

What sets the Gold Price – Is it the Paper Market or Physical Market?



your email address

See if you can find the flaws of reason and argument in this article. Answers provided after the article.

The following article is arranged in Question and Answer (Q & A) format. Through the Q & A approach, this article raises some important issues about price discovery in the gold markets and aims to explain the view that the gold price is being set by the paper gold markets.

BullionStar's CEO Torgny Persson and precious metals analyst Ronan Manly are of the opinion that due to the structure of contemporary gold markets, it is primarily trading activity in the paper gold markets which sets the international price of gold.

Question: The international gold price is constantly quoted in the financial media alongside other major financial indicators. What is this international gold price, and how is it defined?

The international gold price usually refers to the price of gold quoted in US Dollars per troy ounce as traded on the 24-hour global wholesale gold market (XAU/USD). Gold is traded non-stop globally during the entire business week, creating a continuum of international gold price quotes from Sunday evening New York time all the way through to Friday evening New York time. Depending on the context, this international gold price sometimes refers to a spot gold market quote, such as spot gold traded in London, and at other times may refer to the front month of a gold futures contract price as traded on the [US Commodity Exchange \(COMEX\)](#). The front month contract is a nearby month which will usually exhibit the highest trading volume and activity.

The international gold price can also at times be referring to the LBMA Gold Price benchmark price as derived during the London daily gold price auctions (morning and afternoon auctions). LBMA is an abbreviation for [London Bullion Market Association](#).

Therefore, this 'international price' could be referencing a spot gold price, a futures gold price, or a benchmark gold price, but all three would, at a comparable time, be roughly similar in magnitude.

Question: Where does this international gold price come from, where is it derived?

Recent empirical research has determined that gold price discovery is jointly driven by London Over-the-Counter (OTC) spot gold market trading and COMEX gold futures trading, and that the "international gold price" is derived from a combination of London OTC gold prices and COMEX gold futures prices. See "[Who sets the price of gold? London or New York](#) (2015)" by Hauptfleisch, Putniņš, and Lucey.

In general, the higher the trading volume and liquidity in a specific asset market, the more that market contributes to discovering prices for that asset. This is also true of the global gold market. Between them, the London OTC and New York trading venues account for the vast majority of global gold trading volume, and in 2015, the London OTC spot market represented approximately 78% of global turnover while COMEX accounted for another 8% (See Hauptfleisch, Putniņš, and Lucey (2015)).

Based on London gold clearing statistics for 2016, a quick calculation shows that total trading volume in the London OTC gold market is estimated to have been at least the equivalent of 1.5 million tonnes of gold in 2016, while trading volume of the 100 oz COMEX gold futures contract reached 57.5 million contracts during 2016, equivalent to 179,000 tonnes of gold. Gold trading volume on the London OTC gold market in 2016 was therefore about 8.4 times higher than in the COMEX 100 oz gold futures contract.



LBMA Unallocated Gold Trading, 1.5 million tonnes in 2016

However, COMEX has been found, by the above academic research, to have a larger influence on price discovery than London OTC, despite the lower trading volumes of COMEX. This is most likely due to a combination of factors such as COMEX' accessibility and extended trading hours via use of the GLOBEX platform, the higher transparency of futures trading compared to OTC trading, and the lower transaction costs and ease of leverage in COMEX trading. In contrast, the London OTC gold market has limited trading hours (during London business hours), barriers to wider participation since it's an opaque wholesale market without central clearing, and trading spreads which are dictated by a small number of LBMA bullion bank market makers and a handful of London-based commodity brokerages.

The bottom line though is that both sets of trading statistics, London OTC and COMEX, are gigantic in comparison to the size of the underlying physical gold markets in London and New York.

Question: So, does the physical gold market or the paper gold market set this international price of gold?

The international gold price is purely set by paper gold markets, in other words it is set by non-physical gold markets. Based on their respective gold market structures, the London OTC gold market and COMEX are both paper gold markets. Supply of and demand for physical gold plays no role in setting the gold price in these markets. Physical gold transactions in all other gold markets just inherit the gold prices that are discovered in these paper gold markets.

The London OTC gold market predominantly involves the trading of synthetic unallocated gold, where trades are cash-settled and not physically delivered (i.e. no delivery of physical gold). These synthetic gold transactions have little connection to any underlying gold holding, hence they are de facto gold derivative positions. By definition, unallocated gold positions are just a series of claims on bullion banks where the holder is an unsecured creditor of the bank, and the bank has a liability to that claim holder for an amount of gold. The holder, on its side, takes on credit risk towards the bullion bank. The London OTC gold market is therefore merely a venue for trading gold credits.

The London OTC gold market is also one in which the bullion banking participants employ fractional-reserve gold trading to create large amounts of *paper gold* out of thin air (analogous to commercial lending), where the trading is also leveraged and opaque, and where this paper gold is only fractionally backed by physical gold. This “gold” is essentially synthetic gold. See BullionStar Gold university article "[Bullion banking Mechanics](#)" for further details on fractional-reserve gold trading.

Since COMEX only trades exchange-based gold futures contracts, it is, by definition, a derivatives market. Cash-settlement is the norm. Only 1 in 2500 gold futures contracts traded on COMEX is delivered. The rest are cash-settled. This means that 99.96% of COMEX gold futures contracts are cash-settled. See [BullionStar US Gold Market Infographic](#) for details.

Given COMEX trading gold futures and London trading synthetic unallocated gold, both the London and COMEX gold markets essentially trade gold derivatives, or paper gold instruments, and by extension, the international gold price is being determined in these paper gold markets.

Beyond the London OTC gold market and COMEX, all other gold trading venues are predominantly price takers that take in and use the gold prices established by London and New York. These other markets include physical gold markets around the world which look to the international gold price as an input into their domestic gold price setting mechanisms and conventions.

Question: Explain a little more about the market structures of these London OTC and COMEX markets?

By definition, futures trading is trading of securities whose value is derived from an underlying asset but whose securities are not those of the underlying asset, i.e. derivatives. COMEX gold futures contracts are derivatives on gold. COMEX registered gold stocks are relatively small, very little physical gold is ever delivered on COMEX, and even less physical gold is withdrawn from COMEX approved gold vaults. COMEX gold trading also employs significant leverage. Hauptfleisch, Putniņš, and Lucey (2015) state that “*such trades [on COMEX] contribute disproportionately to price discovery*”. Note that the COMEX gold futures market is actually a 24-hour market but its liquidity is highest during US trading hours.

Turning to the London OTC gold market, nearly the entire trading volume of the London OTC gold market represents trading in unallocated gold, which to reiterate, merely represents a claim by a position holder on a bullion bank for a certain amount of gold, a claim which is rarely exercised. London OTC gold trades also predominantly cash-settle. Traders, speculators and investors in unallocated gold positions virtually never take delivery of physical gold.

This is a fact confirmed by a [UK HMRC / LBMA Memorandum of Understanding published in 2013](#) which states that in the London gold market “*investors acquire an interest in the metals, although in most situations, physical delivery will not occur and in 95% of trades, trading in unallocated metals will be undertaken.*” Additionally, in 2011, the then LBMA CEO Stuart Murray also confirmed that there were ‘[very substantial amounts of unallocated gold](#)’ held in London.

A [2015 legal opinion on unallocated gold drafted by respected global law firm Dentons](#) describes unallocated gold as ‘synthetic’ gold and as a derivatives transaction.

Dentons states that “*the reality of unallocated bullion trading is that buyers and sellers rarely intend for physical delivery to ever take place. Unallocated bullion is used as a means to have “synthetic” holdings of gold and so obtain exposure to the price of gold by reference to the London gold fixing.*”

Although the LBMA does not publish gold trading volumes on a regular basis, it did publish a [one-off gold trading survey covering Q1 2011](#) in which it was revealed that during the first quarter of 2011, 10.9 billion ozs of gold (340,000 tonnes) were traded in the London OTC gold market. During the same period, 1.18 billion ozs of gold (36,700 tonnes) were cleared in the London OTC gold market. This would suggest a trading turnover to clearing turnover ratio of 10:1. In the absence of live trading data from the London OTC gold market, this 10:1 proxy ratio can continue to be applied as a multiplier to the LBMA London Gold Market daily clearing statistics, which are published every month, and which are always phenomenally high.

For example, *average daily* clearing volumes in the London Gold Market during [January 2017](#) totalled 20.5 million ounces. That’s the equivalent 638 tonnes of gold *cleared* per day in London. On a 10:1 trading to clearing multiple, that’s the equivalent of 6,380 tonnes of gold *traded per day*, or 1.6 million tonnes of gold traded per year.

Since there are only about 6,500 tonnes of gold stored in London, [most of which represents static holdings of central banks, ETFs and other holders](#), the London OTC gold trading activities are totally disconnected from the underlying physical gold holdings. Furthermore, only about 190,000 tonnes of gold have ever been mined throughout history, half of which is estimated to be held in the form of jewellery. Therefore, the trading of nearly 6,500 tonnes of gold per day within the London OTC gold market has nothing to do with the physical gold market, yet perversely, this trading activity drives global gold price discovery and the pricing of physical bullion trades and transactions.

Revealingly, according to the LBMA bullion bankers who established the reporting of London gold clearing statistics, the then LMPCL chairman, Peter Fava, and JP Morgan’s Peter Smith,

the LBMA gold clearing statistics include trading activities such as “*leveraged speculative forward bets on the gold price*” and “*investment fund spot price exposure via unallocated positions*”, activities which are just side-bets on the current gold price. See October 2003 article titled “[Clearing the Air Discussing Trends and Influences on London Clearing Statistics](#)“, from LBMA Alchemist Issue 32.

In essence, trading activity in the London gold market predominantly represents huge synthetic artificial gold supply, where paper gold trading is deriving the price of gold, not physical gold trading. Synthetic gold is just created out of thin air as a book-keeping entry and is executed as a cashflow transaction between the contracting parties. There is no purchase of physical gold in such a transaction, no marginal demand for gold. Synthetic paper gold therefore absorbs demand that would otherwise have flowed into the limited physical gold supply, and the gold price therefore fails to represent this demand because demand has been channelled away from physical gold transactions into synthetic gold.

Likewise, if an entity dumps gold futures contracts on the COMEX platform representing millions of ounces of gold, that entity does not need to have held any physical gold, but that transaction has an immediate effect on the international gold price. This has real world impact, because many physical gold transactions around the world take this international gold price as the basis of their transactions.

Although gold clearing volumes and the LBMA's market survey provide some useful inputs into calculating London gold trading volumes, there is very little known publicly about how much physical gold actually trades in the London gold market. This is because [the LBMA and its member banks choose not to reveal this information](#). There is no trade reporting in the London OTC gold market, no reporting of physical gold vault positions, no reporting of the unallocated gold liabilities of LBMA member bullion banks, and no reporting of how much physical gold in total these bullion banks retain to back up their fractional-reserve unallocated gold trading system. However, physical gold trading is by definition an extremely minuscule percentage of average daily trading volumes in the London OTC gold market. For details on the workings of the gold market in London, see BullionStar Infographic the “[London Gold Market](#)”.

While one of the three components that comprise the London gold clearing statistics is stated to be “physical transfers and shipments by LPMCL clearing members”, the LBMA doesn’t even see fit to publish a breakdown of these 3 components. This compounds the secrecy and is another example of where bullion banks and central banks keep the global gold market in the dark about how much gold is being physically transferred and shipped

Question: How do local gold markets around the world use the international gold price?

Local gold markets all around the world look to the international gold price, and take in this gold price, usually quoting their local country gold prices in comparison to the international gold price.

In the physical gold market, product pricing of gold coins and bars is based on a combination of the spot gold price plus a premium. The premium is that part of the product price in excess of the value of the precious metal contained in the coin or bar. Given that the physical gold market is a

price taker, physical gold market spot prices feed in from where the price is being discovered, i.e. the international gold price.

For example, the 2017 issue of the Royal Canadian Mint 1 troy ounce Gold Maple Leaf bullion coin is [quoted on the BullionStar website](#) at a US dollar price which reflects the US dollar spot price of gold plus a premium.

Gold coin and gold bar premiums are based on a number of factors. Part of the premium will reflect natural minting / refining costs such as fabrication, marketing, distribution and insurance costs. If the products have been distributed through a wholesaler, the premium will reflect a wholesaler mark-up. Another component of a premium is semi-variable and reflects physical market imbalances caused by supply and demand fluctuations. If demand for a gold coin or gold bar is high, its premium will increase. If supply of the product is abundant, the premium would tend to be lower than if in short supply.

In general, premiums on gold coins are higher than those on gold bars, while premiums on large gold coins and gold bars are lower than premiums on smaller gold coins and gold bars.

Question: What contribution does the Shanghai Gold Exchange make to gold price discovery and does the SGE, with its large physical trading, influence the international gold price?

The Shanghai Gold Exchange (SGE) is the world's largest *physical gold exchange* and nearly all physical gold bars in China flow through the SGE. Gold trading volumes and gold withdrawal statistics for the SGE are certainly impressive. For the year 2016, total SGE gold trading volumes reached 24,338 tonnes, a 43% increase over the 2015 figure of 17,033 tonnes. SGE trading volumes include physical contracts, deferred contracts, OTC trades settled through the SGE, and also trading volumes on the Shanghai International Gold Exchange (SGEI). In 2016, physical gold withdrawals from the SGE totalled 1,970 tonnes, down 24% from 2015's withdrawals of 2,596 tonnes, but still huge on an absolute basis because these withdrawals represent actual physical gold taken out of the SGE vaults.

By the end of 2016, the SGEI (International Bourse), which was launched in September 2014, had recorded cumulative trading of nearly 9,000 tonnes of gold. The Shanghai Gold Benchmark Price (a.k.a. Shanghai Gold Fix), which was launched on 19 April 2016, is a gold auction for 1 kilo gold bars of 99.99 purity quoted in RMB. Over the 8 months from launch to end of 2016, the Shanghai Gold Fix had traded 569 tonnes, which equates to over 1.5 tonnes per day on average.

All in all, the SGE has generated impressive physical gold trading volumes (24,338 tonnes for 2016) and withdrawals (1,970 tonnes for 2016). For the sake of comparison, compare these annual SGE physical gold trading volumes to the bloated London OTC gold market where trading volumes of approximately the equivalent of 6,500 tonnes of gold *per day* are the norm. Such a comparison reveals the fractional-reserve nature of the London gold market and the fact that physical transactions can only be a minuscule fraction of the London market.

But does SGE trading affect the international gold price as derived in the London OTC and COMEX markets, or is the SGE a price taker?

The short answer is that the SGE does not influence the international price and the SGE is a price taker. There may be some lagged influence by the SGE on the international price but this would require further study. The Chinese gold market is still a closed gold market with market frictions and distortions. Gold can be imported into China but cannot in general be exported out of China. There is therefore no freedom of movement of gold out of China. Gold imports into China are strictly controlled via import licenses and these licenses are only issued to a small number of Chinese and foreign banks.

But it's worth looking at SGE premiums to see if changes in SGE premiums ever provide any signalling ability for subsequent changes in the international gold price. SGE premiums arise when the Shanghai gold price trades above the international gold price. SGE premiums are a possible gauge to determine whether SGE trading affects the international gold price. In November and December 2016, SGE premiums rose sharply from less than 0.5% to over 3% which was a period in which gold imports into China surged. However, during that same period, the international gold price fell. So in this case, the expanding SGE premiums had no effect on the international gold price.

A recent study by Metals Focus (MF) consultancy, titled "[*Links Between the Chinese and International Gold Prices*](#)" found that the correlations between changes in the LBMA Gold Price (AM) and SGE premiums are not significant and were in some cases even found to be negative, which in summary means that SGE trading was not affecting the international gold price. MF also calculated some lagged correlations to see if SGE premiums influence subsequent changes in the LBMA Gold Price, due to, for example, *"increased shipments of bullion to China" over subsequent days* and claims that *"SGE premiums have a modest but positive and statistically significant impact on future gold price [LBMA Gold Price] moves"* however, correlation is not causation. Properly functioning financial markets are supposed to instantaneously reflect pricing information in other markets, not take days to reflect it. There are also too many other variables which could also be responsible for explaining why the LBMA Gold Price moved higher after SGE premiums had previously moved higher.

However, unlike the OTC and COMEX, the Shanghai Gold Exchange is structured around physical gold price discovery. The establishment of a gold exchange in Shanghai was first referenced in China's 10th Five Year plan in 2001 as an integral part of the nation's gold liberalisation strategy. Following its launch in 2002, the SGE was quick to promote physical gold ownership and by 2004 was allowing private citizens in China to transact on the Exchange and purchase gold bullion. On the SGE, physical delivery of gold is the norm, not the exception. The SGE has a network of [61 gold vaults in 35 cities](#) across China.

This makes the SGE a nature candidate to take the lead in pricing real physical gold and acting as a physical gold price discovery centre if and when the physical gold markets detach from the paper gold markets, and physical gold demand and supply becomes the natural determinant of the international gold price.



LBMA GOLD PRICE



LBMA Gold Price auction

Question: What is the significance of the LBMA Gold Price?

The [LBMA Gold Price](#) is a twice daily auction for unallocated gold controlled by the LBMA, whose final output is a benchmark gold price. The auction is conducted in US Dollars, however the derived price is also published in 11 other currencies. This auction is the successor to the London Gold Fixing and the benchmark is now a 'Regulated Benchmark' under UK financial regulations and is administered by ICE benchmark Administration (IBA), part of the ICE exchange group. But the new auction mechanics are fundamentally similar to the older London Gold Fixing mechanics. The auction opening prices are based on COMEX and London OTC price quotations and trading prices at auction opening times, i.e. at 10:30 am and 3:00 pm respectively.

Structurally, the LBMA Gold Price auction has very narrow direct participation, with only a handful of LBMA member bullion banks being authorised by the LBMA to take part. These are the same bullion banks which are the market makers and largest traders in both London OTC gold market trading and in COMEX futures gold trading. The LBMA Gold Price auctions therefore lack broad market participation and is not representative of the broader gold market. The LBMA and ICE Benchmark Administration also refuse to reveal the identities of the auction chairpersons, a refusal which suggests that those now involved have connections to the former scandal tainted London Gold Fixing auction. See "[Six months on ICE – The LBMA Gold Price](#)" for more details.

Not surprisingly, the LBMA gold auctions also settle in unallocated gold, so trading and settlement in the auction is also detached from physical gold markets. Trading volumes in the daily gold auctions usually only reach the equivalent of 1-2 tonnes of unallocated gold transfers, and rarely exceed 3 tonnes. So not only do the LBMA gold auctions not offer wide participation to the thousands of gold trading entities around the world, the volumes traded in the auctions are

not representative of the global gold market and the benchmark is therefore not a reliable representation of the global gold market.

Perversely however, the LBMA Gold Price benchmark price is very influential in the gold world in that it is a widely-used valuation source for gold-backed Exchange Traded Funds (ETFs) such as the SPDR Gold Trust and the iShares Gold Trust. Furthermore, it is often used by physical bullion dealers when purchasing physical gold from refineries and suppliers. The LBMA Gold Price is also widely used as a benchmark for valuing financial products such as ISDA gold interest rate swaps, gold options and other gold derivatives, and is even used by other futures exchanges as a reference point on their gold futures contracts, for example the gold futures contract (FGLD) of the Malaysia Derivatives Exchange.

Therefore, this reference price and auction, which is controlled by a handful of bullion banks under the banner of the LBMA, is based on trading synthetic gold, but is referenced widely around the world in countless gold contracts and in countless physical gold markets and retail gold outlets.

Even very large central bank physical gold transactions take this gold fixing reference price derived in London and then use it as a price with which to execute their own independent bi-lateral transactions. For example, when the Swiss National Bank used the Bank for International Settlements (BIS) gold trading desk as its agent to sell hundreds of tonnes of physical gold in the early 2000s, the transaction prices used for the transfers were based on taking the London Gold Fixing price as a reference price. As another example, in 2010, the IMF's so-called 'on-market' gold sales were conducted by a selling agent who also based the sales transfer prices on the London Gold Fixing price. This is the same London Gold Fixing that is [currently under investigation](#) in a New York court class action suit.

Of concern here is that a benchmark that was controlled by a cartel of London-based bullion banks, that was opaque in its operation, and that is currently the subject of a gold price manipulation class action suit, was being used to value very large physical gold transactions. The question must be asked, was this benchmark fit for purpose and to what extent was it representative of the underlying worldwide physical gold market.

Question: So what about outside London and US / NY trading hours. Do other markets contribute more during these other times, for example TOCOM in Japan and MCX in India?

In general, higher trading volumes mean more liquidity to drive price discovery. But since financial markets are integrated, price information rapidly flows between markets due to simultaneously and overlapping trading. Futures markets such as TOCOM in Japan and MCX in India do contribute to gold price discovery, especially at times when the larger markets are not trading, but because these other venues are less liquid, COMEX tends to lead in the lead-lag analysis of futures prices. This finding is according to a [study by financial academics from Bangkok University](#) led by Rapeesorn Fuangkasem.

Question: How does gold lending affect the gold price?

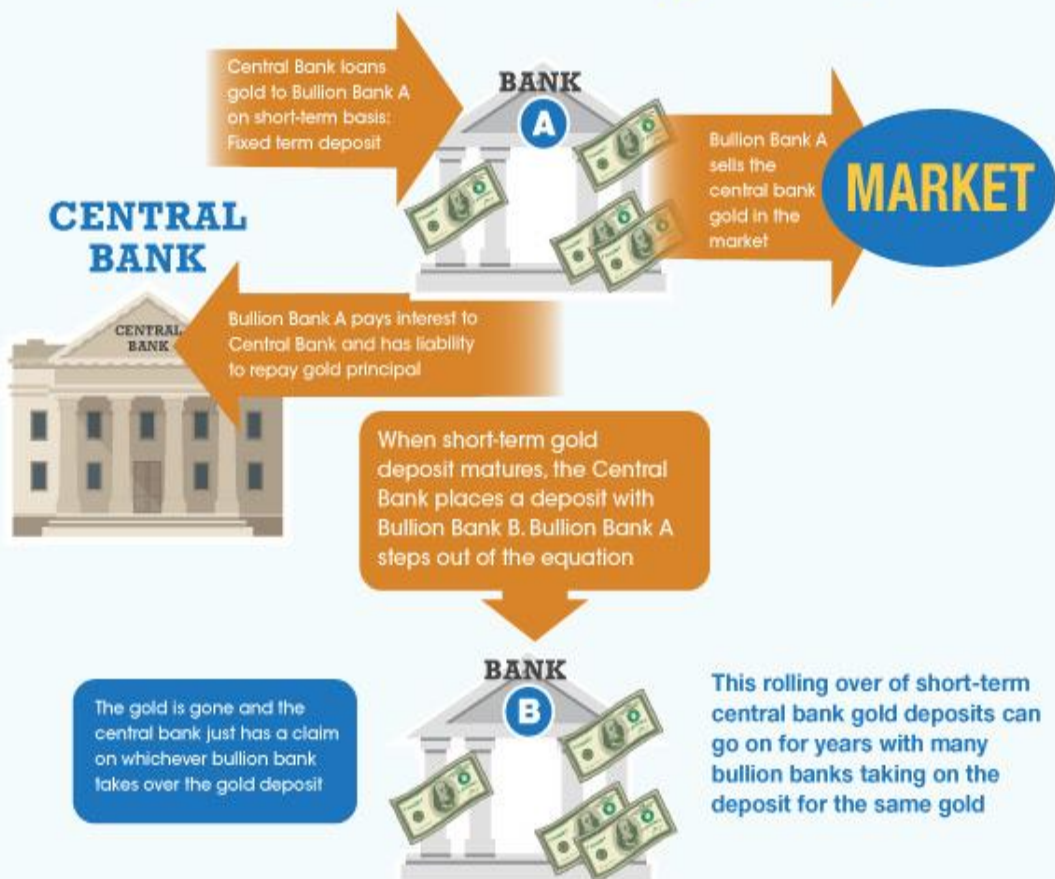
The Gold Lending Market is centred in London at the Bank of England. It is here that central banks and commercial bullion banks interact in the execution of ultra-secretive lending and swaps transactions which increase the available supply of gold. Bullion banks euphemistically refer to this as liquidity provision but these transactions act as a supply overhang on the gold market. Few if any transactional details about the gold lending market are ever made public. If gold lending trade details were market-wide knowledge, their impact would be immediately reflected in the gold price. But they are not. Secrecy about central bank gold lending transactions therefore makes this market informationally inefficient. And when a market is informationally inefficient, the prices in that market do not necessarily reflect the non-public information in that market. Likewise gold lending and gold swaps are not reported distinct from central bank gold holdings. In the perverse world of central bank accounting policies, gold held and gold lend/swapped is merely reported as one line item of 'Gold and Gold Receivables' on central banks' balance sheets. Therefore, the real state of central bank gold holdings is obscured for any central bank engaged in gold lending or gold swaps.

Gold Lending also provides borrowed physical gold for bullion banks to engage in leveraged fractional-reserve bullion banking and trading, mostly in London where the international spot gold price is predominantly determined. Therefore, gold lending, the leveraged and fractional-reserve nature of gold trading, and the lack of reporting of real central bank gold holdings, all align to have a potentially depressing effect on the gold price as discovered in the London Gold Market.

CENTRAL BANK GOLD LENDING VIA BULLION BANKS

Central banks lease gold to bullion banks in return for a gold claim (gold deposit) which pays a modest annual interest of about 1%.
The bullion banks sell this gold into the market

Bullion banks then roll over short-term central bank gold deposits



When a bullion bank leases gold, it loses ownership of the gold in return for a claim of gold. The central bank is then an unsecured creditor to the bullion bank.

Essence of Central Bank Gold Lending to Bullion Banks

Question: Given that paper gold markets determine the gold price, then when or how could physical markets begin determining the gold price?"

There are two sets of gold markets – on the one side, the COMEX gold futures and London OTC unallocated gold spot markets which are both ultra leveraged and which both create gold supply out of thin air, and on the other side, the physical gold markets which inherit the gold prices derived in these paper gold markets. Currently the physical gold markets have no effect on the international gold price."

Any shift away from the dominance of gold price discovery in the paper markets to a dominance of gold price discovery in the physical gold markets could only occur via a disconnect between physical gold prices and paper gold prices. The conditions for such a disconnect to occur would only be possible in an environment in which trading behaviour in the paper markets changed and/or the supply-demand balance in the physical gold market became acutely stressed and out of balance.

A shift in trading behaviour in the paper gold markets refers to an increased preference for converting paper gold claims (unallocated positions or gold futures positions) into physical holdings either directly by exercising conversion rights, or indirectly by selling paper gold and then using the proceeds to buy physical gold. Many of these paper claims are held by institutional and wholesale market clients. An increase at the margin in paper gold holders demanding direct conversion of their paper claims into physical gold would probably make such conversion impossible as cash-settlement of futures and unallocated positions would be introduced and become obligatory.

The indirect option would be to sell paper gold and buy physical bullion on the physical gold market from [bullion dealers such as BullionStar](#). This move into physical gold would raise physical gold demand to such an extent that it could overwhelm available gold supply. At the same time the international gold price would fall because of selling pressure in the paper gold markets, thereby creating a disconnect between the price of paper gold and price of physical gold and would make the continued holding of paper gold claims even riskier.

One trigger that could prompt a shift in sentiment from paper gold to physical gold would be a realization by a critical mass of paper gold holders that physical gold stocks are finite, while paper gold claims are at best fractionally-backed. The acceptance of this reality would be a self-fulfilling prophesy, prompting more and more paper gold claim holders to attempt to rotate into physical gold.

The contemporary physical gold markets have already witnessed sustained flows from West to East over the last number of years driven by huge physical gold demand emanating from China, India and much of the rest of Asia. While physical gold flows are dynamic and while gold flows can and sometimes do reverse out of normal recipient destinations such as Hong Kong, Turkey, Dubai and Thailand, this is not true of China and to a large extent is not true of India either, where gold that gets imported does not come back out again. India has imported over 11,000 tonnes of gold since 2001. China has imported 7,200 tonnes of gold since 2001.

As more and more gold goes into destinations such as China and India in quantities which exceed annual gold mine supply, there is less gold available in above ground stockpiles to meet supply deficits. This is akin to a slow bank run on gold. There is also very little gold stored in the London gold market that is [not already accounted for](#) by central bank gold holdings or ETF gold holdings. Coupled with this, if in the future the paper gold holders shift to a preference for converting their paper claims, this could also be a catalyst for tipping the physical gold market even further into a situation of excess demand and acute supply stress.

In a scenario of a destructing paper gold market, ownership of physical allocated and segregated gold is paramount. This means physical gold that is unencumbered, free from competing claims and titles, and that cannot be lent out or swapped. The paper gold market is already a gigantic bubble which has expanded to an unsustainable size and whose huge fractionally-backed claims are supported by very small physical gold foundations. The unsustainable nature of such a bubble dictates that it's a matter of when and not if the paper gold bubble bursts. In such a scenario, physical gold ownership is the only thing that can protect against a systemic collapse of the financial system and protect against the destruction of the fractionally-reserved gold banking system.

Footnote:

BullionStar's ideological belief promotes freedom of speech and liberty. Likewise, we believe that open debate produces improved analysis and research. Indeed, the BullionStar blog platform encourages varied opinions and well-researched ideas. Debate is particularly important when applied to the gold market, a market which is often opaque and deliberately shrouded in secrecy by its influential bullion bank and central bank participants.

BullionStar's precious metals analyst Koos Jansen has a different view and believes that while paper markets might have some short-term impact on price, the physical gold market is more dominant in gold price formation over the long-term. Due to having taken some time off recently for health reasons, Koos did not contribute to the following article. But he recently summarized his view as follows:

"Due to my research in recent years my opinion has shifted from 'the gold price is purely set in the paper markets' to 'the physical market is more dominant in the long-term whereas the paper market has more impact in the short term'. That's where I stand now. If central banks suppress the price over years/decades they need to supply physical gold or the paper and physical price would diverge. Potentially there is a combination of paper and physical schemes at work."

Koos Jansen will, at a later point in time, present his view by answering and publishing the same or similar questions on the BullionStar website.

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The much-maligned paper gold market

April 5, 2017

The article "[What sets the Gold Price — Is it the Paper Market or Physical Market?](#)" contains some interesting information about the gold market and is worth reading, but it also contains **some logical missteps**. In this post I'll zoom in on a couple of the logical missteps.

The following two paragraphs from near the middle of the above-linked article capture the article's theme and will be my focus:

*"In essence, trading activity in the London gold market predominantly represents huge synthetic artificial gold supply, where paper gold trading is deriving the price of gold, not physical gold trading. Synthetic gold is just created out of thin air as a book-keeping entry and is executed as a cashflow transaction between the contracting parties. There is no purchase of physical gold in such a transaction, no marginal demand for gold. **Synthetic paper gold therefore absorbs demand that would otherwise have flowed into the limited physical gold supply, and the gold price therefore fails to represent this demand because demand has been channelled away from physical gold transactions into synthetic gold.***

Likewise, if an entity dumps gold futures contracts on the COMEX platform representing millions of ounces of gold, that entity does not need to have held any physical gold, but that transaction has an immediate effect on the international gold price. This has real world impact, because many physical gold transactions around the world take this international gold price as the basis of their transactions."

The most obvious error in the above excerpt concerns the effect of 'dumping' gold futures contracts on the COMEX. While this action could certainly have the immediate effect of pushing the gold price down, **the short-sale of a futures contract must subsequently be**

closed via the purchase of a futures contract. This means that there can be no sustained reduction in the gold price due to the selling of futures contracts.

A related error is one of omission, since the gold price is often boosted by the speculative buying of futures contracts. Again, though, the effect will be temporary, since every purchase of a futures contract must be followed by a sale.

With regard to the massive non-futures paper gold market, the existence of such a market is a consequence of gold's unique role in the commodity world. Whereas the usefulness of other commodities stems from the desire to consume them in some way, **gold is widely considered to be at its most useful when it is sitting dormant in a vault. This means that to get the benefit of owning gold a person doesn't necessarily need physical access to the gold.** In many cases, a paper claim to gold sitting in a vault on the other side of the world will be considered as good as or better than having the physical gold in one's possession. Furthermore, in many cases a piece of paper that tracks the price of gold will be considered as good as a paper claim to physical gold in a vault.

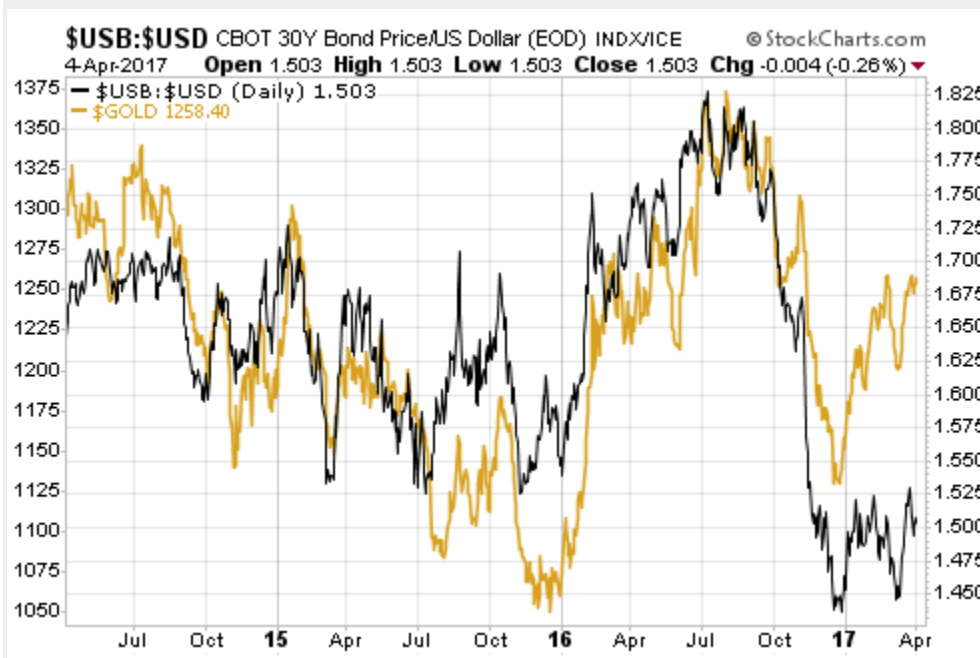
At the same time, there will be people who want ownership of physical gold — either gold in their own possession or a receipt that guarantees ownership of a specific chunk of metal stored in a vault. The gold demand of such people could not be satisfied by a piece of paper that tracked the gold price and was settled in dollars or some other currency. In other words, demand for physical gold could not be satisfied by the creation of so-called “synthetic artificial” gold.

The reality is that the existence of the massive non-futures-related “paper” gold market effectively results in a lot more gold supply AND a lot more gold demand than would otherwise be the case. To put it more succinctly, it results in a much bigger and more liquid market. This, in turn, makes it more feasible for large-scale speculators to get involved in the gold market and would not necessarily result in the gold price being lower than it would be if trading were limited to physical gold.

On a related matter, there is not a massive non-futures paper market in platinum and yet the platinum price is close to a 50-year low relative to the gold price. Also, the general level of commodity prices, as represented by the GSCI Spot Commodity Index (GNX), made an

all-time low relative to gold last year. If the “paper” market is suppressing the gold price, why has gold become so expensive relative to most other commodities?

I view the whole paper-physical debate as a distraction from the true drivers of the gold price. **The fact is that gold’s price movements can best be understood by reference to ‘real’ interest rates, currency exchange rates, and indicators of economic and financial-system confidence — what I refer to as gold’s true fundamentals. For example and as illustrated by the following chart, the bond/dollar ratio does a good job of explaining gold’s price trends most of the time.**



In conclusion, the “paper” gold market is not a problem to be reckoned with. It is just part of the overall gold situation and, as noted above, a consequence of gold’s historical role. Moreover, it isn’t going anywhere, so it makes no sense to either complain about it or base a bullish view on its disappearance.

Is gold a good store of value?

March 29, 2017

The answer to the above question is no, but it's a trick question. Value is subjective and therefore can't be stored, meaning that there is no such thing as a store of value. An ounce of gold, for instance, will be valued differently by different people. It will also be valued differently by the same person in different situations. For example, you might value gold highly in your present situation, but if you were stranded alone on an island with no hope of rescue then gold would probably be almost worthless to you. Rather than asking if gold is a good store of value it is more sensible to ask if gold is a good store of purchasing power in a modern economy, but this question does not have a one-word answer. It has a "yes, but..." answer.

Gold has been a good store of purchasing power in the past, but only reliably so when the initial purchase was made at a 'reasonable' price and the time period in question was extremely long. What I mean is that you can't pay a ridiculously-high amount for an ounce of gold and reasonably expect the ounce to retain its purchasing power, even if the planned holding period is several decades. I also mean that if you buy gold at a time when it is being valued at a relatively moderate level you will be at risk of suffering a loss of purchasing power unless you are prepared to hold for decades.

Now, it's not possible to come up with a single number that reflects the economy-wide change in the purchasing power of any currency, but by considering the change in the US\$ gold price over time and making some basic assumptions about the change in the US dollar's purchasing power we can get some idea of how gold's purchasing power has shifted. Here are some examples.

First, from its September-2011 peak to its December-2015 bottom the US\$ gold price fell by about 45%. There's no way of calculating the change in the US dollar's purchasing power over this period (the official CPI and all unofficial CPIs are bogus), but we can be certain that the US\$ lost purchasing power. We can therefore be sure that gold lost more than 45% of its purchasing power over this roughly-4-year period.

Second, from its January-1980 peak to its February-2001 bottom the US\$ gold price fell by about 70%. Again, there's no way of calculating the change in the US dollar's purchasing power over this period, but we can be certain that the US dollar's purchasing power was

much lower in February-2001 than it was in January-1980. We can therefore identify a 21-year period during which gold lost substantially more than 70% of its purchasing power.

Third, anyone who bought gold near the January-1980 top (37 years ago) and held to the present day would still not be close to breaking even in purchasing-power terms, even though the nominal price is now about 50% higher. Moreover, it's conceivable that buyers of gold near the top in January-1980 will never break even in purchasing-power terms, regardless of how long they hold.

Fourth, by making the same type of rough-but-realistic assumptions about changes in the US dollar's purchasing power it can be established that there were two periods of 8-10 years over the past 5 decades when there were huge increases in gold's purchasing power.

The point is that when gold is not money (the general medium of exchange) it tends NOT to maintain its purchasing power over what most people would consider to be a normal investment timeframe. Instead, gold's purchasing power tends to experience massive swings. **By being knowledgeable and unemotional you can take advantage of these swings. What you can't reasonably expect to do is conserve your purchasing power by mindlessly buying gold at any price.**