Global Precious Metals Conference 2022

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Introduction

Good morning everybody; I would like to start by thanking the organisers for inviting me. It is always a pleasure to speak at LBMA events and I vividly remember lots of interesting discussions at previous meetings. So, thank you for having me.

I was asked to cover the macroeconomy, central banks and gold, which is a pretty wide field for 30 minutes, but I will cover all three of these items in turn[1].

The first two are key to understanding the rather unusual and challenging current macroeconomic and financial environment.

This environment, in turn, underscores the value of portfolio diversification for reserve managers and the investment community in general.

Gold continues to be a very relevant asset class in this context – even though sharply rising interest rates and a record run of the US dollar did put a stop to its stellar performance between 2018 and 2020, when the price per ounce surpassed the $2,000 mark.

Macroeconomic backdrop

Let's begin with the macro backdrop, which – recently – has been shaped by two powerful forces: Covid and the war in Ukraine.

The results are all too familiar: high and rising inflation and a deteriorating growth outlook, even as actual growth (and labour markets) have remained somewhat resilient, at least until very recently. The evolving energy crisis in Europe is currently putting this resilience to the test.

What was a rather stable period for expectations in 2019 abruptly shifted downwards in early 2020, due to the pandemic and associated lockdowns.

What then followed was a period where the economy was expected to rebound, with intense supply chain problems (and shifts in demand) emerging as both drags on growth and drivers for inflation.

[1] The views expressed are the personal views of the author and may not be the views of the BIS.

It is important to note that these effects were broadly synchronised globally and seen to be mostly temporary, at least initially. However, inflationary pressures soon broadened and were then exacerbated by the Russian invasion of Ukraine and its effects, in particular, on food and energy prices (ie an "economy of scarcity").

Adversely, the effects of the war in Ukraine are more asymmetrical in nature – for example, in terms of their effects on food or energy producers and the economies on the demand side. And there are strong regional effects as well, with Europe, in particular, suffering from a large dependence on (predominantly Russian) gas supplies and regional supply chains. Some economies are clearly benefiting from rising oil/gas prices and many others are suffering heavily. Even within a country, some sectors may benefit while others suffer.

In any case, the results overall are much-diminished growth expectations in the context of rising inflation forecasts. (See the latest revisions for growth and inflation forecasts from the IMF and World Bank).

These changes in expectations and the associated monetary policy responses have taken place against the backdrop of elevated asset valuations after many years of monetary and – at least during the pandemic – fiscal stimulus. They have resulted in broad-based sell-offs across key asset classes (including both fixed income and equities; there is "nowhere to hide"). This, in turn, has made for an extremely challenging year (actually one of the worst years since World War II) for investors, including central bank reserve managers. Some are experiencing not only negative returns but also a considerable drawdown in equity capital.

But before moving on to the financial market implications, let me elaborate on the macroeconomic backdrop – and on the policy challenges arising from this.

Macroeconomic backdrop and arising policy challenges

Basically, the current environment is one where stagflation risks now loom large, and these are magnified by pre-existing macro-financial vulnerabilities, particularly the high public and private debt levels globally.

In this environment, as highlighted in the BIS's most recent Annual Economic Report, the key task for monetary policy is to restore low and stable inflation, while limiting as far as possible the cost to economic stability.

There are at least three key elements (inflation, the war in Ukraine, and macro-financial vulnerabilities) that are important in this context; I will cover each of these in turn.

An important issue regarding inflation is that inflation regimes have self-reinforcing properties.

Low inflation has helped to moderate wage and price developments pre-pandemic. Price increases were mostly relative, or interpreted as such, and thus largely ignored.

The current risk is that behavioural adjustments could entrench recent high inflation outcomes, if these turn out to be persistent.

Indeed, some signs of persistence have emerged. Market indicators and surveys of longer-term inflation expectations, such as the five-year forward US breakeven inflation rates, have recently drifted upwards (to around 2.3%; five-year forward US inflation swaps were at around 2.5%, before falling back somewhat).

This suggests that we may have entered a transitionary period that could put us on the path to a self-reinforcing, high-inflation regime. Some important market players have recently expressed the risk that inflation might drop to a level of 4–5% within a few quarters. However, it might be much more difficult to bring inflation down to the target level of around 2%.

After the pandemic and due to geopolitical factors, we are observing a step back from globalisation. It is likely that a lesser degree of international division of labour will generally lead to additional price pressures.

Central banks will therefore want to act in time to arrest these trends and make sure that longer-term inflation expectations are not being unanchored, and, indeed, this is what has prompted them into decisive action.

(In fact, emerging market economy (EME) central banks have tended to act first, followed by the United States and, more recently, other major central banks, such as the ECB and the Bank of England).

Forceful action on interest rates started early in 2022, but let us keep in mind that trimming the balance sheets of central banks (ie quantitative tightening) is only in its early stages.

The war in Ukraine has added to these challenges.

The primary channel, as mentioned, is higher commodity and food prices, particularly for oil/gas, fertilisers and agricultural products.

There are both direct effects (feeding straight into inflation measures) and indirect effects (via production costs/value chains, which have strong regional implications).

We have seen both of these play out, which will also weigh on growth and on investment, due to greater uncertainty. Energy prices and natural gas prices, in particular, pose a direct risk of recession, especially in Europe, which is both a major importer and geographically close to the source of the disruption in Russia.

As a result, while inflation pressures in the United States are rather broad – with services inflation (including housing) a key driver – inflation pressures in Europe are still driven primarily by food and energy prices, but there are also early signs of broadening price pressures in the service industry in Europe.

Indeed, developments in China could be a further source of stagflationary impetus. It is sometimes forgotten that China has accounted for about a quarter of global growth over the past 20 or so years, while exerting persistent disinflationary pressures, even as China's domestic demand has pushed up commodity prices. Both forces may now be waning, with demographic change and the zero-Covid policy weighing on economic activity and productivity growth.

Financial factors (eg in the property sector) may further brake growth, also in China.

This leaves macro-financial vulnerabilities.

The key point here is that past accommodative policies and the pandemic response have pushed up debt levels across countries, while supporting asset prices against rising levels of inflation.

As a result, the required monetary policy response has given rise to a "nowhere to hide" price adjustment, which would be exacerbated if rising rates were to push debt service burdens to intolerable levels. Rising default risks from the looming energy crisis would also do their part.

It is clear that all this translates into a rather complex policy environment. This makes calibration of the appropriate policy response a balancing act in search of a soft landing.

Historically, soft landings have been difficult to achieve.

Recent BIS research suggests that tightening cycles which started with high GDP growth or high job vacancies have generally been followed by soft landings. And such conditions are prevalent in many economies. That said, some indicators point to risks for a hard landing: a rapidly increasing inflation rate, low term spreads and high household credit-to-GDP ratios.

Postponing the necessary adjustments now may require an even stronger response later.

This has prompted central banks into action, at a time when growth expectations would otherwise seem to suggest easier policies ahead. The result is the possibility of market accidents from abrupt shifts in market positioning amid shallow market liquidity.

Recent developments in financial markets

This takes me to recent developments in financial markets. There is good news and bad.

On the bad side, 2022 is on track to become the worst year on record for investors. Both equities and bonds are down substantially year-to-date, and only commodities and other real assets have provided some sort of cushion.

Unfortunately, many of the better performing assets are not actually accessible for many investors. Reserve managers, for example, would struggle to invest in infrastructure or non-gold commodities.

The good news is that banking systems have generally been resilient inspite of highly volatile markets and falling asset prices. Markets also have held up quite well in terms of functioning.

However, the growing number of difficult episodes should not be underestimated (eg the so-called dash-for-cash in March 2020 or, most recently, the sell-off in gilts prompted by the UK mini-budget) in otherwise very liquid government bond markets. Liquidity has generally been shallow (ie at lower end of the usual range), even in US Treasuries, and it is deteriorating again.

But, in terms of technical market functioning, we have been for the most part well served – in part because of appropriate measures on the part of the authorities (eg US FIMA and overnight reverse repo facilities).

Yet, central banks have barely started to adjust their balance sheets and outright asset sales are on the cards or are at least likely, including in the case of the US Fed (where the balance sheet is down by (only) about 2% from its recent peak). This, and at times elevated market positioning amid sustained macroeconomic uncertainty, means that the risk of market accidents remains.

Indeed, the United Kingdom's recent mini-budget episode highlights that, with central banks having stopped buying, bond markets have been growing less tolerant of fiscal policies that are perceived as ill-timed.

One risk has become evident: fiscal policy has sought to compensate and sometimes overcompensated for economic hardship due to the pandemic and now inflation has impacted households and businesses. This can be counterproductive for monetary policy actions that seek to bring inflation down. And rising deficits are much more difficult to finance in a period of quantitative tightening than in a period when central banks bought up a big portion of debt issues (government bonds, mortgage bonds, corporate bonds).

Overall, this places more of an emphasis on solid fiscal policies and effective communication from fiscal and monetary authorities. It also highlights that we need to brace ourselves for surprises from crowded positions or hidden leverage, as highlighted by the margin calls faced by UK pension funds from their liability-driven investment derivatives positions.

Gold as a reserve asset

One thing that the most recent volatile market environment has helped to highlight is the value of asset class diversification. This includes gold, which is known to be volatile, but with relatively low correlations vis-à-vis other reserve assets.

Indeed, the key point about observed gold holdings in reserve portfolios is that you need to use both quantitative and qualitative considerations to assess the appropriate level of gold in your portfolio. Currently this allocation is at around 14% of central bank reserves worldwide, but with some differentiation between advanced and emerging market economies (EMEs).

EME central banks have purchased more gold over the last 10 years than all AE central banks sold under the Central Bank Gold Agreement between 1999 and 2009.

Let's start with the quantitative angle. On this, recent research in the BIS Banking Department provides some clues.

The main point is that gradually increasing the share of gold in reserve portfolios from a starting point of zero will bring clear diversification benefits. However, gold's market risk profile is not to be neglected and this puts a limit on the target allocation of gold in any given portfolio.

This calls for the qualitative angle. Widely accepted reasons for holding more gold include:

Gold is durable and largely imperishable, and nobody's liability if you hold it physically in your vaults, which frees it from default or counterparty risk.

Unlike currencies and debt instruments – which are claims on foreign governments or institutions – gold kept in your vaults isn't subject to political manipulation or to monetary and fiscal policies.

Gold has been empirically proven to serve as an inflation hedge, although only over the long run.

Most importantly, it is widely recognised for its potential value in highly adverse scenarios. This is the so-called "war chest" value or "tail risk hedging" value of gold, which is difficult to capture in standard quantitative analyses.

However, gold should not be seen just as a dormant asset in a vault for the rainy days. Gold is an asset which offers opportunities in the financial markets. It can be used to create liquidity via gold/currency swaps or as collateral, often more cheaply than using other assets. Sometimes using options or placing deposits to enhance the return can be an appropriate strategy. From time to time, there are opportunities to take advantage of price differences between trading centres or bar sizes or the fineness of bars. For example, there was big scarcity in Comex bars during the first part of the pandemic due to reduced refining capacity. It can be very beneficial for central banks to remain active in the gold market even if they are not buying or selling outright.

Gold has performed best when investors' confidence is shaken by financial instability and credit issues. There are plenty of examples for exploding retail/coin demand during episodes of financial uncertainty.

As a result, gold has a role to play in reserve portfolios that goes way beyond the optimal shares determined on the basis of pure risk-return considerations.

Indeed, the recent period of generally rising levels of reserves amid historically low interest rates – and, hence, low opportunity cost – appears to have sparked a run-up in gold holdings (in tons) over the past decade – back to levels close to the peaks seen in the 1970s.

Compared with my early days on the gold desk at the Austrian central bank in Vienna (in the early 1980s) I see a reduced number of big commercial and investment banks active in the gold market. Some bank mergers have taken place, of course, but some banks have decided to withdraw. For the future, it would be beneficial for the central bank community to see more institutions back in the gold market.

Let me summarise. Various factors make for an exceptionally complex policy environment at the current juncture.

Calibration of the appropriate policy response amounts to a balancing act, and history tells us that soft landings are difficult to achieve. Indeed, current interest rate and inflation levels as well as asset valuations and debt levels suggest that the likelihood of a hard landing is rising in some countries.

At the same time, there are signs that we are in a transitional inflation regime, with a real risk of sliding into self-reinforcing high-inflation outcomes.

Thus, central banks have no choice. Postponing the necessary adjustments now may require an even stronger response later.

The result is a major repricing in financial markets amid elevated uncertainty, shallow liquidity and the risk of more market turbulence, should investors be wrongfooted.

Global central bank reserve levels have fallen from their recent peak of about $13 trillion (end of 2021) to approximately $12 trillion, according to IMF data. This is a decline of about 7% caused partly by valuation effects but also by intervention in the FX markets by some central banks to support their currencies as the US dollar appreciates. Gold remains a highly regarded asset class in central bank reserve portfolios.

Finally, given that no presentation on financial markets is complete without a reference to sustainability, let me add a few words on gold in this context.

With central banks' increased focus on environmentally and socially responsible investing, it has never been more critical to require that our assets come from responsible businesses. This applies to gold too. (See eg the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas).

For example, one may wonder whether the metals on our balance sheets have been responsibly produced and sourced. In the past, even if infrequently, links between gold production and unlawful armed conflicts have been discovered.

How can investors avoid funding these practices? Attention has to be given to the approaches undertaken by gold miners, refiners, dealers and investors to ensure they adhere to best practices along the supply chain. Of course, what constitutes best practice is an evolving concept, like a number of things in the E, S and G spectrum.

The bottom line is that investors will need to be provided with confidence that their money is indeed placed in responsible assets, whether financial or real.

In this context, “sustainable or green gold”, just like “sustainable or green investing”, is set to become a major trend.

Thank you very much for your attention.