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MACROSOM

Gold Crash: The Cypriot Connection

Wednesday, April 17, 2013

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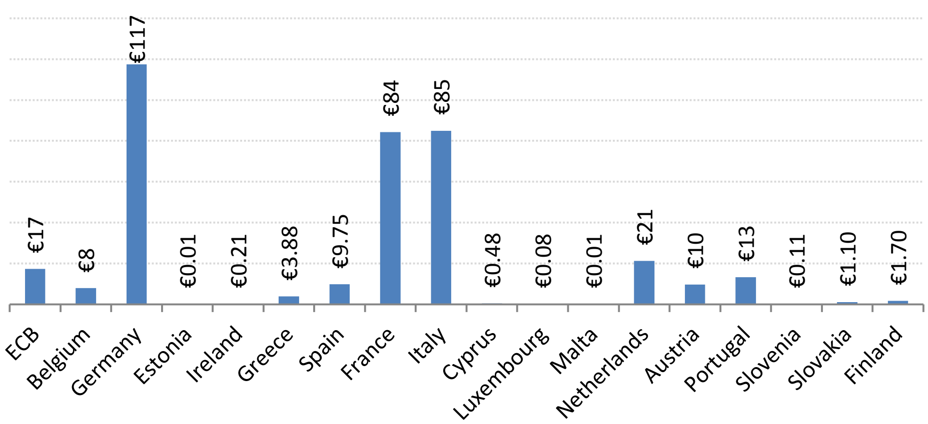
Cyprus may sell its small gold hoard, but it's unique -- other euro area nations can't and won't.

There have been many explanations -- and more than a few rumors -- surrounding the recent crash in gold (see "Gold and Commodities: Breaking Bad" April 15, 2013). One of the more persistent is that a plan for the Central Bank of Cyprus to sell its "excess" gold holdings -- a tiny sale in the grand scheme of things, to raise only €400 million as part of its bailout program -- could become a template for other euro area central banks. The idea is: as goes Cyprus, so will go Italy, Spain and any other distressed euro area economy.

If it were true, this would really matter for the gold price, as euro area national central banks are very large holders of gold (please see the chart below). If they were forced to liquidate their holdings, it would put severe and persistent downward pressure on the gold price.

ECB and National Central Bank gold holdings

EUR, billions   Assumes gold price EUR 1,076/ounce (USD 1,400/ounce)



Source: ECB, TrendMacro calculations

Happily, there is a lot less than meets the eye here. We believe there will be no major gold liquidations by euro area central banks anytime soon.

The combination of circumstances surrounding Cyprus's possible gold sale -- and for now, it remains just a possibility -- are quite unique.

Update to strategic view

GOLD, EUROPE MACRO: Rumors are flying that the possible sale of gold by Cyprus will be a template for other distressed euro area nations with far larger gold holdings. Such rumors are completely unfounded. Cyprus is a unique case. Among other reasons, Mario Draghi made clear that national central bank gold sales would only be allowed if the proceeds are used to repay Emergency Liquidity Assistance (ELA) -- and Cyprus and Greece are the only two nations now using ELA. To the extent that the massive move down in gold over the last week was exacerbated by groundless rumors of euro area sales, then we would expect -- to that extent -- to see gold recover from its panic lows.

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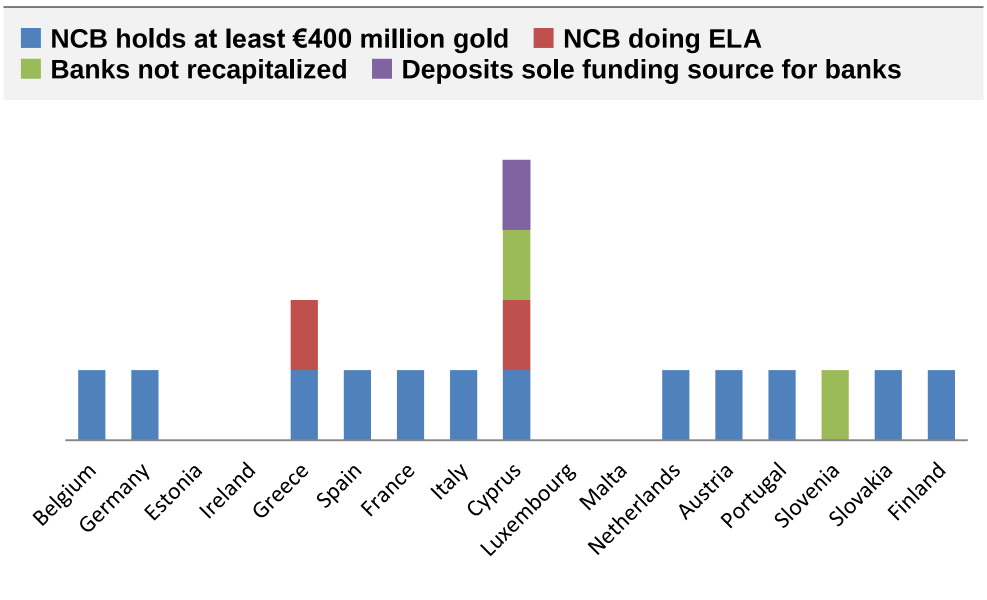
- First, Cyprus was one of the few euro area nations to not have already undergone a substantial bank recapitalization.
- Second, at €482 million, Cyprus holds only a small amount of gold. But many euro area nations hold even less.
- Third, the Cypriot banking system has very little debt that could be haircut, leaving only the politically unappealing alternative of bailing-in depositors (see "On the Cypriot Depositor Bail-in" March 17, 2013).
- Fourth, the Cypriot banking system is now one of only two in the euro area to be reliant on Emergency Liquidity Assistance (ELA) from its national central bank (see "On the ECB's Move Against Cyprus" March 21, 2013, and "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011).

This last point is key. ECB President Mario Draghi, when asked last Friday about the Cypriot plan to sell gold, said it was a decision for the Cypriot central bank, and that *any profits from the sale of gold must be used to pay down ELA*.

- So to sell gold, a euro area nation must own gold to begin with, must need to recapitalize its banks, must have no conventional way to do so, *and* must have a central bank that has done ELA which the gold sales are to exclusively repay.
- Only Cyprus qualifies on all four counts (please see the chart below). Greece partially qualifies, because at least its central bank is doing ELA. But for the most part, as the politicians keep saying, Cyprus is, in fact, unique.



Source: NCBs, TrendMacro calculations

It may well be that Cyprus will sell its gold in the coming months -- all €500 million of it. But for that sale to be forced in any other euro area state,

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Recommended Reading

Does High Public Debt Consistently Stifle Economic Growth? A Critique of Reinhart and Rogoff
Thomas Herndon, Michael Ash and Robert Pollin
Political Economy Research Institute
April 15, 2013

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circumstances would have to change significantly from where they are at the moment.

We believe that the gold crash was part of a larger move in commodities in general, and that it derives from fundamental global risks having to do with the resurgence of deflation and the continuation of slow growth (again, see "Gold and Commodities: Breaking Bad"). But to the extent that the massive move down in gold over the last week was exacerbated by groundless rumors of euro area gold sales, then we would expect -- to that extent -- to see the gold price recover from its panic lows.

Bottom line

Rumors are flying that the possible sale of gold by Cyprus will be a template for other distressed euro area nations with far larger gold holdings. Such rumors are completely unfounded. Cyprus is a unique case. Among other reasons, Mario Draghi made clear that national central bank gold sales would only be allowed if the proceeds are used to repay Emergency Liquidity Assistance (ELA) -- and Cyprus and Greece are the only two nations now using ELA. To the extent that the massive move down in gold over the last week was exacerbated by groundless rumors of euro area sales, then we would expect -- to that extent -- to see gold recover from its panic lows.