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MACRO MORNING BRIEFING

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The Facets Of Chinese Gold Demand

SAFE ends gold accumulation, for now

- Rise in gold prices suggests gold share of reserves is now excessive
- CNY expectations a crucial driver behind Chinese interest, but not absolute
- Import volumes and retail trade are quite stagnant

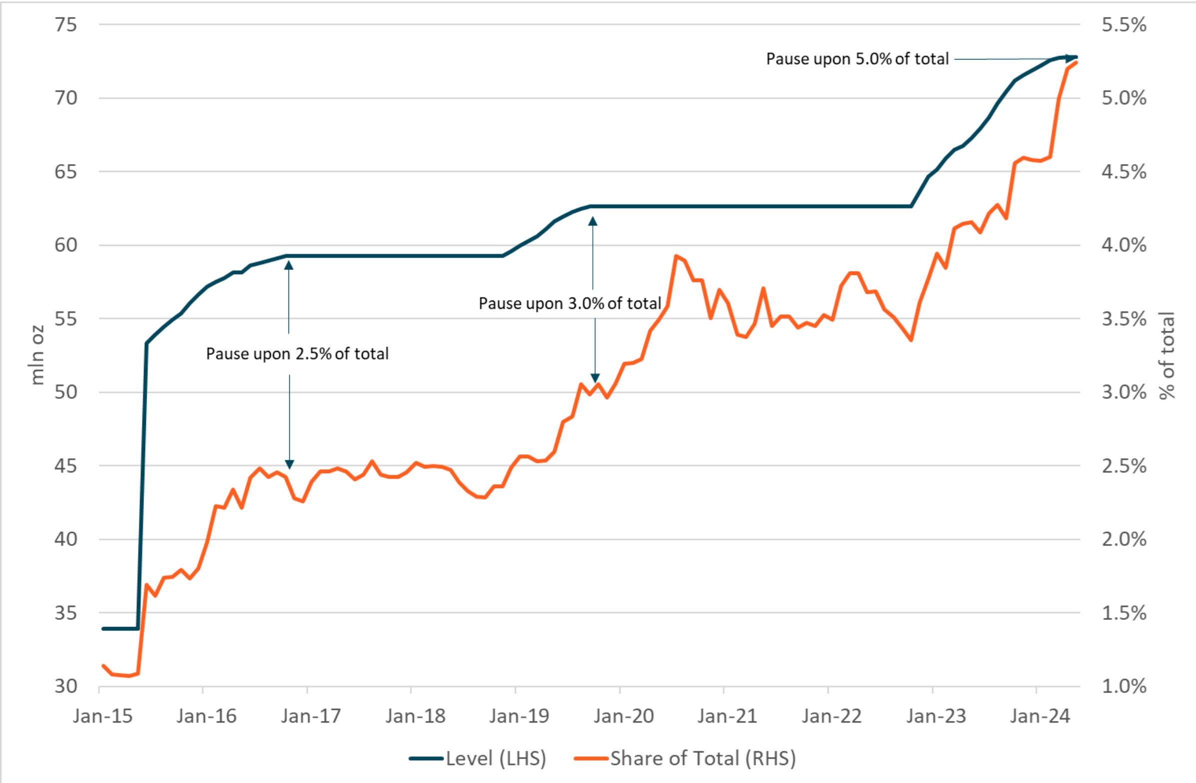
Pause in reserve build-up likely an asset allocation technicality

Throughout the Federal Reserve's rate-hike cycle over the last two years, gold prices appeared impervious to the rise in nominal and real dollar rates. This has cast doubt on conventional wisdom regarding the drivers of the yellow metal. Evidently, the risk of inflation persistence and higher equilibrium real rates has helped gold re-rate. However, and as has been the case with the rally in alternative investments, fears of fiat currency debasement and the need for real value protection may have generated higher marginal demand, amongst retail investors and larger public- and private-sector asset managers alike.

Perhaps one of the most important sources of said marginal demand has been sovereign buying and, as the holder of the world’s largest official reserves, China’s accumulation since Q4 2022 has been a reliable source of support for prices – until last month. Last week China reported that although total reserves had increased by $31.2bn – the biggest monthly rise this year – the levels of gold holdings were unchanged. Gold prices reacted poorly on the day; there was even a knock-on effect on other commodities and commodity currencies. Markets may have taken this news as a sign that China probably did not see additional risk of value losses in fiat currency, be those generated by conventional easing amongst developed market central banks or through further weakness in the renminbi.

We believe the explanation for ceasing gold purchases is far more mundane: as with any conventional asset manager, valuations in the asset had hit allocation targets. On a riskadjusted basis, any further increase would test tracking error tolerance, so it was evidently time pause. In troy ounce terms, the pace of gold purchases had already been slowing quite sharply in March and April – the months in which gold as a share of China's official reserve levels breached 5%, measured in dollar terms. Assuming that China largely follows the International Monetary Fund's composition of foreign exchange rate reserves (COFER) templates, with regular rebalancing, then China would probably hold more gold than sterling (4.84% as of Q4 2023), slightly less than JPY (5.70%), and more than double the standard level of renminbi held by other central banks (2.29%).

Exhibit #1: China Gold Reserve Levels & Share Of Total



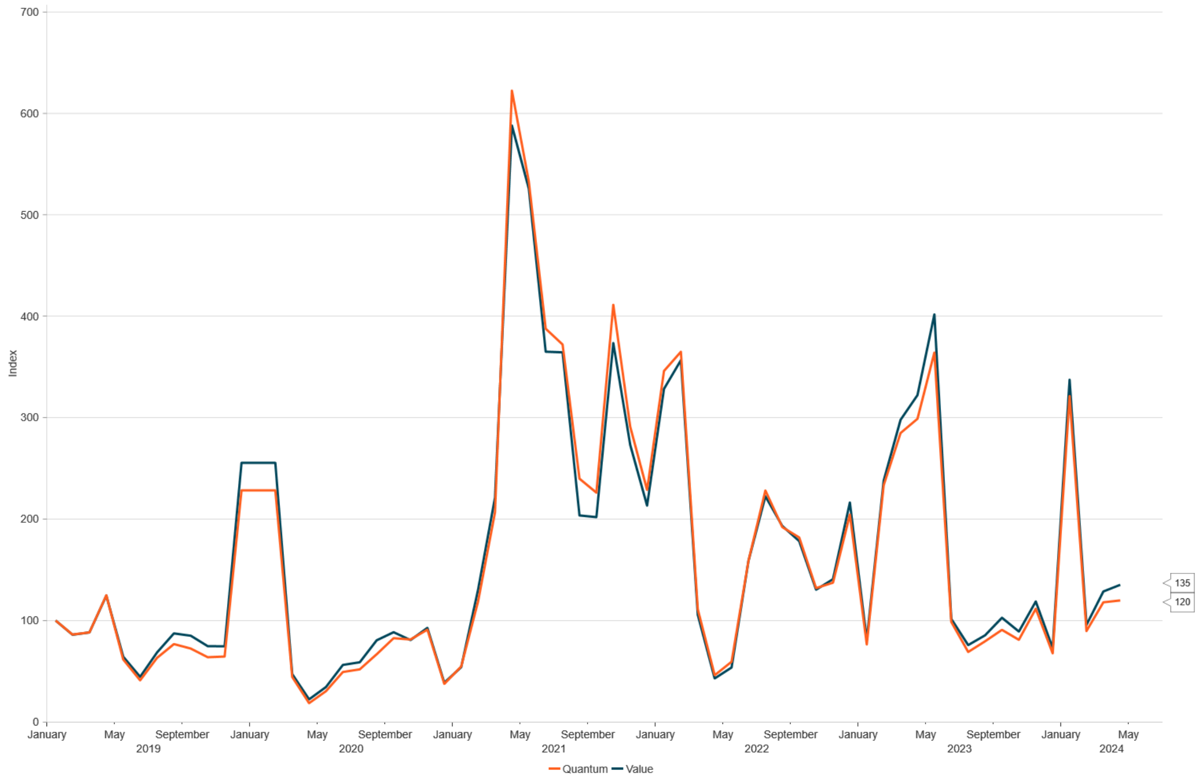
Source: Bloomberg, BNY Mellon

On a volatility-adjusted basis, 5% should be considered relatively high. Gold's (and most commodities') propensity for price volatility has always weighed on central banks' investment intentions. Former PBoC Governor Yi Gang in 2013 said that while he appreciated calls for China to add to gold reserves, "the market for gold is very small. Even if we aggressively purchase gold…the most we can diversify is 1%-2%, because the market is too small". At the time, he also warned that physical demand for gold was very high, and expressed concerns that reserve purchases would only serve to further increase prices.

Yet, over a decade on, the State Administration of Foreign Exchange's (SAFE) view on its own ability to absorb gold purchases has changed. Yi went to on to become PBoC Governor and SAFE's total gold holdings and share of reserves have doubled between the time he made those comments and his departure from the PBoC. So far, market-to-market returns have certainly justified the accumulation, and there appears to be a long-term strategy in place for SAFE to steadily increase holdings. After SAFE started reporting monthly holdings in 2015, there have been three distinct phases of purchases, with pauses upon gold's share hitting 2.5%, 3.0%, and more recently 5%, respectively (exhibit #1).

We take no view on whether the share will increase further and there will be different motivations in doing so. However, we highlight that the challenge ahead for further accumulation has more to do with the size of China's reserves. The phase of rapid reserve growth is over and despite the country's intent on moving up the export value chain aggressively, this is easier said than done, especially with trade relations deteriorating. For example, Turkey has imposed 40% tariffs on Chinese electric vehicles (EV), suggesting that barriers will not be limited to developed economies with whom relations are currently difficult.

Exhibit #2: Gold Imports Value & Volume

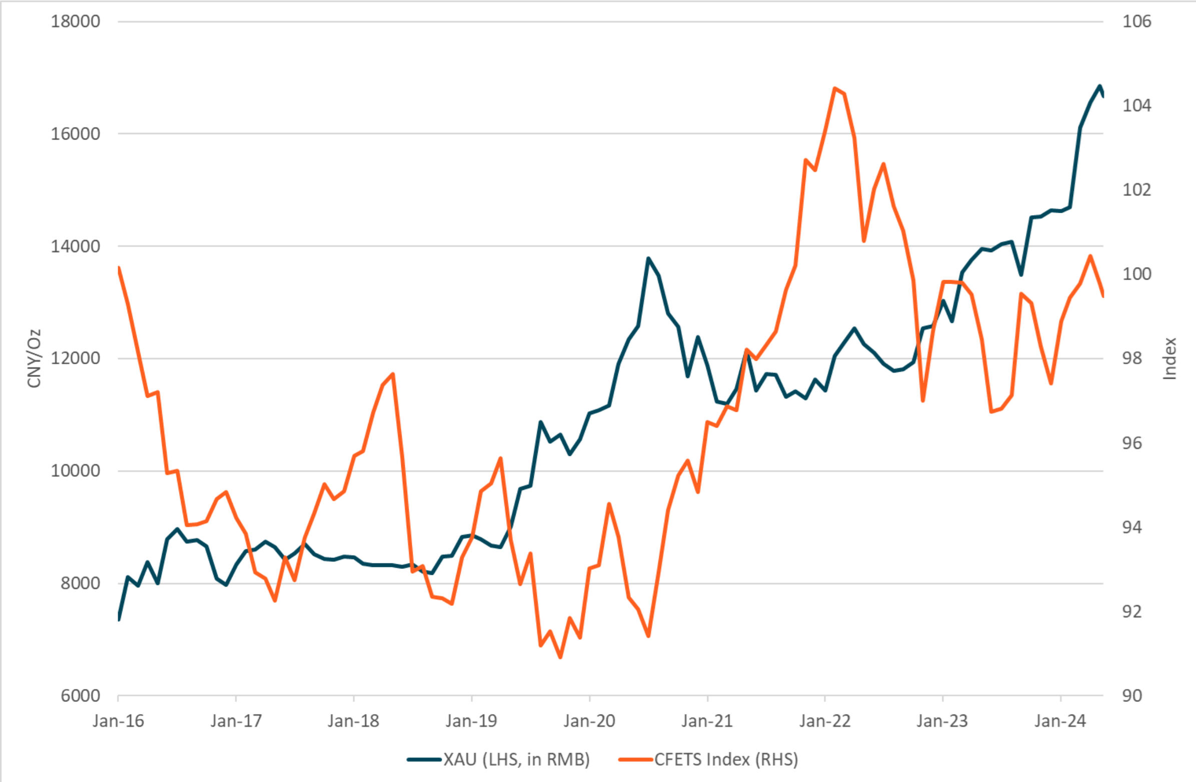


Source: Macrobond, BNY Mellon

The extent of gains in realised physical demand for gold from Chinese households is more debatable. Yi's comments in 2013 were related to retail purchases of jewellery for cultural and celebratory purposes, rather than investment demand. For the former, the record presently is mixed. China remains a large domestic gold producer but as general production has faced challenges due to pandemic restrictions between 2020 and 2023, import levels and quantity have seen significant volatility (exhibit #2). Even with persistently low nominal yields which should be supportive for gold, it is difficult to identify a clear uptrend at present.

Furthermore, gold in CNY terms (exhibit #3) has increased materially in recent years, but there is no guarantee that any such shifts are due to concerns over losses in purchasing power. If anything, 2024 has proven the exception: the CFETS trade-weighted renminbi index has held in a relatively tight range, mostly due to CNY strength on crosses. The perception of CNY losses against the dollar is likely a dominant demand driver for gold amongst 'normal' households, but the relationship this year is questionable.

Exhibit #3: Gold In CNY Terms vs. CNY Index

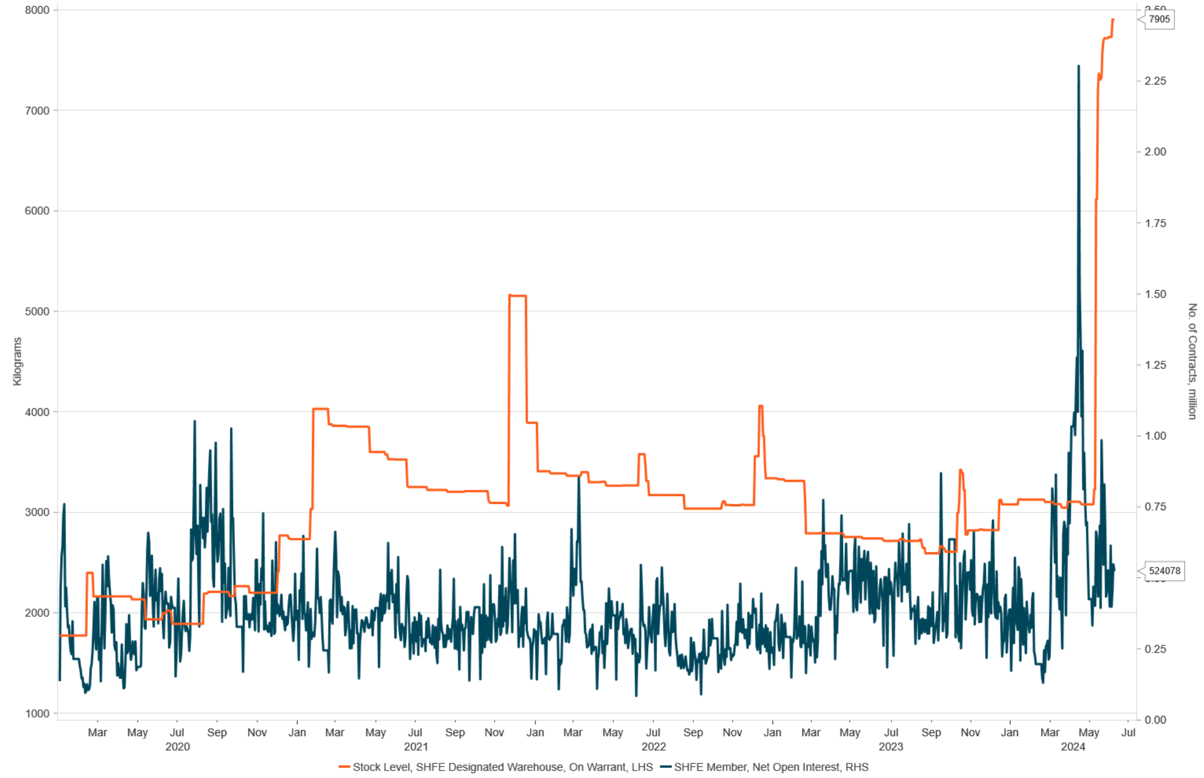


Source: Bloomberg, BNY Mellon

There is clear evidence, however, that active exchanged-based trading by Chinese investors – retail or institutional – is extremely active at present, and this has led to a commensurate rise in onshore inventory. Based on Shanghai Futures Exchange data, open interest and inventory have surged during recent sessions (exhibit #4). Aspects of domestic and global policy have played strong roles in the process, but Beijing may also be heeding former Governor Yi's concern of a decade ago that SAFE buying risks generating price surges, which in turn could also have a knock-on effect on activity in futures markets.

If the current adjustment in prices helps normalise demand dynamics for gold in China, the coast will perhaps become clearer for China to continue accumulating in the future.

Exhibit #4: SHFE Inventory & Open Interest



Source: Macrogond, BNY Mellon

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