



Ganesha and the Price of Gold

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The fact that investors around the world are turning to gold is remarkable. Unlike a bond, stored gold offers no yield and, unlike a stock, gold provides no leverage to the performance of an enterprise. Buying gold is not an investment per se, compared, for example, to buying a gold mining stock, where a company's financial performance is linked to its resources and production, at the same time providing leverage to the gold price. In fact, industrial applications for gold consume far less than the annual supply, thus investing in gold is fundamentally different from other commodities. According to the [World Gold Council \(WGC\)](#), investment demand for gold, e.g., from Exchange Traded Funds (ETFs), was up 46% in the third quarter of 2009.

Gold is commonly viewed as an inflation hedge and, because it is the only financial asset with no counterparty risk, as a safe haven, but the spectacular rise in the gold price indicates more than caution on the part of investors. Gold hit a low of \$713.50 per troy ounce on November 13, 2008 (London Bullion Market Association PM Fixing) and closed at a 52-week high of \$1,115.25 on November 11, 2009, up an astounding 56.31% from its 52-week low.



Central bank gold is the proverbial elephant in the room that no one wants to talk about. With [official gold holdings](#) of 29,633.9 tonnes of gold worldwide, compared to [world gold production](#)

of roughly 2,400 tonnes per year, central bank gold sales, leases and purchases, have a huge influence over the gold price. Central banks are [changing their reserve asset compositions](#) and a number of central banks, led by India and China (which has been [the world's largest gold producer](#) since 2008), are [buying gold](#). Evidently, the full faith and credit of the United States of America isn't what it used to be. Faced with a [weakening world reserve currency](#), the [questionable status of the world's largest economy](#), and [unsustainable US government spending](#), central banks are rendering a quiet vote of no confidence on the US dollar.

The US economy, the US government, US banks, and US stock markets exhibit various problems including [unemployment](#), looming [commercial real estate defaults](#), the [US budget deficit](#), a massive [public debt and huge unfunded liabilities](#), [residual toxic assets](#) on bank balance sheets, mounting [mortgage defaults](#) and [credit card delinquencies](#), an emerging [stock market bubble](#), etc. Unless the economic problems of the US can be addressed, the US dollar will quite probably lose its status as world reserve currency. Whether a transition to a new world reserve currency would take place in a cooperative manner, e.g., a managed retreat of the US dollar, or in a more disruptive way is unclear.

Gold Supply and Demand in 2009

Under ordinary economic conditions, a rising gold price might reflect, for example, increased demand, the effects of currency debasement or inflation expectations, but a sustained rise in the gold price characterized by growing global investment demand indicates something more. New York University Professor of Economics [Nouriel Roubini](#) has suggested that commodity prices reflect an emerging global asset price bubble fueled by [the fast-growing US dollar carry trade](#). While Professor Roubini's "mother of all carry trades" thesis accounts for the effects of low US interest rates driving global speculation and a decline in the US dollar, it does not specifically consider gold, which has unique supply and demand characteristics.

Based on data provided by the [WGC](#), [Gold Fields Mineral Services Ltd.](#) (GFMS), and the [US Geological Survey](#), the [world gold supply](#) is expected to be approximately 2,400 tonnes in 2009. Gold demand is expected to exceed supply by roughly 1032 metric tonnes (1 metric tonne is the equivalent of 32,150.7466 troy ounces), a large shortfall equal to 43% of the gold supply.

Assuming the average decline in industrial consumption for all of 2009, compared to 2008, will be roughly the same as that of the most recent quarter:

- The jewelry industry, by far the largest industrial consumer of gold, is expected to consume roughly 1,705 tonnes of gold by the end of 2009. Jewelry demand was down 22% in the third quarter and is expected to account for only 71.04% of the 2009 gold supply.
- The electronics industry, where consumption was down 25% in the third quarter, is expected to consume roughly 76.1 tonnes of gold by the end of 2009.
- The field of dentistry, where consumption was down 11% in the third quarter, is expected to consume roughly 49.75 tonnes of gold by the end of 2009.
- For all other industries, where consumption was down in the third quarter an average of 9%, total consumption is expected to reach 79.08 tonnes of gold by the end of 2009.

Total industrial demand is, therefore, expected to reach 1,909.93 tonnes of gold by the end of 2009, or approximately 79.58% of the estimated 2009 gold supply.

Although gold is not actually circulated as money, [gold coins and bullion bars are in high demand](#) and [investment demand](#) was up 46% in the third quarter. Investment demand is expected to account for roughly 1,727 tonnes of gold in 2009, an amount that exceeds the demand of any single industry.

Outside of the electronics industry, where [scrap gold recovery](#) is high, and the field of dentistry, gold is not typically consumed destructively. As a result, unlike any other commodity, the vast majority of gold mined throughout history, estimated at [162,780 tonnes](#) by the end of 2009, remains in existence today.

Central Bank Gold and the US Dollar

Despite the fact that it is not generally used as money, gold is held by central banks as a currency reserve and [official central bank gold holdings](#) amount to 29,633.9 tonnes worldwide. Official gold holdings represent roughly 18.2% of all gold ever mined and the expected 2009 gold supply is equivalent to roughly 8.1% of official gold holdings.

Since gold no longer served an official monetary purpose after 1971, which marked the end of the Bretton Woods system, central banks began to sell and to lease gold based on their individual requirements and continued to do so until 1999. Prompted by the [UK Treasury's planned sale of 415 tonnes](#) of gold (58.04% of UK gold reserves at the time), the [Washington Agreement on Gold](#) was established in 1999 to maintain the value of remaining central bank gold reserves by coordinating central bank gold sales. Under what is now the [Central Bank Gold Agreement](#) (CBGA), central banks have sold gold in limited quantities (400 tonnes annually between [1999](#) and 2004, 500 tonnes annually between [2004](#) and 2009, and [400 tonnes in 2009](#)). However, official sales do not account for gold leasing.

Central banks lease gold to earn interest thus offsetting storage costs by leveraging what had been until this year an otherwise marginalized financial asset to generate cash flow. Rather than borrowing cash at higher interest rates, gold producers, for example, may lease gold and sell it to raise cash, paying the lessor in physical gold from future production. Gold dealers may wish to lease gold in order to cover derivative positions, such as options or futures, either paying the lessor in physical gold or settling contracts in cash. In cases where leased gold is sold by a lessee into the open market, the gold supply is affected, which might affect the gold price. Although [gold lease rates](#), which have been historically lower than interest rates, and [central bank participation](#) in gold leasing arrangements are documented by the London Bullion Market Association (LBMA) and other organizations, gold leasing remains an unregulated market. Since gold leases can be settled either in gold or in cash, it is difficult to calculate the effects of gold leasing on the supply and demand dynamics of gold or on the gold price. In any case, since 2008, [central banks have reduced gold leasing](#) at traditionally low rates, e.g., rates below 1%.

What is more important is that [central bank gold sales had begun falling short](#) of the annual sales allotment of the CBGA in 2006, declining to an estimated [345.5 tonnes in 2008](#). Since 1999, the gold supply has averaged approximately 2495 tonnes per year, while central bank gold sales through 2008 averaged an estimated 394 tonnes, equivalent to 15.8% of annual supply on average. In 2009, however, [central banks became net buyers of gold](#) and some central banks began to [repatriate gold reserves](#). China, for example, began [adding gold to its reserves](#) and [India recently agreed to purchase 200 tonnes of gold](#) from the International Monetary Fund (IMF).

Setting aside gold leasing, central bank gold sales, having effectively added an estimated 15.8% annually to the gold supply for the past decade, can only have had a dampening effect on the gold

price and as well as on gold investing. Therefore, the effect of central banks rather suddenly switching from net sellers of gold to net buyers of gold is equivalent to a reduction in the 2009 gold supply of approximately 15.8%.

In addition to the projected 43% shortfall in the 2009 gold supply, the [US dollar's precipitous decline](#) led to a rise in commodity prices across the board. The US Dollar Index hit a 52-week low of 74.93 on November 9, 2009, down approximately 16.39% from its 52-week high of 89.624 on March 4, 2009.



Demand for gold in 2009 is expected to exceed the supply by 43%, including a reduction in supply of approximately 15.8% due to the effective termination of central bank gold sales, while the US dollar is down approximately 16.39%. At the same time, there has been a fundamental shift in central bank policy. Eastern central banks in particular, led by India and China, are buying gold, while Western central banks have cut back gold sales and have reduced gold leasing at traditionally low rates.

Setting a Gold Price Target

The 16.39% decline of the US dollar tends to be reflected rather directly in commodity prices, thus the gold price, considering that the demand for gold is global, could reasonably be expected to rise approximately 16.39% from its 52-week low in 2009 based solely on the decline in the US dollar.

The effect on the gold price of the 2009 supply shortfall of 1032 metric tonnes could be extraordinary if obvious shortages were to occur, or it might be nominal if consumers of gold were to substitute another commodity, e.g., silver. Substitution, however, seems very unlikely both in terms of industrial uses for gold and in terms of investment demand. Thus, a naive estimate of the impact of the supply shortfall on the gold price might assume that the gold price would rise no more than the shortfall in supply, i.e., by no more than 43% (inclusive of the estimated 15.8% reduction in supply due to the effective termination of central bank gold sales and setting aside entirely the subject of gold leasing).

Combining the 16.39% decline of the US dollar and the estimated 43% shortfall in supply might suggest a gold price approximately 62.6% higher than the 52-week low of \$713.50 (London PM Fix), which occurred on November 13, 2008, 1 year ago, i.e., a naive price target of 1,160.15 as of November 2009. The 52-week high of \$1,115.25 on November 11, 2009 was approximately 56.31% higher than the 52-week low, thus the actual gold price at that point was lower by roughly 6.29% compared to the 52-week low than the naive price target of 1,160.15. Based on these estimates, the gold price does not seem to indicate an asset price bubble.

Which Way is the Elephant Going?

The proverbial elephant in the room is on the move and the room is not very big in comparison. It seems likely that Western central banks are holding off further gold sales, at least while discussions on a new world reserve currency, i.e., IMF [Special Drawing Rights](#) (SDRs), are taking place. Led by India and China, key [IMF members want gold included](#) as a component of the a world reserve currency. As long as using gold as a component of a new world reserve currency is a possibility, not only are central bank gold sales on hold but central banks will almost certainly continue to buy gold in the foreseeable future.

There is no fundamental reason for the current gold price trend to reverse in the foreseeable future, and, despite the steep rise of the gold price in 2009, gold does not appear overvalued. It seems possible, although unlikely, that if gold were to again be marginalized in a new world reserve currency regime, as it was under the US dollar standard after 1971, central banks might again start selling and more aggressively leasing gold at some point in the distant future. In that case, the gold price would eventually fall, perhaps to some stable, lower level, once again reflecting the conflicting desires of central banks to both leverage their gold reserves and also maintain their value. However, given the global financial crisis stemming from of the US dollar's 64-year reign as world reserve currency, it seems much more likely that central banks will guard their hoards jealously in coming decades.

Alternatively, if a new world reserve currency were to emerge having a significant gold component, what would then be a certainly higher gold price would likely remain at a higher level indefinitely. It also remains possible that the decline of the US dollar could accelerate or that the apparent differences between Eastern and Western central banks could become more acute, in which case the gold price could rise more rapidly and the process of deploying a new world reserve currency might be accelerated as well as potentially disruptive.



The Hindu deity Ganesha, widely revered as the Remover of Obstacles, is readily recognizable because he has the head of an elephant. Gold languished from 1971 until 2009 as a commodity that central banks had little better to do with than to systematically dissipate through sales and leases, while the most significant problem they thought they faced was the risk of dishoarding too much too quickly. From 1971 until 2009, central bank gold entering the market was a factor of the gold price and a risk for investors. After 38 years, the effective termination of central bank gold sales has rather abruptly removed that obstacle.

Desiring to mitigate risks associated with the US dollar, central banks, led by India and China, have, in effect, promoted gold from its 38-year status as a non-financial commodity once again to its historical role as the premier global financial asset. This historic change in central bank policy signifies a profound break with the past and broadcasts a clear message: gold is a world-class financial asset fairly valued at more than \$1,000.00 per troy ounce. With this momentous event, the words “as good as gold” again have meaning.

An analysis of supply and demand fundamentals suggests that the current gold price does not indicate an asset price bubble, and the historic change in the status of gold by central banks implies a major revaluation not yet reflected in the gold price. As the restructuring of the global economy continues, particularly with respect to the world reserve currency, there is a clear possibility that the gold price will move up sharply from current levels.

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