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POLICY BRIEF SERIES

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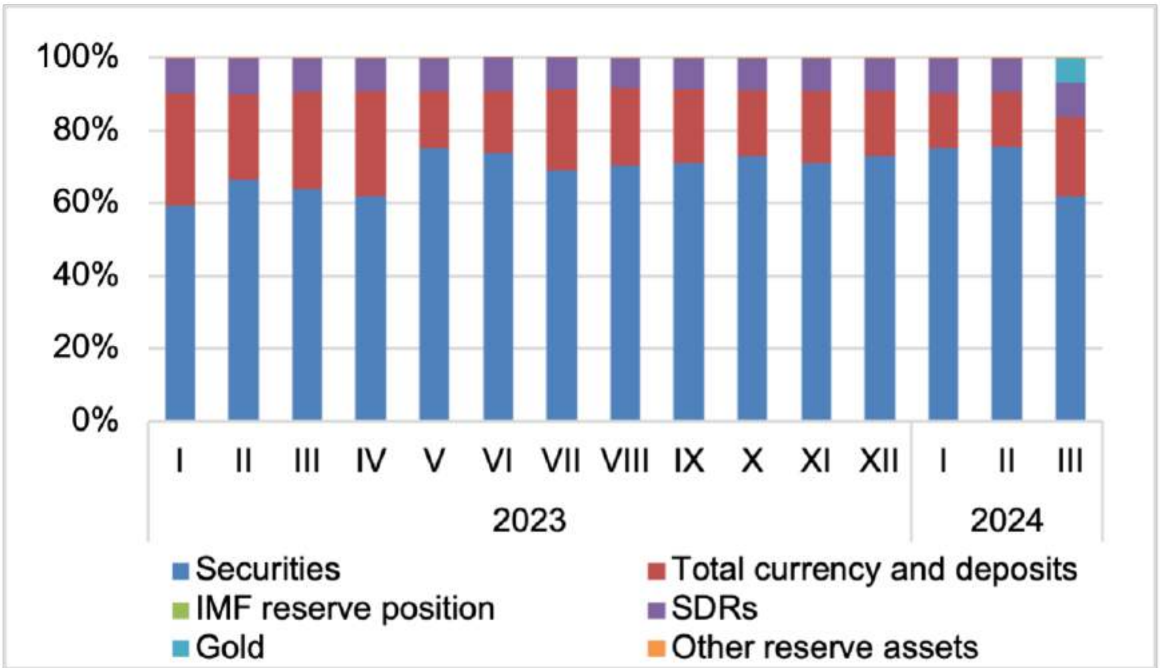
Why the National Bank of Georgia Is Ditching Dollars for Gold

The National Bank of Georgia (NBG) recently acquired 7 tons of high-quality monetary gold valued at $500 million, constituting approximately 11 percent of the banks' total reserves. This marked the first occasion that Georgia acquired gold for its reserves since regaining its independence. The acquisition is a significant event, prompted by the NBG's stated aim to enhance diversification amidst increased global geopolitical risks. However, diversification is just one of the reasons many countries are extensively purchasing gold. Another reason for increasing gold reserves is to lessen one's reliance on the US dollar and to protect against sanctions, as seen with Russia and Belarus following the annexation of Crimea. While the NBG's gold acquisition aligns with economic rationale, recent domestic developments suggest other motives. Actions like sanctions on political figures, anti-Western rhetoric, and recent legislation (the Law of Transparency of Foreign Influence), diverging Georgia from an EU pathway call for speculation that the gold purchase is driven by fear a of potential sanctions and as a preparedness strategy.

Introduction

The National Bank of Georgia (NBG) has broken new ground by adding gold to the country's international reserves for the first time ever. Georgia has thus become the first country in the South Caucasus to purchase gold for its reserves. In line with its Board's decision on March 1, 2024, the NBG procured 7 tons of the highest quality (999.9) monetary gold. The acquisition, valued at 500 million US dollars, took the form of internationally standardized gold bars, purchased from the London gold bar market and currently stored in London. Presently, the acquired gold represents approximately 11 percent of the NBG's international reserves (see Figure 1).

Figure 1. NBG's Official Reserve Assets and Other Foreign Currency Assets, 2023-2024.



Source: The National Bank of Georgia.

NBG emphasizes in its official statement that the acquisition of gold is not merely symbolic but rather reflects a deliberate strategy of diversifying NBG's portfolio and enhancing its resilience to external shocks. The NBG's decision was made during a period marked by significant economic and political events both within and outside Georgia. Key among these were global and regional geopolitical tensions that amplified concerns about economic downturns and rising inflation. The Covid-19 pandemic in 2020 led to stagflation across many countries, including Georgia. Despite some recovery in GDP, high inflation continued into 2021. Furthermore, the Russian war on Ukraine disrupted supply chains, and pushed global inflation to a 24-year high 8.7 percent in 2022. In response, stringent monetary policies aimed at controlling inflation were implemented across both developing and advanced economies. Looking ahead, there is an expectation of a shift toward more expansionary monetary policies that should help lower interest rates (and lower yields on assets held by central banks). These global conditions provide context for the NBG's strategic focus on diversification.

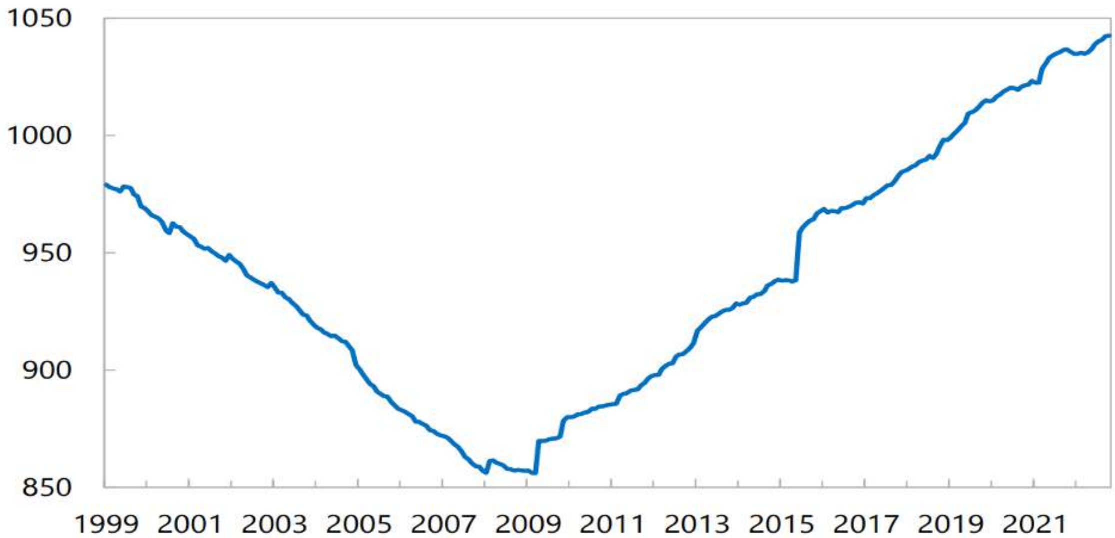
However, alongside these economic events, Georgia also faces significant political challenges. Since the beginning of Russia's war in Ukraine in 2022, political tensions in Georgia have escalated. Notable actions such as the U.S. imposing sanctions on influential Georgian figures, including judges and the former chief prosecutor, have, among other things, intensified scrutiny into the Russian influence in Georgia. Concerns about the independence of the Central Bank, which changed the rule of handling sanctions applications for Georgia's citizens, and legislative initiatives like the Law of Transparency of Foreign Influence, which undermines Georgia's EU accession ambitions, have triggered reactions from the country's partners and massive public protests. Moreover, anti-Western rhetoric from the ruling party has raised concerns. In addition, the parliament of Georgia recently approved an amendment to the Tax Cide, a so-called 'law on offshores'. The opaque nature of the law, as well as the context and speed at which it was advanced, sparked outcry and conjecture about its true purpose. These elements lead to speculation that the decision to purchase gold may be motivated by a desire for greater autonomy or a fear of potential sanctions, rather than purely economic reasons.

In the context of the above, this policy brief seeks to explore the motivations behind gold acquisitions by Central Banks, drawing on the experiences of both developed and developing countries. It aims to review existing literature that explores various reasons for gold acquisitions, providing a comprehensive analysis of economic and potentially non-economic factors influencing such decisions.

The Return of Gold in Global Finance

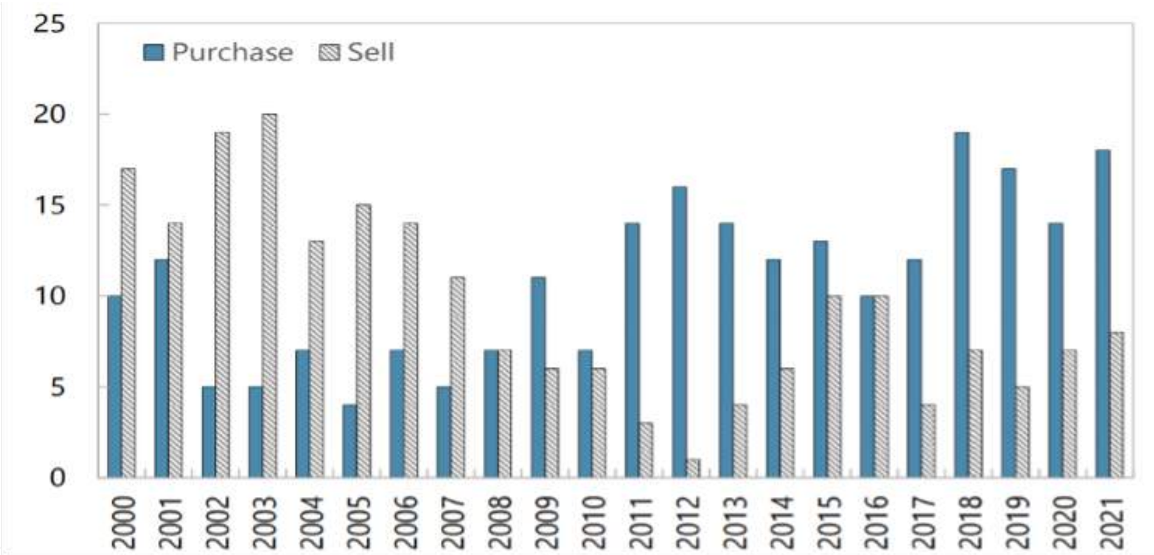
Over the past decade, central bank gold reserves have significantly increased, reversing a 40-year trend of decline. The shift that began around the time of the 2008-09 Global Financial Crisis is depicted in Figures 2 and 3, highlighting the transition from a pre-crisis period of more countries selling gold, to a post-crisis period where more countries have been purchasing gold.

Figure 2. Gold Holdings in Official Reserve Assets, 1999-2022 (million fine Troy ounces).



Source: IMF, International Financial Statistics.

Figure 3. Number of Countries Purchasing/Selling Monetary Gold, 2000-2021 (at least 1 metric ton of gold in a given year).



Source: IMF, International Financial Statistics.

In 2023, central banks added a considerable amount of gold to their reserves. The largest purchases have been reported for China, Poland, and Singapore, with these nations collectively dominating the gold buying landscape during the year.

China is one of the top buyers of gold worldwide. In 2023, the People's Bank of China emerged as the top gold purchaser globally, adding a record 225 tonnes to its reserves, the highest yearly increase since at least 1977, bringing its total gold reserves to 2,235 tonnes. Despite this significant addition, gold still represents only 4 percent of China's extensive international reserves.

The National Bank of Poland was another significant buyer in 2023, acquiring 130 tonnes of gold, which boosted its reserves by 57 percent to 359 tonnes, surpassing its initial target and reaching the bank's highest recorded annual level.

Other central banks, including the Monetary Authority of Singapore, the Central Bank of Libya, and the Czech National Bank, also increased their gold holdings, albeit on a smaller scale. These purchases reflect a broader trend of central banks diversifying their reserves and enhancing financial security amidst global economic uncertainties.

Conversely, the National Bank of Kazakhstan and the Central Bank of Uzbekistan were notable sellers, actively managing their substantial gold reserves in response to domestic production and market conditions. The Central Bank of Bolivia and the Central Bank of Turkey also reduced their gold holdings, primarily to address domestic financial needs.

The U.S. continues to hold the world's largest gold reserve (25.4 percent of total gold reserves), which underscores the metal's enduring appeal as a store of value among the world's leading economies. The U.S. is followed by Germany at 10.5 percent, and Italy and France at 7.6 percent respectively. At present, around one-eighth of the world's currency reserves comprise of gold, with central banks collectively holding 20 percent of the global gold supply (NBG, 2024).

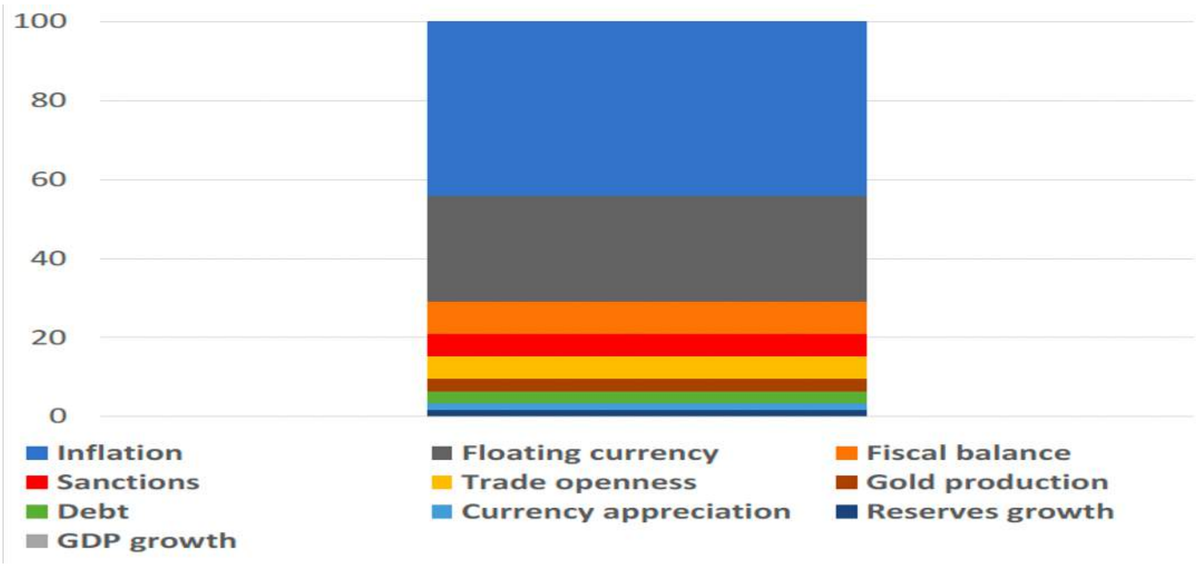
Why Central Banks are Buying Gold Again

A 2023 World Gold Council survey (on central banks revealed five key motivations for holding gold reserves: (1) historical precedent (77 percent of respondents), (2) crisis resilience (74 percent), (3) long-term value preservation (74 percent), (4) portfolio diversification (70 percent), and (5) sovereign risk mitigation (68 percent). Notably, emerging markets placed a higher emphasis (61 percent) on gold as a "geopolitical diversifier" compared to developed economies (45 percent).

However, the increasing use of the SWIFT system for sanctions enforcement (e.g., Iran in 2015 and Russia in 2022) has introduced a new factor influencing gold purchases of some governments: safeguarding against sanctions (Arslanalp, Eichengreen and Simpson-Bell, 2023).

In addition, Arslanalp, Eichengreen, and Simpson-Bell (2023) conclude that central banks' decisions to acquire gold are primarily driven by the following factors; inflation, the use of floating exchange rates, a nation's fiscal stability, the threat of sanctions, and the degree of trade openness (see Figure 4).

Figure 4. Determinants of Gold Shares in Emerging Market and Developing Economies.



Source: Arslanalp, Eichengreen, and Simpson-Bell (2023).

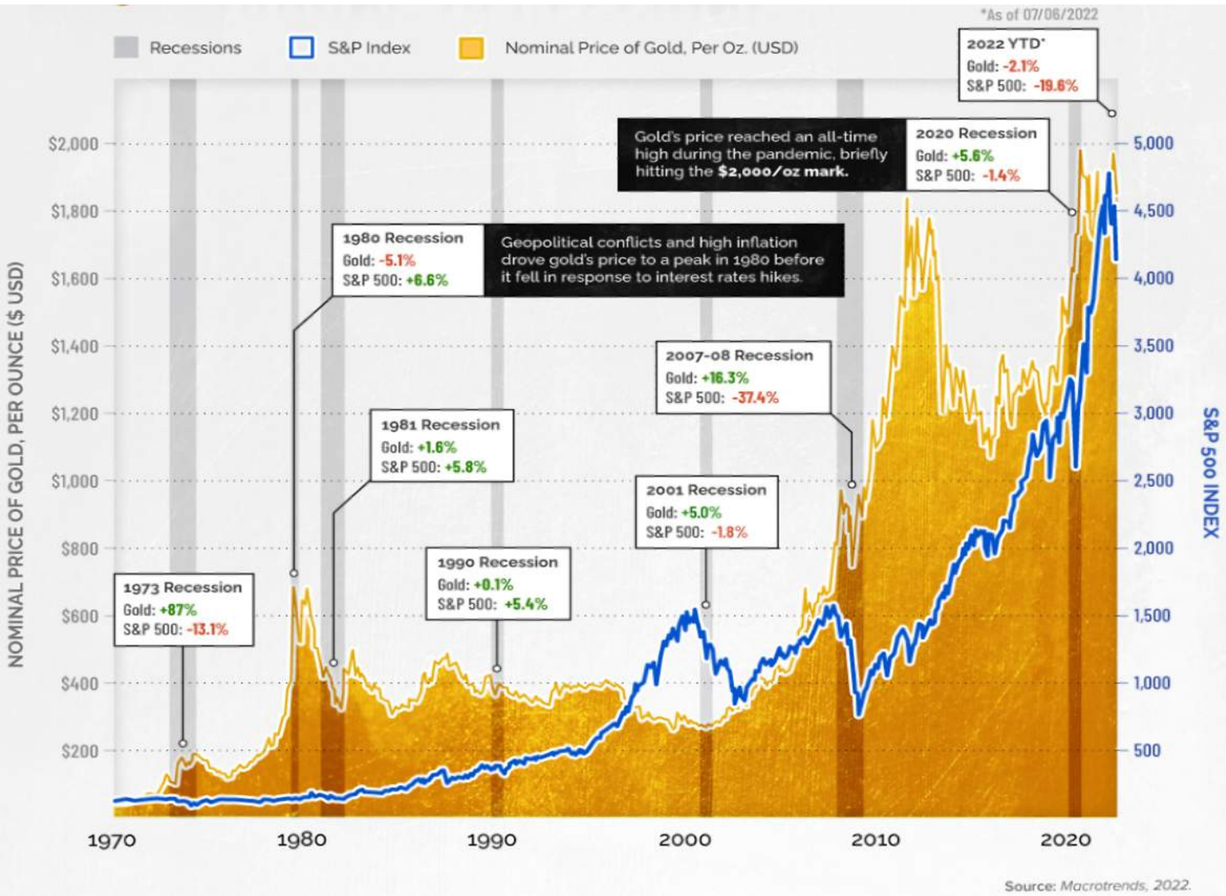
Gold as a Hedging Instrument

Gold is considered a safe haven and an attractive asset in periods of significant economic, financial, and geopolitical uncertainty (Beckman, Berger, & Czudaj, 2019). This is particularly relevant when returns on reserve currencies are low, a scenario prevalent in recent years.

A hedge against inflation: Inflation presents a significant challenge for central banks, as it erodes the purchasing power of a nation's currency. Gold has been a long-standing consideration for central banks as a potential inflation hedge. Its price often exhibits an inverse relationship with the value of the US dollar, meaning it tends to appreciate as the dollar depreciates. This phenomenon can be attributed to two primary factors: (1) increased demand during inflationary periods; and (2) gold tends to have intrinsic value unlike currencies (Stonex Bullion, 2024).

Diversification of portfolio: Diversification is a cornerstone principle of portfolio management. It involves allocating investments across various asset classes to mitigate risk. Gold, with its negative correlation to traditional assets like stocks and bonds, can be a valuable tool for portfolio diversification. In simpler terms, when stock prices decline, gold prices often move in the opposite direction, offering a potential hedge against market downturns (see Figure 5).

Figure 5. How Gold Performs During Recession, 1970-2022.



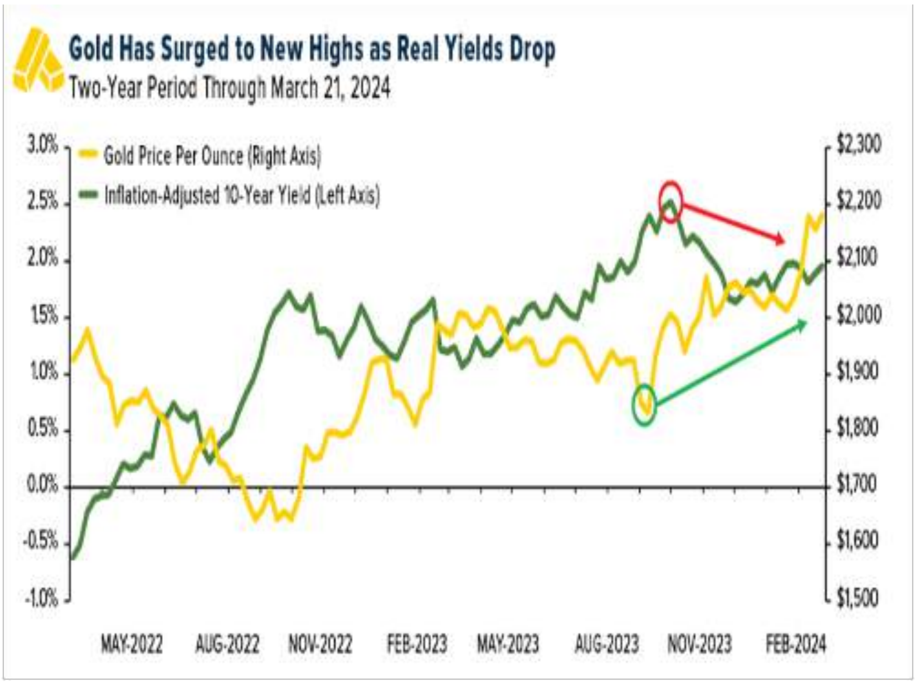
Source: Bhutada (2022).

Hedge against geopolitical risks: de Besten, Di Casola and Habib (2023) suggest that geopolitical factors may have influenced gold acquisitions for some central banks in 2022. A positive correlation appears to exist between changes in a country's gold reserves and its geopolitical proximity to China and Russia (compared to the U.S.) for countries actively acquiring gold reserves. This pattern is particularly evident in Belarus and some Central Asian economies, suggesting they may have increased their gold holdings based on geopolitical considerations.

Low or Negative Interest Rates: When interest rates on major reserve currencies like the US dollar are low or negative, it reduces the opportunity cost of holding gold (gold is a passive asset that does not generate periodic income, dividends, and interest benefits). In other words, gold becomes a more attractive option compared to traditional investments that offer minimal or no returns. The prevailing low-interest rate environment, particularly for major reserve currencies like the US dollar, has diminished the opportunity cost of holding gold.

This phenomenon applies to both advanced economies and emerging market economies (EMDEs). Notably, EMDEs with significant dollar-denominated debt are particularly sensitive to fluctuations in US interest rates. Arslanalp, Eichengreen, and Simpson-Bell (2023) conclude that reserve managers are increasingly incorporating gold into their portfolios when returns on reserve currencies are low. Figure 6 illustrates the inverse relationship between the price of gold and the inflation-adjusted 10-year yield.

Figure 6. Gold Price and Inflation-Adjusted 10-Year Yield.



Source: Bloomberg, U.S. Global Investors.

In addition to its aforementioned advantages, gold offers central banks a long-term investment opportunity despite its lack of interest payments, unlike traditional securities. While gold exhibits short-term price volatility, its historical price trend suggests a long-term upward trajectory (see Figure 7).

Figure 7. Gold Price per Troy Ounce (approximately 31.1 grams), in USD.

Source: World Gold Council.

Gold as a Safeguard Against Sanctions

Gold is perceived as a secure and desirable reserve asset in situations where countries face financial sanctions or the risk of asset freezes and seizures (see Table 1). The decision by G7 countries to freeze the foreign exchange reserves of the Bank of Russia in 2022 highlighted the importance of holding reserves in a form less vulnerable to sanctions. Following Russia's annexation of Crimea in 2014, the Bank of Russia intensified its gold purchases. By 2021, it had confirmed that its gold reserves were fully vaulted domestically. The imposition of sanctions on Russia, which restrict banks from engaging in most transactions with Russian counterparts and limit the Bank of Russia's access to international financial markets, further underscores the appeal of gold as a safeguard.

While the recent sanctions imposed by G7 countries, which limit Russian banks from conducting most business with their counterparts and restrict the Bank of Russia from accessing its reserves in foreign banks, are an extreme example, similar sanctions have previously impacted or threatened financial operations of other nations' central banks and governments. This situation raises the question of whether the risk of sanctions has influenced the observed trend of countries' increasing their gold reserves (IMF, International Financial Statistics, 2022).

Table 1. Top 10 Annual Increases in the Share of Gold in Reserves, 2000-2021.

Country	*Year*	*Increase in Gold Share (ppt of Reserves)*	*Increase in Gold Volume (Percentage)*	*Coinciding Events*
Turkey	2020	21%	29%	Sanctions by the US (2018) and EU (2019); COVID-19 pandemic (2020)
Belarus	2010	17%	57%	Sanctions by Russia in 2010
Lao PDR	2001	10%	328%	A series of bomb blasts in 2000 before presidential elections in 2001
Turkey	2017	9%	50%	Coup attempt in 2016; Constitutional referendum in 2017
Sri Lanka	2009	8%	299%	Purchase of gold from IMF following the global financial crisis
Paraguay	2012	8%	1141%	Sanctions by Mercosur and Unasur in 2012
Hungary	2021	8%	200%	COVID-19 pandemic in 2020
Belarus	2006	8%	25%	Sanctions by the EU and US in 2006
Sri Lanka	2000	7%	437%	1997-98 Asian crisis; Assassination attempts before elections in 2000
Belarus	2008	7%	33%	Sanctions by the EU and US in 2006

Source: IMF, International Financial Statistics; Global Sanctions Database (GSDB). Note: Excludes countries with central bank gold purchases from domestic producers.

As outlined in Arslanalp, Eichengreen and Simpson-Bell (2023), there were eight active diversifiers into gold in 2021, each purchasing at least 1 million troy ounces (Kazakhstan, Belarus, Turkey, Uzbekistan, Hungary, Iraq, Argentina, Qatar), exhibiting distinct international economic or political concerns. Kazakhstan, Belarus, and Uzbekistan maintain ties with Russia through the

Eurasian Economic Union. Turkey has faced sanctions from both the European Union and the U.S. Iraq has experienced disputes with the U.S., while Hungary has faced similar issues with the European Union. In 2017-21, Qatar was subjected to a travel and economic embargo by Saudi Arabia and neighboring countries. Argentina may have had concerns about asset seizures by foreign courts due to sovereign debt disputes.

Furthermore, according to the Economist (2022), gold is costly to transport, store, and protect. It is expensive to use in transactions and doesn't earn interest. However, it can be lent out like currencies in a central bank's reserves. When lent out or used in swaps (where gold is exchanged for currency at agreed dates), it can generate returns. But banks prefer gold to be stored in specific places like the Bank of England or the Federal Reserve Bank of New York, which brings back the risk of sanctions. For instance, During the Iranian Revolution in 1979 and the subsequent hostage crisis, the United States froze Iranian assets, including the gold reserves held in U.S. banks (Arslanalp, Eichengreen and Simpson-Bell, 2023). The National Bank of Georgia intends to transport its acquired gold from England to Georgia for storage, which could potentially reduce storage costs, but further decrease liquidity.

Arslanalp, Eichengreen, and Simpson-Bell (2023) conclude that since the early 2000s, half of the significant year-over-year increases in central bank gold reserves can be attributed to the threat of sanctions. By examining an indicator that tracks financial sanctions by major economies like the United States, United Kingdom, European Union, and Japan, all key issuers of reserve currencies, the authors have confirmed a positive correlation between such sanctions and the proportion of reserves held in gold. Furthermore, their findings suggest that multilateral sanctions imposed by these countries collectively have a more pronounced effect on increasing gold reserves than unilateral sanctions. This is likely because unilateral sanctions allow room for shifting reserves into the currencies of other non-sanctioning nations, whereas multilateral sanctions increase the risks associated with holding foreign exchange reserves, thus making gold a more attractive option.

The NBG's Historic Decision

The National Bank of Georgia's (NBG) recent acquisition of gold for its reserves is likely motivated by a desire to diversify its portfolio and hedge against inflation and geopolitical risks. However, recent developments in Georgia raise questions about the timing of this policy decision, bringing political considerations into the picture.

Among these developments is the 2023 suspension of the IMF program for Georgia, due to concerns about the NBG's governance (Intellinews, 2023). The amendments to the NBG law in June 2023, which created a new First Deputy and Acting Governor position – superseding the existing succession framework – contradicted IMF Safeguards recommendations and raised concerns about increased political influence (International Monetary Fund, 2024). How the recent gold purchase reflect on the future of IMF cooperation is thus a relevant question to ask.

Another ground for concern is the recent approval by the Georgian Parliament of the anti-democratic "Foreign Influence Transparency" law and the anti-Western rhetoric of the ruling party, which have sparked intensive public protests. European partners warn that the law will not align with Georgia's European Union aspirations and that it could potentially hinder the country's advancement on the EU pathway. Rather, the law might distance Georgia from the EU. This law has also increased the concerns for further sanctions on members of the ruling party, government officials, and individuals engaging in anti-West and anti-EU propaganda.

Furthermore, the recent amendment of the Tax Code, the so-called "offshores law" allows for tax-free funds transfers from offshore zones to Georgia. This, combined with other developments, raises questions about whether the government is preparing for potential sanctions, should its relationship with Russia continue to strengthen.

Conclusion

In conclusion, this policy brief highlights that central banks' acquisition of gold reserves, especially in emerging economies, is motivated by a combination of economic and political factors. The economic incentives include the need for portfolio diversification and protection against inflation and geopolitical instabilities, a trend that became more pronounced following the 2008 global financial crisis. Politically, the accumulation of gold serves as a strategic move to lessen dependency on the U.S. dollar and as a defensive measure against potential international sanctions, as highlighted by the post-2014 geopolitical shifts following Russia's annexation of Crimea.

In 2024, Georgia purchased gold for the first time since regaining its independence. While its gold purchasing strategy seems to align with these economic motives, the recent domestic political dynamics suggest a deeper, possibly strategic political rationale by the National Bank of Georgia. The imposition of U.S. sanctions on key figures, and recent legislative actions deviating from European Union standards, all amidst increasing anti-Western sentiment, indicate that the NBG's gold acquisitions might also be driven by a quest for greater safeguard against potential future sanctions. Thus, while economic reasons for the purchase are significant, the political underpinnings in the NBG's recent actions raise numerous unanswered questions.

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Dr. Keshelava actively contributes to research projects, particularly in the development of Regulatory and Gender Impact Assessments at the ISET Policy Institute. He played a pivotal role in formulating the Gender Impact Assessment (GIA) methodology and has collaborated with various Georgian ministries on Regulatory and Gender Impact Assessments. In addition, Dr. Keshelava provides comprehensive training to governmental ministries' staff, enriching their analytical and policy formulation capabilities. He also teaches various courses in the bachelor's program at ISET and the Ph.D. program at Tbilisi State University, further extending his expertise to future economists.

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