The European Central Bank Gold Agreement Part 3

The Washington Agreement Trilogy

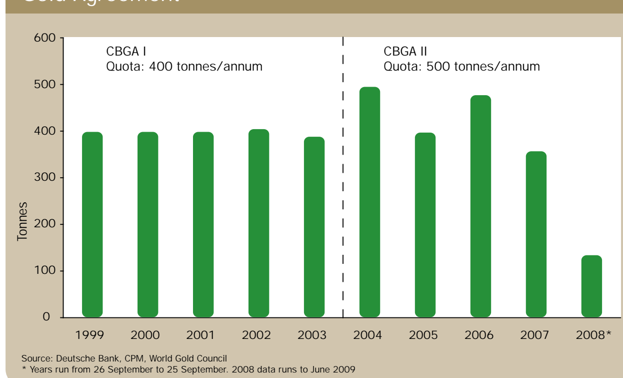
By Matthew Keen, Director, Deutsche Bank

On 7th August 2009, the European Central Bank (ECB) announced the extension of the Central Bank Gold Agreement (CBGA) for another 5 years. The signatories for the CBGA3 were the same as the second agreement and they along with the ECB agreed to cap their combined annual sale at 400 tonnes per annum.

No one will deny that the original European Central Bank Gold Agreement (ECBGA) forged in Washington prior to the IMF meetings in September 1999 was an inspired strategy and of significant importance to just about all sectors of the gold market at the time. Now, ten years on, I suppose the question being asked is what relevance (if any) does ECBGA have in today's climate.

It is a question that has been asked by central banks, bullion dealers, and even the producer community for some time now, and judging by the very late announcement of ECBGA part 3, it may have been touch and go right up to the last minute. Bottom line of course is that on August 7th 2009, a total of 18 European countries have signed up to a third agreement to run until September 2014. However, it has not stopped market participants questioning its relevance, even now.

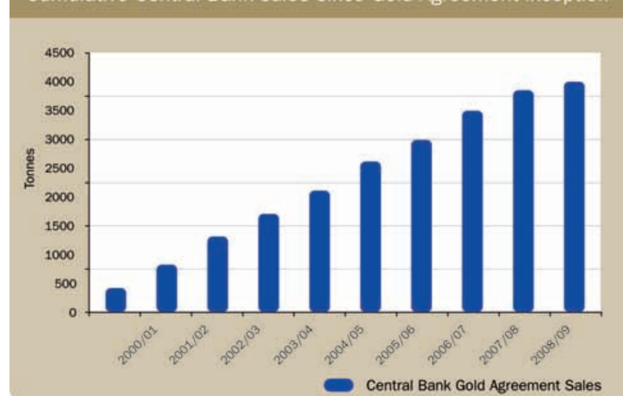
Looking at the rationale for ECBGA in the first place, the real overriding benefit was the provision of a transparent mechanism for wholesale official transactions to take place. Following 18 years of a bear market, it is fair to say that at the end of the last decade, central banks were making a fair amount of noise about the relevance of their ever depreciating asset. Whilst the actual tonnage of sales in the late 1990s was not overly important, the tarnished reputation of gold was weighing heavy on prices and there was a feeling that central banks were literally queuing up to get their sell orders into the market. As you can see from the chart opposite, the establishment of the agreement did allow for a flood of activity which saw almost 100 million ounces of gold come into the market in the seven years that followed. This rate of selling had not been seen since the mid 1960s when the US liquidated a couple of thousand tonnes.



The irony is that the period between 1999 and 2005, which saw more official sector gold sales than at any other time in history, also marked the start of the bull run which is still going strong ten years on. People close to the gold market will know that whilst the ECBGA was a demonstration of "intervention" of a sort, it had a knock-on effect that was to let the industry know that a sea-change was required for the long term health of the market and the valuations of the gold portion of their reserve portfolios. Unfortunately Gordon Brown did not get it and the UK Treasury offered up the majority of its gold at the inception of the agreement. The chain of events that followed the signing of the agreement led to the major producers pledging to cease their hedging activity, a pact which was later "upgraded" to an active hedge reduction policy that is still being followed today.

Like most good trilogies, you have to wait until the final episode before you can piece together some of the strands from earlier episodes. In this case the answer to the question "why was the ECB Gold Agreement dubbed the "Washington Agreement" in the first place"? Well, most people who have been around the market for a couple of decades (or more) will know that every second IMF gathering is held in Washington and that generally, way down the list of agenda items was the subject of gold.

Without wanting to go off on too much of a tangent, the main reason, as far as I am aware, for gold to be on the agenda at every IMF gathering was that the IMF itself wanted to modernise gold's role in monetary policy. And frankly, the only way to get traction on the subject was to have the issue of gold discussed amongst the major gold holding members at one of its annual summits. The IMF had attempted to write gold out of the system on several occasions during the last 50 years, which led to two amendments to its constitution, in 1969 and again in 1978. The first of which introduced the SDR (Special



Drawing Right) with 1 SDR being equal to 0.888671 gram of fine gold, which was the par value of the US dollar of 1st July 1944. The second amendment was to make the SDR the principle reserve asset in the international monetary system, paving the way to remove gold as the ultimate reserve asset. So in short, the IMF had been desperate to get the item of gold on the table. Then, in 1999, a core of gold holding countries from Europe actually met in Washington, prior to the official IMF meetings to discuss what could be done about gold's spiralling fortunes and the rest, as they say, is history. The irony is that the IMF was certainly not involved in the pact that was formulated, hence the Washington Agreement was purely a reference to location whereas moving in to ECBGA part 3, we are looking at Washington having a very different role to play.

ECBGA 1 will go down in history as a crucial agreement which lay the foundation for gold to end a 20-year bear market and start a massive bull run which has led to a quadrupling of the price. As I write this article, the gold price is sitting comfortably above $1,000 per ounce. The second agreement was important as a mechanism for transparency, but here we are in Q4 2009 asking the question, "who benefits from ECBGA part 3"?

Well there are no clear winners this time around in the way there were ten years ago. Adding support to the gold price is clearly not a priority for the gold holding central banks around the world today and lease rates, which were also linked to the rationale for trying to fix the market a decade ago, are also rather a non-event. This agreement in fact appears to be rather looser than the first two in as much as lendings are not referenced at all this time around.

The amount of lending by the official sector was flagged as part of the problem with the first agreement, the rationale being that if the official sector stopped providing liquidity to the market, the cost of borrowing could naturally rise to a level that might make forward selling less attractive to the hedgers. Whilst that statement is perfectly logical, the combination of de-hedging and a massive increase in investor long positions have meant that supply far exceeds the demand at the moment and that is not about to change any time soon. For that reason, all restrictions on gold lendings have been removed from ECBGA 3.

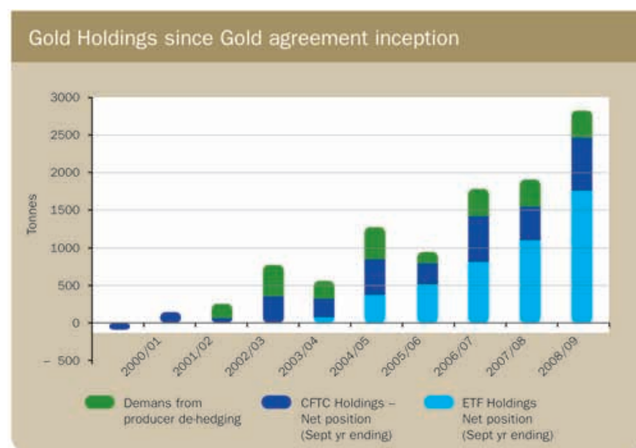
ECBGA1 will go down in history as a crucial agreement which lay the foundation for gold to end a 20 year bear market and start a massive bull run which has led to a quadrupling of the price. As I write this article, the gold price is sitting comfortably above $1,000 per ounce. The second agreement was important as a mechanism for transparency, but here we are in Q4 2009 asking the question, "who benefits from ECBGA part 3"?

Traditionally most central bank activity in gold is limited to deposit or swap business and following the credit crunch of 2007, it is fair to say that this element of a bullion bank's business is completely dead and buried deeper than most South African primary ore, and short of a resurgence of hedging from the majors, it's difficult to see what will change this current oversupply dynamic. For the first time in history, gold deposit rates are actually in negative territory. I do not just mean that the swap versus USD rates imply a negative gold deposit rate, I mean that with insurance costs higher, credit charges higher and vault space becoming a real concern, there is an argument to say that there are now real costs associated with holding a gold position and that cost has to be borne by the client. Traditionally, bullion banks have been happy to pay a nominal fee to have client deposits on their books but not any more!

So back to the crux of what is left in the agreement and who it benefits.

The IMF benefit for starters. In their very thorough presentation to the senate, they needed to deliver not only their rationale, but also their plan for execution and the ECBGA structure does go a long way towards ticking that box. The other thing that we would be wise to remember is the issue of disruptive rhetoric that plagued the market in the late 1990s. Without wanting to name names, gold has had a bit of a role as a political football and it is not unusual for a government and its central bank to have slightly inconsistent strategies when it comes to utilising the asset in question. If that country has signed up to the ECBGA then we can take random headlines that appear on the newswires from time to time with a pinch of salt. The presence of the agreement nips most harebrained ideas in the bud, but even in a case where politicians do throw a strategy out involving their country's gold we can be slightly more relaxed that if it does go further than the concept stage, it will fall within the transparent structure of ECBGA.

Ten years ago, the four biggest gold holding countries in Europe were Germany, France, Switzerland and Italy, collectively holding more than 11,500 tonnes between them, being around a third of all official sector gold. The consequence of any one of those countries unloading gold was simply unthinkable ten years ago and yet, under the auspice of ECBGA part 1 and 2, the Swiss were able to unload almost two-thirds of their gold and the French have sold almost a quarter of their stock without the market falling apart. Germany and Italy are two countries that have adopted a passive stance yet hold a combined total of almost 6,000 tonnes. Any policy shift by either of those two countries could bring us back to the bad old days of the late 1990s. So, in conclusion, it is clear to see that several European countries who were active in the



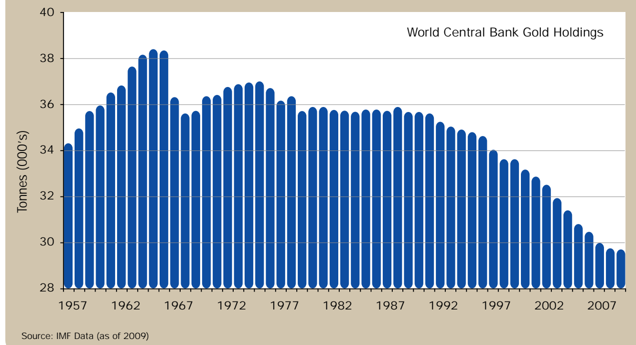
(Gold as a percentage of total reserves)***

Country	Q1 2000	Q1 2009	Tonnages
Germany	33.3	70.2	3,412
France	41.1	74.2	2,452
Italy	46.1	66.9	2,451
Switzerland	43.3	38.0	1,040
Netherlands	45.0	62.0	612
ECB	14.0	23.2	537
Portugal	38.6	90.3	382
Spain	12.2	39.8	282
Austria	19.5	56.0	280
Belgium	18.1	41.3	227
Sweden	9.9	14.2	134
Greece	6.7	92.1	112

Tonnes	Year 1 2004-05	Year 2 2005-06	Year 3 2006-07	Year 4 2007-08	Year 5 2008-09
Eurozone to September 11, 2009	352.2	385.8	352.8	211	136
of which:					
European Central Bank to end July, 2009	47.0	57.0	60.0	72.0	35.5
Austria to end July 09	15.0	13.7	8.7	0.0	0.0
Belgium to end July 09	30.0	0.0	0.0	0.0	0.0
France to end July 09	115.0	134.8	115.1	115	82.5
Germany to end July 09	5.4	5.3	5.1	4.8	4.3
Netherlands to end July 09	55.0	67.5	14.0	19.5	9.0
Portugal to end July 09	54.8	44.9	0.0	0.0	0.0
Spain to end July 09	30.0	62.5	149.3	0.0	0.0
Country not yet known			0.5		4.3
Sweden to September 7, 2009	15.0	10.0	10.0	10.0	13.5
Switzerland to date	130.0	0.0	113.0	137.0	0.0
Total reported or estimated selling	497.2	395.8	475.8	358	149

Source: World Gold Council

The Long Term Decline in Central Bank Gold Holdings



past have simply reached a point where they do not feel any urgency to sell. After all, since the birth of ECBGA ten years ago, gold will have undoubtedly been the best performer in a reserve portfolio, but it could be argued that so much of the positives that ECBGA brought to the market could be unwound if the agreement was simply mothballed at this point. I think that of all the "agreements" that have been created over the decades, this one is quite an easy one to maintain with most of the member countries happy to.

Looking at the last five years, it is clear to see that several countries who were active in the past have simply reached a point where they don't feel any urgency to sell. After all, since the birth of ECBGA ten years ago, gold will have undoubtedly been the best performer in a reserve portfolio. So, in conclusion, the extension of the ECB Gold Agreement for a third term is helpful to the market as a whole, but on the flip side, it does take away any spontaneity that central banks might have enjoyed in the past. Mind you, giving up the ability to make a "snap decision" is probably something that most central banks will not miss.■

Matthew Keen *started his career at Johnson Matthey Bankers in 1982, moving to Engelhard in 1987 where he started specialising in PGMs. He set up JPMorgan's PGM business in 1991, where he remained until the Chase merger ten years later. He is currently a director at Deutsche Bank with global sales responsibility for Central Banks and the official sector. He also has responsibility for the bank's Platinum Group Metal business and the develpoment of various Rare Metals businesses.*

Gold...

A fully integrated precious metal management company, Rand Refinery is the world's largest single-site refining and smelting complex, with a reputation for quality, reliability and integrity built up over eight decades. Based in Germiston – in Gauteng, South Africa – we are conveniently placed for access to Johannesburg's OR Tambo International Airport.

www.randrefinery.com

We are committed to the highest standards in all aspects of our business:

- LBMA accreditation
- LBMA referee status
- Dubai Metals and Commodities Centre accreditation
- OHSAS18001 (health and safety)
- ISO14001 (environmental)
- ISO9001 (quality)

We offer:

- The latest technology in both refining and smelting
- a knowledgeable team, steeped in the business
- analytical services
- stringent security
- a comprehensive vault, clearing and air forwarding service
- fabrication of a range of value-added products

CONTACT DETAILS
Rand Refinery Limited
Tel: +27 (0) 11 418-9000
Fax: +27 (0) 11 388-2792
Email: gold@gold.co.za
PO Box 565 • Germiston 1400 • Gauteng • South Africa