<http://fofoa.blogspot.com/2011/10/rpg-update-4.html>

**WEDNESDAY, OCTOBER 5, 2011**

**RPG [Reference Point, Gold] Update #4**



On New Year's Eve I dubbed 2011 "Year of the RPG" in deference to Robert Zoellick's recent editorial in which he described gold as "a key reference point to allow people to assess the relations between different currencies." This description was so close to Freegold that Zoellick's FT editorial led us to an additional name, "Reference Point Gold" or Freegold-RPG.

Throughout the year I posted "RPG Updates" every time the ECB published its quarterly Consolidated Financial Statement for the Eurosystem in which it revalues the system's reserves to market value denominated in its own currency, the euro. Such "marked to market" (MTM) revaluation is an important first step in allowing gold to be "a key reference point to allow people to assess the relations between different currencies." Here are the links to my first three updates:

[Update #1](http://fofoa.blogspot.com/2011/01/reference-point-gold-update-1.html)
[Update #2](http://fofoa.blogspot.com/2011/04/reference-point-gold-update-2.html)
[Update #3](http://fofoa.blogspot.com/2011/07/euro-gold.html)

There has been some confusion about the details and the relevance of this quarterly, system-wide or consolidated revaluation of reserves and the ECB's role as the system's aggregator. In the beginning, each participating country had to "buy in" to the system with a specified, euro-denominated value of foreign currency/gold reserves.

On April 18, 1998, eight months before the launch of the euro, ANOTHER explained that the idea of *any* gold being part of the initial buy-in had been a recent development. He wrote that it was initially discussed that gold would be only 5% of the buy-in, but that the BIS had decided that making gold 15% to 30% would render a euro that was stronger in oil. Less than three months later, on July 8, 1998 at a [press conference](http://www.ecb.int/press/pressconf/1998/html/is980708.en.html), Willem Duisenberg, President of the ECB, announced the final decision:

*Ladies and gentlemen, the Vice-President and I are here today to report on the outcome of the second meeting of the Governing Council of the European Central Bank held yesterday.

…The Governing Council decided on the size and form of the initial transfer of foreign reserve assets to the European Central Bank from the national central banks participating in the euro area. This transfer is to take place on the first day of 1999. It has been decided that the initial transfer will be to the maximum allowed amount of EUR 50 billion, adjusted downwards by deducting the shares in the ECB's capital subscription key of the EU central banks which will not participate in the euro area at the outset. The transfer will thus be equal to 78.9153% of EUR 50 billion, i.e. approximately EUR 39.46 billion.****The Governing Council furthermore agreed that this initial transfer should be in gold in an amount equivalent to 15% of the sum I have just mentioned, with the remaining 85% being transferred in foreign currency assets. I should stress that the decision on the percentage of gold to be transferred to the ECB will have no implications for the consolidated gold holdings of the ESCB.****The precise modalities of the initial transfer will be finalised before the end of the year.

Before the end of the current year the Governing Council will also have to adopt an ECB Guideline pursuant to Article 31.3 of the Statute of the ESCB, which will subject all operations in foreign reserve assets remaining with the national central banks -including gold - to approval by the ECB.

In connection with the setting-up of common market standards, the Governing Council also reached agreement on a number of issues related to the quotation and publication of reference exchange rates for the euro. Specifically, it was agreed to recommend to market participants the "certain" method for quoting the exchange rates for the euro (i.e. 1 euro = X foreign currency units) and to have daily reference exchange rates for the euro computed and published by the ECB.*

It should be noted that this initial transfer was not a surrender of assets to a third party central bank, but instead it was a buy-in, a purchase of equity in the system itself. So while a country might have contributed 8% of the ECB's gold, that country now owned 8% of the interest in the system. And being part of a system, that country also agreed to all operations in foreign reserve assets, not just those transferred to the ECB, being centrally coordinated by the system aggregator, the ECB.

So all this early talk about "gold backing" and various percentages—5% or 15% or 30%—turned out to be quite confusing in the beginning. Soon after the very first quarterly revaluation one astute reader asked FOA about it:

**Goldfly** (5/8/99; 22:04:55MDT - Msg ID:5787)
**FOA - 15% backing?**
<http://www.ecb.int/press/pdf/wfs/1999/fs990430en.pdf>

Actually, it looks like they're at 30%

From the Eurosystem Weekly Financial........

Asset 1 Gold: 105,323

Liability 1
Banknotes in Circulation: 332,280

Asset 1/Liability 1 = 31.69

$1000 gold would equal 100% backing(!?!?!)

GF

**FOA** (5/8/99; 22:24:54MDT - Msg ID:5790)
**Reply**
Goldfly (5/8/99; 22:04:55MDT - Msg ID:5787)
FOA - 15% backing?

Goldfly,
Hello again. Truly the ECB percentage as a number does not mean much at this time. It's the concept that is 180 degrees against the IMF / dollar system. For anyone to measure the value of Euro backing at present, is like looking at gold at today's price. It's out of context.

The beauty of the ECB ploy, is that it doesn't lock them into a rigid gold exchange standard. With gold trading in the open, all currencies are free to be exchanged for gold at any given point in time. The old IMF / dollar manipulation of gold, used from the early 70s gained nothing and cost the world dearly for the benefit of the fictional US living standard it created. Had they just allowed gold to rise from the beginning, commerce would have been much more balanced, nation to nation.

Prior to the Euro, Europe had to play the IMF game. The same game that has now backfired on the US today. They truly don't need the IMF and may pull out later. FOA

Now there is an interesting note in this exchange to which I would like to draw your attention. Goldfly was erroneously looking at the consolidated value of Eurosystem Central Bank gold versus the total number of euro bank notes. This is not what we look at, and it is not even particularly relevant since they aren't running a "rigid" (as FOA called it) Bretton Woods-style gold standard, but what Goldfly observed at 31% in 1999, has today grown to 50%.

We don’t look at the gold on the asset side of the balance sheet versus the euros on the liability side. And we also don't look at the present value of only the subscription fee to the system, the reserves held by the ECB itself. We look at the aggregate reserves for the Eurosystem as a whole (lines 1 and 2 on the asset side only) and how the **proportion** of gold in those reserves has evolved over time.

On a CB balance sheet there is a distinction we can make between assets in general and those assets that qualify as reserve assets. At the central banking level such as the ECB, its institutional liabilities largely take the form of issuance of currency banknotes and deposits held on behalf of commercial banking institutions (such as those being held to meet a commercial bank's reserve requirements, and to facilitate check-clearing between institutions) which are denominated in its own domestic monetary unit (i.e., the euro.)

The requisite assets to balance against these liabilities are largely in form of euro-denominated claims on commercial credit/banking institutions. As these claims are often collateralized by government bonds, at the very end of the rope it is fair to say a large portion of assets held by the central bank take the form of government bonds even though they were (largely) acquired indirectly through typical financing operations to extend credit to the commercial institutions.

These euro-denominated claims (assets) are suitable for offsetting euro-denominated liabilities, but they do nothing in regard to **your rare "rainy day" when it is found necessary to defend the euro's stature against its foreign peers. For that purpose a central bank needs to have either gold (which is a universal asset) and/or a position in foreign currency claims against non-resident (foreign) institutions. It is this combination of gold assets and foreign currency assets that constitute the official "reserves" of a central bank.**
The proportion of RESERVE assets among the central bank's TOTAL assets is normally a judgment call. Generally, the more unstable or insecure a central bank deems its national government and economy to be on the world stage, the larger the proportion of assets it will hold in the form of reserves. (Recall the expansion of reserves among Asian countries following the 1997 Asian Contagion crisis.)

And regarding the make-up of the reserve assets specifically, it is ultimately a central bank's own internal management decision that determines what proportion of reserves are in the form of gold versus foreign currency. At launch, January 1, 1999, the make-up of the Eurosystem's reserves was 30% gold and 70% foreign currency claims on non-euro area residents (mostly dollars, in fact, probably mostly US Treasuries left over from supporting the US trade deficit for 20 years to buy the time necessary to launch the euro).

In addition to the distinction I just explained, another key definitional aspect of CB **reserves** is that they are *"****readily available****to and* ***controlled by****monetary authorities for direct financing of payments imbalances, for indirectly regulating the magnitude of such imbalances through intervention in exchange markets to affect the currency exchange rate, and/or for other purposes… the concept of reserve assets should encompass those assets over which authorities exercise****direct and effective control****."* (my emphasis, quote from the IMF BOP Manual)

So aside from being either gold or foreign currency-denominated claims on non-residents, the two main criteria for assets to qualify as *reserve* assets for central banks are **availability** and **control**. This official definition ***ought*** to translate loud and clear into an institutional *preference* for in-house physical gold holdings over the alternatives. (After all, try to truly consider and assess the concept of "control" insofar as it applies to an asset defined as a mere "claim" on a foreign entity denominated in a foreign monetary unit! Does anyone remember Nixon?) That we have not yet fully attained this operational reality despite the logical preference for it is what our long-winded discussions regarding the slow evolution from dollar-centric toward Freegold tries to explain in a rational political context.

There is one other nuance in CB reserve reporting standards that I should mention. The reason the ECB makes its *"net position in foreign currency"* (claims minus liabilities regardless of residence) so prominent in the commentary portion of its ConFinStats is explained in Chapter III of the ECB's [Statistical Treatment](http://www.ecb.int/pub/pdf/other/statintreservesen.pdf) (Oct. 2000):

*"Since the monetary crises which took place in most of the Asian countries in the late 1990s, international organisations have gradually become more concerned with the availability of reliable information on the capacity of a country to contend with potential financial crises. Consequently, the IMF ... requires additional details on international reserves and other foreign currency claims and drains from those presented so far in international standards, addressing, for the first time, the compilation of figures on reserve-related liabilities."*

In other words, taking the liability side into account for the "*net*position in foreign currency" came into vogue thanks especially to the experiences of the Asian contagion crisis wherein it was shown how quickly and easily a nation could be stressed by its liabilities denominated in foreign currency. So the *net* position in foreign currency is now a fundamental part of any CB's overall Health-O-Meter. And so with this view in mind, it is clear that a value shift away from foreign currency reserves toward gold, the universal reserve asset, is also a shift in the overall ***quality*** of a portfolio.

But the strict definition of reserve assets within the Eurosystem is simply the **GROSS** total of the qualifying asset items and foreign-denominated claims on non-residents of the euro area as summed from the asset side of the balance sheet, without any further adjustment for items on the liabilities side. In other words, the official reserves are calculated through the simple addition of asset items #1 plus #2, which is what I use in these updates.

**The De Facto Ascent of Gold**

It is a common misconception that any retreat from dollar-denominated CB reserve assets would, in itself, destroy the value of the CB's portfolio of reserves. This canard is often used by the anti-gold financial media to explain the dollar's apparent strength, claiming that the world is trapped in perpetual dollar use by the existence of its humongous dollar reserves. Here is **Randy Strauss** from my post [Gold: The Ultimate Hedge Fund](http://fofoa.blogspot.com/2010/01/gold-ultimate-hedge-fund.html):

*[article] ...Even in light of all of this shifting by central banks into other currencies, the dollar still comprises 2/3 of global reserves and attempts to shift away from the dollar would destroy the value of central banks’ portfolios.*

**Randy's Comment:** Although I should be well used to it by now, it still amazes me every time I see comments like the final remark here regarding any significant shift from dollars will lead to the destruction of central banks’ portfolios. It’s almost as if the commentator is trying to help indoctrinate a paralyzing fear as a means to prevent any such attempt on the part of the CBs, and to also create enough grass-roots doubt against such an attempt ever being made that we the people won’t perceive any benefit in trying to front-run with our own flight out of dollars and into gold...

It is an error in thought or judgment, however, to believe that a “destruction” of the dollar portion of the portfolio would therefore proportionately destroy the portfolio as a whole. That would only be the case if all other things remained unchanged, but life seldom works out so neatly as that. Sometimes an action can set forth an immediate chain reaction that literally changes EVERYTHING you thought you knew about the situation!...

In the world of the “new normal,” it is indeed possible (and someday soon desirable) to let the fuse be lit and allow the CB store of dollars be consumed. And to be sure, it is singularly the latent potential energy of the gold component that allows us to make this analogy with gunpowder. The natural chain reaction in the tiny open market for physical gold would immediately bring to bear massive “heat” and “pressure” upon its price… \*\*POW\*\* thus swelling the “volume” of its value relative to all other things. So even without radical changes to the quantity of physical holdings, a simple expansion in golden value will more than compensate the average portfolio of the central banks against the destruction of the dollar component.

Still can’t wrap your head around it? Bear in mind that the gold price is not a simple one-to-one inverse relationship with the dollar. There is a great leverage lurking in there, but it has been largely masked by the artificial abundance of paper gold which weighs down upon the equilibrium price. And even so, since 2002 the dollar value has decline by just 20% on a trade-weighted basis, whereas the gold price has responded with a 300% gain. And the moreso that the public and private parties of the world rightly gravitate toward physical gold instead of the illusion of paper derivative gold as the solid foundation of their savings and diversifications, the moreso you will see this price leverage grow in favor of larger multiples of gold price gains against modest dollar losses....

Central bankers will increasingly prefer gold reserves over the paper reserves created by other countries. Not only for the reasons of reliability/trust as cited in this article, but moreso because in choosing predominantly gold over foreign paper for central banking reserves will give those various national monetary officials an improved degree of latitude in their pursuit of an independent monetary policy.

WITH gold reserves, a central banker in a vibrant national economy can choose to enjoy a strong currency relative to gold, but, importantly, it can still alternatively choose to exercise loose monetary policy (for economic or political reasons) in which its currency is made weak as measured relative to gold. But regardless of choice for the relative strength or weakness of the national currency, the abiding benefit of choosing gold reserves is the superior stability — the systemic strength against procyclicality — that gold offers to the asset side central banking balance sheet.

WITHOUT gold reserves, pursuit of a national currency policy that is (according to their preference) generally strong OR generally weak is made less expedient either way because the health of the central bank’s balance sheet is subordinated to the quality of its foreign paper reserves which are themselves subordinated to the particular monetary policies being pursued by those foreign governments. Generally this structure of foreign paper reserves offers only the option for national monetary weakness built upon other international weaknesses, and worst of all it exposes the national monetary balance sheet to procyclical systemic failure — a domino whose fate is written largely in the hand of its neighbors.

**When you understand how it is that it is economically (and therefore politically) undesirable for other major currencies to appreciate against their peer currencies (which is exactly what would happen to any currency replacing the dollar’s reserve status), you will subsequently know why gold shall continue to emerge as the de facto solution to the international reserve question.

And here I emphasize de facto rather than de jure because this has become a global phenomenon driven by a natural evolution(survival and ascent of the fittest) and does not require any additional international treaty or enabling legislation as a prerequisite or for motivation.

The breeze is fair and the road ahead is clear for the ascent of gold.**

R.

From my post [Your Own, Personal, Freegold](http://fofoa.blogspot.com/2009/10/your-own-personal-freegold.html), here's how the *leverage*in gold as a reserve asset behaves. This is what the Eurosystem's quarterly MTM parties reveal, and it can work on an individual level the same as it does for central banks, thus the title of my post. BTW, the pivot point in these illustrations is the physical plane of real goods, real services and real world capital:



**Whoop There It Is**

And now let's have a quick look at the results of the latest [MTM party](http://www.ecb.int/press/pr/wfs/2011/html/fs111005.en.html):

In the week ending 30 September 2011 the increase of EUR 56.8 billion in gold and gold receivables (asset item 1) reflected quarterly revaluation adjustments.

The net position of the Eurosystem in foreign currency (asset items 2 and 3 minus liability items 7, 8 and 9) increased by EUR 13.2 billion to EUR 191.1 billion. This change was due to the effects of the quarterly revaluation of assets and liabilities, the customer and portfolio transactions carried out by Eurosystem central banks during the period under review and US dollar liquidity-providing operations.

**Quarter-end revaluation of the Eurosystem’s assets and liabilities**

In line with the Eurosystem’s harmonised accounting rules, gold, foreign exchange, securities holdings and financial instruments of the Eurosystem are revalued at market rates and prices as at the end of each quarter. The net impact of the revaluation on each balance sheet item as at 30 September 2011 is shown in the additional column “Difference compared with last week due to quarter-end adjustments”. The gold price and the principal exchange rates used for the revaluation of balances were as follows:

**Gold: EUR 1,206.399 per fine oz.

USD: 1.3503 per EUR

JPY: 103.79 per EUR

Special drawing rights: EUR 1.1564 per SDR**



In other words, **the decade-long trend continues, even in the face of all that "dollar strength." Last quarter gold made up 62.7% of the Eurosystem's reserves. This quarter it rose to 65% of the reserves.** This is especially remarkable given not only the dollar's recent "strength" which accounted for most of the rise in currency reserves, but also the dramatic price plunge in gold just a week before the party.

You'll find much more on the Euro-MTM/Freegold-RPG model in the earlier "Updates" listed at the top as well as the other posts I linked including this one: [Gold: The Ultimate Wealth Consolidator](http://fofoa.blogspot.com/2010/07/gold-ultimate-wealth-consolidator.html).

**Conclusion**

Don't make the mistake of assuming central bankers are stupid, or anti-gold, or that they are not fully aware of the concepts and principles I am writing about. When I write about the "logical preference" for gold, or the "de facto ascent of gold" to global IMFS reserve asset par excellence status, or gold as "the de facto solution to the international reserve question," these are logical, de facto realities of which central bankers are acutely aware. So when you hear them talking about complex solutions requiring massive[ly unlikely] global cooperation, new international treaties and enabling legislation, realize that they are talking about ditching the dollar in the most diplomatic terms they can, and then recall Randy's words:

***When you understand how it is that it is economically (and therefore politically) undesirable for other major currencies to appreciate against their peer currencies (which is exactly what would happen to any currency replacing the dollar’s reserve status), you will subsequently know why gold shall continue to emerge as the de facto solution to the international reserve question.

And here I emphasize de facto rather than de jure because this has become a global phenomenon driven by a natural evolution (survival and ascent of the fittest) and does not require any additional international treaty or enabling legislation as a prerequisite or for motivation.

The breeze is fair and the road ahead is clear for the ascent of gold.***

And after you think about it for a while, maybe you'll start to understand why gold was the asset chosen to occupy the #1 spot on the Consolidated Financial Statement of the Eurosystem, and why this is a key driving force (along with impartiality and systemic stability) behind the evolution to a 90+% gold proportion of reserves in the new international "Freegold-RPG" monetary system. And then, as Randy suggested above, you might want to **front-run the CBs with your own flight out of dollars and into gold**. Randy ended with [this](http://www.usagold.com/cpmforum/?p=174010), and so will I:

*"Again, on average the central banks have 10% gold. The ones who have less are scrambling. How about you? Do you have enough gold to put a suitable \*BANG!\* in your portfolio?"*

Sincerely,
FOFOA

Posted by FOFOA at [11:15 PM](http://fofoa.blogspot.com/2011/10/rpg-update-4.html)

**306 comments:**