

Official Sector Activity in Gold

First Half 2009



July 2009

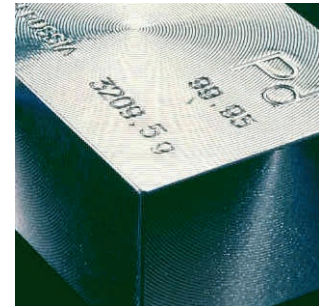


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Contents

Overview	4
Sales & Purchases by Country	5
Outlook for Central Bank Activity in the Gold Market	7
Focus Box: The Gold Lending Market	10

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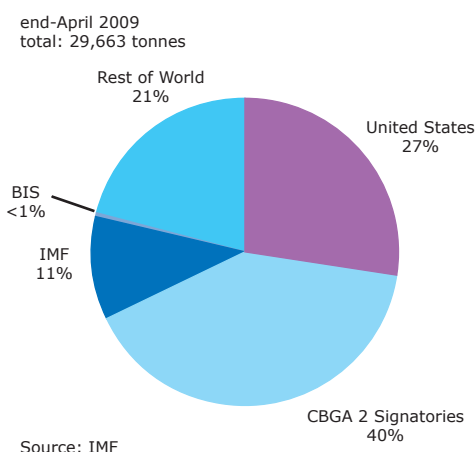
Overview

GFMS' estimates of the impact of official sector activity on the gold market are based on a combination of publicly available data and information collected through field research. The lag that often exists between central bank activity in the gold market taking place and it being identified means that our estimates may be revised in future. Data in this report should therefore be viewed with this caveat in mind.

Net official sector sales in the first half of 2009 are currently estimated to have totalled 39 tonnes, down by a hefty 73% year-on-year. This net figure was the product of gross sales of 95 tonnes and gross purchases of 56 tonnes. Looking at the quarterly development, the bulk of gross sales took place in the first quarter. Indeed, a combination of very low gross sales plus some moderate buying, resulted in the second quarter actually seeing modest net purchases overall by the official sector.

The low net official sector sales number registered in the first half was primarily driven by falling sales from Central Bank Gold Agreement (CBGA) signatories. Combined sales from the group are currently estimated at 92 tonnes over the period, 17% short of those recorded over the second half of last year and also down by 43% year-on-year. As the end of the second CBGA approaches (at the 26th September), total sales from current

Official Sector Gold Holdings



Background Information

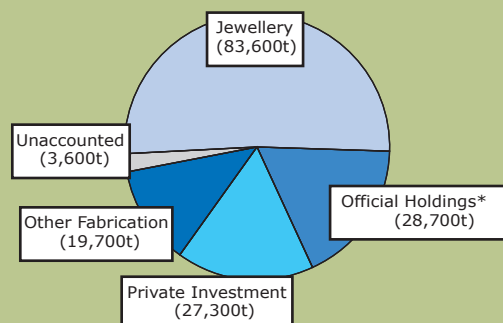
Largely due to gold having been the basis of monetary systems from as far back as the early part of the 18th century through to the 1960s, the yellow metal has continued to take up a significant portion of the official reserves of central banks around the world (a global average of 10% at end-April 2009). According to GFMS data, these holdings accounted for some 18% of total above-ground stocks of gold at end-2008. The figure is equivalent to nearly 12 years of global mine production at current levels.

Given this information, the importance of official sector gold activity to the market and for the price of the metal is self-evident. Moreover, history provides the evidence to support this. First of all, the shift by the official sector from a broadly neutral position in the 1970s and 1980s to substantial net sales in the 1990s and through to the current decade was a factor (among others) that resulted in gold prices falling well below the \$300 mark in the late 1990s. In addition, the rise in central bank lending over the 1990s provided the liquidity required for producers to enter short positions in gold, during a decade when producer hedging accounted for over 6% of annual gold supply.

More recently the "anti-gold" climate that was prevalent throughout the 1990s and in the early part of the current decade seems to have come to an end. Although the official sector remains a net seller overall, sentiment towards gold, as suggested by comments made by central bank officials, as well as the appearance of small-scale purchases by certain countries, has shifted to one considering the metal to remain an important reserve asset. This change in sentiment has been boosted particularly by the prolonged period of US dollar weakness, coupled with gold's strong performance and demonstrable portfolio diversification properties.

Above-Ground Stocks of Gold

Above-ground Stocks, end-2008 = 163,000t



* Excluding gold lent or supplied
Source: GFMS

members in the first nine months of the final Agreement year have reached just 140 tonnes, the lowest ever level since the start of the first CBGA in September 1999.

Countries outside the Agreement remained on the demand side of the market on a net basis in the first half, in aggregate generating total purchases of 56 tonnes of gold.

The year to-date has seen a further fall in the amount of bullion lent to the market by the official sector. There are two main reasons for this ongoing slide - the level of gold lease rates and heightened concerns over counterparty credit risk that were much enhanced by the collapse of Lehman Brothers last year. A detailed discussion of the lending market in 2008 as well as over the first six months of this year is provided in the dedicated focus box at the end of this report.

Sales & Purchases by Country

Sales

Gross central bank sales over the course of the first half of the year are estimated to have totalled 95 tonnes. Keeping with recent tradition, the vast majority of these sales were accounted for by signatories to the CBGA.

The biggest seller from within the CBGA group was France. The country's central bank sold nearly 44

tonnes of its reserves over the first five months of this year, and it seems likely that further sales also took place in June. The sales were part of France's plan to sell up to 600 tonnes under the current Agreement. By end-May this year, the central bank had sold 576 tonnes, in principal leaving the maximum amount of gold it could still sell under the current CBGA to no more than 24 tonnes.

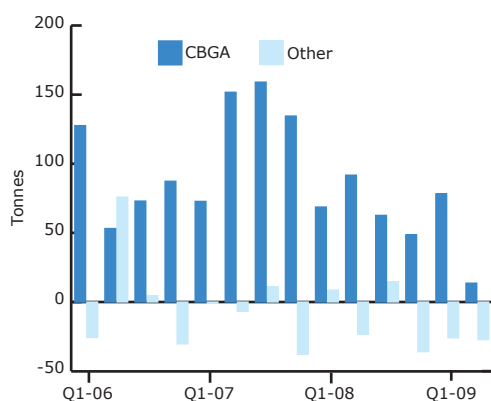
The second largest seller from within the CBGA was the European Central Bank (ECB). On 31st March 2009, the ECB completed gold sales amounting to 35.5 tonnes. Information contained in weekly financial statements of the Eurosystem suggests that at least part of these sales took place in the forward market.

Elsewhere, Sweden sold some six tonnes of its reserves in the first five months of this year. The country planned to sell 15 tonnes in the final CBGA year and has so far sold just over nine tonnes.

Greece reported a marginal decline in its gold holdings, which is believed to have been related to the minting of coins.

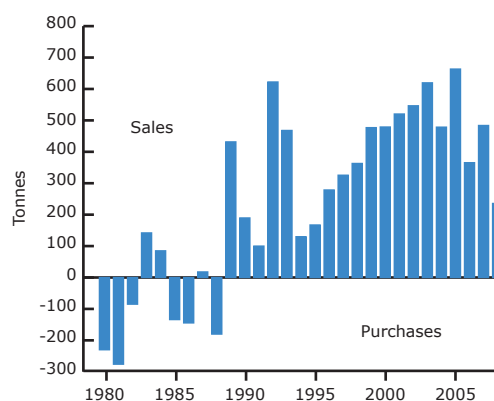
Finally, weekly financial statements of the Eurosystem suggest that approximately seven tonnes were sold by the group in June. Based on its selling pattern since the beginning of the current CBGA, at least part of that quantity is believed to have been accounted for by France.

Quarterly CBGA & Other Sales & Purchases



Source: GFMS

Annual Net Official Sector Sales & Purchases



Source: GFMS

Moving to sellers outside the CBGA, the annual report of the Bank for International Settlements released at the end of June confirmed that the institution had sold five tonnes over the 12-month period ending 31st March 2009.

Purchases

GFMS currently estimate that gross purchases in the first half of 2009 reached 56 tonnes. Although almost doubling year-on-year, gross purchases were 39% lower than they had been in the second half of 2008.

Once again the bulk of the purchases were accounted for by undeclared activities, details of which cannot be given in respect of confidentiality. Nevertheless, it is worth stressing that the gross purchases figure reflects moderate rises in a number of countries' holdings, often sourced locally, rather than any major addition to one or

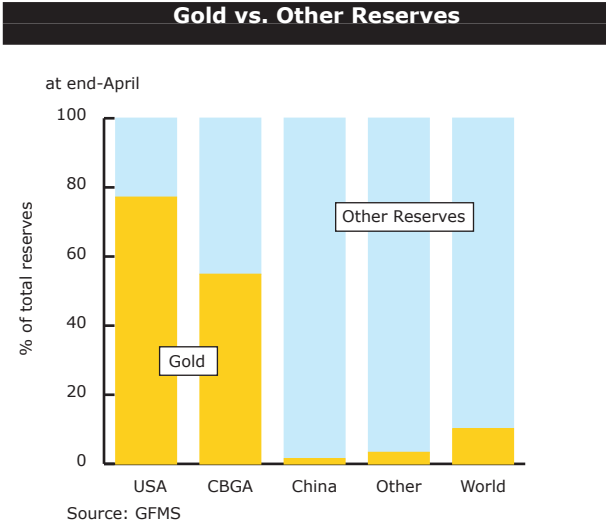
more central bank's gold reserves via operations in the international market.

The balance of central bank purchases consisted of a number of small declared increases in gold reserves, amounting to one tonne or less, from a handful of countries, including Mexico, the Philippines and Belarus.

As regards China's announcement in April this year that the country had increased its gold holdings by 75% from 600 to 1,054 tonnes since 2003, we believe such purchases would have gradually taken place over time and that there may also have been an element of transfer from non-monetary to monetary gold holdings. In any case, we see no evidence of large scale and direct purchases in the open market by this country either in 2008 or during the first few months of 2009.

Top-10 Foreign Exchange Holders	
(US\$ billion, end-May 2009)	
Country	Foreign Exchange Reserves
China	2,089
Japan	993
Russia	386
Taiwan	313
India	242
South Korea	212
Brazil	194
Hong Kong	193
Singapore	170
Algeria	141

Source: IMF; respective central bank websites



Outlook for Central Bank Activity in the Gold Market

GFMS expect that in the second half of 2009 central bank sales will remain at the low end of the spectrum, with net supply to the market from this source forecast to reach about 100 tonnes. If our expectations prove correct, this would mean that net official sector sales in 2009 overall, at some 140 tonnes, would record their lowest level since 1994's trough of 130 tonnes. To further put this year's drop in official sector supply into perspective, basis GFMS' data from 1999 to 2008 net sales averaged no less than 487 tonnes per annum.

Our second half forecast is based on the assumption that net sales from within the CBGA will remain low, largely as sales targets are met and new sellers fail to emerge, while net purchases outside the group will keep at modest levels. Indeed, in the last edition of this report, GFMS had already pointed out that sales from CBGA signatories would see a sizeable fall this year. However, the decline in CBGA sales more recently has exceeded our expectations, with for example Eurosystem disposals in the first three weeks of July totalling less than one tonne.

After the current CBGA expires in September this year, we expect sales from its members will remain very subdued. This is mainly due to the unwillingness of the four largest large bullion holders within the group, namely Germany, France, Italy and Switzerland, to embark on any new or large scale sales programmes.

Starting with Switzerland, the second largest seller under the current CBGA, as discussed in our previous report, the country completed its sales programme last September, having already confirmed that it had no intention to sell more gold over the medium term. Moving to Germany, in late January this year, the German Finance Minister

Peer Steinbrueck warned against the central bank selling gold, in response to the call made by the country's budget office that the Bundesbank should consider selling gold or foreign exchange reserves in order to help finance government stimulus measures. This development plus the Bundesbank's repeated decision not to take up its 600-tonne sales quota under the current CBGA suggests that it is unlikely that we will see any large scale disposals from the country in the next few years.

More recently, there has been much discussion taking place over the prospect of sales from Italy as the government plans to impose a tax on notional gains in the value of gold reserves held by the Banca d'Italia. Despite the new tax proposal, we remain of the view that major gold sales by Italy are not probable over at least the medium term. We have come to this conclusion partly because any decision to make sales would be the responsibility of the Banca d'Italia and the ECB and not that of the Italian government.

Finally, as discussed elsewhere in this report, France is on the verge of completing 600 tonnes of gold sales under the current CBGA. Since the decision was made to sell up to 20% of the country's gold holdings, the global financial backdrop has changed dramatically and gold's performance in euro terms has been fairly impressive. We would expect such considerations to mean that any new sales programme is unlikely to be initiated for some time to come.

Outside the Agreement, we expect other countries will in aggregate remain modest net buyers of gold. Strategic purchases of limited magnitude, such as those seen over the first half of this year, remain probable both for the purposes of reserve diversification and, more broadly, on national security grounds. However, we doubt that any major acquisitions will take place, in large measure due to the potential for such purchases in the

open market to disrupt gold and foreign exchange markets and also for them to create political difficulties at a time when the financial system is particularly fragile and requires a common front to be presented (at least in public) by the main economic powers.

These observations are especially pertinent when it comes to the world's largest holder of foreign exchange, China. As previously mentioned, a few months ago the country announced a 454-tonne increase in its gold holdings. We believe the principal reason why China has increased its gold reserves is the need for the central bank to diversify its reserve portfolio away from huge dollar dominated foreign exchange reserves.

Looking forward, over the long run there is a good chance that China will increase further its gold holdings. This is because the yellow metal provides a useful, albeit limited, form of diversification and the ultimate store of value and hedge against currency depreciation. Nevertheless, any direct, large scale purchases from China in the open market would seem very unlikely, as such a move would not only have a profound impact on the gold market but would also potentially place the value of its US dollar holdings under extreme pressure and, to put it mildly, 'complicate' the country's relations with the United States, its largest trading partner. Thus instead of more visible and highly sensitive transactions in the international market, we may see further discreet and relatively modest official purchases in the local gold market.

Returning to the outlook for official sector activity outside the CBGA over the rest of this year, we would conclude that on the (gross) sales side, there is little scope for major disposals outside the CBGA. Instead, a handful of countries may be sellers of moderate amounts of gold, either to raise foreign exchange or to take advantage of the higher gold prices that we expect to materialise before the end of the year.

It should be noted that our forecast for gross sales in the second half of 2009 explicitly excludes any disposals this year by the IMF. After the US House of Representatives' passage in June this year of a bill which would effectively allow the IMF to sell 403.3 tonnes of gold, the sales programme is expected to be agreed by the Fund members.

Basis the recent announcement made by a senior director from the Fund, to avoid disruptions to the gold market, the planned sale of 403 tonnes of gold will take place within a new European central bank gold pact which is currently being negotiated. However, given that the deciding vote by the Fund's member countries is not expected before the final quarter of this year, we remain doubtful that any IMF gold sales will take place in calendar 2009.

Central banks' swing into net demand territory during the second quarter of 2009 was something of an exception. We do not believe that this heralds a sustained shift by the official sector from being a net seller to a net buyer. This is above all the case over the next two to three years due to the very high probability that the IMF will dispose of 403 tonnes of gold. In this sense, ongoing net supply from official stocks will continue to be a negative for the price, albeit more moderately so than in the not too distant past when annual disposals typically were around the 500 tonne level. However, looking at the trend in official sector sales and the greater risk these days of 'buy side' surprises, one might conclude instead that this area of the market has become more positive than negative for the price, especially taking into account the impact this all has on investor sentiment. In conclusion, the official sector, which after all accounts for some 18% of global above-ground stocks of gold, will continue to be an important focus for the market, in particular given changing attitudes towards gold and the increasing pressure for fundamental changes to the international financial system.

Gold & Other Official Reserves

	Country	Gold in Tonnes	Gold in US\$ bn ¹	Other Reserves in US\$ bn	Gold as % of Total Reserves	Data as of end-
1	United States	8,134	255.1	70.7	78.3%	May
2	Germany	3,413	107.0	44.7	70.5%	May
3	Italy	2,452	76.9	36.8	67.6%	May
4	France	2,448	76.8	28.6	72.9%	May
5	China	1,054	33.1	2,093.1	1.6%	May
6	Switzerland	1,040	29.5	49.9	37.2%	April
7	Japan	765	24.0	1,000.0	2.3%	May
8	Netherlands	612	19.2	11.8	61.9%	May
9	Russia	540	17.0	387.3	4.2%	May
10	Taiwan	424	12.5	300.1	4.0%	March
11	Portugal	383	12.0	1.1	91.6%	May
12	India	358	10.2	242.7	4.0%	April
13	Venezuela	356	10.5	17.6	37.4%	March
14	United Kingdom	310	9.7	46.0	17.5%	May
15	Lebanon	287	8.5	22.2	27.5%	Mar
16	Spain	282	8.8	12.6	41.1%	May
17	Austria	280	8.8	12.6	41.0%	May
18	Belgium	228	7.1	9.9	41.9%	May
19	Algeria	174	4.9	141.6	3.4%	April
20	Philippines	155	4.9	34.7	12.3%	May
21	Libya	144	4.2	94.3	4.3%	March
22	Saudi Arabia	143	4.5	29.7	13.1%	May
23	Sweden	131	4.1	25.3	14.0%	May
24	Singapore	127	4.0	171.5	2.3%	May
25	South Africa	125	3.9	31.9	10.9%	May
26	Turkey	116	3.6	68.0	5.1%	May
27	Greece	112	3.5	0.4	90.1%	May
28	Romania	104	3.3	37.8	7.9%	May
29	Poland	103	3.0	58.2	5.0%	Mar
30	Thailand	84	2.6	118.9	2.2%	May

¹ Market valuation based on end-month gold prices respectively
Source: IMF and central bank websites

The Gold Lending Market

The purpose of this focus box is to provide a detailed discussion of central bank gold lending, focusing on developments over the 18 month period to end-June, as well as to outline GFMS' expectations on central bank lending going forward. Particular emphasis is given to how this ties into the wider gold lending market as well as its impact on gold borrowing costs.

The official sector has traditionally been the dominant source of gold supplied to the lending market. Although this continues to be the case, the amount lent has dropped considerably in recent years. According to GFMS data, lending by central banks and other official institutions peaked at over 4,600 tonnes in 2000. By the end of 2008 the figure had dropped to just under 1,900 tonnes, with a further fall of nearly 600 tonnes taking place during the course of last year. Moreover, the first half of 2009 has reportedly seen another sizeable reduction in lending.

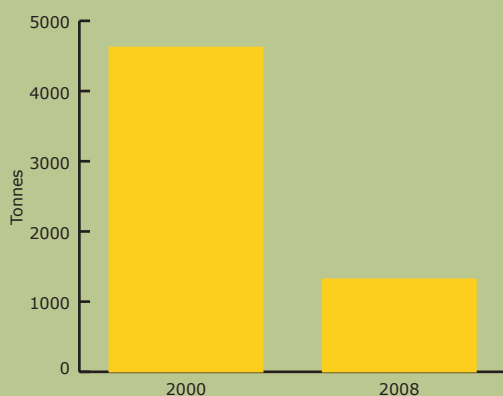
The bulk of this decline can be explained by the slide in gold leasing rates over much of the current decade. For instance, from 1998-2001

3-month leasing rates averaged around 1.4%, whereas from 2002-2008 the comparable average slumped to less than 0.3%. In addition to return considerations, which have not gone away, since the start of the credit crisis lenders have become increasingly focused on the safety of their gold deposits with commercial banks.

These concerns over counterparty credit risks became even greater in the wake of the failure of Lehman Brothers last September. As a result, many central banks decided to cut the number of institutions they were prepared to deal with and required high quality collateral against even short term loans. These developments have together resulted in a much less smoothly functioning lending market and to a re-pricing of liquidity, something to some extent seen in the jump in leasing rates during the latter part of 2008. Indeed, during September and early October these rose by over 200 basis points, with the 3-month reaching a peak of 293 basis points on 8th October.

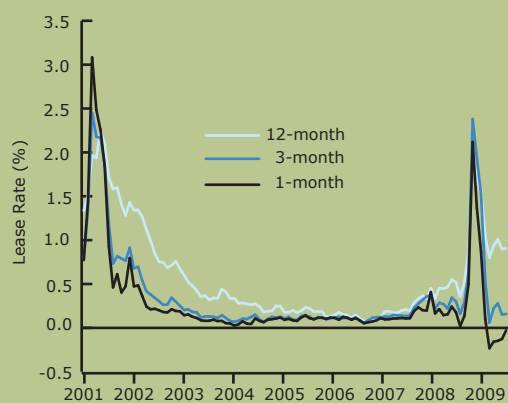
Even though leasing rates this year have dropped back considerably, we do not believe that this is due to the generally greater risk appetite seen in

Central Bank Gold Lending



Source: GFMS

Gold Leasing Rates - Historical



Indicative only - calculated using daily Libor & Gofu data
Source: LBMA

recent months; our information is that this is yet to have much impact on central banks' willingness to lend out their gold.

There are several reasons why published gold leasing rate data has only partly reflected the drop in official sector lending referred to above. First, for most of the time that central banks have been running down their swaps and deposits, investors' unallocated long positions have increased and these have provided some offsetting liquidity to the market. Second, and more importantly, there have been important declines in borrowing demand over the 2001-2008 period. The most critical of these concerns producer hedging, where the overall book has slumped by nearly 2,600 tonnes since 2001.

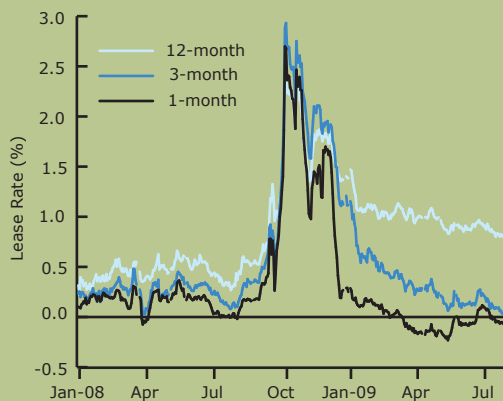
The reduction in borrowing has also come about due to the slide in fabrication demand over the same period, something that will have been particularly acute over the last six months. Third, since the onset of the credit crisis there has been increasing scepticism that published leasing rate data accurately reflects prices in the actual market. The explanation for this is that credit spreads have widened considerably, both between central banks and commercial banks and in the interbank

market, with the result that deals being struck for similar quantities at the same tenor can be priced very differently depending on which bank is the counterparty of the lending institution.

Looking ahead and focusing specifically on the second half of 2009, GFMS expect central bank lending will continue to contract. Whether this will be at a somewhat slower pace than what was seen last year and, even, in the first six months of this year, is hard to tell. On the one hand, the improving health of commercial banks should eventually lead to some greater willingness to lend on the part of central banks. On the other, published leasing rates have dropped back to very unattractive levels. For example 3-month gold averaged only 20 basis points in the second quarter.

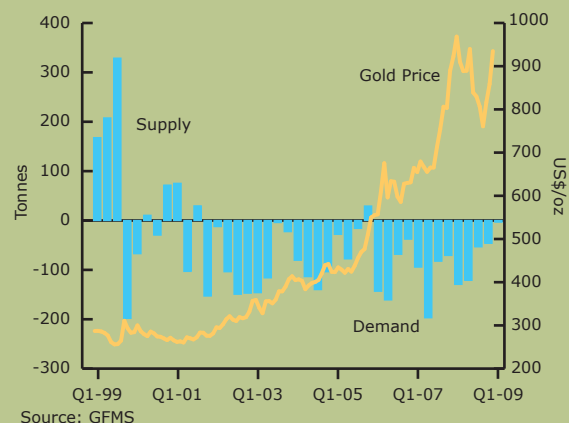
As for the level of leasing rates, we would expect ongoing declines in central bank lending eventually to push up borrowing costs, especially given the fact that producer de-hedging is slowing considerably this year. Nevertheless, we are doubtful that any major jump in rates can be sustained unless and until borrowing demand picks up considerably, something that looks improbable over at least the next six months.

Gold Leasing Rates



Indicative only - calculated using daily Libor & Gofo data
Source: LBMA

Net Producer (De-)hedging



Source: GFMS

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