

What are the shortcomings of holding gold reserves?



Introduction

- **Gold reserves with the Reserve Bank of India surged over 12 times in 20 years.**
- **RBI has been in possession of gold reserves, as a part of the foreign exchange reserves.**
- **As at end-March 2021, the Reserve Bank held 695.31 tonnes of gold as part of its foreign exchange reserves.**



The reason for keeping Gold

- **The buying gold appears to be driven by a desire to reduce the dominance of the US over the global economy.**
- **Also, India's desire to add gold reserves seems to be driven mainly by the fear of depreciation in dollar value causing capital loss.**
- **RBI's recent gold purchases started in 2018.**

It was led by two events

- **US dollar fell sharply** in 2017 as the trade war with China and crash in commodity prices.
- **Yields on US treasury bonds spiked sharply.**



Twin objectives

The twin objectives of foreign exchange reserves management:

- **Safety**
- **Liquidity**

Also, Gold helps in **return optimization.**



Drawbacks of Holding Gold

- **Volatility**: Gold prices are volatile and can result in sharp capital loss.
- For instance, gold prices crashed around 30 per cent in 2013.
- **Hedge only in Short Term**: Gold's property as a safe haven has been questioned quite often in recent past. While it does provide a hedge in periods of extreme stress that last for short durations.
- It was seen in March 2020, over longer time-frames, gold is not an effective hedge for the portfolio.
- **Liquidity issue in times of Stress**: Liquidity in gold is relatively lower when compared to other fixed income securities.
- If central banks begin offloading large quantities of gold in the market, it tends to impact gold price adversely, affecting the residual holding in the reserves.
- **Does not help in Trade**: The assets that make up the reserves should be decided based on the currency-composition of the country's external trade, currency in which it has borrowed overseas, the key currency to which its value is linked and so on.
- Given these factors, India needs to hold a chunk of its reserves in US dollars.

Way Forward

- Holding a part of reserves as gold is not a bad idea given that it acts as a diversifier and **does not carry any default risk**.
- **The RBI needs to decide how much exposure it wants in gold and regulate its purchases accordingly** over the next two years.
- **BIS recommends that given the volatility of gold returns, only a very small share of gold appears quantitatively adequate under most circumstances**.
- However, there is **evidence of a potential insurance value of gold in adverse scenarios**, which can support higher allocations of gold in cases where the **protection against tail risks** is a key reserve management consideration.

