The new agreement on gold

Central banks have decided gold is not to be the "plaything" of the market. But have they boxed themselves in?

The central bank's policy statement on gold (see below for details) is not only a landmark in the history of the gold market, but a significant and possibly hazardous move by the leading central banks that are either party to the agreement or have associated themselves with it. Some thoughtful observers feared that the central banks had not thought through the possible implications of their collective action: did they realise they had a tiger by the tail?

The market did not know quite what to make of the move. The price, which even before the agreement had been edging upwards from its low of $252 an ounce to around $270, soared to touch $325 before dropping back to around $290 per ounce at the time this issue was passed for press. Similarly, lease rates jumped and then relapsed as further supplies of liquidity came onto the market, notably from the Central Bank of Kuwait, which in another highly unusual step decided not only to lend its entire stock of 79 tonnes through the Bank of England, but also to announce it publicly.

The market participants who were most obviously at the sharp end of this radical treatment were operators who had sold gold short and some gold producers with over-ambitious hedge programmes, notably Ashanti. It was widely believed that Ashanti had entered into complex gold derivative programmes without fully "stress-testing them" against a possible, even if unlikely, jump in the gold price. The board of Ashanti had actually asked that such tests be conducted, but none of the tests included an assessment of what would happen if gold jumped 20% in five days since that was considered inconceivable.

But the big question for central banks is whether they have committed themselves to a course of action that will be difficult to implement in practice. The agreement itself is quite rigid - apparently making no allowance for the possibility that they might wish to expand lending to the market in particular circumstances, such as a lending operation for a bullion bank requiring liquidity. Moreover, it will be difficult to avoid situations where the agreement will need to be re-interpreted or modified, and that is likely to prove a very tricky exercise: which central banks will be allowed to sell, if for example, some of the "already decided" sales do not in fact materialise? If a prolonged period of shortage of physical gold results, will some banks press for permission to sell? What will happen at the end of the five years?

In these and many other circumstances it could be difficult for the central banks to avoid moving into a position

where they are in effect managing the gold market - and from there it is but a short step to having an "unofficial" official gold price. The market is likely to test the authorities persistently and relentlessly in the long run - both on the downside and the upside.

The central banks' aim is clear enough. They want to avoid the value of one of their principal assets being determined by the activities of speculators and driven by market rumours, especially when uncertainty about the intentions of the central banks fuelled those rumours and when the central banks provide the liquidity which speculators used to drive down the price. In short, central banks are saying: "gold will not become the plaything of the markets." But the longer-term result may be to bring gold right back into the system in a way that even the gold-loving central banks of continental Europe did not intend when they entered into the September 1999 agreement on gold.

What the agreement said

The new agreement announced in Washington on September 26 is the first collective central bank action designed to affect the gold market since the ending of the London "gold pool" in 1968. It was issued by the central banks of the euro area (including the ECB itself), the Bank of England, the Bank of Sweden and the Swiss National Bank. It is understood that Eddie George, Governor of the Bank of England, played an active role in hammering out the details of the agreement (though he actually signed the agreement on behalf of the UK Treasury, legal custodian of the UK gold reserves).

The agreement limits gold sales by the participating central banks to a maximum of approximately 400 tonnes a year and a total of 2000 tonnes in the five-year period. Only sales that have already been decided on can go ahead. Of this total, 1,300 tonnes is allocated to the Swiss and 365 tonnes to the UK, with approx 335 tonnes for a country or countries that have already decided to sell but not as yet made an announcement. Market speculation currently suggests this is likely to be the Netherlands, or Belgium. The quotas are not transferable, i.e. if the Swiss decide not to sell as much as 1300 tonnes in the next five years but instead only 1000 tonnes, then no other institu-

tion can sell the remaining 300 tonnes. On the other hand, it is understood that the intention to sell 2,000 tonnes will be fulfilled.

The central banks participating hold 15,998 tonnes, nearly 50% of the world's official gold holdings. But in addition, US has already announced its intention not to sell or lend gold and Japan followed suit the day after the Agreement was announced. The IMF and BIS are likely to abide by the spirit of the agreement. These institutions account for another 35% of world holdings, bringing the total amount of official gold covered to about 85%.

The agreement included a limit on gold leasing (lending). The signatories to this agreement have agreed not to expand their gold leasing and their use of gold futures and options over this period.

The words used are not totally clear on whether gold leasing is to be frozen at current levels, or whether some leeway will be allowed as long as the total at the end of the period equals that at present. But together with the fact that neither the US nor the IMF can lend gold, this implies that the supply of additional gold for lending is likely to be tightly constrained over the next five years.

The remaining 4,500 tonnes

There are around 75 countries outside the agreement that have official gold reserves and they hold nearly 4,500 tonnes (13% of the world total). The largest is Taiwan (422 tonnes) followed by Russia (411 tonnes), China (395 tonnes), India (357 tonnes), Venezuela (301 tonnes) and the Lebanon (287 tonnes).

These form a very varied group which hold gold for many different reasons. India's reserves have fallen in the last few years, but Russia, the Philippines, Poland and Romania have substantially added to theirs. The apparent decline in Venezuela's reserves is a reflection of swap activity; Venezuela has made clear it has no intention of selling.