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China'sGold Market: Booming Again

Chinese private sector demand is expected to rise above the 1,000 tonne mark in 2013 even though growth is likely to slow somewhat after a stunning first five months.

"Housewives gold rush keeps price from falling". That was the headline at the beginning of May amid reports of a veritable stampede for 'cheaper' gold jewellery and bars in China. Indeed, it is probable that the surge in gold purchases during April and May from China, India and other price sensitive markets helped to prevent an even more severe fall in the price. This would in part have been due to their real demand-side impact but also because of the effect on market sentiment of news stories such as that quoted above. However, going forward, will Chinese(and other Asian buyers) continue to mop up excess global supply sufficiently to buoy prices and maybe even help drive them higher again? Expectations have certainly been raised by news that Chinese gold demand (basis jewellery consumption and bullion bars) increased by 20% year-on-year in the first quarter. Were this growth rate to be maintained,consumers' demand for jewellery and bullion bars alone would be 153 tonnes greater this year than it was in 2012. Yet, that might even be a conservative figure given reported shortages of gold jewellery and bars in China during April and May. Indeed, it is quite feasible, taking into account all sources of demand, that the private sector in the country could absorb over 1,000 tonnes of the yellow metal this year, the bulk of it in the form of plain 24-carat jewellery but with a hefty contribution too from the purchase of bullion products.

Before addressing the outlook for demand over the remainder of 2013 it is worth putting the recent burst in growth into a longer-term context. Data from Thomson Reuters GFMS in the table below show that a decade agoChinese private sector gold demand from a combination of jewellery, all 'industrial uses' and investment came to 217 tonnes. By 2007 that figure had jumped to 361 tonnes, driven chiefly by its jewellery component. Fast-forward to 2010 and we see that total domestic demand had risen further to 687 tonnes, with a noticeable contribution from investment following market liberalisation measures by the Chinese government. This impressive growth occurred in spite of the yuan gold price rising by 44% between 2007 and 2010, basis annual averages for the two years in question. Driving demand was of course a major rise in consumers' incomes: The Chinese economy grew by a cumulative 32% in the three years 2008-10. An international perspective on this major expansion in the Chinese gold market is also interesting: In 2003 China accounted for 5% of private sector global gold demand (excluding de-hedging), this figure leaping to 16% in 2010.

2011 was an outstanding year for the gold market in China, total domestic demand for the yellow metal expanding by close to 22% or around 149 tonnes to reach 836 tonnes. Compared to the previous year's fireworks 2012 was therefore somewhat disappointing, with total gold demand creeping up to 840 tonnes. Nevertheless, the consolidation of the Chinese market at a very high level of demand whilst most others saw declines resulted in China accounting for no less than 21% of private sector gold demand (excluding de-hedging) in 2012.

Chinese Domestic Market Gold Supply/Demand*

	2003	2007	2008	2009	2010	2011	2012
Mine production	210.6	280.5	292.0	324.0	350.9	371.0	413.1
Scrap	28.5	41.6	70.3	116.3	133.2	124.7	119.7
Total Supply	239.1	322.1	362.3	440.3	484.1	495.7	532.8
Jewellery (fabrication)	194.0	297.1	329.6	363.6	432.3	495.6	498.4
Industrial (all uses)	16.0	31.7	41.3	53.4	63.6	69.7	67.2
Investment (coins + bars)	7.0	32.2	68.7	113.0	191.3	270.8	274.2
Total Demand	217.0	361.0	439.6	530.0	687.2	836.1	839.8
Surplus/Deficit	22.1	-38.9	-76.3	-89.7	-203.1	-340.4	-307.0

*Excludes Imports/Exports and Official Sector

Source: Thomson Reuters GFMS (*Gold Survey 2013*)

What the table also shows is the swing from the Chinese domestic market being in net 'surplus' at the beginning of the 2000s into a rapidly growing 'deficit', with local sources of supply (namely mine production and scrap) falling well short of domestic demand. Indeed, by 2011 this 'deficit' had grown to some 340 tonnes, with the country having become the world's second largest importer of gold bullion after India. Although this 'deficit' dropped back in 2012 to 307 tonnes, China's importance to the international bullion trade actually grew last year due to a rise in its imports, whilst shipments of refined gold to India declined substantially.

China's imports over the last decade would have increased by even more than they did had it not been for a spectacular rise in mine production. According to Thomson Reuters GFMS, in 2002 the country's mines produced 211 tonnes of gold. This figure has increased steadily since then to reach 413 tonnes last year. In 2008 China became the world's largest producer of mined gold and has extended its lead at the top of the table since then. For instance, in 2012 China accounted for 14.4% of global output – one in seven ounces mined – compared to 8.0% a decade earlier. This performance is particularly noteworthy because much of the country's production comes from hundreds of small operations. The lack of consolidation in the industry is evidenced by the fact that the top 10 Chinese mining companies collectively only account for half of China's gold mine production. Foreign observers have for some time wondered how long the Chinese gold mining boom can continue. It is understood that many smaller producers have high production costs and that they seek to extract maximum value from operations over the shortest possible time frame. This would seem to be a recipe for production to fall steeply at some point. However, in spite of the sceptics output has continued to grow, with the China Gold Association reporting an 11% year-on-year increase in gold mine output in the first quarter of 2013.

As discussed above, China's structural 'deficit' requires that the country import gold to make up the gap in the market. As the 'deficit' has grown so has the country's imports from overseas, most of this bullion transiting Hong Kong before being imported via the Shanghai Gold Exchange. Thomson Reuters GFMS figures show China importing a gross 892 tonnes in 2012. This is far in excess of the apparent domestic market 'deficit' of 307 tonnes. The explanation for this is the 'round tripping' of gold between Hong Kong and Mainland China related to interest rate and foreign exchange markets arbitrage. The scale of this business has grownand last yearaccounted for no less than 372 tonnes of the country's estimated gross imports. This left net imports at a still considerable 520 tonnes.

The implication is that some other source of demand accounted for the difference of 213 tonnes between net bullion imports and the apparent 'deficit' in the Chinese market. A possible explanation is undeclared official sector purchases. There would seem to be a precedent for this, as the official sector in the past appears to have made gold purchases via the domestic (as well as the international) market. For instance, from December 2002 to March 2009 China's monetary gold reserves as reported to the IMF came to 600 tonnes, with this figure suddenly being revised to 1,054 tonnes in April 2009. Many wondered if this simply represented the transfer into the country's official reserves of gold purchased prior to this date by State bodies. Certainly the motivation for China gradually and quietly to build up its official gold holdings is clear: Gold provides an excellent form of foreign reserves diversification in that it is not the liability of a foreign government, unlike the country's huge holdings of US Treasuries. Given that China held only 1.7% of its declared foreign reserves in gold at the end of 2012 ($56bn out of $3,387bn) there is clearly scope for it to accumulate more bullion. Moreover, it would make sense for any such buying to be discreet and therefore mainly conducted through the domestic market.

While the subject of official sector purchases by China will remain a matter of speculation unless the Authorities indicate otherwise, the private sector in China has clearly continued to absorb a growing amount of gold, principally in the form of jewellery but with bullion bars also an important form of demand. As discussed at the beginning of this article, first quarter demand in China for jewellery (basis consumption not fabrication) and bullion bars combined grew by 20% year-on-year. Indicative also of the strength of demand in the first three months were Hong Kong net bullion exports to Mainland China, which reached 218 tonnes over the period, 60% of that quantity in March alone. Furthermore, growth in Chinese demand would certainly have been higher in April and May when gold prices plunged to well below $1,400. That said, recent information from China is that demand in the latter part of May had dropped back to "normal" levels. This is supported by data showing the premium on the Shanghai Gold Exchange over loco-London falling sharply towards the end of the month.

Assuming there is no major move in the yuan's exchange rate, which seems likely, the outlook for demand in China for the rest of this year will in no small measure depend on the course taken by the international price and gold buyers' price expectations. In theory a much weaker gold price this year, an average for example well below $1,500, ought to result in strong year-on-year growth in demand from consumers and investors who will be enjoying a rise in incomes and who have few obviously safe places to put their money. (Chinese stocks and property are widely regarded as 'risky' investments, with the latter too expensive for many smaller investors and also subject to controls on speculation.)Such a price scenario could be the basis for total domestic demand from the private sector in China to climb by some 200 tonnes in 2013 and exceed the 1,000 tonne mark, implying an annual growth rate of about 20-25%. A stronger outcome one senses would need the price successively to plunge new depths as each fresh round of frenzied buying, similar to that seen in April and May, would require the incentive of even lower prices.

Of course, if at some point a declining price results in expectations changing then demand may not react as strongly as might be expected. In this regard, it is important to note that much of the recent spate of buying has been predicated on a popular view that the drop in gold prices is a temporary phenomenon and that in the longer run the precious metal will rise in value. If buyers start to doubt this, growth in the Chinese market over the remainder of 2013 may falter. Another reason for caution is that there is certainly an element of purchases (particularly of jewellery for weddings) being brought forward. To some extent this will have a dampening effect on demand over the rest of this year.Nevertheless, in spite of these caveats and given the already very strong first five months of the year, China's appetite for gold in the form of jewellery, for the manufacture of industrial products, coins and bullion bars is likely to account for around one quarter of all global private sector gold demand in 2013. Yet although this outstanding performance will undoubtedly prevent an even more severe drop in prices it will not be sufficient on its own to shift gold back into a bull market.