IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

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NON-MONETARY GOLD: A POSSIBLE WAY FORWARD

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1. This paper offers a clarification to one of the alternative proposals set out in BOPTEG Issues Paper 27B, on the treatment of non-monetary gold. The current authors consider that the clarified proposal can fully meet the objectives of the earlier Issues Paper but in a way which responds to the concerns expressed by some BOPTEG members.

The Issue

2. The underlying concern in this debate has been to address the perceived "distortion" of physical trade statistics due to the inclusion of all bullion market transactions undertaken between resident and non resident counterparties. In the words of the paper, "The inclusion of all resident/non-resident gold transactions as gross imports and exports of goods would seriously distort the economic accounts …"[1] of countries with developed bullion markets, such as Japan and the United Kingdom.

3. As a solution, IP27B proposed the creation of a new financial instrument classification – Financial Gold – similar in nature to the current SNA concept of Monetary Gold but broader in its scope. Physical gold would then be classified as: Commodity Gold if it were held for industrial use or as a valuable; Non Monetary Financial Gold, if held by financial institutions and/or bullion traders for market making purposes; and Monetary Gold (a subset of Financial Gold) if held by Central Banks as a reserve asset. Such a delineation would then regard inter dealer trading as transactions in financial assets – not purchases and sales of goods – such that bilateral trading positions could then be netted, and resident/non resident business recorded as net financial transactions, that is as financing entries, rather than as trade in goods within the balance of payments.

4. Implementing such a proposal is not straightforward. Specifically, it requires that gold transactions which result in a change of classification – between commodity and financial or between monetary and non monetary financial – should be separately identified, and a reclassification entry logged. This in turn requires that the boundary between commodity and financial gold is well defined.

5. Objections to the proposal are nevertheless principally conceptual. A shared characteristic of financial instruments within the SNA framework is that they are issued by an institutional unit and so represent a liability to that unit as well as an asset to the holder[2]. Gold is an asset which has no corresponding liability so, in an SNA framework, has the hallmarks of a valuable rather than a financial instrument. Nevertheless, the global market in which gold is traded is highly sophisticated, exhibiting all of the characteristics of a financial market.

[1] Issues Paper 27B, paragraph 6.
[2] Monetary gold and SDRs are exceptions but their status as exceptions is noted in the SNA and their treatment as such remains contentious.

The Proposal

6. In seeking to define a possible boundary between financial and commodity gold, IP27B presents various alternative proposals. That contained in Paragraph 11 has attracted particular interest. This definition, which emerged from discussions with gold traders, views financial gold as "gold traded between counterparties through electronic metal accounts".

7. The IP is attracted to this definition both because of its precision and practicality. But the description of trading through dematerialised electronic accounts has raised the additional possibility that inter dealer turnover may not in fact give rise to the rapid changes in ownership of commodity gold which were thought likely to dominate conventional measures of trade in goods. The point at issue is whether traders exchange title to physical gold or whether the regular process of trading takes place in a genuine financial asset – a deposit – which happens to be denominated in units equivalent to physical gold, but for which the credit positions of one institutional unit are matched by a liability position for another unit.

So What Are Metal Accounts?

8. Metal accounts are any form of account facility provided by a third party, which give the holder the market risks and benefits of holding physical metal without the need to provide secure storage. They record the holder's outstanding balance, expressed as a quantity (weight) of metal – gold or other precious metal.

9. But such accounts occur in at least two distinct forms:

- As a record of title to specified allocated gold; and
- As a claim against a third party to deliver unallocated gold.

10. In the former guise, metal accounts are primarily targeted at the investment market. The account provider typically offers a one stop service to investors – purchasing storing and selling investment grade bars and coin to order. Accounts of this type constitute "full outright ownership of the metal" and, as such are advertised as 100% backed by physical stocks.

11. By contrast, accounts denominated in unallocated gold are targeted at the professional gold market. Account providers hold title to physical (allocated) gold and issue claims to account holders denominated in unallocated gold. The account holder does not hold title to physical gold but instead holds an unsecured claim against the account provider, in effect a deposit with the account provider.

12. The two forms of account can operate in tandem. For example, a gold refiner in Australia might deposit and hold allocated gold in an Australian metal account but then be called upon to deliver gold in London. Instead of physically transporting bullion, the refiner can use a facility known as a Location Swap through which his allocated holding in Australia is exchanged for an unallocated claim against a London account provider. This claim can then be converted into an allocated holding allowing delivery of physical gold to the customer. The process described here involves an exchange of title to physical gold between the refiner and the Australian account provider; a counterpart exchange of claims against the London account provider between the Australian account provider and the refiner; and an exchange of title to allocated

gold between the London account provider and the refiner; matched by a counterpart reduction in the refiner's claim against the London account provider. Transactions in physical gold are here seen to be settled through transactions in claims for unallocated gold.

13. The systems used for OTC gold trading are equivalent to those described above. Physical gold typically enters or leaves the gold market through a transaction between an account holder and a metal account provider, who will normally be a market maker. The first round effect is to raise the stock of allocated gold held by the account provider and to raise equivalently market claims for unallocated gold against the provider. Thereafter, inter dealer trading of metal account claims take place and will either be settled for cash or through the further transfer of title to physical gold. Accordingly, bullion market turnover overwhelmingly constitutes transfers of claims against metal account providers - transfers of title to allocated gold following clearing and settlement, are small by comparison.

14. These account types are fully reflected in the London Market. The London Bullion Market Association (LBMA) is the representative body for gold and silver trading in London. It lists nine market making members of which five offer clearing services. Trading is conducted through balances held by its fifty or so ordinary members with the market making members – trading balances taking the form of unsecured claims on unallocated gold. Allocated gold accounts, where holders own title to specified bars also exist but are used either to settle claims or as safe custody, rather than for trading purposes. For example, the Bank of England provides an electronic book entry service for the transfer of title to allocated gold used by LBMA members and other central banks. Daily turnover in these allocated gold accounts has averaged around 3% of unallocated gold turnover in London over the past year.

The Statistical Treatment of Allocated and Unallocated Gold

15. The distinction between allocated and unallocated metal accounts would seem to be a fundamental one. The former are equivalent to a custody record of title while the latter are an unsecured claim against a third party to deliver a specified quantity of metal of defined purity. As such, transactions in these latter credit balances cannot be classified as transactions in gold, since no change in title to physical gold occurs.

16. Unallocated gold credit balances can be viewed as equivalent to a foreign currency deposit. They represent the unsecured claim of the holder to receive from the account provider a stated quantity of gold. They are not title to gold. For its part, the account provider views credit balances in unallocated gold as a liability to be recorded on its balance sheet. Physical gold held by the account provider against these liabilities are held in its own name and will appear as assets (valuables) on its balance sheet. There is no requirement for such holdings to match outstanding liabilities to account holders.

17. Such patterns are observable in the currency analysis of UK banking data. For the LBMA market makers who contribute to these data, deposit liabilities denominated in gold can be identified and typically substantially exceed gold assets. Interestingly, gold liabilities reported by these market makers are predominantly held by non residents.

18. Classifying unallocated gold accounts in this way brings an immediate resolution of the potential problems highlighted by Issue Paper 27B without the need for a new and controversial financial instrument class. It delivers the same results for the trade in goods statistics as the proposed Paragraph 11 definition of Financial Gold in Issue paper 27B. However it does not include the requirement to record reclassifications under OCVA whenever the change in ownership of gold causes it to move from being a financial asset to commodity gold or vice versa.

19. Moreover, classifying metal accounts in this way should facilitate statistical collection. The boundary between allocated and unallocated gold is a precise one which is already recognised in the balance sheets of account providers. In addition, if transactions in unallocated gold deposits are to be regarded as financial, then such transactions need only be collected or estimated net. There is no requirement to record the gross flows needed when gold transactions are regarded as trade in goods.

Questions for BOPTEG

20. BOPTEG members are invited to consider:

- Whether unallocated metal account credits can be classified as financial assets?
- If so whether they meet the definition of deposits or some other existing instrument?

- If they can, whether this removes the case presented in Issue Paper 27B for the creation of a new instrument class – Financial Gold?

- If they are deposits, whether they can be classified as foreign currency deposits, or whether a specific deposit class needs to be assigned?

- Whether the classification of unallocated accounts as financial assets has any knock on implications, not considered by the paper, for the current SNA treatment of Monetary Gold?

- Whether other forms of electronic commodity account exist which should be considered alongside electronic metal accounts and classified similarly?