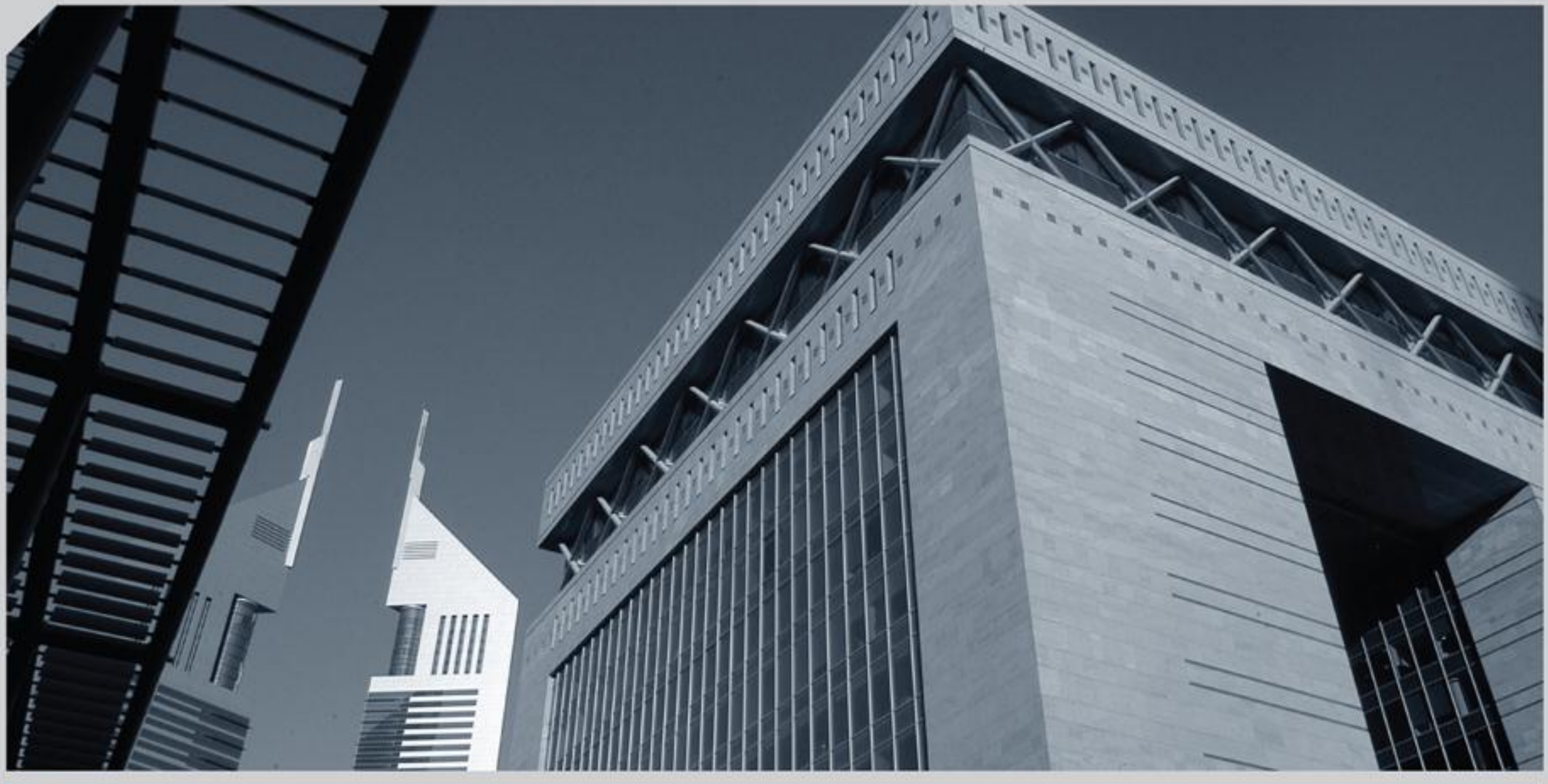

Role of Gold in the New International Financial Architecture

Media Roundtable

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8th Dec 2010

Dubai International Financial Centre
DIFC

Agenda

The Shift in the Global Economic Epicentre

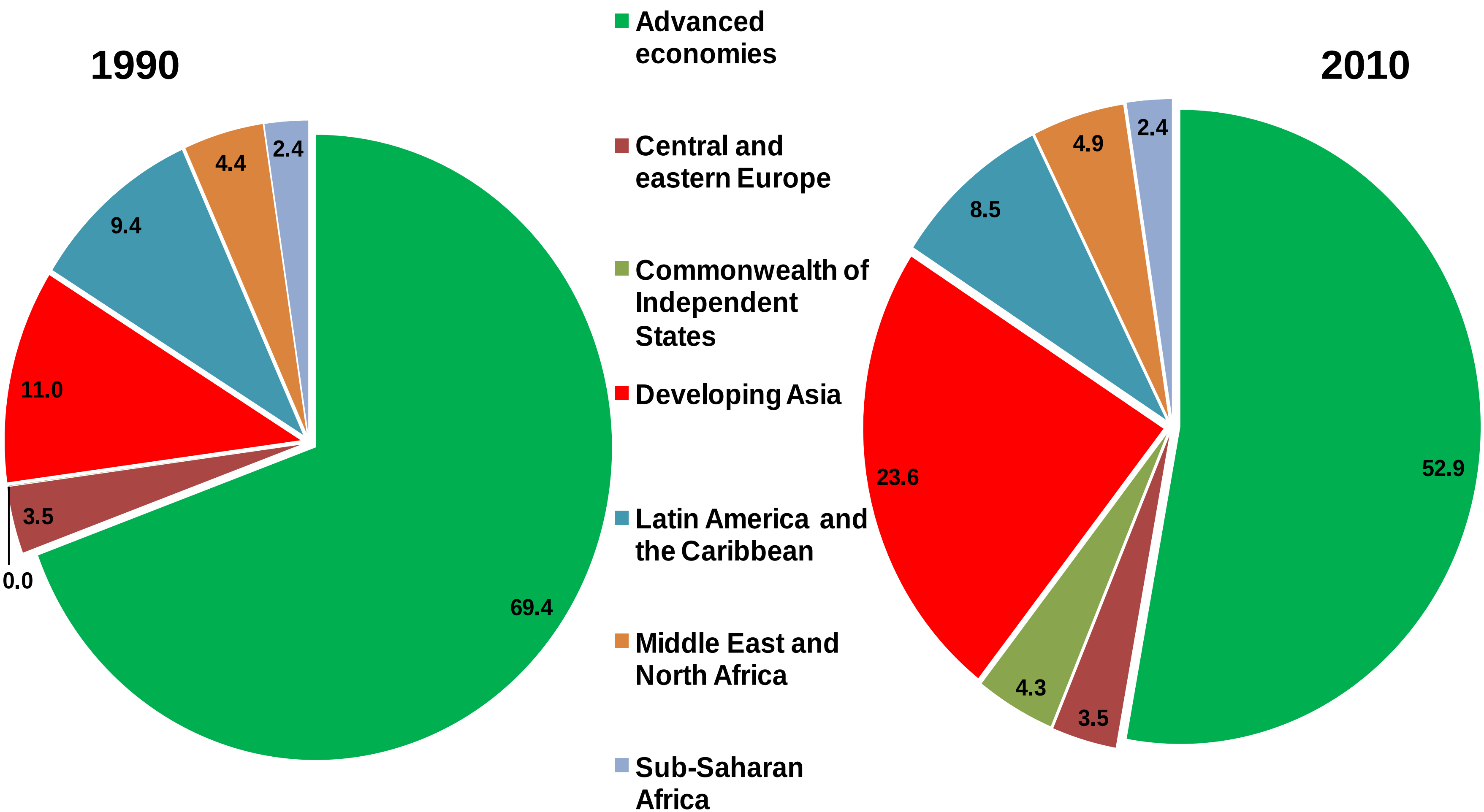
The Dollar as a Reserve Currency

The Value of Gold and its Role as an Anchor

Proposal to Move to a “Hard SDR”

Bottomline

Shift in Global Economic Geography: 1990-2010



Source: IMF WEO, Oct 2010

Share of World GDP by Country/ Region 1990-2030

Country/Region	GDP (millions Geary-Kharis dollars)		Maddison's 2030 forecast	Forecast new calculations	Maddison's Growth rates	Maddison's Forecast growth rate	New forecast
	1990	**2008**	**2030**	**2030**	**1990-2003**	**2003-30**	**2008-2030**
W. Europe	6033	8698	12556	12069	2.05	1.75	1.50
USA	5803	9485	16662	15475	2.91	2.56	2.25
Other WO	862	1449	2414	2364	3.07	2.39	2.25
Japan	2321	2904	3488	3575	1.17	0.95	0.95
Rich	15020	22536	35120	33484	2.33	2.06	1.82
E. Europe	663	1031	1269	1269	1.33	1.79	1.79
Russia	1151	1282	2017	2017	-1.76	2.98	2.98
Other f.USSR	837	960	1222	1222	-2.17	2.43	2.43
Latin America	2240	4046	6074	7753	2.61	2.48	3.00
China	2124	8909	22983	30797	8.56	4.98	5.80
India	1098	3415	10074	12306	5.73	5.68	6.00
Other Asia	3099	7060	14884	16732	4.36	3.83	4.00
Africa	905	1735	2937	3778	2.96	3.00	3.60
Rest	12117	28438	61460	75873	4.19	4.12	4.56
World	27136	50974	96580	109357	3.21	3.23	3.53

Source: Angus Maddison (2004) and Andrew Mold (2010)

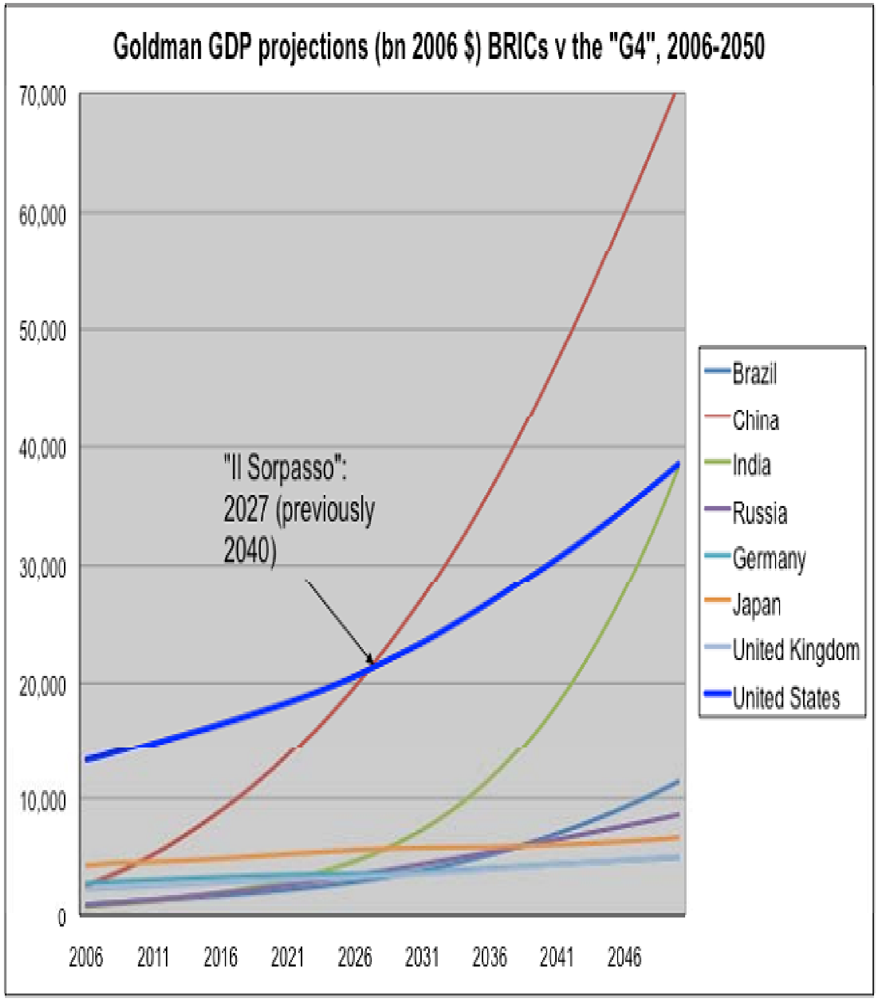
Shift in Global Financial Geography

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010(E)
World Market Cap	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
United States	46%	47%	50%	47%	45%	43%	39%	36%	31%	33%	31%	31%
Rest of Developed	46%	45%	41%	42%	44%	44%	44%	44%	41%	41%	41%	39%
Emerging Markets	8%	8%	9%	11%	12%	13%	16%	20%	28%	26%	28%	30%
BRIC	2%	3%	3%	3%	4%	4%	6%	9%	17%	15%	17%	17%
Rest of Emerging	6%	5%	6%	7%	7%	9%	11%	10%	11%	11%	11%	12%
of which GCC	0.3%	0.3%	0.4%	0.9%	0.9%	1.3%	2.5%	1.3%	1.7%	2%	1%	1%

Source: S&P, 2010

The Global Economic Epicentre Moves East

- The financial crisis led to two major changes:
  - Accelerated a shift of the global economic epicentre
  - Sapped investor confidence in paper assets & raised the appeal of gold as a safe haven asset.
- The financial system is moving from a "hub and spoke" to a "spider web" model.
- In a multi-polar world, **it will be difficult for a single country to provide the reserve currency**: its relative size in the world would be too small compared to the growing volume of global trade and financial transactions.
- Specifically, the US cannot continue running a large current account deficit adding indefinitely to their liabilities without putting their economy & capability of borrowing internationally in dollars under severe strain.



Source: Goldman Sachs

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US$ as an International Reserve Currency

- At present, the dollar is used in nine out of ten international transactions, serves as a currency peg for 89 nations, and makes up nearly two-thirds of global reserves.
- Dollar is still the dominant currency for issuers in the global debt market: 39% of all debt securities issued anywhere in the world are denominated in dollars – it is the favorite among Middle East, Latin America, and Asia-Pacific issuers - compared to 32% euro-denominated issues. (L Goldberg: "Is the International Role of the $ Changing?", FRBNY, May 2010)

Share of $ in Central Banks Reported Allocated Reserves

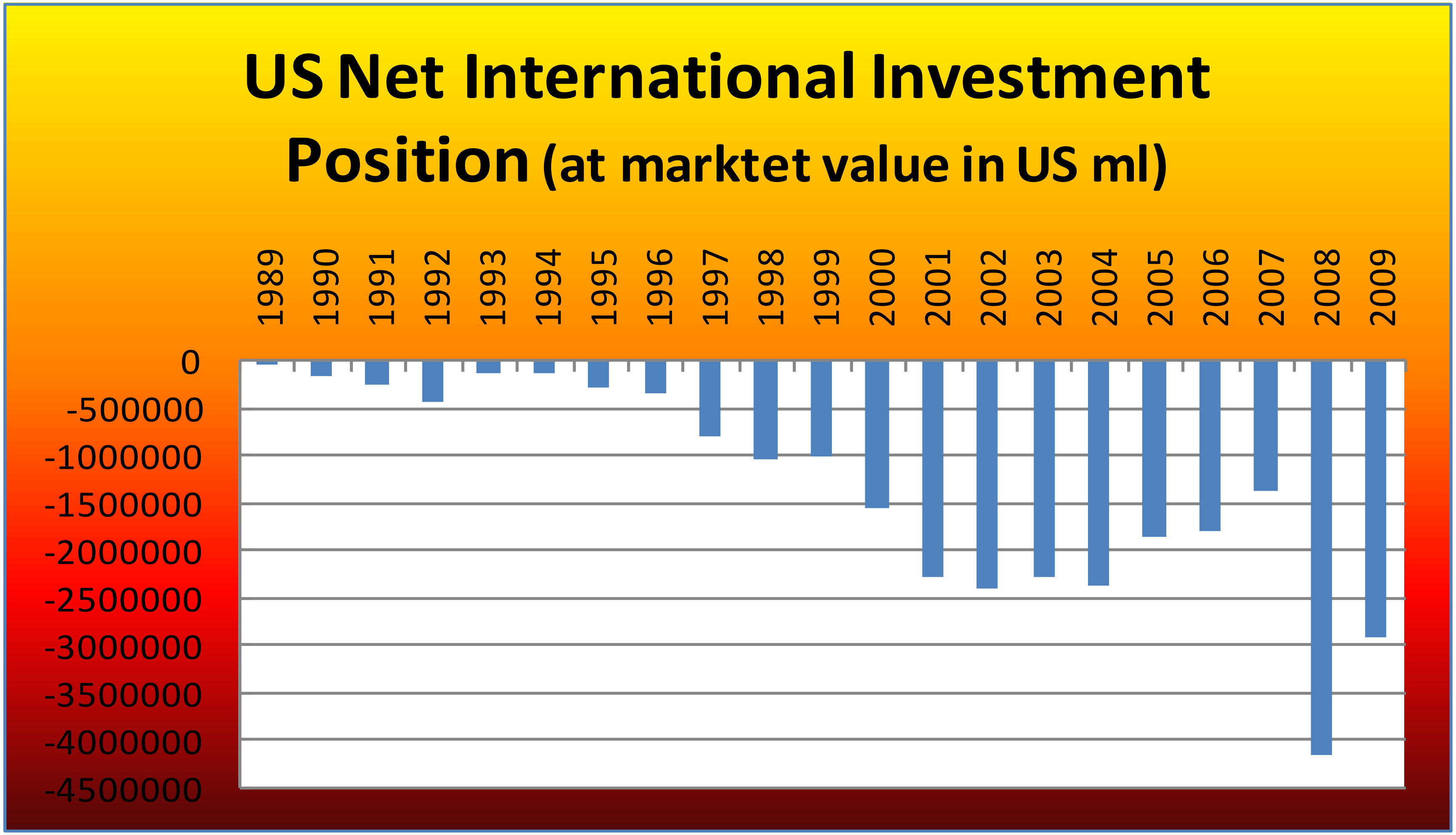
	1995	2000	2005	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10
World	59.0%	71.1%	66.9%	63.2%	62.9%	62.9%	64.5%	64.1%	65.2%	62.8%	61.5%	62.2%
Advanced Economies	53.9%	69.8%	69.3%	64.5%	64.7%	64.7%	66.9%	67.2%	68.8%	65.9%	64.9%	65.4%
Emerging & Dev. Eco	73.7%	74.8%	62.7%	61.8%	61.0%	61.0%	62.2%	60.7%	61.1%	59.3%	57.7%	58.5%
MENA	73.4%	76.8%	61.6%	67.1%	63.3%	63.8%	62.6%	60.5%	60.5%	60.8%	62.7%	62.7%
GCC	73.4%	86.6%	88.4%	76.9%	66.6%	64.2%	75.3%	85.8%	86.4%	86.9%	86.8%	86.2%

Source: IMF COFER database

Reserve Currency & the Triffin Dilemma

- **Triffin:** the country whose national currency serves as an international reserve currency **must run a current account deficit to supply the global liquidity required** for international transactions. However, the **deficit cannot be so large as to make the ensuing debt service unsustainable.**
- Increasing inability of the US to provide the reserve currency is evident:
  - US **external liabilities** went from almost zero in the early 1990s to almost $4 trn in 2008 and then declined sharply to just short of $ 3trn;
  - Global **foreign currency reserves** amounted to $8.1 trn by the end of 2009, with China having amassed $2.4 trn
- A solution to this problem could be envisaged along two hypotheses:
  - either one, or a few other, reserve currencies emerge or
  - a new **international unit of account** (an international currency) managed by a supranational institution needs to be designed.
- Europe's lack of integration in financial markets + insufficient liquid and safe assets => **appeal of the euro** as the next reserve currency is dismal.
- **Chinese yuan** is not freely convertible + Chinese financial markets are far from deep, liquid or well regulated and are not accessible by foreign investors.

US External Liabilities



Source: US Bureau of Economic Analysis

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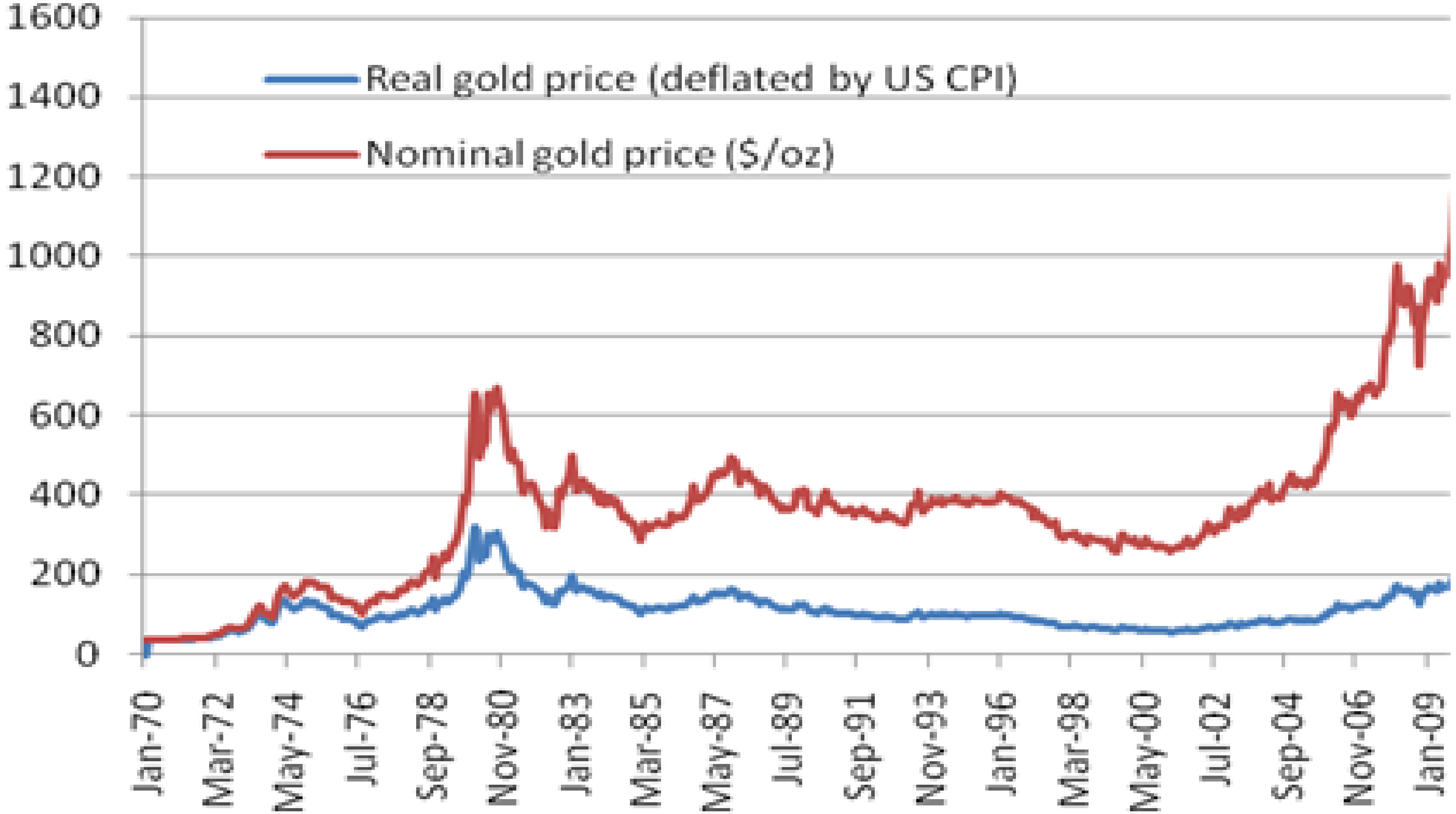
Nominal vs. Real Gold prices: still below peak



Source: Bloomberg, DIFC Economics

Gold as a percentage of total reserves 2001-Q1 2010

	2001	2002	2003	2004	2005	2006	2007	2008	2009	Q1 2010
US	55.7	57.2	59.2	60	71.3	75.1	78.6	77.3	70.4	71.5
Germany	37.4	42.9	47.6	49.6	55.6	62.5	67.4	68.9	66.5	67
Venezuela	24.7	30.2	22.9	21.4	19.7	19.8	28.3	23.1	36.8	46.1
China	2	2.2	1.9	1.3	1.2	1.1	1	0.9	1.5	1.5
Russia	10.4	8.9	6.7	4.3	3.5	2.7	2.5	3.4	5.1	5.3
India	6.5	5.6	4.6	3.8	4.3	4.1	3.5	3.9	6.9	7.1
ECB	15.7	17.8	21.8	22.3	24.2	24.7	25.8	22.6	25.6	25.8
MENA region										
KSA	**6.7**	**7.2**	**7.8**	**6.8**	**1.5**	**1.3**	**1.2**	**2**	**2.7**	**2.7**
Lebanon	33.7	30.7	23.5	25.5	28.5	30.3	37.3	28.4	25.6	25
Algeria	7.9	7.7	6.6	5.3	4.8	4.3	4	3.3	3.9	4
Philippines	14.1	18.5	20	19.1	13.8	12.7	10.5	11.5	12.3	13
Jordan	3.3	3.5	3.2	3.3	3.9	3.7	4.8	4	3.7	3.7
Qatar	**6.6**	**8.7**	**12.2**	**11.8**	**12.8**	**11.3**	**11.3**	**11.4**	**12**	**n.a.**
Kuwait	**4.9**	**6**	**6.9**	**6.9**	**5.7**	**5.9**	**6.3**	**6.2**	**7.6**	**7.7**
Egypt	1.1	1.2	1.1	0.8	0.9	0.9	1	1.1	1.3	1.4
Malaysia	2.3	2.4	2.1	1.9	2.2	2.2	2.4	2.7	3.3	3.6
Morocco	3.9	2.3	2.4	2.1	1.9	2.2	2.4	2.7	3.3	3.6
Libya	8	10.1	8.9	7.3	5.7	4.7	4.6	4.2	4.8	5
Yemen	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.5	0.9	n.a
Tunisia	2.9	3.2	3	2.4	2.5	2	2.3	2.1	2.1	2.5

Source: World Gold Council.

Role of gold as a reserve asset

The traditional reasons for investors/central banks holding gold are:

- **“War chest” argument** – gold is seen as the ultimate asset to hold in an emergency and in the past has often appreciated in value in times of financial instability or uncertainty;
- Ultimate **store of value**, inflation hedge and medium of exchanges – gold has traditionally kept its value against inflation and has always been accepted as a medium of exchange between countries;
- **No default risk** – gold is “nobody’s liability” and so cannot be frozen, repudiated or defaulted on;
- Legacy effects resulting from **gold’s historical role in the international monetary system** as the ultimate backing for domestic paper money.
- “**Tail Risks**”: events that can be devastating

A Quick Simulation

- The GCC countries have historically maintained less than 5% of total reserves in gold.
- This is in comparison to the ECB's 25% gold proportion.
- What would be the additional gold holdings required by the GCC Central Banks to achieve this 25% mark?

Change in Gold Holdings to increase proportion of gold to 25%

	Current Gold holdings (tonnes)	Value of gold reserves ($ mn)	Total Reserves ($ mn)	Gold as % in total reserves	Simulated increase in gold holdings to reach 25% (tones)
Kuwait	79.00	2760.62	23028.03	12.0	164.75
Qatar	12.40	434.02	18803.74	2.3	134.31
Saudi Arabia	322.90	11290.10	420983.93	2.7	3010.11

Source: World Gold Council, DIFC Economics

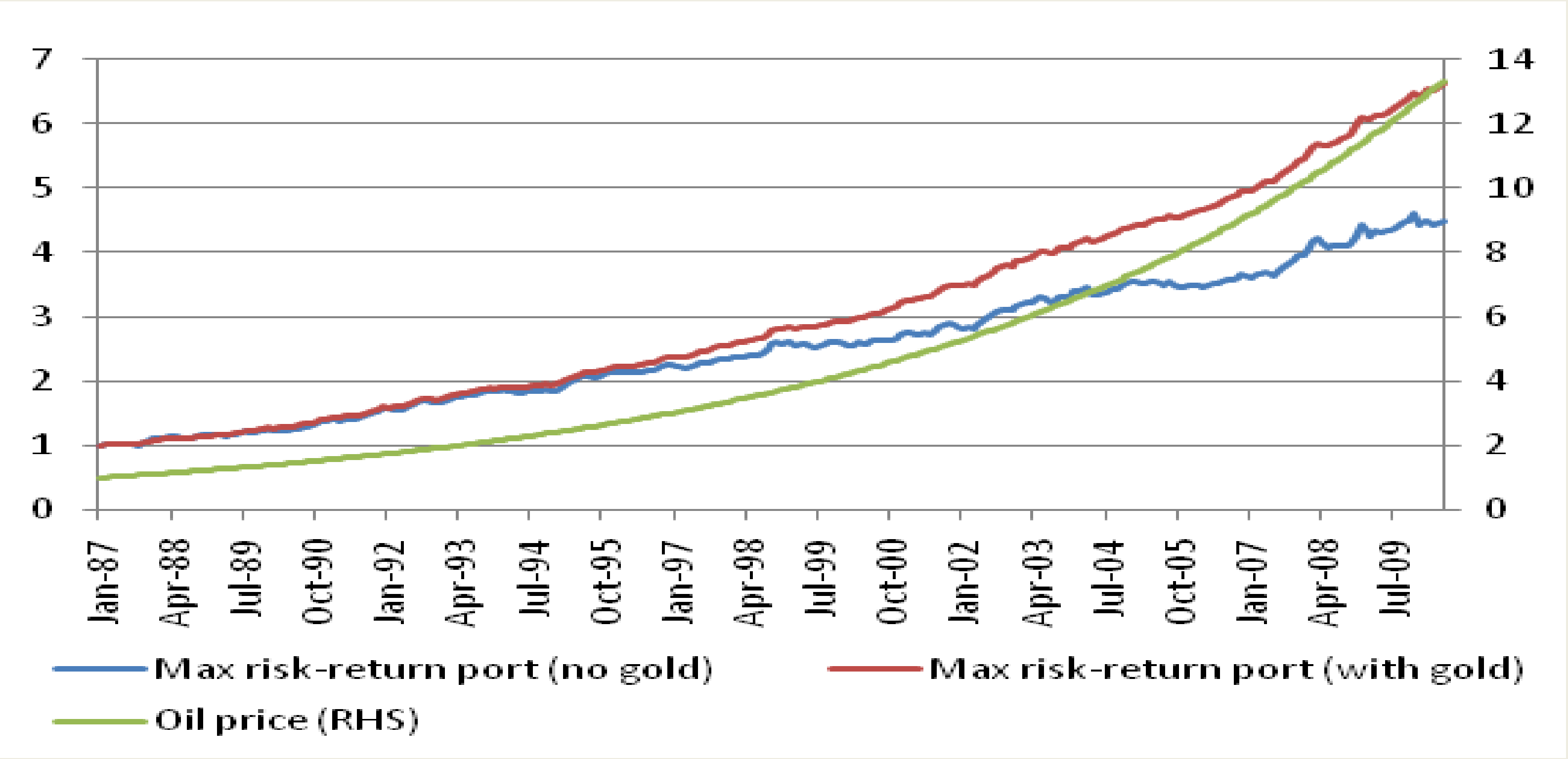
Optimal Reserves Portfolios: with & without Gold

	Position 0 (A)	Position 100 (A)	Position 0 (B)	Position 100 (B)
US Treasury Bills	65.0	0.0	65.0	0.0
US Intermediate Bonds	0.0	65.0	0.0	65.0
Gold	0.0	0.0	1.6	25.0
LIBOR	15.0	5.0	15.0	0.0
G7 Gov't Bonds ex. US	20.0	30.0	18.5	10.0
US Agencies	0.0	0.0	0.0	0.0
Expected Return	5.91	7.62	5.96	8.42
Standard Deviation	2.09	5.04	2.06	7.04
Sharpe Ratio	2.84	1.51	2.89	1.20

Source: Morningstar EnCorr

Value of Wealth

- A dollar invested in a portfolio **with gold** would have earned the fictional central bank $6.6 by May 2010 – which is almost 1.5 times more than an investment portfolio with no gold!
- This only strengthens the case for a central bank to hold gold – especially regional central banks, given the abundance of oil wealth too.



Source: Bloomberg, DIFC Economics

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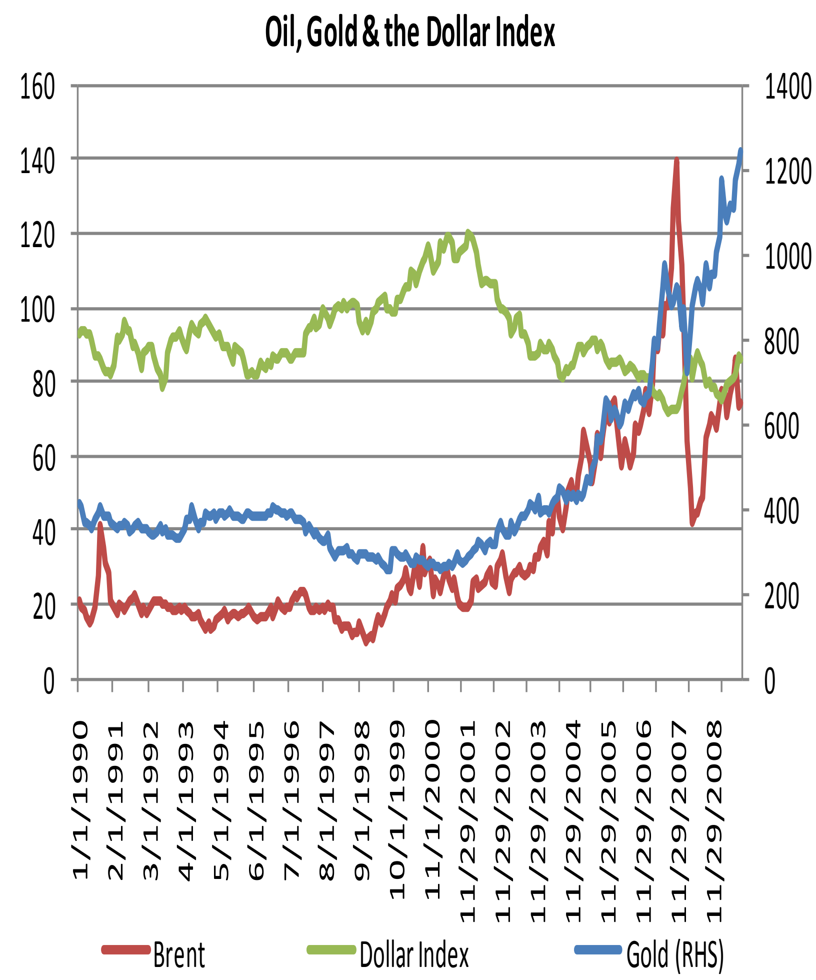
Role of Gold as an Anchor

A single reserve currency issued by a country whose relative economic share is dwindling exposes the world to severe instability & becomes a source of global systemic risk.

Can gold play a role in a multi-currency fiat currency environment resulting from a multi-polar economic map?

Gold - two stylized facts:

1. **Gold price tends to be counter-cyclical**: it tends to spike in conjunction with high inflation periods or at times of severe slumps threatening to turn into depression and/or triggering a deflation.
2. **Gold is perceived as a hedge against extreme events**; hence its price is dictated by the assessment that investors or some classes of investors make of those “tail risks”



Source: Bloomberg, DIFC Economics

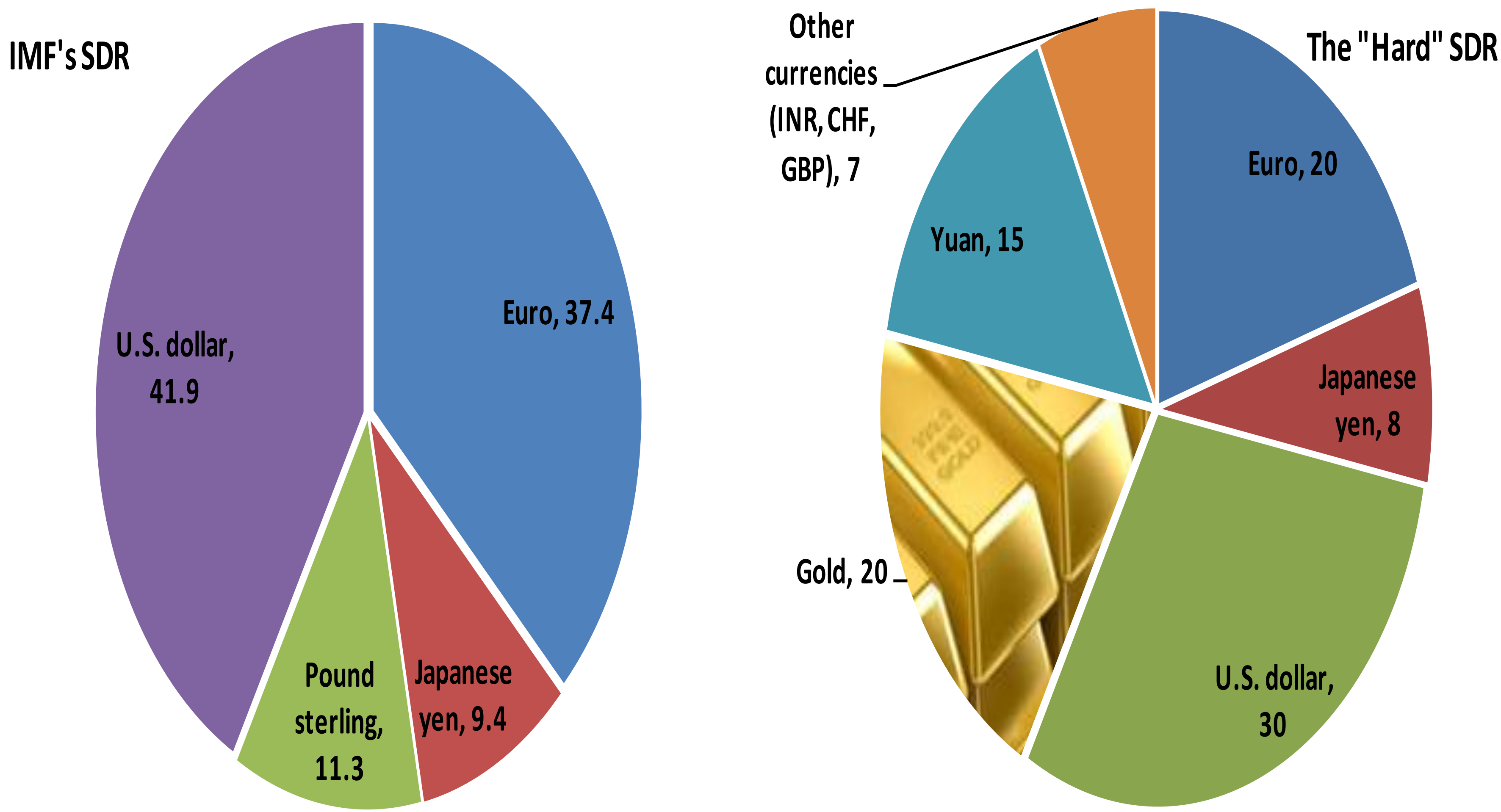
Using the SDR

- The SDR is the reserve asset created in 1969 through the IMF, with a value initially defined as equivalent to 0.888671 grams of fine gold.
- After the Bretton Woods collapse in 1971, the SDR was redefined as a basket of currencies, today consisting of the euro, Japanese yen, pound sterling & US dollar, with the basket composition reviewed every five years.
- The total stock of SDR amounts to 204 bn (equivalent to more than $300 bn). The largest SDR allocation ever, 161.2 bn, became effective on August 28, 2009 implementing a decision taken by the G20 in Apr'09 for the IMF to take a pivotal role in addressing the many crisis hotspots ravaging the world economy.
- However, this increase in SDR supply is not large enough to address the fundamental imbalances, growth of international trade, nor provide a significant alternative to dollar denominated assets in central bank reserves.

Moving to a "Hard SDR"

- For the SDR to be an alternative reserve currency: (a) the total issuance needs to be boosted (b) it would need additional backing and arrangements – in other words a "hard" version of the SDR must be created.
- It would be **desirable to create a new SDR basket** and include in it an asset whose value is largely uncorrelated with the value of fiat currencies. Gold would be the natural candidate with backing for the gold proportion coming initially from the IMF's gold stock. Given that the IMF still holds substantial gold reserves, **an SDR basket where the weight of gold would be between 20-25% could be reasonable.**

SDR Currency Composition



Source: IMF, DIFC Economics

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Bottom-line: Need a “Hard SDR”

Gold’s role as an anchor in the new financial architecture cannot be downplayed for three reasons:

1. the world is heading towards a multi-polar economic configuration reminiscent of the first phase of globalization at the turn of the 20th century;
2. the role of the dollar as a reserve currency is creating a set of serious tensions between domestic stability in the largest economy and the liquidity needs of an increasingly integrated world;
3. mature economies are facing a public debt and fiscal crisis with the non-negligible risk that governments will want to inflate away their debt rather than raise taxes, reduce social and entitlement programmes and/or increase retirement age to postpone and reduce social security liabilities and other entitlement benefits.

A new international monetary system, ‘Bretton Woods II’ or ‘Shanghai I’ should be based on a multi-currency system including the $, Euro, Yen, BP, Yuan and Gold underlying a new “Hard SDR”.

Robert Zoellick: The G20 must look beyond Bretton Woods

"…*The G20 should complement this growth recovery programme with a plan to build a co-operative monetary system that reflects emerging economic conditions. This new system is likely to need to involve the dollar, the euro, the yen, the pound and a Renminbi that moves towards internationalisation and then an open capital account.*

The system should also consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values. Although textbooks may view gold as the old money, markets are using gold as an alternative monetary asset today."

Op ed Financial Times 8 November 2010

Role of Gold in the New International Financial Architecture

Thank You!