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BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTTEG)

ISSUES PAPER (BOPTTEG) # 27A

THE TREATMENT OF NON-MONETARY GOLD IN THE MACRO ECONOMIC ACCOUNTS

Executive summary of a paper prepared for the UK Office for National Statistics
Philip Turnbull, Consultant in Official Statistics
August 2004

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INTRODUCTION

1. This paper is an executive summary of the full paper. It is designed to be the appropriate Issues paper for BOPTeg. The paper has been commissioned by the UK Office for National Statistics and will be presented to international statistical expert groups reviewing the existing international standards on national accounts and balance of payments. The issue addressed is the current and future treatment of gold in the System of National Accounts 1993 (SNA93 and planned revision) and the 5th edition of the Balance of Payments Manual (BPM5 and planned revision). Any changes would naturally also apply to other macro-economic standards e.g. those for Monetary and Financial Statistics (MFS) and for Government Finance Statistics (GFS).
2. The proposal in this paper is to extend the statistical treatment of gold as a financial asset to all financial institutions, rather than just the monetary authorities as in the present standards. Thus transactions and holdings of gold would be split into two categories: commodity gold, classified as trade in goods and inventories or valuables; and financial gold (including monetary gold) classified as a financial asset.
3. This paper supports and amplifies BOPTeg Issues Paper #27 prepared by the Bank of Japan, May 2004

CURRENT INTERNATIONAL STANDARDS AND PRACTICE

4. Gold held by the monetary authorities as part of the official reserves of a country or by international financial institutions such as the IMF and BIS is classified as monetary gold and a financial asset. As with SDRs there is no corresponding financial liability, an exception to the norm for financial assets. Direct sales between the monetary authorities are classified as a financial transaction in the SNA.
5. Non-monetary gold is treated as a commodity either for intermediate consumption or additions to inventories (for industrial use e.g. for electronics, dental or jewellery manufacture) or as a 'store of wealth' classified to the SNA capital account as valuables alongside precious stones and works of art etc.

6. Sales of monetary gold to non-monetary holders are decomposed into two flows: (1) a change in classification (demonetisation) of the gold by the monetary authorities under “other changes in volume” to the balance sheet; followed by (2) a sale of valuables by the monetary authorities from their SNA capital account, and an export of goods if the purchaser is a non-resident. A similar treatment applies in reverse.
7. Physical gold owned by depository corporations is classified as a non-financial asset, however the banks’ corresponding liabilities will usually be in the form of deposits denominated in gold and these are financial liabilities under the international standards.

Previous standards

8. The previous international standards were inconsistent. SNA68 had two categories of gold: financial (including monetary) and industrial (or commodity) gold and permitted all sectors of the economy to hold financial gold as a financial asset. Reclassifications between financial gold and industrial gold were accommodated as imports and exports regardless of whether or not the sale involved a non-resident. BPM4 in contrast permitted only the monetary authorities to hold gold as a financial asset (as in the current standards), but also implied an import and an export of physical gold to account for monetisation or demonetisation.
9. In the discussions leading up to the current standards, the presumption was that the treatment would be brought in line. The SNA expert group on external transactions agreed on the current treatment at a meeting in March 1987. Subsequent papers were presented to various expert groups and they confirmed the current treatment, but with minority objections from the UK and Japan.

Current Practice for Non-Monetary Gold

10. As part of the research for this paper the author has examined current practice in the USA, Switzerland and Japan as well as in the UK. These are all countries that have a large and international financial market in gold. In summary: only USA appears to fully follow the current international standards for non-monetary gold. Switzerland, and to a lesser extent Japan, has retained a wider interpretation of gold as a financial asset, while the UK has been unable to implement the treatment of non-monetary gold due to lack of data on cross border changes of ownership.

CONCERNS AND SHORTCOMINGS OF THE CURRENT STANDARDS

11. The core problem is that the international macro-economic standards are at variance with the financial markets in not treating gold as a financial asset. Inclusion of all gold transactions between residents and non-residents as imports and exports of goods would seriously distort the economic accounts of those countries with large international markets in gold. Purchases (or imports) of gold as a financial asset would not represent goods for use in the production process of the country concerned, nor would sales (or exports) be the outcome of a production process.

12. The effect on GDP is negligible since any increase in gold inventories or valuables is offset by the negative effect of greater imports of gold and visa versa. Trade in goods as an economic indicator could however be seriously distorted by the existing standards. The UK figures are not known (since Customs only record physical movements, not changes in ownership), but could be as high as three-quarters of the existing trade flows. In Japan recorded trade in non-monetary gold in 2003 was 14% of imports and 19% of exports.

Gold as a financial asset

13. Throughout history, gold has been used as a medium of exchange or directly as money. In time of political social or currency crises this is still true. Gold has a number of characteristics that can make it more like a financial asset than a commodity or valuables such as fine art, antiques or even other precious metals:
 - a. It is traded round the clock on financial markets in an equivalent way to foreign currencies. At any time there is a single quoted and recognised international price based on standard definitions.
 - b. Gold is fungible and readily assayed. Any form of gold can be re-processed into standard high quality bars for on sale on the markets.
 - c. The gold markets are highly liquid. Average turnover in London New York and Tokyo combined is the region of 50 million troy oz per day (worth around \$20bn).
 - d. Gold is traded not just in the spot market. There is a highly sophisticated market of secondary and derivative instruments just as would be expected for a financial asset.
 - e. There is a gold lending/deposit market and quoted interest rates.
14. All sectors may trade gold in this way, particularly financial institutions trading amongst themselves. Gold traded as a commodity is bought for end or intermediate use in the production process, for industrial inventories or as a store of wealth.

Lack of symmetry between assets and liabilities denominated in gold

15. Banks and other financial institutions trade gold between sellers and purchasers or borrow and lend it, but they do not hold significant amounts as physical assets. Gold held in their depositories or vaults is mostly other people's gold, held by the bullion banks for safe custody. There are two methods of placing gold with a bank, either as an allocated holding or an unallocated deposit. Allocated gold, which is more common in Europe than the USA, is a specific and uniquely numbered physical piece of gold, which remains in the ownership of the individual or institution placing it for safe custody with a bank. Unallocated gold deposits in contrast represent a claim on a fixed quantity of gold (in practice the market price of that quantity on the day of withdrawal). They are treated in commercial accounts and in the macro economic accounts as a foreign currency deposit and a financial liability of the bank concerned. The assets of the bank corresponding to these liabilities will be either physical gold or more often loans denominated in gold made to end users such as gold mining companies.
16. Both deposits and loans denominated in gold are financial instruments, but the small quantity of physical gold actually owned by the banks is classified as a non-financial

investment in valuables. However the liquidity of this gold is immediate and unlike any other kind of non-financial asset such as works of art, buildings or computers.

17. An even bigger problem exists in terms of the classification by the assets holder of the deposit liability of a bank denominated in gold. Monetary authorities making gold loans to commercial banks (or equivalently placing gold on deposit with banks) are advised in the international standards to treat this as off balance sheet and to continue to report the gold as part of the official reserves (BPM5 Para 434 refers, but amplified in the Reserve Template Guidelines, Para 99). Thus the financial asset recorded in the system and the corresponding financial liability, are different financial instruments (monetary gold and foreign currency deposits respectively). This is a fundamental breach of a basic rule of SNA, that all financial assets except monetary gold and SDRs have a corresponding financial liability. Gold repos made by monetary authorities are in contrast treated a collateralised loans and treated consistently in the accounts.

Goods and Merchanting

18. SNA93 requires trade in gold, other than directly between monetary authorities, to be treated as imports and exports of goods. The BoP Compilation Guide Para 138 however advises that the buying and selling of goods, including non-monetary gold, should be treated as merchanting services if the goods do not cross the national boundary of the compiling country. The service transactions are recorded net, valued as the profit or loss made on the sales of the goods. Merchanting is also a category in SNA93, but is not defined there.
19. However for countries with an international market in gold (such as Japan, Switzerland, UK) there is little correspondence between the activities of traders on the bullion market, cross-border movements of gold, and the concept of merchanting of a good. The identification of a particular shipment of non-monetary gold, which has been purchased from a non-resident and subsequently sold to another non-resident, is not generally possible, nor meaningful. The gold may be brought to London for safe custody without ever being owned by a UK resident, alternatively it may remain in a London vault/depository throughout several transactions. The purchaser on the London market will not usually be the end users and will resell the gold, most likely to a non-resident trader in gold, who may in turn resell it to local non-resident end users such as jewellery manufactures.

ALTERNATIVE TREATMENTS

20. The **main proposal** is to reintroduce the SNA68 concept of financial gold, but to restrict it to holdings by and transactions between financial institutions. Physical gold (investment grade only) held by financial institutions plus assets and liabilities denominated in gold would all be financial assets. The current category of monetary gold would then become a subset of financial gold. Financial gold would be an asset without a corresponding liability in the overall SNA sector accounts, as with monetary gold at present.

21. Other sectors of the domestic economy would only hold commodity gold as a valuable or for intermediate consumption as at present. When a financial institution sells gold to a non-financial institution the gold would be demonetised to a valuable first, and the subsequent transaction would be a transaction in commodity gold. If one end of this transaction involves a non-resident then it would be recorded as imports or exports of commodity gold. Similarly monetisation of gold would occur after the purchase of commodity gold by a financial institution from a non-financial institution (e.g. from a mining company or refiner). Financial derivatives and bank deposits/loans denominated in gold would however continue to be financial assets for all sectors of the economy as in the current international standards.
22. This is a pragmatic proposal. The reason for not proposing that all sectors of the economy should be allowed to hold financial gold (as in the SNA68) is that the purpose for undertaking gold transactions by other sectors is generally different. They are end users: producing gold, using it in the production process or investing in a 'valuable'. Most financial institutions however are intermediating in a financial market for gold. Transforming maturity, counterparty and currency risk in the process just like any other financial instrument. They match their asset and liability positions in gold either directly or via the use of financial derivatives. In general, they do not hold gold as a valuable or inventory in the sense of the concept as defined in SNA.
23. One consequence of such an extension to the financial asset boundary in SNA and BPM would be a need to measure any corresponding service earnings on dealings in financial gold by financial institutions.
24. The treatment of gold loans (deposits) placed with financial institutions by central banks also needs to be clarified in the manuals to ensure consistency between recording by asset and liability holder. The monetary authorities might record a reduction in physical gold (sale) and the creation of a foreign currency deposit (denominated in gold), to match the liability in foreign currency deposits reported by the banks. Alternatively both sides could treat it as an off balance sheet transaction in the same way as stock lending transactions. Under such a treatment, banks would need to record short positions in gold when they on-sell gold acquired from central banks in this way. The focus of the Reserve Template Guidelines is on the asset side: the liabilities side also needs to be articulated.
25. Should the main proposal above not find favour with the international experts, an **alternative** is needed to cater for those countries that have international markets in gold. As already explained, the BPM Compilation Guide (Paragraph 138) recommends a merchanting treatment for such markets. A modification to the definition of merchanting in BPM5 is needed to cater for this.
26. Merchanting should be defined in terms of purchases from and corresponding sales to non-residents by a resident enterprise without any intention of holding the goods as inventories or valuables for any significant period of time. The current link to no physical movement of the gold into, or out of, the country performing the merchanting operation should be removed (at least for the case of international gold markets). This is fully consistent with the definitions and concepts of assets and liabilities in the economic accounts. Physical movement of goods is only a proxy for the underlying economic concept of change of ownership.

27. A separate Issues paper on Merchanting is being prepared by IMF. If it is decided to continue the current concept of merchanting with no exception for the international gold markets, a new "gold" item could be introduced under the merchanting heading to cover all gold dealing net transactions.

POINTS FOR DISCUSSION:

- (i) Does the nature of trading in gold by non- Monetary Authorities mean that non-monetary gold can be considered as a financial asset as well as a commodity?
- (ii) Does BOPTEG agree with the main proposal to introduce the concept of financial gold for gold traded between financial institutions: such gold would be a financial asset, and monetary gold would be a sub-set of it: trading by other sectors would be in commodity gold?
- (iii) If not, does BOPTEG agree that the definition of merchanting of gold should be broadened to remove the restriction on cross-border movement: in practice this would only affect those countries with an international market in gold?
- (iv) Alternatively does BOPTEG agree that a new "gold" item could be introduced under the merchanting heading for all gold dealing net transactions?