

De Beers and Beyond: The History of the International Diamond Cartel*

Diamonds are forever

A gemstone is the ultimate luxury product. It has no material use. Men and women desire to have diamonds not for what they [diamonds] can do but for what they desire.¹

To hear these words from a person who attributes his entire wealth and power to the trade of diamonds illustrates the peculiar nature of the diamond market: Jewelry diamonds are unjustifiably expensive, given they are not actually scarce and would fetch a price of \$2 to \$30 if put to industrial use. Still, by appealing to the customers' sentiment, diamonds are one of the most precious luxury items and enjoy almost global acceptance. This fact is often attributed to the history of one company. DeBeers, founded by Cecil Rhodes in 1870, has been a highly successful and effective controller of the diamond market, having developed a unique purchasing and marketing cartel that has influenced prices in the market virtually undisturbed for almost a century. Lately, however, there are signs that more and more players seem ready to challenge DeBeers' dominance, and ever since, DeBeers has struggled to keep the cartel intact.

Diamonds and the Cartel

For centuries, the only two countries producing diamonds were India and Brazil. Up to the middle of the 19th century, the world supply of diamonds was so scarce that even monarchs and noblemen found it hard to get

hold of them. The idea of making diamonds available to the general public seemed unthinkable. When diamonds were first found in South Africa in 1867, however, supply increased rapidly, although the notion of diamonds as a precious and rare commodity remained to the present day.

Similar to the gold miners in California, diamond miners in South Africa tended to rush to the latest findings.² As a matter of principle, diamond miners preferred to work by themselves. However, the scarcity of resourceful land and the need for a minimum of common infrastructure forced them to live together in limited areas. In order to fight off latecomers and to settle disputes, Diggers Committees were formed and gave out claims in a region. Each digger would be allocated one claim, or, at most, two.

Since digging diamonds on a larger scale was virtually impossible for individuals, small claimholders soon merged into larger ones. Moreover, equipment for digging, hauling the dirt up and pumping water out of the mines was purchased or rented by groups of miners, thereby forced to cooperate even more intensively.³ Cecil Rhodes was one of the first businessmen to rent out pumping equipment and soon realized that he had tapped a vast market potential. He reinvested the initial proceeds from equipment rental in acquiring claims. By 1880, he held a large enough share of diamond claims to justify a separate company purely concerned with managing the mines: thus DeBeers Mining Company was created. By 1887, the company was the sole owner of South African diamond mines.

Concurrently, Cecil Rhodes took control of the distribution channels through "The Diamond Syndicate," an alliance of merchants

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¹Nicky Oppenheimer, DeBeers deputy chairman, at a Foreign Correspondents Association Lunch. (Source: Reuters.)

²In fact, most of the early diamond miners used to be gold diggers, attracted by the enormous riches surrounding diamonds.

³The diamonds were located in increasingly lower soils that contained underground water.

in Kimberley who abided to Rhodes' terms of business, recognizing that their own interests and DeBeers were compatible in that both aimed for high prices and a notion of scarcity.

In the following three decades, a German immigrant named Ernest Oppenheimer established himself as a prominent figure in the South African diamond and gold industry. After some time as a diamond expert, he entered the gold business by creating the Anglo-American Corporation of South Africa, owning a dominant share of South Africa's gold mines. His greatest ambition, however, was to gain a place on the board of DeBeers, the company he felt would provide him with the best opportunities to expand his knowledge and power in the diamond industry. Oppenheimer sensed that the structure of the syndicate would provide DeBeers with insufficient power to control the distribution of diamonds in the long run. In particular, he was aware of the danger that the members of the syndicate might be tempted to break away in the expectation of greater quantities and prices. DeBeers board members, however, viewed Oppenheimer as an overambitious *nouveau riche*, and blocked his way into the board for decades. Not to be discouraged, Oppenheimer gradually bought blocks of DeBeers shares whenever they came up for sale, until finally he was one of the two most significant single shareholders, the other being Solly Joel, his friend and business partner. At last, Oppenheimer gained full control and ownership of DeBeers in 1926. Soon after, he was named chairman. An even larger company, the Diamond Corporation, was formed that had subsidiaries dealing with producing and selling diamonds all over the world. Outside contracts were practically made impossible by an exclusivity requirement that each supplier was forced to sign with the CSO.

Over time, new discoveries of diamond reserves in Australia, Siberia, and Western Africa became known and eroded the company's monopoly position in diamond supply. Harry Oppenheimer, Ernest's son, quickly realized the threat this implied and focused his efforts on maintaining power in distribution through the Central Selling Organization (CSO), the company's marketing arm.

The structure of the DeBeers conglomerate has remained widely unchanged ever since: A subsidiary of DeBeers buys diamonds from all producers, including DeBeers' own mines

(which represented about one half of total supply). Each year, DeBeers determines the total amount of diamonds it plans to sell in the market. Each producer is guaranteed a fixed percentage of total output, that is, DeBeers commits to buy that amount and market it through the CSO. Producers, in turn, are charged a handling and marketing fee, ranging between 10 and 20 per cent, depending on the amount purchased and the general demand situation.

The Central Selling Organization serves as a clearinghouse for the entire industry. It regulates the quantity and price in the market. Packages of diamonds are bought and sold at sights, held ten times a year in London, on a take-it-or-leave-it basis. As it remains a privilege to attend sights by the CSO, few dealers dare to refuse a package offered to them. The attempt to haggle over quantity and price of the offered package could well lead to the sightholder not being invited again. Over 80 per cent of the world's diamonds were traded through the CSO in its early days. Recent developments have caused a downward trend in this percentage; present estimates range between 65 and 75 per cent.

The buyers from CSO are mainly diamond dealers who have the stones cut and polished and resell them at one of the world's main diamond clearing centers: Antwerp, New York, and Tel Aviv.

One of DeBeers' main roles is to maintain the notion that diamonds are a scarce commodity. This they do by means of advertising and by purchasing excess supplies when that is needed to avoid price decreases: as a matter of principle, prices are never lowered by DeBeers. This tightly-knit organization has proven beneficial for most in different ways: producers, often state-run diamond mines in developing countries relying heavily on diamonds, are provided with a stable inflow of foreign currency. Dealers enjoy stable price increases which can easily be passed on to consumers. DeBeers, however, seems to be benefiting the most from the agreement, asking for what producers often perceive as inappropriately large fees and in turn charging prices to merchants at their own discretion. The temptation for both producers and dealers to by-pass the CSO is therefore quite significant.

The cartel under threat

Israel: Downstream Rebellion

The huge profits in virtually every sector of the industry finally turned out to be the major stumbling block for DeBeers in the mid-1970s. In the 1970s, Israel was going through a period of high inflation; diamonds were one of the few stable currencies and means for storage of value; diamonds as collateral were the best way of securing preferential loan rates. This induced merchants to hoard a significant amount of diamonds with a view at reselling them later. As a result, the supply of diamonds was artificially reduced, driving up prices.

DeBeers, while enjoying further increases in profits from such price increases, foresaw the imminent catastrophe: Up to that time, diamonds “were forever,” that is, not to be resold. As soon as diamonds were held for investment purposes, however, the exact quantity in the market at a given time would be beyond DeBeers’ control. In particular, if a significant number of decided to dump their holdings in the market at the same time, quantity could increase and prices fall rapidly, thus hurting the image of diamonds as a rare product.

DeBeers tried to soften the speculative waves through a variety of instruments. It created a temporary surcharge levied on diamonds sold through the CSO. The surcharge could be withdrawn at any time without prior notice. This measure was designed to dampen the incentives for speculative transactions: a speculator stood to make large losses in case the surcharge were withdrawn and the price drop suddenly. In addition, a DeBeers representative was sent to the defiant Israeli dealers to warn them that if they continued disobeying DeBeers’ orders, the number of diamonds allocated to them would be cut by 20 per cent, only for DeBeers to observe the merchants clinging to their accumulated stocks even more, further driving up the prices. Finally, as if the previous measures did not succeed in stopping hoarding, Israeli sightholders were dismissed from the Syndicate’s diamond sightings-the highest penalty they could have suffered.

In combination, these measures proved an effective way of disciplining the cartel: Interest rates on diamond loans were back up to normal levels, and diamond prices had stabi-

lized. Israeli dealers disposed of their stock and conceded their price and quantity-setting autonomy to DeBeers again. They paid a considerable price for their defection, however. In the late 1970s, one in every four employees in the Israeli diamond industry lost his job. Moreover, many Israeli dealers lost their cherished position in the CSO’s circle of proteges.

While DeBeers successfully managed to whip the mutineers back into place, it suffered from the events in the late 1970s for some years to come. Contrary to their previous policy of controlled price increases and demand regulation, DeBeers too was enticed to take advantage of the bear market for diamonds. Prices set at the CSO’s sightings went up rapidly, soon reaching levels unimaginable only five years before. This further fueled the speculative bubble, which eventually burst, as diamond hoarders decided to dump their holding in the market to realize their capital gains. At this stage, all that DeBeers could do was to react buying the excess supply from the market and preventing too big a price crash. With the quantities involved, however, this proved to be costly: DeBeers’ stocks in diamonds soared to almost \$2bn in 1984.

Zaire

A brief period of stable activity was soon disrupted by another attack on the cartel. Zaire felt that the terms they were given by the CSO fell below their expectations. Zaire claimed they were charged a 20 per cent handling fee on their diamond sales, and that they could easily recover some of that on the free market for industrial diamonds while undercutting the cartel’s artificially high prices. And so they did. The timing of Zaire’s move proved rather unfortunate, however. Because the cartel had run up huge stockpiles of all kinds of diamonds, DeBeers was quite prepared to release some of it in the market at a price much below the prevailing market price. Zaire, who contributed less than 3 per cent of world production, was in no position to push prices upwards, and had to suffer a dramatic drop in its revenues.

Zaire relying heavily on diamond export revenues, it soon returned to DeBeers to appeal for readmission into the cartel. DeBeers obliged and offered significantly worse terms to Zaire than initially. Once again, the defecting party was severely punished for its refusal

to follow the terms of the cartel.

Russia

As early as in 1957, large quantities of diamonds were discovered in Siberia. DeBeers quickly realized the latent threat posed by these supplies and allegedly negotiated an agreement with the Soviet government to channel their diamonds through the CSO. Understandably, the terms were never revealed, but industry sources were convinced that DeBeers made sure virtually no Siberian gems would enter the market through other channels than the CSO.⁴ It was estimated that Soviet production represented between 20 and 30 per cent of world production, or some 10 to 11 million carat. DeBeers, under the estimated terms of the deal, guaranteed the purchase of 95 per cent of Soviet production, while allowing the Soviet diamond industry to cut, polish, and sell the remaining five per cent autonomously. This was seen as a concession the cartel had to make in order to keep the larger part of the Soviet diamonds under their control. It is also believed that prices paid for Soviet diamonds exceeded the prevailing cartel prices by up to 10 per cent. Until the early 1980s, the Soviets were satisfied with the preferable treatment they were offered and honored the agreements with DeBeers.

The Soviet Union eventually realized that the profit potential from selling directly to the market was enormous. Adding to this the need for foreign currency and, more recently, the political turmoil following the breakdown of the former Soviet Union, the cartel was once again put to the line. In early 1984, Antwerp—Europe's main clearing market for polished diamonds—was flooded by high-quality Russian diamonds at a low price. Diamond dealers, who had only just restored their confidence in DeBeers' ability to discipline the market, were thrown into a state of confusion: Should they continue purchasing from the cartel? Should they buy polished Russian diamonds at a significant discount? Diamond suppliers were subject to a similar dilemma: should they continue selling through DeBeers, or should they follow the Russians? DeBeers,

meanwhile, suffered from severe cutbacks in profits; quick action was called for.

Eventually, the Soviet Union rejoined the cartel, this time in an official way and at what industry participants believed to be substantially improved conditions. In particular, DeBeers guaranteed Russia a steady inflow of foreign currency by buying all of the latter's output, not a percentage of DeBeers' determined target output. This freed Russia from the task of finding buyers for the vast quantities it was producing. For the remaining manufacturers, Russia's outbreak implied a very welcome side effect: DeBeers' position was so profoundly under threat that, in 1985, the company was forced to offer its faithful suppliers a price increase of 7.5 per cent in order to keep them from joining forces with Russia. For the first time, DeBeers did not punish mutiny in its ranks, partly because Russia was not formally part of their cartel, partly because Russia was too strong a competitor to play hardball with. In contrast, dealers who had bought Russian gems during that period were deprived of their sights and made to pay for their wrongdoings. The industry was puzzled as to the Russians' long term goals: If the government, who was overseeing the diamond operations through Komdragmet, the Committee for Precious Gemstones, was merely in search for hard currency, the survival of the cartel could be secured simply by offering them favorable credit deals and guaranteed payments. If on the other hand they were to abandon the cartel altogether and establish an alternative means of distribution, no concession would be sufficient to make up for the enormous profits to be made by replacing DeBeers.

By the mid-1980s, an unsteady equilibrium had been achieved: The terms for diamond manufacturers had been notably improved, the Russians were back under DeBeers' umbrella, and diamond dealers were expecting the next move by either of the sides.

In October 1987, investing in diamonds became an attractive option again. The stock market crash decreased confidence in paper investments; accordingly, demand for tangible assets increased. DeBeers, in need of financial relief, took full advantage of this situation by repeatedly raising prices at its sightings, while at the same time discouraging the purchase of diamonds for investment purposes. Once again, dealers disregarded DeBeers' warnings

⁴Official relationships between the countries had just been stalled that year, so the existence of such agreements would have presented a major embarrassment for both parties, which is why they consistently denied deals of any such kind.

and either resold their packs at a premium or built up supplies for themselves. Instead of reacting through the purchase of excess diamonds or severely punishing defectors, DeBeers started a marketing offensive to raise consumer demand by tapping into new potential markets (such as Japan) and consumer groups (such as male consumers); and by repeatedly emphasizing that “diamonds are forever” (that is, not to be resold).

Australia

Over time, new threats to the cartel materialized: In Australia, massive findings have been made that, if sold outside of the cartel, could represent a threat to its stability similar to the Russians’ defection (if not quite as unpredictable). Argyle Diamond Mines PLC, who was operating Australia’s most profitable mine, opted for a less aggressive strategy: Instead of confronting DeBeers with another threat to their dominance, a strategy that might have sent the cartel into eventual oblivion, Argyle opted to operate in niche markets, such as rare, high-priced gems or colored gems. Coloured gems are not an important part of DeBeers marketing plan; selling them through the CSO would have been particularly unattractive for Argyle. By creating an image of its own for coloured gems, Argyle entered into a highly profitable situation without necessarily provoking the industry leader.

In late 1995 and early 1996, however, the CSO imposed price cuts for most of Argyle’s gems of industrial and near-gem quality. Moreover, it decreased the fraction of Argyle’s production that DeBeers agreed to purchase to 85%. Argyle was outraged and threatened not to renew its marketing contract with the CSO. DeBeers’ inflexibility eventually led Argyle to break away from the cartel in 1996. Since then, the Australians have worked in close cooperation with the Indian diamond cutting industry, which now processes about 95% of Argyle’s rough diamonds output. A DeBeers spokesman declared that “[DeBeers] are not surprised. Argyle has been fairly vocal about its position in the last month.”⁵ Nonetheless, DeBeers response was immediate: prices for the type of stones marketed by Argyle fell sharply in 1996, and in the first half year of 1997 Argyle reported a setback in sales

and profit. DeBeers continued to point out that “even if the Australians drop away from the CSO, it would not have a great impact.”⁶ However, their subtle (or not so subtle) ways of influencing the quantities offered in the market indicated that they would not let such behavior go unpunished. Despite all of the difficulties experienced as a consequence of this move, Argyle has continued to market independently, desperately avoiding the fate Zaire suffered when it opted to rejoin the cartel.

Angola

In the midst of a civil war and in need of fast cash inflows, Angola followed in 1992 the Russian’s move of a few years earlier: while maintaining its agreement with DeBeers, Angolan producers increased the supply of rough diamonds by selling them directly in the market. Angola was not quite big enough to destabilize the cartel on its own, but having to sweep \$500m worth of Angolan gems off the market did not help DeBeers’ situation (especially in light of diminishing demand and increasing stocks). However, the Angola problem was never perceived as a long-term threat to the CSO but rather as a product of the political turmoil in country at that time. Differently from previous cases, DeBeers did not inflict any harsh punishment and let the Angolan diamond producers largely alone.

Canada

Adding to the woes of the cartel, another major producer came into existence: Near Koala, in Northwest Canada, a sizeable source of diamonds was discovered in 1991. Output estimates of \$1.1bn indicated that if DeBeers failed to secure distribution of these gems, the cartel might once again be doomed to extinction. Not surprisingly, DeBeers, RTZ Corp. (the world’s biggest mining corporation) and Australia’s Broken Hill Proprietary (BHP) Co. scrambled for the right to explore the new mines. It was not only a matter of tapping into a rich source of revenues to be made, but also of maintaining (or acquiring) a dominant position in production and distribution.

Control over the Ekati mine, the largest mine in Canada’s Northwest Territory was won by BHP Co., which also had substantial US-based business interests in steel, copper,

⁵Daily Telegraph, June 8, 1996, p. 3.

⁶South China Morning Post, February 5, 1997.

petroleum and minerals. While DeBeers has urged BHP to sell its output through the CSO, BHP fears that this might trigger an investigation by the US anti-trust authorities. In fact, the latter have for many years attempted to take on the CSO's near-monopoly. However, the fact that DeBeers' operations are all located outside of US territory makes them immune to anti-trust legislation. Negotiations between BHP and DeBeers are still underway; production is scheduled to start in 1999.

Russia, Part II

The early 1990s forced DeBeers and the Russian diamond industry into an uneasy alliance: DeBeers was aware that Russia was the single most powerful outside member of the cartel and would therefore have to be courted to be kept in the cartel. Russia, on the other hand, was in dire need of credit and hard currency, with their only credible security being their vast supply of diamonds. By destabilizing the industry, the Russians would have hurt themselves. In June 1993, in preparation of a loan proposal to western banks, the Russians disclosed, albeit unofficially, the size of their diamond stockpile as being about 200 million carats, which would be the largest diamond treasure in the world. This disclosure, together with CSO-like sightings held by the Russians, signalled to DeBeers that Russia had the potential to form a distribution cartel similar to the CSO. On the other hand, it is not clear the Russians would manage to stand on their own: "without a guarantee from DeBeers to buy the stones, Russia can find no lender willing to take the risk."⁷

The 1990 agreement between Russia and DeBeers was to expire in December 1995. Russia, after hinting that their stocks would enable them to run a parallel distribution channel, further demonstrated their power by "leaking" a large fraction of their own stones into the market. Unofficial sales through channels other than the CSO were estimated at \$800m, as compared to \$1bn sold to the CSO. Understandably, Russia expected another improvement in the terms it is offered before it stopped from further "demoralizing the industry;"⁸ accordingly, it formulated its new demands: An increase in the share of

CSO's sales, higher prices, and a seat on CSO's board. DeBeers felt that these demands were absolutely unjustified for a diamond producing nation that, despite its large stocks, was believed to be running out of diamonds and was in great need of foreign cash. Consequently, DeBeers was in no mood to yield, in part also because the competencies on the Russian side were not clearly defined. Komdragmet and Almazy-Rossi-Sakha (ARS) are the major players in the Russian diamond industry: Komdragmet owns the stockpile, while ARS own the mines and controls diamond production. Each player pursues a different goal: Komdragmet represents State interests and is interested in securing foreign cash inflows sooner rather than later; ARS, in turn, has an interest in keeping diamond prices high and supplies limited. The three parties could not reconcile, and finally, in 1996 –for the first time since 1957–, Russian diamond producers and the CSO did not have a joint marketing agreement.

The previous agreement was maintained on an informal basis for another year, during which Russia remained uncommitted to the CSO and continued selling much more than the agreed 5 per cent of their output in the open market. DeBeers lost its patience and announced the end of the agreement in December 1996. Russia sought to resume talks with DeBeers, realizing that its foreign reserves are highly dependent on stable revenues from diamond sales. An Antwerp dealer, expressing the general sentiment of the unsettled downstream merchants, said: "If everyone sticks to the deal then everyone wins. But if anyone is stupid enough to break the agreement, then everyone loses."⁹

Rumors of declining production at ARS' mine in Sakha emerged. DeBeers and the Russians, following high-level negotiations, finally reached an agreement, essentially on DeBeers' terms. Not content with this, DeBeers began to undermine ARS' authority and the government's tight grip on the Russian diamond industry. In their customarily discreet style, DeBeers started buying a controlling share of the Lomonosov and Verkhovina diamond fields, believed to be "two of the world's richest undeveloped diamond deposits,"¹⁰ much to the dismay of the cash-strapped ARS and

⁷Diamond-backed loan proposal, *East European Markets*, February 4, 1994, p. 10.

⁸Sunday Times, December 10, 1995.

⁹Financial Times, October 16, 1997, p. 28.

¹⁰Economist Intelligence Unit Country Alert, March 12, 1998.

Komdragmet. At least for now, DeBeers seems to have re-gained the upper hand on the Russian diamond industry, this time by undermining it from the inside.

Attempts by major producers to defect from the cartel seem to repeat themselves at shorter and shorter time intervals. While it has been possible to force Zaire and Angola back into the cartel, Canada, Australia and Russia do not seem to accept such simple, uncompromising behavior by DeBeers: persuasion and incentives will play an increasingly important role in the future. Ultimately, however, the question that needs to be addressed is whether the “system we [DeBeers] propose is the best one in the long term.”¹¹

¹¹George Burne, director of DeBeers and the CSO, at an information session for diamond producers in Canada. Source: Financial Post, November 11, 1996.