The Yuan Gold Fix – almost here!

By Julian D. W. Phillips 16th September 2015

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China conducted trial runs for the planned launch of a Yuan-denominated gold fix last April in line with the announcement that in 2015 there would be a Shanghai 'Fixing' later in the year. The state-run Shanghai Gold Exchange (SGE), on whose international platform the fix will be launched, conducted the trial with major Chinese banks and a few foreign banks. With only 3 ½ months before the end of the year we expect the launch is imminent.

Why?

The current fundamentals in the gold market show that demand out of India and China is absorbing more than the entire newly mined gold supply leaving only scrap supplies for the rest of the world's demand. We believe this supply has been supplemented by liquidity out of New York and London. This extra supply has allowed the gold price to remain near the price lows of the last two years. But it has meant that while pricing power has remained in the developed world's gold markets it has been at great and growing cost to the liquidity levels of these markets.

- It is debatable whether the developed world wants to keep the gold price low as confidence in the important global currencies wanes because of volatility and competitive devaluations.

- It is also debatable whether China is acting in a way that it maximizes the volume of gold it can acquire by letting the gold price remain low.

But there does come a point where, if liquidity is being supported by the release of gold from the bullion banks, a higher price might increase these supplies in an effort to hold the price down?

With that in mind, we note the Bank of China is now a member of the LBMA gold price setting group of banks, with more Chinese banks likely to follow. Top Chinese banks including Industrial and Commercial Bank of China and Bank of Communications are members of the exchange, along with foreign banks Australia and New Zealand Banking Group, Standard Chartered and HSBC, among others. Thus the groundwork is being laid for an efficient set of Chinese arbitrage operations. Currently, these banks remain almost invisible in terms of today's gold price.

We are fully aware that HSBC does arbitrage gold from the U.S. / London into the Shanghai Gold Exchange, as demonstrated in the last 40 tonne 'bear raid', when such an amount sold at the close in New York on a Friday was dropped into the SGE on the Monday. Initially, it dropped the price there, but the second week of this happening saw the arbitraged gold absorbed almost immediately. No doubt this was a good learning curve for the Chinese banks, now in a position to arbitrage gold in the same way.

Most importantly, as with its desire to see the Yuan as one of the currencies that make up the basket of currencies in the Special Drawing Right of the IMF, China as the world's largest buyer of gold into their country, do not want to see New York or London control its price. We do not know how long it will take before China does have pricing power over the gold price but we are fully aware that, that is their aim.

In the last week, we have seen the Yuan's path to its nationalization take a step forward has permitted the world's central banks to deal in the Yuan. As these institutions have no Yuan as yet, they will be buyers. Because of this the Yuan will displace in percentage terms the grip the U.S. dollar and the euro have on global central bank reserves.

At the moment around 63% of the world's currency reserves are in dollars with around 23% of these in euros. The balance is made up of other currencies of which the Yen and Pound Sterling are among them.

With China increasing gold reserves and becoming the world's main physical gold market it is a natural step forward for them to take hold of gold's pricing power in Shanghai. It is just a matter of time until this happens.

Yuan not Dollars for gold

It is also notable that for outsiders to buy gold on the SGE they will have to pay Yuan for it, not dollars. This not only promotes the Yuan internationally it delivers a blow to the concept that gold is only priced in dollars. But this is not just a Chinese objective.

Already in Europe gold professional do not deal in dollars for gold, they price in the euro and the Swiss Franc, not the dollar. So the moves towards gold being priced in many currencies is well under way.

It is another step to the ending of dollar hegemony and replacing it with a multi-currency monetary system, one we believe will see a great deal of turbulence, elevating the role of gold in the new system!

How?

China plans to launch a Yuan gold fix this year through trading of a 1 kg contract on the SGE. The huge amounts of gold that have been re-refined in Switzerland and shipped to Asia has been the subject of any articles and well evidenced by Swiss export figures.

The SGE will act as the central counterparty, unlike the London fix where the bullion banks settle trades amongst themselves. As we said above, the Shanghai Gold Exchange is controlled by the People's Bank of China, which itself is acquiring gold on a monthly basis currently around 16+ tonnes a month. There is strong evidence to add credence to the belief that the PBoC is acquiring much more through its agents SAFE and CIC, who are holding it for them, until it suits the PBoC to take it onto their own books.

The Yuan "Fixing" exercise in April was like beta testing and since then there have been discussions on how best to implement it. Participation in the fix will be open to members of SGE's international board and more trial runs will have been made since then to hone the process to dovetail into the global gold market.

The SGE, which has been at the forefront of China's pricing efforts, opened an international bourse last year, allowing foreigners to trade Yuan-denominated gold contracts for the first time. This has not yet seen large volumes. But we see it as being a global pricing center for gold, in time.

If the Chinese 'Fix' becomes a success, it will add pressure on the London benchmark, which is used worldwide by producers, refiners and central banks to price holdings and contracts. The London LBMA 'Fix' will have to exist side-by-side with Shanghai, with arbitrageurs smoothing out price differences. If this does happen, then gold's pricing power would lie in the hands of Shanghai fairly quickly.

For instance, should physical gold sales in London be directed at keeping prices down, the rapacious demand for gold in China will allow arbitraging banks to absorb it in London directly. If this does happen, we would expect to see speculative downward pressures to diminish, as the SGE takes control of liquidity in the market. To see the size of this demand we only have to look at the massive withdrawals of gold from the Shanghai Gold Exchange on a week by week basis currently:

Shanghai Withdrawals

As the People's Bank of China owns the Shanghai Gold Exchange and all gold entering through China must flow through the SGE these figures are stated to be an accurate measure of gold imports to China, according to the head of the Shanghai Gold Exchange. We have no basis on which to dispute this.

SGE Withdrawal week ended	Physical gold withdrawn
July 3rd	44.3 tonnes
July 10th	61.8 tonnes
July 17th	69.2 tonnes
July 24th	73.3 tonnes
July 31st	53.3 tonnes
August 7th	56.1 tonnes
August 14th	65.3 tonnes
August 21st	73.0 tonnes
August 28th	59.9 tonnes
September 5th*	36.8 tonnes*
Total	**593.0 tonnes**

September 5th figures are for a three day trading week with the Exchange closed for the Chinese Victory Day celebrations on the Thursday and Friday.

These figures cover 10 weeks leaving another 17 weeks of the year to come, usually showing greater volumes. Consequently, the volumes we expect to see withdrawn from the Exchange will surely top 1,000+ more tonnes.

Withdrawals from the exchange for the first 16 weeks of the year have already reached around 780 tonnes suggesting that if flows out of the SGE are maintained we could be in for a new record year with withdrawals well in excess of those of 2013, which totalled almost 2,200 tonnes, taking the number up to over 2,400 tonnes. [Add the expected Indian demand also growing to reach close to 1,000 tonnes [plus an undetermined amount of smuggled gold – 250 tonnes +?] and total newly mined gold supplies will have gone and a good proportion of scrap supplies eaten into. The remainder of supplies to the markets around the world have to come from the available liquidity held in bullion banks and others who must be being drained of their liquid holdings. After all, the amounts sold from Gold ETFs so far this year and particularly since the beginning of July have been tiny relative to Asian demand.

US trade statistics for gold exports showed that in early 2014 nearly all the gold exported to China and Hong Kong was directly to the latter, while by late in the year 36% was going directly to the mainland. The U.S.G.S. numbers show that a substantial proportion of U.S.

gold exports to Hong Kong and China in October went directly to the mainland. Further checking reveals that this was also the case in September, although not before. The October figures were 12.9 tonnes to Hong Kong and 7.4 tonnes directly to the mainland, or 36% of the total. By contrast, in October 2013, only 0.36 tonnes were shipped direct to the mainland and 17.8 tonnes to Hong Kong. A very substantial change! This tells us that while Hong Kong remains a significant import route, it is not nearly so important in the overall picture, as it used to be.

No Gold Exported from China

With current Chinese regulations not allowing the export of gold from China, the other world gold markets cannot access gold coming into China except through the International market on the Shanghai Gold Exchange. This has not yet shown nearly the vigor it was expected to have but the time is coming when foreign gold demand will have to turn to China for gold through this market or push prices higher to get it.

Two reasons dictate this will happen:

1. The shortage of physical gold that is growing in London and New York is a time bomb, before prices take off to try to source new supplies.
2. Suppliers do see that prices will rise as such shortages increase, so it will pay them to supply the market that will pay the highest price but on a long term supply contract. China will fight hard to get those from London's hands. Competition between Shanghai and London will become heated, for physical gold.
3. We can be certain that China will not want to see a lower Chinese price than a London price, hence the membership of the LBMA price setting body and the growing development of arbitrage operations. This will ensure a gold price more representative of demand and supply. The current pricing power COMEX has at present will evaporate as it proves disjointed from the real gold price. When this happens, it will happen suddenly as physical demand forces it to price in line with fundamentals and not capricious sentiment.

The net result of what will happen either way you look at it will be a global gold price reflecting the underlying realities of Asian demand.

All told the pressure on gold supplies as the global gold market evolves is tremendous. Such pressure has to give way and force a reduction of demand through higher prices.

Threats to the gold markets – Confiscation!

As both Official demand and Asian demand continues to rise [as the number and level of wealth of the Chinese middle classes grows] China has already made clear at the time it announced it new 'official' gold reserves, that we should 'note the holdings of gold in the country'. These include individual and institutional gold ownership.
The implications of this statement was that the government will, if it was deemed necessary, take gold from ALL Chinese owners and use it for the nation's benefit.
Why should such a need arise? We have had a recent dose of currency turmoil and the threat of more persists throughout the world as economic performances diverge. With competitive devaluations ongoing [despite G-20 promises it won't happen] confidence in currencies is waning. This has not been lost on most nations and their central banks.

Gold's role in such extreme times will grow as it reinforces confidence in currencies, as it has done so in the distant past. When the time comes for gold to be used as a confidence builder between different governments it is likely that most nations will follow suit.

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