Perspectives on Gold: A Viewpoint from the Central Bank

Oleg V. Mozhaiskov

Deputy Chairman, Bank of Russia

I would like to thank the conference organisers for this opportunity to share my thoughts on such a complex – even mythical – subject as gold and its prospects for the near- and medium-term. I assume that the request was made for one simple reason: that I, as a senior executive of the Bank of Russia, should know more than other ordinary mortals. In general, this logic is flawed, although there is sense to it: it is necessary to understand the Central Bank's perspective regarding this precious metal, particularly given that it does have approximately 500 tonnes of the metal in its vaults.

It is from this perspective – that of the Central Bank – that I intend to base my presentation. I hope you understand that this is quite a specific topic – the management of gold reserves. This is distinct from the views adopted by gold prospectors, industrialists, investors, speculators and ordinary purchasers of jewellery. For the Central Bank, the gold stock is the international payment reserve for the whole country – for the State authorities, private companies and corporations, as well as individual citizens. Like any reserve, it needs to be conserved, in terms of both actual physical form and value. To a lesser extent, we need to be concerned about its liquidity, or more precisely, market price developments. The Central Bank's duties in managing gold reserves may therefore not seem particularly onerous to a commercial trader, who has to close dozens of transactions daily to achieve results by the end of the day.

In this there is a grain of truth. The Central Bank's specialists do not have to follow real-time price movements every day and every minute, or react instantaneously to every little twist and turn on the market. We are concerned with other, less immediate problems regarding gold. In a figurative sense the Central Bank's attitude can be compared with that of a giraffe. I have in mind an image of an animal that suggests a certain ambiguity, at least in the Russian language. On the one hand, when Russians say that someone is reacting like a giraffe, they are highlighting that person's slow reaction. It even suggests a degree of slow-wittedness. On the other hand, the evident magnificence of the animal commands respect. "The giraffe is tall, and he sees all" – the words of the Russian bard Vladimir Vysotskii are well known throughout Russia.

With this allegory in mind, I would like to mention the issues concerning gold which fall within the "giraffe category", or more formally, present concerns of a central bank. These are several: the volume of actual precious metal stock, both in absolute and relative terms (essentially, the optimum component of the metal in total monetary reserves); methods of controlling the stock; ensuring both security and availability for liquidity purposes and at the same time optimising income-earning potential. All these issues reflect very practical concerns. It may seem strange but all bear direct relation to a problem which is often considered purely theoretical: what is gold currently, and what will it be tomorrow? Real money with intrinsic value? A raw material? A cash commodity that has lost some of its monetary functions? If so, what are the prospects – complete loss of gold's role or a restoration of lost functions, in one form or another?

There is a wide circle of leading financiers who believe that pondering on these themes is a fruitless academic exercise. They are convinced that the heads of the world's richest countries, who once agreed to abolish exchange of national currencies for gold at a fixed rate, have in fact demonetised gold altogether. In their eyes, the existence of official gold reserves is simply a remnant of the past, a financial monument to the gold and gold-currency standards, which ultimately will be absorbed by the global gold market. This market has properly organised infrastructure, products, rules and procedures and central banks are merely one of its clientele. For them, this is the only reality to be reckoned with.

Is this a true picture for gold in the modern world? Many people do not think like this – the reality is more complicated. The contemporary gold market has emerged as a by-product of a series of agreements between governments, initiated by the United States and supported by the other major powers, in whose possession the bulk of all gold ever extracted lies. These agreements (the most important of which were the Jamaica Agreements of 1976) created ideal conditions for stimulating international trade by means of expanding credit facilities in national currencies. The obligations on debtor countries to pay off the trade deficits with gold (upon demand of the creditor countries), severely limited the exporter countries' opportunities for trade expansion. The importer countries were made to live within their means, predicated by their gold reserves. Gold was therefore considered by a number of economists and policy makers, as an instrument guaranteeing order and justice in international economic relations, while others remained convinced that it hindered international economic progress and development. The latter, as you know, secured the upper hand.

That brief look back into the past was necessary to make the following conclusion: the present state of the gold market and its future cannot be analysed in isolation from the problems of the international monetary system. Some people may question this conclusion, because of the incompatibility of the present volumes in the respective gold and foreign currency markets.
I would suggest that the volumes do not matter for this particular purpose. The modern monetary system, although undoubtedly robust and long-standing, in fact has a number of flaws and weaknesses. These, like the birth of the new, can cause health problems to the participants of the system. This disconcerting phenomenon occurs because by taking gold out of international payments turnover, people are undermining payment discipline. The discipline I have in mind is at a macro-level, that is the discipline of rich industrial countries whose convertible currencies have taken the role of an international trade medium by virtue of their economic strength and have been accepted by the world community as reserve units of payment.

Although there are several reserve currencies, blatant lack of discipline is demonstrated by the US dollar. I am leaving aside the main aspects of this problem, such as the social and economic injustice of a world order that allows the richest country in the world to live in debt, undermining the vital interests of other countries and peoples. What is important for us today is another aspect, which is connected with the *responsibility* of the state issuing the reserve currency and for the international community preserving that currency's buying power. Having in mind the actual behaviour of the dollar on the forex markets, the problem could be more accurately termed as the *irresponsibility* of the US government in relation to the market valuation of its currency in international circulation.

Today, the net debt owed by the USA to the outside world (the so-called "international investment position") is in the region of US$3 trillion. To understand the scale of this figure, let me remind you that it exceeds the total sum of official currency reserves in all the world's countries (including the USA). According to the International Monetary Fund statistics last year-end, the world pool of foreign currency reserves totalled SDR 2,013 billion or about US$2,800 billion. The volume of cash only ("greenback" banknotes) available outside the US totals about US$400 billion. The world has come to a paradoxical situation in which the creditor countries are more concerned with the fate of the dollar than the US authorities.

Thus, the evolution of the US dollar reserve role in recent years has given ground to some quite pessimistic forecasts, based on the rational economic theory. No wonder that the number of those who have held assets in dollars and now wish to diversify them partly into gold – the traditional shelter from inflation and political adversity – is steadily growing. The statistical correlation between the market prices of dollar and gold is obvious. For the problem we discuss today it means specifically that gold, in addition to its unique physical and chemical properties used in industry, has retained its particular monetary attractiveness for cautious financial investors and its market price is still heavily influenced by the state of the international monetary system.

This dualism in gold price formation distinguishes it from other commodities and makes the movements in the price sometimes so enigmatic that market analysts need to invent fantastic intrigues to explain price dynamics. Many have heard of the group of economists who came together in the society known as the "Gold Anti-Trust Action" and started a number of lawsuits against the US government, accusing it of organising an anti-gold conspiracy. They believe that with the assistance of a number of major financial institutions (they mention in particular the BIS, JP Morgan Chase, Citigroup, Deutsche Bank and others), some senior officials have been manipulating the market since 1994. As a result, the price dropped below US$300 an ounce, at a time when it should, if it had kept pace with inflation, have reached US$740-760. I prefer not to comment on this information but dare to assume that the specific facts included in the lawsuits might have given ground to suspicion that the real forces acting on the gold market are far from classic textbooks that explain to students how prices are born in a free market.

Therefore, even those who stick to traditional economic theory in analysing and projecting gold market developments should admit that various factors that influence gold price interact between themselves in a constantly changing manner, sometimes in a very odd way. Here, as in nuclear physics, some factors disappear briefly or cease to act, and in their place comes a new dominant market factor. This causes confusion for the forecasters in their efforts to build a logically balanced model for the metal price movements. Therefore I do not even dare shed light on the methodology of gold price forecasting, but would like to risk outlining the basic factors, which are permanently (and I stress permanently) acting on the market. There are four of them – two relating to the raw material properties of gold and two to its monetary qualities.

As an economist educated in the Marxist economic school, I believe that the base for gold prices is rooted in the sphere of the real economy. Like any mineral raw material, mined gold has its intrinsic value. This value fluctuates quite significantly depending on the location, time and technology of extraction. The market averages out the individual expenses, optimising them at a level that is acceptable to the industry that uses the metal in its production. The absolute values in monetary terms for this factor fluctuate, although they are the least mobile element of the price. The production cost category has its own "floor and ceiling". The technological particularities of gold extraction determine the minimum price level at which reproduction is economically feasible in the industry as a whole. We think that the worldwide level is currently about US$200 per ounce. This is the minimum price limit. With lower prices the industry will plunge into a zone of catastrophe. Therefore, the average costs of gold production in volumes sufficient to satisfy expected market demand (over the past 15 years this has averaged 2,500 tonnes with an upward trend) are the first factor.

The second factor is the real volumes of demand generated by the consuming industries for physical gold. The behaviour of industrialists (jewellery plays the most important role) is mainly caused by factors connected with an economic activity cycle. During the 1990s there was a significant but uneven rise of demand for jewellery: from 2,200 tonnes in 1990 to 3,200 tonnes by the end of the decade, with a peak of 3,350 tonnes in 1997. The first three years of the new millennium saw a decline of demand from jewellers; the volume of metal purchased by the industry dropped down to 2,550 tonnes in 2003. The fundamental correlation between gold prices and the volume of demand from industry is normally linear in character. This correlation cannot be the sole cause behind the dramatic falls in prices, but can show a vector for price movement, which can be enhanced or indeed maximised through the efforts of speculators.

However, even when speculative activity is relatively quiet this vector is not always clear. There are "anti-phases" in economic activity in various parts of the world, and on top of these, various national traditions in demand for the metal. A recent example of this occurred at the turn of the century. After prices reached a 20-year low of US$252 in May 1999, demand for physical metal increased and pushed the price temporarily to a new "equilibrium level" of US$300 by the end of the year. The concept of "equilibrium" reflects the situation on the market when its participants believe that they are aware of a balance between supply and demand. It brings a measure of price stability to the market. Such a situation appeared to take place following the Washington Central Bank Agreement.

However, as soon as demand started to shrink again and a danger of excess supply arose, prices went down. This was the beginning of a two-year market stagnation, with the price wavering within a range of US$270-290. It was not sufficient for the metal producers, but they were unable to control the situation. It was investors who created the weather conditions in the market.

Now the time has come to admit that investment demand was, and still is, the main driving force behind price fluctuations on the gold market. The changing character of demand heavily depends on what is going on in the international foreign currency and financial markets. The investors pay continuous attention firstly to the dollar rate of exchange and secondly to the level of interest rates for financial assets. The volatility of these indicators directly influences the investors' interest in gold. Since this interest is realised not through operations with physical metal but through deals with gold derivatives on stock-exchange and non-stock-exchange markets (where gold is only mentioned as a base asset), the volume of these deals can exceed the volume of trade in physical metal dozens of times. Last year turnover in gold derivatives was about 4,000 million ounces (or 129,000 tonnes), but physical metal actually sold totalled 120 million ounces or some 3,860 tonnes. As it is said, feel the difference!

It is true that the markets for derivatives linked to other raw materials also usually exceed the operations with base assets. The difference in volumes is incomparably less (5 to 10 times). At the same time the markets for derivatives with foreign currencies and prime securities as base assets are developing every bit as rapidly as the gold derivatives. What can we infer from that? One conclusion, at least, is clear: gold is predominantly a financial asset, not merely a precious metal.

In this capacity gold is competing with other financial assets on a variety of parameters. Being inferior in terms of returns, it is far more reliable than anything else for protection against war-related, political, financial, economic and credit risks, and also provides a high level of liquidity and lower management costs. However, since the rate of return is the main measure of success for financial institutions under normal conditions, investment-related decisions depend directly on the stability of the international monetary system, strength (or weakness) of the dollar and the level of interest rates on financial markets.

This dependency is not linear in nature. Correlation factors change from time to time because decisions are taken by investors individually on the basis of their market expectations. As a result, investors' reaction may race ahead or lag behind developments on the forex and financial markets. If we examine gold price movements over the last 10-12 years, it becomes clear that during the first half of the 1990s the dominant factor was the weak dollar and the market was still living in hope of a recurrence of the 1980s "gold fever".

From 1997 onwards, as the dollar strengthened, these hopes were dispelled, investors turned around and the price fell to the level of support on the physical market. It seems to us that the depth and duration of this depressed phase of gold prices was to a considerable extent caused by the wide use of gold derivatives by investors. Insofar as these instruments are intended for protecting banks and their customers against unwanted and unexpected changes in price dynamics, they can provoke massive closing of the existing position at a specific moment. This process may take the form of a chain reaction. As a result, the price falls below the level dictated by the sensible interests of investors.

I would also like to note that recently central banks have been playing a significant role on the gold market. Low interest rates on the money markets and revaluation of gold reserves in line with lower market prices have exacerbated the problem of the financial efficiency of gold stock management. In order to earn some income on the stock and compensate for "book losses" caused by its revaluation, a number of central banks have started to place a part of the reserves into deposits with commercial institutions (leasing operations). Data available to me suggest that these banks deposited about 1,000 tonnes in 1991 and ten years later the volume of the deposits reached 4,800 tonnes. Naturally, the central banks' activity increased market liquidity and thus also put downward pressure on the gold price. The influence of these operations, however, must not be exaggerated. It is even incomparable with the pressure that was exerted on the gold derivatives market.

The same conclusion can be reached in reference to the central banks' sale of some of their gold reserves. All market participants have been paying particular attention to these operations since September 1999, when fifteen European central banks agreed in Washington the orderly sale of 2,000 tonnes of gold from their official reserves over the next five years. One month ago, the agreement was extended for a further five years (to September 2009), setting the total sale limit at 2,500 tonnes or 500 tonnes per year. One may wonder if these agreements and sales indirectly indicate that these countries have embarked on a long-term gold demonetisation programme, and that their statement that "gold will remain an important element of global monetary reserves" is nothing but a sort of soothing therapy for the market. Such opinions exist, although do not prevail.

I think that the agreements do not give ground for this view. First, the participating countries own between them 12,300 tonnes of gold. The share of the metal in their official monetary reserves has reached 36%. This is significantly higher than the average for all the world's countries (10-12%). So the sales can be seen as the optimisation of the reserves structure. Secondly, the countries making the sales (France, Germany and some others) are currently enduring budget deficits exceeding the limits laid down by the Maastricht Treaty. Hence this may explain the temptation to solve their budgetary problems without reducing expenditure or raising taxes.

The current decisions by the monetary authorities in European countries could therefore be considered as sensible, like the actions of certain Asiatic states that in recent years increased the gold portion within their monetary reserves. The internal imperfections of the international monetary system (which I spoke about earlier) have already led to a number of regional financial crises and still carry the danger of larger upheavals. Under these conditions, the growing interest of investors in real assets, in gold in particular, is more than justified. And on that optimistic note, I would like to end my presentation. ■