Session 1

Keynote Speech

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Good morning ladies and gentlemen. Let me first start by thanking the organisers for having invited me to come here, because this conference is a very important event.

When you are invited to participate in a conference, especially if the location is attractive, you immediately say ‘yes, of course’. And then after a while, there is a moment of doubt and you start regretting what you did, because you have to find the topic and you have to prepare it. I found selecting a topic a little bit difficult because I am not a gold specialist, but in the invitation letter, it mentioned the eternal question of gold in the official sector. So I agreed to adopt this title, believing that there was enough encompassed in this.

To be frank, as a central banker, I am not necessarily the most qualified person to speak about the public sector holdings of gold, for two reasons. First of all, because gold as an asset has been used well before Central Banks were invented. The second reason is that we should of course not limit the public sector to the central banks. There are many other public sector entities that are holding gold. I will try to share some thoughts with you. One thing I think that will appear in my presentation is that despite the gold sales of the past decade, gold remains, and will remain, an important asset for the central banks and, particularly, for the Eurosystem.

I will divide my presentation into three parts, the past, present and future.

The Past

As I told you, gold has been used as a currency and as an asset well before central banks were invented. Contrary to popular ideas, gold was not the first metallic money used to avoid the difficulties and inconveniences of a barter economy. Many other goods have been used as money, some are quite exotic. I remember when I joined the central bank years ago, I discovered that there were other forms of money than the traditional ones. For example, the shells used by the native Americans or whales teeth used in the Fiji Islands, or huge stone discs in the Pacific, or even tobacco. In Virginia in the US, tobacco had been the currency for 200 years – for a much longer period than the gold and the gold exchange standard put together. There were many forms of money, but metallic money came quite early because it helped avoid some of the disadvantages of these other forms of money; some were prone to decay, or were too heavy for transport, or were too easy to reproduce. Among the metallic money, two forms were dominant: silver and gold. As an aside, silver has been used on a much larger scale than gold as money.

It is only very late in history, probably only the last quarter of the 19th century that central banks really started to accumulate gold as a reserve. This building-up of gold reserve was particularly important during the two world wars because of all the uncertainties in the world. It reached a peak in the 1960s and, at that moment, the official gold stocks reached a level of 38,000 tonnes, which was roughly half of the above-ground stocks at that time. At that moment, gold was at the centre of the international monetary system. It was the anchor to which currencies were linked (via the dollar usually).

The problem with the so-called gold exchange standard that was introduced at Bretton Woods is that, contrary to what we had in the initial gold standard approach, there was no longer a link between gold held by central banks and money supply. We observed progressively an increase of the money supply that was no longer consistent with price stability. We had a period of permanent inflation that led to difficulties and, at the end, President Nixon in August 1971 decided to suspend the convertibility of gold into dollars, which was the end of the system. At that moment, gold was no longer the centre of the monetary system. It simply became an asset, but of course an asset of particular importance. That was the past.

Present

So what do we do in the central banks with gold? As I said, it is no longer important from the monetary policy or pure monetary perspective, but it is important to add as an asset. Let me say a few words about the role of gold within the Eurosystem. The Eurosystem holds 10,800 tonnes of gold, while the total of official gold holdings is a little bit less than 30,000. So the Eurosystem alone holds roughly one-third of all official gold reserves in the world. But this has evolved over the past 10 years. When we started the ECB and the euro in 1999, the total balance sheet of the Eurosystem was €700 billion. In 11 years, it has increased three-fold. It reached a peak at the end of 2008 of €2.1 trillion – three times as big. During the same period of time, the share of gold diminished, although gold in our reserve doubled. We have now reached €220 billion in gold. As the balance sheet increased even more quickly, the share of gold came from something like 14-15% of the total balance sheet to 10%. This increase of the balance sheet of the Eurosystem has different sources of course. One source of the increase is the evolution of bank notes in circulation. When we started with the euro, we had 370 billion bank notes in circulation. Now we have around 750-770 billion, more than double in 11 years, so automatically of course the balance sheet is bigger. A second element is that the reserve requirements we impose on banks has increased. Banks are obliged to maintain some deposits with the central banks and this is based on the short-term liabilities of the banks themselves. As the balance sheets of the banks have increased quite dramatically over that period, automatically their deposits with the central banks have increased as well. The third reason for this big increase in the balance sheets of the Eurosystem of course has to do with those non-standard or non-conventional measures we have introduced in order to cope with the crisis that started on the 9th August 2007 and reached its peak immediately after the collapse of Lehmann Brothers. Just to give you an order of magnitude, before the crisis, say around June 2007, the outstanding amount of lending we were providing the banking sector with was something like €450 billion. We have now reached, following the collapse of Lehmann, just less than €900 billion. The idea was to ensure that the banking sector didn't collapse because of the absence of liquidity in the market simply because banks were reluctant to lend to each other. All these three elements, bank notes, reserve requirements and the non-standard measures explain this huge increase of the balance sheet of the Eurosystem from €700 billion in total to €2.1 trillion. Since then, it has reduced slightly during 2009 and now our balance sheet is something like €1,800 billion. This is because those exceptional measures are still present, but the total volume has reduced slightly. Gold now is again in value and represents something like 13-14% of our balance sheet. So we are back in value to the proportions we had in the past, although I repeat that, in value, the gold we have has doubled over the period. We now have €220 billion of gold in our portfolio.

Now why do we have gold? There are regularly voices that say that it is not efficient so why have it? Central banks, to justify their gold holdings, use different arguments and they don't all emphasise the same points of view. There are four ideas behind those gold holdings: the economic security; the capacity to face unexpected needs; the question of confidence; and the risk diversification issue.

In terms of economic security, it is clear that gold is quite unique in terms of its physical and chemical properties. It is almost immune to decay, it has a very high density, it is a rather soft metal, it can be stored for very long periods of time with a small volume for high value, it is quite easy to manufacture, and so on. Also one characteristic that is very interesting for us is that it is no one else's liability. The problem for central banks, and for any investors, is when you have a portfolio of, let's say, government securities. Usually, we are quite conservative in central banks; there is always a risk that the behaviour of the issuer of the asset can have a huge influence on the value of the assets you have acquired. This is not the case of gold. So this is a unique characteristic that is quite reassuring. We also have a first factor that the value of gold in terms of real purchasing power has been more than maintained over history. Let me immediately say that the good performance of the past is not a guarantee of future good performance of course. We may see next year in Berlin whether this is still true.

The second factor that is often used is this capacity to face unexpected needs. There are some circumstances that are extremely improbable and rare, but if they occur, they can be highly damaging. Those circumstances are, for example, wars or an unexpected surge of inflation (there are some countries that could witness this), or a generalised crisis that leads to the repudiation of foreign debts or even the isolation of a country. Of course, those situations are rare, but we cannot say that they will never happen, and they are extremely difficult to anticipate or predict. In those circumstances, gold remains the ultimate and global means of payment that is still accepted and it is one of the reasons used by some central banks to justify gold holdings.

Gold can also be used as collateral. For example, in 1974, the Banca d'Italia secured a loan that was granted by the Deutsche Bundesbank by providing gold as collateral. In 1991, India received a loan from the Bank of Japan that was also based on gold collateral.

The third element of justification is confidence. Of course, gold is no longer backing the currency in circulation. It was the case under the gold standard when actually the value of the currency was nothing. Paper money had no value in itself but it was fully backed by gold. So the value was the gold held by the central banks. This is no longer the case, it doesn't exist in modern central banking, but still one can argue that this notion of confidence is still there. What makes the value of money today is faith. You believe that the money you have is good. There is nothing else. Of course, this faith will be justified or not by the behaviour of the authorities, by the central banks, but if there was a little bit of gold behind it, it could contribute to increase this face in the currency. Of course, we are far away from the plastic gold standard, but some argue that gold still plays a role and, for example, the IMF itself said recently that the gold holdings gave a fundamental strength to its balance sheet. We also know that, for example, some rating agencies are taking comfort due to the presence of gold in the portfolio of either governments and/or central banks.

I recognise immediately that there is a great dose of psychology behind this. As I am neither a psychologist nor a psychiatrist, I will not elaborate further. Although, since the start of the crisis more than three years ago, I think we definitely need more psychologists and psychiatrists in the market, but that's another story.

The fourth reason for having gold in the portfolio of central banks has to do with risk diversification. Gold presents very good characteristics in this respect. It is clear that risk diversification is important for any investor, but it is probably even more valued in central banks. Central banks are usually quite conservative when they invest, and risk diversification is surely something extremely important in terms of their choices. There are several studies that show that when you have gold in a portfolio, you have no systematic and no non-diversifiable risk in your portfolio. There are many studies that have demonstrated this. There are a certain number of conditions and you need, for example, a sufficiently long time horizon for the investment and so on, but this is something that seems accepted now.

My colleagues who are dealing with gold, or trading in gold, have also conducted some studies. We have three families of assets in terms of foreign exchange reserves. We have assets in US dollars, we have assets in Japanese yen and we have gold. The studies compared several portfolios with different compositions. All portfolios without gold systematically, and it was statistically significant, had a higher volatility than any portfolio where there was some gold. It is also true that, of course, there are several optimum portfolios in this respect, but all portfolios that did have good characteristics in this respect had at least some gold in their composition. This is based on some statistical and economical method that is called Standard Mean Variance Portfolio Optimisation. This study was conducted very seriously and compared with other studies in other central banks, and we reached the same conclusion. It is not enough to determine how much gold we should have in our portfolio. We also need more from the mental approaches and studies to determine exactly what we should have, but still there is this idea that gold contributes to a good risk diversification of the portfolio.

So those four factors, the economic security, the capacity to face unexpected needs, the notion of confidence and, finally, the issue of risk diversification explains why gold is important in the portfolio of the central banks.

Future

I would like to look at the future and address two issues. The first one is the so-called CBGA (Central Bank Gold Agreement) and the second issue is what will be the place of gold for central banks and authorities in general in the future.

First of all, looking at the CBGA, this new CBGA was announced in August 2009 and is the third agreement of its type. Looking at the first of this type to begin with, in 1999, the signatories of the Agreement (15 central banks, the Eurosystem, the Bank of England, the Swiss National Bank and Riksbank in Sweden) wanted to minimise the adverse impact of their own sales of gold. This was the first idea. They therefore decided to set up a formal and transparent agreement, and because the terms of the agreement were published, the market was well aware of the intention. Among many things, they communicated first the idea that gold would remain an important element of global monetary reserves. So the central bank community, or at least this group of signatories, said that gold would remain important to them. They said that they would sell gold, but it wasn't that they wanted to get rid of gold. The Agreement also said that central banks would not enter into the market as sellers except for those sales already decided and, for that, there was an agreement not to sell more than 400 tonnes per year, therefore no more than 2,000 tonnes over the whole life of the Agreement, which was five years. At that time, the gold production was running at something like 200-500 tonnes per year, so this additional supply via the sales of the central banks meant an increase of something like 16%. One could have expected a negative reaction on the prices, but in the first three trading days after the Agreement had been announced, the spot price increased by 14%. So the perception was bullish rather than bearish, and the idea was simply that the market was better informed, and there was suddenly much less uncertainty related to the possible sales by central banks, and that contributed to the standardisation of the market. During the five-year period, the signatories indeed sold those 2,000 tonnes. What was important also was the way it had been organised. The big sellers under the first Agreement were the central banks of Austria, Portugal, Switzerland and England. As an example, between 2002 and 2004, the Bank of England sold half of its stock of gold, roughly 300 tonnes. The others, for example, the Swiss National Bank, waited until the Bank of England had sold the lion's share of this amount before entering itself very actively in the market, and the Banco de Portugal waited until the very end of the Agreement to start selling. All this was co-ordinated and it contributed to avoiding any shock on the market. In total, the reduction of gold held by those 15 central banks during those five years was something like 2.5-3% per year. In 2004, the Agreement reached its end and it was decided to enter into a new Agreement, not exactly with the same central banks – there were a few changes – but the Agreement was reconducted. There was a difference. It was announced that the self-imposed ceiling would no longer be 400 tonnes but would be 500 tonnes, and therefore the total would be 2,500 instead of 2,000 tonnes over the five years. And there again, this could have led to some bearish reaction, but it was not the case, simply because the market now was reassured that those sales could be organised well and should not have a negative impact on the market. I should say that the members of the Agreement sold only 1,875 tonnes at the end of this second agreement, much less than was initially agreed. Over the five years of the second Agreement, the price of gold has doubled, which is not bad for the gold holders. It is amazing to observe this, because if you look at the statistics provided by the World Gold Council, in 1998, there were in the public sector holdings, 33,500 tonnes of gold. At the end of 2008, we had 30,000 tonnes. So a reduction of 3,700 tonnes is the fastest and biggest decline ever observed in gold holdings. I think the CBGA contributed to that; in spite of this, the prices didn't go down. On the contrary, the price of gold increased.

Now, in 2009, we reached in September the end of this CBGA No. 2 and it has been decided to enter into a new Agreement – again for a five-year period – so it will end in September 2014 and we will be coming back to a ceiling of 400 tonnes per year – 2,000 tonnes in total. As we didn't use the ceiling of the former Agreement, it doesn't make sense to maintain such a high ceiling. Another change is that the IMF has also announced that it will sell something like 400 tonnes in the coming year. It has been stated in the Agreement that those sales can be accommodated within the ceiling decided by the signatories of the CBGA. So, in a certain way, the IMF is not a member of this Agreement, but we will co-ordinate things to ensure that everything will happen as if the IMF was a member of the CBGA. This is clearly something which is there for the next five years and maybe for longer, if justified, so this is surely an element that contributes to a stabilised gold market.

So what about all the central banks in the world? Will the amount of gold held by official sectors globally continue to decline or not? It is very hard to make any forecast in this respect. Forecasts are always difficult, especially when they concern the future of gold. Nobody knows.

But there are some elements that can help us to make up our mind. First, it is clear that risk diversification is more and more an issue nowadays, and we have seen public sector authorities that are mainly sovereign wealth funds that have quite seriously changed their approach and diversified their investment, buying real estate or buying commodities. We have even seen some of them buying raw material to secure the needs of their own country and so on. So, it is not excluded that gold can also benefit from that diversification and it is something that could possibly play a role. For the central banks, there are a few observations. For the CBGA signatories, in their portfolio of foreign exchange reserves, the group has between 50-55% in the form of gold. Gold clearly remains something important in the portfolio of the central banks. In the Eurosystem, I told you that the whole system is currently holding 10,800 tonnes of gold; for example, the Deutsche Bundesbank has 65% of its foreign reserves in the form of gold. For the Banca d'Italia and the Banque de France, it is more than 60%. For the De Nederlandsche Bank, it's more than 50%. For the Swiss National Bank, it is 30%. You know what those central banks will do through this CBGA, so there will probably be a small reduction in volume, but probably not in value.

So what about other reserve-holders in the world? Periodically, the biggest reserve-holders in the world do not really have gold. China and Japan, for example, have only 2% of their foreign exchange reserves invested in gold. If you look at other big reserve-holders such as Russia or Taiwan, the proportion is slightly higher but still well below the figures I mentioned for the signatories of the CBGA. So, I don't think I take a huge risk if I anticipate that those countries are very unlikely to appear on the sales side of the market. If anything, we would observe a stabilisation, if not an increase of gold in the official reserve.

This leads to my conclusion. If, by chance, you wanted to keep something from my presentation, I think there are three elements that I wanted to make very clear. The first one is that the Eurosystem holds more gold in value now than 10 years ago, even if it has sold quite a lot of gold. The second thing is that even if gold prices can be volatile, gold really makes sense as an element that contributes to the diversification of risk in the portfolio, particularly the portfolio held by the official sector – even if some central banks will continue to sell gold and even if a new potential seller has emerged, for example, in the case of the IMF. I will not conclude with any kind of certainty that gold holding will continue to decline in the coming years.

Thank you for your attention.