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Gold's Recovery as a Vital Global Reserve Asset

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SYNOPSIS

Although its role has evolved, gold has remained an essential global reserve asset in the international monetary system. Increased geopolitical and inflationary risks have made gold even more valuable in recent years.

COMMENTARY

Since ancient times, gold has served as a pivotal global reserve asset, medium of exchange, and unit of account. The "gold standard" established in the early 1900s further elevated its status in the international monetary system (IMS).

Gold remained an important global reserve asset following the move from the gold standard to the "adjustable peg system" after the Second World War. However, following the US' unilateral abandonment of the adjustable peg system in 1971, gold gradually lost its lustre. Nonetheless, with heightened inflationary and geopolitical uncertainties internationally in recent years, gold has again rediscovered its glitter as a vital global reserve asset.

The Rise and Fall of the Gold Standard

Gold's rise to prominence began around 1500 BC when the Egyptian kingdom established gold as the first recognised medium of exchange for international commerce. From the time of the Romans in 50 BC, the English in 1066 AD, and today, gold has been used for trade and as a store of wealth to varying degrees.

The gold standard – a monetary system that allows the conversion of paper money into gold and vice versa – gained prominence in 1821 when England became the first nation to adopt it. Following the rise of international commerce, Germany adopted the gold standard in 1871. By the early 1900s, a majority of developed countries had adopted it.

However, in 1914, Europe plunged into the First World War, precipitating the demise of the gold standard. Furthermore, as a result of misaligned economic policies during the Great Depression, the UK was unable to maintain the gold standard, which allowed the US to emerge as the largest gold reserve holder from the 1930s. Henceforth, the gold standard and the predominant role that gold played in the IMS were terminated.

The Rise and Fall of the Adjustable Peg System

The Bretton Woods System was established at the end of the Second World War. The agreement led to the adjustable peg system, whereby the US Dollar (USD), the system's centre, was pegged to gold, while the currencies of other countries were pegged to the USD.

However, as the system's centre, the USD had to be used as the global prime reserve currency. Such undertakings required the US government to run persistent current account deficits to sustain the demand for its currency. Additionally, to maintain the system's stability, the US government had to ensure price, monetary, and fiscal stability within the country.

Consequently, in the early 1960s, economist Robert Triffin debated the need for a new global reserve currency by identifying that the overabundance of USD would eventually exceed the US government's gold reserves, resulting in a run on Fort Knox.

Indeed, the adjustable peg system eventually collapsed in 1971 when President Richard Nixon announced the end of gold convertibility. The US government's excessive domestic and military expenditure during the 1960s led to the overvaluation of the USD versus gold, which sparked a rush for gold redemption, that ultimately caused the collapse.

Following the system's collapse, the US government declared the USD fiat money, thereby making the USD the primary international currency for trade and foreign reserves. Furthermore, the petrodollar's emergence in the early 1970s led to increased demand for the USD and USD assets. This phenomenon led to further demand for the USD, effectively diminishing the role of gold in the IMS.

The Resurgence of Gold

However, the demand for gold as a reserve asset has significantly grown since the 2008 Global Financial Crisis. The International Monetary Fund reports that global central banks increased the amount of gold in their foreign reserve portfolios by US$20 billion during the third quarter of 2022. This was the largest recorded quarterly growth in official gold demand in 55 years. On the flip side, the share of USD reserves held by the central banks has fallen significantly by more than 11 per cent over the past two decades.

Hence, the crucial queries are: (i) What are the primary explanations behind gold's resurgence, and (ii) Will central banks internationally continue to expand their demand for gold?

Two major factors stand out as possible causes for the resurgence.

First, gold is viewed as an excellent "safe haven" reserve asset during significant financial, geopolitical, and economic turmoil. Moreover, gold is frequently recognised as a valuable asset for portfolio diversification and a strong hedge against inflation.

Undoubtedly, central bankers are concerned about the surge in global inflation and other broader issues, such as geopolitics, the US presidential election in November 2024, and the course that monetary policy and the markets will follow.

Additionally, bondholders – commercial banks, asset managers, and central banks – globally have suffered substantial losses due to the dramatic increase in interest rates since the end of 2021. Given this, government bonds have become less reliable as a source of reserves for central banks. Furthermore, it would be reasonable for governments to grow more cautious with their investments given the geopolitical upheaval in Eastern Europe and, more lately, the Middle East.

Indeed, countries such as Singapore and India and central banks in Eastern Europe have made significant gold purchases in recent years. Consequently, central bankers are more willing to diversify into alternative assets such as gold that will protect their nations' reserves.

Second, gold is regarded as a safe reserve asset in the event that nations are imposed with financial sanctions and/or when their financial assets could be frozen or seized. The G7's decision to freeze Russia's and Iran's foreign reserves and impose financial penalties has raised concerns about the notion that financial assets may be readily seized, and that central banks should retain reserves in a different form, like gold, to make them more resistant to international sanctions.

A survey conducted by Invesco among 57 central banks and 85 sovereign wealth funds revealed that many sovereign investors were "concerned" about the precedent set by the seizure of Russian assets. Ninety-six per cent of the respondents stated that the continued investment in gold was motivated by its reputation as a safe haven.

Indeed, after annexing Crimea in 2014, Russia increased its gold purchases. Russia further declared in 2021 that its gold was safely stored within the country and beyond the reach of international seizure. Likewise, with the US "weaponising" the USD to punish Moscow for its invasion of Ukraine, several nations, most notably China, responded swiftly by selling their US Treasury securities to purchase gold as a hedge against possible US sanctions.

Will this resurgence in central bank demand for gold persist?

With the heightened geopolitical tensions between the US and China, Russia and Ukraine, and in the Middle East, it is reasonable to anticipate a significant spike in central banks' demand for gold.

In addition to current geopolitical challenges, conflicts between major powers in the Indo-Pacific and South China Sea are also unpredictable. Such risks will undoubtedly increase central banks' demand for gold as a safe-haven reserve asset, while the demand for the USD continues to recede.

The current global reserve system with the USD as the dominant international currency is at risk. Indeed, China and several other nations are taking steps to break away from the USD and use their domestic currencies and gold for trade payments and foreign reserves.

Most of all, the "new world" is now marked by conflict and the separation of nations into opposing political and economic blocs. As Philippe Gijsels, the chief strategist for BNP Paribas Fortis puts it, "People are hedging against a new world", which will undoubtedly result in greater demand for gold.

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