WHEATON PRECIOUS METALS

# Metals & Markets Blog

## Ignore Waning Central Bank Gold Demand

May 31, 2020

METAL

# The heavy-weight champion of central bank gold demand 'retires'

- Central bank gold purchases expanded markedly during 2018-19, both in total volume and breadth of participation.
- The purchases, in conjunction with a rising gold price and an escalating monetary disorder, were given prominence by industry analysts.
- That surge is set to suffer a "significant" setback with the Bank of Russia announcing it has suspended its procurement program.
- However, neither the central bank rally nor the impending setback has much to do with price.

After 51 consecutive quarters and 1,871 metric tons – the equivalent of 18 blue whales[a] – the Bank of Russia has halted its gold procurement program:

> Effective from 1 April 2020, the Bank of Russia suspends purchases of gold in the domestic bullion market. Moving forward, subsequent decisions on gold purchases will be made subject to financial market developments. The reference to the Press Service is mandatory if you intend to use this material.[b]

According to *Gold Demand Trends*, the World Gold Council's quarterly report, this will, "undoubtedly have a significant impact on the level of global total net purchases." No doubt! After all, the Rus bank was the reigning titleholder of this demand segment.

But is this concerning news for the gold investor? No it is not.

## 2018-19 CENTRAL BANK GOLD RALLY

In 2018 industry analysts vigorously burnished central bank doings to a glossy patina. Firstly, acquisitions were surging to levels not seen since 1965 – the midpoint of the period during which the gold-backed Bretton Woods monetary order disintegrated. Secondly, banks that had hitherto been silent for decades were participating.

From Warsaw came news that Narodowy Bank Polski had both bought and repatriated 125 tons of gold between the third quarter of 2018 and second quarter of 2019. It was the first purchase since at least 1983.

Out of Budapest, an update that Magyar Nemzeti Bank bought gold in October 2018, the first time since 1986. And when the gold investor read the explanation for the acquisition his or her pupils dilated in a manner usually reserved for long lost lovers – or in your blogger's case, pork loin with a side of applesauce (emphasis added):

> In normal circumstances, gold has a confidence-building feature, i.e. it may play a stabilising role and act as a major line of defence under extreme market conditions or **in times of structural changes in the international financial system or deep geopolitical crises**.

From Mumbai, word that the Reserve Bank of India bought gold for the first time since 2009. It started to do so in December 2017 and continued throughout 2018.

Out of Beijing, the People's Bank of China began to *regularly* report how much gold it was setting aside for reserves – which is unusual for the bank.[c]

From Ankara, Türkiye Cumhuriyet Merkez Bankası's gold reserves rose by 51 tons in 2018 and another 159 in 2019, continuing a trend that had started in the second quarter of 2017 after having been quiet throughout the 2000s.

Overall, during 2018-19, the ten banks with the largest volume increase in gold reserves added a somewhat funny total of 1,111 tons.

The notable increase in both depth and breadth was further highlighted by a rising US dollar gold price. The industry analyst presented the trend as signal confirmation: not only was a bull market underway and it was supported by the white shoes of financial firms – the crème de la crème of fiduciary temperance, sophistication, and professionalism.

## CENTRAL BANKS ARE NOT CENTRAL

But, as explained in February's *Metals & Markets Blog* post, central banks are not central. Not to political reserve currencies – and as the following paragraphs will reveal – neither to Nature's. It was not important that they were buying gold at an above-average pace in 2018-19, and nor will it be when the opposite holds true.

Your blogger was, admittedly, bewildered by the confluence of it all. How was it that that central banks had, for once, found themselves at the tip of the spear heading into a burgeoning monetary battle, instead of bringing up the rear, as is their predilection? This blogger believes the balance of probabilities lies firmly with the notion that it was just a coincidence. A quick review of the past 20 years shows how much more probable that conclusion is than any collective realization that "structural changes in the international financial system or deep geopolitical crises," were upon us – though they were and are.

In the early 2000s, as both the post-Cold War Globalization and the Great Moderation[d] approached their respective apices, central banks sold gold unsparingly. It was easy to appreciate why. The metal was a vestige of a 'less civilized' past when ideology split the world and before monetary technocrats 'gained control' over the global economy. In the new millennium, the Iron Curtain had been drawn back, the communist Chinese were teaching everyone how to be capitalists and countries needed more gold like they needed more M1 Abrams to defend the Fulda Gap. History had been defeated and gold was part of that 'barbaric' losing side. So they sold. And gold's response? Price appreciation.

[a] Your blogger prides himself on translating complex topics into simple, everyday terms. To that effect, here are some common items that put the tonnage into perspective: 20 Space Shuttles (empty and excluding the main engines, of course); not one, but three aureate Christ the Redeemer statues atop the Corcovado peak; 310 African bush elephant bulls charging across a Serengeti plain; or, imagine hiking a Pacific forest grove and stumbling into General Grant, the giant sequoia and second heaviest tree in the world, made of gold.

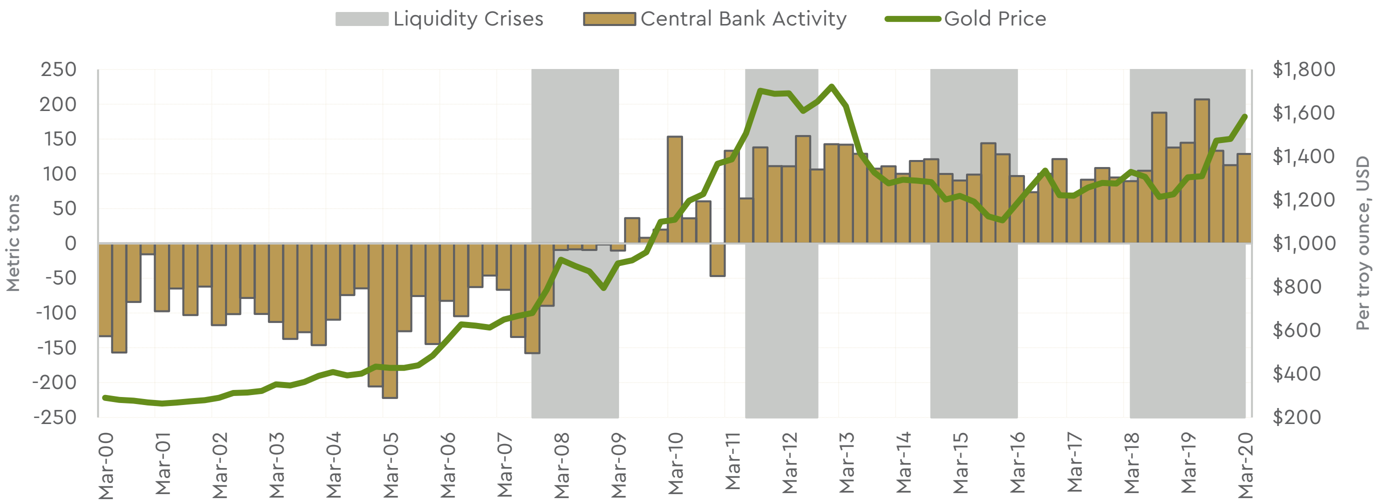
[b] If the European Central Bank, Banque du Canada, or Federal Reserve informed this blogger that referencing the press service was mandatory the reply would come back in the form of a guffaw and sinus-clearing snort. But every economist knows not to cross the Central Bank of the Russian Federation.

[c] The People's Bank of China has a habit of discovering hundreds of tons of gold in some forgotten crate and only then reporting them to the International Monetary Fund. In December 2001, the bank reported a 106-ton increase from the quarter before; it's plausible. In December 2002, another 100-ton increase in a single quarter; again, plausible. But then for the next seven years no purchases were reported. In April 2009, the bank announced it had bought 454 tons of gold between 2003-09. The bank then reported zero additions until July 2015 when it said it had purchased (found?) 604 tons that was purchased between 2009-15.

[d] The name assigned to a period of economic tranquility starting in the mid-1980s that was theorized to be, in part, the result of advanced monetary policies.

**CENTRAL BANKS ARE NOT CENTRAL TO GOLD PRICES**

(WORLD, GOLD, CENTRAL BANK PURCHASES/SALES AT QUARTER-END VS. LONDON PM FIX QUARTERLY AVERAGE)




Our current Silent Depression – only the third worldwide economic depression of the last 150 years – has come in four waves. The first wave breached the sandcastle walls of the Great Moderation with the New York and London banking crises. It began on August 9, 2007 when BNP Paribas announced it was no longer capable of valuing three of its funds due to market illiquidity. The wave crested in mid-March 2009 when America's Financial Accounting Standards Board acknowledged that it would review – and by inference, dilute – the mark-to-market rules. During that seven-quarter financial maelstrom the central banking community sold. Every. Single. Quarter.

The Green Shoots reflation lasted from April 2009 through March 2011. Central banks added to their reserves for the first time since 1988 averaging 50 tons a quarter. Prices rose.

The second once-in-four-generations liquidity crisis began in April 2011, climaxing in July 2012. Central banks more than doubled their purchases to over 115 tons per quarter on average. During this period everything was in alignment: accelerating purchases, escalating monetary disorder and rising prices.

During Global Growth (fourth quarter 2012 to second quarter 2014), the second reflation, central banks added 120 tons on average each quarter, the most during any period since at least 1965. And yet prices fell.

Oddly, during the third wave, from the third quarter of 2014 through the first of 2016, central banks pulled back on their purchases to 110 tons per quarter. Gold prices fell too.

In the most recent reflation, Globally Synchronized Growth, central banks averaged 95 tons a quarter. Gold prices stagnated.

And so no wonder that, in comparison to the 95-ton rate of 2016-17, the 140-ton per quarter average of 2018-19 is impressive. Doubly so with the addition of new names. Triply so considering the escalating monetary crisis. And 'quadruple-y' so as prices rose.

But a retrospective of the last two decades shows there have only been two periods when central banks were buying, at an accelerating rate, during a crisis and with prices rising: the 2011-12 European Sovereign Debt crisis and what will become known as the 2018-?? De-Globalization crisis.[a]

## A COUNTER EXAMPLE

But perhaps the reader believes that this blogger asks too much of public banks to correctly lean into trends so as to keep an even, monetary keel?

Consider the private banking system. The Primary Dealers are 24 banks from America, Canada, France, Britain, Switzerland, Japan, Germany and Hong Kong who are granted the privilege of buying (and obligation to bid on) United States (US) Treasury securities. The Treasuries are the gold standard of the modern, credit-based monetary order. Primary Dealers are like the central banks in Moscow and Beijing in that they are first in line to purchase national production of gold(-standard securities).

In the early 2000s, just like central banks with gold, the Primary Dealers were net short of Treasuries. And why shouldn't they be? The world was governed by return, not risk. But note when the inflection occurred. Their peak net-short position was July 18, 2007. By the end of 2008 they were net-long.

Over the next decade they sold off these positions as reflations took hold. But right as the liquidity crises began to manifest these banks hoarded Treasuries. The relationship was positively correlated, without lag.

## HISTORY, NOT CENTRAL BANKS

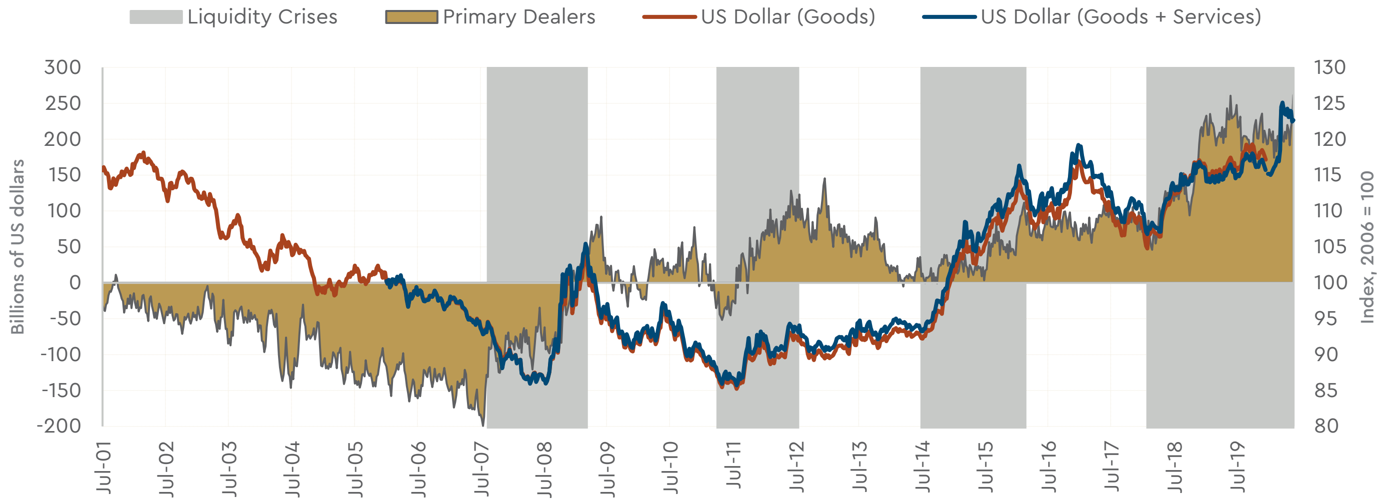
When the gold investor hears of central bank purchases, he or she imagines the reasons are along the lines of what De Nederlandsche Bank writes (emphasis added):

> "Shares, bonds and other securities are not without risk, and prices can go down. But a bar of gold retains its value, even in times of crisis. That is why central banks, including DNB, have traditionally held considerable amounts of gold. **Gold is the perfect piggy bank – it's the anchor of trust for the financial system. If the system collapses, the gold stock can serve as a basis to build it up again.** Gold bolsters confidence in the stability of the central bank's balance sheet and creates a sense of security.

[a] Not that this is what it was or is. It was the fourth withdrawal of liquidity by global money center banks in advanced economies in the past dozen years. The underlying reasons have to do with Tokyo, the 19th National Party Congress of the Chinese Communist Party and the unsustainable, chimeric momentum of the Globally Synchronized Growth reflation. However, the 2018-19 slowdown will be blamed on trade wars. Reinforcing the break in trade is the pandemic, which exposed the lack of resiliency in global supply chains (e.g. healthcare goods and pharmaceuticals being manufactured in China).

**FOR-PROFIT BANKS ARE CENTRAL TO MONETARY CONDITIONS**

(COLLATERAL, PRIMARY DEALERS, US TREASURY NET POSITION, EXCLUDING TIPS VS. TRADE-WEIGHTED US DOLLAR, WEEKLY)




But central banks are consensus-building, reactive, bureaucracies that need to see a trend established before they enter the slipstream. For every Nederlandsche or Magyar there is a Federal Reserve, represented by this exchange in July 2011:

> **US Representative Ron Paul**: "Do you think gold is money?"
> **Federal Reserve Chairman Ben Bernanke**: "No. It's a precious metal."
> **Paul**: "Why do central banks hold it if it's not money?"
> **Bernanke**: "Well, it's a form of reserves."
> **Paul**: "Why don't they hold diamonds?"
> **Bernanke**: "Well, it's tradition. Long-term tradition."

Oh for Croesus[a] sake!

Today the gold investor learns that central banks are anticipated to step back. Well, that is too bad for them but let not their actions guide the investor. Instead watch the actions of the for-profit banks (e.g. Primary Dealers), the US dollar and real rates of interest for tactical decisions. And infinitely more importantly, turn to history for strategic planning.

We are at the end of several eras. Monetarily, our system malfunctioned in 2007; any hopes of a repair were dashed in 2011. Economically, globalization stopped in 2008 and since 2019 is being pushed into reverse. [b] Politically, we have not seen this number of Vandals, Visigoths and Huns at the gate since the 1930s. Socially, the consent-to-be-governed contract was drawn up four generations ago, but nobody is around anymore that can explain the whys and what-fors. One can do a lot worse than have strategic gold ownership during these moments. If central banks believe that now is a good time to step back, that is their business; but it does not have to be the reader's.

**CENTRAL BANK GOLD ACTIVITY, CRISES AND PRICES**

(QUARTER-END CENTRAL BANK GOLD PURCHASES/SALES, QUARTERLY AVERAGE GOLD PRICE AS PER LONDON PM FIXING)

| *Period* | *Start* | *End* | *Min* | *Mean* | *Max* | *Gold* | *Notes* |
|---|---|---|---|---|---|---|---|
| Globalization | Mar-00 | Jun-07 | -222 | -105 | -16 | $401 | Selling, rising volume, no crisis, rising price |
| Banking Crisis | Sep-07 | Mar-09 | -158 | -41 | -2 | $837 | Selling, falling volume, crisis, rising price |
| Green Shoots | Jun-09 | Mar-11 | -47 | 50 | 154 | $1,158 | Buying, rising volume, no crisis, rising price |
| European Debt Crisis | Jun-11 | Sep-12 | 65 | 114 | 154 | $1,641 | Buying, rising volume, crisis, rising price |
| Global Growth | Dec-12 | Jun-14 | 100 | 121 | 143 | $1,422 | Buying, rising volume, no crisis, falling price |
| Emerging Markets | Sep-14 | Mar-16 | 90 | 111 | 144 | $1,187 | Buying, falling volume, crisis, falling price |
| Globally Synchronized | Jun-16 | Dec-17 | 71 | 94 | 121 | $1,264 | Buying, falling volume, no crisis, no change |
| De-Globalization | Mar-18 | Mar-20 | 89 | 138 | 207 | $1,358 | Buying, rising volume, crisis, rising price |

[a] Croesus, legendary Greek king of the Lydian people who, Herodotus wrote, invented gold and silver coin for use as currency, reigned circa 560 and 546 BCE.

[b] Since 1800 the world has experienced six cycles of globalization and de-globalization. The phase transition from expansion to contraction was volatile and destabilizing resulting in both social and financial losses. During de-globalization free trade falls into disrepute and political radicals emerge amidst social upheaval. Within three to five years of the start of de-globalization about 30 to 50% of countries are defaulting on their sovereign debt, financial crises affect between 20 and 80% of global GDP, and the leading international financial centers sustain foreign investment losses of 20 to 35%. Common de-globalization events include demonetization and the birth or death of a global monetary order.

**These articles are for informational purposes only and are not intended, nor should they be used, as investment, securities, tax, financial, legal or other advice.** In reading these articles, you agree not to use these articles for these purposes and any decisions you make based on any information contained in these articles are the sole responsibility of you as the reader. These articles are not an offer to sell or a solicitation of an offer to buy any security or investment.

**Emil Kalinowski, CFA**
Manager, Metals Market Research

Wheaton Precious Metals International Ltd.
Suite 300 - 94 Solaris Avenue
Camana Bay PO Box 1791 GT
Grand Cayman, Cayman Islands KY1-1109