Central Banks and Gold – A New Challenge

Juan Ignacio Basco

Deputy General Manager, Central Bank of Argentina

I. Introduction

Thank you. First of all, I want to thank the LBMA for inviting me to speak to this audience. This conference has been a very interesting forum for many years for all of us to exchange views about the gold market.

I am going to cover the analysis from the point of view of a central bank and the way in which central banks take the decision to invest in gold, especially in the light of what has happened this last year when we had to face a sudden disruption in price and volatility.

II. Major Gold Holders

As you know, central banks and official institutions have been major holders of gold for more than 100 years. As you can see on this chart, official gold holdings have been 30,000-35,000 tonnes during the last 60 years without significant change. The stability of central banks' gold investment over the years has acted as a buffer in a market that sometimes shows sudden moves.

III. Attitude Towards Gold

Nevertheless, central banks' attitude towards gold changes from time to time. Under the gold standard system, the appetite for gold was obviously high. The breakdown of Bretton Woods and the move to a floating exchange rate system led some central banks to reconsider their need for such high levels of gold in their reserves. During the following 35 years, therefore, central banks became net sellers. This was driven by the impact of high interest rates, which increased the opportunity cost of holding gold. However, the recent global financial crisis seemed again to force a change in the central banks' attitude towards gold and they started to be seen again as net buyers of gold.

IV. Major Sellers in Advanced Economies

It is worth distinguishing between advanced and emerging economies. If you take a closer look at this chart, we find that there is a significant difference in gold holdings among countries and what we have seen as central banks' selling trend was basically advanced economies selling part of their very large gold position. In contrast, emerging markets' holdings of gold are still very underweighted, holding, on average, less than 5% of their reserves in gold.

V. Emerging Countries Net Buyers of Gold

In fact, you can see on this chart that emerging markets have always been net buyers of gold, even though their holdings have always been very low, not only in terms of quantity but as a part of their reserves. Only when we recently saw a huge accumulation of international reserves in these countries did they become relevant as gold buyers. Therefore, the history of emerging economies and gold is a very recent one and has been the major driver of central banks' net buying trend after the global financial crisis. On the other hand, advanced economies also stopped selling gold as interest rates went to zero and the opportunity cost of having this massive amount of gold ended up not being a significant factor for these countries.

VI. Gold as a Percentage of International Reserves

The big question is how much gold should our economies have in their reserves? It is very difficult to know, the decision is always difficult to take and there is no common line of reasoning. The currency of international reserves varies from country to country. Just to show you an example, here is a study covered by the World Gold Council, which tried to determine how much gold was optimal for an emerging economy. It concluded that the median optimal allocation of gold was in the range of from four to seven on a US dollar based optimisation or from eight to 10 depending on risk tolerance in a local currency based optimisation using the local currency as the numeral.

VII. Central Bank of Argentina

In the case of Argentina, we have a long history in trading gold. In the 1990s, before the Argentine crisis, we had a currency board regime under which we had 1:1 parity to the dollar, so at that moment we decided to sell our position in gold. We decided not to have gold anymore and sold it at around $380. For seven years we did not change our decision and we profited from higher interest rates. Fortunately, we changed our attitude back in 2004 when the price of gold was around $400. At that time, we bought back 55 tonnes, which meant 5% of our reserves. We increased our gold holdings to 62 tonnes in 2011 and today the position represents 7% of our reserves. If we see this position from the perspective of the optimal allocation exercise I commented on before, it seems that we are quite neutral right now.

VIII. Attitude Towards Gold in Other LATAM Countries

What about our region? Venezuela has always been the largest gold holder with Argentina second. However, the picture changed in 2011 when Mexico bought 120 tonnes and took the second place among Latin American countries. In 2012, Brazil, after many years of holding the same amount of gold, doubled its position and became the third largest holder in the region. Nowadays, as a result, we are in fourth position.

IX. Central Banks Not Like Usual Investors

The global financial crisis raised new challenges for all central banks. Before the crisis, advanced economies and banks in advanced economies were considered the best safe haven place to invest our reserves. The global scenario changed and led to an important reassessment of market and credit risk views. Consequently, gold's lack of credit risk precisely became a very important driver, in my view, to a new round of gold's official demand. However, you should notice that central banks are not like the usual investor. We deal with national savings, we have no long-term goals and we need to be very cautious when moving.

Here we have a picture that I think is very illustrative of how we usually feel when investing our funds. We seem like the little bird standing on the elephant, trying to ride it. First, when talking about central banks, you are talking about the elephants in the market; in this case size matters. Central banks usually have too many funds to invest and will try not to cause disturbances in the market and especially not to be in the spotlight due to reputational concern. Second, safety and liquidity are the top priorities for central banks and return comes as third. International reserves are assets that must be ready to be used, if necessary, and we will probably need most of them when we are under pressure in worst-case scenarios.

X. Gold's Key Features for Central Banks

This is probably the best way to understand why central banks have been so supportive of gold. Gold's lack of credit, long term store of value and safe haven behaviour during the worst-case scenarios are key features for central banks. Although we have been accustomed to using bills as money, the last global financial crisis reminded us of the implied risk of paper currencies. After the global financial crisis, advanced economies started to have higher fiscal imbalances, higher debt to GDP ratios and, in particular, they started to increase their balance sheets quite significantly. We could see unlimited supply of the traditional reserve currencies and so unlimited downturn risks. In contrast, the supply of gold is very limited. It is almost dependent upon mine supply. If we do not discover new mines, we know that mine supply will be exhausted in 20 years. Therefore, you have, on the one hand, paper money dependent on unlimited supply and, on the other hand, gold having a particular ceiling. Consequently, if gold is seen as a strategic asset it is easier to understand central banks.

XI. Central Banks' Reactions This Year to Date

This year has been a particularly challenging one for gold and central banks. On the one hand, we had a huge amount of private investment flowing out of gold and, on the other we had central banks that kept buying gold during the first semester. During this time central bank purchases were a bit lower and this is another example of how central banks react and move on gold and generally in changing their investment patterns. As I said, we usually move very slowly. We do not try to buy or sell following market behaviours or mood. When the market moves like we saw this year, at first we keep doing the same things we have done before and then we start having internal discussions over the matter and re-analyse if the midterm scenario has changed. Then we decide if we need to change our portfolio rules or not and, if we decide to do it, we will try not to impact the market with our moves.

Now that we know that gold is important to central banks for strategic reasons, what can we do in the meantime?

XII. Reserve Managers' Strategies

1. Tail Risk

If you have a tail risk scenario, like we have this year when changes in the price of gold were above two standard deviations, something that was truly unexpected, in our countries the amount of international reserves is constantly monitored by the public and press. Therefore, we do not feel very comfortable with gold volatility even if gold is not a very large part of our reserves.

2. Hedging

Consequently, we try to reduce portfolio volatility or limit the downside scenario by using some hedging strategies, which I am not going to describe today but you know very well the kinds of things we could do. However, I want to point out some final remarks:

First, using hedging strategies always means some cost and so you need to decide if the high volatility justifies paying that cost. You must ask yourself questions like is it really worth it to hedge short-term volatility; can we stay focused on the long-term scenario or are short-term moves important for us?

Second, we learn that even if we have a cost and the return on our gold portfolio is lower, the Sharpe ratio of our gold portfolio improves using hedging strategies as the reduction in volatility is much higher than the reduction in the yield of our gold portfolio.

Third, it is important to remember that gold is a very precious asset that is always in the spotlight. There is always high reputational risk for central banks and we need to have dynamic management of these positions, but we always need to be very cautious and move very slowly: we should always remember that we are elephants. That is why we will keep on being cautious and maintain our purpose of managing our reserves under the three key points of safety, liquidity and, finally, return.

Thank you.

Terence Keeley

Thank you very much, Juan, for those comprehensive remarks. We also know elephants never forget, so we are going to be asking the panel now a few questions about their experiences and thank you everyone who has sent in questions. Just to remind you, we are going to spend about 15 minutes now speaking to Clemens, Alex and Juan specifically, reminding you once again that the Bank of England does not control the gold; that is controlled by the Ministry of Finance and so Matt will be making some comments later.