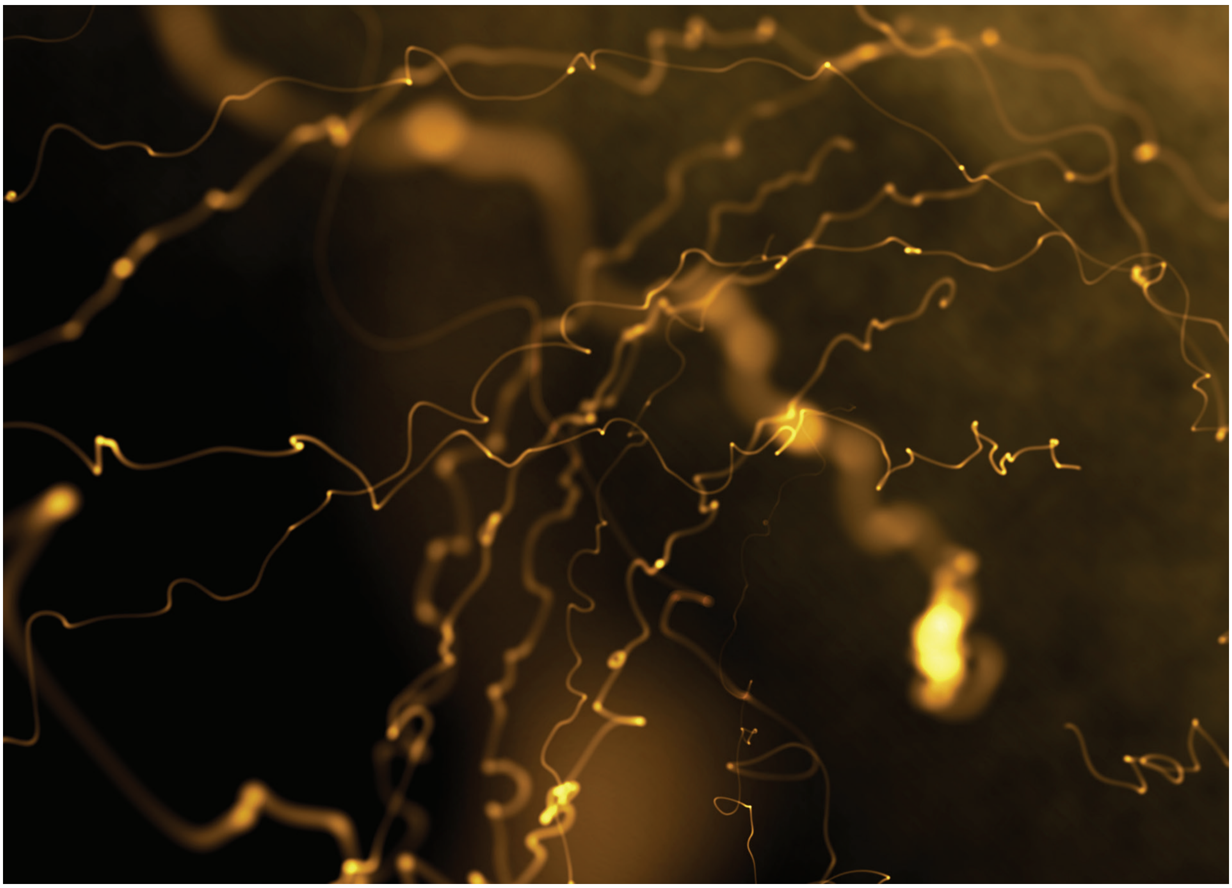
CENTRAL BANKING
FOCUS REPORT

SHINE BRIGHTER
Central banks have not flocked to invest, despite the pandemic

GOLD SURVEY 2020
Reserve managers are disposed to gold ETFs but are not actively investing

ULTIMATE STORE OF VALUE
Róbert Rékási sheds light on the Central Bank of Hungary's gold strategy

Gold for central banking 2020



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The changing role of gold

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Throughout history, gold has played an important role for both its actual and symbolic value. For many ancient civilisations, such as the Incas and Egyptians, gold ownership was limited to members of the royal families, as only they had access to the gods.

Over time, the role of gold changed so that, by the end of the 19th century, many countries fixed the value of their currencies in terms of a specified amount of gold – this later became known as the gold standard. After World War II, countries adopted the Bretton Woods system of monetary management – a regime of fixed exchange rates linked to the price of gold that finally broke down in 1973.

But, while the role of gold has changed within the monetary system, it remains important for investors.

This year, the Covid-19 pandemic and the reaction from central banks had a significant impact on the price of gold. Over the past few decades, central banks have viewed gold as a ‘safe-haven asset’ – an investment that can be used to dodge the impact of negative sovereign bond yields and act as a safeguard against inflation.

Against the backdrop of the pandemic, gold has rarely appeared more attractive. However, in August, central banks became net gold sellers for the first time in approximately 18 months, highlighting the competing demands on investment strategies.

This year’s survey revealed central banks expect gold holdings to increase over the next 12 months. Around 75% of respondents reported that the Covid-19 outbreak would not change how their institutions viewed gold, with many noting the commodity was an elemental part of their portfolios.

Diversification appears to be the biggest driver of central banks’ interest in gold. In real and nominal terms, it has outperformed many other assets in all macroeconomic regimes that have prevailed since the end of Bretton Woods.

More recently, asset managers have begun offering gold investments in the form of exchange-traded funds (ETFs). The survey revealed that, while central banks are positively disposed towards gold ETFs, active interest is the preserve of the minority. Respondents noted that a combination of gold’s quality as a hedge against the US dollar and ETFs’ cost-effectiveness were the main benefits of investing in gold in this way. However, many were concerned with the liquidity risk associated with ETFs.

As this report affirms, 2020 has been a challenging year for gold investors – only time will tell what role it will take as the world recovers from the pandemic. ❑

Rachael King,
Report editor

The ultimate store of value

Central Banking's Victor Mendez-Barreira speaks to Róbert Rékási, head of foreign exchange reserves management at the central bank of Hungary.

Central banks became net gold buyers in 2010, three years after the financial crisis. In response to Covid-19, major central banks have doubled down on unconventional policy measures, which have further depressed yields. In this context, do you expect gold to become increasingly attractive for reserve managers?

Gold remains an attractive asset class for reserve managers. Amid the uncertainties created by Covid-19, gold is acting as a 'safe-haven asset', which is reflected in higher gold prices. The other important consideration is the opportunity cost. Because of the crisis, central banks eased policies further and fiscal policies followed suit. In this context, the opportunity cost of holding gold has decreased further.

Gold allocations as a share of total reserves have increased substantially over the past decade due to an increase in purchases. Have gold purchases reached their ceiling and will this stem demand?

I do not think we are approaching this ceiling. First, recent surveys have revealed central banks are still willing to increase their gold exposures. Second, the drivers boosting the gold price are very powerful. The low and negative sovereign yield environment is very supportive. Geopolitical and global trade tensions also boost the gold price. For example, growing competition between China and the US is a long-term factor that will not go away after the pandemic or with a new US administration. Third, central banks in different regions look at gold in a different way than before the financial crisis. A very obvious sign of this was the termination of the Washington Agreement on Gold in 2019.

Exchange-traded funds (ETFs) have allowed the creation of a more liquid gold market. This development has been credited with contributing to higher prices over recent years. From a central banking perspective, has this development affected gold's assessment as a reserve asset?

For reserve managers there is a basic triangle. We need liquid assets, safe assets, and we should avoid losses on them. This is very challenging to achieve

Róbert Rékási has been head of foreign exchange reserves management at the Central Bank of Hungary since 2013. Having joined in 2001, he has a 19-year career at the central bank, previously working as a portfolio manager.

Rékási has been a chartered financial analyst (CFA) since 2008, and has been president of the CFA Society Hungary since 2016. He graduated with a degree in finance from Corvinus University in Budapest.

in this low and negative environment, and to balance these three goals. In this context, liquidity is extremely important for central banks. Nonetheless, our approach to gold and ETFs is a little different to that of other investors. On the one hand, liquidity in gold markets is welcome and it has improved over recent years. But most central banks usually do not buy ETF products to gain exposure to gold, instead buying through the over-the-counter market. In the case of gold-producing countries, central banks buy gold from the national producers. Another important point separating reserve managers from other gold investors is that we do not normally trade gold on a daily basis. As a result, daily liquidity is less important.

In spite of sustained price increases and higher liquidity, the market has recorded high volatility over the past two years. In fact, since August, it has recorded a significant correction. To what extent can price volatility deter central banks considering a reconfiguration of their portfolios?

First, we should decide the way in which we look at gold through a proper evaluation of costs and benefits of holding gold reserves on a standalone basis. In my view, gold is a strategic asset that has room in foreign exchange reserves. From this perspective, the volatility of the gold price is only one of many factors to consider. The volatility stemming from the gold exposure should also be examined through the share of gold holdings and the correlation gold has with other assets in the reserves portfolio. You should consider the downside risk pressures stemming from other asset classes during periods of stress, when reserve managers need to deploy their reserves. This would usually require a scenario analysis to discover gold's behaviour compared with that of other asset classes.

Over the past few years, gold has been praised as a source of protection from negative rates. However, its price has tended to move in tandem with other recently adopted reserve assets such as equities. Could this correlation diminish gold's allure among reserve managers looking for higher diversification?

Looking at the structure of reserves globally, approximately two-thirds of central banks hold gold; only 25% of them invest in equities. Not every central bank considers the relationship between equities and gold. But I believe there are some common drivers between the price movements of gold and equities. But

Magyar Nemzeti Bank (Hungarian National Bank) in Budapest.

gold is a 'two-faced' asset. It's true that central banks' asset purchases ultimately boost equity prices during times of stress. We have seen that happening this year. But, in more conventional scenarios, gold tends to rise during crises as a safe-haven asset, offsetting losses you may record on riskier assets. And, more importantly, in contrast to equities, gold's strength through economic turmoil is not dependent on central banking policies. It's a much more reliable source of strength in crises.

A relatively small group of central banks – Russia, China and Turkey being the main players – have led gold purchases since the financial crisis. To what extent have their operations been aimed to reduce their exposures to the US dollar, and the effectiveness of US sanctions on their economies?

This goes beyond the traditional reason of holding gold reserves, and portfolio optimisation too. I am certain tensions between the US and China may have contributed to higher gold holdings in China and other countries with difficult bilateral relations with Washington, such as Turkey.

What is especially relevant in this regard is that gold is a very good source of liquidity for US dollars. We live in a dollar-centric global monetary system, and dollar access remains key for every single country. In this regard, reducing US Treasury holdings – while boosting gold – may reduce your immediate exposure to US actions, but still guarantees that, when needed, gold will allow you to raise dollars in the market.

The Central Bank of Hungary sharply increased gold holdings over the last decade to 31.5 tonnes. In June 2020, total reserves stood at €30.2 billion, and the current market value of its gold holdings is in excess of €2.1 billion, more than 5% of the portfolio's value. What has been the rationale behind these purchases?

It was a long-term national and economic policy strategy decision to increase the size of our gold holdings. The decision was driven by stability objectives; there were no investment considerations behind holding gold reserves. In normal circumstances, gold has a confidence-building feature, so it may play a stabilising role and act as a major line of defence under extreme market conditions, in times of structural changes in the international financial system or during deep geopolitical crises. The central bank also decided to repatriate overseas gold holdings. Holding precious metals within the country is consistent with international trends, enhances financial stability and may strengthen market confidence in the Hungarian economy.

An alternative is to hold part of your holdings in major financial and gold trading centres such as London, New York or Switzerland. This is useful in terms of liquidity as you can lend gold through swap agreements in return for US dollars. It can also enhance returns, but this obviously depends on the specific objectives of central banks.

Poland has also followed a similar approach to boosting gold reserves and repatriating them. Do you think the negative rate environment in the eurozone makes gold more interesting for European Union member states that are not part of the eurozone, but have important exposures to the euro?

As mentioned, it was not the main consideration behind increasing the gold reserves of Hungary. Although, if we consider gold investments from a different angle, this is also a factor to bear in mind. If you don't buy gold, will you buy more expensive German government Bunds? The negative interest rate environment can play a crucial role in many reserve managers' minds. Non-eurozone member states, because of their economic ties, must keep some part of their reserves in euro. The question is to what extent: how much loss can these central banks bear year on year?

In August, central banks became net sellers of gold for the first time in 18 months. This was mainly the result of muted purchases, and large sales by one country. Uzbekistan reduced its gold reserves by almost 32 tonnes, thought to be connected to overall difficulties in financing the government's response to the Covid-19 crisis. To what extent can we expect more countries using their gold portfolios to access hard currency in the months ahead?

I would stress once more that gold is a strategic asset. I do not see central banks starting to reduce their holdings significantly. However, some gold-producing countries can adopt this strategy, and Uzbekistan is an important producer. It is an interesting case; up to a point, you could compare it with Norway. Where the Scandinavians leverage oil resources to accumulate reserves and public assets, Uzbekistan has gold-mining activities it can exploit in a similar fashion. Very likely, the state is involved in the gold-mining industry, and the central bank acquires part of the production, which, in some circumstances, can be sold. If you consider the requirement for higher public spending because of Covid-19, it would make sense for them to engage in these operations. But, as a global trend, I do not see a meaningful number of reserve managers following them.

It is widely accepted that gold would thrive in a scenario of stagflation similar to that experienced in the second half of the 1970s. However, taking into account the current below-target medium-term inflation expectations, this seems unlikely. To what extent would you link the outlook for gold as a reserve asset with the evolution of inflation in the coming years?

I would not put too much emphasis on inflation in the short term. In theory, increasing global debt levels at some point could have an inflationary effect. But, in the current context, it is not an immediate threat. Changes to the market structure are more important than the inflation outlook for gold. In the last decade we saw how central banks became net gold buyers mainly because of the ultra-low-yield environment. The development of the ETFs market has boosted it even further. All of these moves took place in a context of subdued inflation. A bullish gold outlook does not depend on the world economy ending up in stagflation.

In August, the US Federal Reserve unveiled a new policy framework that will allow it to temporarily tolerate inflation above the 2% target. It announced in September that it will maintain the Fed funds rate at 0–0.25% through 2023. What repercussions do you expect this policy change to have on the gold market, and the thinking of reserve managers worldwide?

I think is very supportive for the gold market in the long run. Opportunity cost is an important driver of gold price, and yields do not look like they will be rising any time soon. The Fed is basically saying it will keep interest rates low for longer, at least until 2023. On the one hand, that is good for gold prices. On the other, it says it will allow inflation to temporarily be over the 2% target. Let us see whether that is possible but, if that happened, it would also support gold as a reserve asset. That is why I think the Fed's new policy approach to average inflation targeting is so positive for gold.

So far during the Covid-19 crisis, emerging market currencies have remained stable as the reserve portfolios of their central banks. Could this indicate – alongside the weaker dollar fostered by a dovish Fed – gold's role to hedge against currency depreciation has become less relevant for reserve managers?

In the 1980s and early 1990s, global reserves looked very different. Now portfolios are far larger. As a result, most emerging currencies are more stable than they used to be. Nevertheless, beyond the portfolio size, you need to consider asset allocations. In this respect, gold's allocations remain unchanged or have even increased as portfolios have grown larger. Gold is a good hedge against inflation; it is the ultimate store of value. Even if economic fundamentals evolve, and requirements can vary from advanced to emerging economies, gold's strengths remain. ❑

This interview was conducted by Central Banking in October 2020

Gold reserves in central banks – 2020 survey results

This article reports the findings of a survey of central banks carried out by *Central Banking* in August 2020. Those that took part did so on the condition that neither their names nor those of their central banks would be mentioned. By Nick Carver and Robert Pringle.

Executive summary

- The Covid-19 pandemic has not, in the main, changed the view of central banks on gold, although almost one-quarter of respondents said they view gold as a more attractive asset.
- Central bankers typically expect central bank gold holdings to increase over the next 12 months; no respondent expected a decrease.
- When determining a central bank's gold holding, the benefits of diversification stand out as the most relevant factor for reserve managers.
- One in three central banks said they maintain a target allocation for gold: this rose to 39% of respondents when only those holding gold were considered.
- Purchases in the global market are by far the most popular means of buying and selling gold, with derivatives second.
- Overseas storage at a central bank is the preferred way to store gold: more than 80% of respondents said they did this.
- Central banks are positively disposed to gold exchange-traded funds (ETFs), but active interest in investing is the preserve of a minority.
- A combination of gold's quality as a hedge against the US dollar and ETFs' cost-effectiveness are the main benefits for holding ETFs.
- Liquidity risk is the chief concern associated with holding gold ETFs, although larger holders say safety regarding physical gold is more of an issue.

Profile of respondents

The *Gold for Central Banking 2020* survey questionnaire was distributed in August 2020 and had received replies from 26 central banks by the first week of September. The reserve managers that replied did so on condition of anonymity. The 26 central banks are, as a group, responsible for just over $2.6 trillion in reserves as of June 2020.[1] The average holding was just over $100 billion. Collectively, the banks are responsible for $344 billion worth of gold, with an average holding of $13 billion. The group included six central banks with no gold reserves. A breakdown of respondents by national income classification and geography is set out below.

Region	% of respondents	Income classification	% of respondents
Europe	46	High income	54
Americas	31	Upper middle income	27
Asia	15	Lower middle income	15
Africa	8	Low income	4
			Total respondents: 26

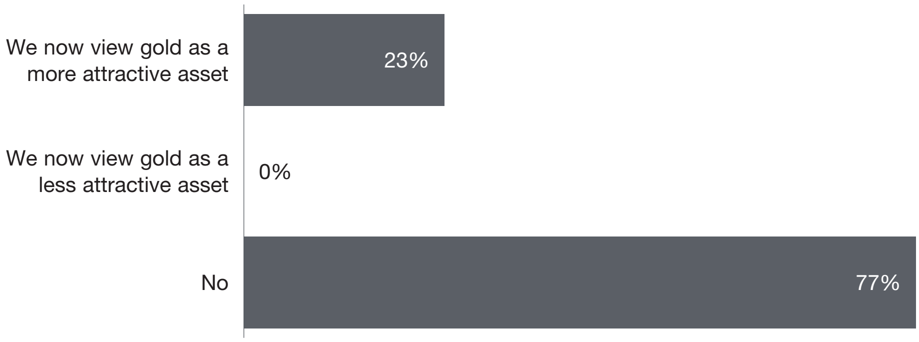
Regional classification follows UN methodology

Income classification follows World Bank methodology

1. International Monetary Fund International Financial Statistics, with gold valued at market prices.

Percentages in some tables may not total 100 due to rounding.

Has your central bank changed its view on gold since the Covid-19 outbreak?



The Covid-19 outbreak has not changed how central banks see gold. This was the view of just over three-quarters of respondents, responsible for $2 trillion in reserves. Several respondents from this group noted that gold was an elemental part of their reserve management framework and as such was not impacted by market moves. A reserve manager from Asia explained: “Gold has been an integral part of our reserves regardless of market condition, and it may likely continue to be so.” A respondent from central Europe said their central bank remained committed: “We were very positive on gold in terms of the role it plays in any foreign reserve portfolio, even before Covid-19, and that has not changed.” Another reserve manager from Europe had seen their view of gold’s strength in a crisis confirmed: “Gold is seen as a ‘safe-haven asset’ in times of financial and political stress. Current market conditions have no impact on its strategic role in foreign reserves, other than to reaffirm the validity of the initial view.”

A contrarian view was offered by a reserve manager from Africa, whose central bank had yet to be persuaded on the benefits of holding gold: “In our view, gold does not provide a regular income, has high volatility and, with the Covid-19 outbreak, its price has risen substantially, making it unattractive to buy for our portfolio.”

Six respondents did however say their central bank’s view had changed. The reserve holdings of this group ranged from $3 billion to more than $300 billion and they were mostly drawn from middle-income countries. In comments, two reserve managers, from Africa and Europe respectively, noted that an increase in the price of gold had strengthened its safe-haven status.

What issues are most relevant in determining your institution’s gold holdings?

The benefits from diversification stand out as the most relevant factor for reserve managers in determining their institution’s holdings of gold. Just under two-thirds of respondents – a group of central banks responsible for $1.9 trillion, and with an average holding of $134 billion – said this was “very relevant”. This group, which included several large holders, was dominated by central banks from middle-income countries. It included over half the respondents from the Americas.

Low real interest rates also figure prominently in decision-making: just over 40% said this was very relevant. This group was also dominated by central banks

	Very relevant		Slightly relevant		Not relevant	
	No.	%	No.	%	No.	%
International geopolitical challenges	7	32	6	27	9	41
Domestic political challenges	1	5	4	19	16	76
Weakening of the US dollar	4	18	9	41	9	41
Covid-19 pandemic	4	18	8	36	10	45
Declining global growth	4	18	5	23	13	59
Low real interest rates	9	41	5	23	8	36
Decline in oil price	0	0	6	27	16	73
Historical performance	6	27	7	32	9	41
Diversification benefits	14	64	4	18	4	18
Contribution to risk of portfolio	8	36	7	32	7	32
Inflation risk	4	18	9	41	9	41

Four central banks did not respond.

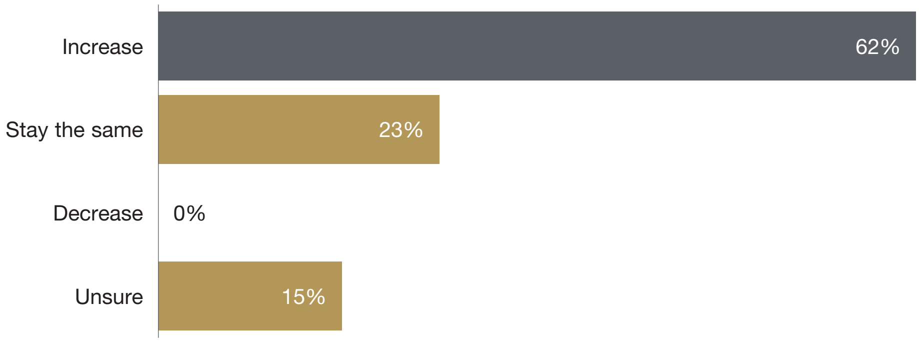
from middle-income countries, and there was significant overlap with views on diversification benefits: all but one of the nine also said diversification benefits were very relevant. The nine were smaller reserve holders, however, holding $85 billion on average. Eight respondents reported that gold's contribution to the risk of a portfolio was very relevant for their central bank, a group that contained several very large holders and was responsible for $1.4 billion. All eight also said that diversification benefits were very relevant.

A similar pattern was observed when looking at the central banks with gold holdings. Of the 18 that answered this question, 61% placed diversification benefits first, followed by low real interest rates (50%) and then contribution to portfolio risk (39%).

Viewing the results through the prism of national income classification revealed a variation in views, however. Diversification benefits scored highest for reserve managers from high- and middle-income countries. Immediately below this, those from high-income countries placed more emphasis on the contribution to the risk of the portfolio, but for middle-income countries, low real interest rates matter more.

Just over half of respondents said "historical performance" was relevant, and several mentioned legacy or legal requirements in their comments. "Decline in oil prices" and "domestic political challenges" were not, however, seen as relevant for this group, and there was only marginal support for "weakening of the US dollar", "Covid-19 pandemic", "declining global growth" and "inflation risk".

How will global central bank gold reserves change over the next 12 months?



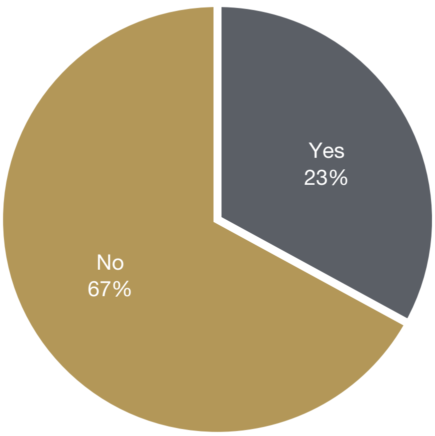
There is little prospect of central banks reducing their gold holdings over the next 12 months, with expectations centred on stock increasing or remaining flat. Just over 60% of respondents – a group of central banks responsible for $1.7 trillion in reserves – said they expect gold holdings to increase over the next 12 months. The percentage was slightly higher among gold holders at 70%. The group of 16 was dominated by central banks from high-income countries (10), with the remainder from lower middle-income (4) and upper middle-income countries (2).

A reserve manager from Europe, whose central bank has significant gold reserves, explained what they saw as the two driving forces behind this: "The growing demand from emerging-market central banks reflecting current geopolitical, political and economic conditions, as well as structural changes in the global economy, will probably last in the future." Six reserve managers, of which two-thirds were from upper middle-income countries, said they thought holdings would remain the same. Indeed, among upper middle-income countries, this was the majority view: only one in three among this group expect gold holdings to increase. In contrast, all four reserve managers from lower middle-income countries expect central banks to hold more gold in 12 months' time. Three of the four reserve managers who were "unsure" were from high-income countries.

Does your central bank have a target allocation for gold?

Maintaining a target allocation for gold is a minority activity among central banks, though somewhat higher among gold holders. One-third of respondents – responsible for $680 billion – said they had a target allocation for gold. All but one of these eight central banks were gold holders. However, narrowing the sample to holders of gold only increases the percentage to 39%.

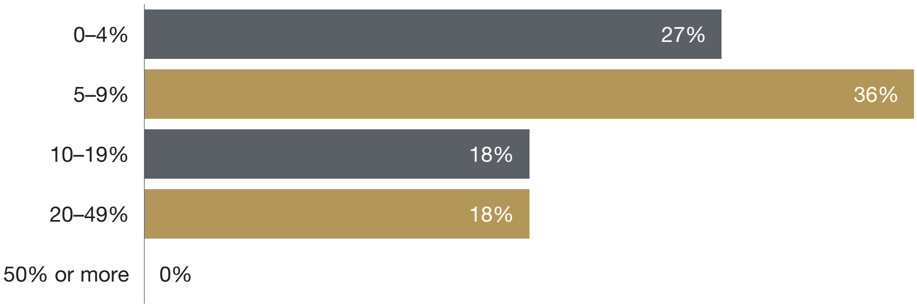
The practice was most common among central banks in middle-income countries, almost half of which said



Two central banks did not respond.

they had a target allocation, with one respondent from a central bank in Asia commenting that they were in "the process [of having] a certain target allocation". In contrast, this was the case in only two of the 12 high-income countries. A large holder from Europe qualified their answer: "[We have] no target allocation. Percentage is derived from value of gold holdings in relation to value of currency reserves." Most central banks with a target allocation target less than 10% – a figure in line with historical percentage holdings for official sector assets.

If yes, what percentage of your total reserves portfolio do you allocate for gold?



Twelve central banks did not respond. Of those that responded, two did not explicitly say they had a target allocation. One central bank selected two ranges for its answer.

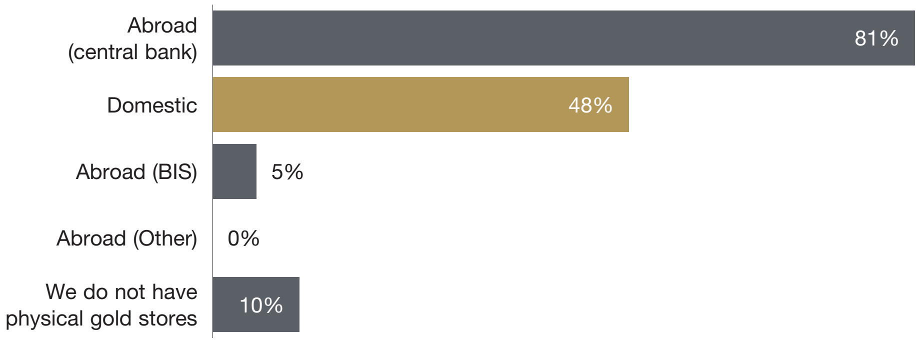
How does your central bank buy and sell gold?

	Current practice		Considering in the next 1–2 years		Considering in the next 3–5 years	
	No.	%	No.	%	No.	%
World market	14	93	1	7	0	0
Domestic market	2	67	1	33	0	0
ETFs	1	50	1	50	0	0
Gold derivatives	4	67	2	33	0	0

Eleven central banks did not respond.

Transacting in the global market is by far the most prevalent means of buying and selling gold. The 14 central banks that said they used the world market were split almost evenly between high-income and middle-income groups. The group contained several large holders and were responsible for a combined $2 trillion in reserves. The average holding of gold among this group was just under $10 billion. Of these, five made use of an additional channel, with derivatives the most popular, and a large holder from the Americas reporting it was considering this. Overall, four respondents said they used derivatives: three of these were very large holders and all four used derivatives with at least one more channel. There was little support for ETFs: the one central bank that said it used this product also used global markets and derivatives.

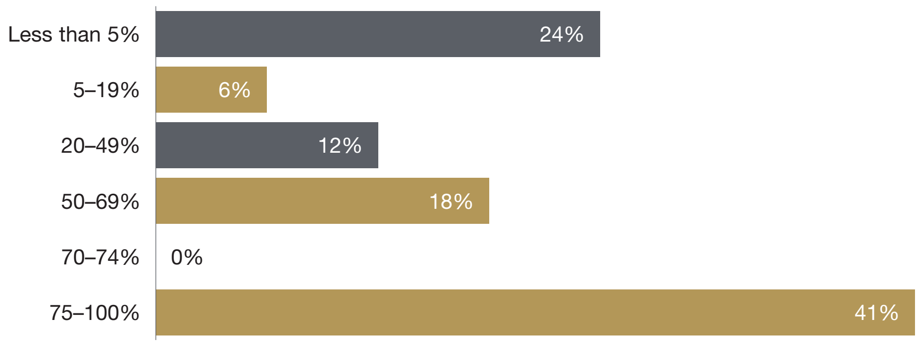
Where does your institution store its physical gold holdings?



Twenty-one central banks responded, of which eight selected more than one option.

Overseas storage at a central bank is the preferred way to store gold for most central banks: more than 80% of respondents said they did this. Of this group, half also said they stored gold domestically. The 17 central banks were responsible for $2.3 trillion and $340 billion in gold and as a group were dominated by high-income countries. Only two central banks exclusively store gold domestically: one from Europe and one from Africa.

How much of your total gold holdings are held abroad?



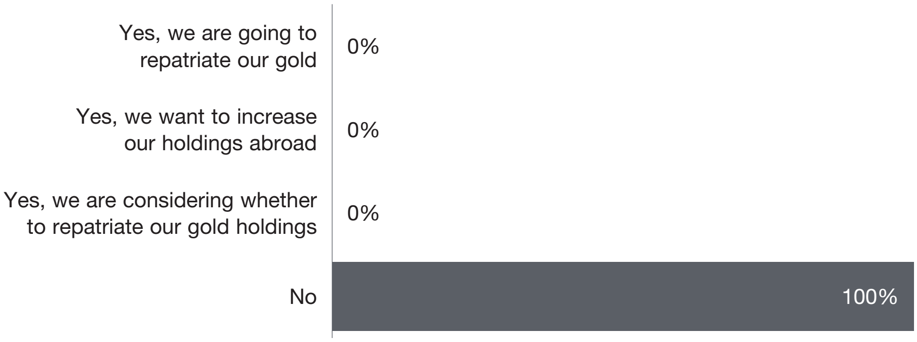
Nine central banks did not respond.

Seven central banks said they stored more than three-quarters of their holdings abroad. The percentage held overseas dropped where central banks had more than one option for storing. These seven were also smaller holders, with an average of $1.4 billion in gold, though two were overall very large reserve holders. By contrast, the central banks that combine domestic and overseas holding are on average much larger holders ($42 billion). The percentages held abroad ranged from the smallest of less than 5% in one Asian and one European central bank to 75–100% in another Asian central bank.

Respondents were unanimous in there not being any bearing of the Bank of England (BoE) versus Venezuela government court decision on their decision to hold gold, but three did offer comments. An Asian central banker underscored its lack of influence: "Our decision to review our gold storage policies is independent of the BoE and Venezuela government matter." Another, from Europe, noted their decision was based on broader considerations: "Potential global geopolitical tensions were one of the premises when deciding on repatriation of part of gold holding to domestic vaults, not any particular case."

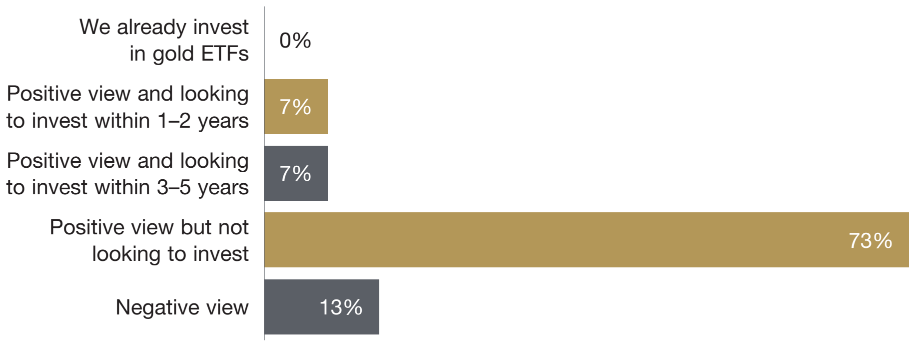
In an extended comment, one reserve manager – after noting their bank had had a "similar experience" – added that "backtesting would prove that gold abroad is not a risk-free asset and that it will always depend on which side the holder stands. And it is very important to consider this because […] gold is supposed to be used during crises and international political tensions."

Has the outcome of the recent BoE versus Venezuela government court decision impacted your decision to store gold?



Four central banks did not respond.

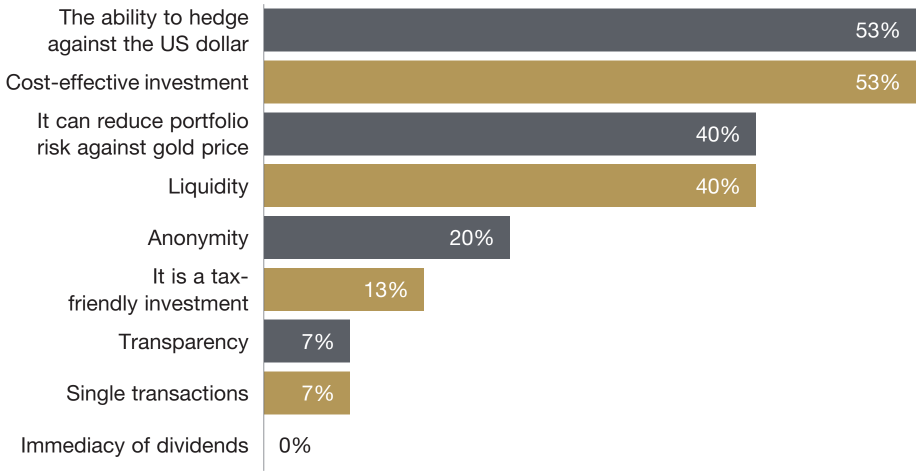
Which best represents your institution's view on gold ETFs?



Eleven central banks did not respond.

Central banks are positively disposed to gold ETFs, but active interest in investing is the preserve of a minority. Eleven central banks – responsible for $615 billion in reserves – had a positive view but were not looking to invest. These were, on average, smaller reserve holders than the survey average and, indeed, smaller gold holders than the sample. One reserve manager from Europe explained their thinking: "Our opinion is that 'paper' gold is not as safe as physical." One central bank from the Americas said it was considering moving into this product in the next one to two years, and one from Asia was looking at it over a three- to five-year horizon. The two central banks with a negative view were both large holders from Europe.

What are the main benefits for central banks that hold ETFs?

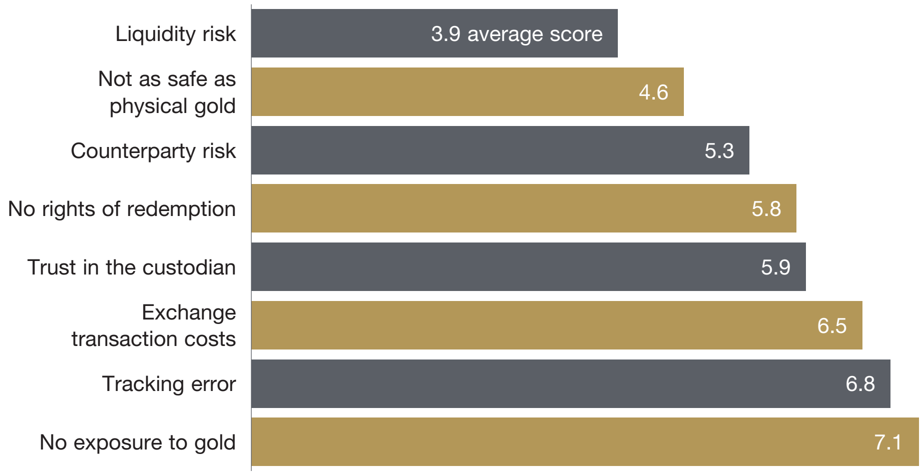


Eleven central banks did not respond.

A combination of gold's quality as a hedge against the US dollar and cost-effectiveness are considered the main benefits for holding ETFs. Over half the survey respondents selected these two options, and three-quarters of the sample of 15 chose at least one of them. This group of 12 was responsible on average for reserves with $46 billion and gold worth $19 billion. It is notable that those mentioning the hedge against the dollar tended to be smaller holders on average of both reserves and gold than those that viewed cost-effectiveness as a main benefit. Liquidity, cited by six respondents, was typically a benefit for larger holders: three of these six were responsible for reserves worth more than $100 billion. In contrast, all but one of the six that saw reduction of the risk against the gold price as a benefit were responsible for less than $10 billion. Among those that said their institution had a positive view on gold ETFs, there was marginally more support for the hedge against the US dollar than cost-effectiveness, but the pattern broadly followed that in the previous table (*What are the main benefits for central banks that hold ETFs?*).

What is the greatest concern for your central bank regarding holding gold ETFs?

Liquidity risk is the chief concern associated with holding gold ETFs: over half of respondents ranked this either first or second. These six were on average smaller holders, at $15 billion in reserves and $270 million in gold, than the survey average. The second greatest concern was that gold was not as safe as physical gold, and, indeed more respondents (five) ranked this first than did liquidity risk (three). These five were on average much larger holders – three held reserves worth more than $100 billion – and were all from Europe. Counterparty risk was third overall and ranked first or second by five respondents. Four of these five were middle-income countries and, as a group, tended to be smaller holders – on average responsible for $30 billion in reserves and $7.5 billion in gold. No single central bank saw the lack of rights of redemption as the primary concern, with only two ranking it second.



Fifteen central banks did not respond. Votes were cast using a scale of 1–8, where 1 denotes the greatest concern and 8 the least.

There was some variation across geography and income groups. Central banks in Europe were unanimous in their concern that ETFs were not as safe as gold: all five European respondents ranked this first, with trust in the custodian the second greatest concern. In contrast, respondents from Asia were more concerned about counterparty risk and as concerned about liquidity risk as they were safety. Large holders, with more than $10 billion, were most concerned about safety compared to physical gold, whereas for smaller holders liquidity was the main concern. ❑

Respondents unanimously voted that the outcome of the Bank of England versus Venezuela government court decision did not impact their decision to store gold

All that glitters – Surveying central banks on gold reserves

Key survey data and comments reinforce the main findings in Invesco's central bank reserve management white paper on the revival of gold as a reserve asset.

Invesco

The joint Central Banking-Invesco gold survey, conducted in August and September 2020,[1] provides interesting reading about how central banks see the role of gold in official international reserves in a low-yield, low-growth, low-inflation world where many central banks have high reserves, far in excess of likely needs for traditional uses such as foreign exchange intervention. The survey's findings reinforce those of Invesco's white paper, *Central bank foreign currency reserves management – Revival of gold as a reserve asset*,and point to evolving views and use of reserves.[2]

The rise of gold in reserve portfolios

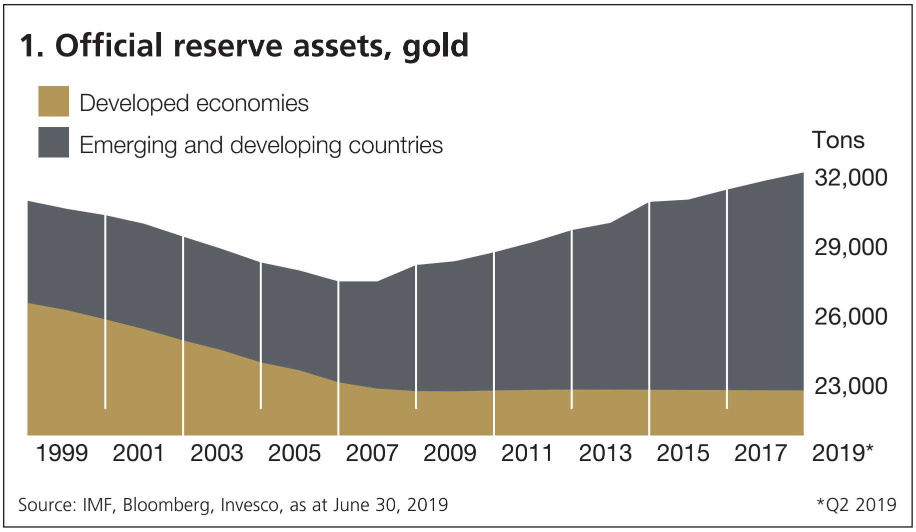
The use of gold in official international reserve portfolios has continued to rise, even after the recent price surge. Most central banks plan to maintain or further increase gold allocations; few plan to cut back. A minority of central banks are more favourably disposed to gold as a result of Covid-19 though, for the majority, the pandemic and lockdowns have not changed their views towards or allocation of gold. Around one-third of respondents to the survey have a specific portfolio weight target for gold. Price sensitivity and valuation concerns are far from common; only one central bank within this survey group expressed direct concern that the gold price was too high (see figures 1 and 2).

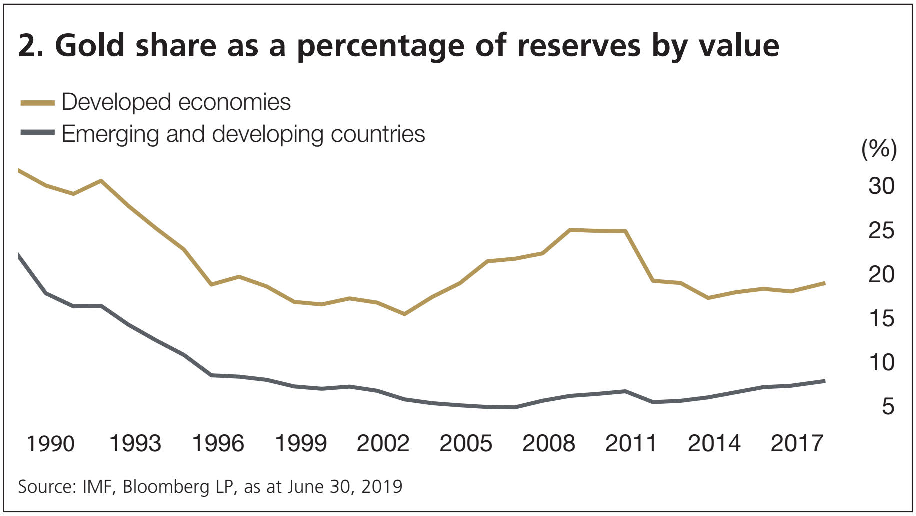
The trend towards divesting gold by developed market central banks stopped with the onset of the global financial crisis in 2007–08 followed by the eurozone crisis of 2010–12. Around the same time, emerging market central banks switched from an almost studied indifference, to becoming major gold buyers, led by China, Russia, Turkey and India.

The perceived benefit of diversification

Diversification remains the most important perceived benefit, reflecting the high concentration of US dollar exposure, primarily in US Treasury, mortgage and high-quality corporate debt.

The desire for diversification is expected to continue to propel interest in





gold as well as other fiat-currency alternatives to the dollar and Treasuries, including China and the eurozone. However, the greater depth in scale, breadth in terms of assets, and liquidity in terms of free float relative to the outstanding stock all suggest there is no full substitute for the dollar. We would therefore expect continued demand for diversification at the margin, to the extent that central bank reserves continue to increase, but would not expect any large or sharp portfolio rebalancing away from the US dollar as the main reserve currency or US reserve assets.

The increasing allure of gold applies as much to private investors worldwide as it does to official investors, including central banks. The increasing use by private and individual investors of gold exchange-traded funds (ETFs) – as well as paper-certificated and, perhaps to a lesser extent, physical gold – suggests gold's diversification benefits might be reduced over time, as ownership broadens out.

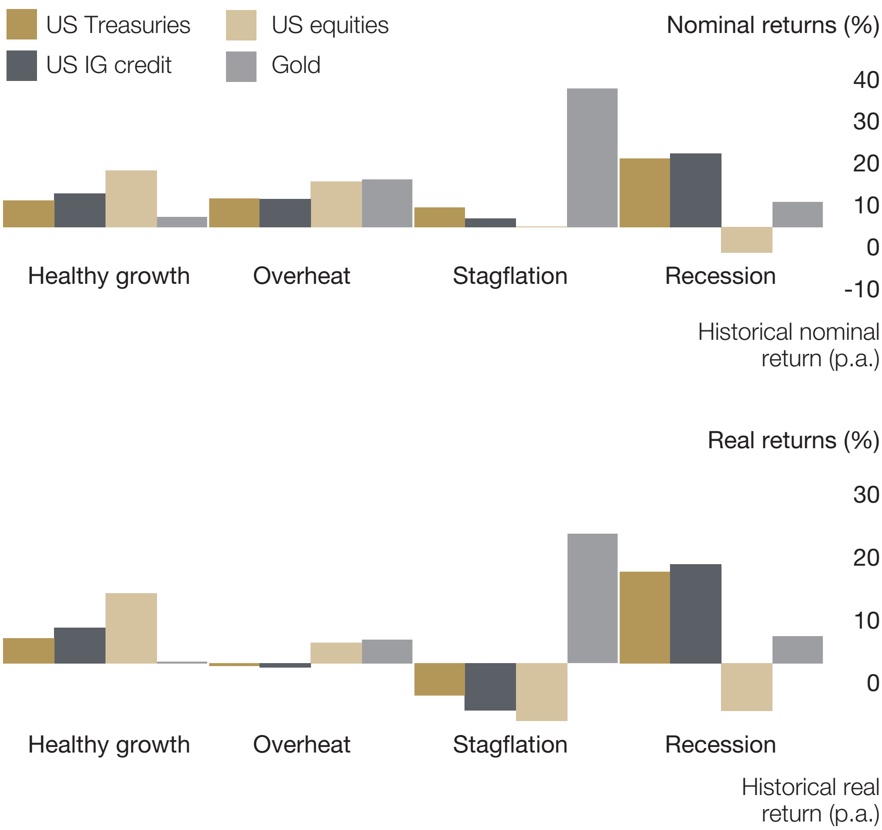
Furthermore, positive scenarios should also be factored in. When and if growth, inflation or both rise far enough, monetary policy would probably be tightened, and yield curves would normalise through higher yields and a steeper slope. The result could conceivably be losses on both risky and 'risk-free' assets –

as occurred during the 2013 'taper tantrum' – as market valuations adjust to less loose monetary and financial conditions, higher discount rates due to rising inflation, expectations and higher real yields.

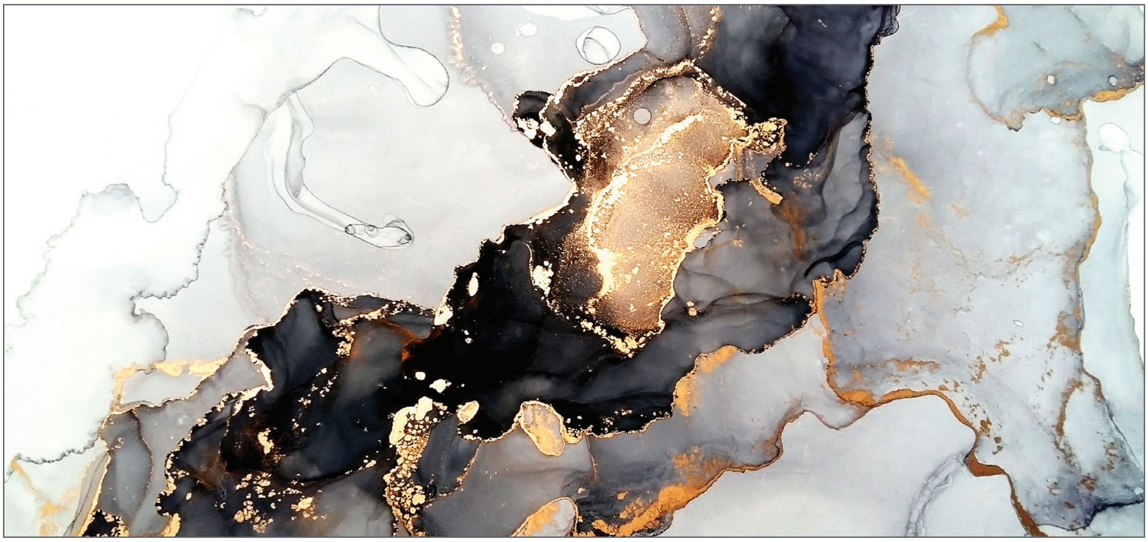
Factors such as these could limit the degree of diversification demand for gold by central banks, though we believe such a highly reflationary or inflationary outcome is unlikely in the foreseeable future. Gold has delivered positive real and nominal returns in all macroeconomic (macro) regimes in the modern era. This performance is expected to sustain private and official investor interest in gold for the foreseeable future, even if it continues to behave more like traditional asset classes with widening ownership. Gold has been relatively volatile with relatively lower returns than other asset classes over longer lookback periods, but we would expect the diversification benefits set out in figure 3 to be more important for central banks.

Uncertainty increases allure Geopolitical, geo-economic and financial uncertainty all increase the allure of gold even as the opportunity cost of holding gold has fallen. In today's low-growth/inflation, zero/negative policy rate and low/negative bond-yield world, alternative reserve assets yield much less than before the major financial crises

3. Annualised asset class returns during discrete economic cycles (USD)



Source: Bloomberg LP, internal calculations, December 31, 1972–September 30, 2019
Past performance, actual or backtested, is not a guarantee of future results.



of the past 15 years and the current pandemic. This historically low-interest rate environment means that the cost of holding gold is unprecedentedly low. Financing the cost of storing physical gold has been directly reduced by low interest rates; and the opportunity cost of foregone interest on alternative reserve assets is lower than recorded in modern times. More than 40% of respondents to the survey cited low interest rates as supporting gold allocations.

The combination of uncertainties is expected to support the demand for gold, which has tended to deliver positive returns in every macro regime. The challenges – as significant as in past macro regime changes – extend to domestic macroeconomic challenges, marked by pressures on fiscal policy around redistribution and taxation, as well as monetary policy and central bank independence; geoeconomics, marked by barriers in trade, investment, finance and technology; and geopolitics, marked by border disputes, disagreements over territorial waters and freedom of navigation, as well as ideological, legal or constitutional differences.

Covid-19-driven domestic macroeconomic policy challenges arguably threaten both low growth and low inflation, or even deflation, as well as high inflation. In the short term, the severe hit to demand, employment and to household income in many countries precipitated by the Covid-19 pandemic, lockdowns and simultaneous surges in both private and public debt could add up to a classical debt deflation trap, which is being fought by extraordinary monetary loosening. However, many policy-makers, academics and investors are equally concerned about the risk of high inflation and financial repression, given the rapid money creation and unprecedented fiscal support on top of supply shocks created by the lockdowns, as well as supply chain disruptions brought about by rising trade and investment barriers or outright geopolitical tensions.

A third concern about higher taxes on capital, wealth and income generated from assets (as opposed to labour income) also lurks in the mind of the markets and many investors, and needs to be factored in by reserve managers as well as other investors, though it did not figure in this survey. This is because high inflation, especially with financial repression, would be a choice central banks can avoid – after all, central banks have proven much more effective at getting high inflation back down by tightening monetary policy than they have at getting inflation up to target by easing policy, especially at or near the effective lower bound for policy interest rates. Furthermore, central banks have contributed to financial repression in the past.[3]

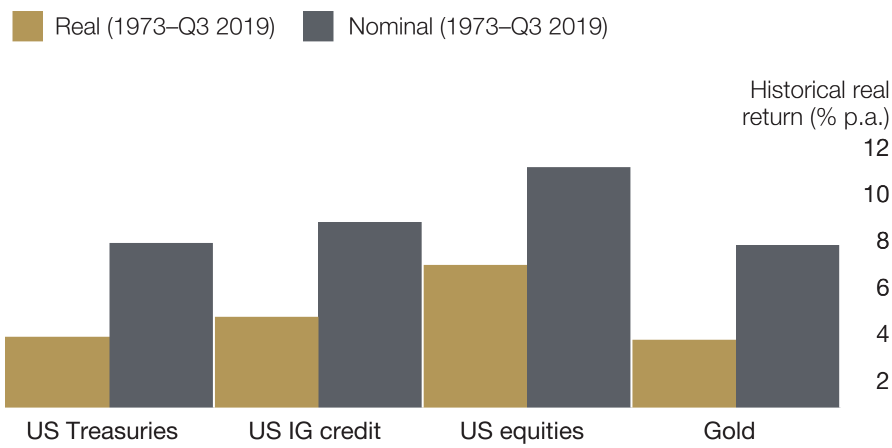
Finally, high inflation is highly regressive and hence a source of inequality, affecting those on low incomes that cannot protect themselves against inflation – namely, the same segments of income distribution that have not benefited from the repeated increases in asset prices in the era of ultra-loose monetary policy; and that arguably have been hindered or left behind by globalisation, technological progress and hit hardest by Covid-19 itself, as well the unemployment effects of the lockdowns. Taxes on capital and corporate income are therefore a distinct possibility as a way of helping to balance budgets once economic recovery is well entrenched.

Gold's historic positive return performance in highly inflationary, disinflationary/deflationary and 'stagflationary' (low growth and high inflation) macro regimes suggests these uncertainties will maintain a significant role for gold in both private and official investor portfolios. Equally, the challenges in the international system are likely to continue to spur demand for gold as an international currency and as an asset that is no-one's liability as a 'reserve currency without a country'.

Reserve diversification and reserve asset yields

The costs and benefits of reserve diversification and reserve asset yields would seem to be associated with central bank reserve asset profit and loss, and, indirectly, quasi-fiscal costs. The balance between diversification and cost for holding reserves seems to split the reserve manager community by the level of per capita national income. Central banks of countries with high per capita incomes emphasised portfolio risk (and hence a focus on diversification), whereas middle-income countries tended to cite low global interest rates (and, hence, opportunity cost) (see figure 4).

4. Long-term annualised asset class returns (USD)



Source: Bloomberg LP, internal calculations.
US Treasuries: Bloomberg Barclays (BBG BARC); US Treasury Index; IG credit: BBG BARC US Credit Index
US equities: S&P500 Index; and gold: Bloomberg <GOLDS Comdty>
Past performance, actual or backtested, is not a guarantee of future results.

Conclusion

Vehicles for gold transactions and holdings are evolving slowly. The *Gold reserves in central banks – 2020 survey* (see pages 54–63) corroborates our other findings, and those elsewhere, that:

- Most central banks still prefer to buy and sell gold in the global cash market, rather than using domestic gold or derivatives markets.
- Overseas gold holdings with other central banks remains the preferred holding strategy, used by 80% of respondents. Some central banks have been repatriating physical gold, in some cases because of geopolitical risks, though this is far from commonplace. Indeed, there was unanimity that the court ruling supporting the Bank of England in holding the Central Bank of Venezuela's gold had no bearing on decisions about where or how to hold their gold.
- Interest in gold ETFs is on the rise, but most central banks remain in an exploratory mode, with many reporting liquidity considerations as an important factor, and some indicating concern about whether a gold ETF was as 'safe' as gold itself is perceived to be. We would expect central banks' use of ETFs to increase over time, not least because fears that ETFs might offer artificial or illusory liquidity in excess of the liquidity of underlying assets. They are widely seen to have been reduced by the relatively smooth operational performance of ETFs during the height of the Covid-19 financial crunch in March 2020 – even as the 'dash for cash' led to a short but sharp selloff in reserve assets such as Treasuries, Bunds and gilts. We believe ETFs may also be useful for some central banks as a less politically sensitive way to buy and sell gold, without the direct political symbolism of 'selling the crown jewels' or national 'family silver' that is sometimes associated with selling gold reserves. ❑

Notes

1. See *Gold reserves in central banks – 2020 survey results* on pages 54–63 for a detailed description, analysis and data on survey responses. Reserve managers representing 26 central banks with $2.6 trillion equivalent in official foreign exchange reserves as of June 2020 responded to the survey, which was anonymous. Respondents indicated a total of around $350 billion equivalent of gold holdings, with a median of holding of some $35 billion.
2. A Das, J Johnson-Calari and A Tobor (2020), *Central bank foreign currency reserves management – Revival of gold as a reserve asset*, Invesco whitepaper series 06, https://bit.ly/3ow6RBF
3. Financial repression for these purposes consists of indirect taxation of financial wealth and income through regulation or capital controls that hold yields or interest income below inflation for extended periods, as occurred in many western countries after World War II. Financial repression has also been common in many emerging market countries, even after the Bretton Woods era, when exchange rates remained fixed and capital controls were kept in place, unlike most developed countries.

Has Covid-19 made gold shine brighter?

The price of gold has skyrocketed this year, but central banks have not flocked to invest as they have done in the past, write Rachael King and Victor Mendez-Barreira.

We are living in uncertain times. Over the course of 2020, policy-makers worldwide have watched international travel restrictions and local lockdowns imposed, entire sectors close and stock markets fall and then rise at an alarming rate. The financial crisis that began in 2007–08 no longer seems a once-in-a-century event.

It therefore comes as no surprise that central bank reserve managers have scrambled to optimise their portfolios during the pandemic. In the past, central banks have turned to gold – universally known as the 'safe-haven asset'. The precious metal has helped central banks tame the impact of negative sovereign bond yields and has acted as a source of value against deflation. It has also helped central banks reduce currency concentration within their portfolios.

During the Covid-19 pandemic, central banks have aggressively cut interest rates and dramatically expanded their asset purchase programmes. This has supported expansionary fiscal policies, but also contributed to further depressing sovereign-bond yields. As a result, longer-term US Treasury yields have fallen to negative levels and the entire German bund yield is now below 0%. Against this background, gold has rarely appeared more attractive.

During *Central Banking*'s National Asset-Liability Management Conference in October 2020, diversification appeared the biggest driver of central banks' interest in gold. In real and nominal terms, gold has outperformed many other asset classes since the end of Bretton Woods.

Amid the turmoil brought about by Covid-19, investors globally have increased their exposure to gold. This has boosted prices in 2020 by 26% to $1,925 per ounce on October 12. Nonetheless, central banks' net purchases have decreased this year in comparison with previous years. Central bank net purchases totalled 233 tonnes in the first half of 2020 – 39% below the levels recorded during the same period in 2019, according to the World Gold Council.

However, this mostly reflects that the first half of 2019 recorded the highest level of net purchases since 2000. In fact, central bank gold purchases in the first six months of 2020 were only 6% below the period average of 247.1 tonnes since 2010, when central banks became net purchasers on an annual basis.

One important factor putting downward pressure on overall gold demand is that some central banks are using their resources to honour their mandates. "During a major crisis, gold is there for you to sell – especially if your country lacks foreign exchange reserves," Robert Rekasi, head of FX reserve management at the Central Bank of Hungary, told *Central Banking*.

According to the World Gold Council, price fluctuations at the start of the year were also due to investors liquidating their gold to raise cash to cover losses in other asset classes. Similar trends were witnessed during the financial crisis, but gold still managed to be one of the few asset classes to post positive returns at the time.

This trend is likely to continue in the months ahead. In August, central banks became net gold sellers for the first time in approximately 18 months. Overall, central banks sold a net 12.3 tonnes during the month. Purchases were concentrated in a small group of regular buyers. The Kyrgyz Republic bought 5 tonnes, India 4 tonnes, Turkey 3.9 tonnes, the United Arab Emirates 2.4 tonnes, Qatar 1.6 tonnes, Mongolia and Kazakhstan, 1.3 tonnes each.

However, these operations were offset by the sales of a single central bank. Uzbekistan reduced its gold reserves by almost 32 tonnes in August.

Historical volatility

Since the financial crisis, gold recorded sharp price movements that asked questions of its position as a stable investment asset during periods of financial volatility. As the US economy consolidated its recovery in 2013, and the Federal Reserve hinted it was planning to withdraw part of its post-crisis stimulus, the gold price started to decline.

By December 2015, the gold price had fallen from $1,700 per ounce to $1,050, at which time the Fed implemented its first rate hike in almost a decade. Despite the price volatility, European central banks, such as those of Hungary, Poland, Russia and Turkey, alongside China, have boosted gold purchases over the past decade.

In the second quarter of this year, Turkey remained the largest gold buyer, according to the World Gold Council. The central bank's net purchases reached 97.8 tonnes, accounting for 85% of global purchases during the period. The central bank's gold holdings now stand at 606 tonnes, still behind the levels held by major European central banks, such as France (2,436 tonnes), Italy (2,451 tonnes) and Germany (3,362 tonnes). Covid-19, which threatens to quash growth for the forseeable future, has arguably made gold more attractive to central banks using it to hedge against swings in exchange rates and inflation.

Nonetheless, the sustainability of recent price increases remains uncertain. The Fed's new policy framework is one factor that could impact the long-term price of gold. In August, the US central bank adopted average inflation targeting, saying it will temporarily allow inflation to increase over the 2% target. This means interest rates in the US are likely to stay lower for longer.

On September 16, in its first policy announcement after unveiling the new policy framework, the Fed signalled the federal funds rate would remain close to zero through 2023.The Fed's unwillingness to hike could be worrisome if, in the aftermath of the Covid-19 crisis, the US and international economies experienced stagflation. In that context, there might have been some doubt as to whether the Fed would tighten fast enough, contributing to investor uncertainty.

There is the possibility gold could behave very much as it did in the stagflation of the 1970s. In an environment of low growth, high unemployment and inflation, gold was boosted by investors seeking refuge. In 1971, gold traded at $35 per ounce but, by the end of the decade, it touched $850 per ounce – a 2,300% increase.

Political landscape

Historically, gold has been used by central banks to reduce currency concentration within their portfolios – specifically for the US dollar. As gold portfolios grew larger, US dollar foreign reserve currency allocations declined from 65.4% in 2016 to 60.9% in 2019.

The sharp fall in dollar liquidity at the height of the pandemic in March and April saw investors and official institutions focus their efforts on securing access to the world's reserve currency. In a dollar-centric monetary system, gold's attractiveness rests on the ability it offers its holders to access dollars. But this traditional role for gold may be about to lose importance.

As part of the set of measures the Fed unveiled in March to improve international dollar access, it created a new facility allowing, for the first time, foreign central banks to access dollars posting Treasuries as collateral. The Fima repo facility, as it is known, allows account holders at the New York Fed to enter into repurchase agreements with the Fed; this line provides central banks with an alternative and secure way of accessing dollar cash other than selling their gold reserves.

For countries facing US financial sanctions, gold remains an attractive alternative. Russia is the prime example of this – after illegally annexing Crimea from Ukraine in 2014 and occupying the east of the country, Barack Obama's administration imposed hefty economic sanctions on Vladimir Putin's regime.

In a bid to limit the effectiveness of these sanctions, Moscow has sharply reduced its US treasury holdings while rapidly boosting gold holdings. In July 2020, Russia's holdings of US Treasuries were recorded at just $5.9 billion.[1] In January 2013, Russia held $164.4 billion in US treasuries.[2]

From 2013 to 2019, Russia's net gold purchases reached 1,313 tonnes – 187.6 tonnes per year, on average – according to the World Gold Council. So far this

year, Russia's net purchases have amounted to 28.2 tonnes. These operations have more than doubled Russia's gold reserves to 2,299 tonnes in October 2020.

However, this strategy seems to have run its course. The Central Bank of Russia surprised the market when it announced the suspension of its gold-buying programme from April 1. In a statement, the central bank gave no reason for the decision, but has hinted in the past it may scale down its gold purchases.[3]

"Further decisions on buying gold will be made depending on the development of the situation in the financial market," the central bank said in its statement. In 2019, the Central Bank of Russia announced it would purchase domestic gold at a discount. As a result, buying slowed to an annual rate of 158.1 tonnes, almost 25% lower than the previous four years.

The future is uncertain

The unprecedented economic shock created by Covid-19 creates an uncertain outlook that also affects gold. Midway through the year, there were signs normality was returning: travel restrictions were eased at home and abroad, people were encouraged to return to work, and positive case numbers across Asia and Europe fell. However, recent weeks have shown complacency is a risky gamble.

New domestic lockdown measures are being imposed across Europe, and the US is unlikely to reopen its borders this year. Continued market instability and growing uncertainty about the future shape of the global economy is likely to be at the forefront of central bankers' minds. Amid sharp GDP falls, negative bond yields, growing tensions between the US and China, and a protracted global health crisis, only one thing seems certain: gold will continue offering shelter to investors. ❑

Notes

1. US Department of the Treasury (2020), *US Treasury securities held by foreign residents in July 2020*, https://bit.ly/3nSHqu2
2. Idem. (2020), *Major foreign holders of treasury securities*, https://bit.ly/3kbmHPT
3. The Central Bank of Russia (March 2020), *The Bank of Russia suspends the purchase of gold on the domestic market*, https://bit.ly/3j0T8ii

How gold has regained its shine

In a year of exceptional circumstances – especially true for gold, which, in August, saw an all-time high price – Invesco explores how pandemic-driven uncertainty has returned the precious metal to the spotlight of the global monetary system.

Invesco

Earlier this year, on August 6, the price of gold hit an all-time high of more than $2,060 per troy ounce. It had fallen back to below $1,900 by the end of September, but many analysts expect the $2,000 threshold to be breached again soon.

The roller-coaster ride has been lucrative for investors. Gold was comfortably the best-performing of all asset classes during the 12 months to the end of the third quarter of 2020, returning more than 28%. By marked contrast, real bond yields recently slumped to record lows, with the amount of negative-yielding global debt topping $15 trillion.

Gold's role in central bank reserve management has itself been a story of ups and downs. While 2018 and 2019 were banner years for purchases, August 2020 saw central banks become net sellers for the first time in 18 months – a pullback broadly attributed to the need to free up resources to deal with the Covid-19 crisis.

On balance, much of the evidence today indicates the use of gold in international reserve portfolios will increase. And the arguments in its favour seem to boil down to one crucial objective: diversification.

This is a key message of our white paper, *Central bank foreign currency reserves management – Revival of gold as a reserve asset*.[1] As discussed in more detail in the companion article to this piece, it is also a dominant theme in the *Gold reserves in central banks – 2020 survey* (see pages 54–63).

So why has gold regained its shine for central banks? And why might it go on to gleam even more brightly? This article explores the past, present and likely future of a commodity that, in some way, shape or form, has been central to the worldwide monetary system for millennia.

A brief modern-day history of gold

International acceptance of a fiat currency untethered to gold or silver is a relatively novel phenomenon. It dates back, of course, to 1973 and the collapse of the Bretton Woods system of monetary management.

Under the gold standard, used from the 19th to the first half of the 20th century, major countries' national currencies were accepted for settlement only if backed by an issuing government's commitment to convert its notes into gold at a predetermined price. Under Bretton Woods, conceived in response to the world wars' depletion of gold stocks in the UK and Europe, the US dollar assumed centre stage.

Bretton Woods saw the US fix the dollar to gold at a set price; other nations, in turn, fixed their own currencies to the dollar. Thus the US cemented its position as the new leader of the democratic world, generally seeking to achieve economic and political stability through multilateral means.

The concept of 'benign hegemony' proved persuasive. In 1973, when President Richard Nixon de-linked the dollar from gold, many countries were content to keep their currencies and monetary policies anchored to those of the US – in part because there was no viable alternative, and partly because sporadic American excesses or errors were usually reversed in due course.

As a result, perhaps inevitably, gold lost some of its lustre. By the early 1980s, with US Treasuries generating strong investment returns, it was starting to take on the air of a relic. Developed market central banks set about selling it in the 1990s, leading to the signing of the Gold Accord in a bid to co-ordinate sales and minimise market disruption.

Yet the sanctity of the dollar would not endure in perpetuity. The global financial crisis of 2007–08 put paid to the notion of US government and agency securities as 'risk-free' assets. Developed market central banks stopped divesting their gold, with the Gold Accord finally allowed to quietly expire in 2019; meanwhile, emerging market central banks embarked on substantial investments in gold to reduce exposure to the US financial system. The desire to diversify had taken hold.

Proven long-term performance

Naturally, there have always been reasons for central banks not to invest in gold. These might include a lack of understanding of the market, an aversion to higher volatility or a determination to find superior returns elsewhere. Yet research casts few doubts on gold's capacity to preserve capital and aid portfolio performance.

As reported in our white paper, gold has achieved positive annualised returns ever since the breakdown of Bretton Woods – albeit with considerable short-term fluctuations in price. During the past decade alone, its annualised price volatility of 17% was more comparable to that of equities than that of bonds.

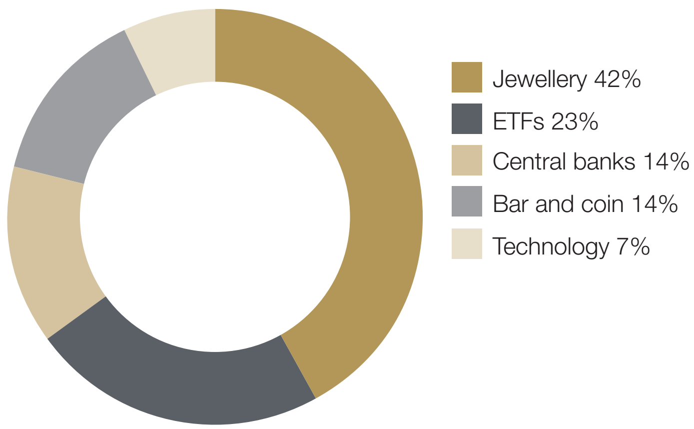
Gold has produced negative returns during 41% of calendar years since 1973. The average loss during these negative years has been -10.7%. This underlines gold's standing as a long-term asset and a strategic component of international reserves.

Maybe more significantly, so too does its positive performance overall during both expansionary and recessionary cycles. This, as remarked on in *All that glitters – Surveying central banks on gold reserves*, has set gold apart from most financial assets, which have tended to be pro- or countercyclical (see pages 64–69).

We can account for gold's uncommon behaviour in this regard by examining the drivers of demand. As illustrated in figure 1, there is a fairly even split between consumption, as represented by the jewellery and technology sectors, and savings/investment, as represented by central bank purchases, exchange-traded funds (ETFs) and physical gold. Consumption demand for gold goes up during expansionary periods, whereas gold's status as a perceived 'safe-haven' asset goes up in the face of recession or financial shocks.

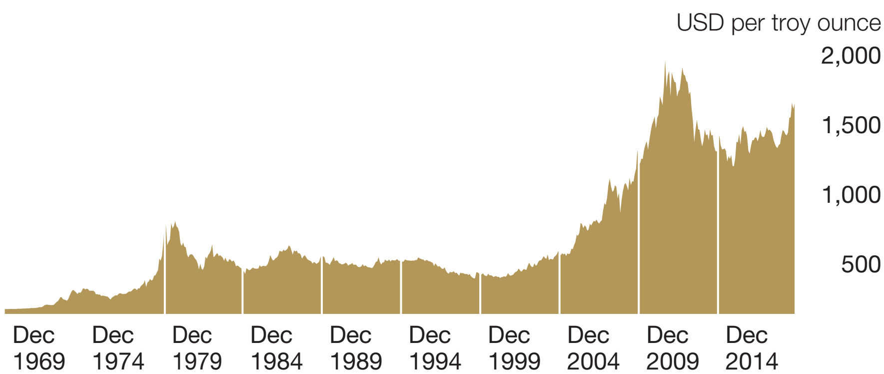
The influences of both forces can be observed in figure 2, which depicts changes in the price of gold during the past half-century.

1. Gold demand by sector in 2019



Source: Metal Focus, World Gold Council. As at 30 September 2019

2. Gold price



Source: Bloomberg, December 31, 1969 – September 30, 2019

The rise that occurred between 2000 and 2019 corresponded with robust economic growth in China and India, both of which are major players in the gold jewellery market, while the twin peaks witnessed in 1979 and 2008 coincided with rampant inflation and the global financial crisis, respectively.

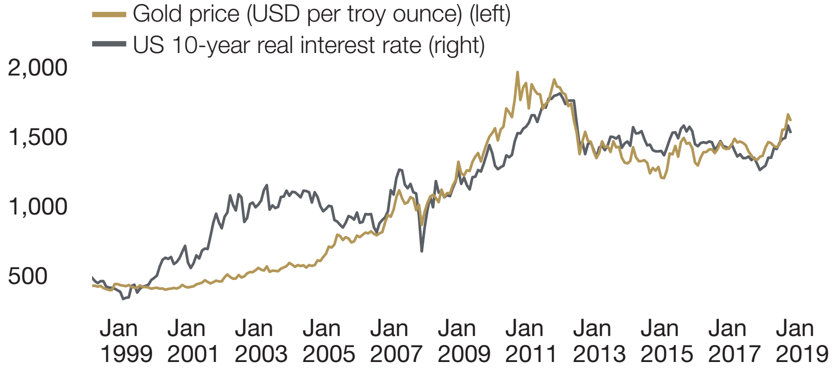
The appeal of negative correlation

As a financial asset, gold is also subject to the direction and level of real interest rates. A key observation is that its price appears to be well supported when rates are declining or low.

The first reason for this is that falling interest rates are typically associated with recessionary conditions and higher risk aversion. As noted in the preceding section, such an environment is liable to augment demand for gold as a perceived safe-haven asset.

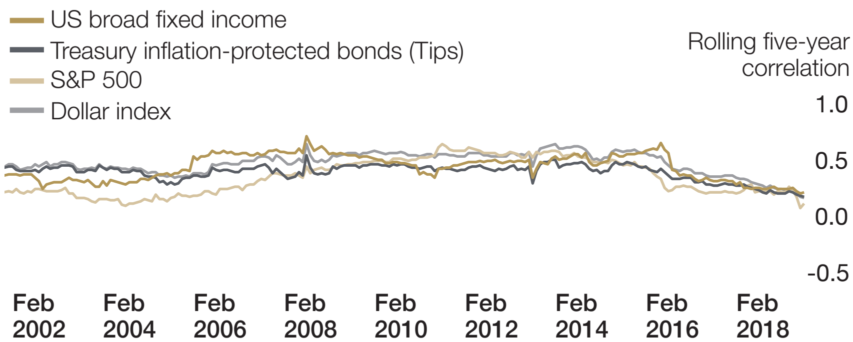
A second reason is that the relative difference in carrying costs between gold and government bonds diminishes when interest rates are low.

3. Gold price and real interest rates



Source: Bloomberg internal calculations, January 31, 1999 – September 30, 2019
Bloomberg <GOLDS Comdty>

4. Historical correlation across reserve assets



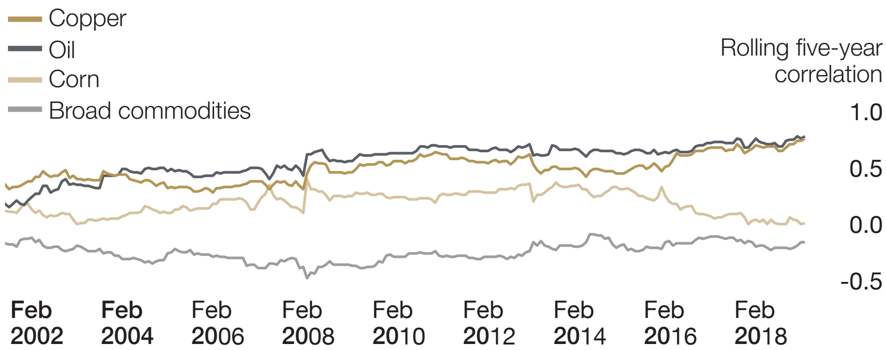
Source: Bloomberg internal calculations
US broad fixed income: Bloomberg Barclays US Aggregate Index; S&P 500: S&P 500 Index; Tips: Bloomberg Barclays US Government Inflation-Linked All Maturities Index; Dollar index: ICE USDX US Dollar Index
January 31, 2002 – September 30, 2019

Moreover, the traditional relationship between the two might even reverse when rates on government bonds turn negative, as is currently the case for Switzerland, Japan and much of the eurozone.

A study of the historical relationship between the price of gold and the level of interest rates reinforces the contention that the two are negatively correlated. For example, inverted on the right-hand scale of figure 3 is the 10-year real rate implied by Treasury inflation-protected bonds; the price of gold is charted on the left-hand scale.

As figure 4 illustrates, there has been an analogous negative correlation between the price of gold and the value of the US dollar. This demonstrates gold's powers of diversification when measured in terms of a trade-weighted basket of international currencies. A similar negative correlation has meant the addition of gold has also improved portfolio outcomes for central banks investing in equities. Gold's diversification effect for a broad fixed income portfolio has been less conspicuous.

5. Historical correlation with commodity prices



Copper: S&P GSCI Copper Spot Index; Oil: US Crude Oil WTI Cushing OK Spot; Corn: USDA Illinois North Central No. 2 Yellow Corn Spot Price; Broad commodities: S&P GSCI Index Spot
The S&P GSCI is widely recognised as a leading measure of general commodity price movements; the index is calculated primarily on a world production-weighted basis, comprising the principal physical commodities futures contracts. January 31, 2002 – September 30, 2019

Uniquely, as illustrated in figure 5, the correlation between gold and other commodities – whether metals or agricultural goods – has tended to be positive during the past two decades. This may be especially salient for countries dependent on commodity exports, as excessive exposure to gold could invite 'doubling up' on the economic and financial risks within a reserves portfolio.

Innovation and de-dollarisation

As noted in *All that glitters*, the advent of gold ETFs has, to some degree, changed how investors of all kinds think about this asset class as a whole. But how might further financial innovation affect market dynamics and, by extension, central banks' attitudes towards gold?

Cryptocurrencies have been suggested as a new reserve asset – one that could potentially supplant gold. As if to underline this possibility, some leading cryptocurrencies have adopted the language of mining to describe how they function.

Like gold, cryptocurrencies do not represent national liabilities. This means they are invulnerable to sovereign risk – whether from geopolitics, inflation or devaluation. They are, though, subject to hacking, a problem exacerbated both by a deliberately anonymous structure and an inherent lack of centralisation and oversight.

These fundamental traits make it unlikely that central banks would hold international reserves in cryptocurrencies. The prospect of a nation's 'digital wallet' suddenly vanishing, with no dependable method of subsequently identifying the source of the incident, seems unconscionable. It is more likely that cryptocurrencies could play a bigger role in domestic monetary and financial systems, which differ from paper currency in form rather than substance.

Meanwhile, away from the sphere of fintech, other would-be reserve currencies jostle for position to little effect. Foremost among these are the yuan, the euro and the pound. All face serious difficulties – most notably lower levels of daily liquidity – in mounting a meaningful challenge to the dollar. The accumulation of gold stocks since 2008 may in part reflect diversification away from the greenback in a world that, as in 1973, affords precious few serious rivals in the safe-haven stakes.

There is also the issue of the dollar's weaponisation and the riposte of 'de-dollarisation'. Countries the US has targeted through sanctions and tariffs have taken aggressive actions to de-dollarise, shrinking their holdings of US securities and turning instead to gold and to other currencies. Russia, China and Turkey were responsible for 70% of central bank net gold purchases from 2016 to 2019, and many of the other nations that have added to their own gold stocks during the past few years are either economically integrated or politically allied with one of these.

The road ahead – paved with gold?

We have seen how several factors have contributed to gold's comeback as an international reserve asset. The recent quest to lessen exposure to the dollar can trace its roots to the global financial crisis, since which time it has been further bolstered by geopolitical tensions and – certainly during the past four years – the US's use of dollar sanctions.

In tandem, macroeconomic considerations have clearly encouraged the unfolding shift. The persistence of low growth, low inflation and, accordingly, ultra-low or even negative interest rates has been vital in solidifying gold's rediscovered appeal.

Combine all of these elements and it is easily recognised that, as stated at the outset of this article, it is ultimately a need to diversify that has led central banks back to gold. While those in emerging markets have been in the vanguard to date, 62% of respondents in our own analysis of central banks across all regions expect gold reserves to increase in the coming months.

This is unsurprising, given that the global political and economic environment should maintain support for both the price of gold and the demand for diversification. The threat of higher trade and investment barriers and the intensification of technological and geostrategic rivalries among great powers are unlikely to end anytime soon, irrespective of who occupies the White House; ditto accommodative monetary policy.

In addition, central banks and governments will undoubtedly continue their debate around the international financial system's excessive reliance on a single currency. This should further spur the search for alternatives to the dollar, with gold the most obvious fallback – at least for the time being.

It should be stressed, in conclusion, that we do not foresee an eventual return to an international or, indeed, domestic system centred on either gold or a single currency. The size of individual financial systems in major economies and the patent requirement for discretionary monetary policies precludes such a scenario. What is much more likely to emerge, we believe, is a more diversified global system – one in which gold, contrary to earlier assumptions of its demise, should continue to fulfil an important role as a safe-haven asset of choice. ❑

Investment risks
The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.
Instruments providing exposure to commodities are generally considered to be high risk, which means there is a greater risk of large fluctuations in the value of the instrument.

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Notes

1. A Das, J Johnson-Calari and A Tobor (2020), *Central bank foreign currency reserves management – Revival of gold as a reserve asset*, Invesco whitepaper series 06, https://bit.ly/3ow6RBF