Gold and the International Monetary System

A Report by the Chatham House Gold Taskforce

Rapporteur: André Astrow

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Preface and Acknowledgments

Since the 1930s, when Chatham House (the Royal Institute of International Affairs) convened an International Gold Problem Study Group, the international monetary system has always been at the heart of our work. In 2010 the Chatham House report *Beyond the Dollar* set out some of the ideas that then fed into the agenda of the G20 working group on the reform of the international monetary system in 2011. In late 2010, partly prompted by an article by Robert Zoellick the president of the World Bank, in the *Financial Times,* and partly because we felt that the discussion on Special Drawing Rights in *Beyond the Dollar* did not extend to an assessment of the role of gold in the basket, we believed that it was time to address in an unbiased and independent way the question of whether there is a role for gold in the international monetary system.

We decided that the best way to address this broad question was to convene a commission of experts from different backgrounds – academia, central banks, the private sector – and different nationalities in order to encourage a more rounded discussion. The Chatham House Gold Taskforce came to life in March 2011 and spent almost a year analysing existing research, with members producing their own research to support its work and debating many aspects of gold as an element of the international monetary system. Through this period the Taskforce was engaged in external consultations (see Appendix 2 for the agendas of those meetings) as well as one-to-one discussions with external experts, seeking views on the topic from the public sector, international organizations, private financial institutions and academia from across the world. Taskforce members attended a number of research discussions held at Chatham House and regularly exchanged views by email.

The work of the Gold Taskforce is summarized in this report by André Astrow, the Taskforce rapporteur, who faced the herculean task of bringing together members' direct input and reporting their collective, if not specific, views on the topic. The report is an imperfect attempt to distil the richness of the debate in which the Taskforce members have been engaged. Being aware of this intrinsic limitation, the Taskforce members have agreed to make their individual written contributions and presentations available to interested readers on the Chatham House website.

This report is an important contribution to the debate on the international monetary system as it provides an independent and unbiased assessment of the benefits and limitations of gold. It would not have been possible without the commitment and support of many people and organizations.

My thanks go above all to the members of the Taskforce (listed on page iv), who gave so much of their time over the course of this project. Members participated in a series of three external consultation meetings and three study groups from March 2011 to November 2011 to discuss the role of gold in the international monetary system. A number of them offered papers and presentations whose ideas were then incorporated in the report. All Taskforce members provided substantive content, data and amendments to various drafts of the text and charts.

I would like to thank Dr DeAnne Julius, chairman of Chatham House, for her enthusiastic support for the project. Despite being unable to serve on the Taskforce owing to personal commitments, she provided timely advice and expertise, and acted as an important point of reference for the whole project.

On behalf of Chatham House, I thank all those organizations that in different ways supported the work of the Taskforce, in particular the Chinese Academy of Social Sciences (CASS), and Professor Yu Yongding and Mr Zhang Yuyan. We hope that this report does justice to the confidence they placed in us.

I also wish to thank the participants in the three external consultations we held in Washington DC, London and Beijing (detailed in Appendix 2).

Special thanks go to our rapporteur André Astrow, for so admirably capturing the sense of the Taskforce's work and summarizing its conclusions, dedicatedly working through several drafts of the report to ensure that all nuances were depicted and each member of the Taskforce felt that his or her views were correctly represented.

This report would not have been possible without the contributions of a number of Chatham House staff, to whom I am very grateful. Nick Maxwell, Programme and Outreach Manager, led this project from its beginning almost to its completion when he left Chatham House on a year's leave to serve as a member of the UK Territorial Army. Richard Varghese, International Economics Research Assistant, provided vital research support across a range of complex topics and sources. Jamie Cirrito, International Economics Administrator, coordinated the logistics for all meetings related to this project. Margaret May, Chatham House Publications Editor, oversaw the editing and the whole publication process as effectively as always. The Chatham House Communications team was prompt as ever to respond to all media queries about the topic.

Finally, I should also thank Benjamin J. Cohen and John Nugée and two anonymous reviewers for very helpful comments on drafts of the report.

Paola Subacchi
Research Director, International Economics,
Chatham House

Executive Summary

In 2011 Chatham House set up a global Taskforce of experts to assess what role, if any, gold could play in the international monetary system in the wake of the current financial crisis. Despite widespread concerns with the performance of the system in recent years, repeated calls by policy-makers across the world for the implementation of far-reaching reforms to the post-Bretton Woods framework have produced few tangible results. A number of influential policy-makers have made allusions to the fact that gold could perhaps once again play a useful role in the international monetary system, but very rarely has bullion featured as a central element in conventional research or policy discussions.

To help fill this void and contribute to the ongoing debate about reform, the Chatham House Taskforce took a fresh and open-minded approach to the different ways gold could be used within the international monetary system. The Taskforce carried out the first in-depth examination of all the different suggested roles for gold in nearly 30 years. Not since the 1982 US Commission on the Role of Gold in the Domestic and International Monetary Systems was bullion discussed in such a comprehensive fashion by a prominent policy group of experts.

Given that discussions on the role of gold often trigger strong emotions and reveal existing prejudices across the policy spectrum, the Taskforce was keen to take as its starting point the perspective that this was a subject deserving of serious and level-headed analysis. Far from dismissing the view that gold might somehow once again play a key role in the international monetary system as the misguided belief of a few gold analysts, the Taskforce carefully assessed in what way bullion could make a positive contribution through intellectually grounded analysis and discussion. In particular, the aim was to fill a gap in the debate on the pros and cons of a fiat money-based international monetary system versus one anchored or partially anchored by gold.

In evaluating the advantages and disadvantages of reintroducing the use of gold in the international monetary system, the Taskforce was fully cognizant of the serious drawbacks of bullion that had led to the demise of the Gold Standard era in the 1930s and the abandonment of the Bretton Woods arrangement in 1971. Nonetheless, the Taskforce was also sufficiently captivated by the positive attributes of gold, such as its lack of credit risk and rich historical importance, to believe the role of gold merited a comprehensive new look within the framework of reform.

The Taskforce focused its attention on four distinct frameworks for reintroducing an element of gold as a means of enhancing the performance of the international monetary system. It investigated the role gold could play:

- as an anchor;
- as a hedge or safe haven;
- as collateral or guarantee;
- as a policy indicator.

In addition, the Taskforce debated the pros and cons of potentially including gold in an expanded currency basket of the International Monetary Fund's Special Drawing Rights (SDRs), an international reserve asset created by the Fund in 1969 which some view as a possible replacement for the US dollar in its capacity as the primary global reserve currency.

Lastly, the Taskforce considered the possible role of 'digital gold' in a rapidly evolving international monetary system which some gold analysts believe could offer a viable alternative to fiat currencies.

Although Taskforce members refrained from making specific proposals or recommendations regarding a possible comeback for gold, their debates and research generated a number of compelling and stimulating conclusions. Key findings include:

- The lessons of both the Gold Standard era and the post-war Bretton Woods period suggest that reintroducing gold as an anchor would undoubtedly be impractical or even damaging, given bullion's deflationary bias.
- Gold has a role to play as a reserve asset for central banks. This is evident from the recent behaviour of central banks in developing countries, and from the fact that gold still accounts for a significant percentage of reserves in a number of developed economies. Gold can serve as a hedge against declining values of key fiat currencies, and can also be useful for central banks looking to diversify their foreign reserves. However, its role as a hedge is not cost-free. Indeed, one major downside of holding gold is that its price can be volatile compared with other reserve assets. Another is that it generates no yield, other than capital gains, which are only realized when it is sold. Gold can therefore have some utility in a portfolio of assets by spreading valuation risk, but would not be very effective as a sole reserve asset.
- The jury is still out on whether gold could play a more significant role in the international monetary system by serving as a policy indicator for monetary or fiscal policy. Since the early days of the financial crisis, the sharp rise in the price of gold would have been thought by policy-makers to indicate the need for tighter policies, which would have been highly damaging in the circumstances. In so far as increased gold reserves reflect a desire for more discipline, it does have a narrow indicator role to play, but from the research examined by the Taskforce there appears to be no consistent and reliable correlation between bullion and a large number of key economic variables that could be employed to inform policy decision-making more effectively.
- The Taskforce determined there was little evidence that expanding the SDR basket to include gold would be effective in strengthening the international monetary system. Although the inclusion of currencies from key developing countries such as China would be a positive step for SDRs to better reflect their growing importance in the global economy, there was less evidence to suggest that incorporating gold into the basket would be beneficial.

As the world becomes increasingly multi-polar, interdependence becomes the rule, and the dominance of the United States is steadily challenged, the global economy can be expected to suffer from bouts of great volatility and uncertainty. In such an environment, gold is likely to continue playing a useful role as an effective hedge and safe haven. But, despite gold's positive attributes, the evidence which emerged from the Taskforce's deliberations led to the conclusion that, in today's world, there is little scope for gold to play a more formal role in the international monetary system.

1. Introduction

1.1 The international monetary system under scrutiny

Reform of the international monetary system is once again on the agenda.[1] Since the onset of the current global financial crisis, the credibility of the international monetary system has come under intense scrutiny, prompting calls for reform by a number of influential policy-makers in the developed and developing world alike. Although this is nothing new and, indeed, such calls often come to the fore at times of crisis, the integration and interconnectedness of today's world economy pose new challenges to policy-makers and raise the question of whether a framework of rules is needed to ensure coordination of policies and support economic growth.[2] While neither the global financial and economic crisis of 2008–09 nor the on-going eurozone sovereign debt crisis can be characterized as currency crises, they have highlighted the need for greater policy coordination and triggered renewed questions about the capacity of the international monetary system to correct imbalances and support an orderly payments system.

With an increasingly integrated world economy divided into one camp of major currencies that float freely and permit the free flow of capital, and another camp with varying degrees of control over exchange rates and cross-border flows, today's international monetary system has been described by the International Monetary Fund (IMF) as something of a 'non-system'.[3] As the Fund has put it,

> the current non-system has the inherent weakness of a set-up with a dominant country-issued reserve currency, wherein the reserve issuer runs fiscal and external deficits to meet growing world demand for reserve assets and where there is no ready mechanism forcing surplus or reserve-issuing countries to adjust (Mateos y Lago et al., 2009).

The global economic crisis has put the spotlight on the international monetary system's ability to play its key roles, identified as the

> framework that facilitates the exchange of goods, services and capital among countries, and that sustains sound economic growth, and [that a principal objective is] the continuing development of the orderly underlying conditions that are necessary for financial and economic stability (Article IV, Section 1, IMF Articles of Agreement).

The international monetary system is thus expected to provide the framework that ensures adequate liquidity without fuelling inflation and enables global imbalances to be corrected, or restricts their emergence, while facilitating an orderly payments system. It is also important that it should inspire confidence globally, with both the costs and burdens shared equitably among those who benefit from its smooth functioning.

On several counts, however, the international monetary system has proved to be inadequate. It relies on the dollar as the predominant international currency, but the United States' ability to use exchange-rate depreciation to boost

1 In the run-up to the London G20 summit in March 2009, the Governor of the People's Bank of China (PBoC), Zhou Xiaochuan, released a statement titled 'Reflections on Reforming the International Monetary System', which is considered to be one of the most influential calls for reform of the international monetary system in recent years. See Zhou (2009). For more details on the current debate on reform of the international monetary system, see Mateos y Lago et al. (2009), Sarkozy (2010), Stiglitz et al. (2010), Subacchi and Driffill (eds) (2010) and Farhi et al. (2011). To track the efforts of policy-makers, academics and other experts on reform proposals, the IMF has set up a dedicated website at http://www.imsreform.org/index.htm.

2 Subacchi and Driffill (eds) (2010). For earlier debates on international monetary reform see Aliber (1966), Triffin (1968, 1988), US Gold Commission (1982), and Krugman (1984).

3 Carlo A. Ciampi notes in Kenen, Pappadia and Saccomani (1994) that the term 'non-system' was used much earlier, perhaps in the early 1970s.

economic growth and help correct its current-account deficit has become increasingly viewed by other countries as incompatible with its role as issuer of the primary international reserve currency. As confidence underpins the entire system, other countries look to the United States to maintain simultaneously the stability of the dollar's purchasing power and an inflation rate consistent with the preferences of the primary reserve holders.

In the early 1960s the Belgian-born economist Robert Triffin warned that the use of one national currency to manage the world's liquidity was likely to lead to a conflict between short-term domestic and longer-term international objectives.[4] When these conflict, national interests will tend to prevail. The requirement that global liquidity should be supplied in the form of national financial assets (usually government debt) creates further challenges; it has been argued that the appetite for US dollar assets, as demand for international reserves increased in the 2000s, depressed US interest rates and fuelled the borrowing boom. The sustained depreciation of the US dollar from 2002 prompted a partial shift towards other reserve assets such as the euro, but flaws in the eurozone's governance, and the inability to compete in terms of size and liquidity of markets, meant that the dollar continued to dominate.[5]

In the longer term, with economic growth in much of the developing world, notably China, expected to continue to outstrip the pace of expansion in the United States itself, the capacity of the latter to support the world's primary reserve currency is gradually being eroded, prompting renewed questions about the future role of the US dollar. As US hegemony appears to be declining, the distribution of costs and benefits of the current system has become controversial. This is reflected in debates over the governance of international monetary institutions such as the IMF, or the responsibility of those countries in surplus and deficit to adjust their economies.

The severity of the current financial crisis has highlighted the urgency of addressing some of the flaws in the international monetary system in order to create a framework for greater financial stability in the future, and with it the restoration of long-term economic growth. The focus of the debate is on the following issues:

- the perennial problem of a national currency as an international reserve asset;
- the potential weakness of the US dollar as a reserve asset and international currency;
- the development of large global imbalances which can undermine the financial stability of the world economy.

A key question, therefore, is whether the primary reserve currency needs an external anchor[6] to guarantee that its value could be maintained. In the past, such an anchor was provided by gold, but both the Gold Standard and subsequently the Bretton Woods framework, which incorporated gold, proved to be flawed.[7] Many years later, however, the vexing issue of value has not gone away, despite the current low rates of inflation, so this is an opportune time to rethink this question and offer fresh thoughts and recommendations on reforming the international monetary system.

1.2 The return of the gold debate

Recent developments in the world economy, notably the sharp rise in the price of gold, a shift in central bank behaviour with respect to bullion, and the decision by some clearing houses and financial institutions to accept gold as collateral have all contributed to bringing gold to the fore in discussions on reforming the international monetary system.

The role of gold often evokes strong emotions and reveals existing prejudices across the policy spectrum; on

4 Testifying before the US Congress in 1960, Triffin exposed a fundamental problem in the international monetary system – the 'Triffin dilemma' – which suggests that to supply the international community with adequate liquidity, the reserve currency issuing nation (the United States) has to run a current-account deficit. In doing so, it becomes more indebted to foreigners. This eventually leads to an erosion of confidence in the value of the reserve currency (US dollar) (IMF, 2012).

5 For further reading, see Cohen (2010).

6 Usage of the term anchor in this report refers to whether gold has a role in being tied to or linked with the expansion or contraction of the global monetary base.

7 See details in Chapter 2.

occasion it has been politically exploited. At one end of the spectrum are those politicians, such as Ron Paul, a libertarian Republican presidential candidate in the United States, who have always distrusted central government, lambasted the Federal Reserve over its loose monetary policies and long argued for a return to the Gold Standard era as a way to limit discretion.[8] Many on the other side of the debate dismiss suggestions that gold could play a useful role in the evolution of the international monetary system, following John Maynard Keynes' description of the Gold Standard as a 'barbarous relic'.[9] Even in 1923 Keynes argued that 'advocates of the ancient standard do not observe how remote it now is from the spirit and requirements of the age'.[10]

Today, the myriad problems facing the world economy as it struggles to recover from a deep financial crisis has prompted repeated calls by French President Nicolas Sarkozy and other policy-makers to establish a new Bretton Woods framework. 'We live in a new world, so we need new ideas,' he announced boldly in January 2011 as he set out his ambitious G20 mission.[11] The aim, he stressed, would be to reduce exchange-rate volatility in currency and commodity markets, dampen global capital flows and address the world's trade imbalances which he said were being caused by 'international monetary disorder'.[12]

A number of influential and mainstream policy-makers have argued that it would be beneficial for gold, once again, to play a more significant role in the international monetary system, without advocating a return to a gold standard *per se*. The former Italian prime minister and former president of the European Commission, Romano Prodi, has proposed the creation of a euro bond backed by member states' gold reserves.[13] Robert Zoellick, president of the World Bank, has said that a new monetary system should 'consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values'.[14]

A 'Bretton Woods III', however, still remains a distant goal, and it is already abundantly clear that the lack of political consensus at the G20 level would make the creation of a new monetary architecture a prolonged process. Since an initial flurry of activity, the momentum for reform within the G20 has waned noticeably, with leaders increasingly preoccupied by the urgent need to address the eurozone's sovereign debt crisis. In fact, at the Cannes Summit in November 2011, many of the reform initiatives were left off the agenda altogether.[15] In the absence of a broad consensus among key governments, change and reform of the system, if it is to come at all, is most likely to arise from a gradual process of incremental adjustment and adaptation. A 'big bang' approach to reform is clearly not on the cards as the international monetary system has evolved in such a way that all key members are locked by divergent interests in a form of stable disequilibrium (Subacchi and Driffill, 2010).

In pursuing a more evolutionary approach to reform, the Group of 20 leading economies, together with the IMF, have been looking for ways to bolster the international monetary system, for example by exploring how to expand the currency basket behind the Fund's Special Drawing Rights (SDRs) by incorporating the currencies of a number of key emerging markets (IMF, 2011a; IMF 2010). Since the global financial crisis, the governor of the People's Bank of China, Zhou Xiaochuan, has suggested that SDRs could eventually replace the US dollar as a global reserve currency and that the renminbi

8 Forbes, S., 'If you want to restrain government, you restrain the power to create money. And that's what gold does.' 'Dr. Ron Paul's Gold Standard', *Forbes*, 13 January 2010, available at http://www.forbes.com/2010/01/13/gold-standard-fed-intelligent-investing-ron-paul.html. As the US presidential campaign heated up, Herman Cain, then Republican candidate, added his voice to the gold debate, saying that he would like to return to a world where 'a dollar is a dollar' and that 'yes, we do need a gold standard for that'. Tett, G., 'Is there a shadowy plot behind gold?', *Financial Times*, 22 October 2011.

9 'In truth, the gold standard is already a barbarous relic.' Keynes (1924), p. 172.

10 Keynes (1923), pp. 172–3. In addition, Paul Krugman, Nouriel Roubini and other prominent public economists have dismissed a return to the gold standard.

11 Sarkozy (2011).

12 Giles, C. , 'Uphill battle for French G20 Presidency', *Financial Times,* 22 September 2011.

13 Romano Prodi and Alberto Quadrio Curzio, 'EuroUnionBond, here is what must be done', *Il Sole 24 Ore*, 23 August 2011.

14 Zoellick, R., 'The G20 must look beyond Bretton Woods II', *Financial Times*, 7 November 2010.

15 Europe's sovereign debt crisis and in particular, then Greek Prime Minister George Papandreou's decision to hold a referendum over a proposed bail-out deal, overshadowed G20's core reform agenda at Cannes in November 2011.

and the currencies of other developing economies should now be adequately represented in the underlying basket.[16]

Broadening the basket, according to the Chinese authorities, could set the stage for transforming what is now little more than an accounting unit into a global reserve currency to rival the US dollar and the euro, thereby facilitating world trade and bolstering the stability of the global financial system.[17] To date, however, little progress has been achieved on this front as the proponents of an expanded SDR basket face opposition, particularly from the United States, which points out that currencies such as the renminbi cannot be considered for inclusion unless they are both widely traded and freely convertible. Indeed in October 2011 the IMF Executive Board rejected broadening the SDR basket (IMF, 2011a; IMF, 2011b).

Gold, meanwhile, has not been a central element in recent mainstream research or policy discussions on reforming the international monetary system, beyond the renewed calls by Zoellick and other policy-makers who believe it should be part of the solution. Indeed, the last prominent policy group to discuss the role of gold was the US Commission on the Role of Gold in the Domestic and International Monetary Systems in 1982. At that time, the Commission concluded that the flexibility of the post-Bretton Woods era was preferable to a formal role for gold, but given the lack of progress with the reform process today, there is merit in assessing in greater depth whether gold could once again play a useful role in addressing some of the problems facing the international monetary system.

Can gold provide the system with an anchor or at least partial anchor that is universally trusted? Can the role of gold be expanded or formalized as an indicator to gauge inflation expectations or as an early signal of changes in US interest rates – beyond the role it performs currently as a hedge or safe haven? What is so special about gold that, despite its demise as a long-standing anchor in the international monetary system nearly 40 years ago, some influential policy-makers believe it could once again play a useful role in this regard? What sets gold apart from other commodities such as silver or other precious metals, that it could perhaps play a future role in bolstering the system?

1.3 The Chatham House Gold Taskforce and the goals of the report

To address these questions and, most of all, to assess what contribution, if any, bullion could make to the current international monetary system in the wake of the global financial crisis, Chatham House set up a global Taskforce of experts in 2011. The purpose of the Taskforce was to enable dialogue and discussion between independent experts, policy-makers and business leaders on critical issues related to gold and the international monetary system. The Taskforce took a fresh and open-minded approach to exploring the advantages and disadvantages of reintroducing gold in the system and identified a number of possible scenarios for reform. Building on the analysis of the Chatham House publication, *Beyond the Dollar: Rethinking the International Monetary System* (Subacchi and Driffill (eds), 2010), the work of the Chatham House Taskforce aimed to fill a gap in the renewed debate on the pros and cons of a fiat money-based international monetary system versus one anchored or partially anchored by gold.[18]

In assessing the pros and cons of using gold in the international monetary system, the Taskforce was fully aware of the cloud that bullion had left in the aftermath of the Gold Standard experience and the demise of the Bretton Woods arrangement. But the Taskforce was also sufficiently intrigued by some of gold's positive characteristics and the growing interest it has attracted since the onset of the financial crisis to warrant a fresh look at bullion in the context of reforming the system.

This topic is not new to Chatham House. Indeed between 1929 and 1931, Chatham House convened a special Study Group on 'The international functions of gold' to examine the problems arising from the post-war international

16 Chinadaily.com, 23 March 2009. See also Kenen (2010).

17 See Wiesmann, G., 'IMF urged to ease way for renminbi', *Financial Times*, 2 September 2011.

18 Fiat money/currency is money whose value depends on the power and standing of the issuer, usually a sovereign with the power to tax.

monetary settlement, which contributed to the Great Depression and ultimately led to the suspension of the Gold Standard by the British government in September 1931. This Study Group,[19] which included John Maynard Keynes, was of course grappling with a very different set of issues from those facing today's Chatham House Taskforce, but delving into its findings is instructive for drawing out what lessons, if any, are relevant in determining whether gold could once again have a useful role to play in bolstering the international monetary system some 80 years later.

After three years of severe economic crisis, by 1931 the UK economy had become hamstrung by the Gold Standard, which made it impossible for the sterling exchange rate to shoulder the burden of adjustment. This forced the embattled British government to break the pound's fixed parity with gold and to devalue the currency. The result was a rapid improvement in the competitiveness of British exports; cheaper credit was made available and the UK economy began to emerge from depression (Schenk, 2011b).

Prior to the UK's decision to abandon the Gold Standard, two of the key concerns preoccupying members of the Study Group were that gold could not be mined fast enough to match the growth of the global economy, and the fact that the United States and France held the lion's share of gold in the world. This prompted the Study Group to focus on proposals aimed at addressing ways of 'economizing' on gold, which would enable central banks to operate a Gold Standard with far less bullion than had previously been required.[20]

In attempting to answer the question: 'how far is gold a player in the tragedy of the price collapse?', the Study Group's deliberations were not conclusive, but as one member, Sir Cecil Kisch, put it, 'it is easy to make it the scapegoat'. In setting out the Study Group's thinking on price stability and gold, he argued it was important to distinguish between two different issues: 'Has the handling of the credit question been prejudiced by gold shortage or gold maldistribution?' and 'has the credit question been mishandled despite adequate gold?' (Kisch, 1931). Kisch noted that the amount of gold actually held by central banks relative to the total deposits in money was comparatively small, but that on these small proportions of bullion an enormous credit structure was raised.

It was important, therefore, that all countries had the same views concerning the amount of gold required to maintain the credit structure. However, the gold problem, Kisch pointed out, was viewed very differently in different countries. The United States and France, which had the largest gold reserves, were 'not predisposed to regard gold as a serious culprit in the matter of world depression', whereas the United Kingdom, whose gold holdings by comparison were relatively small, held the view that 'gold has played a large part in precipitating the catastrophic price fall in recent years' (Kisch, 1931).

In Keynes' view, the most pressing issue was to sustain international lending to prevent a global liquidity crisis, and he looked to France and the United States, with large gold holdings, to lend more – not entirely different from today's situation of global imbalances and the massive accumulation of foreign-exchange reserves by a number of central banks. The analogy stops there, however, given that this was a period of plummeting prices, and an era when the gold price had been very stable for a long time. In fact, in the previous 100 years to 1930, the price of gold had only risen marginally from \$19/oz to \$21/oz (Schenk, 2011b). These features of the international monetary system back then stand in stark contrast to the volatile gold prices of recent years (see discussion in Chapter 4, and particularly Figure 4.1).

19 The papers delivered before the Study Group from 1929 to 1931 are published on the Chatham House website. See Royal Institute of International Affairs Study Group (1931), available at http://www.chathamhouse.org/publications/papers/view/178235.

20 See also the Genoa Conference of 1922.

2. From the Collapse of the Gold Standard to the Demise of Bretton Woods

2.1 Why did the Gold Standard fail?

In modern times, the international monetary system has been subject to the discipline of a gold standard on two occasions: the Gold Standard of 1870–1914, and the Gold Exchange Standard of the inter-war years, both of which have been associated with periods of sharp and painful economic depressions (the 1890s and the 1930s).[21] In the run-up to the First World War, the Gold Standard provided the foundation for the expansion of the global economy in the first age of globalization. This was a time when governments had a limited responsibility for the economic welfare of their populations and intervened less in their national economies. Monetary policy sovereignty was not deemed to be as important as today, so the loss of sovereignty required for the Gold Standard was more easily forgone. Indeed, adherence to the Gold Standard was sometimes interpreted as a 'seal of approval' to international markets of the creditworthiness of emerging markets (Bordo and Rockoff, 1996). The 19th-century Gold Standard was also supported by the use of sterling as an international currency that greased the wheels of commerce. In a period of globalization driven by technological advances and international migration, the deflation prevalent up to the mid-1890s was not accompanied by dramatic falls in output.[22]

To finance the war effort, however, the Gold Standard was suspended by combatant countries during the First World War as governments issued inconvertible paper currency and prices rose sharply with the increase in demand for military supplies. Once the war came to an end, there was a widespread desire to restore the Gold Standard, but monetary expansion during the conflict had pushed prices up so much that when calculated at pre-war parities the available supply of gold had declined relative to the money value of the income it was intended to support.

What emerged was a Gold Standard (or Gold Exchange Standard) in which most countries were encouraged to hold mainly foreign currencies, notably sterling or the US dollar, as their international reserve assets, rather than gold. Gold was withdrawn from public circulation in most countries and replaced with paper notes and non-gold coins, with their convertibility restricted to wholesale amounts.

Because inflation levels during the First World War had varied greatly between nations, some of the countries that returned to the Gold Standard chose to enter at pre-war prices while others adopted new valuations. The United Kingdom, for example, returned to the Gold Standard in 1925 at pre-war parity despite a dramatic reduction in its international competitiveness. Others, such as France and Belgium, did so at a new parity that devalued their national currencies from pre-war levels, in effect making the wartime inflation of prices permanent.

Meanwhile, Germany, which had left the Gold Standard in 1914, was in no position to re-enter after the war as it had been forced to sacrifice much of its remaining gold reserves in reparations. As a result, the German authorities issued virtually limitless amounts of marks without any backing to buy foreign currency to restore economic growth and pay for further reparations. This led to the unprecedented hyperinflation of the early 1920s in the Weimar Republic. Under the Gold Standard, hyperinflation would have been

21 The Bretton Woods era is sometimes equally described as a Gold Exchange Standard in the light of the US dollar's gold convertibility.

22 It should be noted that the physical volume of gold had not declined, and the problem probably could have been resolved had the price of gold been increased by a factor of three or four.

impossible as the money supply could only expand at the rate at which the gold supply increased but, without the backing of bullion, Germany lost its anchor for long-term price stability.

The Gold Standard of the inter-war years did not last long, collapsing in stages between 1931 when the United Kingdom left it and 1936 when its last adherents, France, the Netherlands and Switzerland, abandoned it. The final straw for the United Kingdom was its realization in mid-1931 that the low ratio between its gold holdings and the amount of short-term obligations that could potentially draw on these reserves made it impossible to defend the fixed value of gold (Schenk, 2011b).

Despite the adjustments and modifications that had been made to the inner workings of the Gold Standard in the pre-war years, the fact that the new financial framework required price deflation as a precondition for economic growth and prosperity proved to be a fatal flaw. Indeed, the requisite price deflation would have had to be accompanied by even higher levels of unemployment and further large falls in living standards, which would have been politically unpalatable in Britain and elsewhere. Eventually this forced all the other countries, one by one, to abandon the Gold Standard.

Whether the Gold Standard was responsible for prolonging the Great Depression or merely contributed to it is a matter of some debate, but it clearly prevented the banking crisis of 1931 from being contained (Eichengreen, 1992). Indeed it limited the ability of central banks to rely on monetary policy to combat falling prices by expanding the money supply and lowering interest rates. In the United States the Federal Reserve, whose commitment and adherence to the Gold Standard was underlined by its reluctance to engage in expansionary monetary policy, defended the fixed price of dollars with respect to gold until 1933. In an environment of plummeting demand and economic contraction, the Federal Reserve actually raised interest rates in 1931 at a time when the economy was in near freefall and maintained high rates in a bid to increase demand for US dollars. It took a further two years before the United States, having suffered from further deflationary effects, was finally forced to abandon the Gold Standard, and only at this point was the country finally able to embark on a sustained economic recovery.

2.2 The rise and fall of Bretton Woods

In the early 1940s British and American policy-makers (notably John Maynard Keynes and Harry Dexter White) began to draw up plans for a post-war international monetary system. This culminated in the Bretton Woods Conference of 1944 at which 44 countries endorsed a plan to set out a clear set of rules, institutions and procedures to govern the international monetary system in the aftermath of the Second World War.

The Bretton Woods arrangement was backed by the creation of two new institutions, the IMF and the World Bank, which were established to help build a framework for economic cooperation designed to avoid a repetition of the vicious cycle of competitive devaluations of the 1930s. Indeed, policy-makers learned one of the key lessons of the inter-war years: they set as a major objective of the Bretton Woods agreement the establishment of a new monetary system capable of preventing the 'beggar-your-neighbour' policies that had contributed to the breakdown of the Gold Standard and had prolonged the Great Depression (Subacchi and Jenkins, 2011).

The new political and economic dispensation reflected the hegemony of the United States as the dominant power of the post-war period and with it the consolidation of the US dollar's supremacy as the world's pre-eminent currency (Eichengreen and Flandreau, 2009). Under the Bretton Woods agreement, gold was still important but it had a less prominent role to play. Countries agreed to a system of fixed but adjustable exchange rates where most international currencies were pegged directly or indirectly to the dollar, which in turn was tied to gold at a set price of $35/oz.[23] Central banks had the right to convert their dollar holdings into bullion, and the London

23 Pegging to the US dollar was *de facto*. Formally, according to Article IV of the original Articles of Agreement, parities were to be defined in terms of gold or in terms of the US dollar 'of weight and fineness of July 1, 1944', i.e. gold. So gold was intended to remain the ultimate unit of account for exchange rates. Countries in the Commonwealth mainly pegged to sterling, which was itself pegged to the dollar (Schenk, 2010).

gold market was re-opened in 1954 but still sanctioned by exchange controls. In effect, all currencies pegged to the US dollar implicitly also had a fixed value in terms of gold, enabling the greenback to establish itself as the primary international reserve currency. With ambitious national recovery programmes, states opted to retain monetary policy sovereignty with limited exchange-rate flexibility by restraining capital flows through elaborate controls (Schenk, 2010).

The Bretton Woods framework introduced a degree of flexibility in the new exchange-rate regime, allowing countries facing serious economic difficulties to devalue their currencies against the US dollar in a limited way if a 'fundamental disequilibrium' occurred in the balance of payments. They also had access to short-term funds from the IMF to enable them to avoid undergoing the adverse effects of the deflation that had characterized much of the Gold Standard era. Strict capital controls protected the exchange-rate pegs and shielded countries from the damaging effects of capital flight.

Although the new framework underpinned a remarkable post-war boom in the 1950s and 1960s, the central role of the US dollar pegged to gold increasingly created tensions within the international monetary system. As the United States began running up persistently large external deficits while supplying the global liquidity required for international transactions, the volume of dollars held as foreign-exchange reserves by both official and private holders came to exceed the amount of gold in the Federal Reserve by a significant amount. This gradually undermined the credibility of a fixed price for gold on demand for all holders of US dollars.

In an attempt to sustain the credibility of an official, fixed price for gold, the G10 states[24] agreed in 1960 to set up a Gold Pool that intervened in the London market. But by 1966 the central banks of the G10 countries were forced to become active sellers of gold in order to prevent its price from rising. This resulted in a significant reduction in the amount of bullion held as reserve assets. Following the November 1967 devaluation of sterling, which then still served as a secondary global reserve asset, speculation against the US dollar price of gold ratcheted up, causing the Gold Pool's operations to be suspended in March 1968 (Schenk, 2010).

This was the first official step in the Bretton Woods era towards explicitly moving the international monetary system away from gold and deliberately encouraging the demonetization of bullion. While central banks had pledged to continue trading gold at the official price of \$35/oz, the private market price was allowed to float. The emergence of a parallel private market for gold where the price soared well above the official fixed price led to speculation and eventually prompted even central banks to cash in their dollars for US bullion.

These pressures meant that maintaining a fixed price of gold on demand for all those holding US dollars became untenable. Finally, in August 1971, President Richard Nixon decided to suspend the gold convertibility of the dollar, in effect closing the gold window and triggering a devaluation of the US dollar. The commitment to pegged exchange rates prompted a last effort to prop up the system through the Smithsonian Agreement with new parities in December 1971, but the market pushed the limits of the ability to defend these new rates. From June 1972 sterling floated against the US dollar and from March 1973 most other currencies did so too. The Bretton Woods regime had come to an end. It took another five years before the formal role of gold was removed by an amendment to the IMF Articles of Agreement, which sought to promote the SDR as the foundation of the international monetary system. This marked the culmination of more than 40 years in which the role of gold had been reduced in progressive stages.

2.3 After Bretton Woods

Although the virtue of relying on gold in the international monetary system had been the discipline it imposed on macroeconomic policy, this discipline also turned out to

24 The G10 countries were Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom and the United States. In 1964, the group was strengthened by the association of Switzerland, but it remained known as the G10.

be its Achilles' heel. It was too rigid and the limited flexibility of nominal exchange rates allowed by Bretton Woods was too costly – and was only possible at all because of the existence of widespread capital controls during that period (Driffill, 2010). When the effectiveness of capital controls was eroded with the rise of offshore markets through the 1960s, states could no longer pursue monetary policy sovereignty at pegged exchange rates. Rather than abandon sovereignty, states allowed exchange rates to float.

The evident weaknesses of the Bretton Woods system prompted initiatives to reform the international monetary system, and more specifically proposals to develop a deliberately managed and neutral global reserve asset, culminating in the development of the IMF's SDRs. Initially agreed in 1967 and implemented by the Fund in 1969 as part of the Bretton Woods system, they never developed as hoped. Proposals to enhance the role of SDRs and to reduce the role of national currencies were put forward in 1972, but the technical limitations of the SDR, uncertainty about the implications for international liquidity and disagreements over whether such proposals would relax pressure on the United States to correct its balance of payments prevented further reform. Nevertheless, enhancing the role of the SDR was built into the 1978 Second Amendment to the IMF Articles of Agreement, which spelt out the members' commitment to bolster the role of SDRs as the primary international reserve asset, independent from gold. The demonetization of gold was thus achieved, but the initiative to enhance the role of SDRs was never fulfilled (Schenk, 2011a). Largely because of the enormous and liquid market for US dollar assets, the post-Bretton Woods system continued to function reasonably well, although not without problems, in the decades that followed.[25]

The experience of the prolonged collapse of the Bretton Woods system showed the difficulty of retaining pegged exchange rates in an environment of increasing capital mobility when nation-states prioritize the exercise of independent monetary policies. The gold anchor proved unsustainable as the market lost confidence in the ability of G10 central banks to defend the fixed gold price of the dollar. In considering this issue for the future much depends, therefore, on the long-term credibility of maintaining any gold anchor.

25 See, for example, the Plaza Accord of 22 September 1985, signed by Germany, France, Japan, the United Kingdom and the United States to depreciate the US dollar in relation to the Deutschmark and the yen by intervening in currency markets.

3. Current Challenges for the International Monetary System

3.1 The world economy in transition

In the past 20 years, the world economy has undergone a radical transformation, which has contributed to increased vulnerabilities in the international monetary system. The peace dividend from the end of the Cold War with the subsequent break-up of the former Soviet Union, together with the rapid rise of China and India on the world stage, have placed new demands on the system. Tensions were less evident while the world economy was booming in the first decade of the 21st century, but with the onset of the crisis, the fragility of the international monetary system has come to the fore.[26]

The global banking crisis, following a period of unprecedented leveraging in the financial system, occurred in the first instance because of excessive risk-taking by many banks, especially in the sub-prime sector of the United States housing market, and because of bad risk management. These distortions were facilitated on the one hand by global imbalances driven by Americans who were encouraged to live beyond their means and who leveraged cheap credit, and on the other by Chinese exporters and savers who were generating an enormous current-account surplus. By taking advantage of its cheap labour costs, China was able to export lower prices to the rest of the world and then funded the United States' ever-growing current-account deficit by investing its own surplus into US Treasury bonds.

Today, as the United States and West European countries struggle to extricate themselves from the worst financial crisis since the Great Depression, the contrast with developing Asia is striking. Economic growth continues to disappoint in the United States, weighed down by a housing market which remains in the doldrums. In the eurozone the sovereign debt crisis has sparked serious concerns that the world economy may tip back into recession. And, in the aftermath of far-reaching government and central bank interventions to bail out numerous banks and other financial institutions, the developed world is now faced with a mountain of public debt that is partly the consequence of the bail-out of troubled banks and/or fiscal stimulus packages aimed at kick-starting national economies.

By contrast, GDP growth in developing Asia, led by China, has continued to far outstrip economic expansion in the West. Indeed the contribution of developing Asia to world output growth has doubled in the past 20 years, and now represents more than a quarter of global GDP (Asian Development Bank, 2011). In the wake of three decades of economic liberalization, China has already overtaken Germany as the world's largest exporter, and has now leapfrogged the United States to become the world's biggest market for cars.

China could well surpass the United States as the largest economy in the world within the next decade. At current market prices, the United States' GDP of $14.5trn in 2010 is still far ahead of China's $5.9trn, but calculated on the basis of purchasing power parity (PPP), which measures GDP using exchange rates adjusted for price differences of the same goods between countries, China's economy is already close to that of the United States and could overtake it within several years.[27] Still, on a per capita basis, China remains a relatively poor country and it faces some

26 Nonetheless, the crisis has also revealed some of the strengths of the international monetary system in containing its adverse effects and actually reducing global imbalances (Allen and Moessner, 2011). The Asian financial crisis of 1997–98 was the first signal that the international monetary system was unstable. The response to that crisis, namely managed exchange rates and persistent imbalances, has shifted the crisis from the international monetary system to the international financial system. For more details on the distinction between the two, and the use and function of an anchor, which is different in each system, see Fosler (2011b).

27 See 'Climbing Greenback Mountain', Special Report: The World Economy, *The Economist*, 24 September 2011.

severe challenges, such as fragility in the banking and financial system, as well as growing income inequality, that threaten its path to prosperity.

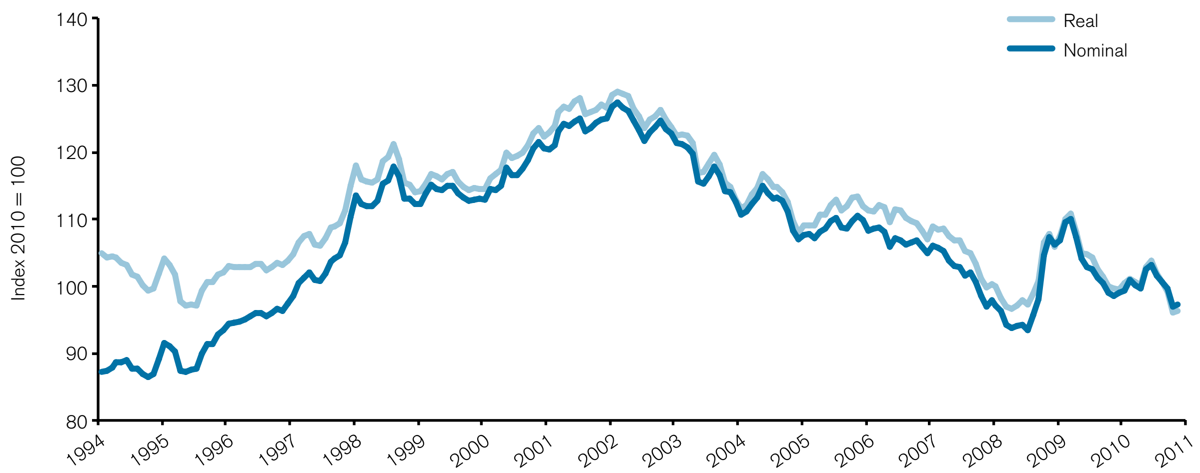
3.2 The buck stops here?

Being the issuer of the world's principal reserve currency has no doubt benefited the United States in a number of ways – what the then French finance minister Valéry Giscard d'Estaing ruefully described in the 1960s as 'exorbitant privilege'. The United States has had far more control over its own monetary policy than would otherwise be the case, and it has enjoyed lower financing costs than other developed countries. Moreover, it does not need to acquire costly reserves of its own and worry about the risk of an external financing crisis if its exports become uncompetitive, given that it can always print more dollars.[28] As the World Bank summed it up, countries like the United States 'benefit from domestic macroeconomic policy autonomy, seigniorage revenues, relatively low borrowing costs, a competitive edge in financial markets and little pressure to adjust their external accounts'.[29]

However, these benefits have increasingly been a mixed blessing, particularly since the onset of the current financial crisis. This state of affairs has produced a potentially destabilizing situation, with the United States, the world's largest economy, becoming by far and away the largest debtor, and China, the world's largest creditor, assuming an enormous currency mismatch risk in the process of financing American debt.

The enormous quantity of outstanding US dollar assets held by central banks, the long-term weakness of the US dollar since 2002 (Figure 3.1) and doubts about the worth of such a mountain of American debt have all contributed to a renewed interest in replacing the dollar as the primary reserve currency. At present, however, there is no genuine or credible alternative. To host an international currency requires deep and liquid financial markets, and the US Treasury and bond market continues to be unrivalled. Among the other currencies used as international reserves, neither the euro nor the yen currently has the potential to become the primary reserve currency. Even before the sovereign debt crisis afflicting the eurozone, there were question marks over the willingness of the European authorities to allow the euro to become a key

Figure 3.1: US dollar effective exchange rate



Source: Effective Exchange Rate Indices, Bank for International Settlements.

28 Ibid.

29 See 'Global Development Horizons 2011 – Multipolarity: the New Global Economy', World Bank, 2011, in Saft J., 'Welcoming the dollar's demotion', *International Herald Tribune*, 20 May 2011.

reserve currency. Meanwhile, the yen cannot be a serious contender as the Japanese economy remains too small to support a reserve currency and, like the eurozone, its growth is too slow and it is predominantly in surplus (Nugée, 2010; Cohen, 2011).

Although the US dollar's position has been weakening and there has been some diversification of global reserves (albeit inflated by exchange-rate changes), it is still unquestionably the world's principal reserve currency and it continues to serve as a safe haven because of its liquidity. The diversification of reserves, which reflects concerns about the US dollar as a store of value, nonetheless obscures the fact that it continues to dominate markedly in its other functions as the world's primary international currency: as a medium of exchange and as a unit of account. And even despite anxieties about its role as a store of value, 85% of all foreign-exchange transactions are still made in US dollars; half of all foreign debt securities are denominated in dollars; two-thirds of US banknotes circulate abroad; and much of international trade continues to be invoiced in dollars (Glick, 2011). Down the road, however, as the US share of world GDP continues to decline, the sustainability of the dollar's dominant position in the international monetary system, not just as a store of value but also as a medium of exchange and a unit of account, is likely to be brought into doubt, making its foundations increasingly unstable.

According to the World Bank, the growing importance of emerging markets over the coming decade – particularly China, which will account for an ever larger share of the global economy – is expected to lead to a multi-polar world where the US dollar will lose its status as the primary reserve currency by 2025 and share the top spot with the euro and the renminbi. The World Bank believes this scenario for the international monetary system is more likely than a status quo scenario centred on the US dollar, or one using SDRs as the main international currency (World Bank, 2011). As the former head of the IMF, Michel Camdessus, said recently, the international monetary system will need to be 'renewed so that emerging markets are recognized, changing from a dollar-denominated system to a multi-currency one'.[30]

This is in line with the findings of a UBS survey in May 2011 of more than 80 central bank reserve managers, sovereign wealth funds and multilateral institutions, collectively controlling over $8trn in assets. More than half of the managers polled at UBS's annual seminar predicted that the US dollar would be replaced by a portfolio of currencies within the next 25 years.[31] This marked a distinct shift from previous surveys, in which the majority of managers believed the dollar would retain its status as the principal reserve currency. The results underscored the growing dissatisfaction with the dollar amid moves to diversify away from it. They also pointed to an increased role for bullion over the next decade, with 6% of managers saying the biggest change in their reserves would be to add more gold – in contrast to previous years when none of the managers polled said they intended to do so.

3.3 The rise of the renminbi

In the light of the growing dissatisfaction with the US dollar as the world's primary reserve currency, and given that neither of the other contenders for the top spot – the euro and the yen – is in a position to become the dominant player in the international monetary system, many more eyes are turning towards the renminbi as a possible answer, but this shift is expected to be a gradual process. Although the US dollar may be suffering from long-term weakness, there is still no other currency that can compete with it today. The renminbi still has very little international exposure, is not fully convertible, and operates in a country lacking a sound institutional framework – all major handicaps.

Moves to internationalize the currency will also provide the government with an opportunity to move away from its long-standing but controversial growth strategy.[32] As World Bank president Robert Zoellick has pointed out, if the Chinese authorities hope to continue expanding the

30 See 'Emerging markets to account for 80% of future global growth: ex-IMF chief', Xinhua News Agency, 24 June 2011.

31 See Farchy, J., 'Central banks see shift from dollar', *Financial Times*, 28 June 2011.

32 See Subramanian A., 'Coming soon: when the renminbi rules the world', *Financial Times*, 12 September 2011.

economy at the pace of the past three decades, it is hard to see how that expansion could be accommodated within an export and investment-led growth model, so China will need to rebalance through boosting demand, lowering savings and increasing consumption. Without far-reaching structural changes, China risks becoming caught in a 'middle-income trap'.[33] And to escape it, China will have to abandon many of the current restrictions on the renminbi.

These big policy challenges are being pursued as part of a two-pronged strategy, first by boosting cross-border usage of the renminbi in trade settlements and secondly by making the local currency more attractive to non-residents by developing an offshore market in Hong Kong for renminbi-denominated assets (Subacchi, 2010). As a result, the value of cross-border trade transactions denominated in renminbi has surged from virtually nothing in 2009 to more than $265bn in the first 10 months of 2011.[34]

In a further sign that this strategy is being pursued vigorously, both Singapore and London have been singled out as future trading centres for the renminbi. Although, for political reasons, Singapore is unlikely to overtake Hong Kong as the primary offshore trading hub for the renminbi, it has the financial infrastructure to become another key trading centre for the Chinese currency. Meanwhile, making London an alternative hub should provide additional impetus to China's internationalization strategy by giving Beijing access to the largest foreign-exchange trading centre in the world.

Underscoring Beijing's desire to bolster the offshore renminbi market, China announced that effective 13 October 2011 foreign companies holding renminbi deposits outside the country would in future be able to use them for foreign direct investment (FDI) into China. Representing an important new step in the Chinese authorities' attempts to ease the country's financial controls, this development will provide a further boost to the so-called dim-sum bond market (renminbi-denominated debt issued offshore) as a potential channel for FDI funding, particularly in Hong Kong. But just as significantly, by opening a channel of renminbi inflows back to onshore asset markets, it represents another important step in completing the circle for the global circulation of the currency (HSBC, 2011).

Another small step in the gradual internationalization of the renminbi came with the announcement by the Hong Kong-based Chinese Gold and Silver Exchange Society on 17 October 2011 that it was launching a new service that allows institutional and retail investors to use their renminbi bank deposits to buy gold for the first time. The product, the Renminbi Kilobar Gold, enables investors to settle either through a spot market (to buy the goods and allow for settlements in two days) or physical delivery (moving the goods and cash to a place for exchange). While it is a spot contract, the physical delivery can be deferred if both the buyer and seller agree. The Hong Kong renminbi gold market thus serves two main purposes: it allows Chinese investors to buy gold with renminbi and it also gives offshore renminbi real purchasing power. Although this innovation is unlikely to have immediate repercussions beyond Hong Kong, it is an important part of the territory's strategy to establish itself as China's offshore financial services centre, and it also signals Beijing's methodical approach to raising the international profile of the renminbi.[35]

However, it will still be quite a leap for the renminbi to transform itself from being a currency in which a certain amount of the country's trade is settled to being a fully-fledged international currency – let alone one enjoying reserve-currency status. Only a tiny fraction of the world's $4trn in foreign-exchange deals each day is for trade settlement. The US dollar, meanwhile, continues to dominate all currency trades (85%), with the renminbi still accounting for a minuscule 0.3% of turnover.[36]

Nonetheless, the strategy to internationalize the currency will be given an additional boost if the renminbi is included in SDRs.[37] In 2009 China's central bank governor called for the creation of 'an international reserve currency that is disconnected from individual nations', arguing that reform 'should be a gradual process that yields win-win results for all' (Zhou, 2009).

33 See Zoellick R., 'The big questions China still has to answer', *Financial Times*, 2 September 2011.
34 The data are from Ministry of Commerce, China (November 2011).
35 McKelgue J., 'A new way to buy gold with "redbacks"', *MoneyWeek*, 18 October 2011.
36 'Climbing Greenback Mountain'.
37 Some observers expect the renminbi will already be included in the SDR basket by 2015. See Saidi et al. (2011).

The G20 under President Sarkozy pursued this goal by pressing for the renminbi's inclusion in the currency basket if China was willing to make concessions on its exchange-rate regime. However, this initiative met with opposition, especially from the United States, which re-iterated that to be included in SDRs, currencies have to be widely traded and freely convertible.[38]

In any event, the renminbi's course to full internationalization and convertibility is unlikely to be plain sailing, and China will have to undertake major policy reforms on several fronts to achieve its objectives, notably the development of an institutional framework (legal, financial, accounting, etc.) that other countries have taken years to establish. Although it has begun the process of internationalizing the renminbi, and perhaps even turning it into one of the world's key international currencies, the challenges facing China's policy-makers are unprecedented in this regard.[39]

In theory, to achieve full convertibility China would typically need to remove the capital-account restrictions and the domestic financial controls that are currently in place. Adding to the challenge is the fact that China is the first country that will be attempting to internationalize its currency in the era of fiat money where there is not even a residual link between the reserve currency and gold. As a result, the renminbi will be forced to compete directly with the US dollar in the international arena, as opposed to establishing its credibility by comparing the convertibility of both currencies to gold. Building an international reputation for the renminbi, particularly when it is not fully convertible, means that making it widely accepted in those parts of the world where the US dollar dominates is likely to take many years (Subacchi, 2010).

Thus the dollar may be suffering from long-term weakness, but its role as an international currency is certainly far from over, while the prospects for another global currency to replace it in the near future are not bright. This could leave the door ajar for gold to play a more deliberately managed role supplementing the US dollar in the international monetary system – prompting the Taskforce to consider just how this might be achieved.

38 See Wiesmann, 'IMF urged to ease way for renminbi'.

39 For a provocative view of the rise of China in the longer term and its impact on the international monetary system see Subramanian (2011).

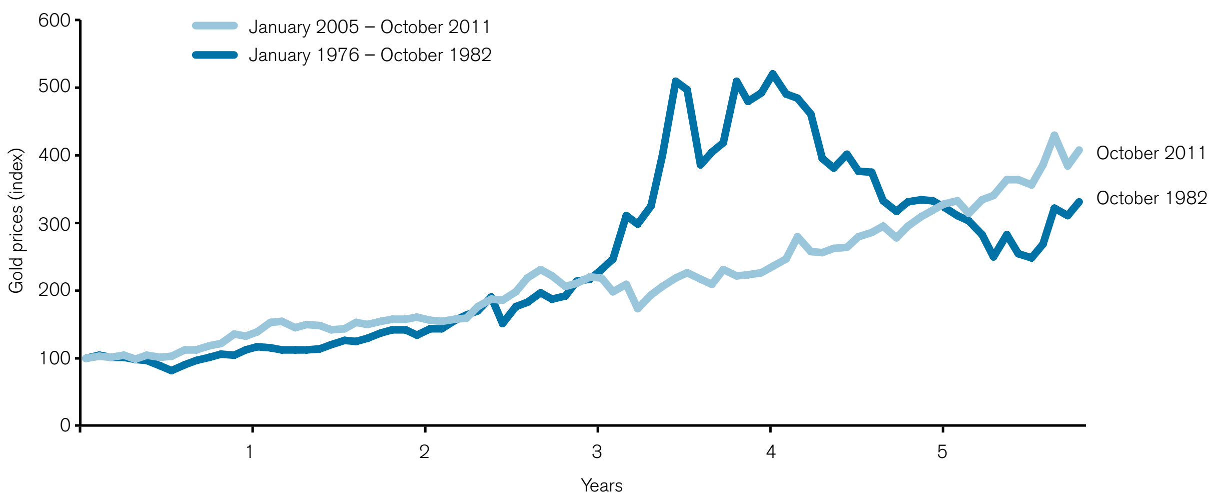
4. Is There a Role for Gold?

4.1 Benefits and costs of gold in the international monetary system

To serve as a currency, a commodity must meet several requirements: its physical characteristics have to be easy to define and it should be relatively immutable, but not to the extent that it cannot be purified in such a manner that it is acceptable as an asset. It also needs to be relatively rare. In this narrow sense, gold meets these criteria. Gold has the advantage that it is not degradable and also has the distinct benefit of not being any particular country's liability, thereby removing the risk of default versus fiat currencies. In addition to its physical characteristics enabling it to act as a medium of exchange, a store of value and a hedge against inflation of fiat currencies, its long-time historical role in the international monetary system during much of the 20th century has made gold an attractive choice of asset for a number of central banks and other financial institutions in times of monetary turmoil.

Gold becomes more attractive when the viability of the fiat money system comes into question, when inflation expectations are high or when exchange rates among the primary global currencies are particularly volatile. Today, all three of these preconditions are evident to a greater or lesser degree (although inflation expectations are still relatively low), and have helped drive up the price of gold to record levels (Schenk, 2011a). While the nominal price today is very high, the gold price has soared during episodes of uncertainty in the past, particularly in the period 1979–82. In this case the price subsequently fell sharply. The current market dynamic is compared with this previous episode in Figure 4.1, which shows that the current price rise is not yet as dramatic as the surge and collapse of 1979–82. Should market uncertainty recede, it is likely that the gold price will cease to climb so aggressively and it may even be reversed.

Figure 4.1: Monthly gold prices: Index Jan 1976 = 100, Index Jan 2005 = 100



Sources: IMF International Financial Statistics and Chatham House calculations.

One key argument for reintroducing gold in the international monetary system is that there is no default risk associated with bullion since it is not a liability of any particular government. This tends to insulate gold from vulnerability to any single country's economic policy, which is particularly relevant today when government liabilities are ballooning (Saidi and Scacciavillani, 2010). Furthermore, it helps to reduce the impact of the Triffin dilemma as reserves can be built up without forcing debt issuance on another country.

A second argument is that fixing the gold price of currency will exert discipline over the creation of money. By helping to promote price stability, gold discipline normally is able to keep inflation under control (so long as there are no sudden increases of supply) and also tends to inhibit reckless banking by restricting money supply growth. Unlike fixing an exchange rate to another national currency, the growth of the money supply is constrained by the growth of gold supplies rather than determined by the economic policies of the country issuing the numeraire currency. Indeed, perhaps one of the great virtues of the Gold Standard era (except for the period 1896–1914 when inflation emerged) was the long-term anti-inflationary impact that it provided, as the money supply could only grow at the rate at which the gold supply increased. On the other hand, as discussed earlier, the discipline that the Gold Standard imposed greatly undermined the flexibility required to react to crises – a major constraint – and the rigidity of the system forced countries down a very damaging deflationary path in the interwar period.

With these issues in mind, the Taskforce considered four frameworks for reintroducing an element of gold to improve the performance of the international monetary system. It assessed the role gold could play as an anchor; as a hedge or safe haven; as collateral or guarantee; and as a policy indicator. In addition, the Taskforce explored the possibility of including gold in an expanded SDR basket to determine whether SDRs could be transformed into an alternative global reserve currency, and it also examined to what extent digital gold could play a future role in an ever-evolving international monetary system (see case studies below).

A return to a Gold Standard, with its potentially deflationary bias, is widely thought to be unachievable, not least because the supporting conditions that existed during its heyday are not present today – a dominant economic philosophy favouring very limited government intervention, widespread restrictions on private capital movements, and a belief that floating exchange rates undermine international trade and domestic prosperity (Truman, 2010).[40] The power of central banks to set or manipulate the world gold price has also been eroded as the private gold market has grown relative to the amount of gold at the disposal of central banks.

Even a partial return to the Bretton Woods era is generally deemed to be unrealistic, or undesirable, in today's world as the United States and any other reserve currency country would be likely to resist the idea of submitting to the discipline of a fixed value of gold. Nonetheless, it is important to understand the increasingly informal role gold is once again playing in the current crisis as a hedge or safe haven.

To play an even more formal role as a hedge or safe haven it would be imperative that gold did not impose unacceptable constraints on national economic policies. For example, it is difficult to know whether the international monetary system would have performed better or worse in the present crisis if gold had been given a more formal role. Greater discipline on financial markets might have been helpful in inhibiting the reckless banking and excessive debt accumulation of the past decade. However, with the onset of the global crisis, had gold had a more formal role to play, the rigidity it imposes might also have been a handicap when a more flexible policy response was required.

4.2 Gold as an anchor

Part of the appeal of gold is the notion that it could serve once again as an anchor for the international monetary system. Undoubtedly, there are some clear advantages in fixing the gold base to the amount of money in circulation. For example, as a fixed monetary anchor, gold can help

40 For a detailed discussion on the Gold Standard see Bernanke and James (1991), Eichengreen (1992) and Bernanke (1995). The Gold Standard could also be inflationary if substantial new gold sources were to be discovered, as was the case, for example, following the gold discoveries of 1896.

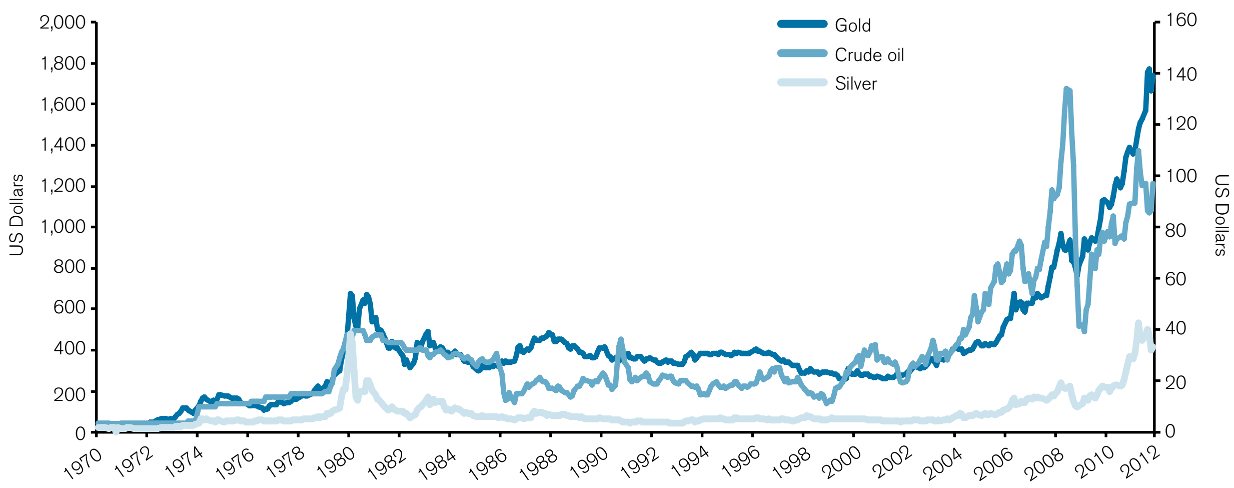
stem inflationary pressures, given that central banks are then unable to create unlimited quantities of paper money at will because of the limited supplies of gold.

Nonetheless, the adverse effects of using gold as an anchor far outweigh the benefits. Indeed, the Taskforce concluded that the prospect of gold making a comeback as an anchor to the international monetary system would be not only impractical but also highly damaging. Gold prices are volatile and no one, not even a central bank, is able to control them effectively. Although the demand for gold usually increases in periods of inflationary expectations or of economic uncertainty, it can also rise in response to speculation, so managing these dynamics to guarantee a fixed price of gold in a given currency such as the US dollar is almost impossible (Schenk, 2011a). Moreover, as gold prices, like those of other commodities, are often volatile, they are not necessarily a good counterweight against inflation (Figure 4.2). In fact, a serious drawback is that a gold anchor can become particularly unstable precisely when a stabilizing force is needed most. As gold prices tend to rise when inflationary expectations and/or other risks in the fiat monetary system increase, the gap between the reference price and the market price is likely to widen at times of uncertainty (Fosler, 2011a).

Adding to the challenge of using gold to anchor the international monetary system is the fact that gold is traded so extensively in the global financial markets. Indeed, a recent survey conducted by the London Bullion Market Association estimated daily trading volume at around $240bn.[41] This, coupled with the reality that the majority of gold is used in a fabricated form for jewellery, would make it extremely difficult for central banks to control its price. In effect, recognizing this fact is what led the Nixon administration to end the convertibility of gold through the Federal Reserve at the official fixed price in August 1971. Being unable to control the gold price in private markets, central banks cannot ensure a fixed price relationship between gold and a given currency. With only 34% of global gold stock held by central banks, and in the light of the unequal distribution of these gold reserves, no single central bank is in a position to defend a fixed price for gold in terms of domestic currency.

Although it is far from clear what is the 'right' price for gold, given the large volume of global money in circulation, the disadvantages of using bullion as a monetary anchor are clear: a return to a gold standard could inflate the price of gold significantly, while restrictions on money supply growth could provoke a severe downturn in the growth cycle of global economies (Goodburn, 2011).

Figure 4.2: Commodity prices (USD): Gold (LHS), silver (RHS) and crude oil (RHS)



Source: IMF International Financial Statistics.

41 http://www.lbma.org.uk/assets/Loco_London_Liquidity_Surveyrv.pdf.

Box 4.1: Are gold-laced SDRs the answer?

In assessing what role gold could play in reforming the international monetary system, the Taskforce turned its attention to SDRs in an attempt to build on the vast array of literature in recent years, including the analysis published in the March 2010 Chatham House report *Beyond the Dollar*.[a] That report included an ambitious proposal to enhance SDRs by including additional currencies in the currency basket and encouraging their wider use in international transactions, but it did not include a potential role for gold. The Taskforce therefore investigated to what extent gold-laced SDRs could play a useful role in the international monetary system.

The creation of the SDR was the culmination of almost a decade of discussion among the G10 and other members of the IMF in the 1960s. In the final analysis the members of the IMF could not agree whether it should supplement or replace the US dollar, and the terms of the SDR were quite opaque: it became a right to draw on the component convertible currencies rather than a currency in its own right. It was introduced just at a time when inflation and excessive international liquidity were the key problem, so issuing large amounts of new reserve assets was not possible. And in the end, the allocation of SDRs was very limited. Although SDRs never fulfilled the role for which they had originally been intended, they did survive, remaining very much on the sidelines as the international monetary system developed.

Today, SDRs function as a unit of account, and they also form a small part of national reserves of the international monetary system. After special allocations in the wake of the global crisis, in 2010 there were SDR 204bn in international reserves, comprising just 3.25% of global foreign-exchange reserves. The valuation of the SDR is based on a weighted basket of international currencies, chosen for their full convertibility with a market-determined exchange rate as well as their importance in international trade, financial flows and foreign-exchange reserves. The SDR basket is thus composed of four currencies: the US dollar (41.9%), the euro (37.4%), the British pound (11.3%) and the Japanese yen (9.4%), with the weights designed to reflect their relative importance in the international monetary system. By having the world's main currencies in such a basket, the intention was that it could be more stable over time than any one currency on its own – the stability of purchasing power being, after all, the *sine qua non* of a desirable reserve currency and unit of account (Julius, 2010).

In an increasingly multi-polar world in which the United States' relative economic share is gradually diminishing, reliance on a primary reserve currency exposes the world economy to greater financial instability and risks. Therefore, the development of a multi-currency system in the form of an expanded SDR, backed by the largest economies, could help provide much-needed financial stability to the international monetary system.

Because SDRs are subject to restrictions on their use, they would have to be adjusted in various ways to make them more attractive as a central bank reserve asset, as a store of value and as a means of exchange. Expanding the SDR basket of currencies to include the renminbi once it is fully convertible and those of leading developing economies would help make SDRs more representative in a multi-polar world. But other steps would also need to be taken to strengthen the case for making SDRs a viable candidate as an international reserve currency, notably by allowing private-sector transactions in SDRs and developing a credit market in SDRs. Last but not least, current IMF rules and regulations would also have to be modified – a move likely to trigger strong political opposition from some member states.

Another consideration is that if SDRs were to become a primary international reserve currency, their supply would need to be expanded or contracted continuously, taking into account key global macroeconomic variables such as GDP and trade levels, inflation, interest rates and unemployment. Such adjustments would be necessary to avoid periods when international liquidity is either excessive or inadequate, but this necessarily raises critical governance issues since the IMF is unlikely to be able to function effectively as a global central bank.

As things stand, the total stock of SDRs is not large enough to make any impact on the fundamental imbalances in the world economy or to provide a significant alternative to US dollar-denominated assets in central bank reserves. For the SDR to become an alternative reserve currency, not only would total issuance need to be greatly increased, but it would need to be liquid and marketable.

To develop a gold-laced SDR into a credible international reserve currency, however, would first require altering the IMF's Articles of Agreement: at present no country is able to base its currency on gold and the IMF is not allowed to use its gold reserves in this way. In effect, since SDRs are everyone's liability and gold is not part of any currency's base, bullion could not be made part of SDRs. Although modifying the Articles of Agreement may be achievable, it would no doubt take time to gain sufficient support from member countries to make such far-reaching changes to the IMF's rules and regulations.

Some gold proponents argue that a 'hard SDR' version would have to be created with additional backing and arrangements to become an alternative reserve currency (Saidi and Scacciavillani, 2010). This would involve creating a new SDR basket which included an asset, such as gold, whose value is largely uncorrelated with the value of fiat currencies. A 'hard SDR' in which gold would account for up to 25% of the basket would require a proportional adjustment in the actual weights and currency amounts of the dollar, the euro, the pound and the yen (Saidi and Scacciavillani, 2011).

However, as SDRs are a right to claim reserve currencies from IMF member countries, their utility depends on the willingness of Fund members to accept them. If they were 'gold-laced', the liability of the countries that undertake to provide US dollars and other leading currencies in exchange for SDRs would be dependent on the price of gold. The behavioural pattern of the price of gold means that such liabilities would increase in money value just at the time when they were hardest to meet. As a result, it is likely that the countries that provide liquidity to SDRs would resist the inclusion of gold in the basket, and their resistance would be decisive since they are essential to the functioning of the SDR scheme. In fact, a policy change of this nature involving gold would be likely to have the unintended consequence of undermining the willingness of countries to underwrite an expanded SDR basket.

Resistance to creating a gold-laced SDR, let alone a 'hard SDR', to rival the US dollar as a global reserve currency would no doubt be considerable, particularly among policy-makers in the United States. Although the Taskforce acknowledged that expanding the SDR basket could help strengthen the international monetary system as the transition to a multi-polar world leads to greater volatility, it concluded there was little available research that a gold-laced SDR would bring additional benefits.

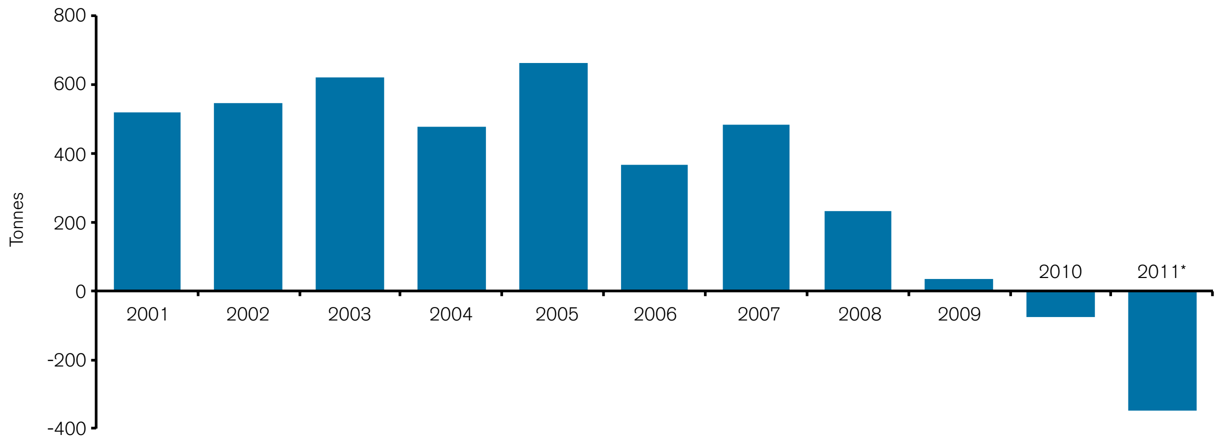
a For further details see Williamson (2009), Mateos y Lago et al. (2009) and Ocampo (2009).

4.3 Gold as a hedge or safe haven

The Taskforce also examined the role of gold as a hedge or a safe haven. Although gold has no formal position in the international monetary system today, it nonetheless continues to play an important role, constituting about 12% of international reserves. In recent years, that percentage has been rising, not only because the price of gold has increased, but also because central banks have become net buyers, rather than net sellers, of bullion. This trend continued in 2011, as Figure 4.3 shows.

The vast majority of this activity has been by the central banks of developing countries, which have traditionally held little or no gold in their foreign-exchange reserves. As Table 4.1 highlights, their gold holdings still account for a very small percentage of foreign-exchange reserves compared with many developed economies, even though a number of developing countries have been steadily accumulating gold reserves.

Figure 4.3: Net central bank gold sales



Source: GFMS.
*Q1–Q3 2011.

Nonetheless, the global stock of gold held as reserves by central banks (about $1.4trn, excluding the IMF and the Bank for International Settlements as of Q3 2011) is just a fraction (even at current prices) of today's global stock of money. According to recent money supply (M2) data (i.e. currency and deposits) released by the Federal Reserve, the stock of money in the United States alone totals about $9.7trn, or about seven times the global stock of gold reserves.

It is far from clear what proportion of gold is optimal in a central bank's reserve portfolio, as it will depend on a number of factors: the size of the reserves and their adequacy for daily needs; whether the country is a gold producer; the central bank's risk tolerance, confidence in fiat currencies and its views of future price movements. However, a consensus seems to be emerging among the newly asset-rich countries that having some bullion should increasingly become a key part of their long-term strategy.

Indeed, asset-rich central banks that have been buying gold see it as a useful way to diversify their holdings, reduce their exposure to US dollars and protect themselves against tail risks – really bad outcomes such as hyper-inflation or sovereign default – but there are other reasons as well. The traditional view of gold as the ultimate asset still carries weight and there is no default risk in holding gold. A key drawback of gold is that it generates no interest return, but if actively used, gold reserves can generate positive returns in a rising market. Indeed, a number of central banks in search of higher returns have engaged in gold lending, gold swaps and collateralized borrowing.

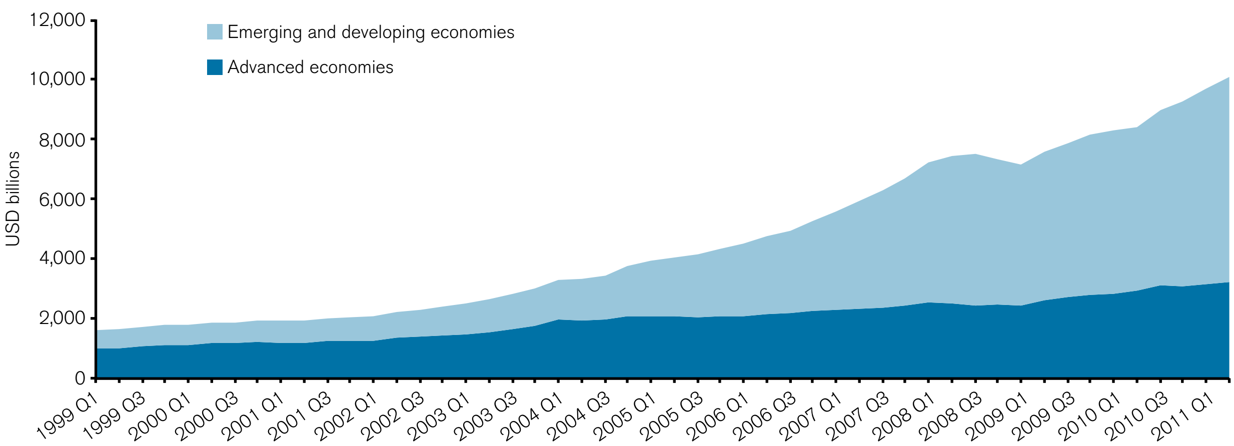
In the past few years, there has been a tangible shift in the behaviour of central banks when it comes to managing their reserves. At present, as noted above, the dollar is still the primary reserve currency, with the euro, the yen and the pound all considered less attractive options, and the renminbi still to achieve full convertibility. However, a persistent dissatisfaction with the ability of the dollar to maintain its value has led to some diversification. In the past decade, there has been an enormous accumulation in foreign-exchange reserves, which has coincided with a dramatic shift in the balance held by developed and developing countries. Whereas in 2000 reserves held by developed economies ($1.2trn) were almost double those of emerging-market economies ($0.7trn), by the first quarter of 2010 the reverse had become true, with the latter having accumulated $5.5trn, compared with just $2.8trn in the developed world. Since then, as Figure 4.4 demonstrates, central banks have continued to stockpile foreign-exchange reserves, with the total rising to an estimated $10trn in 2011, including about $3.2trn by China alone.

Table 4.1: Gold holdings and forex reserves, Quarter 2, 2011

Country	GDP (USD millions)	Gold (tonnes)	Gold (USD millions)	FX reserves (USD millions)	Total reserves (USD millions)	Gold as a share of total reserves (%)	Gold as a share of GDP (%)	Total reserves as a share of GDP (%)
United States	14526550	8133.5	393686.6	136,618.9	530,305.5	74.2	2.7	3.7
China	5878257	1054.1	51021.4	3,219,760.5	3,270,781.9	1.6	0.9	55.6
Japan	5458797	765.2	37039.0	1,100,758.8	1,137,797.8	3.3	0.7	20.8
Germany	3286451	3401.0	164617.4	66,004.6	230,622.0	71.4	5.0	7.0
France	2562742	2435.4	117882.2	60,253.3	178,135.4	66.2	4.6	7.0
United Kingdom	2250209	310.3	15017.4	79,662.6	94,680.0	15.9	0.7	4.2
Brazil	2090314	33.6	1626.6	334,143.7	335,770.4	0.5	0.1	16.1
Italy	2055114	2451.8	118677.1	48,090.7	166,767.8	71.2	5.8	8.1
India	1631970	557.7	26996.8	291,724.5	318,721.2	8.5	1.7	19.5
Canada	1577040	3.4	164.1	62,324.1	62,488.2	0.3	0.0	4.0
Russia	1479825	836.7	40499.5	484,004.5	524,503.9	7.7	2.7	35.4
Spain	1409946	281.6	13630.8	20,268.1	33,898.9	40.2	1.0	2.4
Australia	1237363	79.9	3865.2	40,318.5	44,183.7	8.7	0.3	3.6
Mexico	1034308	105.9	5124.9	128,767.6	133,892.4	3.8	0.5	12.9
Korea	1014482	39.4	1908.9	309,454.9	311,363.8	0.6	0.2	30.7
Netherlands	780668	612.5	29644.8	20,712.6	50,357.4	58.9	3.8	6.5
Turkey	735487	116.1	5619.8	93,737.1	99,356.9	5.7	0.8	13.5
Indonesia	706752	73.1	3537.9	116,130.2	119,668.2	3.0	0.5	16.9
Switzerland	527920	1040.1	50342.9	240,063.8	290,406.7	17.3	9.5	55.0
Poland	469401	102.9	4981.6	104,138.7	109,120.3	4.6	1.1	23.2
Belgium	467779	227.5	11011.2	17,825.3	28,836.5	38.2	2.4	6.2
Sweden	458725	125.7	6085.4	44,844.3	50,929.7	11.9	1.3	11.1
Saudi Arabia	448360	322.9	15629.6	496,859.0	512,488.6	3.0	3.5	114.3
China, Taiwan	429845	423.6	20504.9	398,603.3	419,108.2	4.9	4.8	97.5

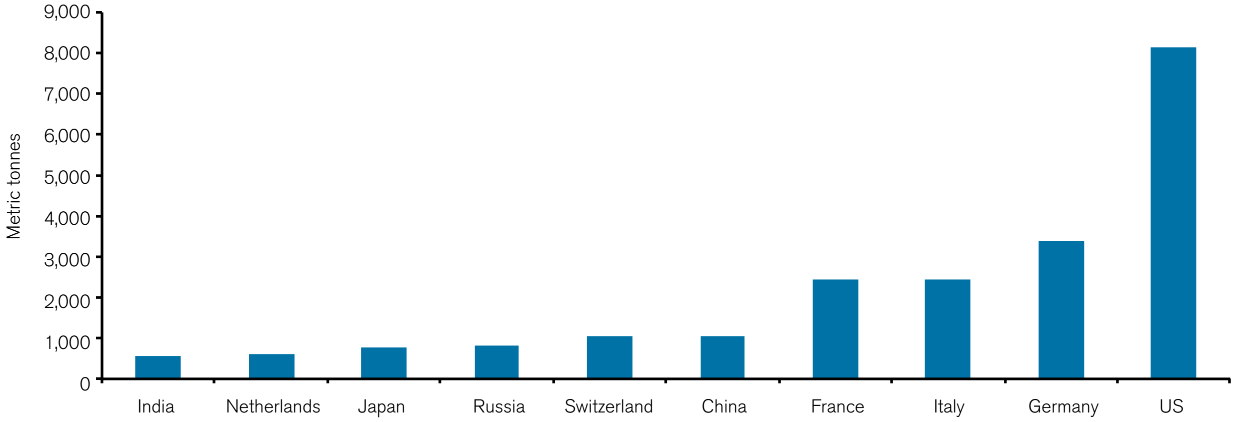
Sources: IMF, World Gold Council and Chatham House calculations.

Figure 4.4: Foreign-exchange reserves of advanced and developing economies



Source: IMF, Currency Composition of Official Foreign Exchange Reserves (COFER).

Figure 4.5: Gold reserves by country, Quarter 2, 2011

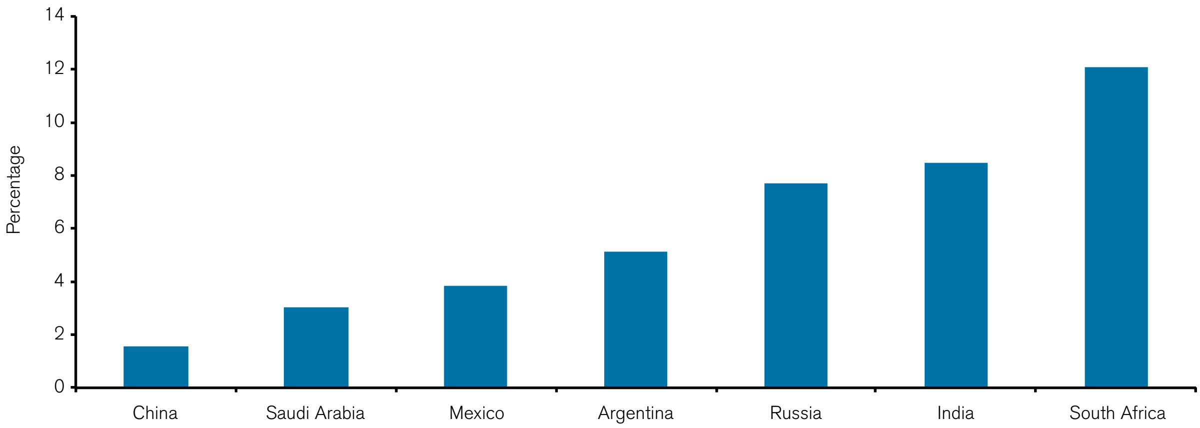


Source: World Gold Council.

Gold, however, has continued to form an important proportion of the foreign reserves of several major developed economies. The United States holds by far the most gold of any nation, as Figure 4.5 shows, with 8,134 metric tonnes out of a world total of 30,717 metric tonnes, which amounts to 74% of its total foreign reserves. But a number of other developed countries have also maintained the lion's share of their reserves in gold, including Germany with 3,401 metric tonnes (71%), Italy with 2,452 metric tonnes (71%) and France with 2,435 metric tonnes (66%). This reflects statutory requirements as well as the legacy of the Bretton Woods era.

Leading developing and emerging-market economies such as China (1.6%), India (8.5%) and Russia (7.7%) hold only a small proportion of gold in their reserves, but they have significantly increased the size of their holdings in the past decade as their total reserves have increased. Since the onset of the financial crisis, the central banks of some smaller emerging markets including Sri Lanka, Mauritius and Bangladesh also have significantly increased their purchases of gold. Both Sri Lanka and Mauritius have more than quadrupled their gold holdings since mid-2007 and in the case of Bangladesh, the rise has been nearly nine-fold.[42] Indeed, in a number of developing countries, gold is starting to play a more important role in their reserve management strategies – even under a system built on fiat money (see Figure 4.6).

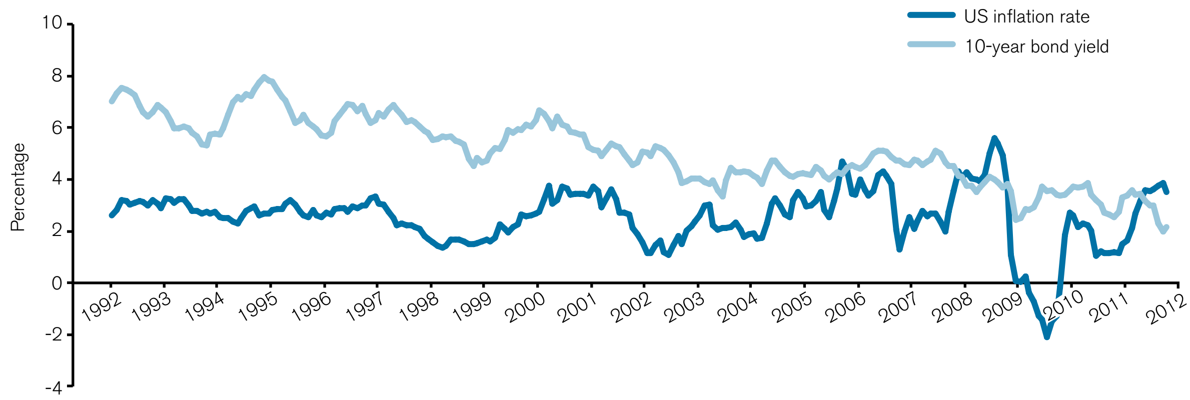
Figure 4.6: Gold as % of reserves, Quarter 2, 2011



Source: World Gold Council.

42 Data from World Gold Council (October 2011).

Figure 4.7: 10-year bond yields and inflation

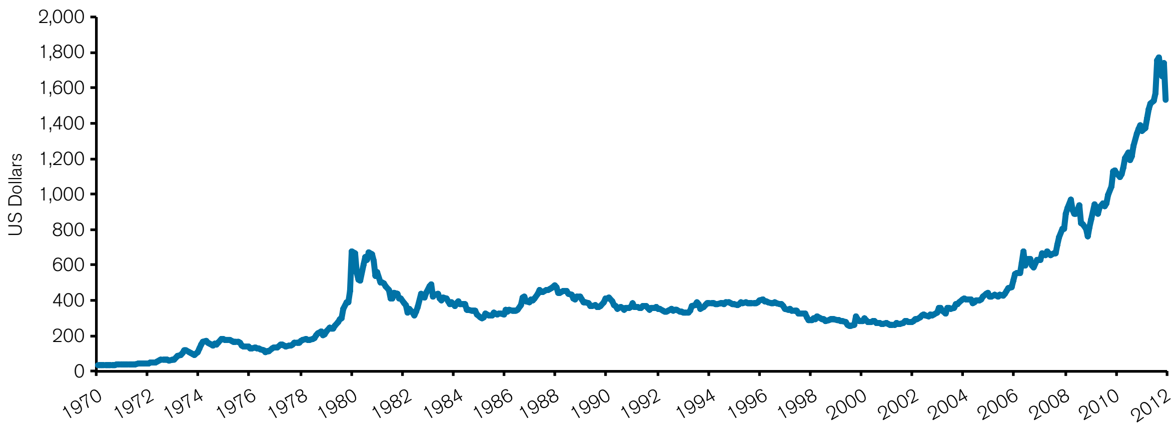


Source: US Bureau of Labor Statistics and Federal Reserve.

In times of recent economic turmoil, most central banks have held onto their gold reserves and in some cases increased them, even when the price of bullion has soared, in order to diversify their reserves and provide a hedge against currency depreciation. The price level and demand for gold may indicate the extent to which markets perceive bullion as an insurance against tail risks. In this narrow sense, it might be possible for gold to play a more formal role in the international monetary system as a proxy indicator of global economic overheating or as an early warning of recession, in similar fashion to the way benchmark 10-year US bond yields serve as a predictor of future inflation (see Figure 4.7). If so, reserve currency providers such as the United States would then have to pay greater attention to the behaviour of the gold market in formulating their monetary and fiscal policies.

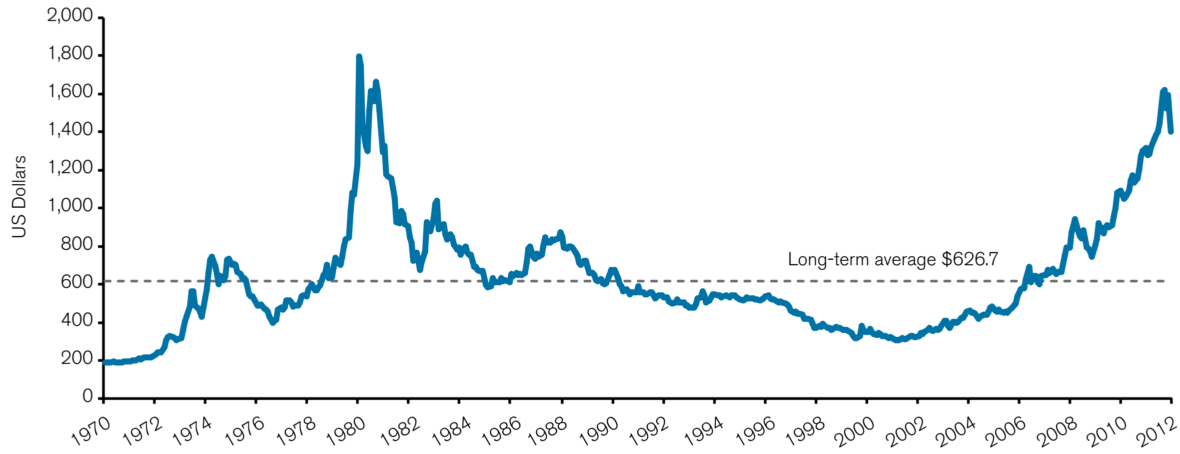
Since the financial crisis, gold has become an even more attractive investment option among private investors, with investment demand in gold virtually doubling in 2008 from the previous year. Its safe-haven properties have added to its appeal and led to a surge in its price. The sharp rise in the price of gold from $279/oz at end-2001 to a peak of $1,900/oz in early September 2011 (before settling at around $1,750/oz by end-January 2012) has become a story in itself. But much of this sharp increase has taken place since mid-2007, when the price of gold was still hovering well short of $700/oz, as Figure 4.8 highlights. This rise reflected market concerns as the financial crisis broke, followed by the lingering sovereign debt woes of the eurozone.

Figure 4.8: Monthly evolution of gold prices



Source: IMF International Financial Statistics.

Figure 4.9: Monthly evolution of gold prices (real, 2007 dollars)



Source: IMF International Financial Statistics, US Bureau of Labor Statistics and Chatham House calculations.

One widely held argument for a renewed role for gold in the international monetary system is that its counter-cyclical qualities can serve as a hedge against specific risks, such as bouts of inflation or financial contagion. The Taskforce, however, was not convinced and found that there are also times when its usefulness as a hedge is rather limited and that its counter-cyclical qualities are inconsistent over time and across asset classes (Kendall, 2011).

Gold's traditional role as a hedge is reflected by the behaviour of investors who have flocked to gold in search of a safe haven, notably as a hedge against declining values of the US dollar and other key fiat currencies. The dramatic rise in price has also drawn in speculators looking for a quicker return. As the Chairman of the Federal Reserve, Ben Bernanke, said at a Congressional hearing in July 2011, 'I think the reason people hold gold is as protection against what we call "tail risk" – really, really bad outcomes. To the extent that the last few years have made people more worried about the potential of a major crisis, then they have gold as a protection.'[43]

Gold will therefore continue to be an attractive asset even when particular paper assets have lost value. However, the drawback is that its price tends to be highly volatile compared with other reserve assets and it generates no yield (other than capital gains, which are only realized when it is sold). It can therefore have some utility in a portfolio of assets by spreading valuation risk, but at the same time it would not be very effective as a sole reserve asset.

Box 4.2: Digital gold currency

The search for new means of payment, spearheaded by advances in technology, led to a flurry of activity in the field of digital gold currency in the late 1990s. Since then, however, the track record of digital gold, a form of electronic money based on ounces of gold enabling users to pay each other in units that hold the same value as bullion, has been – to say the least – a mixed success.

Digital gold advocates claim that it offers a truly global and borderless world currency system which is independent of exchange-rate variations and political manipulation. Unlike fractional reserve banking (where

43 See Capie et al. (2005) and Sommer J., 'In a Gold Lovefest, Shades of 1980', *New York Times*, 23 July 2011.

banks maintain reserves that are only a fraction of the customers' deposits), digital gold schemes hold 100% of clients' funds in reserve as gold or other precious metals which can then be exchanged via digital certificates. Digital gold proponents also claim that deposits are protected against inflation, devaluation and other risks inherent in fiat currencies, but the industry has had its share of problems. Several digital gold companies such as OS-Gold, Standard Reserve and INTGold were launched and failed between 1999 and 2004, while in 2007 the United States Department of Justice indicted the proprietors of one prominent firm, e-gold Ltd., on four counts of violating money-laundering regulations, before it was forced to suspend all operations in 2009.

Although the digital gold industry is certainly not alone in the financial services arena to suffer from similar problems, such setbacks have raised serious doubts about this sector's ability to establish itself as a nascent but potentially credible alternative to fiat currencies. Nonetheless, at a time when there are heightened concerns about the effectiveness of the international monetary system, and growing risks of recession and deflation, this could be an opportunity for non-state money to develop. Despite an inauspicious start, digital gold currency could be well placed to benefit from further advances in technology and innovation.

The technological development that has facilitated electronic payments was the GSM technology that allowed the creation of a network covering all mobile phone users in the world. With handset compatibility, digital value could now be transferred from one phone to the other. But to evolve as money, digital gold's marginal cost of acquiring information would need to fall. Indeed, paper money took root as a means of lowering transaction costs and it would be essential for digital gold to lower these costs still further.

For digital gold currency to become more widely established and to be considered a viable alternative not only to fiat currencies but to fiat electronic currencies as well, its design must possess all the features of a secure means-of-payment system. The inclusion of gold has given the system a degree of credibility, and in a practical sense digital gold currency has many of the attributes that are required, starting with acceptability and portability. It also has the advantage that it is divisible, allowing transactions of any value to take place, and its homogeneity is important in order to avoid confusion. Moreover, digital gold currency offers recognizability, ensuring there is no need for special expertise in identifying the money, while advances in cryptography can make digital gold very difficult to forge.

However, being a non-fractional reserve system is a limitation, notably its inherent lack of liquidity. Therefore, a precondition for extending the popularity of a digital gold currency is a growth in confidence among users to the point where they would be prepared to accept a form of fractional reserve system whereby some fraction of the gold stored serves as backing for a much larger payment service. To boost confidence in the system, particularly in the light of the fraudulent activities of some in the industry, as well as other risks such as data security, the Global Digital Currency Association – a non-profit association of online currency operators, exchangers, merchants and users – was established in 2002. This was the industry's first attempt at self-regulation, but the results so far have been underwhelming.

To transform digital gold from a niche market to one that achieves wider acceptability, an independent central settlement agency or clearing house would need to be created to standardize the different digital gold schemes and help play a key regulatory role. Otherwise, it is difficult to see how digital gold could ever challenge the position of traditional fiat currencies, even at a time when their effectiveness in the international monetary system is being openly questioned.

4.4 Gold as collateral

In the wake of the European sovereign debt crisis and the rapidly declining value of high-quality collateral, a growing number of clearing houses and financial institutions have begun using gold as collateral to back transactions processed through them by traders. With investors increasingly perceiving gold as a safe haven asset in the face of severe market turmoil, several clearing houses such as LCH.Clearnet, CME Group, and IntercontinentalExchange – which typically use cash and government bonds as security – have introduced the use of bullion in recent years. An interview with a clearing house revealed its reasoning for gold's inclusion as an acceptable collateral source was twofold: to diversify their own collateral pool, and customer demand from gold holders who wanted to make use of their gold while still maintaining their long position.[44]

Likewise, JPMorgan has begun accepting gold to satisfy collateral requirements in repo transactions, which would allow banks to use bullion as security when lending to each other. Banks have also begun charging more for storing gold, reflecting the enormous surge in demand for assets that are seen as safe. In the UK, almost all the bullion-dealing banks raised their fees in 2011, in some cases more than doubling the rates they charge for vaulting gold, as storage space was put at a premium. Much of the growing demand came from exchange traded funds (ETFs), which collectively now hold more gold than most central banks.

The Bank for International Settlements (BIS), the so-called 'bank for central banks', has also been more involved in the gold market in the past two years. In 2011, gold reserves of the BIS increased abruptly and significantly, just as the European debt crisis began. The BIS did not disclose why its reserves increased beyond stating they were part of some customer swaps. However media reports and discussions with bullion banks suggested that troubled commercial banks were swapping gold with the BIS' central bank customers to raise cheaper funding at the beginning of the European sovereign debt crisis. For central banks this was a way to lend cash against a high-quality collateral like gold. More recently, BIS data revealed that central banks withdrew 635 metric tonnes of gold in the year to end-March 2011. This represented the largest withdrawal of gold in more than a decade, prompting the BIS to acknowledge that the fall in the value of gold deposits reflected 'a shift in customer gold holdings away from the BIS'.[45]

It is somewhat uncertain whether these two actions were related in central banks making more active use of their gold holdings. While elevated credit risks and increasing concerns about tail risks have increased the usage of gold amongst central banks and by a growing number of exchanges, the Taskforce found limited research that would indicate that gold can play a more official role than it already does, as collateral in the international monetary system.

4.5 Gold as a policy indicator

The jury is still out on whether gold could play an even more significant role in the international monetary system by serving, for example, as a policy indicator or trigger for decision-making. The price of gold tends to rise whenever there are signs of disorder in the fiat money-based international monetary system, but the Taskforce concluded that the extent to which it could be used by decision-makers as a signal for policy changes is questionable.

The historical behaviour of the gold price does not provide a particularly good indicator for monetary and fiscal policy (see Table 4.2). Gold correctly indicated that the United States needed tighter monetary policy in the 1960s and in the late 1970s (actually, the price peaked in January 1980, a few months after the crucial tightening of US monetary policy had been initiated). However, the price fall of about one-third between 1996 and 2001 did not foreshadow a period of weak growth and any need for policy easing. In fact, US fiscal policy was tightened sharply over that period, and there were budgetary surpluses in 1999 and 2000, without any apparent damage to the US economy. Even more recently, the rise in the gold price since the onset of the financial crisis in 2007 would have been thought by policy-makers to indicate a need for tighter policies which, if implemented, could have been deeply damaging.

44 "Gold as a Source of Collateral", World Gold Council, 2011.

45 Farchy J., 'Central banks pull most gold bullion in a decade from BIS', *Financial Times*, 8 July 2011.

Table 4.2: Has gold influenced policy?

Time period	Episode	What did it indicate?	Did it influence policy?
1960s	US gold losses	Concern about US external deficit. Tighter US monetary and fiscal policy.	No. Bretton Woods collapsed.
1979–80	Price rise	Concern about inflation. Tighter monetary policy.	No. Monetary policy was tightened, but not because of gold.
Early 2000s	Price fall	Confidence about inflation and outlook for growth.	No.
2007–11	Price rise	Concern about bank solvency and US deficit.	No.

Source: Allen (2011).

Some gold analysts argue that bullion prices are a good proxy for key macroeconomic variables, and therefore should be preferred as an indicator or measure of global economic overheating or underperformance. The Taskforce did find that in certain periods gold prices correlated to some of these events; and they also found a correlation at certain times with other commodity prices. However, neither gold nor commodity prices more broadly appeared particularly effective as economic indicators. Nor did gold prices correlate closely with a host of typical leading indicators, such as industrial output and real GDP growth, inflation rates, global trade volumes, housing starts, consumer and business confidence surveys or stock market prices. Therefore, in terms of using gold price movements as an indicator on how to adjust liquidity in the international monetary system, gold was rarely found to be a good proxy for key macroeconomic indicators to support such decisions.

5. Taskforce Conclusions

The debate on how to address the myriad challenges facing the international monetary system often evokes strong emotions across the policy spectrum, but even sharper reactions are usually triggered when gold finds its way into the discussion. The Chatham House Taskforce, therefore, was mindful to take a step back from the hype, working hard to keep an open-minded approach in its deliberations while carrying out a thorough examination of the role gold already plays or could play once again in an ever more complex international monetary system.

Not since the 1982 US Commission on the Role of Gold in the Domestic and International Monetary Systems had a prominent policy group of experts made a serious and extensive assessment of bullion and the monetary system. At the time, the Commission concluded that the flexibility of the post-Bretton Woods era was preferable to endorsing a formal role for gold. Likewise, the Chatham House Taskforce stopped short of making specific proposals or recommendations regarding a potential comeback for gold in the international monetary system, but its in-depth discussions and written contributions spanning an eight-month period nonetheless generated thought-provoking and innovative perspectives,[46] from which a number of key conclusions emerged.

- The current financial crisis has highlighted the urgency of addressing deficiencies in the international monetary system in order to get the world economy back on track and create a framework for greater financial stability in the future, and with it the restoration of sustained economic growth. In the light of the long-term weakness of the US dollar, the Taskforce explored whether gold could again serve as an anchor to back the value of the primary reserve currency, particularly in times of crisis. Drawing on the lessons of the Gold Standard era and the Bretton Woods experience, the Taskforce concluded that the reintroduction of gold as an anchor would not only be impractical; it could even be damaging, given its deflationary bias.
- There is no clear-cut role for gold as a policy indicator, despite what some gold analysts believe. Indeed, the historical behaviour of the gold price does not provide a particularly good indicator for either monetary or fiscal policy. In fact, since the financial crisis, the rise in the gold price has indicated the need for tighter policies which, had they been implemented, could have been deeply damaging. To an extent, gold does play a limited indicator role today since the price rise reflects a lack of market confidence in the future value of key currencies and the low return on other financial assets. But the Taskforce found no consistent and reliable correlation between bullion and a host of key economic variables that could be used to inform policy decision-making. As a general guide for adjusting liquidity in the international monetary system, therefore, gold was not found to be a good proxy for key macroeconomic indicators.
- Since the onset of the financial crisis, gold has been propelled into the spotlight, with both central banks and investors viewing bullion as a hedge against specific risks such as inflation and financial contagion, and as a store of value. Gold has indeed served as a useful hedge against declining values of the US dollar and other key fiat currencies, and it has become an element in central banks' quest for foreign reserves diversification. But its role as a hedge comes at a cost. Gold will continue to be a valuable asset even when particular paper assets have lost value; however, the

46 See Chatham House website for published Taskforce papers: http://www.chathamhouse.org/research/international-economics/current-projects/gold-and-international-monetary-system..

disadvantage is that its price is often quite volatile compared with other reserve assets and it generates no yield. It can therefore have some utility in a portfolio of assets by spreading valuation risk but, on the other hand, it would not be very effective as a sole reserve asset.

- Although an intriguing idea was considered by the Taskforce – to expand the IMF's SDRs basket to include gold – the proposal failed to convince most members of the group that this would actually bolster the international monetary system. In future, adding currencies from key developing countries, such as China, was thought to be desirable by many Taskforce members to better reflect their growing importance in the world economy. But the Taskforce found little evidence that also including gold in the basket would bring substantial benefits and, on the contrary, concluded that it might actually be an obstacle to reform.
- In the transition to an increasingly multi-polar world in which interdependence is the norm and the United States' hegemony is steadily being challenged, the global economy is likely to face periods of volatility and uncertainty. Gold can thus be expected to continue playing a significant role in the international monetary system, serving as a valuable hedge and safe haven, particularly in times when tail risks predominate.
- For gold to play a more formal role in the international monetary system, it would be imperative for it neither to hamper the system's performance nor to create unacceptable constraints on national economic policies. The discipline imposed by a gold standard on monetary policy might have served as a brake on the imprudent banking and massive debt accumulation of the past decade, but it is likely that the inflexibility of a fixed price for gold would have been a serious drawback with the onset of the financial crisis when a far more flexible monetary response was required.

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Appendix 1: About the Taskforce Members

Bill Allen is a visiting senior fellow at the Faculty of Finance, Cass Business School, City University London and a specialist adviser to the House of Commons Treasury committee. He was educated at Oxford University and the London School of Economics. From 1972 to 2003, he worked at the Bank of England, including as Head of Money Market Operations Division, Head of Foreign Exchange Division, Deputy Director, Monetary Analysis, Deputy Director, Financial Market Operations, and finally (2002–03) as Director for Europe and Deputy Director for Financial Stability. Since 1990, he has provided technical assistance to emerging countries including Poland, Korea, South Africa, Turkey, Syria and Thailand, and has advised the Russian Ministry of Finance.

Forrest Capie is Emeritus Professor at the CASS Business School, City University, London, where he was Professor of Economic History (1986–2009), Head of the Department of Banking and Finance (1989–92), and Editor of the Economic History Review (1993–99). He has been a British Academy Overseas Fellow at the National Bureau, New York (1978), a Visiting Professor at the University of Aix-Marseille (1977) and at the London School of Economics (1992–93), and a Visiting Scholar at the IMF (2000). He has written widely on money, banking, and trade and commercial policy. He was a member of the Shadow Chancellor's advisory panel (1999–2005), and is currently a member of the Academic Advisory Council of the Institute of Economic Affairs, on the Council of the Taxpayers Alliance, and an Academician of the Academy of Social Sciences. Between 2004 and 2010 he was on secondment at the Bank of England, writing the latest instalment of their history, from the 1950s to 1980.

Meghnad Desai is Emeritus Professor of Economics at the London School of Economics. He is an Indian-born British economist and a serving member of the House of Lords for the Labour party. He received his PhD from the University of Pennsylvania and has written extensively on a wide range of subjects. From 1984 to1991, he was co-editor of the *Journal of Applied Economics*. He has been both Chair and President of Islington South and Finsbury Constituency Labour Party in London and was made a life peer as Baron Desai, of St Clement Danes in the City of Westminster, in April 1991. In 2005 he retired as Director of the Centre for the Study of Global Governance, which he founded in 1992 at the LSE. He was Chairman of Training for Life, Chairman of the Management Board of City Roads and on the Board of *Tribune* magazine. He is an Honorary Associate of the National Secular Society.

Gail D. Fosler is President of the GailFosler Group LLC, a strategic advisory service providing in-depth analysis of economic, financial and public policy issues and creating new concepts and frameworks for business and government leaders. She is also Senior Advisor to the Business Council, and leads its partnership with the Conference Board. She was educated at the University of Southern California and gained her MBA at New York University. During her 20-year career at the Conference Board, of which she is a former President and a Trustee, she held a number of leadership roles dedicated to expanding the organization's intellectual capacity and global expansion. As Executive Vice President and Chief Economist, she directed its economics programme, and was twice named America's most accurate economic forecaster by *The Wall Street Journal*. She served as Deputy Staff Director and Chief Economist of the US Senate Budget Committee and is a board member of Baxter International and Swiss Re America Holdings.

Haihong Gao is a professor and director of the Section of International Finance, and director of the Research Center for International Finance, Institute of World Economics and Politics, Chinese Academy of Social Sciences (CASS). She is the standing director of the council of the China Society for Finance and Banking, on the council of the China Society of World Economy and director of the council of the China International Finance Society. Educated at Peking and Durham Universities, whe was a visiting scholar at the University of California at Davis, under the Ford Foundation Scholarship, and a past recipient of the British Council Scholarship and the World Bank Youth Fellowship. Her recent publications include *Globalization and China: Theory and Trends* (with Yu Yonding and Lu Aiguo); *Conditions for the RMB to become an International Currency* (with Yu Yongding); *Global Dollar Standard: Challenges for Asian Financial Integration* (edited); and *The RMB Exchange Rate: Policy Options and Risk Prevention from Global Perspective.*

John Gault is the President of John Gault SA, and served as Managing Director, IED Consultants SA and Chief Economist of the International Energy Development Corporation (IEDC) group, now part of Kuwait Petroleum Corporation. Prior to joining IEDC in Geneva in 1982, he was affiliated with the Boston-based energy-consulting firm of Jensen Associates, Inc. In a career spanning more than thirty years, Dr Gault has advised clients in the Middle East, Europe, Japan, and North and South America on a wide variety of commercial and public policy issues. A graduate of Yale and Harvard Universities, he has taught economics at the American University of Beirut and Bir Zeit University (West Bank), and is the author of numerous publications concerning taxation and fiscal systems, government price regulation, the economics of exhaustible resources, the politics of international oil trade, and methods of designing appropriate contractual terms.

Gerard Lyons is the Chief Economist and Group Head of Global Research at Standard Chartered, and an Economic Advisor to the Board and a Member of the Bank's Executive Forum. Previous roles at the Bank include Member of the Global Markets Management Team and of the Risk Management Committee. He previously held senior roles at leading international financial firms. He is a member of numerous panels and committees, including the Panel of Economic Advisors to the Mayor of London and the World Economic Forum's Global Agenda Council on Banking and Capital Markets. He is a Fellow of the Society of Business Economists and on the council of the Royal Economic Society, and a member of the European Commission's 'informal network of leading China experts'. He publishes widely on economic and financial issues, including regular newspaper columns, and is the author of 'The Qatar 2020 Report', and co-author of the 'Report of the Commission on the £ Sterling'. He has twice topped the *Sunday Times* annual forecasting table.

Catherine Schenk is Professor of International Economic History at the University of Glasgow. She has been visiting professor at Hong Kong University and visiting research fellow at the International Monetary Fund and the Hong Kong Institute for Monetary Research. She has published widely on international economic relations including the development of international financial centres, the role of Hong Kong in the international banking and financial system and the development of the international monetary system from 1945. Her most recent works are *The Decline of Sterling 1945-92* (Cambridge University Press, 2010) and *International Economic Relations since 1945* (Routledge, 2011). Her current project is on the development of international banking regulation since the 1960s.

Paola Subacchi is Research Director, International Economics at Chatham House. Her main research interest is in the functioning and governance of the international financial and monetary system, with a particular focus on post-crisis policy and institutional change. She is a contributor to peer-reviewed journals and current affairs publications and a regular media commentator on issues of macro-economic importance. Recent publications include *The Euro on the Brink: 'Multiple' Crises and Complex Solutions* (January 2012); *Legitimacy vs Effectiveness: A Dynamic Approach to Global Governance* (September 2011); *Preventing Crises and Promoting Economic Growth* (April 2011, co-authored with Paul Jenkins); *'One Currency, Two Systems': China's Renminbi Strategy*

(October 2010); *Who Controls the International Monetary System?* (May 2010); *Beyond the Dollar: Rethinking the International Monetary System* (March 2010); An Italian national, she studied at Bocconi University in Milan and at the University of Oxford.

Michael Wong is the Chairman of CTRISKS, a credit rating agency licensed under the Securities and Futures Ordinance in Hong Kong. He is widely recognized as a Basel III expert in Asia and is a professor in bank risk management at the City University of Hong Kong, where he was granted a university-wide Teaching Excellence Award. Dr Wong served as a founding member of the FRM Committee of Global Association of Risk Professionals (GARP) in 1998–2002 and helped develop the examination to be a global standard on risk management education. Before his career in academic research and credit rating, he worked in investment banking for more than seven years, heading gold and forex trading. He has published more than 40 journal articles and authored/co-authored 12 professional books. He is a graduate of the University of Cambridge, University of Essex and Chinese University of Hong Kong.

Rapporteur

André Astrow is Director of A&W Consultants (UK) Ltd. His main areas of expertise and research interest are in the global economy, sovereign risk and African affairs. A political scientist by training, he worked for 20 years at the Economist Intelligence Unit (EIU). He led the EIU's Country Analysis division of economists and editors, producing analysis and forecasts on more than 200 countries. He was also responsible for its Country Risk Service and served for many years as the Regional Director for Africa. Before joining the EIU, he was assistant editor of Africa Report magazine at the African-American Institute in New York. He has written extensively on African countries, was awarded a PhD in Interdisciplinary Studies at the University of Kent at Canterbury, and published a book, Zimbabwe: *A Revolution that Lost its Way?* (Zed Press, 1983).

Appendix 2: Taskforce Meeting Agendas

Chatham House Taskforce on Gold and the International Monetary System

Thursday 14 April 2011, 0800–1030
The University Club of Washington DC
1135 Sixteenth Street, NW, Washington, DC 20036

The main purpose of the meeting is to provide a forum for the discussion, dialogue and conversation on strengths and weaknesses of the current international monetary system and dialogue on whether, given market properties of gold, there is a potential role for gold in response to the following weaknesses in the international monetary system: reserve accumulation, beyond the traditional motives for holding reserves; exchange rate volatility in the international monetary system; uncertainty about the availability of international liquidity in a financial crisis; large and volatile capital flows; persistent global imbalances; absence of good substitutes to the US dollar as a reserve asset. In particular, we hope to discuss issues around the SDR's potential development in the international monetary system, and whether there should be a role for gold in the SDR.

Dr Paula Subacchi, Chatham House: Opening Remarks
Richard Varghese, Chatham House: The return of the 'gold debate', problems with the international monetary system, and the terms of reference of the Chatham House Taskforce

Participants

Irena Asmundson, Policy and Strategy Department, IMF
Wayne Atwell, Managing Director, Casimir Capital
Ashish Bhatia, Government Affairs, World Gold Council
John Bridges, Managing Director, JP Morgan
Lord Desai, Professor Emeritus, London School of Economics
Sean Fieler, Equinox Investment Partners and Chairman of the American Principles Project
Gail Fosler, President, The Gail Fosler Group LLC
Haihong Gao, Senior Fellow, Director of Research Section of International Finance, IWEP, Chinese Academy of Social Sciences*
John Gault, President, John Gault S.A. Geneva*
Nick Maxwell, International Economics Programme and Outreach Manager, Chatham House
George Milling-Stanley, Managing Director, Government Affairs, World Gold Council
John D. Mueller, Director of the Economics and Ethics Program of the Ethics and Public Policy Center
Rebecca Nelson, US Congressional Research Service
Vincent R. Reinhart, Resident Scholar, American Enterprise Institute
Dr Nasser H. Saidi, Chief Economist and Head of External Relations at the Dubai International Financial Centre Authority (DIFCA)*
Dr Paola Subacchi, Research Director, International Economics, Chatham House
Richard Varghese, International Economics Research Assistant, Chatham House

* Participation via teleconference.

Chatham House Taskforce on Gold and the International Monetary System

International Economics Roundtable Discussion
Friday 28 October 2011, 0930–1430
Chatham House, 10 St James's Square, London SW1Y 4LE

Agenda

Chair: DeAnne Julius, Chairman, Chatham House

0945–1000 Welcome by the Chair and Introduction

Presenter: *Richard Varghese, Chatham House*
The return of the 'gold debate', problems with the international monetary system, and the terms of reference of the Chatham House Taskforce

1000–1200 ***Session 1: The Value of Gold: Central Banking Perspective on the Use and Performance of Gold***

'I think the reason people hold gold is as protection against what we call "tail risk" – really, really bad outcomes … To the extent that the last few years have made people more worried about the potential of a major crisis, then they have gold as a protection.'

Ben Bernanke, July 2011

The price of gold has reached record levels and central banks, particularly in the emerging world, have initiated large gold purchasing programmes.

- *Does gold behave as a currency?*
- *What is the de facto function of gold within the international monetary system?*
- *Why are central banks in the emerging world buying gold?*
- *How can we expect the gold price and central bank purchasing of gold to respond in plausible scenarios for the global economy over the next five years?*

Presenters: *John Nugée, Official Institutions Group, State Street Global Advisors Ltd*
The role of gold in central banking

Martin Fraenkel, former Global Head of Commodities at Crédit Agricole CIB and NM Rothschild and Sons
What can a central bank do with gold?

Bill A. Allen, Cass Business School, City University London
Drivers of demand from central banks for gold and its use as an informal indicator for central bankers

1230–1415 ***Session 2: Market Performance of Gold and Policy Implications***

Policy-makers are accused of lacking discipline through the economic growth cycles. However, gold informally plays an indicator role in financial markets and in the monetary system, helping us to identify where in the business cycle we are.

- *Does gold behave as a currency?*
- *What is driving behaviour in the private sector?*
- *What does the gold price indicate and, crucially, is it countercyclical?*
- *How is it different from other commodities and other indicators?*
- *How should policy-makers react to the indicator role of gold and could gold (prices) provide a guide for monetary or fiscal policy?*

Presenters: *Michael Lewis, Managing Director, Global Head of Commodities Research, Deutsche Bank*
Market performance of gold and its use as an indicator for financial markets

John Gault, President, John Gault S.A., Geneva
How does the gold price compare to other macroeconomic indicators?

Tom Kendall, Vice President of Commodities Research at Credit Suisse
Gold: cycles and bubbles

1415–1430 Chair's closing comments and summary of discussion

Taskforce on Gold and the International Monetary System

Chatham House and IWEP–CASS
Thursday 10 November 2011, 1400–1630
15th Floor, Chinese Academy of Social Sciences (CASS) Building
No. 5 Jianguomen Nei Avenue, Dongcheng District, Beijing, PRC

Agenda

Chair: Yu Yongding, Academician of the CASS and former member of the Monetary Policy Committee, PBoC

Welcome and introduction

Zhang Yuyan, Director-general, IWEP, CASS

Dr Paola Subacchi, Research Director, International Economics, Chatham House
Problems with the IMS, and return of the gold debate, role of the Chatham House Gold Taskforce

Introductory comments

Stephen Green, Head of Research, Greater China Global Research, Financial Markets, Standard Chartered
Central banks in emerging economies use of gold and the Standard Chartered Gold Super Cycle report Roundtable discussion, covering:

- Problems with the IMS, and return of the gold debate; role of the Chatham House Gold Taskforce
- Use of gold by central banks in emerging economies
- Drivers of China's accumulation of gold as a reserve asset

Professor Catherine Schenk, Professor of International Economic History, School of Social and Political Sciences, University of Glasgow
Gold in the SDR proposal and analysis of what it would mean

Dr Michael Wong, City University Hong Kong
Gold as an element in the internationalization of the RMB

Roundtable discussion, covering:

- Perspective on whether we need more 'discipline' in the international monetary system, and what kind of discipline, and for whom, and whether gold could play a role
- Gold as an element in the internationalization of the RMB
- Gold in the SDR proposal

Closing remarks

Yu Yongding, Academician of the CASS and former member of the Monetary Policy Committee, PBoC

All meetings were held under the Chatham House Rule.

International Economics at Chatham House

International Economics at Chatham House produces policy-oriented research and analysis of the challenges facing the global economy today. It maintains links with policy-makers and researchers around the globe to ensure that our independent analysis of global economic issues translates into practical and timely policy insight on the challenges facing the world economy today. The main themes include the changing world economy and the G20 framework, reform of the international monetary system, growth of emerging market financial centres, and international competitiveness and growth.

A changing world economy and the G20 framework

In the wake of the recent financial crisis, the G20 has played an important role in facilitating international economic policy cooperation. It has yet to be seen, however, if the group can move beyond its roots as a crisis committee and play a more institutionalized role in confronting the array of challenges facing the global economy today.

The International Economics team has focused its research to explore the future prospects for the G20 and set out an ambitious schedule for international economic policy cooperation (*Preventing Crises and Promoting Economic Growth: A Framework for International Policy Cooperation*). In addition, current research explores the role of G20 observer countries and those outside the G20 process in international economic policy cooperation.

Reform of the international monetary system

The international monetary system is in flux – no longer meeting the needs of an increasingly unbalanced global economy, but not yet ready to move beyond the dollar as the world's reserve currency. Current research explores the future of the international monetary system, and assesses the prospects for a range of proposed reforms.

Apart from the work of the Gold Taskforce, recent research has focused on the prospects for a multi-currency reserve system (*Beyond The Dollar: Rethinking the International Monetary System*) and investigated China's ambitions for the renminbi as an international reserve currency (*'One Currency, Two Systems': China's Renminbi Strategy*).

Growth of emerging market financial centres

As the epicentre of global economic growth continues to shift towards emerging markets, Chatham House International Economics has embarked on a series of studies into the specific challenges and opportunities facing financial centres in emerging economies.

Recent work has focused on the strengths and weaknesses of the Gulf as a global financial centre (*The Gulf Region: A New Hub of Global Financial Power*) and the outlook for the Japanese financial sector in the light of recent international trends (*The Outlook for Tokyo: New Opportunities or Long-Term Decline for Japan's Financial Sector?*).

Current research explores the prospects for financial centres in the Greater China region, including Hong Kong, Taipei and Shanghai, as well as the challenges and opportunities that shifting global financial influence may pose for Singapore's role as an established Asian financial centre.

International competitiveness and growth

The past quarter-century has seen massive changes in the world economy. Trade integration and the globalization of value chains, with more and more manufacturing now taking place in emerging economies, have created new challenges together with new opportunities. As we move forward into the next decade, it is critical to address the issue of how the industries of the future will look, and which sectors/industries will lead future growth.

International Economics is undertaking a series of projects to examine the outlook for key global industries over the next decade. These include a series of research study groups on the changing industrial landscape and industry case studies identifying emerging 'global champions'.

Chatham House is also partnering with the University of Warwick's Centre for Competitive Advantage in the Global Economy (CAGE) to explore how markets, institutions, and public policy interact to create and sustain competitive advantage in response to these global changes.

Recent publications:

- Legitimacy vs Effectiveness for the G20: A Dynamic Approach to Global Economic Governance
  Briefing Paper
  Paola Subacchi and Stephen Pickford, October 2011
- Preventing Crises and Promoting Economic Growth: A Framework for International Policy Cooperation
  Chatham House/CIGI Report
  Paola Subacchi and Paul Jenkins, April 2011
- 'One Currency, Two Systems': China's Renminbi Strategy
  Briefing Paper
  Paola Subacchi, October 2010
- Aiming for New Vigour: The UK in the Global Economy
  Briefing Paper
  Vanessa Rossi and Jim Rollo, June 2010
- The Role of the US in the Post-Crisis Economic Order
  Chapter in *America and a Changed World: A Question of Leadership*
  Paola Subacchi, May 2010
- Beyond the Dollar: Rethinking the International Monetary System
  Chatham House Report
  Edited by Paola Subacchi and John Driffill, March 2010

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