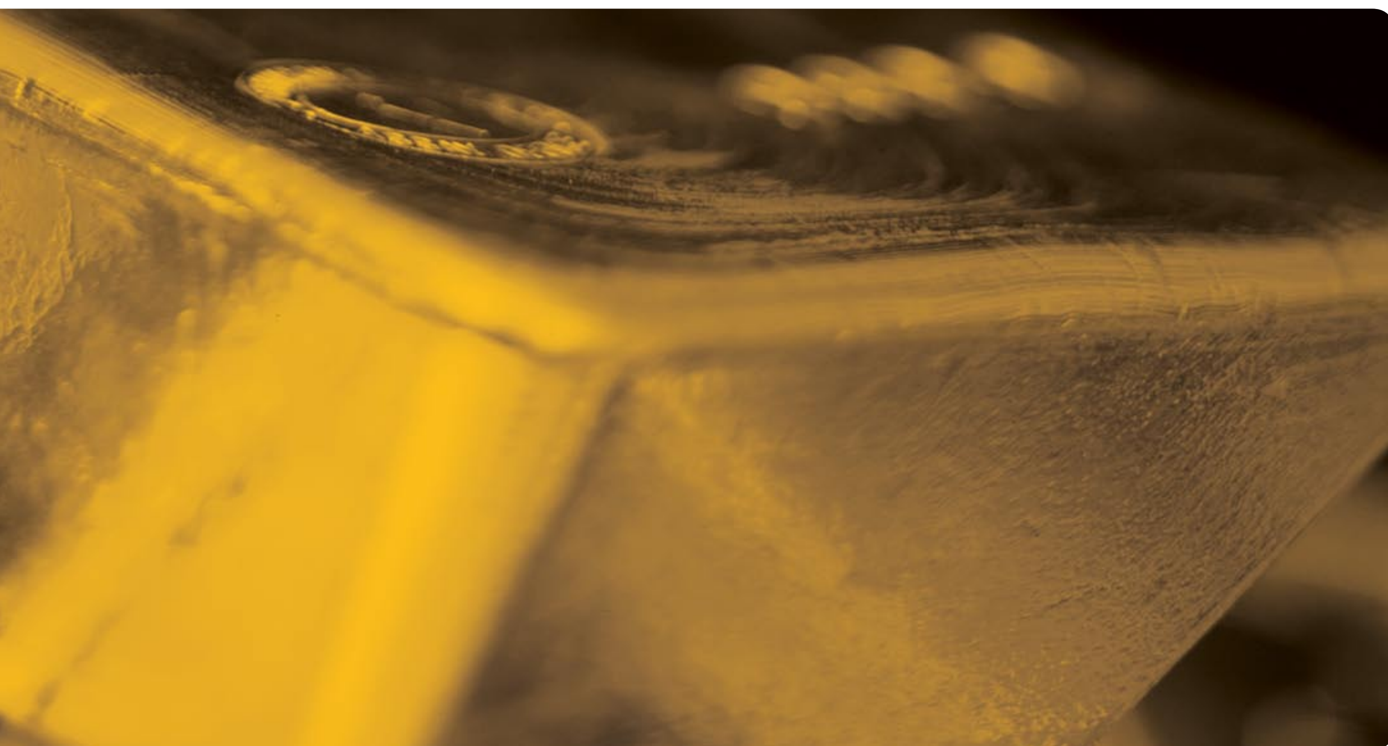
WORLD GOLD COUNCIL

THE EVOLUTION IN CENTRAL BANK ATTITUDES TOWARD GOLD



gold

About The World Gold Council

The World Gold Council's mission is to stimulate and sustain the demand for gold and to create enduring value for its stakeholders. The organisation represents the world's leading gold mining companies, who produce more than 60% of the world's annual gold production in a responsible manner and whose Chairmen and CEOs form the Board of the World Gold Council (WGC).

As the gold industry's key market development body, WGC works with multiple partners to create structural shifts in demand and to promote the use of gold in all its forms; as an investment by opening new market channels and making gold's wealth preservation qualities better understood; in jewellery through the development of the premium market and the protection of the mass market; in industry through the development of the electronics market and the support of emerging technologies and in government affairs through engagement in macro-economic policy issues, lowering regulatory barriers to gold ownership and the promotion of gold as a reserve asset.

The WGC is a commercially-driven organisation and is focussed on creating a new prominence for gold. It has its headquarters in London and operations in the key gold demand centres of India, China, the Middle East and United States. The WGC is the leading source of independent research and knowledge on the international gold market and on gold's role in meeting the social and economic demands of society.

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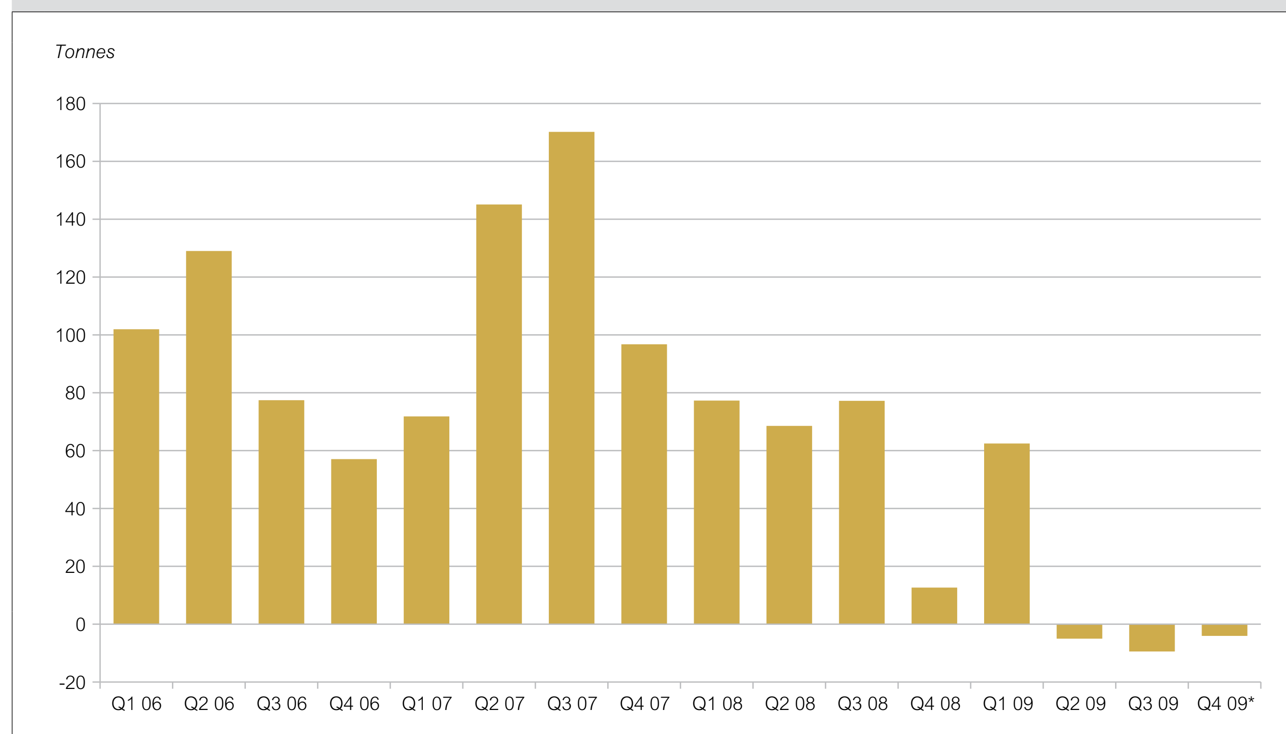
The evolution in central bank attitudes toward gold

Jill Leyland, World Gold Council

Introduction

During 2009 central banks and official institutions as a whole became net buyers, rather than sellers, of gold (see figure 1). Net annual sales for the year as a whole, at 44 tonnes, were a small fraction of those of previous years. Since 27 September 2009, the start of the third Central Bank Gold Agreement, the only significant seller to date (April 2010) has been the International Monetary Fund (IMF), although the Fund's sales of 212 tonnes of gold in 2009 were completed in off-market transactions with central banks, and therefore did not constitute net selling to the private sector. IMF statistics for February 2010 show a decline in the Fund's gold holdings of 6 tonnes, marking the beginning of on-market sales within the ceiling set by CBGA3. Among signatories to CBGA3, Germany has sold a small amount for coin minting. In contrast a number of purchasers have emerged on the buy side in addition to countries such as Russia and Belarus who have been adding to their gold reserves for some years. India, Sri Lanka and Mauritius together bought over half of the gold the IMF had available for sale. China announced in April 2009 that it had added 454 tonnes to its gold reserves since 2003, a 76% increase. The Philippines, whose gold reserves fluctuate as it buys up domestic production and later sells on the market, was a net purchaser in both 2008 and 2009, as it was in most years before 2003, in contrast to being a net seller in the years 2003 to 2007. Venezuela, which also periodically buys domestic production but for many years had used it in ways which did not entail increasing its formal gold reserves, was recently reported on Bloomberg as intending to buy more domestic production and also adding to its gold reserves.

Figure 1: Net official sector sales (tonnes)



*Source: GFMS. * Provisional*

Our previous publication, *Structural Change in Reserve Asset Management*[1] looked in more detail at how official sales, primarily from European central banks, have declined in the last two to three years and how purchases, notably from emerging market countries, have risen, setting this into historical context. This publication looks at the reasons this shift has occurred and how the events of recent years, in particular the financial crisis, have tipped the balance away from net official sector selling towards net buying.

Central banks do not always publish the reasons for their reserve management decisions – and when reasons are publicly announced they are unlikely fully to reflect the long deliberations that develop policy. Nevertheless based both on information in the public domain, and on the regular discussions executives of the World Gold Council have with central banks, it is possible to deduce the main reasons underlying the evolution in central bank attitudes which have led to this shift in outcomes.

Central banks and gold: advantages and challenges

Central banks manage their foreign reserves carefully. They have a responsibility to their citizens and government for the prudent management of what is part of the wealth of the nation. Not only must the reserves cover day to day needs for foreign exchange but their value must be preserved, as far as possible, even during times of turbulence. Objectives in reserve management typically include stability, liquidity, the furtherance of exchange rate and other national policy goals, the avoidance of disruption to financial markets and financial return. The relative importance of these goals will vary over time: stability and liquidity, for example, have been of particular importance during the financial crisis while changes in exchange rate policy, eg from a fixed or pegged to a floating rate, will have immediate implications for reserves management. Fashions also vary. For example, during the 1990s there was increased pressure on a number of central banks to obtain a financial return or yield from their reserves whereas in earlier times stability and prudence were considered more important. Finally the needs of each central bank will be individual according to the circumstances of their country, economic policy goals, political considerations, and the central bank's own mandate.

Set against this background, each reserve asset presents its own particular advantages and challenges. For example, the dollar is the world's main trading currency, offers a huge range of financial instruments and has excellent liquidity; against this its worth is susceptible to US economic policy, it has lost value over the last decade against both the euro and gold and, if there are political issues between the country concerned and the US, this can affect the attitude towards dollar assets in ways not always consistent with optimal reserve asset management.

Gold is no exception to this rule and has its own set of advantages and challenges. Gold is no one's liability; unlike any currency its value is not dependent on any one country's economic policies; it has a reputation as a safe haven, and indeed often acts as one. As a result of these attributes it can be considered as a defence against unknown contingences. All of these are clear advantages. A further advantage is that including gold in a currency portfolio normally brings diversification benefits since returns on gold tend to have a low correlation with other assets typically invested in by central banks. Citizens generally like the fact that their country holds gold reserves – gold's long history, its physical presence and its reputation all contribute to this. Thus the existence of gold reserves can increase public confidence in a central bank. For countries where gold is mined, gold holding or purchasing by the central bank can be viewed as supporting a local industry.

On the other hand challenges include the cost of holding gold (vaulting, insurance, shipping and settlement costs when traded) and the need for specialist management skills since the gold market is different from currency markets. Another problem is the fact that decisions on gold holdings can be more politically sensitive than those on currency holdings and therefore cannot always be taken on purely professional grounds, potentially causing opportunity costs. Reserve managers can find that decisions on gold have to be referred upwards whereas equivalent decisions on managing currency reserves would be left to them. Gold, while a less volatile asset than stock exchange indices, can be more volatile than major reserve currencies; its price can also appear more volatile due to the volatility of the currency in which its price is quoted. This can pose accounting issues and potentially harm the central bank's reputation if there has been an apparent or real loss on gold in any one period. Interest that can be earned on gold if it is lent

[1] *By Natalie Dempster, November 2009. Available on www.research.gold.org/research*

out tends to be lower than that which can be obtained from currency assets. Finally, some central banks may find that their mandate forbids certain actions in respect of gold (for example there may be constraints on lending) to which other currencies are not subject; occasionally there may be legal restrictions.

Thus in deciding whether to increase, reduce or leave unchanged their gold holdings central banks will weigh up a number of factors and set them against the current economic and political environment. Decisions are rarely straightforward but reflect a complex balancing of pros and cons. As economic and other circumstances evolve, so the balance of advantage might shift from holding gold to buying or selling it, and back again.

The era of net selling

During the 1980s most central banks kept their gold holdings stable but in the 1990s, and in particular during the second half of that decade, the balance of advantage shifted in the eyes of some and led to net official selling becoming a significant feature of the gold market. Several reasons accounted for this: the generally good macroeconomic circumstances of the 1990s so that gold's safe-haven properties hardly seemed needed; the downward trend in the gold price of the period; and increased pressure on reserve managers in many central banks to make their assets generate a return, making gold's usually low interest rate unattractive. Selling was not confined to European central banks, but they became the dominant sellers due to the fact that for historical reasons gold accounted for a high proportion of total reserves for many of them.

These reasons meant that gold's disadvantages weighed more heavily than before in the minds of central bankers. So while some central banks with significant gold holdings sold, those with small holdings, where gold was only a small proportion of total reserves, did not generally buy.

This sentiment continued into the early years of the 21st century. Global economic growth remained buoyant in the first half of the decade. While signs of unease in both economics (for example the end of the dot-com boom in 2000, the downward movement of the dollar from 2002) and politics (notably 9/11) existed, these were offset by positive economic signals. Further, while the gold bull market in dollar terms started in 2001 it was not until 2005 that a clear upward multi-currency price trend (including the price in euros) started.

In particular, CBGA selling continued at around or above 400 tonnes a year up to and including the third year of the second Agreement (2006-07). Net selling outside the CBGA, while always a smaller number, remained significant up to and including 2005.

Even during this period a few central banks, such as Poland, and (up to 2002) the Philippines, came to the opposite conclusion and increased their reserves. China added 105 and 100 tonnes to its reserves in 2001 and 2002 respectively but this is thought to have been a transfer from stocks previously held to supply the domestic jewellery industry, such stocks no longer being needed after the opening of the Shanghai exchange in 2002[2]. There were occasional, generally small, purchases by CIS countries; apart from Belarus, this was mainly from countries with a domestic gold industry.

Perhaps a more significant exception was Argentina which added 55 tonnes to its holdings in 2004. This reflected changes in the country's exchange rate policy. During the 1990s, the time at which it operated a currency board system with its currency pegged to the US dollar, Argentina sold its gold (and most of its non-dollar currency holdings) to reflect its exchange rate policy. After the currency board was abandoned, and once the new regime had settled down and the currency had stabilised, the country started to buy other currencies again. The central bank also decided to buy gold again for a number of reasons: its contribution to portfolio diversification and hence to improving overall stability of the country's foreign reserves; its standing as a currency asset; and because it was already at that time seen by the central bank as recovering its role as an asset that could protect against financial crises.

Changes in attitude take effect

Around the middle of the decade, concerns intensified about the extent to which the global economic boom was built on debt and the size of global imbalances. These concerns increased sharply after the start of the financial crisis in August 2007. Central banks started to look at gold with a more favourable eye and the advantages of gold started to weigh more heavily in their deliberations.

[2] *Prior to the opening of the Shanghai exchange in late 2002 all gold mined in China was required to be sold to the People's Bank which in turn supplied the domestic jewellery industry.*

Net selling outside the CBGA turned to net buying, albeit on a modest scale, in 2007. Qatar added 12 tonnes to its reserves during that year. In 2006, Russia started to report significant increases in its official gold reserve holdings to the IMF and has continued to do this regularly since then.

After 2007 sales by European central banks under the Central Bank Gold Agreement started to slow quite sharply. Sales during the fourth year of CBGA 2 amounted to just 358 tonnes with those in the final year (2008-09) just 158 tonnes. In part this was due to a number of central banks having completed their sales programmes. By Year 5 of CBGA 2 only 5 banks were selling compared to 10 in the first year. Sales by signatories in the first year of CBGA 3 (2009-2014) have so far (end-March 2010) been almost non-existent, although it appears that the IMF started its sales into the market under the Agreement in February 2010, as distinct from off-market sales to other central banks.

This change in CBGA signatories' selling pattern was not, however, because gold accounted for a lower proportion of foreign exchange reserves. The effect of the gold sales on the gold proportion of total foreign exchange reserves, in most case, was far less than the impact of the rise in the gold price as shown in Table 1, which compares gold holdings, and gold as a percentage of total reserves, at the beginning of the first Agreement (September 1999) and at the end of the second Agreement (September 2009). With the exception of those countries which sold more than half their gold holdings (Switzerland and the UK) the rise in the price of gold, coupled possibly with movements in other reserves, has outweighed the impact of the reduction in gold holdings. (It should be noted when looking at this table that Germany has only sold small amounts of gold for coin minting and the UK sold 50 tonnes before the start of the first CBGA). We have to look for other reasons to explain the lack of any significant current selling.

And, as European central bank sales all but disappeared, so have purchases by other central banks risen. India, China and Russia have all added to their gold reserves recently as well as Sri Lanka, Mauritius, the Philippines and, it appears from IMF data, Venezuela, in addition to some ongoing purchasing by Belarus and continuing small-scale net acquisitions by other CIS countries.

For all countries a combination of economic and political factors has influenced the sharp slowdown in selling, and more recently the start by some nations of adding gold to their reserves. We shall now look at these reasons in more detail.

Table 1: The effect of two Central Bank Gold Agreements: Gold in tonnes and as a % of total foreign reserves for countries selling under CBGA, end September 1999 and end September 2009

	Gold tonnes		Gold as a % total reserve	
	End Sept 1999	End Sept 2009	End Sept 1999	End Sept 2009
Germany	3,468.6	3,407.6	35.2	64.0
France	3,024.6	2,435.4	42.5	63.3
Switzerland	2,590.2	1,040.1	41.1	28.0
Netherlands	1,011.9	612.5	48.8	50.1
ECB	747.4	536.9	14.9	25.6
Portugal	606.7	382.5	39.9	83.7
United Kingdom	664.3	310.3	17.8	14.7
Spain	523.4	281.6	13.2	33.7
Austria	407.5	280.0	20.5	50.9
Belguim	258.1	227.5	17.5	30.9
Sweden	185.4	125.7	10.4	8.5

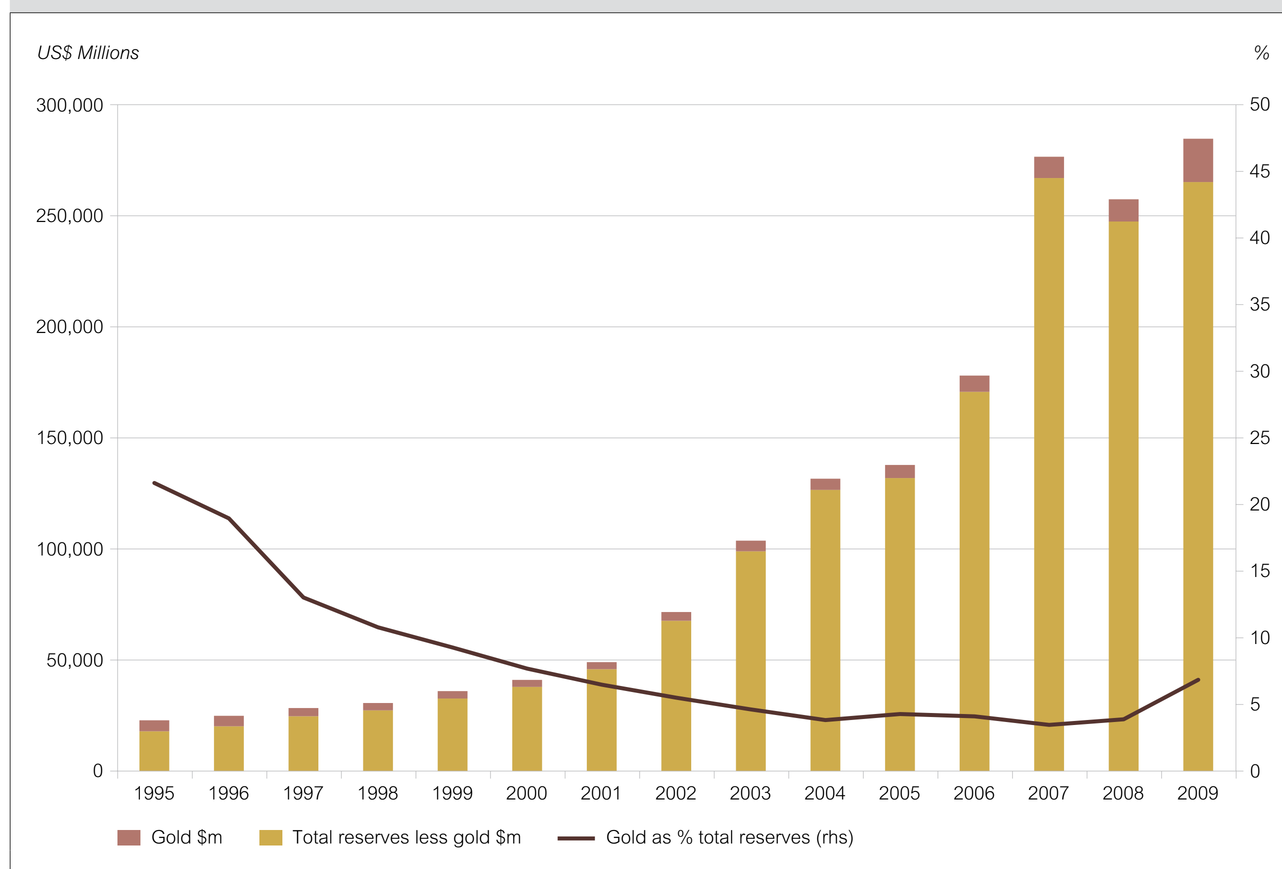
Source: WGC calculations based on IMF data

Growth in foreign exchange reserves required some rebalancing

Global reserves have grown substantially over the last few years. But the growth has been primarily in currencies. It has also occurred disproportionately in a small number of countries, such as China, India and Russia. The rise in the gold price over recent years has not been sufficient to maintain the gold proportion of reserves as its impact has been countered or outweighed by the growth of currency assets. Simple rebalancing would require some increase in gold holdings. Thus in the case of China, while gold accounted for 2.2% (itself a very low percentage) of total reserves at the end of 2002, just after the 2001-02 additions to gold reserves had been completed, this proportion would have sunk to around 1% without the 454 tonne addition announced in April 2009. Even with this acquisition, gold still only accounts for around 1.5% of total reserves.

Rebalancing its reserves composition was one reason given for the purchase of 200 tonnes of gold by India in 2009 (see figure 2). Back in the mid-1990s, before the strong rise in foreign currency reserves of recent years, gold accounted for around 20% of total reserves. With no new purchases of gold, this proportion fell to around 4% in 2007 and 2008 before the 200 tonne purchase in late 2009 restored it to around 7%.

Figure 2: Gold and foreign currency reserves in India

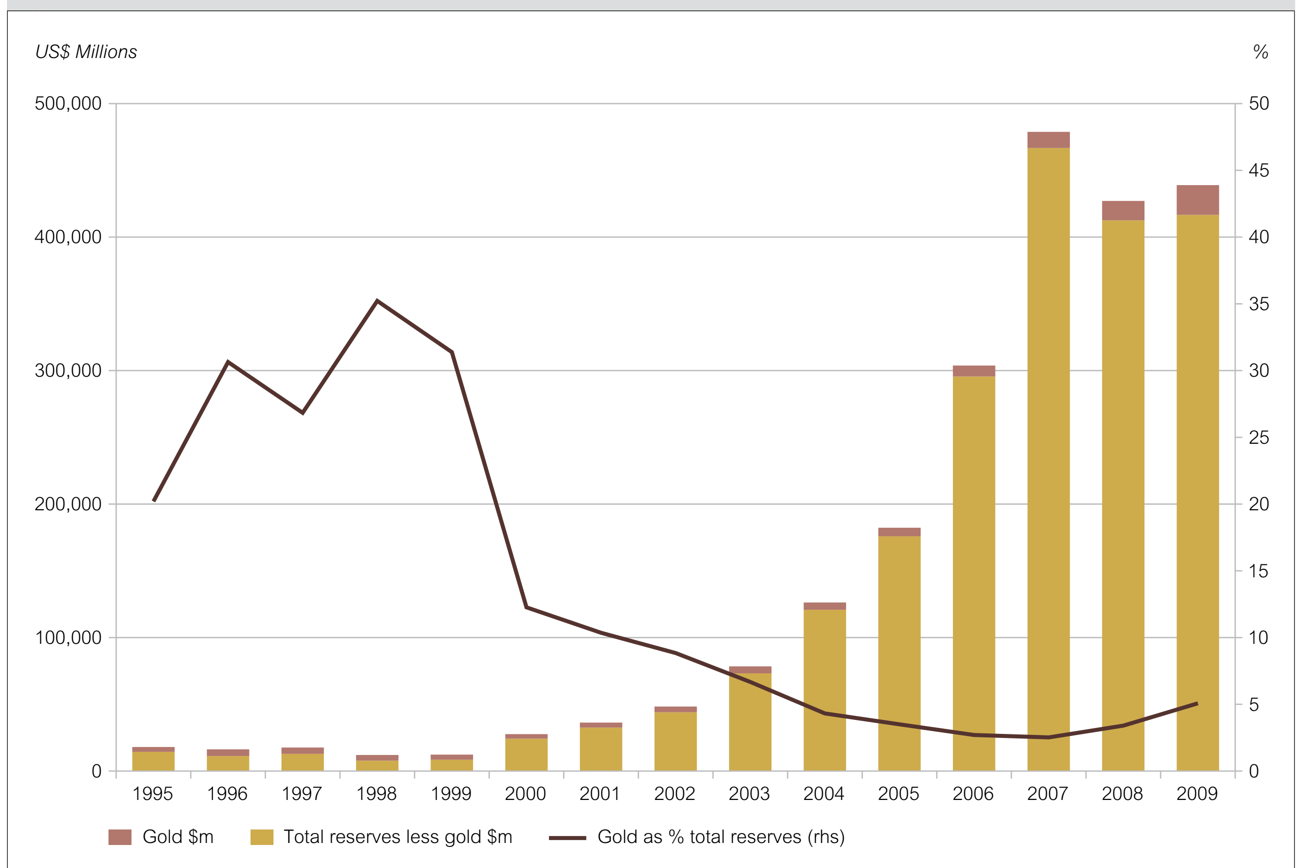


Source: WGC calculations based on IMF data

A similar story is shown with reported Russian holdings (see figure 3). Gold accounted for between 20 and 35% of reserves in the late 1990s but this was a period when other reserves were low. The strong growth in foreign currency holdings then reduced the gold percentage to less than 3% in 2007 but the increased purchasing of recent years has raised the percentage to around 5% in early 2010. Russian officials have several times spoken of the desirability of increasing the amount of gold held in reserves for portfolio diversification reasons, although no formal percentage target has been set. The need to support the domestic gold mining industry has also been given as a reason for purchase. However, the main reason Russia holds gold in its reserves and wants to continue to build up its gold reserves is because gold is widely regarded as the primary asset of last resort, the one asset that maintains its value under all circumstances.

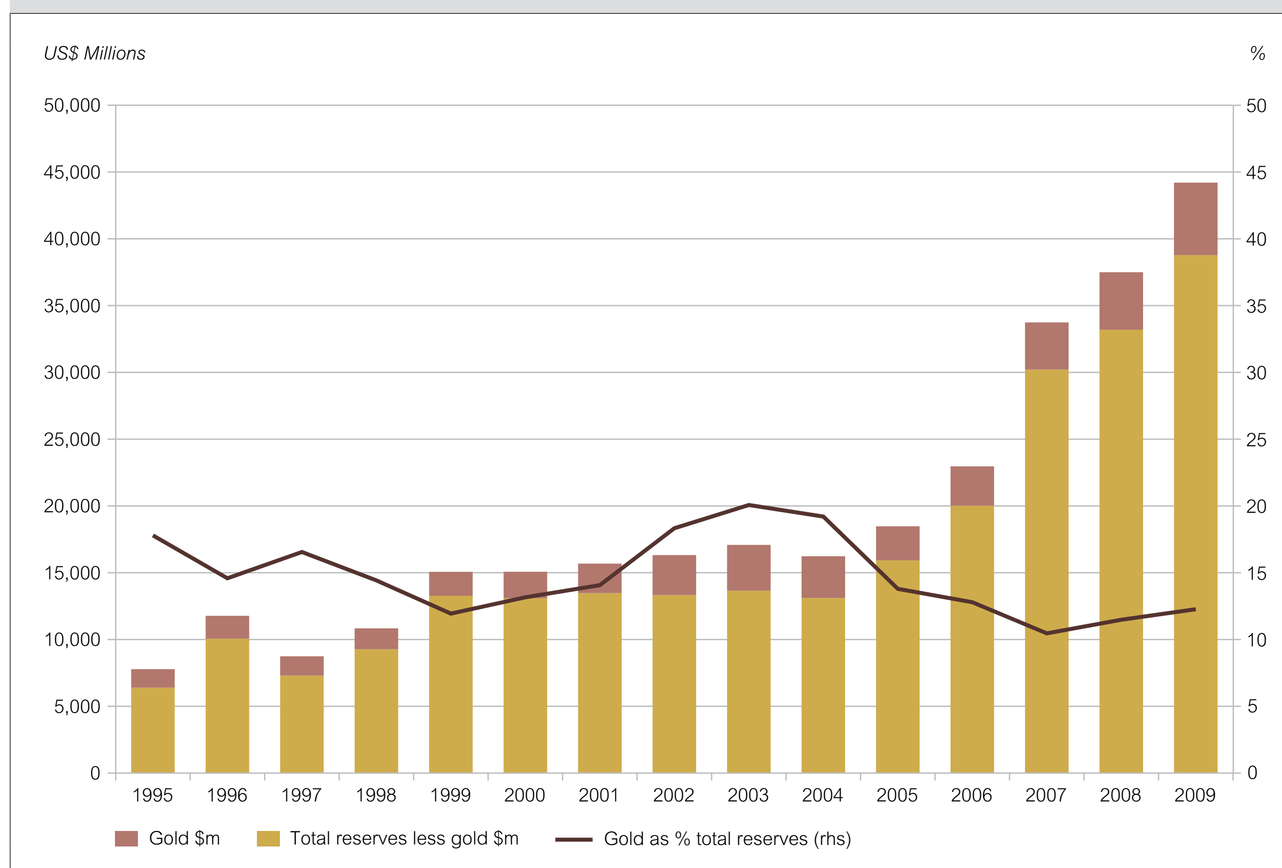
A final example here is the Philippines. The bulk of gold mined in the Philippines comes from small-scale mining, The central bank buys nearly all this, adds the gold purchased to its reserves and at times sells into the market. This practice has enabled the central bank to keep the gold percentage of its reserves within the 10 to 20 percent bracket (see figure 4). While the Philippines reduced the proportion of gold held in their external reserves to around 12% as a result of the net selling of 2003 to 2007, the net purchases in 2008 and 2009 have generated a small increase. The Philippines central bank has stated publicly that it holds gold for its diversification, security and inflation hedge benefits in addition to the fact that the Philippines is a gold-producing nation.

Figure 3: Gold and foreign currency reserves in Russia



Source: WGC calculations based on IMF data

Figure 4: Gold and foreign currency reserves in the Philippines



Source: WGC calculations based on IMF data

Concerns over other major currencies

An additional reason for some central banks to consider buying gold is the decline in the US dollar against the world's main trading currencies and fears that it will decline further. Between the end of 2001 and the end of 2009 the US currency lost 38% of its value against the euro while its effective rate[3] fell by 32%. Falls in the dollar occurred in every year during this period with the exception of 2005 and 2008. Further, the increase in the government deficit as a result of the financial crisis, coupled with the potential for a dollar flight should there be a loss of confidence in the economic credentials of the US government, mean that a questionmark over its future remains.

In addition to the simple need to diversify away from the dollar, gold has a reputation as a dollar hedge[4], potentially, therefore, protecting against any further fall in the US currency.

If there are concerns over the dollar, this does not mean that there is any more confidence in its main rival, the euro. The euro is still a young currency which has not yet had time to prove itself fully. There is substantial concern, in particular, at the moment over the impact that the debt situation of Greece, Portugal, Italy and Spain (and still to some extent Ireland) will have on the currency, highlighted by the current Greek crisis.

According to the latest data (referring to end Q4 2009) published by the IMF, 62% of declared foreign exchange reserves were in US dollars and 27% in euros[5]; these would equate to 55% and 24% respectively of total reserves including gold. The only other significant currencies identified, sterling

[3] *Calculated from the effective rates compiled by the Bank of England.*
[4] *See, for example, Gold as a Hedge against the US Dollar, Capie, Mills and Wood, and Commodity Prices and the Influence of the US Dollar, Kavalis, both available from www.research.gold.org/research.*
[5] *Taken from the IMF's COFER database. Note that countries accounting for over 40% of reserves do not declare a currency breakdown to the IMF. This is thought to include countries such as China which are believed to have a high proportion of dollar assets in their reserves.*

and yen (which have their own problems including notably concerns over the level of government debt) – account for 4% and 3% of the total respectively, with the Swiss franc and unidentified currencies making up a further 3%. Thus there is no currency placed to profit significantly from the problems besetting the dollar and euro. Gold, which accounts for around 10% of total foreign reserves, is best placed to profit from these woes.

The structure of the international monetary system, and its heavy reliance on the dollar, was itself one of the key underlying factors that led to the current crisis. Countries whose reserves were growing steadily as a result of consistent balance of payments surpluses tended – indeed were often obliged – to buy dollar assets, as a result of the limited alternative currency options. This resulted in an inflow of money to the US and hence to an increase in money floating around in the American financial system which ultimately found its way to sub-prime mortgages and other less desirable assets. Yet while the world is so heavily reliant on the US dollar this outcome is inevitable. This need to reduce dependence on the US currency adds to the pressure to diversify reserves into other assets.

The crisis has underlined the need for stability and public confidence

Gold's advantages have been very apparent since the crisis broke. Its long reputation as a safe haven and inflation hedge[6] have been apparent in the minds of investors including central bank reserve managers. Its price performance has echoed this and reinforced its reputation. In the first half of 2007, before the crisis broke, its price averaged $658 per ounce. In the last six months of 2009 it averaged $1,029 per ounce, a rise of 56%. In euro terms it rose 42% over the corresponding period.

The rise in the gold price by itself during the past decade had already made the metal more attractive in the eyes of central bankers, but its performance during the crisis has been conclusive. In particular the rise in the price has been a deterrent to selling – no one wants to be seen to sell a successful asset. A high price can in contrast prove a deterrent to purchasing since no-one wants to buy at what they believe may be the peak.

The extent of monetary easing has raised fears of possible future inflation in many minds. Gold's reputation as an inflation hedge has come into play here. Finally the fact that gold holdings arguably improve public confidence in a currency or central bank has been a useful characteristic of the yellow metal for reserve managers in a time of crisis.

Additional factors also argue for gold

A diversified portfolio is arguably more important than ever in a time of crisis. Gold's dollar hedge characteristic by itself is useful here. However the diversification argument for gold is more widely based than that. Research carried out by central banks has normally confirmed that gold has good diversification properties in a currency portfolio. These stem from the fact that its value is determined by supply and demand in the world gold markets, whereas currencies and government securities depend on government promises and the variations in central banks' monetary policies. The price of gold therefore behaves in a completely different way from the prices of currencies or the exchange rates between currencies.

Two further factors are in play at the current time.

The IMF's decision to sell just over 400 tonnes of its gold in order to help create an income generating endowment to improve its financing has offered the possibility to central banks of buying a quantity of gold off market in a short period without running the risk of being market-disruptive. At the time of writing, three countries have purchased IMF gold. The purchases by Sri Lanka and Mauritius, at 10 tonnes and 2 tonnes respectively, were both relatively small but the 200 tonne purchase by the Reserve Bank of India would certainly have had a market impact.

One factor making many country Eurozone central banks comfortable with their gold holdings is the current tendency for them to analyse their gold holdings not as a percentage of their holdings of foreign (non-euro) reserves but as a percentage of all their assets including those in euro. While in some cases gold is a large proportion of foreign reserves it is a more modest proportion of total assets as Table 2 shows.

[6] *See for example: The Golden Constant: The English and American Experience, 1560-2007, Roy Jastram with updated material by Jill Leyland, 2009, published by Edward Elgar, ISBN 978 1 84720 261 1. Also a number of studies on www.research.gold.org/research notably: Gold as a tactical inflation hedge and long-term strategic asset, Dempster and Artigas; Gold as a Store of Value, Harmston; and Gold as a Safe Haven, O'Connell.*

Table 2: Gold holdings of Eurozone central banks and their relation to foreign reserves and total assets

	Gold tonnes	Gold as % foreign reserve	Gold as % total assets
Germany	3,412.6	68.9	11.1
Italy	2,451.8	64.9	18.3
France	2,492.1	67.5	9.0
Netherlands	612.5	59.9	10.7
Portugal	382.5	89.1	15.1
Spain	281.6	38.8	2.7
Austria	280.0	46.8	6.7
Belgium	227.5	40.6	3.0
Greece	112.5	90.1	4.1
Finland	49.1	16.5	3.3
Slovak Republic	35.1	5.2	4.8
Cyprus	13.9	38.6	2.6
Ireland	5.5	15.9	0.1
Slovenia	3.2	9.9	0.7
Luxembourg	2.3	18.2	0.0
Malta	0.2	4.3	0.2

Source: WGC calculations based on IMF data and central banks' annual reports

Conclusion

The events of the last few years have highlighted gold's advantages to central banks; these advantages now weigh more heavily in the balance than before. It seems unlikely that there will be any return to widespread selling in the near future although individual entities may have specific reasons to sell (as currently does the IMF). It remains to be seen how much further purchasing will occur. The current price is perceived by some to be high and this will deter some potential purchasers; if the price remains around present levels for an extended period then this perception is, however, likely to wane.

And what of the longer-term future? Clearly economic and political circumstances will not always highlight gold's advantages to the same extent as the present. It is possible, perhaps likely, that at some point in time the official sector will once again become a net seller of gold. What does not seem probable is that the net selling will become as one-sided as it was in the 1990s. Since the gold price was freed in 1971, gold has now twice performed well during periods of global crisis – in the 1970s and again now. In the past it was possible to argue that the crises of the 1970s were the teething problems of a new economic order and that the positive experience of economic management developed in the 1980s and 1990s had solved those problems. In contrast, the crisis which started in 2007 has proven once again that boom tends to be followed by bust and that economic nirvana still eludes humankind. As long as this remains true there will still be a compelling case for gold as a reserve asset for nations, just as there is for gold as an investment for individuals and institutions.

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World Gold Council
55 Old Broad Street
London
EC2M 1RX
United Kingdom

Tel +44 (0)20 7826 4700
Fax +44 (0)20 7826 4799

Email info@gold.org

www.gold.org

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