Central Banks In Rising Nations Bulk Up On Gold, Fueling Prices

Norm Alster
Thu Dec 10, 7:07 pm ET

As gold has stormed to new highs, a well-endowed class of buyers has joined the stampede.

After two decades in which they were net sellers of gold, the world's central banks have been loading up on the precious metal.

China, India, Russia and others have made major gold purchases in recent months. Gold market gurus and investors believe the central banks helped push bullion above $1,200 an ounce.

Even after a recent sharp pullback, some believe that with more central bank buying in the cards, gold still has head room.

"It's very positive for the price of gold," said Leo Larkin, equity metals analyst with Standard & Poor's. "We're at the early stages of central banks becoming buyers."

The greatest buying potential comes from the banks of developing nations. Even after selling gold for much of the last two decades, Western banks hold huge shares of their foreign reserves in gold.

For the U.S., it's 77.4%, reports the World Gold Council. For France, just over 70%. For Germany, it's 69.2%.

But developing countries often hold little gold. Russia had just more than 4% of its foreign reserves in gold as of Sept. 30. Brazil and Mexico had less than 1%.

What if former have-nots now evolving into have-lots decide to boost their gold reserves to match Western hoards?

Gold bulls would carry the day should there be "a wave of manifest transfer of wealth from West to East," said Jon Nadler, senior analyst with Kitco Metals, a Montreal-based bullion dealer and refiner.

Nadler, who is actually bearish on gold, concedes that the recent and prospective buys of central banks have contributed to gold's strength. "Perceptually, they've been a psychological boost."

He also argues that gold prices have raced ahead of fundamentals. "My feeling is that a pullback will eventually ensue," he said.

Nadler sees $680 to $880 as a "much healthier" price range.

Central bank buying is certainly not the only force fueling gold. Geopolitical concerns, the eroding dollar

and worries over huge budget deficits in the U.S. and elsewhere are all factors, says Thomas Winmill, portfolio manager for the Midas Fund.

"There's a real concern that we're moving into a world where we'll see massive printing of currency. There's interest in finding an asset that protects against currency devaluation," said Stephen Land, lead portfolio manager of the Franklin Gold & Precious Metals Fund.

Leveraged hedge funds plying the dollar carry trade also have been a major factor in pumping up the price of gold. The carry trade involves borrowing dollars at near zero-interest rates and pouring the proceeds into other investments -- including gold.

"The market is running primarily on investment fumes that are fueled by the dollar carry trade," Nadler said.

Gold is in large part a play on rock-bottom interest rates and a plunging dollar. Last week's jobs report and speculation that the Federal Reserve might tighten a little earlier buoyed the buck and pushed gold below $1,120 by Wednesday. But February gold futures steadied Thursday, closing at $1126.20.

India, China Key

Gold bulls are counting on further central bank buying. The intentions of China, Russia and India loom especially large.

India in early November announced it would buy 200 metric tons of gold from the International Monetary Fund. Since then, rumors have surfaced that India is looking to buy still more. An IMF spokesman declined comment on Indian buying interest.

China is the gorilla peering down the mineshaft. The World Gold Council estimates that with recent buying, China has more than 1,000 metric tons of gold reserves, making it the sixth largest government holder of bullion.

That's still well behind the U.S., the global market leader with more than 8,000 metric tons as of last September. China has the resources to dramatically increase its gold stores. Even with recent buys, gold represents less than 2% of its total currency reserves.

Like other central banks, China has been tight-lipped about its plans. Many of its purchases have also been off-market, escaping detection.

"The Chinese have no interest in showing their cards," Land said.

Some watchers speculate China could seek to equal or exceed U.S. gold stores. This would require purchases of 7,000 metric tons and would certainly "shoot prices higher," Nadler said.

He doesn't expect these buys to materialize. Instead, he expects China to "slowly accumulate" further reserves.

In the past, China has pointed to a goal of gold as 2% of currency reserves. As China's holdings of

dollars soared, it's had to buy gold just to keep bullion's share of total reserves constant. At 1.9% of reserves, China is near its oft-stated target.

Russia and India have been determined buyers in catch-up mode. The question is just how much they want to catch up.

India once had 20% of its reserves in gold, Nadler says. As it earned huge stores of foreign currency in recent years, that share dropped to 4%. Its recent IMF buy lifted that to 6%, Nadler estimates.

If India intends to get anywhere near its former 20% level, it will continue to be a major buyer.

Russia once had large stores of gold. In a massive liquidation of commodities, it "cleaned out its vaults when the regime fell," said Nadler. Russia has built back up to over 560 metric tons.

Stability in oil prices would help Russia continue to buy, the Midas Fund's Winmill says. Like China, Russia has first crack at gold mined in its borders. The central banks in both cases can absorb massive output before it even comes to market.

"Central bank buying will be an important psychological factor for the next two to nine months," Winmill said.

He figures the price of gold will stabilize around $1,200 the next few months. He expects a $100 rise per quarter beginning in Q2 2010. That would take gold to around $1,500 by the end of 2010.

Bad Market Timing

Investors might want to think twice before following the lead of central bankers.

The central banks of Europe were big sellers in the '80s at prices of $400 or less an ounce. The worst market timer was Britain, which sold a huge chunk of its reserves.

"They pretty much were selling around the $255 to $270 range," said S&P's Larkin. "I think they're awfully embarrassed about what happened."

As Nadler put it, "Central banks are notoriously bad market timers."