WORLD GOLD COUNCIL

World Gold Council response to the European Commission's

Green Paper on the feasibility of introducing Stability Bonds

Brussels, 23.11.2011

The World Gold Council (WGC) welcomes the European Commission's (EC) efforts to seek lasting solutions to the ongoing tensions in the Eurozone's sovereign debt markets. In particular through the complete or partial substitution of national bonds with common issuance bonds ("Stability Bond"). The WGC agrees with the Commission that in order to ensure the lowest possible cost of funding for the Stability Bonds, credit enhancements should be considered and one such enhancement could be the partial collateralisation of the bonds with gold. However, the paper fails to address important legal considerations that would surround any such mobilisation of the region's gold reserves. The WGC would also expect central banks to abide by the spirit of the Central Bank Gold Agreement (CBGA) when structuring any such gold-backed Stability Bond.

(1) Gold can play a valuable role as high quality collateral

Gold is the ideal form of collateral. It has no credit risk, a uniquely diverse demand base, ranging from jewellery to technology to investment to central banks, and it exhibits counter cyclical tendencies, performing well relative to other assets during periods of economic stress. This is clearly evident from gold's performance throughout the European sovereign debt crisis. The gold market is also deep and liquid, trading an estimated $240 billion a day through the London Over-The-Counter market alone, with a financial market size of approximately $2.9 trillion.[1] [2] Due to gold's high quality and liquidity as a financial asset, it is frequently used as collateral to secure global funding at minimal costs and is often the most advantageous of all collateral types during crisis periods.[3]

These characteristics explain gold's growing use as collateral in the official and private sector and the European Parliament's (EP) recent unanimous endorsement of gold's use as collateral at clearing houses in the forthcoming European Market Infrastructure Regulation (EMIR). As global policy makers and regulators increasingly recognise gold's role in this capacity, the WGC would also expect gold to be included in the liquidity buffers being introduced under the fourth Capital Requirements Directive (CRD IV).

(2) The Treaty and the Statute

There are, however, important legal considerations surrounding any such mobilisation of the region's gold reserves. Due to the complexities of the Treaty and Statue we have sought legal opinion on the use of gold in this manner. Following that, our understanding of the situation is as follows. Gold, as part of the official foreign reserves of the Member States, is held and managed by Eurosystem central banks not governments.[4] The Treaty on the Functioning of the European Union (TFEU) and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank establish that national central banks and the European Central Bank (ECB) must remain independent

[1] Daily trading volume is an estimate determined through a survey conducted by the London Bullion Market Association (LBMA) in Q1 of 2011 available at http://www.lbma.org.uk/assets/Loco_London_Liquidity_Surveyrv.pdf

[2] The financial market of gold is estimated by the World Gold Council using Reuters GFMS' estimates of outstanding gold stocks summing Private and Official stocks of gold and valuing it at the average first quarter London pm fix gold price. For further explanation see the World Gold Council's report "Liquidity in the Global Gold Market."

[3] Gold forward rates (GOFO), published daily by the LBMA) are typically in-line with or lower than funding available against other sources of high quality collateral like highly rated sovereign debt.

[4] *Treaty on the Functioning of the European Union*, Article 127. This article reads " The basic tasks to be carried out through the ESCB shall be: ..to hold and manage official foreign reserves of the Member States..."
Note: In the Green paper, the authors write that, "gold reserves which are largely in excess of needs in the most EU countries...[could enhance the quality of the underlying guarantees]." As noted prior the management of official reserves are the responsibility of the ESCB, therefore the determination of whether reserves of any quality (e.g. US dollars bonds, gold, etc) are adequate or in excess is for the ECB and national central banks (ESCB) to decide.

of governments in pursuit of their primary objective of price stability. [5] The Treaty also expressly prohibits the direct financing of governments. [6]

The use of gold as collateral for the issuance of Stability Bonds could imply that creditors holding these debt instruments would ultimately be repaid by the use of this gold. If this were to take place, it could be determined that the gold was sold for the benefit of the repayment of debt incurred by one or more euro area governments, which could imply financing of governments by the ECB and national central banks and would therefore be in breach of the Treaty.

(3) Mobilisation of gold as collateral to support the ECB's secondary mandate

That said, there may still be scope for such a move under the existing Treaty and Statute. It would require the Governing Council of the ECB to independently arrive at a decision to mobilise the region's gold reserve in order to collateralise a new Stability bond. We believe this could be legitimately executed under the existing Treaty under the pretext of meeting the ECB's secondary objective "to support the general economic policies of the member states". Although this could only be carried out if the Governing Council were to determine that it did not interfere with its primary objective of price stability. The gold would need to be sold or transferred to a new joint debt issuance agency, for example, removing it from the central banks' balance sheets. We do not believe it would be possible to pledge gold as collateral while it was still part of the region's foreign exchange reserves.

(4) ESCB should continue to abide by the principles of the CBGA

European central banks should continue to act responsibly as a monetary authority and incorporate the principles of the Central Bank Gold Agreements into any deployment of gold. Central banks hold over $11.7 trillion in foreign currencies and gold reserves and collectively are the largest holders of many reserve assets, one of which includes gold.[7] Due to central banks' large foreign currency and gold reserve holdings, central banks have a responsibility as monetary authorities to be mindful of their large holdings and the significant market disruptions they can have by collectively and sometimes individually transacting in very large sizes in the market.

Since September of 1999, European central banks have coordinated their sizeable activity in gold through a series of Central Bank Gold Agreements, whereby the central banks have agreed collectively to a total amount that they will sell in any given year.[8] Through this coordinated effort, the central banks have been able to conduct their activity without disrupting the gold market. Given the size of the Eurozone's gold reserves of approximately 10,800 tonnes, the ECB and ESCB have a responsibility to limit any potential market disruptions in the gold market in the event of a default on the Stability bonds. This could otherwise seriously impact the value of other central banks' gold holdings around the world, the export earnings of gold-producing emerging market countries, the jewellery trade including designers and marketers, and private investors. In practice this could mean limiting the amount of gold backing each bond and possibly staggering the payments of gold in the event of a default.

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[5] Article 130 of *Treaty on the Functioning of the European Union (hereinafter the 'Treaty')*; Article 7 of *Statute of European System of Central Banks and of European Central Bank* (hereinafter the 'Statute')
[6] Article 123 of the *Treaty*; Article 21 of the *Statute*

[7] IMF International Financial Statistics as of June 30, 2011. This amount includes foreign currency and gold reserves valued in US dollars.

[8] A detailed account of the Central Bank Gold Agreements is available at http://www.gold.org/government_affairs/reserve_asset_management/central_bank_gold_agreements/