Chairman’s Remarks

Jeremy A Charles
LBMA Chairman

Good morning, ladies and gentlemen. I should like to offer you all a very warm welcome to Montreux and the 7th Annual Conference of the London Bullion Market Association.

I am especially pleased that the Association has chosen to hold this year’s event in Switzerland, given this country's long-standing historical association with precious metals and its particular relationship with the London bullion market.

Last evening the conference got off to wonderful start, thanks to the hospitality of the members of the Swiss Precious Metals Association, who generously sponsored our welcome reception – my thanks to all of them.

Most of us are too young to remember that the Swiss banks were amongst the first commercial institutions to purchase gold on the London Fixings immediately after its establishment in 1919. Today, the country remains one of the most important international precious metals centres.

The thriving private banking sector here has had a major influence on global investment demand over the last two or three years. When this is coupled with the high-tech precious metals refineries – all of whom manufacture high quality products for the global physical markets – it is obvious why this country plays such a central role in the industry.

My good friends at the Swiss National Bank have of course ensured that the gold market’s spotlight has been trained on this country during the past several years. It is testament to the cooperation between the London and Swiss markets that the recently concluded sale by the Swiss government of some 1,300 tonnes of gold was conducted in a manner which caused no disruption to the international market.

So for these reasons and more, it is truly a great pleasure to be here today.

This year, the markets have continued to see volatility on a scale that most younger traders had never previously experienced or perhaps even dreamed of. Prices for all four of the metals that many of us trade have recently reached multi-year highs.

However, it is recognised that headline news does not always reflect a welcome scenario for everyone involved in our industry.

Mining companies, as well as those investors who foresaw the dramatic rise in prices, have been the most obvious beneficiaries. At the same time – for industrial consumers – higher prices, and, in many cases, higher borrowing costs have had a detrimental impact on their businesses.

However, there is no doubt that since our last conference, it remains the investment sector that is firmly in the driving seat, and I am particularly looking forward to hearing from our experts on this topic later today.

Growth in the global markets continues unabated. New exploration is being driven by higher prices, while new technological applications are helping to sustain physical consumption.

New exchanges are being developed in many domestic markets to facilitate the increase in producer, consumer and investment demand. This year we have seen the start of trading in Dubai and Taiwan, and it is likely that other exchanges will soon be offering platforms for both physical and futures trades.

Global stock markets are once again providing a platform for commodity-related business via the latest hot topic – Commodity Exchange Traded Funds.

Gold led the way to what is now an easy route into a broad-based range of commodities that are
tradable on many stock exchanges around the world – Australia, the UK, South Africa, the US and Europe all offer ETF products. There is no doubt that many other stock exchanges are now urgently looking to join this particular club.

All in all, the outlook is extremely positive for our industry. After two decades in the doldrums, I firmly believe that we are still only in the early stages of what will be the most productive, dynamic and interesting period of time during my 30 years in this industry.

People have questioned me about the threat to the London market from the increased competition posed by these new markets. In my opinion, no such threat exists.

London remains the location for the central pool of metal liquidity. So long as this pool resides in London, then the financing centre for the global industry will also remain in London.

The gold and silver supporting the majority of the new investment products is stored in London vaults. The world’s central banks still see London as both the prime entry point for transactions and the safe haven choice for custody of this prized asset. It is London where the majority of precious metal trades are handled.

This may sound somewhat complacent. But London has a reputation for embracing change and for working in an international arena, and the LBMA very much welcomes these developments in the global industry.

Our programme this year takes place over the traditional day and half. We have chosen a broad suite of topics and speakers to ensure that you all take something positive away with you from our conference.

As you would expect, gold remains our main focus. However the other three precious metals that are on our programme are now playing an increasingly important role in our future wellbeing in terms of our health, our environment and our economic development, and it is therefore appropriate to give some additional coverage to these metals. This reflects a general desire by both our membership and the broader market to gain a better understanding of the role in our society that these metals now play.

At last year’s conference in Johannesburg, I attended a workshop on the latest uses of PGMs and other metals in the industrial sector. It was not only extremely interesting, but it was standing room only!

In line with this global expansion of interest in precious metals, I am very pleased to inform you that the LBMA itself has continued to expand, primarily by the admission of new Members and Associates which are not UK-domiciled companies. We are currently looking at enquiries from a further five potential Members or Associates. I am also delighted that this year we welcomed an additional Clearing Member to the market.

We have also added four new refiners to the London Good Delivery List in the first half of this year.

Perhaps at this point I should mention the ongoing proactive monitoring of Good Delivery refineries. This monitoring ensures that the refiners of gold and silver bars on the List continue to demonstrate the same high technical standards that they did when they were first accepted onto it.

For those that no longer reach the highest standards expected of our market, de-listing is the likely outcome. The integrity of the market is paramount, and as part of my chairmanship I will press this particular message home with vigour. Second best will not be accepted by the LBMA.

As I mentioned earlier, liquidity remains key. The start-up of new precious metals exchanges represents a widening of choice for market clients.

London traditionally has enjoyed a high concentration of liquidity passing through the market. However, where there was once a single concentration of trading liquidity, there are now multiple platforms spread across the globe.

Today we not only have the OTC Loco London market, we have futures markets, physical markets, ETFs trading on stock exchanges, commodity indexes … and we even have ETFs on commodity indexes!

The effect of this has been to fragment liquidity and this, in my opinion, has helped to create a much greater degree of volatility than we have seen at any time in the past. Therefore the LBMA deemed it appropriate to reaffirm the strength of the London Market in the strongest possible way.

At a meeting earlier this year, the nine Full Members who guarantee to provide the core liquidity to the market renewed what I call their vows of commitment.

This obliges those Members to make prices to each other upon request for a minimum quantity of gold and silver in spot, forwards and options – thus preserving a highly liquid marketplace during regular London working hours and, in most cases, well beyond.
The LBMA also recognised the need not just to reaffirm the commitment of those current market makers, but also to examine the possibility of encouraging even broader participation from its Members in the interbank market. We have achieved this by offering a new classification for Market Making membership.

This new category enables LBMA Members to quote as a market maker for any combination of spot, forwards or options, which Full Market Making members are still obliged to quote in all these products. We believe that, once additional market makers have been accepted on this basis, there will be a significant benefit to the London market as a whole.

This in turn will benefit clients, and so I would encourage those members who could do so to apply for reclassification as a Market Maker in one or more of these three products.

I am confident that, because of the commitment by our members, the London market will continue to thrive, and I should like to take this opportunity to thank all the members and my colleagues in the LBMA Executive who together have been at the forefront of this initiative.

I should also like to thank my colleagues on the various committees, particularly the Public Affairs Committee, who have been instrumental in arranging this conference.

Now it only remains for me to say that I hope that you all have a very enjoyable conference; that you have sufficient opportunity to make new friends and develop new business and, of course, that you enjoy your time in this wonderful country. Thank you.
Thank you for giving me the opportunity to speak to you this morning. The last time a member of the Governing Board of the Swiss National Bank (SNB) had the opportunity to address this audience was in June 1999, when our present Governor, Jean-Pierre Roth, had the difficult task of explaining why the SNB intended to sell 1,300 tonnes of its gold reserves. Back then, the gold market environment was quite different: the price of gold had steadily declined to US$250/oz and there were widespread concerns in the market place that central banks were intending to liquidate a substantial part of their gold reserves.

In seven years, the market has, in many ways, come full circle: the price of gold climbed to above US$700/oz before receding below US$600/oz, levels that were last seen in 1981. Central bank activity in the gold market is not considered as a threat anymore. The agreements of 1999 and 2004 between 15 European central banks – the so-called Washington Agreements – have removed much of the uncertainty regarding central bank sales. Indeed, market rumours today are arguably more concerned about central banks buying gold than they are about central banks selling gold.

As many of you know, the SNB completed its gold sales program fifteen months ago\(^1\). In total, 1,300 tonnes were sold. The decision to reduce our gold holdings by half was taken for two reasons that were highlighted by experts as early as 1997. First, the SNB arguably had more gold than it needed. Switzerland’s official gold holdings per capita were five times higher than those of the next G10 country. Second, the SNB had – on a mark-to-market basis – excess capital reserves that were no longer required for monetary purposes. As a result, the decision was taken to sell 1,300 tonnes of gold. In May 2000, as soon as the legal framework had been amended to allow market sales, the SNB started its gold sales operations. We adopted a very transparent strategy and tried, within the constraints of the Washington Agreement, to maximise the proceeds of the gold sales in Swiss francs. The average selling price of USD 350/oz was 17 dollars higher than the average London fixing of the selling period. Of course, with today's prices around 600 USD/oz, you might think that we revisit our sales program with mixed feelings. As a matter of fact, price forecasts, which are inevitably subject to great uncertainty, did not feature prominently in the SNB’s decision to sell gold. The timing of the gold sales was largely influenced by factors that the SNB did not fully control. Once we were allowed to sell, we started our program within the window of opportunity that had been negotiated with other central banks under the first Washington Agreement.

Today the SNB is no longer in the spotlight with regard to its gold policy. This makes my task today easier than President Roth’s seven years ago. I have no newsworthy information to present to you regarding our gold policy. Instead, I will briefly reflect on six commonly held arguments related to commodities and, more specifically, to gold. The point of considering these arguments is not to either reject or confirm them definitely but rather to illustrate the likely speculative nature of long-term gold price forecasts. Since it was freed from central bank intervention, the gold market has been quite

\(^1\) For a detailed overview of SNB’s sales program, see Hildebrand (2005), SNB Gold Sales – Lessons and Experiences, Institute for International Economics, Washington.
volatile. Historical evidence as well as analytical considerations suggest that price volatility will likely remain an important feature of the gold market.

**First argument: Gold is a commodity like any other**

Since the collapse of the Bretton Woods System, gold has lost its role as an anchor for the international monetary system. Does that mean that it has become a commodity like any other? Before trying to analyse fundamental differences or similarities between gold and other commodities, let’s look at what prices tell us: At first sight, gold and other commodity price cycles indeed look similar: the boom in the gold market since 1999 clearly has parallels in other commodities as well. Oil prices have increased sevenfold since 1999; industrial metals have increased threefold since 2001. Similarly, the extraordinary gold bull market at the end of the seventies occurred in the context of rising oil and commodity prices. This parallelism, however, is not perfect. The average correlation between weekly price changes of gold and oil throughout the last 20 years is a mere 0.1. For metals, the correlation with gold is slightly higher but remains below 0.2. Both correlations have varied heavily within the period; currently, they are clearly on the high side (Graph 1).

**Graph 1: Correlation between gold, metals and oil prices**

Despite similarities in price movements, the gold market has a number of distinct features relative to other commodity markets. Arguably, the most important distinction is the fact that the ratio of available supply to annual production is much higher for gold than for other commodities. A significant proportion of the estimated 160,000 tonnes of all gold worldwide available in the form of jewellery, bars, coins, etc. (sixty times the annual mine production) could be brought to market at relatively low cost. Thus, in contrast to other commodities, gold prices are not only dependent on the current mine production and processing demand but are also influenced to a great extent by the supply and demand behaviour of existing and potential owners of gold. In other words, the investment motive is a much more important driver in the gold market than in the market for other commodities. Of course, mining and processing demand have an important role in the long term, but the medium-term price equilibrium depends heavily on the investment or disinvestment decisions of the private and public sectors.

**Second argument: Commodity supply cannot catch up with demand**

A common argument in commodity markets relies on a kind of Malthusian logic: due to limited supply, prices must rise in the long run in order to match increasing demand. This argument has been invoked for centuries. However, secular trends show the contrary: in almost all commodity markets, prices have decreased relative to other goods and services. This secular relative price decline does in no way imply that bottlenecks in production or increased demand cannot trigger a commodity price cycle. These cycles are often caused by the delayed reaction of supply to an increase in demand, which tends to push up prices temporarily. But in due time, higher prices tend to trigger new mining investments and foster technological progress.

This raises the question of whether we are currently witnessing a commodity cycle like any other or whether things might be different this time? On the demand side, there can be little doubt that the increased demand caused by the integration of China and India in the world economy is a once-in-a-century historical event. On the supply side, there has been a significant increase in exploration investment since 2002. It remains to be seen whether the increased supply will be sufficient to bring prices down significantly. The depletion of easy-to-mine resources has contributed to a significant rise in extraction costs. Other factors might also push in the same direction: for instance, it is possible that the internalisation of external mining costs, previously born by society as a whole (i.e. through the degradation of the natural environment), might contribute to commodity prices remaining at elevated levels.

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2 For instance, Metals Economics Group (2005) estimates that expenditures for commercial nonferrous metals exploration increased from a 12-year low of USD 1.9bn in 2002 to USD 5.1bn in 2005, a level just slightly lower than in 1997, when expenditures were at their highest level.
With regard to gold, on the other hand, I am doubtful that the main source of uncertainty is related to surprises in future mining supply or fabrication demand. As I mentioned before, absent new vast discoveries, investment demand will arguably continue to dominate future gold prices.

**Third argument: Today’s commodity investment boom is structural and will be long-lasting**

Let’s turn our focus to investment demand. In recent years, institutional and private investors appear to have rediscovered commodities as an asset class. According to some market estimates, investment in commodities has surged tenfold since 2003 and amounted to USD 120bn in May 2006. Many market analysts see this increase as the beginning of a new trend: their argument goes roughly as follows: if all pension funds had only 3% of their assets invested in commodities, this would represent a total investment of more than USD 500bn.3

The gold market has also benefited from a surge in investment demand. According to market specialists, net investment exceeded 700 tonnes in 2005. Exchange-traded funds (ETFs) have become particularly popular because they give investors the opportunity to make flexible and liquid investments in gold, even for small volumes. At the end of 2003, gold ETF investments accounted for less than 20 tonnes. Today, they likely exceed 500 tonnes.

Does the risk/return payoff of commodities justify this new interest? Empirical studies have shown that the inclusion of commodities as an asset class improves the efficient frontier of a portfolio. Nonetheless, we all know that returns and correlations can change. With respect to correlations, there is arguably no compelling reason why low correlations between commodities and bonds or equities should change significantly going forward. The case for diversification with regard to investing in commodities may therefore well remain intact. With regard to returns, however, things appear more complicated, particularly if we base our analysis on the return of commodity futures indices. In the past, most commodity markets have been in backwardation: futures prices were lower than the spot price. This was beneficial to investors buying commodity futures, because they could profit from a so-called roll-yield. This yield can be interpreted as a risk premium priced into the futures contract to compensate the holder for bearing the commodity price risk. However, if the number of investors ready to bear this risk increases significantly, the risk premium could disappear or even turn negative. In fact, for some time now, the near-term structure of many commodity prices has experienced a change from backwardation to contango. It seems to me, there may well be a connection between this change and the growing trend to invest in commodity futures.

Contrary to other commodities, gold has typically been in contango. The reason is that there is plenty of gold around and plenty of market participants – including central banks – willing to lend it. As a consequence, gold lease rates are usually lower than USD interest rates and gold futures prices higher than spot prices. The roll yield is thus negative, which is one of the reasons why investment in gold futures did not generate the same returns as investments in broad commodity future price indices. So what return should we expect from investing in gold? History shows that gold has been able to keep its value in real terms, but compared to bonds or equities, no real return has been realised (Graph 2).

**Fourth argument: Gold mine hedging is “passé”**

As you know, in the second half of the 1990s, gold mines increasingly sold their future production on a forward basis. In doing so, they pushed up gold supplies by more than 10% per year, thus reinforcing the already negative price trend. As from 2001, mining companies increasingly abandoned this type of price hedging, which amounted to a *de facto* reduction in the supply of gold and thus contributed to rising prices.

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This raises the question of what constitutes an optimal hedging policy to maximise shareholder value. One of the reasons gold mine companies typically give for reducing their hedge book is that shareholders want to incur a gold price risk when investing in mines. While there is arguably some logic to this argument, investors clearly have other alternatives if they seek exposure to the price of gold. There is no doubt that no hedging at all would have been better from a shareholder’s perspective than the kind of procyclical policy that was followed in the past. Nonetheless, it seems to me, we cannot rule out that the gold mining industry will start increasing its hedging activities again at some point in the future.

**Fifth argument: Central Banks will adopt a homogeneous attitude towards gold**

At the end of 2005, central banks had officially declared reserves of around USD 3,500bn. Of this amount, around 15% was invested in gold (Graph 3).

*Graph 3: Evolution of World Official Reserves*

The proportion of gold varies considerably from one country to another. For instance, it amounted to more than 70% for the United States, 50% for the Eurozone, 40% for Switzerland, 4% for India, 2% for Japan but less than one percent for Brazil, China, Hong Kong, Korea or Malaysia.

These variations have always been a source of market rumours. At the end of the nineties, the prevailing question was: what if European central banks would reduce their gold holdings to 10% of their reserves? Now, the question is: what if Asian central banks would increase their holdings to 10% of their reserves? I doubt that in the foreseeable future, these national discrepancies related to gold reserves will diminish significantly, let alone disappear. Countries have different geopolitical situations, different historical backgrounds, different levels of development and different functions for their official reserves. These differences give rise to different priorities with regard to the role of gold reserves.

**Sixth argument: Increasing living standards will boost private gold demand in emerging Asia**

My comments on this last argument will be brief. As often when looking at economic issues, there are substitution and income effects at work. On the one hand, prosperous Asian workers will be able to save and consume more, which should be reflected by an increased demand for gold. On the other hand, as financial markets and banking systems become more developed and more secure in today’s emerging economies, the palette of alternative saving vehicles will increase and we should expect the relative proportion of wealth invested in gold to decrease. In other words, we might expect the income effect to be strong at the beginning before receding and giving way to the substitution effect.

**Conclusions**

Despite the demonetisation of gold, the yellow metal continues to have a special significance for central banks. Unlike currencies, the value of gold does not depend on a national sovereign. Moreover, payment transactions with gold are fully under a central bank's control. These are two important reasons why gold, more than any other type of investment, serves to ensure the capacity to act in extreme crisis situations. From an investment viewpoint, the price of gold often moves in the opposite direction to other financial assets, in particular to the US dollar. The price for this ‘insurance function’ is reflected in the fact that gold is less profitable in the long term than other financial assets.
It is not surprising that Switzerland – a small, open, developed country with a highly integrated financial sector and an ageing but relatively wealthy population, continues to invest a significant proportion of its reserves in gold. At present, the SNB holds 1,290 tonnes of gold or roughly 30% of its assets. Price fluctuations in both directions are to be expected and may be strong and sustained.

As was the case in the past, such price fluctuations will modify the proportion of gold on our balance sheet from year to year. These short-term fluctuations should not give rise to great concern. Experience has shown that extreme movements in markets tend to level out in the long run.
Going Back to Gold? Historical Perspectives

Professor Niall Ferguson
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When I was a teenage double bass player, I dreamt of playing Montreux, but I did not quite have this in mind. Rather than a jazz festival, I thought I would give you a little film festival this morning. I am sure you are all familiar with the great movie version of Ian Fleming’s *Goldfinger*. In one scene, Sean Connery says to Goldfinger, ‘You don’t expect me to talk, do you, Goldfinger?’ Goldfinger replies, ‘No, Mr Bond, I expect you to die.’ This is my favourite line from all the Bond films. (There is a laser beam pointed directly at Connery’s groin at this point). More seriously, what is interesting about *Goldfinger* is that, if you return to the original novel, it contains a rather lucid if simplified exposition of the way the gold standard used to work.

You can tell that Fleming came from a distinguished banking dynasty. In this passage, Bond has the gold standard, or rather the Bretton Woods system, explained to him by a Bank of England official named Smithers: ‘Gold and currencies backed by gold are the foundation of our international credit. ‘We can only tell what the true strength of the pound is, and other countries can only tell it, by knowing the amount of valuta we have behind our currency. You know about the currency crisis and the high bank rate? Of course. Well, England needs that gold, badly – and the quicker the better.’

This is one of the rare occasions when an international man of mystery, a secret agent, is sent out by the British government to save a monetary system. By 1959, however, the idea that the pound’s value depended on the amount of gold in the Bank of England’s reserve was quite anachronistic. After all, as early as 1924, John Maynard Keynes had proclaimed the gold standard to be nothing more than a ‘barbarous relic’. There is a memorable passage from his *Tract on Monetary Reform* (which I often think is the best thing Keynes ever wrote): ‘All of us, from the Governor of the Bank of England downwards, are now primarily interested in preserving the stability of business, prices, and employment, and are not likely … deliberately to sacrifice these to an outdated dogma … of £3 17s 10½d per ounce.’

Keynes comes out of the argument better than Smithers/Fleming because as you all know, the gold standard disintegrated little more than 10 years after *Goldfinger* was published, and the whole notion that the international monetary system could be brought down by a SMERSH—

**Keynes vindicated (1) 1971**

- August 15, 1971: Nixon closes ‘gold window’

This cartoon from the period depicts the enormous American economy precariously balancing on a tiny bar of gold.
Keynes has been vindicated even more in recent times by the unwinding of gold positions by the world’s central banks. You will remember that back in 1999 the Treasury announced its decision to sell a large part of the Bank of England’s gold reserve. That decision in some ways mirrored what was being decided at the time the European Central Bank (ECB) was being created. Compared with the amount of gold in the reserves of the member banks joining together to form the European Monetary Union, the ECB was really quite short weight in gold. The European central banks have continued, as you all know, to sell gold since that time.

If one looks at official gold holdings now, the amounts are quite small, with the notable exception of the United States, which still sits on quite a substantial hoard. That raises the question, ‘Is gold in a transition from bars to bling?’ Is that the fate of all barbarous relics – to become mere jewellery, no longer a serious part of the international monetary system? As is well known, all the gold that was ever mined only amounts to about 145,000 tonnes and about one fifth of that is held by central banks and international monetary organisations. The amount that is actually dug up every year could give you a growth rate of about 1.7% on that stock, but most of the new gold goes to jewellery, dentistry and industry, not to the international monetary system, which appears no longer to have a need for gold.

The interesting question I want to address this morning is whether this relic could be revived. I want to focus specifically on the possibility that in the wake of an incipient, perhaps already quite far advanced, crisis of the US dollar, which since 1945 has been the pre eminent international currency, there could be a return to the gold standard. Could we see gold come back to replace the dollar as the basis for the international monetary system? This question was raised only the other day in an op-ed article in the Wall Street Journal.

It is a question that never entirely disappeared from the back of Alan Greenspan’s mind. If you trace Greenspan’s career back to before his time at the Federal Reserve, he had his gold standard phase. A point that is often made is that as Asians – Indians in particular – grow more wealthy and at the same time more sceptical about the US dollar as a store of value, they too may find the notion of a new gold standard attractive. It has been argued for some time now that in Asia a surrogate Bretton Woods system was created in the years since the 1997 emerging markets crisis, the so-called Bretton Woods II model. However, Bretton Woods II is an informal system whereby Asian currencies peg themselves more or less loosely to a fiat currency, the dollar. The question is whether such a system is simply too inflationary and generates too much credit around the world to be sustainable, particularly given the possibility that the anchor currency – the dollar – could be unilaterally depreciated by the US government as a way of diminishing its external liabilities.

The long run history of gold as the basis for the international monetary system is to me endlessly fascinating, and an enormous literature exists on how the gold standard worked in the successive phases of its existence.

Let us contemplate the possibility of a new gold standard in reaction to the fundamental crisis of the paper dollar standard that we have in fact been living through since the time of Nixon. Back in 1959 when Nixon was in the early phase of his political career, there was around $500 in circulation for every ounce of gold held by the American authorities; now it is in excess of $37,000.
Going Back to Gold? Historical Perspectives

Niall Ferguson

English football history. Since 1966, the last time England won the World Cup – I am sure they will win it again at some point in the future, though not this year – the dollar is now worth roughly 6% what it was worth then. This is a pretty weak anchor for an international monetary system, and you have to wonder at what point disillusionment is going to set in.

I will revert towards the end of my remarks to the extraordinary phenomenon that the global hegemon – I prefer the term ‘empire’ – is today a colossal debtor, whereas in the heyday of the gold standard, the English-speaking hegemon or empire was an enormous creditor. This is of course the foundation for nervousness about the long-term value of the dollar.

As the United States becomes the world’s debtor, it is unusual by comparison with Latin American countries in being able to borrow abroad in its own currency. We know from recent American history there is always a strong temptation to debase the currency when large quantities of it are held by foreigners.
ranging from full gold to paper. It is only by around 1908 that nearly all economies are authentically gold based. With the outbreak of the First World War just six years later, that pure gold standard was suspended more or less everywhere and was never wholly restored.

The critical point, which I am sure you are all familiar with, is that one should not regard gold – as is sometimes suggested in financial media commentary – as a hedge against inflation. It is not quite that. When you compare its performance with the real returns on stocks, gold has underperformed quite dramatically since 1966. What is important about gold from the point of view of asset allocation is that it is generally negatively correlated against the real returns on stocks, which has all sorts of interesting implications when you think about the recent upward surge in the price of gold. Does this in fact presage a period of low real returns on international stock markets? Not many people think so, but it is one possible inference to be drawn from the literature.

For those reasons – the relatively strong performance of gold recently and the weakness of the dollar, which is the other side of the coin – it is worth looking back and asking how the gold standard actually performed and what the point of it was. Is there in fact a case for returning to it? Should we carry on running the international monetary system on the basis of paper, or is there in fact an argument for building an anchor out of gold?

There were four phases of golden exchange rate stability, or world monetary anchoring to gold: 1819–1859, an age of bimetallism; 1871–1914 which was the classical gold standard; 1924–1931 which was the bastard son of the gold standard, the gold exchange standard; and 1947–1971, the Bretton Woods standard, which was really a dollar standard, though implicitly a dollar backed by gold. The time during which the world was authentically anchored to a pure gold standard was thus really quite a short period. Although the British had adopted the gold standard in the 18th century, it only became a global system in the late 19th century. In 1868 we can still distinguish a number of different kinds of monetary standard,
authorities. It obliged them to commit themselves to time consistent monetary and fiscal policies. That is why Churchill famously called the gold standard ‘knave-proof’.

Secondly, according to Michael Bordo and others, bond markets prior to 1914 regarded the gold standard as a kind of ‘seal of good housekeeping approval’. If you were on gold, it meant you probably would not debase your currency any time soon. You probably would not engage in reckless fiscal policy either, and so it was relatively safer to lend and invest money in countries that were on gold.

Superficially, this analysis is quite persuasive. Long-run price stability – if you take average mean inflation rates for the different monetary eras – was exceptionally low in the period of the pure gold standard up to 1914. Average long-term interest rates for the major economies of the world were also lower in that period.

However, it seems very important to me, before we come over all nostalgic about gold, to recognise the disadvantages of the gold standard. First, in the simple economic model known as the policy ‘trilemma’, if you make an exchange rate or gold price commitment in your monetary policy and do not have capital controls, there are real limits to how far your domestic national monetary policy can be regarded as independent. Monetary policy makers in such a case cannot really pay any significant attention to growth or unemployment because all their efforts must be focused on meeting the gold target. I think it is helpful to think of the gold standard as another system of targeting in which either the price of gold or, more commonly, the gold reserve was the target that had to be met.

A second important point about how the gold standard worked was that, although it implied long-term price stability, it also implied quite high volatility in short-term rates, inflation and economic activity. That seems to be one of the corollaries of all systems whereby a single monetary target takes precedence over others. In trying to meet that target, the Bank of England before 1914 constantly had to adjust its minimum lending rate, the so-called Bank rate.

Thirdly, the gold standard pegs the international monetary system to a very scarce metal and that implies a real constraint on the growth of credit. It turned out to be perfectly possible for the gold standard to generate deflation, if growth outstripped the availability of gold for monetary uses.

Fourthly, perhaps the most important argument in the literature in recent years, a system as rigid as the pure gold standard has the capacity to transmit crises very rapidly around the world. In a relatively minor way in 1907 and an absolutely spectacular way in the Great Depression, the gold standard turned out to be a system that could generate tremendous international monetary and financial crises.

The volatility story is interesting. We are living through a period – though it might not seem like that in the light of recent weeks – of amazingly low volatility. By almost any financial measure, in terms of growth, inflation or asset prices, our fiat money era evinces much lower volatility than even the time of the classical gold standard.
If we home in on the periods when Britain was on some version of the gold standard, we find quite striking volatility in prices. World gold production suffered a significant stagnation from around the 1900s to the 1930s, and it is no coincidence that this was a time when deflationary pressures became a serious problem for the international economy.

Finally, there was the potential for asymmetries in the gold standard. If central banks did not play by the rules, gold could be hoarded in the reserves of a particular bank. The United States became a systematic hoarder of gold in the 1920s with disastrous repercussions for the rest of the international system.

That explains the populist backlashes against the gold standard in the late 19th century and the inter-war period. The populist movement in the United States mobilised farmers against what was seen to be a London-centred conspiracy to cause their debts to grow in real terms. In my Rothschild book, there is a wonderful American cartoon from that era which depicts London – or is it the Rothschild Bank; the two are in some measure equated – as a huge octopus sucking money out of the rest of the world, including the American Midwest. Many populists argued strongly against the gold standard and in favour of re-monetising silver to try to inject some inflation back into the world economy.

The gold standard, in sum, meant volatility and periods of deflation for many people. If we consider the price of wheat in Chicago from 1841 to 1944, there were periods when quite steep price declines occurred. This reminds us that if you do price things in gold, more plentiful commodities are likely to experience quite serious deflation.

I promised you a little Montreux film festival. You may not realise, but The Wizard of Oz – a film you almost all will have seen – is actually based on an allegorical satire attacking the gold standard. The book was first published in 1900 by Frank Baum and, if you read the original, it is clearly an anti gold standard tract. The yellow brick road is an illusory road that ultimately leads Dorothy and her companions to the fraudulent Wizard of Oz, who turns out to be a little man behind a curtain and not the powerful wizard he is said to be.
There is a lesson to be learned from *The Wizard of Oz* in our own time. Tempting though the yellow brick road may seem at this time of relative dollar weakness, it is nevertheless a dangerous road to go down. There is still a very strong case to be made for good old paper money, fiat money, and for floating rates.

Firstly, the possibility of paper money and floating rates solves the problem of the trilemma: you can have free capital movements, but also an independent monetary policy provided rates are allowed to float. Floating rates are probably better – Keynes’s central point – as a way of creating economic equilibrium by offsetting differentials between national economies in inflation or productivity than the alternative, which is to drive down nominal wages and prices (in cases of diminishing competitiveness). Secondly, and this is a critical point that we are only just beginning to understand, it is possible to have long-term price stability with paper money, provided central banks do not abuse the privilege they enjoy of being able to print the stuff. Inflation targeting – increasingly fashionable amongst monetary authorities around the world – is a kind of surrogate gold standard in itself, a paper standard in which the rules are explicit inflation targets rather than targets in terms of gold standards or gold reserves.

I want to conclude by offering you some brief reflections on why a gold standard could never work in the 21st century. Think for a moment about the difference between then and now.

In the 19th century, money was scarce but energy was plentiful. That was one of the characteristics of a monetary system based on rare precious metals, but energy systems based on coal that was ludicrously abundant. The 19th century was a time of long-term consumer price stability, but lower and more volatile growth. It was also a time of much lower social mobility. The social orders of the 19th century world were dominated by quite exclusive elites of rentiers who could collect their gold-denominated interest payments on their gold-denominated bonds without doing a stroke of work in their lives. Finally, the 19th century was a time when the great English-speaking empire was a creditor.

Our world is diametrically opposite to that world. Our world is a world where money is plentiful because it is made of paper – or to be precise, cloth, or nothing at all if it is electronic money – whereas energy is becoming increasingly scarce as the age of hydrocarbons draws painfully to a close. In our world, we have become used to long-term currency depreciation. The fact that the dollar is worth 6% in gold terms of what it was worth in 1966 does not really upset us as much as it should. Why? The payoff to us comes in the form of relatively high and not very volatile growth. Perhaps even more importantly, psychologically, we quite like this world of inflating paper money because it makes it so much easier to become a millionaire. There is something terribly gratifying about a world of low but persistent inflation, particularly if we are the owners of real estate and can fantasise about how much more it is worth each year without our ever having to do anything much except maintain the roof.

Money illusion is alive and well in the 21st century and the truth of the matter is that we do not want that illusion to be shattered. What Keynes called our ‘animal spirits’ as investors may have actually come to depend on it; we are, in truth, addicted to inflation. All we have done lately is relocate it from commodity markets to asset markets and that, of course, is crucial for the way the world economy grows. The debtor empire, the United States, could not function in a gold standard world. Long ago, time would have been called on the growth spurt of the last decade and a half, because time would have been called on the American empire’s ability to borrow.

For all these reasons, I believe there is no going back down the yellow brick road. Much as we may love gold – much as the central bankers may deprecate inflation in their speeches – in truth we are addicted to paper money illusion.
Opening Session

Questions and Answers

Participant: Do you find it odd that the US is the biggest holder of gold and also the biggest debtor in the world?

A – Niall Ferguson: That is an excellent question; it is deeply paradoxical. In some ways, this is what must have been going through Alan Greenspan’s mind a few years ago when he said that gold was still the ultimate store of value. There is also the problem of past dependency. When you have accumulated that much gold by abusing the rules of the gold standard, getting rid of it would cause a spasm throughout world gold markets. To all intents and purposes, this gold has been buried and may remain buried for the foreseeable future. This has to be the explanation, rather than any profound sense that the dollar is underpinned by gold. I find it hard to believe that many Americans regard the dollar as being fundamentally a gold backed currency. Returning to Goldfinger, in a sense that heist happened: Fort Knox has to all intents and purposes disappeared out of the international monetary system. I think that gold might as well not be there, for all the role it plays in the international financial system.

Q – John Reade, UBS: Would you not say that it is too soon to declare the fiat money system sustainable? Is not the increasing indebtedness of the United States an example of where we may see the end game for the fiat money system?

A – Niall Ferguson: The end game, in so far as that is the right term, seems to me likely to take the form of some kind of significant depreciation of the dollar against other currencies. However, there are two reasons this is harder to do than meets the eye. If one thinks back to the great gyrations of the dollar in the mid-1980s, a lot of us kept expecting something similar to happen in our time. The trouble is that right now, the pressures are being resisted quite aggressively by other fiat money authorities, which are prepared to print any amount of their own currency to shore up the dollar rate and keep their own currencies weak. What is the end game in that kind of game? This is the real puzzle from a game theoretical point of view. If Asian central banks are committed to resisting the appreciation of their own currencies, there is nothing to stop them printing as much money as they like, apart from the possibility of generating inflation in their own economies – and there I see a distinct possibility for trouble. If anything is driving the overheating of the Chinese economy about which we hear so much, it has been this extraordinary growth of reserves and the authentic limits that exist to sterilisation when such policies are being adopted. If there is an end game, look for it in Asia rather than the United States.

The second point is that when things do go wrong in the international financial system, as we have seen in the last few weeks, the dollar still has this residual safe haven status. This is something of a paradox, a bit like the paradox of the gold in Fort Knox. Although the principal source of financial disequilibrium is the United States trade deficit, the dollar itself, the American unit of account, continues to be regarded as in some sense a haven of security for investors. If there were to be instability in the Far East, it might paradoxically encourage investors to shift back into US dollar denominated assets.

In a sense, I have drawn back from an excessively pessimistic view of the dollar because it seems to me I have detected what I had previously missed – these countervailing tendencies in the way that Asian central banks can operate now that they are holders of vast quantities of reserves and in the way that the US acts as a safe haven despite its profligacy.

Another thought one could add is that nobody quite knows what the ceiling is for the net external liabilities of the United States. The British experience – when Britain was a dominant imperial player – is that if an empire has imperial credibility, it can borrow large amounts of money from the rest of the world and pay interest at surprising low rates. In all the debate about the end game, I have yet to see a credible assessment of what the ceiling really is for net external liabilities, and I am willing to bet it is much higher than 20 to 25% of US GDP.

Q – Sandy McGregor, Allan Gray: One of the features of the gold standard was that it worked when governments were smaller than the market. From the 1930s until recently, governments were bigger than the market and could boss it around. We now have a situation where perhaps governments are less powerful relative to the markets. Therefore they no longer have the powers that could manage a
fiat system, and gold starts taking a role in the financial system because of ordinary investors and people, not because of anything to do with governments. The gold standard originally came from the people – it was a democratic institution. The governments took it away from us and now the people want it back.

A – Niall Ferguson: That is an interesting theory on the origins of the gold standard that I had always attributed to Isaac Newton, not just your common or garden person. The notion that this is a story of governments versus people is nevertheless quite an attractive one. What really caused the gold standard to break down was the need that governments experienced twice or three times during the 20th century to borrow colossal amounts of money and mobilise millions of people for the First World War, the Second World War and then this strange “welfare war”, in which governments spent almost as much money on welfare programmes as they had previously spent on warfare, mobilising people into idleness rather than into employment. These great fiscal shocks were completely incompatible with the old gold system and required central banks to be turned into printing presses to finance government debt.

I do not think that is over, because I do not think that governments have been rolled back as much as we imagine in this wonderful liquid world we currently inhabit. The liquid world that has so emancipated investors in our time is ultimately a creation of still nationalised, or quasi nationalised, central banks. In many ways, we have all acquired a stake in it that we did not previously have. We have all become beneficiaries of this liquid world, in which government still accounts for large percentages of GDP in terms of expenditure and redistribution of income.

Much as I like the idea of a reclaiming of the gold standard by free investors, to my mind governments are as powerful as ever, and their power consists not only in their ability to print money to finance their own borrowing, but a power which, when the European Union tried to challenge it, national governments simply resisted – think of the Stability and Growth Pact. It also exists in their continuing ability to intervene and regulate corporate entities, both in the financial and wider business world, a power which I think we underestimate at our peril. They ultimately have that legitimacy that comes from elections, at least in the free world, and that is a legitimacy it seems to me will always trump the power of the individual – and not very well organised – investor.