



## Transcript

# Is there a Future Role for Gold in the International Monetary System?

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### **Vicky Pryce:**

Okay, well, good afternoon everybody. I guess there is a problem with this, as you can't see us all. Thank you very much for coming to this discussion on: Is there a Future Role for Gold in the International Monetary System? I am going to chair it. I am Vicky Pryce, I am senior managing director at FTI Consulting, and I used to be joint head of the government economic service. Just to say a few words in terms of background. Obviously, the reason for today's event is the global economic crisis. And the concern which has surrounded the international monetary system's performance, which perhaps leaves a lot to be desired, has led to Chatham House to set up a global task force of experts to assess what role, if any, gold could play in the international monetary system. And what we are here to discuss today is the findings of the report of the task force. We have two authors of the report here with us.

What it does do is it concludes that, indeed, gold can play a role in times of economic uncertainty of the sort that we have just been through, or as we are going through right now. However, what they also conclude is that the role of gold should remain limited to avoid hindering the international monetary system's performance, or creating constraints on national economic policies. I think I have said all things that we'd like to perhaps challenge or at least talk about, so what we are doing today is just having short presentations by two of the authors, and also by someone who has been commenting on this issue, and then we will open it up for discussion. And we will finish promptly at half past six.

So, just to introduce the speakers. The way we will do it is in order of the people sitting on my left. So, Professor Schenk will speak first, who is a professor of international economic history at the University of Glasgow. She has been visiting fellow for the Hong Kong research for monetary research, the Hong Kong authority, and the International Monetary Fund (IMF). Her current research focuses on efforts to reform the monetary system in the 1970s and 1980s – this is why it is quite relevant – and the development of international banking regulations since 1965. I will introduce each speaker in turn. So, first of all, Catherine, five to seven minutes; you can do it sitting there or standing up, whatever you prefer.

### **Catherine Schenk:**

I think this is a group here where we can sit here are you comfortable with that, or?

Okay, fairly just to give some background. The issue of gold in the international monetary system, indeed, the issue of gold in the international economy more generally has been extraordinarily attractive and it is extraordinarily attractive because of the huge surge in the gold price. The seemingly inexorable increase and increase in the gold price that has attracted the attention of the market, but also attracted the attention of those who are seeking to resolve some perceived difficulties in the international monetary system, arising out of the diagnosis out of the global financial and economic crisis, but being partly driven by some imbalances, some uncertainties about the role of the US dollar in the international monetary system as the major reserve currency, and the double deficits of the United States and the fragility, perhaps, that this is injecting into the system.

The reason that we think about gold in the international monetary system is partly because it has such a long history and sort of a role and a prominent position as an anchor in the international monetary system. Most famously, of course, in the late nineteenth century 'gold standard', when this was a very formal system, this was a period of the first globalization of the economy – the international economy – a very successful time for many countries built on international migration, international capital flows, and stable exchange rates through a pegged exchange rate to gold.

It was also a time when governments had very little responsibility for the economic welfare of their populations, when there wasn't really an idea about monetary policy, *per se*, and, indeed, fiscal policy was also very limited. However, the charms of gold as an anchor for this system – the 'golden glitter' if you like of the golden age of globalization in the late nineteenth century – and the nostalgia for that period of seeming Pax Britannica of the late nineteenth century, led policymakers to desire return to the gold standard. This was normal, this was the norm, this was the way the international monetary system was organized. So, in the interwar period, the 1920s and 1930s, there was a very strong push to return to a gold standard.

Of course, the whole kind of structure of the international economy had changed by this time. The inflation through the first world war meant that the supply of gold in relation to the amount of money in the economy had changed; so, they kind of came up with a bit of a 'halfway house', if you like; a gold exchange standard. And this proved particularly disastrous. This was also a time when governments were now much more responsible for the economic welfare of their populations, having been through the Great War. And the gold standard of the interwar period is generally considered to have made the Great Depression deeper, longer, and more widespread and global

than it would have been otherwise. And that is because it was a paper exchange rate system, and countries all had to follow the United States in a contractionary economic policy from 1929 onward. So, the gold standard in the interwar period seems to have lost its lustre.

Nevertheless, the tenacity of wanting to have some kind of anchor to the system and some kind of discipline to the system led, after 1945, for another role for gold in the international monetary system. This time, only the dollar really was pegged to gold, and other countries essentially pegged their exchange rates to the US dollar. By this time you're getting into the 1950s, 1960s, a period of huge expansion in international banking, international finance, financial innovation through the euro-dollar market, all these kinds of exciting things happening, and the market ceased to believe in the fixed, set, official price of \$35 per ounce of gold. The amount of US dollar liabilities in the international monetary system greatly exceeded the gold reserves. So, if you were the first person to arrive at the Fed and say, 'Give me this value of \$35 per ounce of gold,' you might get it, but if you were kind of a little bit later in the game, you were less likely to. And as this kind of confidence in that fixed exchange rate eroded, they had to set up a gold pool, so all the central banks – the major central banks – had to intervene in the gold market to try and keep the price at \$35 an ounce. This was hugely expensive from 1964, and eventually the system crashed in March 1968. The market had its will and that \$35 an ounce could no longer be sustained. It became the price at which central banks traded their gold, but the market went on in a supply-demand driven price.

The formal kind of convertibility of US dollar to gold finally ended with the Nixon shock in August 1971, when essentially America just sort of threw their toys out of the pram, if you like, and said they needed support for their international and global role, they needed other countries to adjust, surplus countries to adjust. And this ushered in the floating exchange rate regime in 1973. The death throw, if you like, however, for gold in the international monetary system was a little bit longer in coming. You had the emergence of this special drawing right, which is sometimes called 'paper gold' and it was sort of an international reserve asset that was sort of fabricated, if you like, by the IMF, and others, we might talk about that a little bit down the line.

So, there were reforms, but it really wasn't until 1978 that the IMF and all its participants formally said 'there is no role for gold in the international monetary system anymore, the IMF will start to sell off its gold.' And that sort of role is now over. Right after that, there was a huge surge in the gold price in the 1970s, coming up to 1979, 1980. Huge surge – even more dramatic

than the surge we're experiencing at the moment – and then it crashed down in 1982 as part of the kind of deflationary efforts.

So, I hope this gives you just some background into perhaps why the kinds of roles for gold in the international monetary system are so attractive. But also, we need to look at the economic history of these periods very carefully because they have important lessons for us. They have lessons in terms of... that it operates well when the government doesn't have a lot of economic responsibility for its populations, when the supply of the international economy and the international money supply is in relative proportion to the amount of gold, it caused dramatic deflation both in the 1890s and also in the interwar period. So, the experiences in the gold standard don't really sell it for our needs today.

Okay?

**Vicky Pryce:**

Well, thank you very much. That's great. So, next then we will turn to Michael Lewis who is a managing director in the Global Head of Commodities Research there and before that, he was deputy head of foreign exchange research for seven years. So, Michael, over to you...

**Michael Lewis:**

Yes, at Deutsche Bank.

Thank you very much. Well, let me fast forward a little bit and just sort of say what has changed in the system. So, I have sort of three elements, really: what has changed in the system, and why are we here? The importance of gold, not just for central banks, but private investors; and also, potentially, the conflict between what is happening in the industrialized world and emerging markets.

I think what is sort of interesting and changed in the system is that – I think this is why we are talking about this – there has been a fundamental change in this market over the last two decades. Every single force in gold was really driving gold prices lower in the 1990s. So, where you were looking at real interest rates were very high, inflation was being squeezed out of the system, gold does terribly badly when real interest rates are really high and positive because no one really wants to hold a non yield-bearing asset.

So, you had an interest rate which was really hostile for gold in the 1990s, you had an exchange rate environment as well, an incredibly strong US dollar throughout sort of 1995 to 2000, in particular – that is typically an environment that gold will struggle as well. You also had a US equity risk premium which was collapsing towards zero; so, what you were having was that people were treating equities and US treasuries as the same amount of risk, so in a sense if you put ‘.com’ at the end of your company name, you were almost as safe as the US Treasury in attracting returns. You also had producers of gold selling all their gold forward because they knew this asset was just depreciating over time. You obviously had the collapse of communism, the rise in peace dividend, and the attractiveness of emerging markets; so, on every single count, gold was being hit. And on top of all of that, you had central banks – and, obviously, in Europe that was quite a common feature of very uncoordinated central bank gold sales.

You fast forward from 2001, and every single one of those things has changed. Real interest rates have turned negative, which is incredibly positive for gold. Gold and silver rates love it when real interest rates are negative. You also have a collapsing US dollar, which was very favourable to this market. You had an equity risk premium that realized that US Treasury’s and equities are not the same type of asset class; they are completely different. And, so, the risk premium and equities soared and went through the roof, and that was very beneficial to gold. You had producers now that realized that investors want exposure to this market so they removed all of their hedging programs and decided to ‘de-hedge’, so getting rid of all those hedging books and selling forward. You obviously had, then, 9/11 and all the geopolitical risk... I wouldn’t put too much on that, but there was an idea that all types of risk was going up. And, naturally, you have now central banks as, in aggregate, are net buyers of this commodity.

So, on all fronts things have radically changed. And, for us, that was a sort of signal this was a fundamentally driven rally, that there is fundamental change in interest rates, exchange rates, equity markets, producer activities, central banks, and investors. So, I think that is sort of important. So, when we are looking at... And are we going to be discussing this in two or three years’ time? I think we probably are. I think we have got a situation where we may well be in a Japan-style interest rate environment, which will be zero interest rates for an incredibly long period of time, and we will be continually talking about this. We’ll probably be continually talking about the weak US dollar, and I think the idea that central banks around the world realize that they have got a huge amount of FX [foreign-exchange] reserves and they don’t want to

incrementally buy the US dollar, and they have got enough of that. The incremental buying will be more likely to be in gold, so I think that will be... I think is a signal that US dollar still remains structurally quite weak, for a period of time.

So, the importance of gold has naturally risen quite dramatically, so has gold's role as an asset class, so when we talk to investors they won't look at gold in a basket of commodities, they will almost always look at it as a separate asset class in its own right. In fact, its status has really been enhanced if you look at it since 2007. You have found that actually equities and commodities – particularly energy commodities and industrial metal commodities – their correlations basically went to one with the US equity market. So, there was no correlation of commodities, we were told this was a great diversification asset, but actually what you find is very much that in the distressed environment it becomes very much like an equity, but with gold, it does have the properties that are very different to those more traditional commodities. So, that status has sort of been enhanced, I think, for the asset class.

Naturally, as a reserve asset for central banks, we are seeing the Europeans slowing down their sales of these gold sales, realizing that actually it is not such a bad thing to have quite a bit of gold on their balance sheet. But the big change has really been on the emerging markets – and I think this really goes to the third part of what I would focus on – is the potential conflict between the industrialized world and emerging markets. You have got a situation in which the US is really pumping liquidity. You cannot have gold in an international financial system which tries to tie your money supply, your rate of growth of your money supply to the gold price, which is completely inconsistent with quantitative easing. So, there's no way these central banks in the industrialized world would pursue that. I think the memory of gold, for everybody, is deflation. It is deflation of the 1930s; the quicker you got out of the gold standard the better for you, it is the collapse of Breton Woods, and you could almost say, as you look across the continent, we have got a *de facto* gold standard operating within the eurozone, and Greece may well be tempted to get out of that very deflationary environment. I am not suggesting that they will, but that's a natural sort of idea, that they would want to break away from some form of deflationary standard.

The danger, for me, is that you have got emerging market countries which are on the other side of this, where they see a US policy which is incredibly monetary expansionist, it incites credit bubbles and asset bubbles, it exports inflation to everybody, and with emerging markets there is a natural fear that

US dollar policy may well become too much of a problem for them. So, a natural appreciation in those exchange rates, I think it is interesting to maybe consider: do emerging markets look at their currency baskets and say, should we put gold or commodities within those currency baskets? I don't... that might be more of an academic discussion than what they might actually do, but I think that could be something that these parts of the world will look at; how can they have an internal policy which is not disrupted by what is happening in the US? So I think this is why we look at things like the SDR [Special Drawing Rights], the proposal that the Brazilian *real* may well be embedded in the SP... S... I'm sorry, I am thinking of oil, SPR is going through my mind, there are lots of SPR releases that might happen soon... SDR, Special Drawing Rights, the possibility that China might embed that, the Chinese *yuan* might be integrated in the SDR in 2020. That is where I would say the role may be changing in the international monetary system is that route, not through gold. I don't think... I think there is a big conflict here in terms of sort of deflation, which the western world would not really vote for.

So, my sense is there is definitely a role, it is a role that gold will continue to have because in that criteria that I've looked at, whether it's extra risk premium, the currency environment, the real interest environment, what producers do, what central banks are doing... to me, none of these factors are going to be changing anytime soon. So, this will continue to be a factor that I think will drive this market for quite a number of years, unfortunately, because actually what it means is the economic environment is going to remain pretty painful for quite a lot of us.

So, I think that the role is there as a financial indicator, just finally, the role... gold used to be, in the past, used as sort of an interesting barometer of possibly Fed [the Federal Reserve System] policy, what was the gold price doing? It used to be it was quite a two-year leading indicator to the Fed funds rate. Now, naturally, what we are seeing is that you should not really look at the gold price to embed a view of inflation expectations in Fed policy, because if you did, or if the Fed had done that, we would be in a very worse situation because clearly they would be tightening policy when they should have actually have been easing it. So, I think that gold's role as a sort of financial barometer or indicator have probably lessened, but the drivers that are effecting it are very financial in their nature, rather than the sort of the physical supply and demand of what is happening in the Chinese or Indian jewellery demand or whatever, it is still a very important financial indicator, but not so much for sort of interest rate policy.



**Vicky Pryce:**

Thank you very much, Michael. And then, finally, Gerard Lyons, who is a member of the task force as well as Catherine, and he is the Chief Economist and Group Head of Global Research at Standard Chartered Bank. Not only did you forecast accurately the financial crisis, one of the few sort of 'gloom merchants' at the time that nobody believed, but also his team was voted the best forecasters for 2011. So Gerard, over to you.

**Gerard Lyons:**

Thank you. Well, I should say the past is no predictor of the future. Yeah, my comments follow naturally on from Catherine and Michael. I would like to focus on three areas. First, touching on some key aspects of the report; namely, gold's role within the international monetary system. Second, very briefly, on the commodity aspect of gold. And third, touching on, following on from Michael, the current demand and supply of gold, particularly what is happening with central banks. I am here both as a member of the task force, but in my own right, so I will try and give an even-handed approach, shall we say. I didn't agree with every aspect of the report, but, naturally, being a member of the task force, I agree with many parts of it. But let me paraphrase how I would interpret the report. Is gold...does gold have a role to play in the international monetary system? I would say the answer is 'yes'. But does it have an important or exaggerated role to play? I would say 'no'. It was very much a conclusion that I would agree with that it has a minor role to play.

Gold's importance is not so much that it provides the solution to all the issues that are out there at the moment, but because people look at gold it highlights many issues that need to be addressed. And the report itself touched on or looked at whether gold can play a role as an anchor, as a hedge, its role as a in terms of collateral, and, as Michael just touched on, as a policy indicator. In my view, the important aspects are that while gold is not itself, in my view, the anchor to the international monetary system, it highlights the fact that there is increased focus on the role of gold because of concerns about the international monetary system itself. And the focus on gold highlights the problems out there, although, in the report – and I would say in my own view – gold is not necessarily the solution.

The hedge aspect, the anti-inflationary hedge in particular, I would say that over time, gold as an anti-inflationary hedge has become less important and, as Michael touched on, may be less of an important policy indicator. That being said, Ben Bernanke, the head of the Fed himself, has very much

stressed that he sees gold as a protection against tail risk, against the risk of something going wrong. And I think that very much came out in our discussion and indeed comes out in how people see gold and its role in the international monetary system itself at the moment.

We talked about, in the report, whether gold should be part of the SDR, the conclusion was 'no', and I think that's the right conclusion. The SDR, I would actually would say should not be called a 'Special Drawing Right', it should be renamed the 'Semi-Dollar Reserve'. 71½% of the SDR is dollar and the euro, and there was a strong, and it is indeed a strong case for the SDR's constituents to change, to include emerging market currencies and to reflect a shift in the balance of power away from the west to the east.

The report itself also talked about digital gold. I am not a big fan of that. But, to be...gold is being increasingly used as a digital payment. It doesn't really have the liquidity to achieve that, although some people felt it was a secure payment system.

So the report itself tried to cover all the issues: anchor, hedge, collateral, policy indicator, whether it should be part of the SDR, and the role of digital gold. But, overall, bringing that first part together, I would say that my view is that gold's role in the international monetary system should not be exaggerated, its role is more in a minor capacity, and it is... the very fact that we focus so much on gold is because there are wider questions that need to be addressed about the international monetary system.

The second part about commodities is slightly separate to the report, and I think it's important to stress: gold is an important commodity, but like all other commodities, it can become speculative at times. I would say that the way we describe gold at Standard Chartered is in some respects how we would describe other commodities such as energy and food. There is a firm floor and a soft ceiling. In terms of oil, the firm floor is underlying demand from China; the soft ceiling that can push prices up is geopolitical risks. For food, it is similar underlying demand; the soft ceiling is supply-side shocks. In the case of gold, the underlying demand is quite interesting. India accounts 27% of gold demand, China 24%, and then you see a drop down to the Middle East, which is 6%. Interestingly enough demand for jewellery peaked in the year 2000. So, 'less bling', as someone on the report...on the committee called it. But demand for gold in terms of bars, being held as bars and coin investments, has continued to rise. So, you could argue that consumer demand has tren

ded up, albeit gradually, but the component by which people hold gold is less for fashion and more as a safe haven. Also, we have seen increased demand for gold in terms of ETFs [exchange-traded funds], and fund investment, and a more speculative aspect there.

Interestingly enough, in terms of – in recent years – the soft ceiling, it is not only concerns about the international monetary system, but there is a big issue about whether supply can respond to meeting increasing demand. There has been a significant change in where gold comes from. China is now the biggest producer of gold, replacing many other countries, whereas if we went back twenty, thirty years ago it was South Africa. And, also, in recent years cost of producing gold has increased significantly as wage demands have increased, and there has been significant disruption in the mines. So, the second aspect, that we haven't talked so much about in the report, is gold's role as a commodity itself; that should not be underestimated, as one of the factors driving up the price of gold.

But the third aspect, which is maybe where we go from here. Gold as a policy indicator, gold as a hedge, gold as an anchor can be seen in the broader remit of the dollar's role in the international monetary system. There has been, and there is, passive diversification away from the dollar. Central banks around the world don't necessarily want to hold gold for its own right, but they clearly don't want to continue to put their increased currency reserves into the dollar itself. But, of course, with quantitative easing and concerns about the euro we are seeing quite a lot of questions of where people diversify into. With a multi-polar and multi-currency world, there clearly will be there will be further diversification away from the dollar.

Our view at Standard Chartered is that we will see more countries trying to manage their own currency against the basket of currencies with which they trade. So, an increased role for the Chinese currency, the Indian rupee, etc. But, until we see those currencies becoming genuine alternatives to the dollar, one has to say gold may well step into the plate. Now, you may argue against the theory of it, but the reality is that the data speaks for itself. Central bank net purchases of gold in 2010 were 77 tonnes. Last year in 2011 it was 440 tonnes. The biggest buyers last year were Mexico (100 tonnes) Russia (95 tonnes), but you also saw things like... countries like Thailand, Bolivia, even South Korea. South Korea had not been buying gold since the Asian crisis, has made two major purchases this year. But in terms of where countries hold their reserves, America has 75% of its reserves in gold, of course its reserves are quite small for natural reasons. Germany has 72% of its reserves in gold, but the Europeans don't hold big currency reserves. But

the big players: China only has 1.7% of its reserves in gold; Brazil only 0.5%; and Mexico, despite being the big buyer last year, is only up to 2.9%. So, there is a general perception out there that given the commodity price of gold has been driven up and maybe has speculative elements in that, you will at the same time, in the third part as I have touched on, see central banks may be worried about the dollar, naturally shift more into gold.

So, putting it all together, I would say the report touched on all the key issues, I think the conclusion would best be summarized as: is there a role for gold in the international monetary system? Yes. But it is a minor role, it should not be over exaggerated. And just to conclude, apparently the last time Chatham House had a study report looking at gold, it was just a couple months before Britain came off the gold standard.

[Laughter]