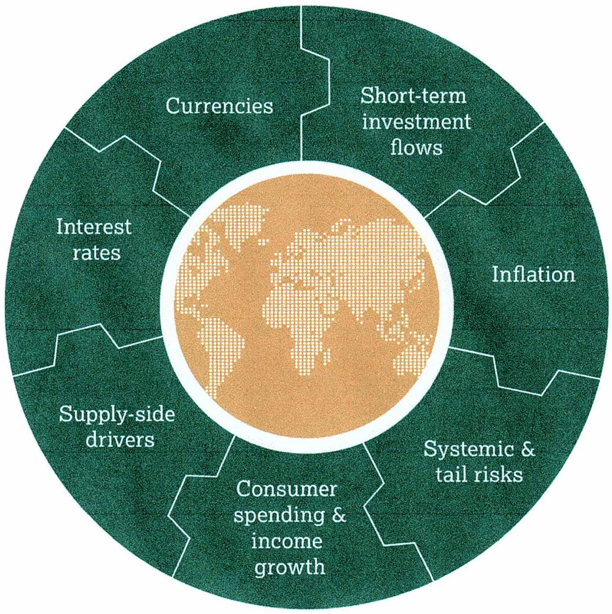
Setting the worldwide SPOT price of gold: the method

This article explains the method of setting the worldwide SPOT price of gold. On forehand I have to explain that the SPOT price of gold does not depend on physical supply and demand, nor on the 7 interrelated themes of the WGC framework. The SPOT price of gold is set in a created opaque market organization with the central bank community in the lead creating 89 percent of the yearly total market volume through so called gold swaps.

The SPOT price of gold is not set through:

- Physical supply and demand
- Framework World Gold Council (WGC), the 7 interrelated global themes



Issues setting the SPOT price of gold:

1. **Stage: The London Gold Market**
2. **The LBMA: A well organized network**
3. **The OTC Gold Market**
4. **Price discovery scheme for the SPOT price of gold**
5. **Benefits**
6. **Remarkable: the G20**

1. Stage: The London Gold Market

In 2016 VisualCapitalist.com made an inside look at the world's biggest paper gold market. They tell us:

- The London Gold Market is the world's centre for wholesale over-the-counter (OTC) gold trading
- The London Gold Market is home to the London Bullion Market Association (LBMA)
- The London OTC gold trading serves as the **PRICE DISCOVERY** market for the worldwide SPOT price of gold

Price discovery is the process by which a buyer and seller reach a specific price.

2. The LBMA: A well organized network (1)

Let's take a closer look at the LBMA

- Set up in 1987
- Successor of the Bank of England
- The BoE was the operating agent during the 1960s for the Goldpool(8)
- The BoE has observes status on the management, physical and vault committees of the LBMA according to Luke Thorn of the BoE in 2013
- The LBMA is a trading organization, not an exchange
- The LBMA has no regulatory responsibilities for the gold market
- But as "The Competent Authority for Bullion" they have contact with Regulators and government agencies
- Claims to be: "The World's Authority for Precious Metals"
- Centred in London with a global membership and client base including the majority of the central banks that hold gold
- Does not require its members to report on turnover etc
- The LBMA "granted" 13 members the status of market maker
- The London OTC gold market is managed by the market makers
- Imposes a "Global Precious Metal Code"
- Provides for central banks a tool for hiding their secret operations in the gold market and their setting of the SPOT price of gold
- Is a ploy of the central bank community

The LBMA "granted" the following 13 members the status of market maker (MM):

Full Market Makers	**Market Makers**	
Citi	Bank of Nova Scotia	Societe Generale
Goldman Sachs	BNP Paribas (No 7 of Top 10 Banks)	Standard Chartered Bank
HSBC Group (No 5 of Top 10 Banks)	ICBC Standard (No 1 of Top 10 Banks)	Toronto-Dominion Bank
JP Morgan (No 6 of Top 10 Banks)	Merrill Lynch	
UBS	Morgan Stanley	

The LBMA chosen Market Organization: OTC instead an Exchange. Ask yourself why?

OTC (2)	**Exchange**
Managed by market makers	Institutional rules that govern trading and information flows about the trading
Lack of transparency in price setting	Clearing facilities for post-trade activities
Quote-driven market only on bids and asks of the market makers	Order-driven markets displays all of the bids and asks
Inaccessible to individuals and retail trade	Centralized communication ro the whole market
Lack of supervision and coordination between regulators	Level playing field for all market participants

3. The OTC Gold Market

We have to explain something about gold SWAPS.

- A SWAP is a derivative contract through which two sophisticated parties exchange financial instruments. Usually the principal does not change hands.
- Gold SWAPS are a form of repurchase agreements in which gold is exchanged for foreign exchange at a specified price with a commitment to repurchase the gold at a fixed price on a specified future date (3)
- A gold SWAP is executed through one buy and one sell transaction, with the central bank selling gold in the first transaction and buying gold in the second (4)

Gold SWAPS are normal business in "Reserves Management" of central banks. The use of gold SWAPS is fully facilitated by "convenient" guidelines for international reserves from the IMF.

Guidelines for international reserves, paragraph 100, IMF 2013:
- "In reserves management, monetary authorities also may undertake gold SWAPS. …Such gold SWAPS generally are undertaken between monetary authorities and with financial institutions.
- Monetary authorities may treat gold SWAPS as collateralized loans, leaving the gold claim on the balance sheet
  - If exchange of cash against gold
  - The commitment to buy back the gold is legally binding
  - The repurchase price is fixed at the time of the SPOT transaction
  - Ergo: The "economic ownership" of the gold remains with the monetary authorities
  - Even though the authorities temporarily have handed over the "legal
- Usually, the central banks receive cash for the gold. The counterparty (a market maker) generally sells the gold on the market but typically makes no delivery of the gold
  - The market maker often takes short positions in gold and bets the price of gold will fall
  - Or takes advantage of arbitrage possibilities…."

The OTC Gold Market is characterized by a lack of transparency,

Joke in LBMA's Alchemist, January 1997

Why this lack of transparency?

"The role of Central Banks in the bullion market preclude 'total' transparency, at least at public level" LBMA CEO Ruth Crowell, 30 January 2015 (5). A few other signs:

- A confidential IMF report from March 1999 about the reporting template for central banks advices western central banks to conceal their gold loans and SWAPS because information about them is "**highly market-sensitive**" and accountability about them would "hinder secret currency" interventions by central banks, in view of the limited number of participants in such transactions.
- "The OTC market provides confidentiality, as transactions are conducted solely between the two principals involved. This is particularly important for central banks activity in the market" LBMA CEO Ruth Crowell, 30 January 2015 (5) (5).

But the LBMA was enforced to hold a survey on the trading first quarter 2011. Why did the LBMA decide to authorise a survey of numbers gold trading?

The answer lies according to Stewart Murray, CE LBMA, within the Basel Committee on Banking Supervision on the new liquidity regulations for banks. The issue is whether gold should be considered as a "high-quality liquid asset" so that it can be included in the liquidity buffers that banks must meet. The World Gold Council (WGC) requested the LBMA to carry out the survey to strengthen its argument that the gold market is sufficiently deep and liquid.

So let's look at the outcome of the enforced survey on trading 1Q2011 (6).

Figure 1 - LBMA Survey of Loco London Gold Turnover

	Q1 2011 Turnover*					
	'000 ounces		Number of trades		Total Value (Sales)	Total Value (Purchases)
	'Sales	'Purchases	Sales	Purchases		
London Turnover	5,593,743	5,350,183	201,713	184,140	$7,754,438,081,578	$7,416,798,373,170
Total Loco London Turnover	10,943,926		385,852		$15,171,236,454,748	
LPMCL Clearing Statistics	1,183,459		122,303		$1,640,689,519,546	
London Daily Avg	173,713		6,125		$240,813,277,059	
Spot	89%	91%				
Forwards	5%	4%				
Other	6%	5%				

*Source: LBMA. Comprised of data from 38 LBMA Members, including all spot and forward Market Makers, for spot and forward Loco London transactions

Results daily averages

It appeared that the real turnover is 9 times the presented clearing statistics by the LPMCL (London Precious Metal Clearing Limited owned and operated by 5 LBMA market makers). And SPOT transactions were 90 percent of the total turnover.
These SPOT transactions form the fundamentals for the worldwide SPOT price of gold.

A survey in 1996 held by Terry Smeeton of the BoE showed that SPOT transactions were 75 percent of the turnover (7).

The clearing statistics presented by the LPMCL are exclusive the clearing figures of the central banks. Logic, as the BIS has been the clearinghouse for central banks gold transactions since the 1930s. The only reason that those gold transactions are led through the market makers is for setting the SPOT price of gold.

Now let's calculate the turnover (share) of the central bank community in the enforced survey of 2011.

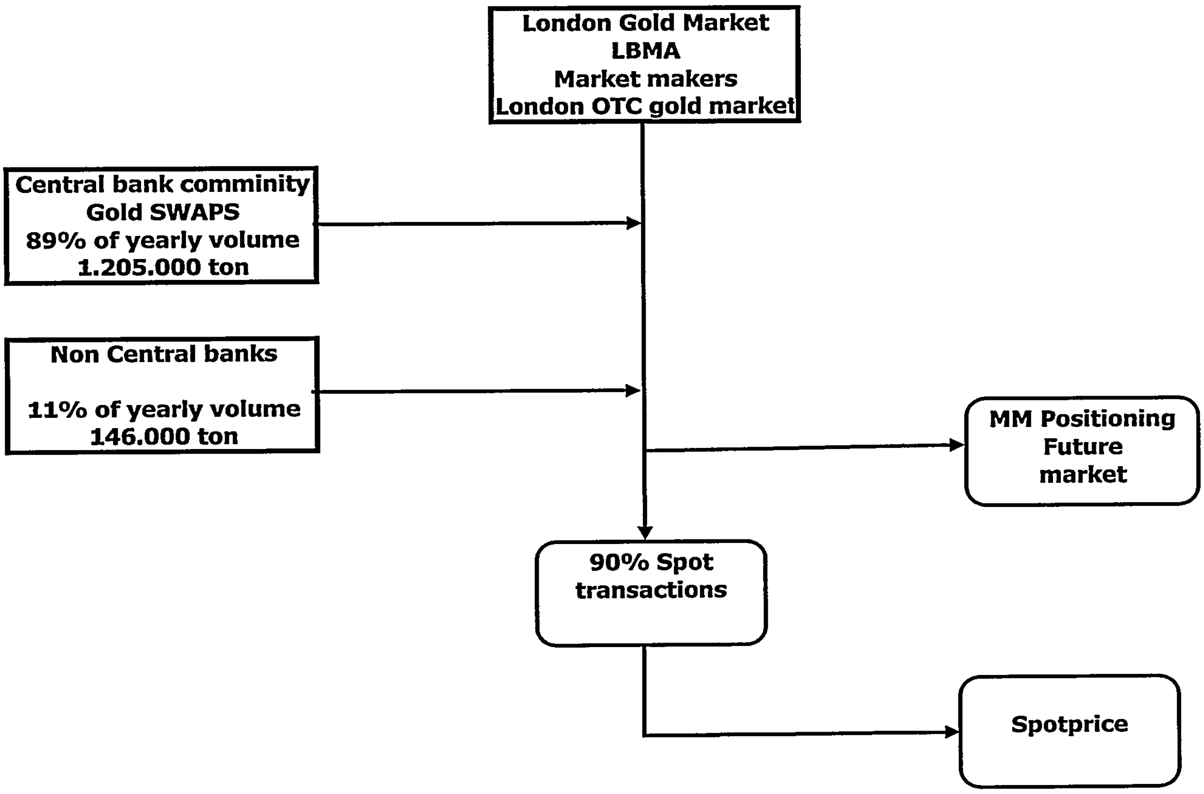
	LBMA Survey 1Q2011 Daily average	**LBMA Survey 1Q2011 On yearly base**		**LPMCL Clearing statistics On yearly base**		**So: BIS Clearing Central Bank Community Survey - LPMCL, yearly**	
Turnover in ounces	173.713.000	43.428.250.000	**100%**	4.696.093.750	**11%**	38.732.156.250	**89%**
Turnover in tons	5.403	1.350.749		146.063		1.204.686	
Number of transfers	6.125	1.531.250	**100%**	485.695	**32%**	1.045.555	**68%**
So: Ounces /transfer	28.361	28.361		9.669		37.045	
So: Tons/transfer	0,88	0,88		0,30		1,15	

Total central bank transactions 2011	1.205.000 ton	89 %
Total non central bank transactions 2011	146.000 ton	11 %
Total turnover 2011	1.351.000 ton	100 %

Physical supply 2011 (mining and scrap) 4.500 ton

Based upon the forgoing we made the following price discovery scheme for the SPOT price of gold.

4. Price discovery scheme for the SPOT price of gold



Now let's look at the benefits of this created constellation.

5. Benefits

- Benefits central bank community
  - Can make interest on cash (instead of gold)
  - Gold remains on central bank balance sheet
  - Central banks set the SPOT price of gold
    - In line with their gold price policy
    - Without selling physical gold
    - Without severe costs

- Benefits market makers
  - Inside information on forehand about the setting of the SPOT price of gold

    NB: the value of a future contract (= order-driven) basically depends on:
    - SPOT price of gold
    - Call or put contract
    - Contract strike price
    - Remaining days before expiring
    - Interest days
    - Volatility of the SPOT price of gold

6. Remarkable: the G20

The gold trading activity on the OTC market is hardly transparent.

In January 2009, the G20 asked for substantial reforms to OTC derivatives markets in order to ‘improve transparency, mitigate systemic risk, and protect against market abuse’. The G20 reform agenda requires standardised OTC derivatives to be cleared through central counterparties on exchange or electronic trading platforms.
Well-known shortcomings are on the so-called pre-trade transparency (information about price quotes and trade sizes is available only to the two parties involved in the trade prior to executing the trade), the post-trade transparency (information about executed trades only made available to market participants other than the two parties involved in the trade, or a narrow set of dealers).
Through this information asymmetry are uninformed participants at risk of making the wrong trading decisions (8).

(1) The LBMA is a ploy of the central bank community, Simons, 15 August 2017
(2) European Commission, 11 September 2016 (partly)
(3) Guidance for Monetary Authorities on accounting for gold, WGC, 31 July 2017
(4) Liquidity in the global gold market, WGC, 2010
(5) Letter regarding the Fair and Effective Markets Review to the BoE, LBMA, 30 January 2015
(6) Loco London Liquidity Survey, The Alchemist Sixty Three, Stewart Murray CEO LMBA, 2011
(7) The Alchemist, London Bullion Market, Survey of Turnover January 1997
(8) BoE Quarterly Bulletin 4Q2011