CONFIDENTIAL

MEMORANDUM FOR THE BOARD **DECEMBER 1996 MEETING**

THE BANK'S HOLDINGS OF GOLD

This paper looks at the Bank's holdings of gold. This is an issue which we have reviewed over a number of occasions in the past, the last being in 1991.

The role of gold in the international financial system has changed significantly since the early 1970s when the US ended convertibility of its currency into gold at a fixed price. Despite this, most central banks have continued to hold a large amount of gold as part of their official reserve assets, though an increasing number are reconsidering the arguments for doing so.

Essentially, while there is some benefit in holding gold as insurance against a breakdown in the international financial system, the continuing poor price performance of gold means that the costs in doing so are large in terms of income forgone. It is becoming increasingly difficult to justify being a passive holder of gold. Gold can no longer be regarded as something "special", and it should be managed as just another component of official reserve assets.

We have recognised this for some time, but until recently we have been reluctant to engage in active management of gold holdings because of the implications of gold sales for the Bank's balance sheet. About 90 per cent of the proceeds of gold sales would represent capital gains, which in the normal course would be payable to the Government. This requires delicate handling. Offering an apparent source of easy revenue at a time when fiscal discipline was needed would have been counterproductive over recent years. It would also feed a public perception that the Government was selling off the "family silver" to pay its running expenses. There would also have been a contraction in the Bank's holdings of official reserves, which would not have been appropriate in recent years as holdings of official reserve assets were already relatively low.

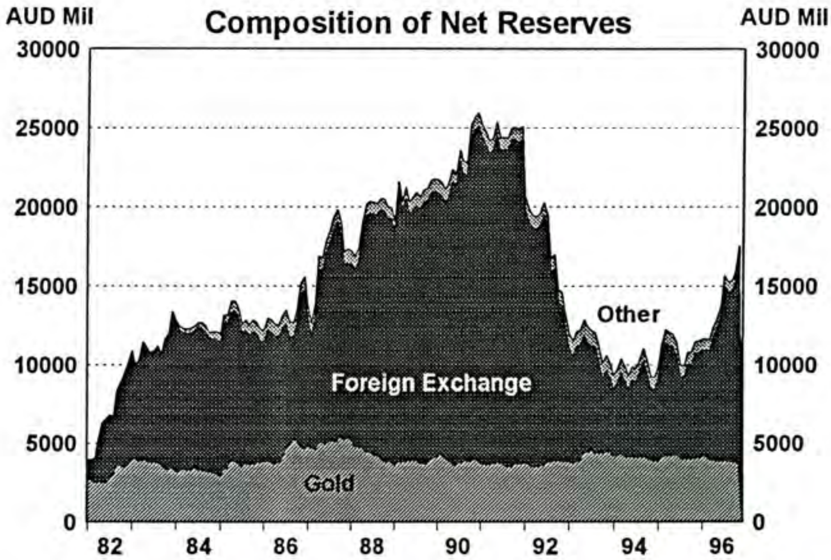
The improvement in the budgetary situation suggests that we may be able to work around these problems by negotiating an arrangement with the Government for the Bank to retain the proceeds of any gold sales, for re-investment in other official reserve assets, opening the way for the Commonwealth to receive a stream of improved earnings into the future. Conditional on this possibility, this paper recommends that the Bank begin to manage its gold holdings in a more active way, recognising that this may well result in a significant reduction in these holdings.

1. Some Facts

The Bank currently holds about 250 tonnes of gold (about $A3.8 billion at current prices) as part of official reserve assets. Unlike other components of official reserve assets, the management of which was upgraded significantly at the start of the 1990s, the management of gold holdings has been passive apart from participation in the gold loan market. The amount of gold owned by the Bank has not changed since the late 1970s.

Gold currently comprises a little over 20 per cent of net official reserve assets.[1] This is about average for the period since the float of the Australian dollar. The composition of official reserves can be seen in Graph 1.

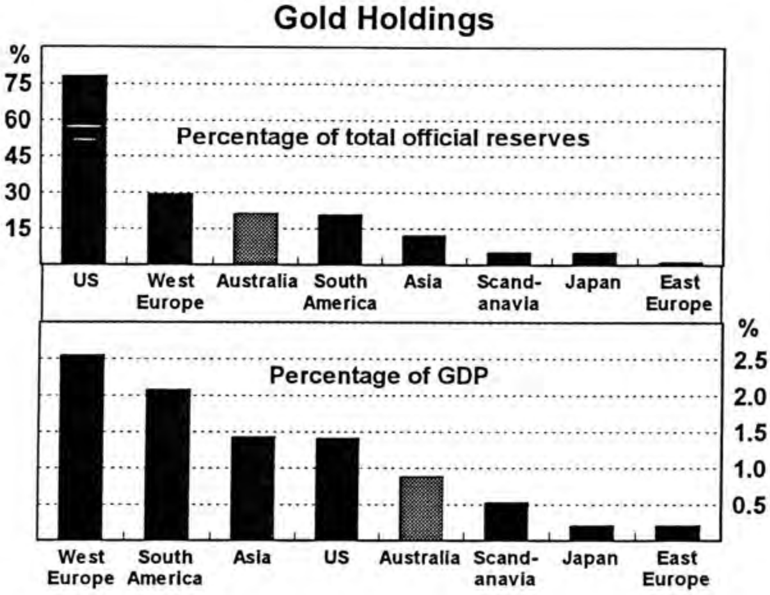
Graph 1



It is hard to draw any useful conclusions about the appropriateness of Australia's gold holdings on the basis of international comparisons. Gold holdings vary a good deal across countries, with differences mainly reflecting historical influences. The two panels of Graph 2 show gold holdings for a range of countries and regions, as a percentage of total official reserves and as a percentage of GDP. The US has very large holdings, accounting for about one-third of all gold held by central banks around the world. Over 75 per cent of US official reserves are held as gold. The high US holdings are a hang-over from the days when the US undertook to exchange its currency for gold at a fixed price. Gold holdings in Europe are also high, particularly in Germany, France, Italy and the Netherlands (where holdings typically range around 2-3 per cent of GDP) and in Switzerland, where holdings are over 10 per cent of GDP due to a requirement for the domestic currency to be backed by gold holdings. Central banks in Asian countries, apart from India and China, tend to hold relatively minor amounts of gold.

1 Net official reserve assets are defined as total reserve assets less amounts sold forward through swaps.

Graph 2



2. Benefits and Costs of Holding Gold

Central banks traditionally hold gold because of its ability to be used in the event of a crisis in the international financial system; it is the only reserve asset that is not a claim on some other government, international institution or bank. However, over the past two or three decades, the world has experienced a number of economic "crises", but gold played no part in coping with them. The continuing development of the international financial system means that the economic or financial circumstances which would require us to call upon our gold holdings for economic reasons look increasingly remote. Denial of access to financial assets on political grounds has been experienced by some countries, but is not considered a significant risk in Australia's case. For one thing there are now three major reserve currencies - US dollars, Deutschemarks and yen - which enables some diversification.

In this environment, the costs of holding gold, in terms of interest forgone, need to be kept clearly in mind. Over the very long run, gold has not been a good performing asset. From 1900 to the early 1970s, the price of gold was officially fixed, increasing only once (from US$21 per ounce to US$35) during 1933. With the end of US dollar convertibility in the early 1970s, and the inflation that followed, the price of gold rose to a peak of about US$800 in 1980, but by 1981, it had returned to around US$400 and since then mostly remained in the range of US$350 to US$400 (see Graph 3).

Graph 3

Gold has returned significantly less than US dollar investments over the long run. The value of $100 invested in US Treasuries in 1900 would now be about $3 700 (assuming all coupons were reinvested) which is about twice the value of a similar investment in gold. The table below shows compound annual returns for gold and US Treasuries for various periods.

Table 1: Compound Annual Returns
(%)

	Gold	**US Treasuries**
1900-1970	0.9	2.8
1970s	31.8	6.8
1980s	-4.2	8.4
1990s	0.1	4.3

In order to increase returns on gold holdings, the Bank has expanded its gold lending activities in recent years. Currently, about half the Bank's gold is on loan. The average interest rate on gold loans, however, is quite low, at around 2 per cent. Last financial year, income from gold lending amounted to a little over $20 million. Interest forgone on the Bank's gold holdings over the same period was about $190 million.

Future movements in the gold price cannot, of course, be known. But there are two important factors which experts claim are working to keep the price of gold down. One is the improvement in production techniques, which has seen world gold production rise from about 1 000 tonnes a year in the early 1980s to over 2 000 tonnes a year at present, despite lower prices. Australia has been a significant part of this trend, with annual production up from 20 tonnes in 1980 to 280 tonnes now. The second has been developments in gold financing, particularly the growth of the gold lending market which has facilitated forward sales by producers and thereby boosted the supply of gold in the market. Gold loans outstanding, most of which are by central banks, have increased sharply in recent years and are estimated currently to be in excess of 2 000 tonnes, roughly equal to one year's world production.

It is likely that the gold lending market will continue to expand. Central banks in total hold about 28 000 tonnes of gold, so the amount currently on loan is only a small part of the potential. While not all central banks engage in gold lending, those that currently do hold about 7 000 tonnes, and it is likely that an increasing amount of this will find its way onto the market as these central banks, like the RBA, gradually expand their lending activities.

There is plenty of potential demand for gold loans from producers, as proven gold reserves in the ground around the world amount to about 38 000 tonnes, many times the amount hedged through forward sales. It is not surprising, therefore, that any signs of upward pressure on gold prices are quickly met by increases in forward sales as producers increase their hedges. In essence, the growth of the gold lending market has meant that the supply of gold has become very price elastic, a situation which promotes price stability.

Outright sales of gold by a number of central banks in recent years are also said to have dampened the price, mostly because they have encouraged speculation about how much more will be sold. Such speculation has been heightened by the proposed move to European Monetary Union over the next few years, which may cause a re-evaluation of reserve holdings in Europe, away from relatively high holdings of gold. Most recently, the decision by the International Monetary Fund to sell up to 5 per cent of its gold holdings (equivalent to about 150 tonnes) for investment in higher-yielding assets, and the announcement that the Swiss National Bank is reconsidering its obligation to "back" 40 per cent of its note issue with gold.

All this suggests that it would be optimistic to expect sizeable increases in the price of gold in the near term. As such, there is likely to continue to be a significant opportunity cost in holding gold.

3. Options for Better Managing the Bank's Holdings of Gold

The composition of the foreign currency component of official reserves is managed to take account of expected returns and risk. There is scope to apply the same principles to holdings of gold, though we recognise that this may need to be on a more restricted scale as active buying and selling of gold could easily be seen as speculative activity. There are a range of techniques which could be used to raise the return on gold holdings to something close to the return on other reserves, provided we are prepared to part with some of the gold.

The experience of other central banks suggests that it should be possible to undertake substantial sales without disruption to the market. Over the past five years, central bank gold sales have amounted to over 1 300 tonnes. Some countries, such as Belgium and the Netherlands, have sold gold in large, one-off, parcels while others (eg Canada) have undertaken smaller regular sales. Details of major sales by central banks in recent years are summarised in Table 2.

Table 2: Net Sales of Gold by Central Banks
(tonnes)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Austria	-	-	-	15	8	11	3	42	8	198	17
Belgium	-	17	-1	108	-	-	162	-	-	141	163
Canada	12	38	43	32	42	56	94	122	68	15	9
Netherlands	-	-	-	-	-	-	-	278	9	-	-
Portugal	2	3	125	1	7	-1	-6	-	-	-	-
Total	14	58	168	156	57	67	259	442	85	354	189

Source: International Monetary Fund, International Financial Statistics

One issue that needs to be resolved is whether the Bank should announce sales in advance, like the Canadians, or undertake the sales quietly. Announcements have the potential to move the market against us, but, in any case, our reporting requirements mean that we report holdings of gold on a monthly basis.

How much gold should be sold is a matter of judgment. It is possible to mount a case for selling it all, but short of this there is scope to sell about half the gold and still have reasonable holdings by world standards. As noted, Australia's gold holdings in terms of GDP are towards the top end of the range for countries outside Europe. If anything, Australia, as a large gold producer, should be at the bottom of this range - ie, as a nation, we have very large reserves of gold in the ground and the question arises as to why we would want to hold much in central bank vaults.

4. Effects on the Bank's Balance Sheet

Of the $3.8 billion of gold held by the Bank, about $3.5 billion represents unrealised gains - the difference between the current market price and the price at which the gold was purchased. If the gold were sold, these gains would be realised and reflect in the Bank's accounts as profits. In the normal course, that would be paid to the Government in accordance with the requirements of the Reserve Bank Act. That is, the sale of gold would not free up funds to invest in other official reserve assets, but would simply result in a contraction in the Bank's balance sheet, and in particular in a fall in official reserve assets.

In our view, a better outcome would be to retain the proceeds of gold sales for re-investment in other official reserve assets. This would require the approval of the Treasurer to allow the realised gains to be retained for the Reserve Bank Reserve Fund. The current budgetary climate suggests that the chances of gaining the Treasurer's agreement to this are better now than they have been for some years. While the Government would not receive the one-off benefit of the realised gains, it would receive an on-going benefit in the form of an additional flow of profits from the Bank, reflecting additional earnings received on reserve assets. Such a course would also minimise the risk that the gold sales would be seen as an attempt by the Government to sell the "family silver". If that agreement could not be reached, we would stay with the status quo.

5. Recommendations

It is recommended that:

- the Governor negotiate with the Treasurer an arrangement whereby the Bank could retain the proceeds of any sales of gold for re-investment in other official reserve assets;
- subject to that agreement, gold holdings be managed in the same way as, and as part of, the overall portfolio of reserve assets, with the presumption being that the proportion of reserve assets held as gold would be reduced.

Financial Markets Group/
Business Services Group
27 November 1996