The Federal Reserve Bank of New York.

The 'Alchemy' of Central Banks

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Central banks and gold have a long history together. Gold was treated as money well before the creation of central banks, the modern-day stewards of monetary policy.

HISTORY TOGETHER

Indeed, many modern central banks were created to manage the gold standard, to which most nations adhered in the decades leading to World War I. The demise of Bretton Woods may also have spelt the end of gold as a central bank reserve asset. But that did not occur. Every existing central bank continues to carry gold on its books as part of its foreign exchange reserves, with some central banks carrying significant amounts of bullion. Almost five decades after the collapse of the Bretton Woods system, gold continues to form an important share of global foreign exchange reserves.

GOLD GETS A REMAKE

Gold remained sought after throughout the 1970s, both by central banks and the investing public, against a climate of rocketing inflation and economic stagnation. Official sector demand for gold contributed to record-setting prices in 1980. Then, after decades of acquiring gold, central banks turned sellers in 1989-90.

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Why? Gold has been described as 'war chest', i.e. useful in times of war if a nation's currency becomes non-redeemable. One argument for the massive gold sales that kicked off in 1989-90 was the official end of the Cold War and the greatly reduced threat of a war in Europe. This afforded gold-laden European central banks a chance to reduce heavy gold reserves. In an early edition of the *Alchemist* (*Alchemist 5*, *October 1996, "EMU Central Bank Holdings"*) then Deputy Governor of the Bank of England Howard Davies referenced the usefulness of gold and its utility as reserve for the then European Monetary Union, but also endorsed the sale of 10 million oz of International Monetary Fund gold to aid debt relief of poorer nations.

A NEW VIEW AND THE GENESIS OF A RALLY

The first Central Bank Gold Agreement (CBGA) in 1999 was a seminal event for the gold market and illustrated the power of the official sector to impact the market. The limit of 400 tonnes a year in sales for five years agreed by the signatories (which included almost every major of holder of gold at the time except the US and Japan) signposted the beginning of the end for a prolonged gold bear market. Central banks continued to sell – but their activities were monitored and regulated.

In *Central Banks and Gold Puzzles (2013)*, Joshua Aizenman and Kenta Inoue study the patterns of gold holdings and trading by central banks during 1979-2010. The pair find that central banks continued to hold massive amounts of passive gold stocks, independent of price. More importantly for price movement, they found a high synchronisation of gold sales by central banks, as most reduced their positions in tandem, and their tendency to report international reserves valuation excluding gold positions.

Bank of England exterior and gold vault (inset left).

The depth of the Sovereign Risk crisis that followed on from the Great Financial Crisis even raised the spectre of possible central bank sales from indebted European countries. The sales did not materialise, however, and central banks husbanded their bullion. This change in attitude was reflected in an article by Paul Mercier, then Deputy Director General of Market Operations, European Central Bank (*Alchemist 57*, January 2009, *'The Eternal Question of Gold in the Official Sector'*).

In an *Alchemist* article (*Alchemist 22*, March 2001, *'Gold Reserve Sales Under the Joint Accord'*), Susanne Capano provided an update on the CBGA, showing its orderly working and that signatories were within target of the sales quota of 400 tonnes a year over five years.

Central bank sales accelerated, however, increasing to more than 600 tonnes in 2005 and, while they continued for the next couple of years, this proved to be the high-water mark for central bank sales, as attitudes by the official sector began to change.

One of the most telling articles, regarding central banks and gold was by Matthew Keen (*Alchemist 47*, July 2007, *'Central Banks: Villains or Heroes'*), in which he pointed out that gold's role as a worthy reserve asset had been challenged several times in the previous decade, often because gold lacks a yield.

This included comments from the UK's Eddie George (Governor of the Bank of England, 1993-2003) justifying the decision to sell a large share of the UK's holdings. That said, Matthew Keen astutely pointed out that the no-yield argument is only employed in bear markets and that when gold rises, its lack-of-yield critics disappear. It turned out that 2007 was one of the last years of heavy central bank selling. Central banks were able to offload an unprecedented 4,000 tonnes in the previous ten years, with a good proportion of the selling going largely unnoticed.

The last year of any sizeable levels of central bank sales was 2008. The full onslaught of the global financial crisis and massive appreciation in gold killed off any further major gold sales.

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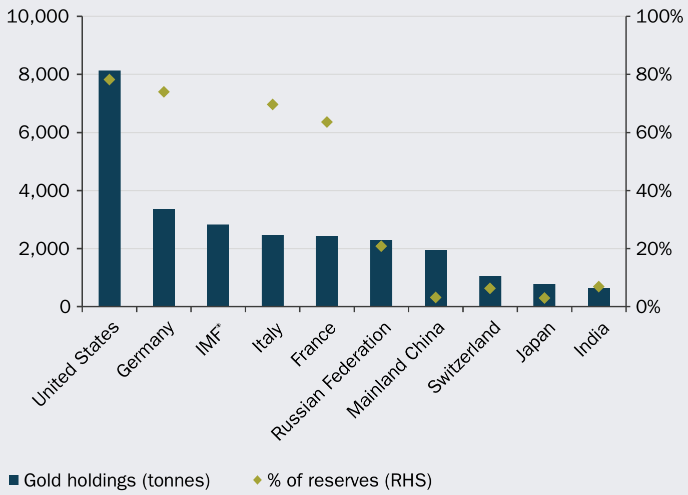
TOP TEN COUNTRY GOLD HOLDINGS AND AS A % OF RESERVES



*% reserves not available

Source: International Financial Statistics, World Gold Council

He pointed out that some of the largest reserve holders of foreign exchange, China and Japan, at the time had only 2% of their foreign exchange reserves invested in gold. Russia and Taiwan held just slightly more.

He posited correctly that those nations were unlikely to emerge as buyers. 2009 marked the last year of net sales of just a few tonnes. Mr. Mercier correctly forecast that gold would be valued by central banks for its diversification properties.

THE PENDULUM SWINGS

Since 2011, central banks have bought more than 5,000 tonnes of gold. The shift from selling to buying was picked up Pierre Lassonde, Chairman, Franco-Nevada Corporation, (*Alchemist 64*, November 2011, *'What a Difference 10 Years Makes'*) correctly forecast that the next 10 to 20 years would be defined by Asian central bank buying. India and especially China were appearing on the scene and European banks were essentially ceasing selling. This helped promote the long-running gold rally, which continues to the present day. More recently, Jagjit Chadha, Director, National Institute of Economic and Social Research, pointed out that excess liquidity from the quantitative easing policies used to combat the global financial crisis have also found its way into other markets and helped buoy gold prices (*Alchemist 88*, March 2018, *'Monetary Policy in an Era of Political Uncertainty'*). That is why he said he saw a new relationship between gold and the financial markets. This neatly explains the bull market we see today.

Gold's utility was reconfirmed by Sylvie Goulard, Deputy Governor of the Banque De France, who stated that since the 2008 global financial crisis, there has been renewed interest in gold from reserve managers (*Alchemist 91*, October 2018, *'Banque de France and Gold: Past and Future'*). Gold confirmed its status as a safe haven and also emerged as a very good asset for diversification, given its low correlation to other asset classes. Building on its long experience in managing its gold reserves, in 2012, the Banque de France began to extend its range of gold services to reserve managers. 2019 was a record year for central bank demand – fully half of the official sector buyers had not been active in the market for at least a generation. One of them was Hungary. In an another article (*Alchemist 97*, May 2020, *'New Golden Age – Building Up Gold Reserves'*), Dániel Palotai and István Veres, of the Hungarian Central Bank, described how the bank increased its gold reserves tenfold in 2018 and also repatriated all its reserves. This is a clear indication that gold is appealing to a new generation of central bankers.

THE *ALCHEMIST* AS BELL WEATHER

Articles in the *Alchemist* over the years have reflected the reasons for central bank gold sales and purchases. But just as importantly, shifts in central bank attitudes and the reasons for those shifts – be they geopolitical, changing economic power, portfolio diversification or safe haven – help explain multi-year moves in gold and are well worth monitoring.

Gold has proven to be an enduring asset throughout the post-Breton Wood decades. Even in periods of high interest rates, gold still has portfolio diversification properties that make it easier to justify sizeable gold holdings from a purely quantitative perspective.

In an era when 'plastic money' and 'electronic money' continue to gain in popularity, the case for holding, mostly passively, large piles of bullion may seem curious. But by revealed preferences, central banks keep viewing gold as a useful component of their portfolios.

INGOT WE TRUST

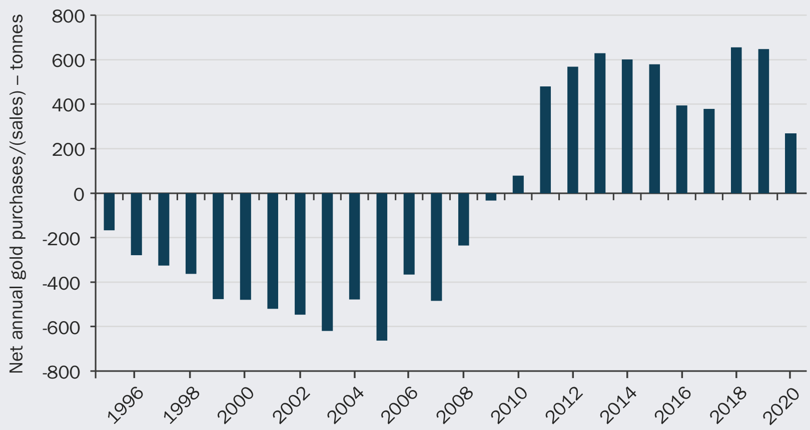
Gold is likely to continue to be favoured by central banks. Gold's position in international finance is nothing short of unique. It is relatively rare but also liquid. It is a commodity and a currency. It is also the only recognised liquid financial asset that is not subject to counterparty risk. Unlike currencies, the value of gold does not depend on a national sovereign. More than any other type of investment, gold serves to ensure the capacity to act in extreme crisis situations. Gold prices often move in the opposite direction to other financial assets, and usually opposite to the US dollar. The price for this 'insurance function' for a central bank to own gold is reflected in the fact that gold may be less profitable during periods when a positive yield can be made from bonds.

GOLD'S POSITION IN INTERNATIONAL FINANCE IS NOTHING SHORT OF UNIQUE

Banque de France gold vault.

Oesterreichische Nationalbank (OeNB), the Central Bank of Austria.

CENTRAL BANKS: NET GOLD PURCHASES/SALES



Source: Metals Focus, Refinitiv GFMS, World Gold Council

This latter factor is what makes gold more attractive in the current dynamic: massive monetary accommodation with zero or near-zero interest rates increases gold's attractiveness by eliminating the opportunity cost of owning gold. This provides the insurance function for free.

Every major geopolitical event tends to awaken an interest in gold, often with central banks playing a role. In more recent times, the regime changes in Eastern Europe ushered in the end of the Cold War.

This reassessment of the geopolitical landscape led to more than a decade of central bank gold sales. The level of sales, however, was modified and governed by the Central Bank Gold Agreement of 1999.

EVERY MAJOR GEOPOLITICAL EVENT TENDS TO **AWAKEN AN INTEREST IN GOLD** OFTEN WITH CENTRAL BANKS PLAYING A ROLE

The 1997-99 Asian Crisis saw the Central Bank of Korea mobilise gold reserves to stabilize its currency.

More recently, the global financial crisis renewed central bank interest in gold.

During the subsequent financial pressures in the eurozone and the sovereign debt crisis, gold reserves in hard-hit southern nations such as Italy, while not utilised, did provide some support as the gold held by the Bank of Italy and other central banks could be mobilised if needed.

For a variety of reasons it is likely that central banks that hold gold will tend to husband their reserves and that some with low levels of reserves will acquire more. Gold goes where the money is. After moving from the colonial world to Europe, to the United States, back to Europe it is now moving to the emerging economies of Asia. This is consistent with the view that central bank's gold position signals economic power and prestige.

James Steel is HSBC's Chief Precious Metals Analyst. He joined HSBC in May 2006. Previously Jim ran the New York research department for Refco, a large US commodities brokerage house, specializing in energy and metals. He also worked for *The Economist* in the *Economist Intelligence Unit* covering commodity producing nations and on the Middle East desk.

His primary duties at HSBC include the production of daily market reports, including long term outlooks for the precious metals markets. These include supply/demand and price forecasts, as well as qualitative analyses. He is a frequent speaker at commodities related conferences. He is often quoted in the financial media and frequently appears on Bloomberg and CNBC. He is an economist by training and studied economics at undergraduate and graduate levels in London and New York.