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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% of its total reserves. This marked the first occasion that Georgia acquired gold for its reserves since it regained independence. This acquisition is a significant event, prompted by the aim to enhance diversification amidst heightened global geopolitical risks, as stated by the NBG.

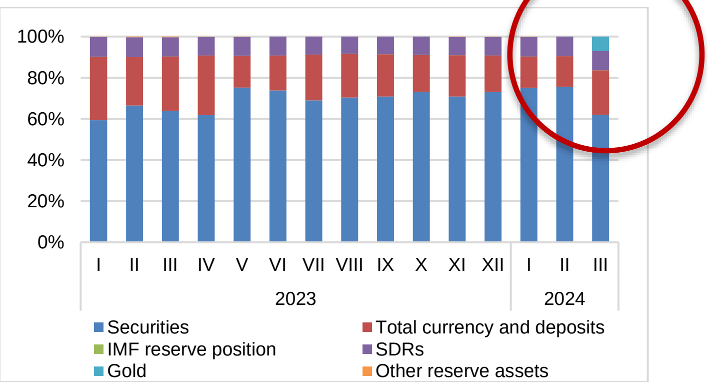
This policy brief examines the rationale behind central banks, particularly those in emerging economies, acquiring gold reserves. The decision typically stems from one or both of the two main factors. Firstly, an economic motivation, involving portfolio diversification and protection against inflation and geopolitical uncertainties. Secondly, a political dimension, wherein countries seek to reduce reliance on the US dollar and shield themselves from potential sanctions. The economic argument gained prominence since the 2008 global financial crisis, prompting many central banks to bolster their reserves with gold. Similarly, Russian aggression and the annexation of Crimea in 2014 led countries (e.g. Russia, and later after 2022 Belarus) to fortify their gold reserves as a safeguard against sanctions, given the difficulty in freezing gold reserves, especially if stored domestically.

While the NBG's gold acquisition aligns with the economic rationale, recent domestic developments raise questions about alternative motives. Actions such as the USA imposing sanctions on influential political figures (e.g. judges, former chief prosecutor), concerns about the Central Bank's governance, and legislative decisions of the ruling party (the Law of Transparency of Foreign Influence) diverging country from the EU path have sparked public dissent and reactions from key partners – USA, EU and other bilateral partners. Coupled with anti-Western rhetoric from the ruling party and a recently passed amendment to the tax code, a so-called "law on offshores ", these factors prompt speculation about whether the gold purchase is driven by a fear of potential sanctions and its preparedness strategy, rather than solely economic considerations as 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.

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. It is noteworthy that Georgia has become the first country in the South Caucasus to purchase gold for its reserves, a move not previously made by either Armenia or Azerbaijan. In line with its Board's decision on March 1, 2024, the National Bank of Georgia 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 is currently stored in London. Presently, the acquired gold represents approximately 11% of the NBG's international reserves (see Figure 1).

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



Source: 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 aimed at diversifying NBG's portfolio and enhancing its resilience to external shocks. In an era marked by economic volatility and geopolitical tensions, gold stands out as a time-tested store of value, offering stability in times of uncertainty.

The National Bank of Georgia's (NBG) decision was made during a period marked by significant economic and political events both within and outside of 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, which saw a 3.3% global inflation rate and a 3.4% decline in global GDP compared to the previous year. Despite some recovery in GDP, high inflation continued into 2021, with a global rate of 4.7%. Furthermore, the conflict between Russia and Ukraine disrupted supply chains, pushing global inflation to a 24-year high of 8.7% in 2022. In response, stringent monetary policies aimed at controlling inflation were implemented across both developing and advanced economies. Looking forward, there is an expectation of a shift toward more expansionary monetary policies that should help lower interest rates (and lower yield on assets held by the central bank). These global conditions provide a context that supports the NBG's strategic focus on diversification.

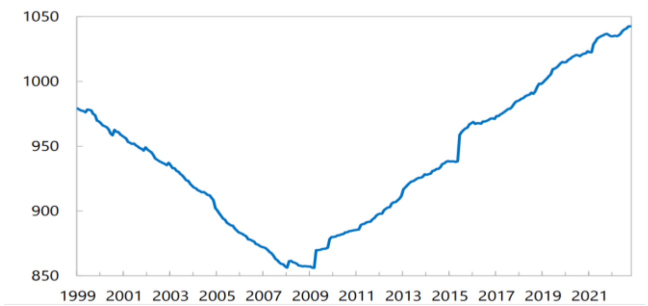
However, alongside these economic events, Georgia also faced significant political challenges. **Since the beginning of Russia's war in Ukraine in 2022, political tensions in Georgia have escalated.** Notable actions, such as the USA imposing sanctions on influential Georgian figures, including judges and the former chief prosecutor, have intensified scrutiny. 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 deviates from the EU's direction, have triggered reactions from the country's partners and massive public protests in the country. Moreover, anti-Western rhetoric from the ruling party has raised concerns. In addition, the parliament of Georgia recently approved the amendment to the Tax Cide, a so-called 'law on offshores'. The opaque nature of the law, as well as the context and speed with which it was advanced, sparked outcry and conjecture about its true purpose [1]. 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.**

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 thoroughly review existing literature that explores various reasons for these acquisitions, providing a comprehensive analysis of economic and potentially non-economic factors influencing such decisions.

The Return of Gold on Global Finance

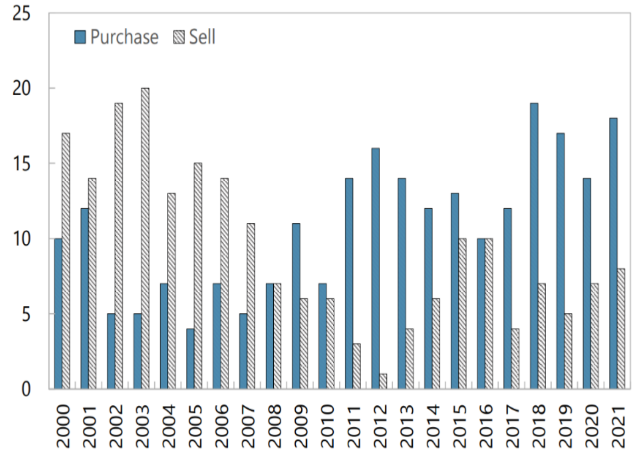
Over the past decade, central bank gold reserves have significantly increased, reversing a 40-year trend of decline that began around the time of the 2008-09 Global Financial Crisis. This shift is depicted in the referenced figures, with Figure 3 highlighting the transition from a pre-crisis period of 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, global central banks added a considerable amount of gold to their reserves, underscoring the ongoing trend of robust buying. The largest purchases have been reported in countries like China, Poland, and Singapore, with these nations collectively dominating the gold buying landscape for the year.

China remains one of the top buyers of gold worldwide. In 2023, the People's Bank of China (PBoC) 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% of China's extensive international reserves.

The National Bank of Poland was another significant buyer, acquiring 130 tonnes of gold, which boosted its reserves by 57% to 359 tonnes, surpassing its initial target and reaching the highest annual level on record for the bank.

[1] The recent amendments to Georgia's "offshore law" offer significant tax exemptions for businesses that relocate from offshore locations to Georgia by January 1, 2028. These exemptions include relief from profit and income taxes on the transfer operations, as well as a one-time exemption from import duties and property tax exemption until 2030 for accompanying tangible assets such as aircraft, machine tools, and cars. The law specifically applies to individuals or groups who wholly own the assets both before and after their transfer. The law's vague details and the rapid manner of its enactment have led to public outcry and widespread speculation about its underlying motives The Law has been vetoed by President Zurabishvili few days ago.

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 USA continues to hold the largest gold reserve (25.4% of total gold reserves), which underscores the metal's enduring appeal as a store of value among the world's leading economies. USA is followed by Germany at 10.5%, Italy and France at 7.6% each. **At present, around one-eighth of the world's currency reserves are comprised of gold, with central banks collectively holding 20% of the global gold supply.** This policy brief will thoroughly investigate the various motivations for purchasing gold (NBG, 2024).

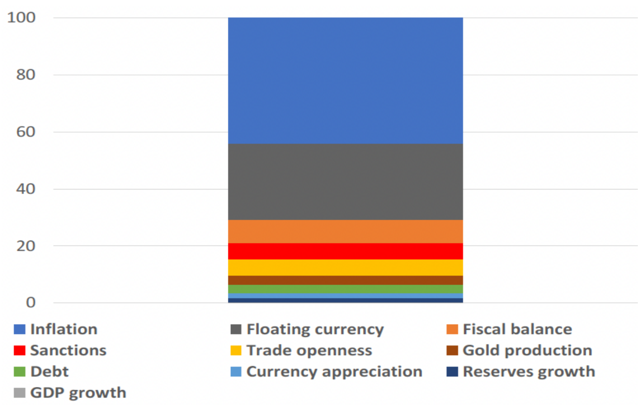
Why Central Banks are Buying Gold Again

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

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 by some governments: anonymity. The potential for multi-lateral sanctions from major reserve currency countries makes the switch from US dollar assets to a less traceable asset like gold highly attractive.

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

Figure 4: Determinants of Gold Shares: Emerging Market and Developing Economies



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

The following two sections will explore the role of gold as a (1) hedging instrument, and (2) safeguard against sanctions.

Gold as a Hedging Instrument

Gold is considered a safe haven and an attractive asset during 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. Gold is often perceived as an effective hedge against inflation, which has become more pronounced recently, and as a means of diversifying investment portfolios, especially in volatile environments (Burdekin & Tao, 2021).

Inflation presents a significant challenge for central banks, as it erodes the purchasing power of a nation's currency. To mitigate this risk, central banks often diversify their international reserves with assets that have historically exhibited a positive correlation with inflation. These assets, known as "inflation hedges," can help to preserve the real value of reserves during periods of rising prices.

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 (Stonex Bullion, 2024):

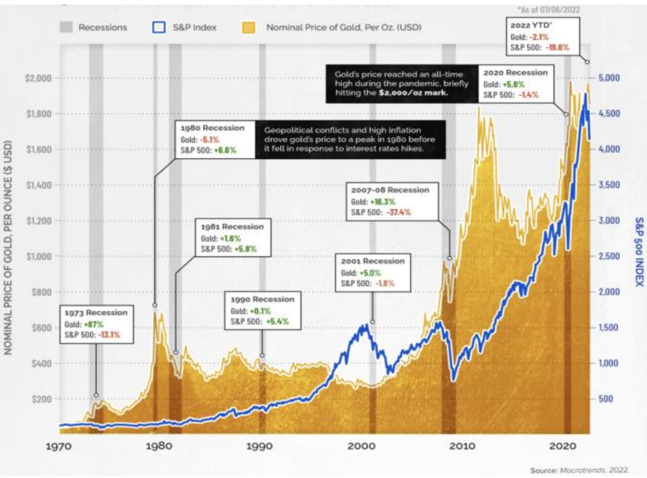
- **Increased Demand During Inflationary Periods:** When inflation is on the rise, investors may turn to gold as a store of value, seeking to protect their portfolios from the declining purchasing power of traditional assets such as stocks and bonds. This increase in demand can lead to a subsequent rise in the price of gold.
- **Intrinsic Value:** Unlike fiat currencies, which are susceptible to devaluation due to inflation, gold possesses intrinsic value. This inherent worth allows gold to maintain its purchasing power more effectively than traditional assets during inflationary periods.

It is worth noting that some argue that even the anticipation of inflation can significantly influence gold prices. Investors, foreseeing a future with high inflation, may choose to invest in gold preemptively. This pre-emptive buying behavior can, in some instances, become a self-fulfilling prophecy, driving up gold prices even if inflation does not materialize at the predicted level.

Furthermore, gold is deeply ingrained in customs and tradition, with central banks and governments maintaining gold reserves for centuries (Capie, Mills, & Wood, 2005). While reserve managers might consider investing in various physical commodities during periods of unattractive financial asset returns, gold holds a special status due to its historical significance, offering a level of respectability and confidence (Baur & Lucey, 2010).

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.

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



Source: Elements.visualcapitalist.com

The benefits of diversification are evident during periods of economic turmoil. For example, between October 9, 2007, and March 9, 2009, the S&P 500 (a benchmark index for the US stock market) experienced a significant decline of 56.8%. In contrast, the price of gold increased by 25.5% during the same timeframe. This highlights how gold's price movement can be independent of traditional assets, potentially offsetting losses in other parts of your portfolio.

Table 1. Gold vs. the S&P 500 in Historical Recessions

Recession Year	Recession Length	% Change in Nominal Price of Gold	% Change in S&P 500
1973	16 months	87%	-13.1%
1980	6 months	-5.1%	6.6%
1981	16 months	1.6%	5.8%
1990	8 months	0.1%	5.4%
2001	8 months	5.0%	-1.8%
2007	18 months	16.3%	-37.4%
2020	2 months	5.6%	-1.4%

Source: Elements.visualcapitalist.com

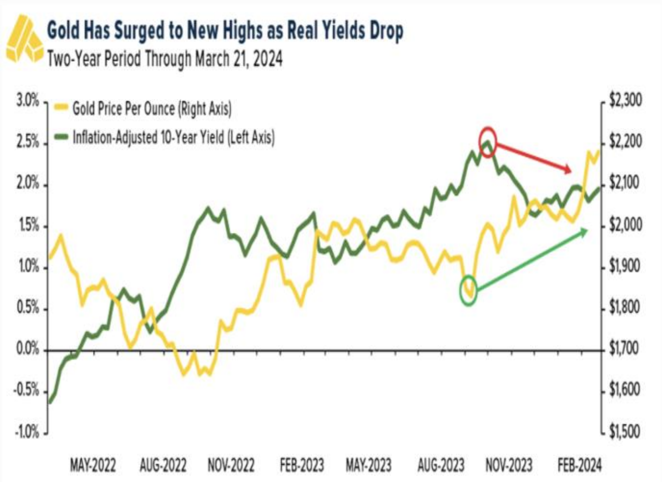
Hedge against geopolitical risks. den Besten, Di Casola and Habib (2023) suggest that geopolitical factors might have influenced gold acquisitions for some central banks in 2022. A positive correlation appears to exist between changes in a country's gold reserves and its geopolitical proximity to China and Russia (compared to the US) 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 (and other potential consequences, such as sanctions, which will be explored in more detail later).

This rationale gains particular weight in light of recent global economic turmoil and heightened geopolitical risks, including the ongoing COVID-19 pandemic, Russia’s war in Ukraine, and ongoing conflicts in the Middle East.

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. Based on the econometric model, 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.

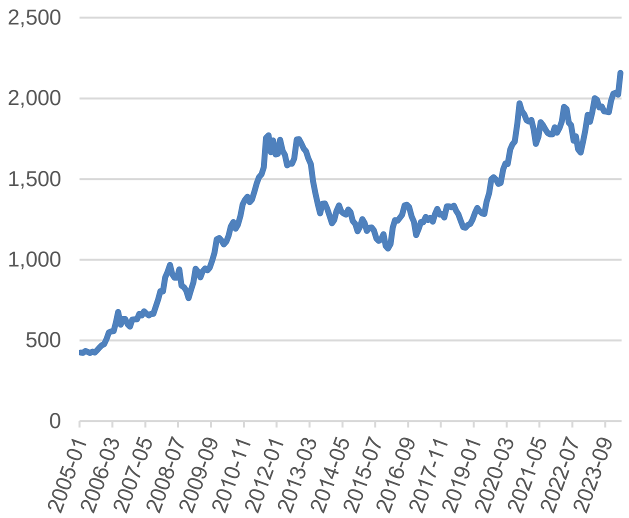
Figure 6: Gold Price and Inflation-Adjusted 10-Year Yield



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). This appreciation potential makes gold an attractive asset for central banks seeking to preserve and potentially augment their gold reserves over extended time horizons.

Figure 7: Gold Price per Tory Ounce - 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 2). The decision by G7 countries to freeze the foreign exchange reserves of the Bank of Russia 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 their 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 against such measures.

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 the 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 toward increasing gold reserves (IMF, International Financial Statistics, 2022).

Table 2. Top 10 Annual Increases in the Share of Gold in Reserves through 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 producer

As outlined in an IMF working paper (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 USA. Iraq has experienced disputes with the USA, 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 (see Table 3, describing the latest trends). In particular, as of 2023, countries such as Venezuela, Uzbekistan, Kazakhstan, Kyrgyz Republic, and Belarus, are among the Top 20 Gold Holdings as a Share of Official Reserves, alongside advanced economies like the US, Germany, France, and Italy (table 3).

Table 3. Top 20 Gold Holdings as a Share of Official Reserves, 2023.

	% of reserves	Mln troy ou.
Venezuela	84.6%	5.183352
Bolivia	75.6%	0.781532
Uzbekistan	75.0%	11.84989
Portugal	72.1%	12.30189
United States	69.7%	261.4965
Germany	68.7%	107.779
France	66.8%	78.35027
Italy	66.0%	78.82826
Austria	60.1%	9.001916
Netherlands	58.2%	19.69082
Lebanon	56.7%	9.221914
Greece	55.8%	3.678966
Kazakhstan	55.5%	9.84331
Cyprus	51.4%	0.446996
Kyrgyz Rep	46.4%	0.755747
Belarus	43.3%	1.734684
Belgium	37.0%	7.310932
ECB	35.1%	16.28485
Curaçao and Sint Maarten	34.7%	0.420996
Ecuador	34.0%	0.844955

Source: World Gold Council

Furthermore, according to the Economist (2022), **gold is costly to transport, store, and protect. It's 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 (IMF, 2023).

However, repatriating gold, as seen with Russia, Venezuela, and others, can limit its utility. Observations of such actions have sparked a debate among experts. Some suggest that countries at risk of G7 sanctions might lean towards substituting their gold reserves with Chinese renminbi, instead of increasing their gold reserves. This issue is extensively discussed in the works of Arslanalp, Eichengreen, and Simpson-Bell (2022) as well as in Eichengreen's separate 2022 study, highlighting the complexities and differing perspectives surrounding the strategic financial decisions made by nations anticipating sanctions.

Arslanalp, Eichengreen, and Simpson-Bell (2022) 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—key issuers of reserve currencies—**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.

Exploring Further Dimensions of Gold Purchasing

While gold is a valuable asset, its liquidity may be lower compared to other financial instruments such as government bonds or foreign currencies. In times of crisis or urgent need for liquidity, selling gold reserves may not be as straightforward or timely, potentially posing challenges for the NBG to access funds quickly when necessary. However, according to officials, the NBG plans to uphold its gold reserves for an extended period, suggesting that liquidity concerns should not emerge. **At present, the proportion of gold in reserves is low, but the issue could become more pronounced if the share of gold reserves were to increase further.** Moreover, the NBG intends to transport acquired gold from England to Georgia for storage, potentially reducing storage costs, but further decreasing liquidity and raising questions about the decision made by the NBG.

Back to 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 into the picture political considerations.

The IMF program has been put on hold since 2003 over concerns about Central Banks' governance. How does the gold purchase reflect on future of IMF cooperation? Approval by the Parliaments of the "Foreign Influence Transparency" law in two readings and the anti-Western rhetoric of the ruling party have sparked intensive public protests. European partners warn that the draft law not being aligned with Georgia's European Union aspirations and could potentially hinder the country's movement onto the EU path. Instead, they warn that the law might distance Georgia from the EU.

Furthermore, a recent amendment of the Tax Code 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 develop.

Conclusion

In conclusion, this policy brief reveals 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 Russian aggression.

Georgia purchased gold for the first time since regaining independence. For the National Bank of Georgia (NBG), while its gold purchasing strategy seems to align with these economic motives, the recent domestic political dynamics suggest a deeper, possibly strategic political rationale. The imposition of U.S. sanctions on key figures, questions surrounding the central bank's autonomy, and 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 are significant, the political underpinnings in the NBG's recent actions raise numerous unanswered questions.

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