Gold as Instrument to Financial (Un)Stability / Towards a New Architecture of the International Financial System

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Abstract

Every country had different instrument to confront with global challenges, especially global financial crisis, and others global problems. Because the crisis was transmitted primarily by trade and financial flows impact of crisis is different among the countries. From one side developed countries implemented different instrument to mitigate the effects, developing countries and transition countries are seriously affected with circumstances of financial effects. No one country funds the real instrument to protect and escape the causes in economic and financial sector. What swaps allowed many governments to do was to replace any instrument to other. But, what about gold reserves as one of instrument to confronted with financial crisis? Does the gold asset can improve and protect the financial turbulences in this and other derogation of financial market. Deeping financial analysis concludes that gold, with its lack of credit risk and liquid market, is one of the most attractive assets in diversification process.

Key words: foreign exchange reserves, global financial crisis, gold reserves,

1. Introduction

This paper examines how countries managed their foreign currency reserves during the global financial crisis. Reports based on changes in reserve stocks suggests that many governments were reluctant to use them during the crisis. As a consequence, a number of recent studies of cross-country experiences during the crisis find little evidence of a positive role of gold reserves in financial crisis-management. This paper examines invistigations in gold reserves during the crisis and aftermath. Primary focus in the paper related to the meaning of the gold asset as diversification model, as well as active purchases and sales of reserves. Gold reserves are the focus of this paper; they reflect policy decisions rather than market movements in asset prices. The data indicate that while reserve stocks remained stable for many countries during the crisis, the others cope with lack of consistence in the impact of the financial and economic crisis on the individual countries and regions worldwide.

Actual question today is focused on examination - how gold can help a central bank meet its foreign reserve management objectives. It also explains how the gold market works, both in terms of the fundamentals of demand and supply, and the trading and vaulting of gold.

The methodology applied in this paper scope both quantitative and qualitative methods, as well as method of historical analysis used by many developed, developing and emerging economies. Primary data is result from adopted empirical methodology and projection method to analyses increasing gold investment activity.

The analyses are based on the many literature sources and review (books, journals, academic articles, expertise studies, final international and government reports), as well as empirical methods in order to provide sufficient knowledge about current and estimated values of investigation impact and gold capital indicators for larger inflow of foreign investors.

The paper is structured as follows: *Section one* presents introduction review; *Section two* focuses on the global financial crisis and circumstances. *Section three* illustrates the surge in reserves holdings in emerging countries. *Section fourth* presents the strategy of gold portfolio: to increase or reduce the reserves? Finally, *Section fife* scopes summary and conclusion.

2. The global financial crisis and circumstances

The global financial crisis led governments to consider and often implement monetary and fiscal policy measures that would have been unthinkable prior to the crisis. Monetary authorities in many countries implemented diferent instrument to go out from crisis. They went from a singular focus on inflation targeting to embracing massive quantitative easing programs. Fiscal stimulus measures were passed in a wide array of countries, many of which had previously severely limited the role of government policies in the macro economy. [1] The crisis originated in the major financial centers in the developed countries, primarily the United States. The force of impact on the developing and transition countries became apparent only gradually. The situation is new; previous crises spread from the developing countries. This time developing countries are the victims of the crisis, but they did not cause it. “The causes of the global financial crisis are to be found in the financial and economic policies of the developed countries, primarily the United States. Developing countries are not responsible for it, but they are now seriously affected” [2]. The crisis did impact the developing countries, principally via financial flows and through trade. But true is that all countries, developped, emerging and developing countries, international organisations as well, try to find precision alghorytm to resolve existing economic problems.

The main cause of the crisis In European countries is high national debt. The four eurozone countries with the highest national debt are Greece (163% of GDP), Italy (121%), Ireland (108%) and Portugal (102%). Of the five most troubled countries, only Spain, at 70%, has a national debt that is significantly lower than both the average national debt of Eurozone countries (88%) as well as that of Germany (82%).[3]

The European debt crisis has long extended beyond the eurozone. Switzerland has been especially affected, as its major trading partner is the European Union. Almost 60% of all its merchandise exports in 2010 went to the EU. Switzerland’s most important trading partner is Germany, which purchases 20% of all Swiss merchandise exports.

3. The surge in reserves holdings in emerging countries

3.1. Gold asset as diversification model

For centuries, buying gold has been recognized as one of the best ways to preserve your wealth and purchasing power. Gold is a unique investment that serves mankind for thousands of years. From the time of the ancient Egyptians, Greeks and Romans to modern times, man has been fascinated by the beauty and charm of gold.

Gold relinquished its role as money after the outbreak of the Second World War, which had devastated the economies of Europe and Asia. At the end of the war, the Bretton Woods monetary system, a regime of fixed exchange rates, was created. This system broke down in 1971 when the US unilaterally ended its gold standard, which set the convertibility of gold and the dollar to US$35 per ounce.

However, while gold's role as money has faded over time – at least in the West – its role in the financial sector has grown. Much of this stems from the changes that have been made to global banking regulations following the 2008 financial crisis.

Gold is legal tender money and many are saying that this is the best form of money the world has ever known. It's about keeping values and of the safe harbor in times of crisis.

Central banks and international monetary authorities have long held gold in their reserves. Good reasons exist for countries continuing to hold gold as part of their reserves and can help managers to reduce portfolio risk and preserve wealth. It is routinely used as a long-term inflation hedge by investors. However, adding gold to a portfolio of assets can also help to reduce risk in other ways.

Several of these motivations are using by different central banks at different times: [4]

Diversification. Gold tends to offer good diversification properties within a currency portfolio. These stem from the fact that its value is determined by supply and demand in the world gold markets, whereas currencies and sovereign debt securities depend on governments' promises and variations in central banks' monetary policies. The price of gold may therefore behave in a completely different way from prices of currencies or the exchange rates between currencies.

Economic security. Gold has maintained its real purchasing power value in the long run and thus may be suited to form part of central bank's reserves and provides economic security.

Physical security. Countries have in the past imposed various forms of exchange controls and, in some cases, complete asset freeze. Reserves held in the form of another country's securities are vulnerable to such measures. When appropriately located, gold tends to be much less vulnerable. Reserves are potential use in an emergency. Total and incontrovertible liquidity is therefore essential. Gold is perceived to provide this.

Unexpected needs. Owning gold represents an option against and unknown future. It provides a form of insurance against improbable but, when they occur, highly unsettling and/or damaging events.

Confidence. The public tends to take confidence from knowing that its government holds gold.

Income. A gold-lending market exist, and gold can be traded on a tactical basis in an attempt to generate profits.

Insurance. The opportunity cost of holding gold may be viewed as a comparable to an insurance premium.

Table 1 Central bank / treasury stock (in metric tonnes fiine gold)

	1930	1935	1940	1945	1950	1960	1970	1980	1990	2000	2010
World					31.096	35892	36606	35836	35575		31491
USA	6358	8998	19543.3	17848	20279	15822	9839	8221	8146	8137.42	8133.5
UK (Bank of England)	1080	1464.56		1772	2543	2489	1198	586	589	562.93	310.25

Canada	165	168	188.84	320	515	787	703	653	459	38.69	3.39
Switzerland	207	582	446	1194	1306	1942	2427	2590	2590	2538.38	1040.1
France	3160	3907	1772	1378	588	1458	3139	2546	2546	3024.63	2435.4
Belgium	287	560	654	653	522	1040	1307	1063	940	258.09	227.49
Netherland	257	435	548.53	240	280	1290	1588	1367	1367	911.82	612.5
Italy	420	240	121.75	28	227	1958	2565	2074	2074	2451.84	2451.8
Russia	375	626	N/A	N/A	N/A	N/A	N/A	N/A	N/A	343.41	836.71
India	193	243	243.92	243	220	220	216	267	333	357.76	557.7
Germany	794	56			0	2640	3537	2960	2960	3468.6	3406.77
China	N/A	N/A	N/A	N/A	N/A	N/A	N/A	398	395	395.01	1054.9
Japan	620	378	145.39	N/A	6	220	473	754	754	753.55	765.2

Source: International financial statistics; World gold council

The size and diversity of gold supply and demand mean that it is highly liquid, and remains so throughout periods of uncertainty. Gold's historic lack of correlation with other reserve assets and negative correlation to the US dollar mean it is commonly used to manage market risk and improve portfolio performance.

Today, the beauty of gold lies in its ability to diversify investments (distribution of funds in different financial instruments). The aim is to reduce the risk associated with the investment compared to putting all funds in one financial instrument to protect property and protect their purchasing power. Gold castings are real and tangible asset throughout history, they are ideal for preserving value and an excellent hedge against inflation, deflation and political uncertainty. Gold castings and coins are highly liquid assets, easily stored and transported.

After the abandonment of the Gold Standard in 1971, there was no anchor for the values of different currencies. There was no easy way, therefore, to price money (across currencies and over time) except in relational terms, and doing so was full of risk. The problem did not appear that the US dollar broadcast to the extent that they have cover in gold. But they could not to resist the temptation to (mis) use of the possibility that they are given, and the import of real resources (material goods) from other countries covering the dollars issued without adequate coverage. When French President De Gaulle tried in the late 60s of last century, that the French government reserves from dollars converted into gold it turns out that only about 5% of the issued dollar is covered in gold reserves. Shortly thereafter the US (1971) unilaterally terminating the convertibility of dollars to gold. Paper is replaced by gold, the dollar printed on paper (no real collateral) and continued operating as world money, because these are the United States, due to its economic, political and military power, could impose others. [5]
Initially this was only a problem for a few nations, and only for a handful of American, European, and Japanese corporations that operated on a truly global level and therefore had to worry about how revenues or debts generated or owed in one market would translate into another. Then came stagflation, the oil price shocks of the early 1970s, and other periods of instability. [6]

4. The strategy of gold portfolio: to increase or reduce the reserves?

The financial crisis and subsequent sovereign debt crisis have heightened reserve manager attention to the need for increased diversification, in particular, away from dollar and euro assets. Furthermore, while the dollar is still the primary global currency - its long term supremacy is less certain. As such, central banks are actively loking to diversify their reserve portfolios and specifically reduce allocation to US dollars and euros. The financial crisis has put the gold into the limelight when investors endeavored to protect their wealth as soon as they began to speculate with the price of gold. Growth of the banking crisis, it was feared possession holding in the form of cash in banks and quickly grew the demand for gold bars and coins. However, gold emerges as the dominant asset for diversification with optimal allocation to gold of approximatately 8%. [7]

In 2010, central banks turned net buyers of gold for the first time in two decades. In 2011 that trend continued with central banks purchasing more than 400 tonnes of gold. Part of this was driven by the decreasing attractiveness of other reserve assets like sovereign bonds, which have been severely undermined by the sovereign debt crises of 2011–12. Gold’s lack of credit risk, market depth, and the fact that it is almost universally permissible in the investment guidelines of the world’s central banks has made it an attractive alternative. [8]

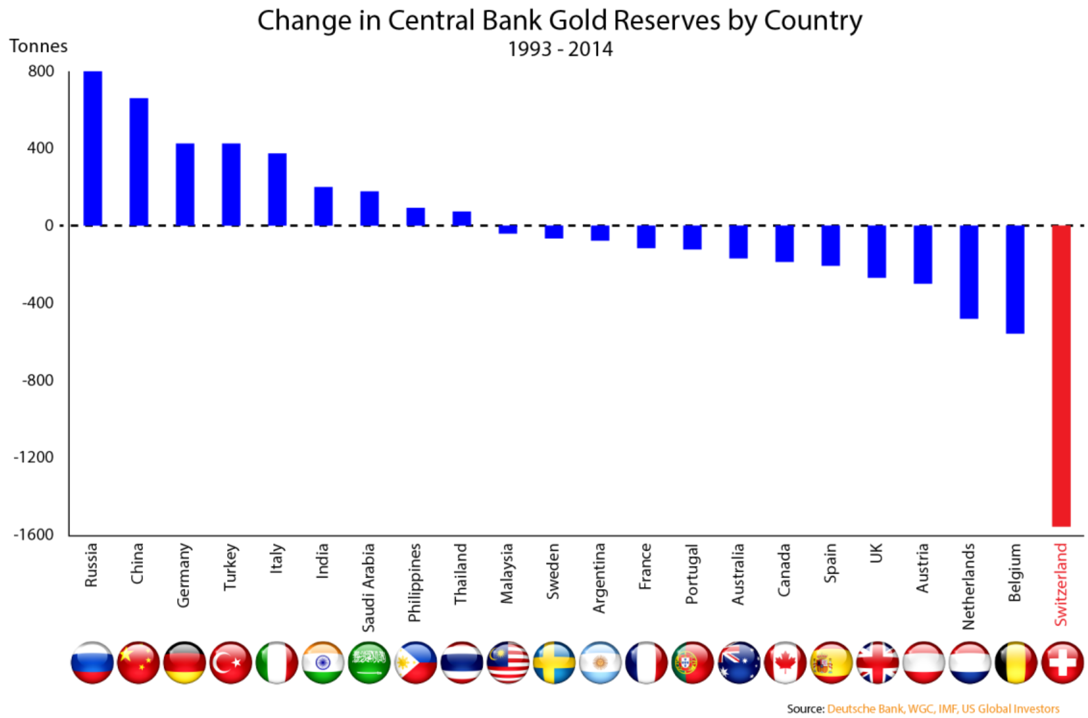
Beyond the prevailing economic environment, another factor driving demand for gold in the official sector has been that gold has been relatively under owned by emerging-market central banks. While advanced economies held, as end-2011, on average 22% of their reserves in gold, emerging-market central banks held on average less than 4%.[9] Given this relative under-allocation to gold, many reserve managers in these markets have been wondering how much gold is optimal.

In recent years, emerging market central banks have been accumulating reserves at a record pace. The global statistics compiled by the IMF, also commonly referred to as the “IMF COFER data”, show that official reserves for all central banks have grown from US$ 2tn in 2000 to greater than US$ 12 tn in 2012, a span of only 12 years. Official reserves primarily consist of US dollar and euro denominated assets and gold. [10]

For example, Russia and its Central Asian neighbors have added to their gold reserves in mid-2013 - Russia's reserves of gold and silver are seventh in the world, and Russian administration continues each month spent nearly half a billion dollars to buy gold. So is Russia, as one of the world's largest exporters of gold, and more than doubled its reserves in the past five years. Russia has more than 513 billion dollars in foreign exchange and gold reserves, according to the June 2013 report of the central bank of that country.

Over the past decade the Russian Central Bank has provided 570 tons of gold, which has become the world's largest buyer of the precious metal. Strengthening the gold reserves is part of efforts to diversify foreign exchange reserves, as well as to strengthen the ruble.

Table 2 Central bank / treasury stock (in metric tonnes fiine gold)



The World Gold Council (WGC) believes that gold consumption in China will continue to catch up with the rest of the world following the deregulation of the Chinese gold market in 2001. Gold investment demand in China entered a new era with the opening of the Shanghai Gold Exchange in 2002. Demand from China's two largest sectors (jewellery and investment) reached a combined total of 428 tonnes in 2009 but domestic mine supply contributed only 314 tonnes during the same year. This shortfall creates a "snowball" effect as China's gold industry may not be able to keep pace with the annual leap in domestic consumption despite rising to be the world's largest gold producer since 2007. [11]

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At the end of 2009, China's net retail investment in gold totalled 80.5 tonnes, up 22% year-on-year. Chinese consumers are typically high savers and gold investment amongst private individuals in China is developing rapidly. Going forward, we believe that Chinese gold investment demand could be supported by higher wealth and incomes and near-term inflationary expectations. Total gold investment demand in China has grown in line with the country's GDP and population since 2001 and we expect this trend to continue in future. Today, China's gold market is enjoying the benefits of liberalisation and deregulation. Gold consumption in China has been on the rise due to the country's rapid economic growth and the continued improvements in living standards of its population.

China is the worlds sixth largest holder of monetary gold, but the proportion of gold in relation to total foreign reserves is very low compared with that of the largest holders - 1.6% compared 70.22% for the US, and 66% for Germany, and 65% for Italy and France. According to the World gold council, China doubled its gold reserves between 2007 and 2012, with holdings of 1054 tonnes in 2013. China is also encouraging banks and individuals to own gold rather than the state.

Table 3 International Financial Statistics: Largest gold reserves by countries (in metric tonnes fine gold)

	2013 Gold holdings (in metric tons)	**Change from 1991**	**% of reserves**
United States	8,133.50	Down 0.2%	70.20%
Germany	3,387.10	Up 14.5%	66.10%
Italy	2,451.80	Up 18.2%	65.10%
France	2,435.40	Down 4.4%	65.00%
China	1,054.10	Up 166.8%	1.10%
Switzerland	1,040.10	Down 59.8%	7.60%
Russia	1035.20	N.A.	7.20%
Japan	765.20	Up 1.5%	2.30%
Netherlands	612.50	Down 55.2	51.20%
India	557.7	Up 58.9%	7.20%

Source: International financial statistics; World gold council

The Increased of gold reserves are registrated in Kazakhstan 1.4 tons (130.9 tonnes of gold in total reserves), Azerbaijan to two tons (eight tons of total reserves), and Kyrgyzstan to 0.1 tons (3.3 tons of total reserves). Also, Ukraine, Greece, Belarus and Bulgaria have also increased their gold reserves, says IMF report.

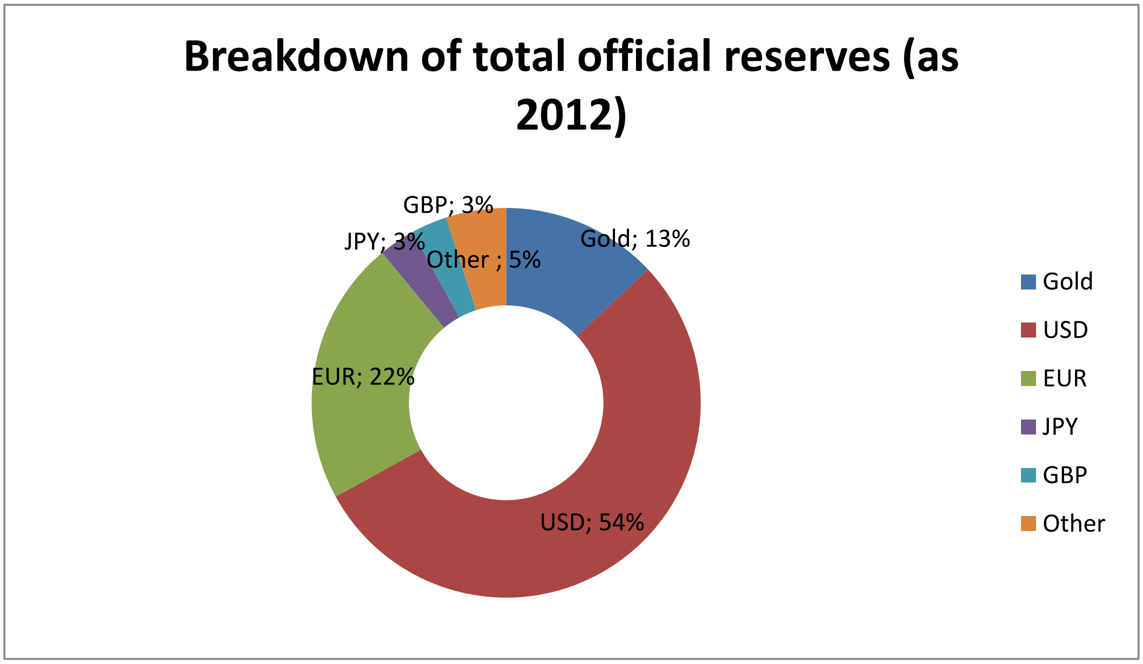

Figure 1 Breakdown of total official reserves (as of 2012)

Gold has an increasing role in the protection of the currency exchange rate differences from the beginning of the 2008 financial crisis fodine and emerging markets showing growing interest for increasing their gold reserves.

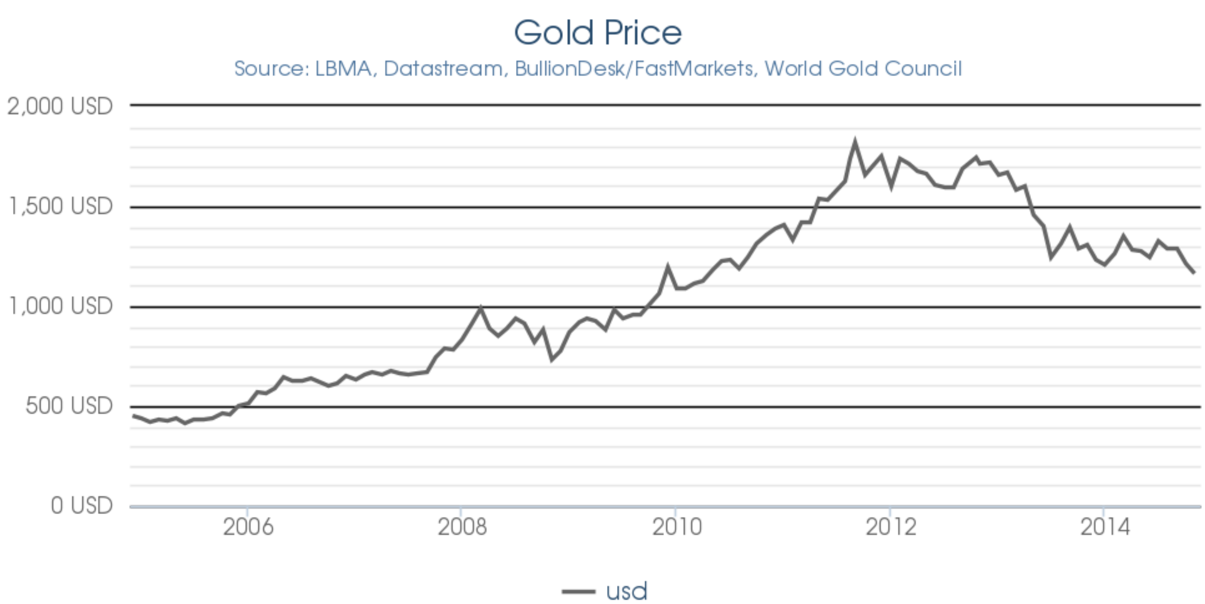

Figure 2 Gold Price

The price of gold is plasticized by 11 percent in June 2013-and that is the biggest drop in the value of this precious metal since 2011. However, in July 2013-and, the price of gold rose by 9 percent.

Germany, which is the second in the world in the amount of gold reserves, in June 2013 downgraded their inventories by 0.8 percent to a total of 3390.6 tons. Its gold reserves are reducing and Mexico, Czech Republic, Denmark, Costa Rica, Guatemala and Zimbabwe. Turkey, which has 11 of the world's gold reserves by colic, in June 2013-and has reduced its gold reserves for the first time this year, and to 3.8 tonnes, so that now in his possession holds a total of 441.5 tons of gold.

The role of gold during and after a move to a multi-currency reserve system is an important issue. Gold will probably play a greater role during the transition period. This is likely to be a period of substantial fluctuation in currency values as market actors attempt to find a new equilibrium. That is where the attraction of gold, an asset which is nobody's liability should stand out: investing would denote no political bias and which should minimise foreign exchange fluctuations. For central banks, concerned with preserving value and naturally politically cautious, gold is likely to prove a haven from currency storms. [14]

- The main prospects of gold will be related on:
- Gold will play a greater role in the future than today - but not a dominant one;
- Gold will not replace fiat currencies; the Gold Standard will not return;
- Gold will increasingly became a currency hedge, not just a dollar hedge;
- Rebalancing of gold in central bank reserves is likely
- Greater attention will be paid to geographical location of central bank gold storage

There is no guarantee that the dollar will remain paramount, nither euro or any currency. Because becoming a successful reserve currency requires more than political ambition, economic size and geopolitical clout. The path to reserve currency status is not an easy one. And the goal, once achieved, may be less attractive than it seemed. For the renminbi, this is a cautionary tale. There has never been a stable period of equal reserve currencies. The only shift from one dominant reserve currency to another took around 60 years. History shows that the fall in the value of one reserve currency does not necessarily translate into a rise in the value of others. Instead, turbulence for one reserve currency may well spell turbulence for all, prompting markets to seek a non-currency safe haven. The answer, usually, is gold.

5. Conclusion

In the recent decade, central banks are increasingly questions their large US dollar and euro diversification and exploring optimal model for denominated in gold asset. Between 2000 and 2012, global central banks shifted away from US dollar denominated assets as US dollar's share of total reserves declined from 62% to 54%.

There was a similar lack of consistence in the impact of the financial and economic crisis on the individual countries and regions worldwide. This time developing countries are the victims of the crisis, but they did not cause it. "The causes of the global financial crisis are to be found in the financial and economic policies of the developed countries, primarily the United States (US). Developing countries are not responsible for it, but they are now seriously affected. The developing countries and international organisations took a number of steps to mitigate the effects of the crisis, but with varying results.

The financial crisis has put the gold into the limelight when investors endeavored to protect their wealth as soon as they began to speculate with the price of gold. Growth of the banking crisis, it was feared possession holding in the form of cash in banks and quickly grew the demand for gold bars and coins. In line with this diversification trend, central banks have also become net buyers of gold. Gold may be the only one with the requisite size, clout and the historical role to help ward off the strains that will beset the world monetary system. In particular, Official monetary and financial institutions believe that the role of gold in the international monetary system will be further enhanced in the coming 10 years as a result of basic uncertainties over the dollar and the euro. In the next period, central banks have long investment horizons, the marginal sovereign default risk that does emerges over time is relevant for them. On the other hand, gold has no credit risk when held in an allocated bank account or in physical form in central bank vault.

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