not be realized from an increase in revenue and margins, per share earnings were increased by using the debt to buy back shares.

Individuals increased their debt levels as well. The decline in interest rates created an opportunity to refinance existing mortgages but instead of lowering mortgage payments we saw an increase in mortgage debt with cash-out refinancing and 125% of equity mortgages. Credit card debt is at an all-time high and consumer debt relative to disposable income is at historically high levels.

In December 2000 I estimated that during the preceding ten years, corporate debt increased by 88% to $4.6 trillion, household consumer credit expanded by 92% to $1.5 trillion and household mortgage debt soared by 82% to $4.9 trillion. Not to mention the U.S. public debt, which amounted to $5.7 trillion, or $54,000 per household, and which is growing at the rate of $123 million per day. On top of this, the savings rate in the U.S. had declined from 7.8% in 1990 to virtually zero. The situation today is worse on all scores.

The U.S. savings rate disappeared as households bet their financial future on the rising stock market and went on a consumption binge. Who could blame them? During the bull market of the 1990’s roughly $13 trillion of new wealth was created out of thin air. If anyone wants to know why there is no inflation showing up in the CPI, take a look at the inflation of U.S. equity prices.

Currently we are facing the very real threat of deflation as the $13 trillion that was created in the stock market starts to evaporate. We are on track for a new record in personal bankruptcies during 2001 and corporate bankruptcies are already having a devastating effect on the economy. Unfortunately the fallout from too much debt has only begun. As more and more new defaults loom the inverse of the wealth effect that stimulated the “New Era” is poised to spiral down the “Greater Depression”.

Declining corporate revenues on top of over-extended balance sheets are eroding corporate profits. Lower profits lead to cutbacks in spending and layoffs, which in turn reduce consumer confidence and cuts back consumer spending. The combination of reduced corporate spending on capital goods and consumer spending is likely to devastate the U.S. economy. I estimate that we probably have about $8 trillion that has to be wiped out of stock portfolios before we should start looking for the bottom of this bear market. I cannot imagine any amount of government stimulation that can prevent this from happening.

If the U.S. economy slumps into a prolonged recession, more accurately called a depression, and the U.S. equity markets shed $8 trillion, will foreigners still send us roughly $400 billion a year to offset our trade deficit?

These are big numbers. To put them in perspective, $8 trillion is almost $30,000 for every man, woman and child in the United States. That is how much money I think is going to be lost before the bear market is over.
$400 billion is almost $1,500 for every man, woman and child in the United States. That is how much money foreigners have to invest in the U.S. every year in order to fund our trade deficit and prevent the dollar from falling.

The U.S. government is trying its best to prevent all of this from happening by stimulating the economy with low interest rates and an increase in the money supply. But it won’t work. The more the government inflates the dollar, the bigger the risk that the dollar exchange rate will drop, raising the cost of imports and increasing the rate of inflation as measured by the CPI. Lower interest rates may also not necessarily stimulate the economy because banks are increasing their credit requirements for fear of loan defaults. Those who want to borrow are not credit worthy and those that are credit worthy don’t want to borrow. This is exactly the same as the problem in Japan right now.

The most likely outcome that I can see is that we are going to have a declining stock market, a short period of deflation followed by a nasty bout of inflation in conjunction with a stagnant, or declining economy and on top of it all, a declining dollar.

Since the gold price is inversely correlated to the U.S. dollar exchange rate, the gold price should rise if the dollar declines. Gold appears to be the single best investment for anyone interested in capital preservation today.

**Conclusion**

We have shown that the gold price is dependant on the currency in which it is quoted. The decline in the U.S. dollar-gold price is due to the strength in the U.S. dollar. Furthermore, the average gold price is in an upswing and has risen by more than 30% during the past four years. The U.S. dollar-gold price could quite readily increase to over $500 an ounce if the U.S. dollar declined to its average exchange rate of the early 1990’s.

The fact that the average gold price is stable and, as we have seen, responds very well to financial instability shows that gold has not lost its value as a store of wealth nor as a safe haven for capital.

There doesn’t appear to be too much evidence of a conspiracy against gold. Nor does it appear that the gold price is being manipulated unless you regard government intervention in foreign currency markets as gold price manipulation. Even then it would be an incredible stretch to conclude that there has been any manipulation of the gold price.

The U.S. dollar’s strength is based upon faith in the U.S. economy and the belief that the U.S. stock market is sound. Fundamentally, the picture is not so optimistic. Further contraction of the U.S. economy and declines in the stock market could cause foreigners to rethink their $400 billion annual investment in the United States. A decline in demand for the dollar to buy U.S. assets should lead to a drop in the dollar exchange rate. This in turn should lead to an increase in the U.S. dollar-gold price.
As an aside
Just as an observation – almost all the critical flaws in the Bretton Woods agreement, that ultimately led to the collapse of the dollar and the spectacular rise in the gold price during the 1970’s, are embodied in the European Community’s common currency, the euro, today. It took 25 years for the Bretton Woods agreement to fall apart. I wonder how long the euro is going to last, or what kinds of problems it might spawn in Europe.

Nonetheless, the dollar is still the reserve currency of the world in spite of its dramatic decline of the 70’s and who knows, the euro may just give the dollar a run for its money.

Paul van Eeden

References:
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How the average gold price and the U.S. dollar exchange rate are calculated:
In order to measure changes in the U.S. dollar's value, we need a foreign currency index that would be both comprehensive and weighted to correct for the relative influence of the specific currencies in the world's economy.

For our purposes, to measure the gold price, we need to look at the value of a currency adjusted for the buying power of the people who use it. One measure of buying power is the economic product of a country. Therefore, it was decided to adjust the weighting of each currency, to reflect its buying power, by multiplying the currency by the relative gross domestic product of the country.

For the sake of consistency, it was decided to use the 1995 GDP per country, converted into U.S. dollars using the average exchange rate for each particular currency during 1995. Each currency was then weighted depending on its percentage of the total GDP for all the countries under consideration.

The currencies were selected out of the 50 largest trading partners of the United States, since these currencies and economies would have the biggest impact on the U.S. and also because these 50 countries encompassed most, if not all, of the largest economies in the world. 15 currencies had to be excluded because either currency data was not available, economic data was not available, or in the case of Brazil, the collapse of the currency to virtually zero created a mathematical problem.
In addition, the following currencies had to be "fudged" a little bit because of incomplete data going back to January 1990.

Chinese renminbi:
Currency data from January 1, 1990 to February 20, 1992 were unavailable. Between February 21, 1992 and February 20, 1994, the renminbi exchange rate changed from 5.9616 to 8.6950, or at an average rate of 0.0037444 per day. The exchange rates for the renminbi from January 1, 1990 to February 20, 1992 were calculated by decreasing the value of the renminbi by 0.0037444 per day from 5.9616, which it was on February 21, 1992.

Philippines peso:
Currency data from January 1, 1990 to November 4, 1991 were unavailable. Between November 5, 1991 and November 4, 1993, the peso exchange rate changed from 26.25 to 28.50, or at an average rate of 0.003082 per day. The exchange rates for the peso from January 1, 1990 to November 4, 1991 were calculated by decreasing the value of the peso by 0.003082 per day from 26.25, which it was on November 5, 1991.

Indonesian rupiah:
Currency data from January 1, 1990 to November 4, 1991 were unavailable. Between November 5, 1991 and November 4, 1993, the rupiah exchange rate changed from 1977 to 2100, or at an average rate of 0.1685 per day. The exchange rates for the rupiah from January 1, 1990 to November 4, 1991 were calculated by decreasing the value of the rupiah by 0.1685 per day from 1977, which it was on November 5, 1991.

Colombian peso:
Currency data from January 1, 1990 to August 18, 1992 were unavailable. Between August 19, 1992 and August 18, 1995, the peso exchange rate changed from 693.25 to 947.22, or at an average rate of 0.23194 per day. The exchange rates for the peso from January 1, 1990 to August 18, 1992 were calculated by decreasing the value of the peso by 0.23194 per day from 693.25, which it was on August 19, 1992.

Peruvian new sol:
Currency data from January 1, 1990 to August 11, 1992 were unavailable. Between August 12, 1992 and August 11, 1995, the new sol exchange rate changed from 1.290 to 2.246, or at an average rate of 0.0008731 per day. The exchange rates for the new sol from January 1, 1990 to August 11, 1992 were calculated by decreasing the value of the new sol by 0.0008731 per day from 1.290, which it was on August 12, 1992.

Russian ruble:
Currency data from January 1, 1990 to July 8, 1993 were unavailable. Between July 9, 1993 and July 8, 1996, the ruble exchange rate changed from 1.045 to 5.132, or at an average rate of 0.003732 per day. Because of the rapid rate at which the ruble was being destroyed, the average decline of the ruble could not be used to calculate the missing data. The exchange rates for the ruble from January 1, 1990 to July 8, 1993 were arbitrarily set at 1. While this is obviously not correct, nor necessarily the best solution, the fact that the ruble makes up less than 2% of the index and the fact that the "fudged" data only affects the period prior to July 9, 1993 meant that
the arbitrary value of the ruble would have a very small effect on the index and that effect would only be during a time in which the dollar, and gold, were relatively stable. Therefore the arbitrary value of the ruble would not materially change the conclusions that could be drawn from using the index.

The list of countries and their respective weightings in the currency index are as follows:

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