Chatham House, 10 St James's Square, London SW1Y 4LE
T: +44 (0)20 7957 5700 E: contact@chathamhouse.org
F: +44 (0)20 7957 5710 www.chathamhouse.org
Charity Registration Number: 208223

Transcript Q&A

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

Dr Gerard Lyons

Chief Economist and Group, Head of Global Research, Standard Chartered

Professor Catherine Schenk

Professor of International Economic History, University of Glasgow

Michael Lewis

Managing Director, Global Head of Commodities Research, Deutsche Bank

Chair: Vicky Pryce

Senior Managing Director, FTI Consulting

28 February 2012

Vicky Pryce:

What we'll do now is we'll open it up. I have to just say that despite the fact we are in Chatham House this meeting is on record, we also… we may have some other of the task force members here but we also certainly have André Astrow who is the *rapporteur*, who put this report together. What we'll do is I'll get questions from you but I'd like you to say who you are, stand up, and give your name and where you come from, if possible. And I'll take sort of one at a time at the beginning and as we start running out of time, I'll take a few together. So who would like to start first? Yes, please, over there. There is a mic [microphone] coming.

Question 1:

Thank you. One point which seems to have been slightly underrated in the comments – although maybe not in the report which I have not yet seen – is the need that is sort of felt in some subterranean way, for a reliable store of value. And if you are somebody who has large quantities of reserves, essentially in currencies, I mean it is not merely the dollar which appears to be a questionable asset, so does any other major currency which you care to name, whether it's the euro, sterling, yen, even possibly Swiss francs. One could make a jolly good case for not owning any of these. Is there any view as to whether that is something which is unlikely to change or whether some currency or other will restore its position to a more reliable store of value?

Vicky Pryce:

Thank you. Catherine, do you want to start on this?

Catherine Schenk:

Gold feels maybe like a nice store of value at the moment because the price is rising, but we need to remember that the price of gold becomes very volatile in times of uncertainty. And one of the lessons from history, and I am the historian here, is that what goes up comes down, and certainly there was a dramatic crash in the gold price in 1982, and a lot of people were caught out. So, while there is a lot of enthusiasm and I do expect that the gold price will be rising for some time, it is not a solid gold store of value in that sense.

Also, that we need to… what is underlying this is the desire of countries to hold very substantial foreign exchange reserves. And that's related to their exchange rate policy. So, greater flexibility in exchange rates reduces, to some extent, the need for foreign exchange reserves. So this is perhaps the link between this issue about foreign exchange reserves and I agree, certainly with Gerard, that diversification of a portfolio is important, but that gold is probably not going to be a huge part of it because it has no yield, and because the price is very volatile. So, at the moment I think it is about 12% of global foreign exchange reserves. So, it will be increasing for those emerging countries in particular, emerging market countries that need that stretch. But as a store of value I think we just need to be a bit chary about it.

Vicky Pryce:

Gerard?

Gerard Lyons:

Yeah, well Catherine touched on one of the key reasons why the UK actually sold its gold at the bottom of the market: the lack of return on gold, although you could probably try to sell it at a much higher price. But I think many central banks in the West very much view gold as not the thing to own and very much view it more in the commodity aspect, and then you would argue more as a commodity rather than having any special characteristics to be possessed in the international monetary system. But certainly from an emerging market perspective, one has to question or argue whether it's better to have gold in your reserves or something more liquid, shall we say.

But, certainly, one of the lessons of the crisis is that central banks or rather countries around the world that had high levels of reserves were seen as better safe havens so certainly there is a desire naturally for central banks across the emerging world to increase their reserves. By very much. My personal view is that the reason why gold is held more is because there is passive diversification. What is happening is that central banks are increasing their reserves, they don't want to actively sell the dollar unless is causes the crisis that they fear, they don't want to put too much of their reserves into the dollar, but you do have a limited number of choices. So almost by default, I would argue, gold has become something you put your reserves in to. But, so long as it is a small proportion of your holdings, maybe it doesn't matter so much, it doesn't undermine the effectiveness of what you can put your reserves to.

Coming back to the question, I think it does touch on the key issue, which I think underlies not only this report but the whole focus on gold. Is it gold in itself? I would say 'no', but is it a reflection, as I touched on, about… concerns about the system, and one of those key concerns is stability, and mainly the stability of the anchor in the system: the dollar. I personally would argue that gold is not the answer, but what we really need to see is credible counter-cyclical policies. In good times you should run big budget surpluses, and in good times you should have very high levels of interest rates. In bad times, you shouldn't necessarily tighten fiscal policy, and I think it is a very important factor in this report that people actually decided there should not be a return to the gold standard because it would impart a deflationary bias into the system. Unfortunately, what you can argue is what is happening on the continent of pro-cyclicality and deflationary bias into the system. But, to conclude, in answer to the question, I think the answer is maybe we will move to a multi-currency, multi-polar world, but any individual country needs to have an effective use of monetary, fiscal, and macro-prudential policies all used together.

Vicky Pryce:

I don't know if you wanted to come in, but just wanted to [ask] one question on this. I know there are other people waiting… Not one question, a reservation, rather, I mean, perhaps we will end up with some agreement between us at to what is an optimal holding of gold for any currency reserve portfolio? The other thing is how it moves? Because if you just look and the figures in this report, the second quarter of 2011, and the figures you gave us, Gerard, in terms of volumes of gold, they had moved hugely, mainly because of changes in prices, but you can see that actually you can't guarantee that you can keep that percentage going. It's huge, in terms of China, it was 4.9% then, whereas you just said it was 1%, so it just moves very, very significantly…

Michael Lewis:

In terms of the price, you mean?

Vicky Pryce:

In terms of the value, yes. So, it is very, very uncertain therefore.

Michael Lewis:

Well… just rank currencies. If you have got a current account surplus and a net credit donation, those are really good things to have in these types of periods. So, you look at countries like Japan, Switzerland, Norway, these are countries where when there is extreme stress in the system, these countries don't rely on foreigners to fund current account deficits. And in periods of extreme distress, repatriation flows will be very beneficial, at least from a currency appreciation point of view, for those parts of the world. So, it is typically anybody who speaks English is in very large indebted nations – New Zealand, Australia, US, here – those are the sort of areas. So, I think there still sort of 'safe havens' out there, but you are right there are sort of interventionist central banks, like the SNB [Swiss National Bank] and the Bank of Japan, I think gold just has to be part of the mix, which kind of follows into what is the optimal sort of share that gold should have?

Gerard Lyons:

I am not sure whether because you work for a German bank you are adopting a particularly Germanic approach to the world [laughter], but I would fundamentally disagree with your view. If you look at surplus countries in isolation, you are wrong. The European monetary system is a classic example of how if you just look at the surplus countries, you actually have an unstable system. In the good times, in Europe, the money flowed from the surplus countries to the periphery economies, and balances were exaggerated, and in the bad times the money flowed back, hence Germany now has a building inflationary problems. If the surplus countries don't spend, then if the surplus countries stick with the surplus – and, indeed, the report came out against gold coming back to a gold standard is you need, in any system, to avoid a deflationary bias. Those people with the surpluses think that they are always right, then the system on the deficit countries, and you build a deflationary bias into it.

Vicky Pryce:

Okay, so that was a bit of a treatise on why the eurozone isn't working. There is a question here in the front, and one immediately behind, I think.

Question 2:

Just an observation really, and also a small question. One of the questions which strikes one is how little has changed, really, in the gold scene over the last thirty or forty years. I do remember the BIS [Bank for International Settlements] in, I think ,the 1970s, saying something reasonably philosophical, like, 'down, deep below in the vaults gold remains unused, but not unloved.' [Laughter] And that has really been the message of the last thirty of forty years.

I would have enjoyed a bit more 'digging', if one can use that expression in a discussion on gold, for instances, I think the angles on collaterals could have been further expanded. I also…because you have just taken a few press reports and so on from the BIS and not really made much of that, I think you could have done far more also in looking at where the gold is actually stored, because you did note that the price for storing gold has gone up. But the fact that the Bank of England has put up its prices, for instance, has led to some notable gold movements over the last fifteen years or so, some of which have got into the press after about ten years. I also do think that the question of gold in the central banks that hold gold themselves, a the treatment of gold and a proportion of gold on the balance sheets of central banks would have been very helpful. If you look at the euro system, the proportion of gold on the balance sheet has, of course, fallen tremendously. And I do agree, obviously, with your view that gold will not return in any very direct way, but I do think also that a treatment of the way gold could be sold by central banks like the [Deutsche] Bundesbank would have been helpful.

I don't understand why you say you are on page 40, on page 26… no sorry, that is… it is in the phrase where you make a point about the Bundesbank and the central bank of other countries why… you say something, somewhere, along the lines of where central banks with gold holdings have kept their gold holdings quite high because of 'statutory reasons'. I did not understand that at all, because as far as I know the reason why the Bundesbank has not sold its gold is just because of taxation, and because of the law that says they have to give the profits to the finance ministry. So, that is the question that I have, what does that mean by 'statuary reasons'?

Vicky Pryce:

Thank you very much. Catherine?

Catherine Schenk:

I think you are right about the issue of collateral, and, as we have been saying, one of the drawbacks of gold is that it doesn't have a yield until we have a capital gain. I mean, one of the ways to kind of generate a yield is to develop…to loan it out and get a return on it. So, there are probably more creative ways, I am not sure that that is increasing the role of gold in the international monetary system, or it is falling into this category that we, I think, are developing a consensus that it will play a role in the foreign exchange reserves or in the portfolio management of central banks, but that is not quite the same as the kind of Newt Gingrich, sort of, forays, or indeed putting gold into the SDR.

In terms of the statutory requirements, I am thinking of Italy, in particular, I think that one came up in the discussion, that they have statutory gold backing for parts of their currency issue, so there are, sort of, particular areas. You will find that, if you look at the table, there is a wide range of countries proportions of gold in the foreign exchange reserves, and we heard about the US being the largest, but that some of the smaller European countries also have a large proportion, and part of this is a legacy of, that they… Gordon Brown didn't sell it off for them, and part of it is the statutory requirements for their currency backing.

Gerard Lyons:

Even though… the questioner made the point about very little has changed, the reality is that a phenomenal amount has changed, and, I think what is interesting is that the role of gold is not dramatically different from the past, even though there has been a phenomenal shift in the world economy. We are seeing a tremendous shift in the economic balance of power, reflected now in the fact that the world economy now is a $70 trillion world economy – even when Lehman [Brothers] went bust it was only a $62 trillion economy. So, even though we have had a financial crisis, or are still in a financial crisis, and here in the West it doesn't look as if the world is growing at all, the world is growing quite significantly.

So, in that respect, we are seeing a significant shift, which does pose big questions about the future role of the dollar, it is a shift where more countries around the world are thinking less as they did in the past about tying themselves to the dollar to gain the credibility of the Fed, and more about what they actually do with their own currency policy in the future. So, in that respect, I think the macro-economic environment has substantially shifted, but what is interesting is that the role of gold, it seems, isn't going to become any different to what it was in the past. So, I think that in itself, even though the outcome might not seem much different to the past, given that the ball game has changed it is quite significant.

Catherine Schenk:

I just maybe support the questioner there, maybe my historical memory is a little bit longer, and a lot of the discussions that we were having in the gold task force it felt like we could have been having in the 1970s, where there was, again, a huge debate about the role of the dollar, we had to replace the role of the dollar, it was a poison in the international monetary system. What is happening to gold with the gold prices rising? You had a recession, you had global conflict, you had Middle Eastern problems, you had inflations (which we don't have so much at the moment), but all these kinds of uncertainties about the international monetary architecture in a time of surging gold prices. There is a legacy there, I think. A lot of these questions are the same.

Michael Lewis:

I think the collateral argument is very interesting because we, I think a number of banks, do offer a number of products now with gold back, with this sort of counter-party risk that now is faced with a lot of people, so I think that. And, obviously, it highlights the stress of this kind of inter-bank market as well, that this is being used as collateral. So, that is a big change, I think, in terms of products that are being offered to investors over the last few years.

Vicky Pryce:

Thank you, other questions? Do you have a question? And then one over there.

Question 3:

Thank you. I haven't got any points to make, but I have a couple of questions. One of you said that there had been a difference, during the international crisis, between the reactions of different countries with different levels of gold, was that really a reflection of the different levels of gold, or simply the different levels… was that a reflection of the mix in their reserves of having higher or lower levels, or was it simply a reflection of the overall level, for example, as I recall Portugal, has actually a sizeable amount of gold in its mix? Has that protected it? One.

Two: question – and maybe it is in the report – was there any clear difference in the attitudes of the central banks, if you talked to the central banks in putting this together, or, you know, no comment from them?

Vicky Pryce:

Okay, who would like to start? Well, of course, in terms of talking to the central banks, you did. So, perhaps, Catherine, you can start on that one?

Catherine Schenk:

Yes. As you can imagine the central banks were quite cautious in their responses. I think they were… they did agree with the sort of general tenants that a return to the gold standard or a monetary anchor using gold is inappropriate. We were in Beijing, for example, and certainly we were talking about the diversification of reserves in a sort of passive way in a time when, and pointing out that certainly China's proportion of gold in their exchange reserves is low, and may be liable to grow, but I think beyond that not so much.

In terms of the impact, the responses to the global financial crisis depending on how much gold you had in your reserves, I'm not sure I am best placed to answer that.

Michael Lewis:

Personally, I don't think that there has been any protection at all given to a country that has got X or Y level of gold reserves. There has been discussion of whether these countries might use and sell them to try and relieve some of their debt problems, but actually the volumes are so trivial compared to the bulk of outstanding debt that I don't think it would make any big impact.

Vicky Pryce:

Gerard?

Gerard Lyons:

I agree with Michael. I think, actually, it is the level of currency reserves, not the level of gold itself. Actually, in China, there have been some policy makers who have been encouraging the general public to increase their holdings of gold, as a sort of hedge against inflation, but I think that is a greater… a wider reflection of the need for China to deepen and broaden its domestic capital markets, because there is few alternatives apart from property and bank deposits and equity, where you put… too much of the money has been going into property. So, it is interesting that sometimes at short periods countries can see a domestic role for gold, but I wouldn't over-exaggerate that either.

Vicky Pryce:

Plus, it must be difficult for them to encourage people to do what they are suggesting if the price of gold is actually dropping all the time. Or at least it didn't look like it. [Laughter] So, there was a question there.

Question 4:

Thank you. I have three related questions. The first one is, the report talks about diversification of the international monetary system in which gold could play one role, but then the question is about the incentives: who has the incentives for the system to be more diversified? And I think this has to do with the supply of currencies and things [incoherent] to some extent.

But this is also related, I think, to a second question, which is the equity element of using gold. You know, I think the fact that gold is so highly concentrated, in that only, about 5% of banks hold 50% or 60% of gold reserve holdings, so there are many central banks that probably would have no incentive of supporting a system in which they effectively, you know, have no say. And then the third aspect is one related to liquidity, and many central banks, I think, are highly sceptical about gold because it is so illiquid. The fact is that if you want to sell it, or you want to buy it, you need to have a gold sales agreement actually, and I think that is a big drawback and I wonder, to some extent, if the report has touched upon that as well.

Vicky Pryce:

I think you have a bit to do. Catherine, do you want to start this one?

Catherine Schenk:

I think the illiquidity is clear, I mean… what you put in your foreign exchange reserves depends on what you want to do with them, and most countries want to be able to sell them quickly. On the other hand, as we found in South Korea, for example, you can never have enough foreign exchange reserves to buck the market if they go after you. So, in a sense, it is an insurance, but not a complete insurance. But liquidity is an important aspect of the portfolio management, which is why the sort of role of gold is likely to be more limited.

In terms of the diversification, we are in a… we may look back in 2020 and see ourselves now in a time of transition in terms of international currencies. Gerard spoke about the changing weight in the international economy, not matching, if you like, the pattern of currency competition or currency distribution. This is an important issue, that there are problems with the yuan as an international currency beyond its inconvertibility and the controls on it, is the structure and the vulnerability of the domestic financial system, which needs to be resolved. The huge re-balancing of the Chinese economy that is required, they are going to need those large foreign exchange reserves, they are still a poor country, they are not in the top 100 richest countries in terms of GDP per capita, and they have important infrastructure problems.

So, part of it is the liquidity that you want your foreign exchange assets to have liquidity, and the dollar is unrivalled for that, you can get in and out of US assets very, very quickly. It is a huge and deep market, and will be the hugest, and largest, and deepest market for a long time to come, and that is really driving the continued attractions for the dollar.

Vicky Pryce:

Gerard?

Gerard Lyons:

Maybe just… I agree with all of those comments. Maybe, given that we just touched upon the Chinese currency there, it may be important to stress out that the Chinese currency's role is likely to become far more important in terms of the international monetary system. One of the most important developments in the last couple of years has been the growth of the Chinese currency market offshore, and that has been primarily in Hong Kong, although good news is that last autumn it was established that Britain would set up an offshore Chinese currency market here in London. But linked in to that there is the whole issue about the need for China to deepen and broaden its capital markets.

One interesting thing is that Shanghai, which aims to become an international financial centre, is establishing a gold exchange market in Shanghai. So, gold has been seen as an important facet in terms of establishing financial centres. But I come back to your question itself, I agree with… we shouldn't over-exaggerate the importance of gold. But maybe, when we look at personal holdings, you are seeing consumers as we look at different key markets, as they become wealthier, hold more gold, particularly in India and in China. The very fact that there has been a big increase in consumer demand for gold in both those markets means that we shouldn't underestimate that—

Catherine Schenk:

—But gold has a traditional role in those cultures.

Dr Gerard Lyons:

Yeah, and has a traditional… and both of those cultures, even though China has an ageing population, India has a very young population, we have big gender mismatches in both of those countries, actually, and there is interesting… male demand for gold is quite significant in both of those countries.

Catherine Schenk:

But gold has been a traditional, sort of, value in terms of jewellery, but also in bars in these countries because of the lack of financial infrastructure, and the lack of alternatives in terms of the banking system, this sort of thing, and that has been quite bad, obviously, for centuries.

Gerard Lyons:

Yeah, and I was going to say, it is very interesting the data really does show that that is already happening, and in fact, as I touched on the gold demand for jewellery has already peaked 12 years ago, but consumers have continued to hold gold more in its investment store of value aspect, in bars and coins – that's very important.

Vicky Pryce:

Well, do you mind if I just… don't come it because I need two, three questions. I will take three questions at a time. So, there is one there, and then André [Astrow] there, and then this gentleman there.

Question 5:

I just wondered on the section on gold as an indicator; there doesn't seem to be any data there. You said that in …the fall in the late 1990s wasn't a harbinger of weakness in the economy and didn't indicate the need for monetary easing but, of course, in 2001 monetary policy was used very significantly, and there was indeed an inflationary scare in 2002 and 2003. So, maybe the lags are longer thank you are allowing for, which is why I would like to see some data. And, so, similarly now, while investors are aware that most countries would like to devalue their currencies, and that the central banks are creating money, the rise in the price of gold may be a rational fear of inflation three or four years down the line; so it is a ketchup problem that you shake the bottle and nothing comes out, and then it all goes splurge in 2014 or 2015. And I wondered if you had more data to back up that section?

Vicky Pryce:

Okay, we will remember that, thank you. Okay, the André [Astrow] here, and then that gentleman here.

Question 6:

Thank you, and I am the *rapporteur* for this report. The point I wanted to make, which was coming back on the previous question and the earlier point about maybe maybe the lack of depth of this report, I would like to clarify that this is actually a different kind of report than the kind that you might typically expect Chatham House to produce. This is much more a synthesis of debate and discussion and analysis of eleven or twelve experts who were chosen to be a part of this task force to debate this whole issue. And we did look at, I think, quite comprehensively all the aspects of gold and the way that gold could play a role going forward.

And, you know, in that sense, I suppose the report doesn't do it justice because it did go into a lot more depth, and there is quite a bit more data and information that you can get if you go to the website – there is a special bit on the website of Chatham House, which is listed in the report. And there you can access a number of the research papers and commentaries and so on that helped to enrich the report itself, so just try to bare that in mind in terms of the kind of role and purpose of this type of report.

Vicky Pryce:

Thank you very much, André, and then this gentleman over here, and that will be the last question.

Question 6:

Thank you. A couple of comments and then a question. The first comment is that you haven't mentioned in the report the fact that gold is only produced in about five countries in the world. Presumably the reason for this is that you would say in the short run the margin is relatively small.

The second question is… but, I mean, with the five countries clearly being China, Russia, the US, South Africa, and Australia; Australia is probably the second biggest, isn't it, in current terms. The second point is about the relationship between the gold stock and the monetary base. You haven't mentioned it specifically, I suppose the monetary base will be about three times the size of the gold stock, something like that. I don't like the idea of… just to say this potentially is a constraint to monetary policy, and presumably this is what we are getting at when we get to the deflationary implications.

Just a final question; what happens to the reserve of currency between now and 2020? I would guess that we won't have a suitable convertible rendering of the yuan until about 2020. The euro is in a fluctuating state, and we don't know when… And it is, I would think it is doubtful whether the US dollar will be a suitable reserve currency up until 2020. So, what is going to happen, how are we going to reconstruct an SDR basket in the interim?

Vicky Pryce:

Well, thank you very much. The challenge now, these are very good questions, is to answer them in the next minute. [Laughter] Actually, the clock there says I have three minutes… it says 18:27, so let us see what we can do in two. Catherine, really quickly.

Catherine Schenk:

Okay, I think you will need to look at the reports to see the kind of detailed underpinning of the research that was undertaken. Certainly, what you have pointed out is that the main indicator is an indicator of uncertainty, it is an indicatory of inflation expectations, I think you are right, and that is not a very reliable indicator because the legs are unpredictable. So, there is probably better indicators out there, I think was the gist of that.

Michael Lewis:

We used to have this two-year lag that was our thing with it, and it was a bit patchy. You identified a really good snapshot where there was some indication, so I think there is a definite perception that inflation is around the corner with quantitative easing, and all this massive increase, and I think that looking at the money stock to gold stock is a really… I think that would be a really interesting set of data to look at as well, which could tie in with what those inflation expectations could be. My sense is the lags now are a lot longer, but there is definitely a perception that gold can provide some indication of that. We have just found that the old rules have kind of broken down a little bit.

Vicky Pryce:

But if it is all going into gold or equities, then it is not really inflationary all this [incoherent] QE that is taking place, is it? So, you've got to bear that in mind.

Gerard?

Gerard Lyons:

In terms of inflation, I think it is important to state that different parts of the world are at very different stages of the economic cycle. It is very hard to get carried away on inflation in the UK, but certainly I think commodity prices have been a firm floor/soft ceiling, will impart some cost push inflation into the system. High energy prices this year will probably be a tax on growth given where the West in terms of the economic cycle. Across the emerging world though, I think there is a much bigger concern.

And as one sees, the consequences of quantitative easing if currencies are sold is that money starts to go into asset price inflation across the emerging world. In that respect, maybe you could say what is happening on gold there, where demand for gold is picking up, is a concern people have in those markets about inflation. In terms of supply, yeah, you are right. China, Australia, Russia, the US, South Africa, then it is Peru, Indonesia, Canada, Ghana, Uzbekistan.

But in terms of the reserve currency aspect, I would expect the dollar to still hold on in the very near term, the US economy is having a steady but not spectacular recovery, but I do very much think that over time, and the very fact that central banks in the emerging world are holding gold in their reserves now doesn't suggest that gold is going to become important, but as I suggested it is a sign of passive diversification. And I would expect to hold the dollar, the hard euro – the soft euro after it has problems and it goes into a two-speed euro in our view – the Chinese currency, the Indian currency, and a whole range of other currencies.

But, in terms of the SDR, the G20 last autumn committed to expanding coverage of the SDR, and I think people are wondering whether the ruble will be in it, certainly the Chinese currency will be in it, but I think there is a shift to a multi-currency world. And the focus on gold in this report is not so much because gold is the solution to all the problems, but because there are many issues and questions that need to be answered.

Vicky Pryce:

Well, we have to stop here, I think we could have carried on for a little longer. I want to thank you all for being here this evening, it was a really great event. Can you join me in thanking the panellists who have done a splendid job taking us through a very difficult issue.

[Applause]