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Research Paper

Runaway Gold Prices – the whys and the wherefores

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Abstract:
Gold has been an object of fascination and desire for centuries. It has been a much-coveted possession for kings and emperors and common folk from times immemorial. But being a scarce commodity, it always commanded a high price. The populace in many countries of the world, including India, have always been captivated by this valuable metal. Its unique properties made it a reliable medium of exchange under the gold standard. With the growth of the capital market, gold continued to hold sway as a medium of investment. It guaranteed safe returns, security of value and acted as a hedge against uncertainties. Though, its global prices had witnessed some ups and downs, but fluctuations were within predictable ranges. Recent international events however, have deeply impacted financial markets and gold as well. The continuous rise in the price of the precious metal has broken all previous records. The rush for possessing gold amidst global turmoil has escalated the demand for it. This paper attempts to understand the phenomenon, seek the reasons for this escalation in the price of gold and find the connection it has to other economic performances and its prediction for future economic events.
Keywords: *Gold, hedge, capital market, escalation, global*

I. Introduction

Gold, the pure, resilient, radiant and royal metal has been the most sought after by most people across the globe. All major civilisations have for centuries been fascinated by the yellow metal, making it an object of veneration and value. Apart from its beauty making it most desirable, it is extremely scarce. 'Copper is present in the earth's crust at 55 parts per million (ppm) and iron at 56,000 ppm, whereas gold is found at 0.0038 ppm or just shy of .004 grams per ton of earth' (Schoenberger, 2011). It is therefore not surprising at all that gold has always had high social value and restricted access. Nothing like gold was ever universally acceptable, making it the natural choice of representing value of other goods and a medium of exchange. Francis Hutcheson, (1694-1746), teacher of Adam Smith, had opined that commodities that are chosen as money on the market are those that are generally desirable and acceptable in exchange, divisible into small quantities without losing their *pro rata* share of value, durable for long periods of time and portable, for which quality they must have a high value per unit weight. Generally, he pointed out that, silver and gold have been the two commodities that have been chosen as by far the most popular form precisely for being desirable and easily carrying a warrant of purity. (Rothbard, Murray N., 1995)

Gold was minted as coins and used as legal tender or later was used indirectly as a reserve backing for the currency in circulation under the Gold standard. The U.S. used gold until 1971 when it was discontinued under President Nixon. One of the reasons for giving up the gold standard was the limit it imposed on a nations ability to issue currency without increasing their gold reserves and gold was a scarce commodity. But though the world has moved on to the fiat currency system, gold continues to hold sway in the financial market.

Gold in the modern era

Gold has traditionally been an object of desire in many countries including India. People continue to buy gold, particularly as jewellery on special occasions. It also imparts a sense of security to households as gold can be used to tide over financial problems. Gold remains an important reserve asset for central banks and financial institutions in all countries and the IMF is one of the world's largest official holders of gold. It is also a valuable asset for individual households and investors. Gold is considered as a safe haven, especially in times of financial crises as it holds its value even during economic turmoil and therefore protects the investor from loss. Thus, even when stock and bond markets witness rapid movements, gold retains its value. Gold is far less susceptible to fluctuations in the rates of exchange than currencies. Therefore, changes in the purchasing power of domestic or international currencies do not impact gold. Investors and individuals use gold as a protection against depreciation in the value of money. Therefore, in times of inflation, there is a movement towards gold.

Gold acts as a hedge against stocks. When the economy is going through a slowdown and the returns from the stock market are falling, investors turn to gold as its value is the most stable. It can also be easily liquidated, justifying its importance as an alternative to stocks in times of market uncertainties. The monetary value of gold has always been increasing; thus, it is profitable to invest in gold as it offers a higher return.
Even during normal times, gold has been considered to be a portfolio diversifier, especially with stock portfolios since price determinants of gold and other financial assets vary. Studies by various agencies show that a portfolio with 25% weightage to gold reduces portfolio risks significantly and increases returns. These studies also reveal the advantage of holding physical gold over paper gold. In modern times gold can be held in various forms-

1. Gold backed ETFs: Simply put, gold backed ETFs are units representing physical gold which may be in paper form or dematerialized form. They are exchange-traded funds and are listed and traded like stocks and are backed by gold of 99.5% purity. These funds aim to track domestic physical gold price.
2. Digital Gold: It is a method of making investment in gold in small payments for a certain period of time from anywhere and anytime through digital access. Digital gold can be bought through bank apps, mobile wallets and net banking websites.
3. Gold Funds: Gold funds are a type of mutual fund that invest in gold directly or indirectly-in physical gold or in the shares of gold mining companies or in gold ETFs.
4. Gold Coins: -They are among the most preferred choices of investment. They are available in different purities, weights and designs.
5. Gold Bars: - Also called gold biscuits, bullion or ingots, they are the most standardized way of owning physical gold. They are generally better for high denomination purchases.
6. Gold Jewellery: The most popular form of owning gold by households both on account of its aesthetic and cultural appeal as well as a security to tide over a crisis.
7. Sovereign Gold Bonds: These are bonds issued by the Reserve Bank of India on behalf of the Government of India. Since they are GOI bonds, they have sovereign guarantee. They are denominated in multiples of grams of gold with the basic unit of one gram, with a minimum investment limit of one gram

Thus, in modern times, there are multiple ways to hold and trade in gold.

The Gold Rush

Since gold is a safe haven, secure, and safest form of holding an asset, it is a go-to asset in times of financial upheavals. When the equities market fumbles, the performance of gold becomes stronger. This explains the rush for gold during unstable financial conditions and the rise in the price of gold. Some main factors that affect the price of gold are=

1. Geopolitical tensions- When some major economies of the world are engaged in strife, investor confidence takes a dive, making investors make a rush for gold. This was seen in the US-China tensions and the Russia-Ukraine conflict.
2. Inflation- In times of inflation when currency value is fast depleting, people throng to gold to protect themselves against losses, since the value of gold remains stable over long periods of time. Thus, the price of this precious metal rise further. This situation is highly visible at present.
3. Global crisis and policy change- When the world becomes a victim of a crisis and policies change quickly to deal with it, people and investors turn to gold as its value is stable, pushing up the price of gold.
4. Economic Growth- Studies reveal that when incomes rise, the demand for gold jewellery, long-term savings and technology. goes up,
5. Industrial Application- A major part of demand for gold comes from its use in industrial appliances like computers, medical devices, navigation systems, etc. Therefore, an increase in the demand for Such equipment leads to a rise in the price of gold.
6. Cultural causes- Gold is an integral part of the culture of many countries like India and China. Festivals, New Year celebrations, gifting and marriages drive the demand for gold pushing up its price at particular times of the year.
7. Interest rates- The demand for gold rises when the rates of interest are falling as investors exit other forms of investment and park their funds in gold instead, and this elevates the price of gold.
8. Uncertainty and risks- Gold being a safe-haven asset is preferred by buyers during economic downturns and rising risks. This flight-to-gold raises its price.
9. Monetary policy changes- When the interest rate on government securities rise, the demand for gold falls and falling rates leads to rising demands for gold pushing up its price.

The most visible reasons for rising gold prices at present maybe explained as follows-
Demand recovery: As the world moved out of the lockdown phase and also out of the recession phase, demands saw a dramatic increase, including the demand for gold. In China, as the government recently abandoned its 'zero-covid' policy, Chinese people have reverted to their normal consumption patterns which includes their growing consumption of gold, leading to rising price of gold. Also, Asians have a greater affinity to gold as an

investment asset compare to the west. Demand for gold peaks in times of festivals and marriages irrespective of other factors giving a major push to gold prices.

Financial turbulence: The international financial market has witnessed turbulent times many times over the years. More recent events being the economic crisis of 2007-12, including the 2007-2010 U.S. subprime mortgage crisis leading to the great recession of this century from 2007-2008, and the European sovereign debt crisis between 2010-2012 faced by the Eurozone countries. These became global phenomena, sending the world into a tailspin. Bank failures and the apprehensions of sovereign default in the Eurozone, translated into excessive volatility in the stock markets not only in the countries of origin but sending shocks throughout the world leading to economic slumps.

Over the last three years, the 2020 Covid-19 pandemic severely impacted the global economy leaving many countries struggling. Despite the strong economic recovery in 2021, financial difficulties were far from over. The recovery and support measures undertaken during the pandemic including large scale infusion of liquidity in the economy, now assumed the form of huge debts of governments as well as private companies. Supply chain disruptions resulting in rising costs of materials and high transportation costs escalated prices. On the other hand, demand continued to rise leading to rapid increase in the rates of inflation across the globe, forcing central banks to adopt monetary tightening measures.

As the west is seen hurtling towards recession or a slowdown, growth across the world is expected to dampen and further layoffs become imminent, gold has again become a hedge and a safe-haven asset to which people and investors are turning to in large numbers. It has become the safest place to park one's funds. Its opportunity cost has risen as returns from other instruments of investment do not look attractive.

U.S crisis and Monetary policy: The price of gold is highly sensitive to the value of the US dollar, the latter being the worlds' reserve currency. The dollar itself is influenced largely by the monetary policy of the Federal Reserve- the central bank of the U.S. Of late the US Fed has been continuously raising its interest rates in order to fight the all-time high inflation witnessed in the country. In the beginning these hikes were steep-setting new records-, now its gradually being reduced and hiking rates are now 0.25% at a time. When hikes were steep, the dollar became very strong, as high rates of interest attracted a lot of capital to the U.S. But since the rate of hikes declined, the dollar is weakening. The greenback and gold tend to move in opposite directions. Thus, while a strong dollar had reduced the demand for gold, a weakening dollar has again made gold more alluring. This has investors flocking towards gold, boosting its price further.

The rate hikes by the Fed Reserve, had adversely impacted smaller banks and the real estate sector in the U.S. representing a growing systemic risk, further adding to gold's case. The sudden banking catastrophe which was triggered by the collapse of the Silicon Valley Bank and the Signature Bank of New York and the crisis faced by the Credit Suisse, shook investor confidence and drove gold prices higher. Though rate hike drop has eased the situation somewhat, the case of an economic slowdown remains, gold remains the preferred investment.

Inflation: When the central banks of many major countries of the world, began infusing liquidity in the economies that had been badly hit by the pandemic and prior to this by the financial crisis in order to revive financial activities and boost economic growth, it pushed up inflation to very high levels. The quantitative method to expand money supply was to lower rates of interest. This was the main trigger for inflation. This led to an increase in prices of almost all goods including gold. Traditionally, gold has been an indicator of future inflation. High inflation creates fear amongst investors about the possibility of a decline in the value of currency, strengthening the demand for and the price of gold, because gold acts as a hedge against inflation and currency devaluation. Another reason for the rise in gold rates in times of falling interest rates is that the opportunity cost to hold gold becomes lower compared to other investments. On the supply side, when costs of production rise in times of inflation, miners sell gold at higher prices so as not to affect their profits and this gets reflected in the form of higher price of gold in the market.

Geopolitical tensions: Heightened geopolitical tensions for more than a year now have aggravated the problems of the world. Since Russia invaded Ukraine, in February 2022, invoking fears of a full-blown global war, uncertainties across the world have been growing. The fighting, the sanctions imposed and the supply chain disruptions all badly impacted the global economy. Oil and gas prices skyrocketed causing major bottlenecks which further pushed up prices. Along with this, the military tensions around Taiwan and the ongoing trade tensions between U.S and China have added fuel to fire. All this was reflected in the stock markets. The stock and bond markets witnessed extreme volatility, giving flat and even negative returns. Investors as well as central banks flocked to gold as a safe haven since it continued to be a perfect hedge in the portfolio giving strong returns.

Present scenario

After a record increase in the rates of interest, The Federal Reserve, has begun to slow done the rates of increase, in an attempt to revive the economy and turn it around from an imminent slowdown. In response, the stock markets rallied somewhat resulting in the price of gold falling marginally. But global financial instability continues to be present. With slower rate hikes, the dollar is looking less promising and this is building up the demand for gold. Experts feel that this is expected to continue in the near future. They say that gold will continue to be a preferred asset class until global uncertainties are over. Inflation continues to be high and the interest cycles are yet to ease fuelling the gold run.

As China has lifted its covid restrictions, the Chinese demand for things, including gold, has resurged adding to the global demand for gold. Central banks continue to buy colossal amounts of gold worldwide. This, along with large scale purchases by investors and slower ETFs outflows have raise the demand for gold to record highs. A survey by the World Gold Council in 2023 revealed that Central banks had bought a 55 year high of 1.136 tons of gold in 2022; 24% of the central banks intend to increase their holding reserves in the next twelve months. 62% of them said that gold will have a greater share of total reserves compared to last year. It is well known that when central banks buy gold in large quantities, gold prices go up. Official sector institutions too continued to buy gold, global jewellery consumption remained flat, while demand for ETFs declined and so did demand from the technology sector. The supply of gold increased marginally.

Gold market in India

Gold has been an integral part of the lives of Indians since times immemorial. The country, fondly called the ‘golden bird’ before the British rule, continues to hold a deep fascination for the precious metal. The most popular form in which we buy and store gold is jewellery. It is estimated that Indians own approximately 9-11% of all physical gold in the world. According to the January 2023 report of the World Gold Council, India bought 611 tonnes of gold jewellery in 2021, second only to China at 673 tonnes. It is said that there is no marriage in India without the use of gold. Gold is used for gifting on numerous special occasions and is in huge demand traditionally on festivals like Deepawali and Akshaya Tritiya. The marriage season sees a massive surge in demand for gold jewellery. The demand for gold during such periods is almost consistent, irrespective of the fact that a large portion of this demand is met through imports.

In a deeply interconnected world, the recent developments across the globe as discussed above, affected the gold market in India too. After seeing a fluctuating trend in 2020 due to the pandemic, the surge in economic activities globally and the resultant inflation raised the demand for the precious metal as a safe haven. Gold prices galloped away to record highs, throwing a dampener to demand by the household sector. Gold prices recorded double-digit growth since 2022. FY saw gold rise by a whopping 15% owing to macroeconomic risks. Gold prices crossed Rupees 60,000 per 10 gram breaking all previous records. As global uncertainties continue, the prices are expected to rise further. From the investors point of view however, all this bodes well, giving very good returns particularly when compared to other forms of financial instruments. As Nifty and Sensex have broadly yielded flat to negative returns, gold has performed extremely well. This is so because investors are driven to flight- to- gold in times of apprehensions about a stock market collapse. Experts believe that gold still looks lucrative as a safe haven and a hedge against inflation, global tensions and currency devaluations. People in India will continue to buy gold for auspicious and cultural reasons as well as for marriages. This demand will be pushed further with the rapid growth of the middle class in the country. The rapid economic growth of the country will propel this demand further. Thus, investments in gold will continue to increase and so will prices with some fluctuations.

II. Conclusions

Gold has proven to be the most stable and hence the most reliable of all assets. Apart from its beauty and historical value, it has been a safe haven asset acting as a hedge against inflation and a diversifier of portfolio investments. It is one of the most liquid assets and valuable. Its demand for numerous reasons will continue to make it a most desired commodity all over the globe. Thus, gold will continue to be valued and appreciated in the coming years just as it has been in the past. The forms or products of gold investments may vary, but gold jewwllery will continue to fascinate people of all cultures. Global experts foresee uncertainties are likely to continue into the near future in the wake of prolonged global inconstancies and these are going to keep reflecting in the monetary and financial markets. Therefore, it seems safe to assume that gold prices will continue to rise, albeit with fluctuations depending on local and global factors, but gold will continue to shine.

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