

At \$400/ounce, gold demand needs only to expand by 2.3% to absorb additional CBGA sales

The impact of the new Central Bank Gold Agreement upon the fundamental dynamics of the gold market is not as stark as might at first appear. Below we explain why, but first, the background:

The Central Bank Gold Agreement, originally emplaced on 26th September 1999, was renewed on Monday 27th September 2004. The Agreement, as released into the public domain on March 8th of this year, reads as follows.

1. "Gold will remain an important element of global monetary reserves.
2. The gold sales already decided and to be decided by the undersigned institutions will be achieved through a concerted programme of sales over a period of five years, starting on 27 September 2004, just after the end of the previous agreement. Annual sales will not exceed 500 tons and total sales over this period will not exceed 2,500 tons.
3. Over this period, the signatories to this agreement have agreed that the total amount of their gold leasings and the total amount of their use of gold futures and options will not exceed the amounts prevailing at the date of the signature of the previous agreement.
4. This agreement will be reviewed after five years".

The signatories to this Agreement are broadly the same as the signatories to the first Agreement, which went into effect on September 26th 1999, and are as follows:

- | | |
|---------------------------------|--|
| - European Central Bank | - Central Bank & Financial Services Authority of Ireland |
| - Banca d'Italia | - De Nederlandsche Bank |
| - Banco de España | - Deutsche Bundesbank |
| - Banco de Portugal | - Oesterreichische Nationalbank |
| - Bank of Greece | - Suomen Pankki |
| - Banque Centrale du Luxembourg | - Schweizerische Nationalbank |
| - Banque de France | - Sveriges Riksbank. |
| - Banque Nationale de Belgique | |

The Bank of England is not this time a signatory, as the UK Government has stated that there are no UK sales planned and that therefore there was no perceived need to become a signatory to the second Agreement. The Bank of Greece has this time been included.

The purpose of this piece is to put the Agreement into an historical and present-day context with particular respect to the physical fundamentals of the gold market.





In specifying that sales under the auspices of this Agreement will not exceed 2,500t in total, nor 500t per annum, the signatories have raised the limit from 2,000t (and 400tpa) in the first Agreement. GFMS' fundamental figures show that net official sector sales overall have added an average of 518tpa in calendar years 2000 – 2004 (basis a forecast 424t of sales for 2004 - net sales in the first half of this year came to 206t). Note that this is slightly out of kilter with the CBGA sales years, which commence in late September, but the overall picture is not unduly distorted. This average figure of 518tpa for the official sector as a whole represents 118tpa over the CBGA limits and constitute 13% of average annual supply over the period.

Seen in a different context, the gold supplied overall into the market from the official sector over 2000-2004(f) is, in terms of tonnage, equal, to within 1%, to the metal required for industrial uses over the same period. Industrial demand in this context refers to electronics, dentistry and other industrial offtake, and excludes demand for jewellery or bar hoarding. Even allowing for the fact that the 2004 figures are of necessity a forecast, the close fit is remarkable. It also begs the question as to whether the market will be in a position to absorb additional metal and, indeed, whether the increased quota will be fully taken up.

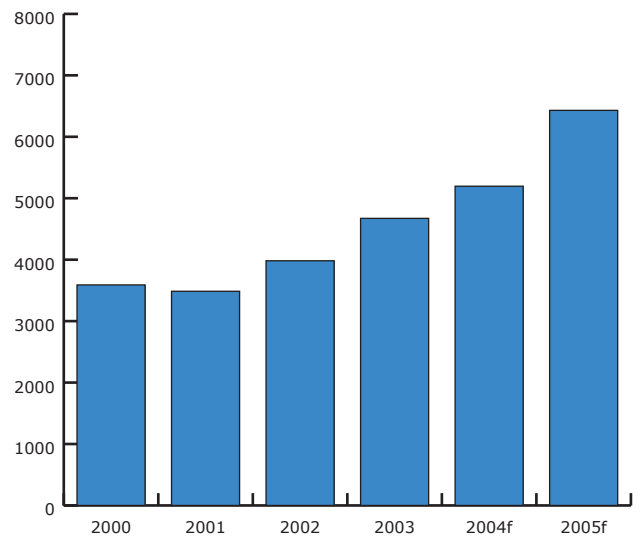
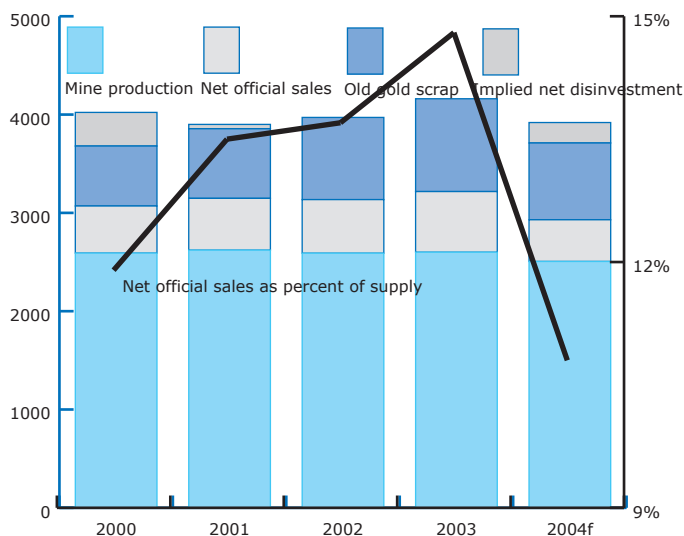
Will it all be sold?

It has been suggested in some quarters that the full tonnage will not be sold although one central banker has opined in public that there would be little point in increasing the scope of the Agreement and then letting it lie fallow. Although negotiations have been under way for some months, this does not of necessity imply that agreed tonnages are mandatory tonnages and there is bound to be some scope for flexibility. The political negotiations that would appear to be ongoing in the background in Germany and in France over the use of the proceeds of any sale (or, more likely, the interest there from) means that it has proved difficult for those two countries to specify, as yet, exactly what they will be proposing to sell, although an upper limit is likely to have been concluded. Germany has claimed up to 600t during CBGA2 and the Governor of the Banque de France indicated in April that they planned to sell 500-600t over the life of the Agreement. If for any reason any country falls short of its original intent, then the Agreement would be likely to allow other countries to increase their quotas. So far the market has been informed by the Swiss and Dutch central banks of firm intentions (130t and 165 to go respectively). The market awaits comment from other banks, but should not expect a rigid timetable to be set before it.

Can the market absorb it?

Time will tell. Meanwhile it is of interest to consider the value of the metal involved and whether the market has sufficient dollars (albeit devalued dollars) to absorb the gold on offer. While the prospect of an additional 100tpa into the market from the CBGA agreement might *prima facie* seem somewhat daunting it is in fact pretty small beer. Before we go on to a brief volume analysis below, however, it is important to bear in mind that this is only a component part (albeit a major one) of the overall activity of the official sector.

Components of Gold Supply (t) 2000-2004 (f) Approximate Value of CBGA Sales (\$m) 2000-2005 (f)





Taking simple annual average prices over the period 2000-2003, using a forecast \$404/ounce for the year 2004 and a conservative \$400 for the year 2005 produces the results in the chart above. The dollar value of the gold potentially sold under the CBGA during 2005 rises to \$6.43Bn from \$5.24Bn in 2004 and an average of \$4.20Bn in the period 2000-2004 inclusive. In bald terms this represents an increase of \$1.18B, or 22.5% over 2004 and of \$2.23Bn or 53% over the period average.

This looks like a tall order, but it only tells part of the story. These sales have to be put in the context of the physical market as a whole, which in 2004 amounted to demand of approximately \$50.89Bn in 2004 and \$41.82Bn over the period average. Against this background, the increased flow of metal supply from the new Central Bank Gold Agreement in its first year of operation amounts to only 2.3% of the 2004 market and 2.8% of the market over the period 2000-2004.

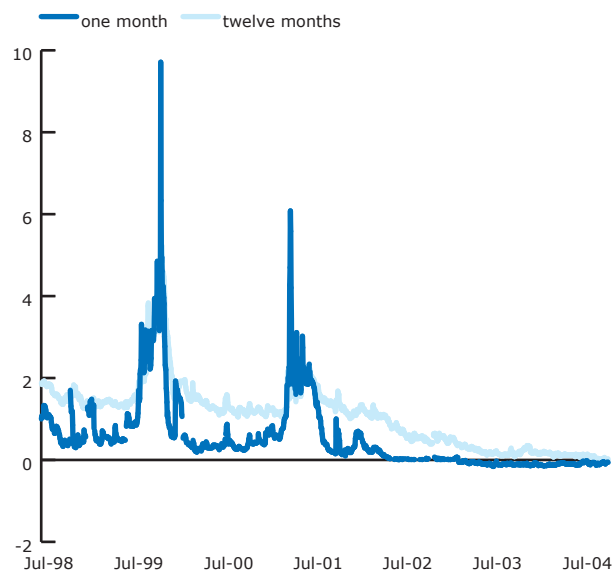
This is not such a tough requirement in the light of the robust activity of the physical gold consumers in 2004; fabrication plus bar hoarding are forecast to be up by approximately 20% in dollar terms in 2004 by comparison with 2003. The impact of producer hedge-lifting in 2004 means that the overall dollar value of tangible physical demand for gold this year is expected to be almost 24% higher than in 2004. The risks in this argument (apart from the obvious possibility of other supply flows) are that hedge-lifting will decrease, although it is still expected to result in a net withdrawal of gold from the market) and the possibilities of renewed investor dishoarding, which can develop for any number of reasons, from natural market forces through to asset rotation and external shocks to the system.

Leasing limits to remain the same

The second Agreement has maintained the status quo with respect to gold lending. The signatories to the first Agreement stated that they would not exceed the level of lending or use of forwards or futures then in place. This has been iterated in the Agreement of 2004.

This should not come as a surprise. With the reduction in the global hedge book and the expected continuation of that reduction there is little foreseeable likelihood of sharply increased demand for borrowed metal. Of course this can change in line with changes to market forces, be they internal or external and one must never discount the possibility of renewed short selling from speculators (which generally involves a borrowing operation), of fresh hedge selling activity on the part of the mining industry (usually but not exclusively against project financing) nor from jewellers hedging their intake. The contraction of the hedge book, however, and the low level of lease rates with gold effectively at full carry for as far out as one year, would certainly tend to suggest that there is no perceived need to raise the limits on lending.

Lease Rates 1998-2004 (%)



London, 13 October 2004



In August 2001, Giacomo Panizzutti of the Bank for International Settlements stated that the outstanding lent position among the signatories to the CBGA had been 2,119t at the time of signing. Given that these banks held approximately 45% of the world's official sector gold when the Agreement was signed, this underpins GFMS' estimates of the time that total central bank and official sector lending was just under 4,800t, a position that had been accumulated since the first hedges were put on, back in the early 1980s. The mine hedge book has since been reduced by more than 1,300t. At that point there were also sizeable outstanding short positions in the market; these have now been reversed and any associated borrowing has been unwound. Some metal has been taken back in by central banks over the time, including at least one CBGA signatory in response to low rates of return, but the majority leave the metal on deposit.

In the mid to late 1990s, as it was impossible to gauge the overall size of the Over the Counter positions in the market, it was taken as a rule of thumb that the global speculative short was anything from a similar level to that on COMEX, up to approximately five times the COMEX position. At the start of September 1999, just before the announcement of the Agreement, the COMEX short among large-scale speculators was 62,910 contracts, equivalent to 195.6 tonnes. As we write, the latest Commitment of Traders figures reflect a net long position of 64,327 contracts, or 200.1t, a reversal of almost 396t. It is arguable that the OTC position has also reversed and is now long and although it is impossible to pinpoint the tonnage involved, there has clearly been a sizable shift.

The Central Bank Gold Agreement was originally designed to ease the burden of uncertainty overhanging the market. Its renewal is intended to sustain a sense of order and the additional metal that may be freed up for market consumption is not expected to put an onerous weight on the market's shoulders.

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GFMS Analytics was formed in September 2004 to provide a fresh analytical angle to the precious metals markets, drawing on MD's Rhona O'Connell's own extensive personal experience in the field as well as GFMS' unparalleled research reach.

GFMS Analytics provides a monthly publication reviewing the performance of the precious metals complex over the previous month in the context of economic, financial and political developments and set against the actions and reactions of other asset classes. This publication also includes an outlook for the gold, silver and PGMs markets and the metals' prices. In addition, the monthly will analyse developments in the mining sector, especially from a corporate angle, while taking into account external developments of interest and relevance.

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