

Managing Gold as a Central Bank

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I. Preamble

Thank you. I showed you my American passport because it may sound obvious that I am American when you hear my accent.

II. Introduction

Thank you very much. I will try to focus on two main points. The first one is to elaborate slightly on why we decided to sell gold and the second one is how we consider gold today.

III. Gold and Banque de France Asset Allocation

1. A Changing Environment Long Before the Crisis

An important point from a Banque de France and probably Eurosystem perspective is to be really aware that we have been in a changing environment for many, many years and I would just like to focus on a few points:

- Due to the Eurosystem, the European Central Bank has its own FX reserves. This means that in case of intervention we will first use ECB reserves and then the FX reserves of the national central banks. This is why we do not have the same liquidity constraint, so it was also an important evolution.
- Under pressure from the public and shareholders, we have to move in a more efficient way to manage the Bank and a way to do this is to reduce cost, but another way is to increase income.
- Due to the functioning of the Eurosystem, we have regular meetings of national central banks where we discuss many topics in market operations and, of course, financial instruments. When you want to introduce, for example, futures or options, you will probably find another central bank within the Eurosystem that already has this instrument among their available financial instruments. Therefore, it helps you to implement new financial instruments.
- When we recruit people from university, they all have a minimum background in finance and are all fully aware of the asset allocation process and so on, meaning that it is also a help for us to move towards better allocation of our assets.
- The question of IT systems was a big issue in our case. We also need up to date IT systems to be able to move towards more diversification.

2. Balance Sheet

I would like to show you a summarised picture of our balance sheet. You can see that on the right-hand side we have bank notes and we could consider that there is zero yield; and we have reserve requirements and they are remunerated at the central bank rate. On the left-hand

side, we have monetary policy, where I would put an average rate of 0.5%; and then we have some financial assets. In these financial assets we have euro portfolios, currency portfolios and, of course, gold. This part is very important, because when you see the balance sheet you see that we have a very, very strong dependency vis-à-vis short-term interest rates and also the level of the main refinancing rate of the central bank.

Going back to 2000, at that time we only had some reserves in US dollars. These reserves were invested in very short-term duration portfolios and in a couple of years we moved from an environment where we had a yield of more than 6% on our financial assets to a world where the yield on financial assets was around 1%. This was a big jump and we became aware that we had to do something to find some additional return and also to have a less volatile return on these financial assets. We went through a process of new asset allocation with currency diversification, longer duration portfolios and the decision to sell part of our gold. At that time, we had 3,000 tonnes of gold and the decision was made to sell 500 tonnes.

3. Defining Asset Allocation

What are the drivers to define asset allocation? I have put on this slide the four most important. I do not think that there is one that is more important than another and it may depend on the strategies that are considered.

The first one is, of course, return, but this is not only financial return. We have some specific rules in central banks which mean that we also have to take into consideration what we can call the accounting return. I will just summarise the point. Say I have an asset at the beginning of the year with a value of 100 and at the end of the year the value of this asset is 110. If the gain is only related to an unrealised gain in terms of FX, because the currency has increased, then this gain will go to the balance sheet in a dedicated buffer, meaning that we will not see one penny in the P&L. However, if the move from 100 to 110 is related to yield, then we will have 10 going into the P&L account. Due to this accounting rule, of course, you have a bias vis-à-vis currency or assets producing a yield.

In terms of risk, we have a risk framework that is very, very strict: we want to protect our capital. However, when I say 'risk' I also mean operational risk, which is now a very, very big issue.

There is also the question of resources in terms of IT and people. A big change is that usually you join the Banque de France by passing an exam and now we have the possibility of hiring people directly from the private sector and from commercial banks. This is also something that has helped us to move towards, let us say, more sophisticated financial products. It remains a big issue, though, and when we consider diversification we always take into account the question of human resources being able to manage a process from the front office to accounting and also the question of IT.

Of course, there is the issue of governance, which is very important because we have to explain our decisions to the public. For example, if we decide to diversify our assets in the

Australian dollar for reasons of return, we have the resources able to do so, but we also take into consideration being able to explain to the public what the drivers were of this decision. Just imagine that we make a loss with this investment; what could be the explanation to the public to say, 'It was in the interests of Banque de France and the shareholders to move towards this diversification in Australian dollars'?

4. Gold Asset Allocation

Now if I focus on gold returns, from a central bank perspective it is probably not the best investment, because we have the gold in Banque de France's vault and, exactly as Clemens mentioned, we do not lend very much, meaning that we do not have a return on gold. However, because of the policy of keeping all the gold in the vault of Banque de France, we do not have a strong risk issue, because it remains in the vault.

In terms of human resources, we had to train some in gold and we had to update the system, but it was not really a big issue. When we decided to sell gold we used options because we had in mind some predefined level, so it was really efficient to use this type of instrument. However, it was not possible at the beginning because we did not have the guy able to manage that or the IT system, so we had to wait for a couple of years before being able to do it.

With regard to governance, the key point was how to explain this decision. This decision was explained by saying that by switching part of the gold, which is a zero yield asset, towards yielding assets we will increase the dividend per year of Banque de France and then we will increase the dividend to the state. We calculate that the average increase in the dividend is between €200 and €300 million, so it was a good explanation to say that it was justified to sell some gold. Be aware that we only sold some gold. We kept 2,500 tonnes. Over four years we sold just above 500. It was also explained that a similar decision was made in the past, because from June 1968 to June 1969 we sold 1,500 tonnes, and we have current holdings of 2,435 tonnes.

5. Current Asset Allocation

How is our asset allocation now? I take into consideration the euro portfolios, which is important because in our reallocation process we fully integrated the fact that we have some euro holdings, so we have some euro portfolios, which represents 40% of the total financial assets. I refer to one of the first slides that had 'financial assets' on the left slide. In the financial assets, we have 40% gold, 40% euro portfolio and 20% in currency – the Australian dollar, the US dollar, the Canadian dollar and others. We now have 30% of our portfolios that are short duration and 70% that are long duration.

IV. Banque de France and Gold Today

1. Still a Strategic Asset

Today, we do not have the same location issue as the Bundesbank, because all our gold is located in Paris. Our bars are not all LGD, but we have an ongoing improvement programme.

We have no plan to sell gold. I will not be the one to make the decision, but I see no plan to sell it.

We are still active in the gold market for our own account. We have a desk dedicated to FX activity, which is small, but now we are diversifying into gold, meaning that we are in the market nearly on a daily basis. The question of loan restart is pending. Of course, we can see some yields that are attractive, but the point is that the environment is totally different. In the past, we used to lend some gold totally blank in the market, meaning without collateral and I am not sure it would be acceptable to the risk committee to lend gold for one or more years without collateral. This is the reason the issue is still pending.

We are still active in the gold market for central banks and official institutions. We do not communicate a lot around that, but central banks are a small community and when a central bank is interested in buying or selling gold or in the process of upgrading its gold or for custody purposes and things like that, they can be in contact with the Banque de France. Due to these regular contacts we now have a small activity in gold dedicated to central banks and official institutions.

Thank you very much.

Terence Keeley

Thank you very much, Alex. That was much clearer than you predicted it would be; very clear. Thank you very much.

Juan, now over to you. Juan Basco has had a very long and distinguished career at the Central Bank of Argentina. In fact, he started there before I finished middle school in 1973. Juan, you have managed the foreign operations, the market operations and the research departments. We look forward to your comments.