Policy Brief
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Gold: a safe haven in difficult times

By Henri-Louis Vedie

Summary

In recent months, the price of gold has rebounded, taking it to new heights. The analysis of the prices of this precious metal over the last two centuries has shown great stability until 1971, when the United States abandoned gold/dollar convertibility, but also its erratic movement since then. Subject to the laws of the market, the price of this raw material depends essentially on demand. This trend confirms that this asset is a safe haven in difficult times, without however contemplating its re-monetization. This rebound, which is cyclical in nature and occurs in the short and medium term, is a godsend for gold-producing countries, at the forefront of which are China, Russia and Australia, but also some African producers, such as Ghana.

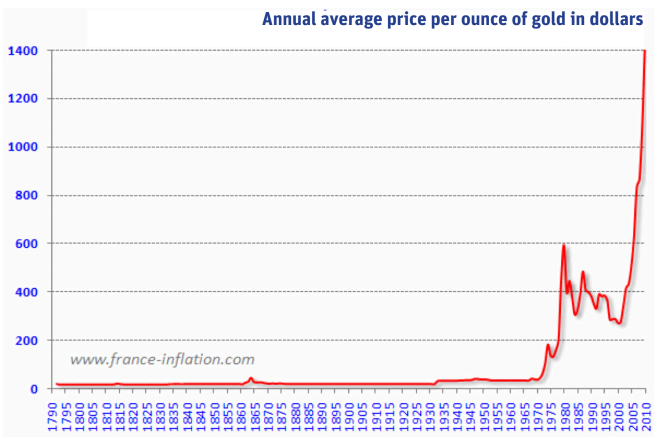
Gold is shining bright, while its prices are at their highest level in history, with an ounce exceeding $2,000. The purpose of this Policy Brief is to examine and look into the reasons behind this recent price surge, which will enable us to know whether this surge is cyclical or structural, and who are the beneficiaries and victims.

I. Current gold price trend over the last two centuries

A. Gold price trend per ounce between 1792 and 2010

Graph 1, below, describes the trend of the average annual price per ounce of gold over the period 1792-2010

Graph 1: Price per of ounce of gold since 1792



Source:www.france-inflation.com

During this period, the history of gold is very much linked to the monetary systems of the time. First used directly as a means of payment, in addition to silver that has preceded it in this function, gold coins were added to silver coins. With the advent of paper money, gold, like silver, will serve as a guarantee to the issuers of bills, guaranteeing their conversion, at any time, by their reserves in gold and silver. From 1870, gold took precedence over silver, gradually becoming the sole standard for the dominant economies of the time, as the convertibility of silver was eventually abandoned.

The successive world wars and the economic crises that accompanied them, sometimes marked by double-digit inflation, have made gold convertibility increasingly difficult to achieve. With the Bretton Woods agreements in 1946, a new era began, limiting convertibility to the dollar, directly indexed to gold, at a rate of 35 dollars per ounce, while other currencies were indexed to the dollar. This continued until 1971, when the United States abandoned gold/dollar convertibility, as its gold reserves were insufficient to guarantee this convertibility, given the mass of dollars in circulation. The Jamaican Agreements of 1976 formalized the abandonment of gold as the standard for an international currency. From this period onwards, gold prices will no longer be set by the states, but according to the supply and demand of this precious gold. The analysis of this graph shows the great stability of the price of gold per ounce until 1971, but also its erratic movement from 1971 onwards.

B. Gold, a safe haven in times of crisis

Between 1985 and 2020, gold experienced four successive peaks: $499.8 in 1987, $1,000 in 2008, $1,921 in 2011, and $2,040 in 2020.

- The peak of 14 December 1987 was the consequence of the stock market crash of the same year. It brought the price of an ounce of gold in dollars from 250 dollars in 1985 to nearly 500 dollars in 1987, a 100% increase. This was followed by a steady drop in prices until the early 2000s, when the price per ounce returned to its 1985 level.

- The peak of 8 September 2009 was very closely linked to the financial crisis of 2008, when prices doubled to reach $1,000 per ounce. It was also the start of a new period of rising prices for the precious yellow metal.

- The peak of 6 September 2011, at $1,921 – another increase of nearly 100% – took place this time in the midst of the sovereign debt crisis, which ended the rebound that had been underway since 2003. This was followed by a steady fall in prices until 2017, when the price per ounce returned to its 2009 level of $1,000.

- The peak of 5 August 2020, at $2,040, is linked to the COVID-19 crisis. Since August 5, the price of an ounce of gold has once again fallen.

These various movements confirm one of the essential functions of gold, that of being a safe haven, while the various peaks are chronologically linked to a stock market crash (1987), a financial crisis (2008-2009), a sovereign debt crisis (2011) and the COVID-19 crisis in 2020.

The question naturally arises, however, of discounting the rates in 2020 dollars compared, for example, to the dollar rate of 1987. A recent study shows that $675 of 1980 would be roughly equivalent to $1,961 of 2011. This can be translated as follows: the last peak at $2040, if we take into account the discounting of the dollar, is not a record peak, but is close to it.

II. Prices, now subject to the laws of the market, depend essentially on demand

On the gold market, there is, of course, a supply consisting of the world's main gold-producing players, either at the level of the state as the owner of the gold resources, or at the level of the mining groups in charge of exploiting them, such as Barrick Gold or Nemmont Mining. They are, today, the main beneficiaries of the price surge, as we will see under (III). On the whole, however, it is the variations in demand that will determine prices. This demand is linked to the different uses of the precious yellow metal. Three of them will be considered here: the use of gold in industry, basically in jewelry; then the use of gold by households and, finally, the use of gold by central banks and financial institutions.

A. Decline in the demand for gold in jewelry

In the first half of 2020, demand for jewelry fell by 47%, and demand for gold bars and coins dropped by 17%. The same trend is observed for diamonds. The main reasons cited are those related to containment and accompanying measures, and the desire not to consume in times of crisis, to build up available precautionary savings. It is estimated that the demand for jewelry from China and India, the world's two largest consumers, would have fallen by two-thirds during containment.

B. A contrasted evolution within households

In this respect, it is worth recalling the words of Philippe Chalmain, according to whom in normal times « gold is an absurd investment, creating no wealth and yielding nothing », while it is more profitable to buy government bonds, which are just as secure and have the advantage of offering coupons. When we know that today's inflation-adjusted gold prices are estimated at $200 below its record level of 2011, Philippe Chalmain's assertion turns out to be entirely true. However, with the appearance of negative interest rates, households adopt a different behavior towards gold; this is particularly true as the dollar is depreciating, which makes Philippe Chalmain say that, « with negative rates, the purchase of gold is not so absurd any more, especially as in certain countries, gold escapes the scrutiny of the taxation system and has the advantage of discretion ».

Households are not rushing for gold because of the crisis, but because they realize, consciously or unconsciously, that the precious metal offers a better net return than any other investment. This is obvious when real interest rates are negative and when the dollar depreciates.

At the beginning of September 2020, demand from households is still sustained, but this trend is cyclical (negative interest rate) and not structural.

C. Strong and growing demand driven by central banks and institutions

When gold reached its first record high in 2011, Europe was experiencing a sovereign debt crisis, hitting Greece, Ireland, Portugal and Spain to varying degrees. This is no longer the case today. Nevertheless, potential investors are far from being reassured by the European Central Bank (ECB), which is still reluctant to raise interest rates.

At the same time, the trade war between China and the United States persists and worries, allowing gold to regain its colors.

▪ This trend began as early as 2000 in the 1990s, and the general trend was for central banks to reduce their gold stocks, particularly in France and Great Britain. The rise in prices in the 2000s put an end to this practice. Beginning in 2010, the accumulation of gold stocks picked up again, mainly in Asia, Russia, Kazakhstan and Turkey, whose stocks are lower, all things being equal, than those of the United States, France, Germany, etc. This situation is continuing today. In 2018, for example, central banks, all of them, bought 651 tons of gold, a record increase of 74%, compared to 2017.

▪ An emblematic appointment, in favor of the gold standard, in July 2019, within the US Federal Reserve.

This appointment concerns Judy Shelton, who wondered in the Wall Street Journal of 21 April 2019, « whether it would not be better to link the supply of money to gold rather than make it depend on the judgment of a dozen officials in charge of setting interest rates ». According to Judy Shelton, the return to the gold standard would, in fact, turn the precious yellow metal into a single currency, putting an end to the manipulation of exchange rates, a well-known Chinese practice regularly denounced by the Trump administration. Even if we are still a long way from the return of the gold standard, the fact of extolling its benefits can only boost demand.

▪ An application benefiting from the « Basel III » bank solvency standards.

These new solvency standards, established by the Bank of International Settlements (BIS), are going to change the recognition of gold as a bank asset. Prior to 29 March 2019, the effective date of these new standards, gold was classified as a Level 3 asset. This resulted in a 50% risk assessment, requiring commercial banks to freeze shareholders' equity accordingly. But it was not a strong incentive to invest in this precious metal. Since 29 March, gold has been recognized as Asset 1, considered as cash, a risk-free asset that does not give rise to the need to freeze shareholders' equity.

In making this decision, the BIS is sending out a double message: first, that in the event of a financial crisis, the main risk is liquidity; second, that the best way to respond to it is gold, whose intrinsic value is known and recognized. Let us add that the gold market is capable of being dynamic and of absorbing large flows, if necessary.

The return of gold to its highest level does not, however, mean its re-monetization, which would imply constant fiscal discipline and a return to balanced public accounts. This is hardly conceivable today. On the other hand, by regaining its place in the financial world, gold implicitly regains its monetary function and becomes the ultimate confidence asset, if need be.

III. Record levels benefit producing countries and gold industry billionaires

A. A godsend for producing countries

In 2019, the top eight producing countries were in order of importance:

China: 383 tons; Russia: 329 tons; Australia: 325 tons; USA: 200 tons; Canada: 183 tons; Peru: 143 tons; Ghana: 142 tons and South Africa: 118 tons.

For 'Fitch Solutions', by 2029 global production is expected to grow at an annual rate of 2.5% to 133 million ounces, compared to 106 million ounces today. This increase may well change the current order.

▪ If the top trio were to remain unchanged, Russia could become the leader with an annual growth rate of 3.7 %, as Moscow is anxious to develop its production in order to increase its reserves and thus be less dependent on the US dollar. In second place comes Australia, which holds 20% of the world's known deposits, followed by China, whose production is expected to stagnate over the decade as a result of stricter environmental regulations and the closure of small, less profitable mines.

▪ Unlike China, African gold-producing countries, with numerous projects, are expected to experience an upward curve, led by Ghana, now the continent's leader, in seventh place in the world, which has supplanted South Africa. It should also be noted that Burkina Faso's rise to prominence, following the merger between Endeavour and Semafo in July, could lead the new group to extract 28 tons of gold per year from mines located mainly in Burkina Faso.

For African gold-producing countries, victims of the fall in oil prices and the consequences of Covid-19 on the reduction of their exports, the surge in gold prices is an unexpected windfall. Examples include Ghana and Burkina Faso. Ghana, whose expected resources of cocoa and oil had been largely revised downwards and which, thanks to the spectacular rebound of gold, saw its growth forecasts rebound to 2%. Burkina Faso also benefits from an expected positive growth of 4% in 2020. On the other hand, for South Africa, the leap in gold will not be enough, it will be much more difficult with an expected negative growth of 3% in 2020. So, while the gold rebound can do a lot, it cannot however do everything.

B. A rebound that benefits the big names in the gold industry

According to Bloomberg's estimates, three fortunes and families, particularly exposed to gold prices, have been collectively enriched by several billion dollars as a result of this rebound, despite the Covid-19 crisis:

▪ The Kerimov family, which owns 77% of Polyus PJSC, Russia's largest gold producer, is said to have seen its fortune grow by 1.7 billion dollars;

▪ The Nesis (Alexander) family, whose ICT Group holds a 27% participation stake in Polymetal International, a Russian precious metals company, Russia's fourth largest gold producer is now valued at $3.7 billion;

▪ The Saudi Mohammed Al Amoudi, whose fortune, estimated at more than $9 billion, comes from a gold mine in his home country, Ethiopia.

A sign that does not deceive, Berkshire Hathaway/Warren Buffet's conglomerate has just considerably reduced its holdings in some of the largest US banks to invest in gold, long forgotten by him. For example, Berkshire Hathaway sold 35.5 million shares of JP Morgan, reducing its stake by 1.2% to 0.7%. And at the same time, the conglomerate took a 1.2 % interest in the Barrick Gold mining group. This is not the first time that Warren Buffet, known for his aversion to gold, has invested in precious metals. He did so in 1997, buying 130 million ounces of silver, only to sell them at a profit shortly thereafter. The future will tell us if history repeats itself.

CONCLUSION GENERALE

Le rebond spectaculaire de l'or confirme l'ancrage de cet actif comme valeur refuge. Pour les experts de la Bank of América, ce rebond pourrait atteindre les 3000 dollars au cours des prochains dix huit mois. Pour autant, cela ne signifie nullement, pour les raisons rappelées, que cela se traduise par une remonétisation du précieux métal jaune. Ce rebond est essentiellement porté par la demande, elle-même tributaire de l'environnement international. Le ralentissement de l'économie mondiale, en 2019, amplifié par la chute des cours pétroliers et les conséquences économiques de la Covid-19, sont autant d'éléments qui ont amplifié la demande. C'est, pourquoi, nous pensons que ce rebond est conjoncturel et non structurel, pouvant perdurer cependant à moyen terme.

About the author, Henri-Louis VEDIE

Holding a doctorate in economic sciences from Dauphine University Paris, and a graduate in Law from Université Paris I, Henri-Louis Vedie is Professor Emeritus at HEC Paris, where he teaches in the Paris campus as well as Moscow, Varsovia, Belgrade, Abu Dhabi, Rabat, and more.

Author of sixteen books, of which the last few concerned Morocco and sovereign funds, hundreds of articles (of which some where translated in English, French, Arabic, Polish and Russian), Henri-Louis Vedie was also a consultant for the European Council and a member of the Economic, Social and Environmental board in Paris.

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