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The rise of central bank gold demand

Gold's increasingly important role in the international monetary system

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Ben Robinson Author, Deputy Head of Research**, Simon Hadley and William Coningsby-Brown** Design and Production
Julian Frazer Senior Editor

The re-emergence of gold as a strategic asset

Since 2009 central banks worldwide have been on a gold buying spree, adding almost 4,000 tonnes of the yellow metal to their reserves. The value of their total gold holdings is around $1.4tn, or 10% of all central bank foreign exchange assets. This rapid increase in gold holdings follows an extended period of decline from the early 1970s to the 2008 financial crisis.

Since the crisis there has been renewed interest in gold's unique characteristics as a safe haven asset that is nobody's liability. This, combined with scepticism over prospects for some of the main reserve currencies and a prolonged period of low interest rates, has amplified gold's appeal. More recently, heightened geopolitical risks have contributed to renewed interest in its 'safe asset' quality. Prospects of rising inflation in the US and elsewhere could spur further demand.

As the renminbi becomes more widely used in international payments and settlements, central banks are taking a growing interest in the currency. The shift towards a multicurrency reserve system will be accompanied by a period of heightened financial uncertainty, supporting central bank demand for gold. As a greater range of reserve currencies emerges, gold could play an increasingly important role in the monetary system. ■

As a more diverse range of reserve currencies emerges, gold could play an increasingly important role in the international monetary system.

Rapid expansion of emerging market gold holdings

Since 1999 more than 20 European central banks have signed a series of agreements to limit the size of gold transactions and improve coordination and transparency of sales. This has contributed to a stabilisation of gold reserves held by advanced economy central banks.

Just four signatory countries (Latvia, Sweden, France and Germany), plus the European Central Bank, have sold more than one tonne of gold over the last 10 years. Germany is the highest seller at 43 tonnes, used for its coin minting programme. This represents a drastic reduction in the pace of sales compared with previous decades. Gold held by the US, which is not a signatory, has remained constant for the last several decades.

Meanwhile, emerging market central banks have been rapidly expanding their purchases, leading to large net year-on-year increases in total central bank holdings globally since 2010 (see Figure 1). These countries' foreign exchange reserves, particularly in Asia, have grown rapidly since the 1997 Asian crisis, which highlighted the need to build such buffers as a 'self-insurance' policy against financial instability.

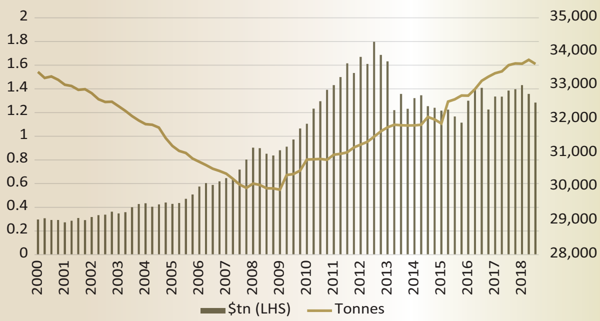
Following the onset of the 2008 crisis and subsequent euro area contagion, growing uncertainty about the main reserve currencies led to increased demand for gold among many central banks. The share of dollar assets in total central bank reserves fell to around 62% in mid-2018 from a high of more than 70% in the early 2000s. The share of euro assets remained relatively stable at around 20%.

The absolute growth of emerging market gold holdings has been in part a consequence of the build-up in emerging economies' foreign exchange reserves since the early 2000s, as central banks sought to maintain a target allocation within an expanding stock of foreign currency holdings.

Since the mid-2014 stabilisation in the level of central bank reserves, spurred by the end of the commodity super-cycle and the drawing down of China's holdings, some countries have preferred to sell foreign currency assets, rather than gold, for financial stabilisation purposes. This has contributed at the margins to higher ratios of gold in some emerging market central bank portfolios.

Figure 1: Highest gold holdings since 1990s

Gold holdings by central banks, $tn and tonnes



Source: World Gold Council, GFMS, OMFIF analysis

Shift of economic weight from West to East

Over the last decade, the centre of economic gravity has shifted eastwards, accelerated by the 2008 financial crisis. China has been responsible for around one-third of global GDP growth since 2014, illustrating its economic importance. The last time the US accounted for a similar share of global growth over a multiyear period was in the early 1980s. China provided around 70% of global investment growth in 2016, highlighting its pivotal role in generating marginal demand changes.

Should these trends continue, the shift of economic weight towards Asia over the coming decades is likely to be substantial. In that case, the rationale for holding larger amounts of renminbi in central bank reserves, possibly at the expense of dollar and euro holdings, could grow.

The current share already understates the importance of the Chinese economy. China accounts for almost 20% of global GDP and more than 10% of global trade, but the renminbi comprises only 1.8% of central bank reserves. This is, however, up from 1% at the end of 2016.

This low share reflects the renminbi's limited convertibility, China's relatively closed capital account and its history of running large current account surpluses. Each of these reduces the extent to which a currency is likely to become a reserve asset.

The low relative share of renminbi in central bank reserves underlines a lack of confidence and transparency regarding Chinese financial markets, which has limited foreign demand for assets denominated in local currency. While mainland Chinese securities markets are the third largest in the world, accounting for around 10% of global outstanding securities, foreign investors own only 2% of these assets. This is by far the lowest share of foreign ownership of domestic assets in Asia.

Growing role of renminbi

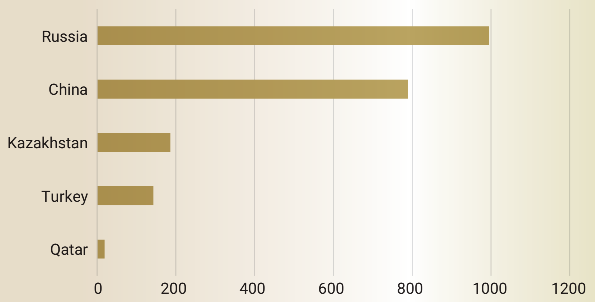
Research by the International Monetary Fund on reserve currency blocs shows the renminbi is emerging as a more influential currency in the world financial system. Fluctuation in the renminbi exchange rate is the predominant influence on the currencies of countries representing around 30% of global GDP, mostly in Brazil, Russia, India and South Africa. By comparison, the dollar bloc represents 40% of global GDP, and the euro 26%.

This growth reflects, in part, China's expanding share of the global economy over the last two decades and Beijing's policies to support the internationalisation of its currency, including in trade and investment. The share of international reserves held in renminbi is, however, far lower than the renminbi bloc's share of global GDP.

In an attempt to boost the attractiveness of holding renminbi, the Beijing authorities are increasing the currency's use through the large scale Belt and Road infrastructure investment programme. Beijing has also focused on creating renminbi-denominated benchmark prices for key global commodities, including oil and gold. Over time, this could increase the share of renminbi in central bank reserves in countries that produce these commodities. China is already among the top importers of both, and is forecast to continue growing strongly in coming decades.

Figure 2: Russian, Chinese central banks lead purchases

Gold increase by country, change since 2014, tonnes



Source: World Gold Council, International Monetary Fund, OMFIF analysis

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Gold's strategic qualities

As countries' ties with China strengthen, some may boost their allocation to gold.

Among the top five non-Chinese central banks (those of Russia, Kazakhstan, Turkey, Qatar and Tajikistan) that have added to their gold reserves since early 2014, all have substantial and strengthening economic ties with Beijing. All except Turkey are exporters of oil and gas, and each has multiple motivations for increasing their gold holdings. These include protection against political risks (Russia and Qatar), currency stabilisation (Turkey) and holding gold as a strategic asset (Kazakhstan and Tajikistan). These countries' close economic relationships with China may also play a role.

Both Hungary and Poland recently boosted their gold holdings significantly, following a rapid expansion in their ties with China. This includes becoming key players in the central and eastern European section of the Belt and Road initiative. They were also among the earliest participants in renminbi-denominated debt issuance (since 2015) in a bid to boost their financial links with Beijing.

Budapest and Warsaw are locked in dispute with the European Union over domestic political and social developments, and are keen to demonstrate that they have alternatives to closer relations with Brussels. Deeper ties with Beijing are viewed as a way to guarantee some independence from the EU.

Russia is seeking to reduce dependence on the dollar and limit its exposure to US currency risk and Washington's sanctions regimes. The central bank has cut significantly its holdings of Treasury bonds and increased its demand for gold and other assets following heightened tensions with

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the West over the 2014 annexation of Crimea.

As well as rebalancing its reserves portfolio out of dollar assets, this strategy involves turning eastward. China has been the focus of its attention, providing further motivation for Russia to hold non-dollar assets, including gold.

People's Bank of China demand

According to official data, the People's Bank of China has been the second-largest purchaser of gold after Russia for more than a decade. The PBoC has added more than 1,200 tonnes since 2009, against 1,400 tonnes for Russia.

Backing the renminbi with sizable holdings of physical gold is one way in which Beijing could seek to increase the appeal and stability of the currency as a reserve asset over the long term.

While the size of the renminbi currency bloc identified by the IMF is large as a share of global GDP, its development has stalled in recent years. For the bloc to grow, and to spur demand for renminbi as a reserve asset, Beijing must relax restrictions on the capital account, enhance China's credit-worthiness (including achieving sustainable public and external positions), strengthen its institutions and maintain financial stability. Reducing its debt burden and moving away from current account surplus are also required.

The PBoC's increased stock of gold reserves could help it achieve some of these objectives and boost confidence in the renminbi. China has been one of the largest purchasers of gold over the last decade. In December 2018, after a two-year hiatus, it increased its gold holdings by another 10 tonnes. At around 2.3% of its total reserves, the share of gold in China's reserves still remains low compared with the global average of more than 10% and the central bank's demand for gold is likely to grow. ■

Conclusions:

Main gold buyers boosting links with China

Myriad factors have propelled central bank demand for gold since the 2008 financial crisis. These include diversification, gold's 'safe asset' status and protection from mispricing of country risk due to large-scale central bank quantitative easing. Low interest rates, and the use of gold as a hedge against both deflation and inflation, have boosted demand. The metal's use as a strategic tool for ensuring greater independence from political risk widens its appeal. These are important motivations for heightened central bank gold purchases.

At the margins, however, the growing role of China and the renminbi in the global economy may be affecting demand. The majority of net gold purchases were made by central banks of countries in south east and central Asia, with strong economic and financial ties with China.

The renminbi market is still small, and China is not able to supply the rest of the world with sufficient amounts of renminbi to turn the currency into a reserve asset. Countries' growing economic and financial links to Beijing may, therefore, have encouraged them to hold non-dollar assets, including gold.

The PBoC's large purchases reflect, in part, a greater desire to enhance the credibility of the renminbi. While full internationalisation and reserve currency status remain a long way off, this is an important step. Indeed, the other main reserve currencies, including the dollar, euro and sterling, are all backed by large gold holdings.

In the years ahead, central banks are set to remain major influencers of the gold market as their multifaceted reasons for holding the yellow metal continue to ensure strong demand.

These factors suggest central bank demand for gold is likely to grow. The end of extraordinary monetary policy in the US and eventually the euro area could support this. Risks associated with normalisation, including for global corporate and sovereign bond markets, particularly in emerging economies, could lead to a risk-off approach, boosting gold demand.

Stock markets, which monetary policy has bolstered – global market capitalisation rose to around $85tn in 2018 from $30tn in 2008 – could see a normalisation-induced correction, which is also likely to be positive for gold.

In the years ahead, central banks are set to remain major influencers of the gold market as their multifaceted reasons for holding the yellow metal continue to ensure strong demand. ■

Official Monetary and Financial Institutions Forum
30 Crown Place, London, EC2A 4EB United Kingdom
T: +44 (0)20 3008 5262 www.omfif.org @OMFIF