

Market Update

Central bank buying activity

September 2018

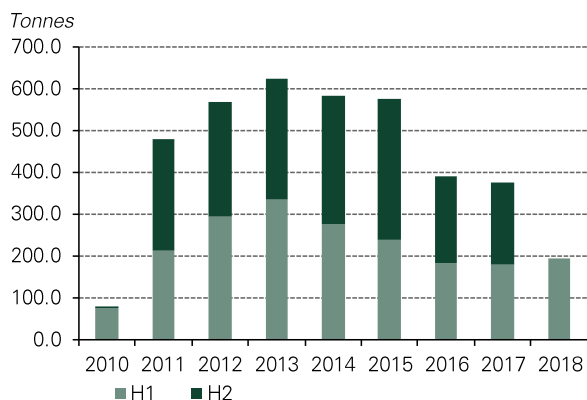
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Gold is an important part of central banks' foreign exchange (FX) reserves. According to the International Monetary Fund (IMF), at the end of H1 2018 central banks collectively owned US\$1.36tn of gold, around 10% of global FX reserves. And central banks are an important part of the gold market: in H1 2018 they accounted for 10% of demand. Looking ahead, we expect central bank demand to remain buoyant. Diversification will continue to be an important driver of demand, as will the transition to a multipolar currency reserves system over the coming years.

A solid start to 2018

Central banks added a net total of 193.3 tonnes (t) of gold to their reserves in the first six months of 2018, an 8% increase from the 178.6t bought in the same period last year. This marks the strongest H1 for central bank gold buying since 2015.

Net central bank purchases since 2010



Source: Metals Focus; GFMS, Thomson Reuters; World Gold Council

A few central banks account for a significant proportion of recent purchases. Russia, Turkey and Kazakhstan alone accounted for 86% of central bank purchases in the first half of 2018.

But in recent years new central banks have entered the gold market. IMF International Financial Statistics (IFS) reveals that Egypt recently bought gold for the first time since 1978, while India, Indonesia, Thailand and the Philippines have re-entered the market after multi-year absences.¹

Largest central bank purchasers since the start of 2017

Country	Tonnes	Country	Tonnes
Russia	383.3	Kyrgyz Republic	4.9
Turkey	125.8	Indonesia	2.5
Kazakhstan	68.4	Jordan	2.2
India	15.3	Egypt	1.7
Colombia	7.1	Philippines	1.6
Tajikistan	5.1	Thailand	1.6
Mongolia	5.0	Serbia	1.1

Note: Data to end-July 2018.

Source: IMF IFS; World Gold Council

Other banks have also reported gold buying activity. Earlier this month Bloomberg reported that the Bank of Mongolia had purchased a total of 12.2t over the past eight months and that Iraq's central bank had taken advantage of the lower US dollar gold price to add 6.5t to its gold reserves.²

Drivers of demand

Although central banks may base their investment strategy on numerous factors, we believe there are three primary reasons for recent gold buying decisions:

Diversification: Many emerging market central banks have a high degree of exposure to the US dollar and turn to gold as a natural currency hedge. Furthermore, gold has also shown itself to be an effective hedge against other reserve

¹ IMF International Financial Statistics: International Liquidity – International Reserves, Official Reserve Assets, Gold. Only changes greater than 0.5t considered

² Very often institutions report late, not revealing their updated gold holdings for several months, hence more recent changes might not be fully captured in Table 1

currencies, such as the renminbi, due to the negative correlation it exhibits against them.

Likewise, other reserve currencies continue to deal with significant issues: the euro faces both political and economic challenges across several member states, the renminbi remains relatively restricted and sterling continues to grapple with Brexit uncertainty. Against the backdrop of persistent low and negative bond yields and limited high-quality investment options, it makes sense for central banks to turn to gold as means to increase portfolio diversification. The Reserve Bank of India specifically mentioned that “diversification of India’s foreign currency assets continued” alongside its recent gold purchases.³

But it’s not just currency risk these central banks are hedging. In an environment of heightened geopolitical tensions, gold is an attractive asset because it is not anyone else’s liability and does not carry any counterparty risk.

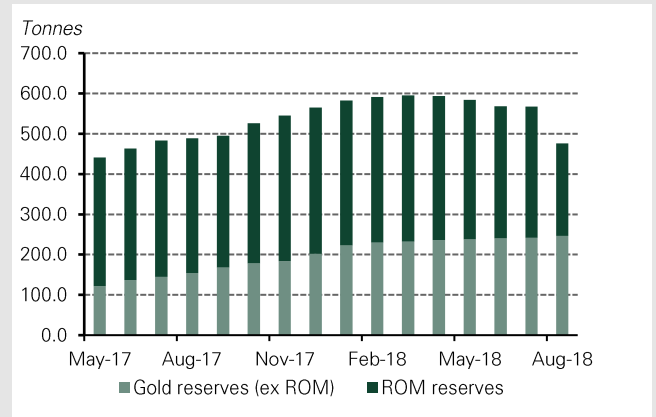
Allocation rebalancing: Emerging market central banks’ FX reserves have risen since the financial crisis, with a number increasing their gold holdings too.

We believe that some emerging market central banks could be adding gold to maintain a certain allocation level as overall reserves grow. Recent gold purchases may reflect higher overall FX reserve balances.

Active management: Gold is not only a strategic asset, but also one that can help central banks meet their tactical objectives. Gold benefits from having a deep and highly liquid market, with daily trading volumes outstripping even those of major developed market sovereign bond markets. Through leases, swaps and other transactions, some central banks deploy gold to actively manage their liquidity or boost returns. Several central banks, including Hungary and Argentina, actively manage their gold reserves to achieve these objectives, demonstrating gold’s versatility not just as a strategic asset but as an actively deployable instrument to meet short-term needs.

Focus 1: Turkey's ROM reserves

While the Central Bank of the Republic of Turkey (CBRT) has been steadily adding gold to its reserves since May 2017, the amount of gold held in the Reserve Option Mechanism (ROM) has been falling in recent months - in August the amount of gold held in the ROM dropped by 96t to 229.7t.



The ROM is a policy tool the CBRT uses to manage commercial banks’ liquidity. Commercial banks have the option of lodging lira, foreign exchange or gold in the ROM as part of their required reserves. In recent years many commercial banks have swapped FX and lira into gold, which they have then included in the ROM.

As financial stress intensified in August, the CBRT loosened its liquidity measures by reducing the amount of lira, FX and gold commercial banks were required to hold in the ROM as part of their required reserves.⁴

It is likely the decline in the amount of gold included in the ROM in recent months reflects unwinding swap activity rather than outright gold sales, although some will relate to profit taking by retail investors taking advantage of the record high gold price in August.

3 Reserve Bank of India, Annual Report, 2018

4 Central bank reserve tweak fails to halt lira drop to record low, Financial Times, 6 August 2018

A multipolar world

Central bank gold behaviour may reflect long-term structural changes that will impact the international monetary system in the coming decades. The gradual shift away from a US dollar dominated system to a multipolar one may alter the investment preferences of central banks. While the renminbi only accounts for a small fraction of official reserves, China's ambitious Belt and Road Initiative has the potential to integrate the economies of East Asia, Central Asia, and Europe much more closely. China's rise as a leading economic force is a near certainty, but the renminbi will likely remain less accessible in the medium term. Gold, a universally accepted asset with a deep and liquid market, can help central banks to adjust their reserve compositions in anticipation of a rebalancing of global economic power.

Gold is already a familiar asset class for central banks, but the changing nature of the gold market – with ever-growing consumption coming from developing economies – means that gold is increasingly aligned with emerging market economic patterns. Central banks may increasingly recognise that the rules of the game are changing.

The longer-term shift towards a multipolar currency system may therefore bring renewed focus to gold as a strategically important reserve asset. You can find more on this topic through our previous research report *Gold in a multicurrency reserve system*.⁵

Summary

Recent gold buying patterns amongst central banks have been driven by several factors. The desire to diversify away from the US dollar continues to drive many central banks' reserve allocation decisions. Growing reserve balances in some countries may have spurred gold purchases too. It is also encouraging to see several central banks utilise gold as an active asset to access liquidity or generate returns.

The long-term evolution of the international monetary system may yet provide further impetus for central banks to evaluate gold in their reserve portfolios. As the world moves towards a multipolar system, gold's time-tested reliability, universal acceptance and deep market make it an excellent choice to meet the needs of central banks. As they navigate the increasingly complex waters of a multipolar world, gold will likely continue to be a mainstay in reserve portfolios – a testament to its importance in safeguarding stability and preserving value.

⁵ World Gold Council 'Gold in a multicurrency reserve system' October 2015

About the World Gold Council

The World Gold Council is the market development organisation for the gold industry. Our purpose is to stimulate and sustain demand for gold, provide industry leadership, and be the global authority on the gold market.

We develop gold-backed solutions, services and products, based on authoritative market insight, and we work with a range of partners to put our ideas into action. As a result, we create structural shifts in demand for gold across key market sectors. We provide insights into the international gold markets, helping people to understand the wealth preservation qualities of gold and its role in meeting the social and environmental needs of society.

Based in the UK, with operations in India, the Far East and the US, the World Gold Council is an association whose members comprise the world's leading gold mining companies.

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