CPM Group

Market Commentary

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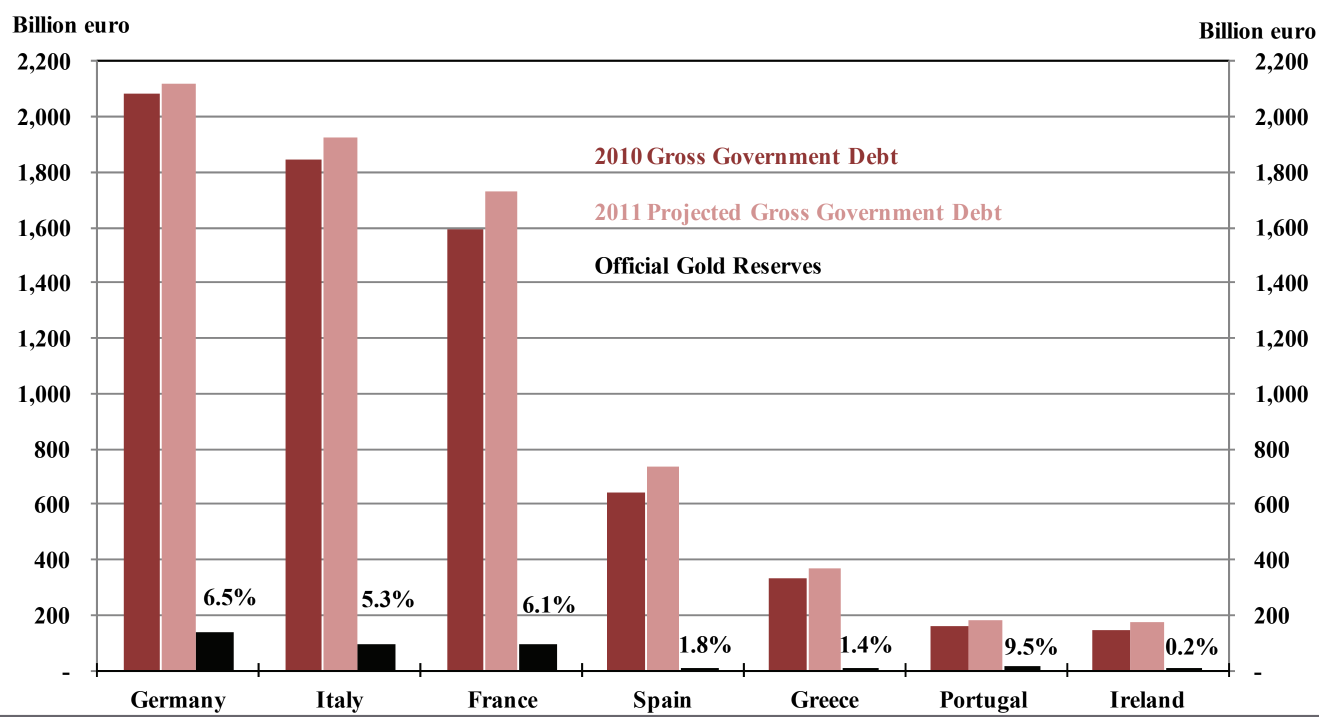
Gold and U.S. and European Sovereign Debt and Deficits

In recent months there has been some talk in the gold market, and also the broader financial press, about the idea that European central banks could or should sell their official gold reserves to alleviate, to some extent, their sovereign debt problems. There also have been similar comments about the United States selling its monetary gold reserves to pay down its debt. This seems highly unlikely to occur for several reasons.

First, it would not make financial sense to sell part of a nation's capital stock to cover a current account deficit or debt. While the debt burdens of these countries is problematic and growing worse, the underlying and more important issue is the structural budget deficits, which continually add more debt to the national balance sheets. The deficits must be addressed before the debt issues can be resolved, and, indeed, solving the deficit problems is the basis for resolving the debt issues. One could argue that using the gold as collateral against loans might make sense instead of outright sales, but this idea runs into the second, more pragmatic issue.

This second obstacle to using the gold reserves to reduce the debt of these governments is the fact that the value of their gold holdings is miniscule compared to the size of their debt. The United States holds 261 million ounces of gold worth around $444 billion at current prices, which would pay for roughly one quarter's worth of deficit, after which the U.S. government would still be facing massive deficits, its debt would not have been reduced at all, and it would not have any gold reserves left. It would have its foreign exchange reserves, but these account for only around 10% of its current monetary reserves.

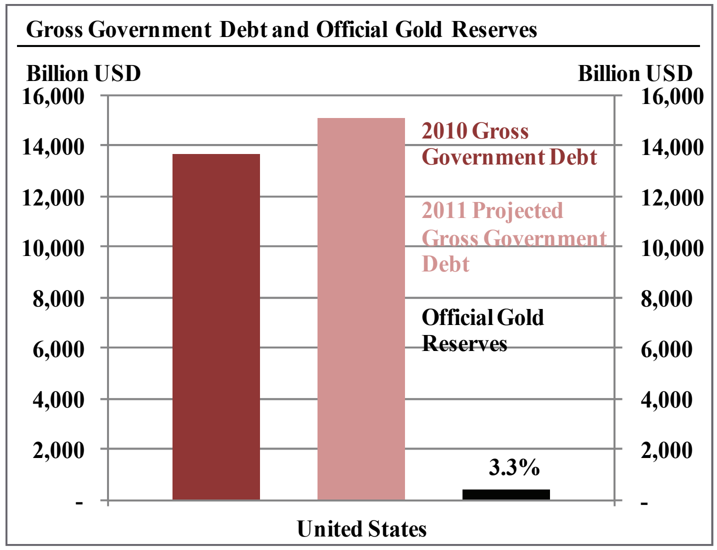
Gross Government Debt and Official Gold Reserves



Notes: Official gold reserves as of October 2011. Gold prices as of 31 October 2011. Gross government debt for 2010 is actual data, except for Portugal. Gross government debt for 2011 are IMF forecast. Ratio of official gold reserves and gross government debt is based on 2010 gross debt.
Source: IMF, IFS, and CPM Group

Gold and U.S. and European Sovereign Debt and Deficits (con't)

Some gold market commentators, in China as well as in the United States and Europe, have suggested that the Chinese government might someday demand the gold in exchange for some of its holdings of U.S. debt, but this runs into two problems: First, again, the small size of the value of U.S. gold holdings compared to the volumes of its debt held by the Chinese government. More importantly, however: There is no clause, agreement, or legal statute that says the U.S. government is or could be compelled to hand over its gold in exchange for Treasury bonds. That link was severed in August 1971. Interestingly, the Chinese government is fully aware of both the folly and futility of such thinking. The head of the Chinese Investment Corporation, the Chinese sovereign wealth fund created in late 2007, in December 2011 stated the official wisdom, which is that the Chinese government would be interested in finding a way to use some of its U.S. dollar holdings to invest in infrastructure projects within the United States, to help rebuild the U.S. economic capacity and provide jobs in the United States.



Notes: Official gold reserves as of October 2011. Gold prices as of 31 October 2011. Gross government debt for 2010 is actual data. Gross government debt for 2011 are IMF forecast. Ratio of official gold reserves and gross government debt is based on 2010 gross debt.
Source: IMF, IFS, and CPM Group

The same obstacles apply in Europe. Gold accounts for large proportions of European central bank holdings, around 70% in the case of Germany, France, and Italy. Selling this gold would leave these governments with virtually no monetary reserves. Furthermore, even though European central banks have among the largest gold reserves in the world and gold prices are at record levels, the value of this gold is insignificant compared to the amount of government debt in these countries. In the case of Germany which has the largest gold reserves of all European countries, the value of its official gold reserves at the end of October 2011 was 135.1 billion euro, which accounted for 6.5% gross government debt of 2,080 billion euro at the end of 2010 and 6.4% of projected gross debt of 2,122 billion euro at the end of 2011.

The situation is even worse in the case of the peripheral European nations, which are in greater need of debt relief. Official gold reserves in these countries account for even smaller amounts of total gross debt. Italian gold reserves at the end of October 2011 accounted for only 5.3% of gross government debt at the end of 2010 and accounted for an even smaller amount of 5.1% of projected 2011 gross government debt. As can be seen in the chart on the previous page, this ratio is even worse for Spain, Greece, and Ireland. Portugal's ratio of official gold reserves to gross government debt is the largest of this group, but is still small, at less than 10%, to make any significant difference.

This Market Commentary has been excerpted from CPM Group's Gold Long-Term Outlook, released December 2011.