Central Banks Join a New Gold Rush

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The world's central banks are likely to be net buyers of gold in 2009 after two decades of selling, sparking a race among analysts to figure out which country will step in with the next big purchase.

Since 1991, central banks have reduced their gold holdings by 10%. It is a trend that has long been cited as keeping an overhang on gold prices. Developed countries like Switzerland, the U.K. and the Netherlands all sold significant amounts of gold to diversify into other assets in pursuit of higher returns.

India's $6.7 billion purchase of 200 metric tons of gold from the International Monetary Fund last month, absorbing half the amount the IMF put up for sale, was the largest purchase by a central bank in 30 years. Now the market is engaged in a guessing game about which central bank may buy the rest.

Eugen Weinberg, an analyst with Commerzbank AG, is looking to China. Jeff Christian, managing director of CPM Group, a New York-based precious-metal research firm, says other Asian and Middle East countries may be likely candidates.

Wei Benhua, a former Chinese official, was cited by Chinese-language magazine Caijing on Monday as saying China, Brazil or Russia may follow India in buying IMF gold.

India's purchase has thrown central banks back into the spotlight as a potentially powerful force behind gold. Even relatively small changes in the balance of a central bank's reserves could have a drastic impact on gold prices because of the relatively small size of the market.

This year could mark a "watershed year," Barclays Capital analyst Suki Cooper said in a note to clients. And, even though central banks mightn't be big buyers of the precious metal, the prospect of added demand may provide key support to the market, they say.

China, Russia and Brazil have tiny holdings of gold relative to their overall foreign reserves, placing them among more likely buyers. China, for example, has just 2% of its reserves in gold, compared with the world average of 10.3%., according to the World Gold Council; and Russia is at 4% and Brazil 0.5%.

The most logical buyers are countries that are running current-account surpluses and that don't have their own domestic gold production, Mr. Christian said.

With a net inflow of dollars and euros every month, central bankers in these countries are worried about the growing exposure to these currencies and have the most desire to diversify into other assets. According to the IMF's International Financial Statistics, Malaysia, Singapore, Kuwait, Saudi Arabia and Venezuela are among other biggest surplus countries behind China and Russia.

Typically, central banks hold a basket of foreign currencies, bonds and precious metals in reserve, using it to make international payments or adjust the value of their domestic currency. The U.S. dollar was considered the preferred reserve currency for decades. But the greenback's recent decline has spooked many countries sitting on big dollar assets.

While China has become an obvious buyer, some analysts say the country is likely to buy production from Chinese mines rather than buy from the IMF. China, the world's largest gold producer, has $2.3 trillion in foreign reserve, with the majority in U.S. Treasury securities.

Even a tiny shift in China's reserves toward gold could have big ramifications, says Andy Smith, a senior metals strategist at Bache Commodities, a subsidiary of Prudential Financial. That makes it likely China probably won't make any big moves, he said.

For example, to increase its gold holdings to the world's average of 10%, China would need to buy $180 billion of gold, or about 5,400 metric tons -- the equivalent of more than two years of the world's mine production. Gold prices would probably spike above $6,500 an ounce, Mr. Smith estimates, making the scenario highly unlikely.

To be sure, the recent surge in prices may deter many banks from buying right now. Since the Indian deal was announced, gold has gained 5%. On Tuesday, gold for November delivery rose for the seventh consecutive day, settling at a record $1,101.90 per troy ounce. India said it paid about $1045 an ounce.

India's purchase "highlighted in two ways the ongoing shift of central banks and governments from being net sellers of gold to net buyers, which we believe will likely continue to provide strong fundamental support for gold prices," analysts at Goldman Sachs said in a note to clients on Tuesday.

As of September, central banks around the world kept a total of 26,297 metric tons of gold, equivalent to 11 years of global production, down from 29,214 tons in 1991, according to the World Gold Council.

David Rosenberg, chief economist and strategist with Gluskin Sheff & Associates Inc., said he sees prices rising through $1,300 an ounce should China buy the remaining 203 metric tons of IMF gold.