Hervé Hannoun: The Banque de France's view on gold and comments on the euro

Speech by Mr Hervé Hannoun, First Deputy Governor of the Banque de France, at a dinner organised by Goldman Sachs on the occasion of the Financial Times Gold Conference held on 26 June 2000.

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Introduction: silver and gold

Ladies and gentlemen, it is a great pleasure and privilege for me to be speaking here in the *Hôtel des Invalides* in front of such a distinguished audience. The organisers gave you the opportunity to visit Napoléon's tomb. So let me, as an introduction, highlight some historical facts, which may not be so far away from the topics I intend to discuss later. Two hundred years ago, the First Consul Napoléon Bonaparte created the Banque de France with himself as one of the shareholders. At the same time, Napoléon built a monetary regime based on a bimetal system (a combined gold and silver standard) that prevailed throughout the 19th century.

At that time, many currencies in the world were based on a gold standard, while a few had a silver standard. France had defined the Germinal franc - which remained absolutely stable for almost 120 years - with respect to its weight in both silver and gold. One Germinal franc was equivalent to 5 grams of silver and to 322 milligrams of gold; the famous 20 franc coin, called the *Napoléon*, was issued at that time (with a weight of 6.45 grams). As the country with the largest circulation of banknotes and coin in the bimetal system, France played a key role in this complex system at the international level. Things are rarely as simple as they seem. The 19th century is often depicted as a time when the international system was based on a single metal currency. However, this was not the case. Until 1873, it worked with a complex bimetal system, based on gold and silver.

Let me turn now to today's financial and monetary world. I will first present the Banque de France view on gold and follow with comments on the euro after 18 months of its existence.

I. Gold

A. The Banque de France's view on gold is based on three main pillars:

- We are in favour of ***gold holding***
- We are against ***gold selling***
- We have a very prudent and conservative approach to ***gold lending***

1. Gold holding

The Banque de France is a major gold holder (with more than 3,000 tons). The creation of the single currency has in no way modified our policy and motivations for holding gold, which remains in our view an important reserve asset.

Let us review the reasons why central banks want to hold gold. What is the rationale for holding gold, a non-interest bearing asset, given that there is no more official role for gold since the collapse of the gold exchange standard?

– First, ***security***: the absence of any credit risk is an intrinsic quality of gold: gold offers ***full*** security as long as it is properly stowed in central banks' vaults.

– Second, ***liquidity***: in situations of political turmoil or high global inflation, gold's liquidity is unchallenged. Certainly, in circumstances of orderly financial markets, gold is not the most liquid of assets (even though it is probably the most liquid of commodities). But its liquid quality becomes apparent and increases as uncertainty grows. In this regard, the absence of a return on gold can be viewed as the price of its "option component": contrary to most other assets, gold prices go up when things go wrong.

– Third motivation for holding gold: ***diversification***.

  Gold bears no interest coupon. If lent, the lending rate is relatively modest. Then there is usually a cost of carry for gold holdings. This is partially offset by the "option component" I mentioned before. But gold is also a very good diversification instrument. Indeed in the long run, the price of gold has shown a very low and even a negative correlation with the dollar (the first-ranking reserve currency) and with US Treasuries. So gold is very useful to build a diversified portfolio as it enables you to improve your risk/return profile.

On the whole, I would say that gold is an ***asset of last resort*** *par excellence* and that recent market developments have in no way altered its intrinsic qualities. There is still a rationale for central banks to hold gold.

2. Gold selling

After having listed all the good reasons for holding gold, you will not be surprised if I reiterate that we have no plans to sell gold!

The leading official holders of gold have not changed their attitude in this respect. Neither the American Federal Reserve System, nor the German Bundesbank, nor the Bank of Italy, nor the Banque de France have any plan to sell gold.

3. Gold lending

Concerning gold lending, the Banque de France, as most of you probably know, is definitely not among the active players in the market. Quite the contrary, alongside the other major holders, it has refrained from an active management of its gold holdings. The Banque de France has always adopted a very prudent and rather conservative approach, acknowledging the fact that the issue of gold lending is a matter of common interest to the major holders.

Two main reasons are traditionally put forward to justify gold lending:

– The first one refers to a question of principle. Foreign currency assets are actively managed. Why not extend this management to gold insofar as gold is considered to be part of a country's external reserves?

– The second reason is that central banks obviously have to take into account profit and loss account considerations. From this standpoint, gold should provide a return just like other assets.

But the reasons for prudent management of gold reserves by central banks are, in our view, of utmost importance.

Central banks are typically "risk averse" when investing their foreign assets on the financial markets; as far as gold management is concerned, an even more cautious attitude is required because of the characteristics of the gold market.

Central banks must be aware that ***their deposits may favour the financing of speculative gold sales***. In other words, for a speculator (or a producer) who wants to take a position against gold, it would be very easy to be short because he can easily borrow from the official sector, which is a potential lender on this market. The result of this policy then would be a drop in the price of gold.

Furthermore, lending is even more delicate for a big holder: what is the use of lending if, at the same time, you are depreciating the value of your holdings? This question is effectively not the same when you hold 3,000 tons as when you hold 300 tons.

Consequently, our policy regarding gold lending could be expressed as follows: a responsible holder must have a ***responsible*** approach to management. This means that the Banque de France has to and does pay due attention to the trade-off between its own interests (ie enhancing the return on its assets) and the impact on the market.

The gold market characteristics described earlier call for a cautious and coherent attitude.

B. This Banque de France view is now widely shared by the central banking community

1. Concerning gold holdings:

The ECB's decision in July 1998 to hold 15% of its reserves in gold, taken from the gold stocks of the national central banks, was generally seen as a positive signal in a market hitherto inhibited by fears that governments might decide upon new gold sales.

This was evidence that gold remains an important element of global monetary reserves.

2. Concerning gold selling and gold lending:

The Banque de France and the Bundesbank have been a driving force behind the 1999 joint statement on gold, which is fully consistent with our traditional position. And I quote:

– "The undersigned institutions will not enter the market as sellers, with the exception of already decided sales.

– The gold sales already decided will be achieved through a ***concerted programme of sales*** over the next 5 years. Annual sales will not exceed approximately 400 tons and total sales over this period will not exceed 2,000 tons.

– The signatories of this agreement have agreed not to expand their gold lendings and the use of gold futures and options over the period." (End quote.)

The so-called "Washington Agreement" has clarified the intentions of the Eurosystem as well as of the Sveriges Riksbank, the Swiss National Bank and the Bank of England with respect to their gold holdings.

First, it has ***re-emphasised the role of gold*** in stating that (I quote) "Gold will remain an important element of global monetary reserves". Second, it has provided the market with some reassuring ***guidance*** concerning the sensitive issue of central banks' gold sales and lending.

Far from destabilising the market, the Washington Agreement brought more transparency to the gold market, and helped foster sounder conditions in the price formation process by reducing uncertainty and overall volatility.

It is true, however, that the initial market reaction to the joint statement was extreme. The immediate impact of the Washington Agreement was all the more dramatic as a number of market participants (gold mines, hedge funds) had accumulated big and, I would say in some cases, excessive, short positions. The fact that the short sellers had to rapidly square their positions induced a brief period of higher volatility, but also created the conditions for a more orderly market and thus, during the last months, gold prices have fluctuated in a relatively narrow range.

On balance, I do think that the joint statement has had a stabilising effect on the gold market thanks to enhanced transparency and clarity concerning central banks' intentions.

Let me now turn to the second topic of my speech: the euro after 18 months.

II. The euro after 18 months

Some years ago, the possibility of a single currency in Europe was met with complete scepticism, especially in the United States. Numerous pundits explained that the euro would not come into being, then, that it would not be launched on schedule and, finally, that it would not work.

A year and a half after the introduction of the single currency, it is worth assessing the results and the prospects of this major change in Europe.

A. The euro is already a great technical and operational success

- A successful launch

The changeover to the euro was an enormous technical challenge. It proved to be a total success. From the early morning of the very first day, everything went smoothly: the euro money market, the decentralised implementation of the Eurosystem's monetary policy and the functioning of the large-value payment systems.

- A clear, efficient and flexible operational framework

The Eurosystem's monetary policy is based on robust arrangements, mainly involving the use of three instruments:

– weekly tenders (or "main refinancing operations");

– overnight marginal lending and deposit standing facilities;

– sizeable amounts (more than €110 billion) of interest bearing minimum reserves which exert a stabilising effect.

This well-designed framework has in practice confirmed its efficiency and flexibility to accommodate various market situations and liquidity configurations.

- A successfully decentralised implementation of the single monetary policy

The Eurosystem's operational framework is based on decentralisation. The decision-making power is held by the ECB's governing bodies, while monetary policy is implemented in a decentralised manner by the National Central Banks (NCB).

Within its own remit, each NCB carries out the regular tenders orchestrated by the ECB and grants refinancing within the framework of these periodic auctions of central bank money. The NCBs manage the settlement accounts of credit institutions, hold the standing facilities for overnight credit and deposits, and also monitor minimum reserves. They are in constant contact with the ECB and supply it with all the daily data essential to the conduct of effective monetary policy.

- A rapid integration of the national money markets

It was crucial to enable liquidity to circulate smoothly from one financial centre to another in the euro area so that operators could conduct the necessary arbitrage between the different centres, thus ensuring a single euro interest rate for each maturity. The TARGET system is the key component of this unification. Right from the start of 1999, it enabled credit institutions to effect large-value, cross-border transactions with same-day value all day long, thus allowing the interbank market to function as a single market right away.

The integration and efficiency of the euro money market is measurable through various indicators such as:

– high trading volumes (around €55 billion per day in the overnight interbank market);

– virtually non-existent quotation differentials between financial centres;

- a high proportion of cross-border transactions, be it on the “unsecured” deposit market, the repo markets or the interest-rate swap market;
- minimal recourse to the Eurosystem’s standing facilities (which means that liquidity adjustments are mostly made on the market).

- Rapid growth of the euro-denominated bond markets

While full integration has clearly been achieved on the money market, obstacles still remain on the bond market, partly reflecting differences in tax regimes and in market organisation and practices, although a good deal of harmonisation has already taken place. However, issuers have rapidly shown great interest in the euro as illustrated by the fact that issuance in euros exceeded issuance in dollars in 1999. The important point to highlight on this subject is not so much that the level of issuance in euros surpassed the amount in dollars, but that the new-born euro bond market has been able to absorb such an increased volume without any disruption.

The euro is already a technical and operational success. I will now try to demonstrate that the euro has the potential to also be a complete strategic success in the future.

B. The euro has the potential to also be a complete strategic success in the future

1. The euro has the potential to become a major reserve currency as an alternative to the US dollar

The euro is already the second most widely-used international currency in the global monetary and financial system. But, 18 months after the introduction of the single currency, it is fair to say that while the euro has become the first financing/issuing currency in the world, it has not so far made the same progress as a reserve/investment currency. The low level of interest rates in continental Europe has fostered the international financing role of the euro (euro-denominated bonds accounted for some 45% of new issues in 1999 which, as I mentioned earlier, somewhat exceeds the market share of new USD-denominated bonds). Conversely, these relatively low remuneration rates have reduced the role of the euro as a reserve currency (in central bank portfolios) or, more generally, as an investment currency (in private investors’ portfolios). Since the launch of the single currency, the low level of interest rates in the euro area and the continuous depreciation of the euro have temporarily slowed down the emergence of the euro as a major reserve currency.

This leads me to say a few words on the depreciation of the euro in the past 18 months.

2. The euro exchange rate misalignment

Let me first recall what the Eurosystem’s position on exchange rates is:

- The Eurosystem rejects both activism and neglect *vis-à-vis* the exchange rate and believes that the pursuit of stability-oriented monetary and fiscal policies is the main prerequisite for reasonably stable exchange rates.
- The exchange rate is not the objective of the single monetary policy, but it is an important indicator included in the second pillar of the ECB’s monetary strategy.
- So while the ECB does not target a Euro exchange rate vis-à-vis the dollar or any other currency, it would be wrong to imply that it pursues an attitude of benign neglect or is indifferent to the exchange rate.
- A strong euro is in Europe’s interest. The more stable it is at home, the better its prospects on the international stage.

Since January 1999, the euro has significantly depreciated against most currencies (by 20% against the US dollar and 25% against the yen). We know that exchange rates can, from time to time, diverge from economic fundamentals. This sort of divergence or misalignment can considerably distort relative prices and alter financial asset choices. You know that we are not satisfied with the current level of the exchange rate of the euro.

Most commentators recognise that the euro is now significantly undervalued and that the tide will turn.

3. The tide will turn

An orderly reversal of the euro's exchange rate will take place as a result of a triple narrowing.

- Narrowing of the growth differential between the United States and the euro area. This is because the current extraordinary growth rate of the United States is probably not sustainable in view of the widening of the external deficit. Euro area growth is well balanced, while the US economy is affected by imbalances. This will be progressively taken into account by the markets.
- A narrowing of the interest-rate differential as a consequence of the narrowing of the growth differential.
- Narrowing of the "restructuring differential" between the United States and the euro area economies. It seems to us that although corporate restructuring in Europe was lagging behind the United States a few years ago, we are now observing a catching-up process.

This leads me to my last point: the undertaking (and speeding up) of structural reforms is a major condition for the euro to be a complete success.

4. The conditions for the complete success of the euro: sound macroeconomic policies and structural reforms

In this regard, the Lisbon European Council meeting last month can be viewed as a further important step towards the necessary medium-term strategy for structural reforms in the Union.

The labour market has become much more flexible in the past few years in Europe.

While Europe has long had a strong tradition of economic regulation, it must be acknowledged that deregulation is well underway in most countries. The change is particularly noticeable in several key sectors such as telecommunications (mobile phones, long distance calls), transportation (particularly airlines) and the power-supply industry (electricity and gas) to mention only a few.

Major countries have embarked upon an ambitious overhaul of their public sectors. In countries with a large public sector, such as Italy or France, ambitious privatisation programmes have steadily reduced the number of state enterprises. In addition to privatisation, state enterprises are changing; companies that remain government-owned are becoming more profit-minded (particularly airlines, railways, etc).

Tax reforms should accompany the reduction of fiscal deficits within the framework of the Stability and Growth Pact. They have already been initiated in several key countries, especially Germany and France.

European firms are restructuring and becoming more internationally competitive.

European firms are going through a deep restructuring process. Mergers and acquisitions have hit new records as companies seek to create national, regional or global champions (M&As close to USD 1,500 billion in 1999 compared with USD 500 billion in 1997). Venture capital and start-ups are booming as investors and entrepreneurs become more convinced that Europe can compete with America in knowledge-based industries. Heavy industries and large conglomerates are restructuring as never before. Finally, new rules on corporate governance are spreading.

The outflows of foreign direct investment merely mirror the dynamism of European firms. European firms were lagging behind US firms in terms of foreign direct investment and they are now catching up. European firms have entered a "globalisation process" whereby they aim to reach a global size through acquisitions.

Conclusion

Allow me to conclude.

The euro area has adopted a sound macroeconomic policy and has embarked upon a fairly comprehensive programme of structural reforms. These reforms will still take time to be fully completed. But they are well underway and have already boosted economic growth, job creation and corporate restructuring. This move has been triggered by the creation of a monetary union and a vast unified financial market. I am impressed by what has been achieved during the past years and the National Central Banks as well as the ECB are strongly encouraging governments and businesses to foster structural reforms in the future.

The euro exchange rate is clearly misaligned relative to euro area fundamentals (robust domestic growth, steady implementation of the single market, abundant domestic savings, healthy external accounts). This is the reason why we consider that the euro has a strong potential for appreciation.

The Eurosystem, which is the guardian of the euro on behalf of the people of Europe, knows that our fellow citizens want the single currency to be at least as solid as their previous national currencies. In France, to give but one example, 96% of the population want the euro to be at least as solid as the franc. Needless to say that it is the same in Germany and in all the other countries of the Monetary Union. For this reason, we all fully subscribe to the recent declaration of the President of the ECB, Wim Duisenberg: "European citizens can be assured that the future of the euro is that of a strong currency, based on price stability and the strength of the European economy".