High time RBI bought more gold

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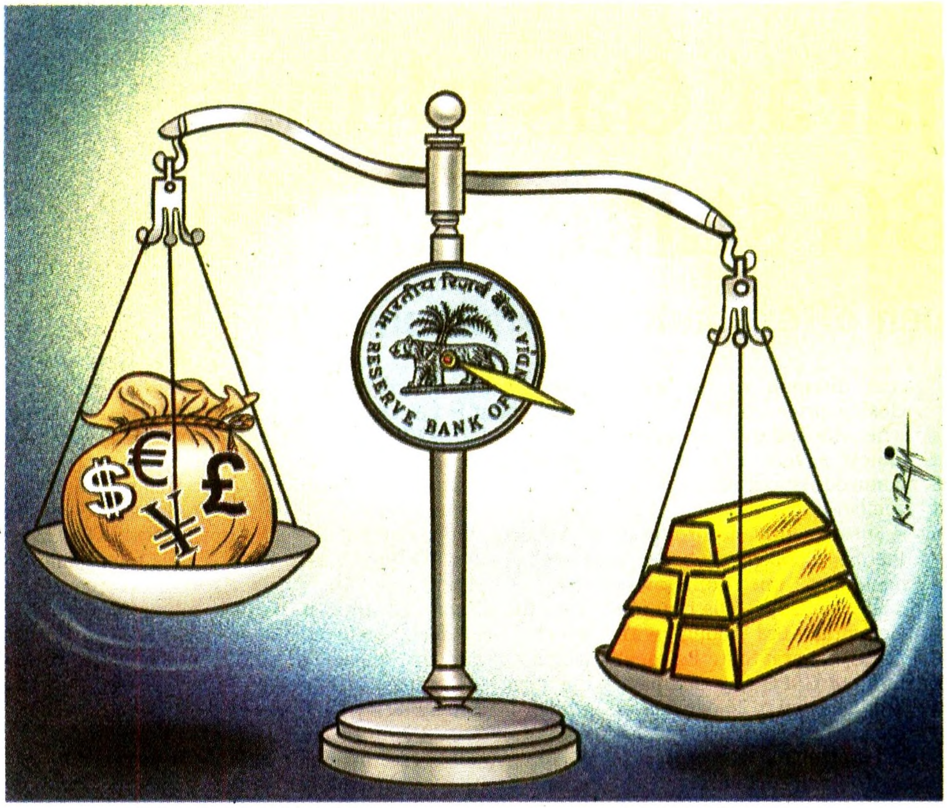
Gold is a good long-term bet, what with developed countries printing currencies quite recklessly.

MAVERICK VIEW

In recent years, the price of gold has been on an unprecedented northbound movement. It is not only the gold bugs who are advocating increased gold holdings by central banks, but also a number of responsible policymakers and opinion makers.



EXCESSIVE PRINTED MONEY

Since 2008, the received doctrine is that recovery of the major industrial economies requires opening up the spigots of printing presses. While the world economy continues to remain in the doldrums, critics of the present policies attribute the absence of recovery to insufficient pump priming.

For instance, Paul Krugman, the internationally acclaimed economist, is critical of the half-hearted measures of the Obama Administration in the US and he refers to the attempts in Europe for austerity as sheer madness.

Ralph Benko, Senior Adviser, American Principles Project and adviser to the Editor, Lerhman Institute, calls such advocacy as "monetary promiscuity".

Is the slowdown in the industrial economies akin to the 1930s when there was an excess of savings over investment opportunities? It is clear that in the present situation savings have been on the decline and the Keynesian pump priming solution is not appropriate. Yet, country after country in the industrial world, as also the emerging market economies, has gone in for unabashed printing of money.

It is an article of faith that excessive printing of money will not ultimately result in inflation.

This is a rare moment when the entire global economy is captivated by totally absurd policies and little is being done to rein in irresponsible governments.

SUSPECT CURRENCIES

The major reserve currencies — dollar, euro, yen and sterling — are all suspect. Countries which offer their currencies to be reserve invest substantial amounts in gold. Major industrial countries hold a substantial proportion of their reserves in gold: US (77 per cent), Germany (74 per cent), Italy (73 per cent), France (72 per cent), and the Netherlands (62 per cent). Industrial countries with a low gold proportion are the UK (18 per cent), Switzerland (15 per cent) and Japan (4 per cent).

Among the emerging market economies, the proportion of holding in gold is generally low: Brazil (1 per cent), China (2 per cent), Malaysia (2 per cent), Mexico (4 per cent), Thailand (5 per cent), Taiwan (6 per cent), Russia (9 per cent), India (9 per cent) and the Philippines (10 per cent). The share of gold for all counties in the world, taken together, is a little less than 13 per cent). China intends to add 1,000 tonnes of gold a year to its central bank's reserves.

A prudent measure for countries with a low proportion of gold would be a "loss minimisation strategy" to ensure that a country is not excessively affected by fluctuations in gold and reserve currencies. These countries are particularly vulnerable if reserve currencies depreciate and gold appreciates.

RAISE GOLD RESERVES

There are distinct advantages in being first off the block in the pursuit of increasing the gold proportion. There has all along been a strong aversion, both in the government and the Reserve Bank of India (RBI), to enhancing the gold proportion in reserves.

It is argued that the present price of gold is too high and that it may well crash. The movements of gold and currencies are not predictable. A 9 per cent gold proportion in reserves leaves the Indian economy vulnerable, if gold prices explode. It would be prudent to gradually raise the proportion of gold to, say, 20 per cent over the next 12-24 months.

The strategy should be to buy gold in the international market in lots of say 5 tonnes, but if the price falls the size of the purchase lots could be stepped up.

CAN PRICE CRASH?

Apart from temporary dips in the gold price, it is most unlikely that there would be any large and enduring fall in gold prices. Central banks with large holdings are unlikely to passively let gold prices fall. More importantly, any fall in prices would trigger countries with a low gold proportion to enhance the share of gold in their reserves. More importantly, there are no signs of the industrial countries backing off from unbridled printing of money. Thus, there is a strong possibility of currency values falling and gold prices rising.

ADVOCACY OF STANDARD

In the recent period there are new advocates for gold. Daniel Eckert and Holger Zschapitz, writing in *Die Welt* (September 16) argue that savers are today faced with financial imbalances. Western governments have amassed huge debts without a parallel in history.

Detlev Schlicter in his book *Paper Money Collapse* argues that remonetisation of gold has already started as central banks and governments have grown accustomed to the "sweet poison of debt".

Benko in his *Signs of a Gold Standard Emerging from Germany* in the *Forbes* issue dated September 25 quotes Jens Weidmann, President of the Deutsche Bundesbank: "Indeed, the fact that central banks can create money out of thin air, so to speak, is something that many observers are likely to find surprising and strange, perhaps mystical and dreamlike too — or even nightmarish." Jens Weidmann asserts that gold is a "timeless classic". He refers to Goethe's *Faust* to say that "inflation was and could only be the invention of the devil" and that "whoever strives in his endeavour, we can rescue from the devil". Critics who accuse gold bugs for atavistic rituals need to recount *Faust*.

Daniel Brebner and Xiao Fu, analysts at Deutsche Bank, in a paper *Gold: Adjusting for Zero* (September 18) set out that gold is an officially recognised medium of exchange and held by the largest central banks. They further argue that gold could be characterised as "good money" as opposed to "bad money", which is characterised by fiat currencies. Benko derives support for gold from these viewpoints and rightly concludes that green shoots of respect for the classical gold standard are beginning to pierce the decaying concrete of Neo-Keynesian monetary theory.

PURCHASE EARLY

If all the major emerging economies were to raise, in unison, the proportion of gold in their reserves to say 15 per cent, the demand for gold would be so high that gold prices would hit stratospheric levels of $3,000 a fine ounce or more. Apart from short-term fluctuations, there is absolutely no possibility of a retrenchment in the price of gold as central banks would step in and undertake purchases.

We in India do not need to wait for the final result of the gold-fiat currency battle. There are distinct gains in undertaking sizeable early-bird purchases of gold by the RBI.

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