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Q&A-Confidence in gold likely to be dampened by the prospect of more Venezuelan bullion coming onto the market-CPM Group

The prospect of the Venezuelan central bank disposing of more of its bullion holdings in the years to come, after it allowed a $1.7 billion swap with Deutsche Bank to expire this month, will likely have a dampening effect on gold prices, CPM Group's managing director told the Reuters Global Gold Forum on Wednesday.

"The short-term price will be affected negatively by investors' concerns over this gold coming onto the market and the uncertainty of timing," Christian said. "The effect will be modest, but it should reduce gold prices by more than a few dollars from where (they) otherwise might have been."

Following are edited excerpts from the conversation:

Q: *What's your understanding of what happened here?*

A: The news last week was that Venezuela's central bank had allowed a $1.7 billion gold swap with Deutsche Bank to expire, keeping the cash, in essence. It reflects the on-going and growing insolvency of the Venezuelan government. There are a lot of uncertainties about what exactly the gold position of the Venezuelan central bank is. Part of this is because of a lack of clarity of the report of gold swaps. Swaps should be reported in the bank's balance sheet as a reduction of gold. Loans, in contrast, remain on the balance sheet, but swaps should not. The bank's gold reserves dropped from 11.8 MM oz in 2015 to a reported 6.0 MM oz earlier this year. It is not clear how much of that was sold outright and how much of it was swapped. Clearly there are other swaps out there. The disposition of the gold, not just the remaining 6.0 MM oz but the other 5.8 MM which was either sold or swapped, is not clear, but where it is is important to understanding what is happening. Unfortunately, there is a lack of clarity in the market about these private matters.

Q: *What will happen to this gold now?*

A: The swap that was allowed to expire was with DB, which ostensibly 'got out' of the gold market a couple of years ago, but still is involved to some extents. That gold would have been hedged by DB. DB most likely will sell it off at opportune times, probably in pieces. The market is unlikely to see 1.3 MM oz of gold sold in one chunk, and DB would have the luxury of being able to work itself out of that position. Some of the gold may well be sold to clients of DB Asset Management operations.

Q: *Is there an expectation in the market that other gold swap arrangements Venezuela has in place could lapse too?*

A: Again, it is not clear how much gold the Venezuelan central bank has out of swaps, and how much it still holds outright. It is likely that other swaps will be allowed to expire, since the bank needs the money and does not have the foreign exchange reserves to unwind the swaps. Additionally, letting the swaps expire gets the bank more cash. This is because the bank only gets around 70% of the dollar value of the gold, reflecting gold liquidity and price volatility issues. If the swaps expire, the bank gets the differential. In the case of the DB swap, the bank initially got $1.2 billion in cash. To unwind the swap it would have had to return the $1.2 billion and maybe pay some additional charges. By letting the swap expire, the Venezuelan central bank gets the $500 million differential between the value of the gold it had swapped earlier and the cash it had gotten at the outset of the swap. Given that the Venezuelan government and central bank desperately need cash, they should be expected to let the other swaps expire, in order to get those differentials and because they do not have the cash to unwind the swaps. Gold is a great investment, but you cannot eat gold, and using it to buy food and other necessities is harder than using dollars.

Q: *Would you expect to see more Venezuelan central bank gold coming onto the market? If so, how?*

A: Yes. As I wrote at the start, all of the gold transactions, swaps and sales, reflect the insolvency of the Venezuelan government, which has been dismantling the Venezuelan economy for many years. As long as this government continues to impoverish the country, it will do everything in its power to stay in power, and that will include selling off the country's patrimony of gold. So, any gold that has been swapped, perhaps as much as another 4.7 MM oz, is likely to be in swaps that will not be unwound. That gold ultimately will hit the market. The remaining gold the government has, whether it is 6.0 MM oz, 4.7 MM oz, or more, also should be expected to come into the market at some point over the next few years, assuming this government remains in power and does not reverse its economically destructive course.

Q: *What sort of impact on price would you expect this volume of gold coming onto the market to have, in the short and medium term?*

A: Any gold on swaps would have been, or should have been, hedged by the counterparts. That gives them the capacity to time their sales or disposals of the gold. The more worrisome volumes are the gold that the Venezuelan central bank might sell outright by itself. Also, the market's expectations of such sales can have, I would say is already this week having, an impact on prices. The probability that the Venezuelan central bank will dispose of something between 4.7 and 11.8 MM oz of gold onto the market over the next several years will have the effect of keeping prices from rising. That is a large amount of additional gold for the global market to absorb. The short-term price will be affected negatively by investors' concerns over this gold coming onto the market and the uncertainty of timing. The effect will be modest, but it should reduce gold prices by more than a few dollars from where it otherwise might have been. Longer term, the gold swapped that may be sold when the swaps are allowed to expire should be only a modest negative factor on prices. The bigger risk comes from direct sales by the Venezuelan central bank, which could be clumsy and disruptive of the market, hitting prices when they are made. They also could scare the market if and when they are made and seen in the market. There is a silver lining for gold in all of this, although it is an arms dealer's silver lining. The gold is being sold because the Venezuelan economy is in disarray and heading toward ultimate collapse. Those sorts of political developments tend to stimulate interest in gold from investors in the longer run.

Q: *How common is it for central banks to carry out swaps and similar arrangements with their gold? Has it been increasing over the last decade?*

A: Central banks used to swap a lot more gold. Our estimate – since it almost all is secretive – is that central bank gold lending and swapping today is perhaps one-sixth of the peak volumes we saw in the 1990s. So, the volumes lent and swapped by central banks is much lower today than it was 15 - 25 years ago. Other entities lend more gold now, and have sort of squeezed central bank lending out of the market.

Q: *Under what circumstances would you expect to see that swapping activity picking up?*

A: We do not expect central bank gold swapping to increase in the foreseeable future. Central banks have less incentive and interest to swap or lend gold. Private lenders are far less demanding in the security and documentation they seek in lending gold, risks are higher to lending, demand for borrowed gold is off sharply, and the interest rates available are less attractive. Sort of the way that "Mortgage light" mortgages squeezed out legitimate mortgage lenders leading up to the mortgage crisis starting in 2007, 'gold lending light' documentation and practices by private lenders has made gold swaps unattractive to central banks. It would take major financial crisis far worse than what we saw in 2008 - 2011 to stimulate a wide wave of central bank gold swaps. There will be banks and governments that run their economies and financial conditions into the ground, and at times some of those banks will use their gold to swap or sell for cash. But it most likely will be instances like Venezuela, and are likely to be few and far between. But then, maybe I give governments more credit than I should. Someone was asking me about government finance issues, as they relate to gold and gold standards last week. I pointed out that a gold standard is not necessary or useful. In fact, to get to a gold standard you would have to have a long period of ethical and effective central bank management, to put monetary affairs in order sufficient to support a gold standard. Once you had that extended period of ethical monetary policy management in place, you would not need nor want the gold standard.

Q: *Has this sort of central bank gold swap lapsed before?*

A: In 1981 and 1982 there were some central banks that gold into financial liquidity crises. They did not let their gold swaps lapse, but they renegotiated them. There have been a few smaller gold loans and swaps that have been allowed to convert to a sale in the past, but typically not because of financial crises as we see in Venezuela. Rather, the central banks were taking advantage of positive for them price developments. Some central banks, in the 1980s and 1990s, used swaps and loans as a way of reducing their gold holdings, instead of outright sales. And there was a wide array of approaches to loans, repurchase agreements, swaps, and sales that were used by central banks back in those periods. Much of that is history now, however. Central banks are far less active in the gold market than they used to be.

Q: *What will this mean for overall central bank demand this year? Could we see net sales for the first time since 2009?*

A: Our expectation has been for net purchases of around 8.0 MM oz this year by central banks and monetary authorities. Depending on how the Venezuela economic trajectory unfolds, it is likely to reduce the net figure, but not wipe it out. Our initial assessment is that it will reduce net additions to official reserves by around 1.3 million ounces, with further swap expirations beyond December, and thus not showing up in 2017 data. So we do not expect to see net sales this year.

Q: *How about in 2018?*

A: We think further Venezuelan swap expirations and sales will occur in 2018, but that we still will see positive total central bank gold acquisitions in 2018. In fact, we project slightly higher net purchases, or have been until the Venezuelan situation unfolded last week.

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