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Central Banks may sell less gold than planned

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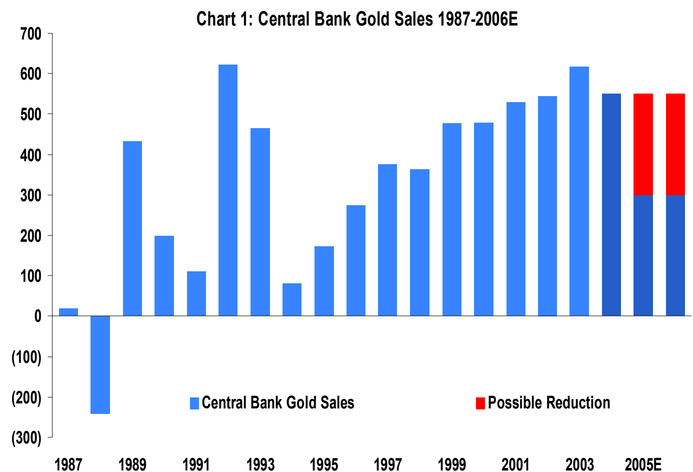
Precious Metals Comment

- **After the recent renewal of the European Central Bank agreement, gold sales of 500 tonnes per annum from agreement countries are fully factored into the market.**
- **We believe that the certainty of these gold sales is much less than the market is currently pricing, and that sales may be as little as 250 tonnes per annum.**
- **This reduction would compensate for reduced producer dehedging and the slowdown in physical demand that we expect – although the signalling impact of such a decision would be greater than the direct volume.**
- **If this view proves correct, we will adjust our gold price forecasts. These currently see gold ending 2004 at $450/oz and peaking at $470/oz in early 2005.**

After the European Central Bank Gold Agreement was renewed earlier this year, official sector sales from this group of countries ceased to be a major issue for gold watchers. Analysts examined the details of the new agreement, which were unchanged except for the increase in the sale quantity from 400 tonnes per annum to 500tpa, and raised their forecasts for supply accordingly. Since an extra annual 100 tonnes of gold supply is not really material in 4000-tonne-per-year market, most commentators treated the higher proposed sale quantity with equanimity. Past and foreseen gold sales are shown in Chart 1.



We now doubt that the renewed agreement will actually lead to an increase in sales by central banks. Rather, we believe there is a strong possibility that the signatory central banks could end up selling materially less gold between 2004 and 2009 than the 2000 tonnes they sold under the terms of the first agreement.

The first European Central Bank Gold Agreement (ECBGA1) was signed in 1999 in Washington as an attempt to calm a gold market that had become worried over the prospects for gold dumping from European central banks' vast holdings. The agreement was specifically framed to include all planned sales (both announced and unannounced), including publicly known sale programmes from the Bank of England, which had said it would sell about 400t, and a 1300t sale by the Swiss National Bank. Smaller quantities were eventually sold by Holland, Austria and Portugal under this agreement.

This time we believe sales contemplated under the new agreement are less certain. The only definite quantity that has been discussed is 120tpa from the German Bundesbank, and it is far from certain that this sale will occur:

- The wording was in the form of an option to sell 120tpa rather than a clear intention to sell that quantity.
- The departure of former President Ernst Welteke appears to have moved gold sales down the Bundesbank's agenda. Certainly there has been less public comment on the issue from new President Axel Weber, who does not appear committed to the sale of Bundesbank gold.
- There has been no decision on how to use the proceeds of any gold sale. Past President Welteke, who was adamantly against the use of proceeds to plug holes in the government deficit, had proposed the formation of a foundation to fund research and development or education projects, but we have heard little on this subject recently.

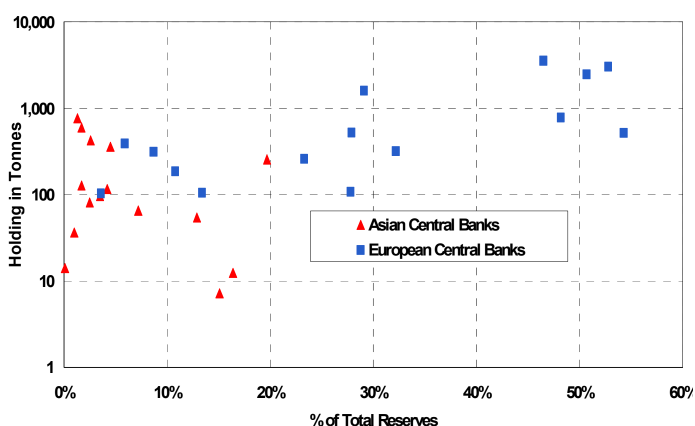
The other large potential sale of gold announced so far comes from France, where Finance Minister Nicolas Sarkozy has said that 500-600 tonnes of gold might be sold to 'raise revenues'. But the Bank of France subsequently stated that it is not ready to sell gold to finance the national budget either directly or indirectly. The only benefit the French government could get from the sale of gold would be from increased dividends from the Bank of France were gold sale proceeds to be invested in interest-bearing securities. This is less attractive than receiving revenue outright, and may make the sale of gold less certain.

With only one month to go before the start of ECBGA2, there have been no firm sales plans announced by any of the supposed new sellers. While it is possible that these could materialise at short notice, we suspect that gold sales are not high on the list of central banks' priorities.

A change of heart?

We have previously argued that European central banks are sellers of gold because it makes up too large a proportion of their external reserves, as shown in Chart 2. This has not changed: gold's recent rally has caused the metal's proportion of total reserves to increase, everything else remaining constant.

Central banks differ in their ability and need to reduce this proportion, however. Eurozone national central banks have considerably less flexibility in diversifying foreign currency reserves than do non-Eurozone countries because Eurozone countries cannot invest in the euro. With this currency choice



unavailable, effective currency alternatives to the US dollar are harder to come by. We believe the ideal proportion of gold held by a Eurozone national central bank is considerably higher than that of a non-Eurozone central bank. This view is supported by comments from Bundesbank President Weber, who described gold as giving a "natural safeguard against dollar fluctuations". In the same interview Weber also said that the metal plays "an important role in managing currency reserves." It may be no co-incidence that the two largest sellers of gold under the ECBGA, the UK and Switzerland, are not Eurozone members.

The demonstration of the quasi-currency nature of gold over the past five years, together with the common view that the large and widening US current account deficit may lead to further dollar weakness, may have led Eurozone central bankers to re-consider, or at least delay or reduce, their plans to sell gold.

What would be the implications of reduced sales?

For the sake of argument, let's assume that only half the expected gold sales take place over the next five years – that is, 250 tonnes per year. The likely impact on the gold market can most usefully be divided into two categories – physical market impact and signalling value.

Physical market impact

If 250 tonnes of expected gold sales were to not take place, this would certainly have some impact – though as we've said it would hardly be overwhelming in the context of a 4000tpa market, for instance not enough to materially change the long-term supply and demand dynamics for gold.

In the short term, however, and to the extent that identifiable supply and demand factors matter in the gold market – we have long argued that currencies together with actions of speculators and investors are more important determinants of the dollar gold price – the quantity is usefully large. We outline the supply/demand balance for gold in Chart 3. Losing 250tpa in expected gold sales would go some way to offsetting two negative supply/demand factors we expect for 2005 and beyond:

- The rate of producer de-hedging, which has been a large positive factor in the gold market since 1999, will slow and possibly reverse in coming years. While we do not expect gold mining companies to increase their hedge positions at the average 300tpa rate seen in the late 1990s, the recent rapid rate of reduction cannot continue indefinitely; from a forecast of 250 tonnes in 2004, we expect de-hedging to slow to 100 tonnes in 2005 and to cease entirely in 2006.
- After posting impressive gains in the first half of 2004, we expect jewellery demand growth to slow in 2005 on the back of slowing global economic growth and the impact of a poorer Indian Monsoon.

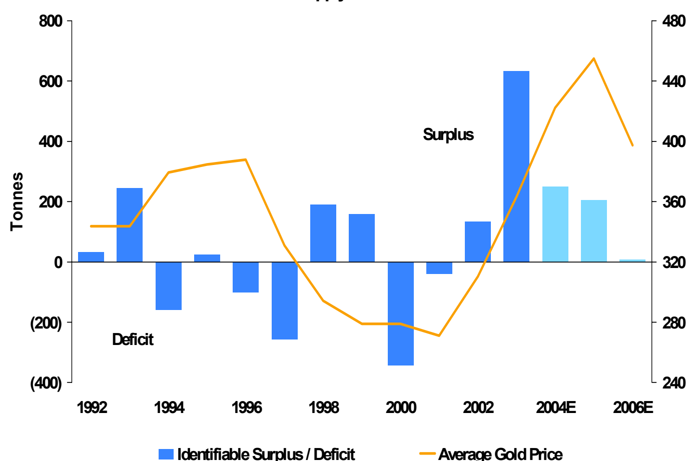
If sales under the ECBGA2 agreement were to come to 250tpa rather than 500tpa, this would counteract these two negative supply/demand factors.

Signalling value

The signalling value of any reduced central bank gold sales would probably be more important than the impact on the physical market; it is certainly harder to quantify or forecast. Certainly we believe that during the late 1990s, the last time that unconstrained central bank gold sales took place, the gold price fell by more than could be explained by the strength of the dollar or by supply and demand factors; also the fact that the gold price typically fell more when a central bank sale was announced than when it was (presumably) transacted indicates that the idea of gold sales had more impact that the actual physical supply.

Other central banks would take note of any change in heart by the ECBGA banks. With such large and high-profile gold sellers present in the market over the past decade, it has been easy for central banks with small or non-existent gold holdings to ignore the possibility of adding to their reserves. This could change.

We doubt that there are any traders presently running short gold positions in anticipation of ECBGA gold sales, but we do believe that the expected 500tpa sale quantity is fully discounted by the market. If participants in the gold market were to suddenly realise that there may be less gold sold under the ECBGA, then gold would move higher to adjust to this change. The investment case for gold becomes easier to make if the 30'000 tonnes of gold held by central banks is seen less as an unwanted stale long position than as a willingly held means of reserve diversification.



Conclusion

Gold, in US dollar terms, will continue to rally if the dollar weakens as we are forecasting. Aside from this dollar weakness, however, we were becoming more concerned about the outlook for the metal in 2005 and beyond due to the factors outlined above. But if our suppositions about a possible fall in European central bank gold sales are correct, this should counteract some of the negative factors in the physical gold market, as well as having a wider impact on both investment demand and the activity of other central banks.

For now we hold our forecast for gold to end 2004 at $450/oz and to trade to high of $470/oz in the first quarter of 2005 before beginning to decline. But if our suspicions are confirmed in coming months, the rally in gold will probably have further to go.

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