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FINANCIAL MANAGEMENT



A Good Mystery Revealed

The Rattler

Earlier this month The Wall Street Journal (WSJ) sent gold and financial markets in a tizzy, publishing an article entitled “Central Banks Swap Tons of Gold To Raise Cash, Surprising Market.”

The article reported that a few European central banks – no names mentioned - had borrowed close to \$14 billion as a 1-year loan from the Bank for International Settlements, and pawned 346 tonnes of their gold as collateral.

Some Background

A central bank, such as the Federal Reserve Bank in the U.S., is a nation’s primary bank. A central bank prints the nation’s currency – the paper dollars we use every day – and holds the nation’s gold reserves. For example, the Fed holds about 5,000 tons of gold in its underground vault in Manhattan, with more of the nation’s gold stacked away at Fort Knox.

Think of the Bank for International Settlements (BIS) as the central bank for central banks. It coordinates monetary policy with its 57 member countries, which include the U.S. and our major trading partners in Europe, Asia and South America.

The Fallout

The WSJ article surprised the markets because central banks have not used gold for collateral since the 1970s, and because this was the largest gold-swap in BIS’ history. That BIS did not mention the countries involved, led to further speculation of the possibility that European nations were on the brink of collapse and were desperately pawning-off their gold for cash. Shortly after the WSJ story ran, the BIS issued a clarification saying that the gold-swap involved commercial banks, not central banks; however this only added fuel to the fire as analysts noted

that no commercial banks held such large quantities of gold, and that the swap was more likely a country in crisis using a commercial bank as cover-up.

Likely Impact on Gold Prices

Ironically, before the WSJ story ran, the World Gold Council had issued a report that made the case for large-quantity gold purchases by central banks, however the WSJ article revealed that central banks not only had no spare cash to buy gold, but were selling off large-quantities of gold to raise cash.

Furthermore, if Europe's weak economy does not recover over the next twelve months, the banks borrowing the money may not be able to pay it back. If that happens, the BIS will likely sell this gold and add to global supply. As Economics 101 tells us, if supply is anticipated to exceed demand, prices should trend lower.

The Final Twists

On the day the WSJ article ran, China announced that it would not be adding to its gold reserves. Gold promoters were hoping large purchases by central banks in Asia would boost gold demand and price. However, China's announcement dashed their hopes and reinforced negative fallout from the BIS transaction.

Also consider that high unemployment and a weak global economy are unlikely to leave ordinary citizens with spare money to buy gold, especially at such high prices. If unemployment stays high, many may resort to selling their gold to put food on the table, only adding to supply.

The Conclusion

Possible future sales of gold by the BIS, lower demand from China and lower demand from weak consumers may be the one-two punch which knocks-out any illusion from modern day Midas's that the age-old desire for gold will bring vast riches.

Therefore, gold bugs beware!