NUS National University of Singapore

Source: *The Business Times*, p24
Date: 28 September 2017

Gold's durability in Asia driving global demand

There seems to be a new-found appreciation for the yellow metal as a portfolio diversifier, inflation and currency hedge, and safe haven asset. BY RAMKISHEN S RAJAN AND SASIDARAN GOPALAN

CENTRAL bank holdings of international reserves across the world stood at around US$13 trillion as at June 2017, compared to a little over US$400 billion in 2000. The data is likely an understatement as it excludes assets shifted to sovereign wealth funds and other forms of state funds. Of these reserves, developing countries accounted for about two-thirds while advanced economies made up the rest.

What currency denominations have these reserves been parked in? Much focus has inevitably been on the US dollar's dominant status. The greenback still constitutes around 65 per cent of allocated foreign-exchange reserves globally. This has been juxtaposed against the renminbi's (RMB) gradual emergence as an alternative global reserve currency, especially since the internationalisation of the Chinese currency and its inclusion in the International Monetary Fund's (IMF) Special Drawing Rights as at Oct 1, 2016.

Latest data from the IMF on the currency composition of foreign-exchange reserves reveals that as at June 2017, the RMB represented about one per cent share of the total allocated foreign-exchange reserves. While the RMB may not become a major reserve currency in the near future, indications are that it has made greater progress as an international currency in terms of being a medium of exchange and unit of account in global trade and investments (though the imposition of capital controls may be counter-productive in this regard). Apart from the US dollar, the RMB, and questions regarding the euro in the light of the eurozone crisis, somewhat less attention has been paid to central banks' holdings of gold.

Ever since the pre-World War I gold standard and post-World War II Bretton Woods arrangement, gold has been an important component of central banks' reserve holdings. In fact, between 1970 and 2009, central banks appeared to be trimming their holdings of gold reserves as they moved to more flexible exchange rates and also looked to diversify into interest or dividend-bearing assets.

Things changed post-global financial crisis, and since 2009 there has been a resurgence of interest in the yellow metal as central banks around the world switched from being net sellers of gold to net buyers. This renewed appetite for gold reflected in central bank purchases may have kept gold prices robust after the initial run-up due, among other things, to the financialisation of the commodity via the introduction of exchange-traded funds in the early 2000s.

AGGRESSIVE BUYERS

Many emerging market (EM) economies in particular have been actively trying to diversify away from fiat monies, especially following quantitative easing policies in the United States and eurozone, and there appears to be a new-found appreciation for gold as a portfolio diversifier, inflation and currency hedge as well as a safe haven asset.

Among the EM economies, China and Russia have, until recently, been particularly aggressive purchasers, likely driven by other strategic calculations. However, despite these purchases, gold still constitutes under 2.5 per cent of China's total official reserves, with the corresponding figure for India around 6 per cent and 17 per cent in Russia.

While growing in importance, EM economies' gold holdings pale in comparison to the average 60-70 per cent share of total official reserves in advanced economies such as the US, Germany, France and Italy. Thus, while China holds a quarter of global official reserve assets, its share of global gold reserves is only about 5.5 per cent. Even if one acknowledges that China's official gold reserve holdings may be under-reported, the gap between its gold reserve holdings and those of advanced economies is substantial.

Official holdings of gold constitute just one part of overall gold demand, with the remainder fuelled significantly by private-sector demand, especially in Asia where cultural affinity for the yellow metal runs deep. Indeed, in aggregate, Asia makes up two-thirds of global consumer demand for gold, with China and India together constituting over 50 per cent. In addition, the Asean bloc – which in aggregate is the seventh largest economy in the world – is also a major source of demand, averaging around 8 per cent of global consumer demand for gold.

Major policy changes and structural issues in Asian economies can potentially impact global gold demand. PHOTO: BLOOMBERG

Gold demand has been traditionally high in Asia both for adornment as well as for hedging against inflation and uncertainties. Beyond traditional demand, there is also an emerging breed of investors attracted by the risk diversification benefits of holding gold as well as using gold as a hedge against tail risk events. Further, retail and institutional gold demand is expected to rise as well with growing wealth in Asia.

In view of the significance of the Asian region in the gold market, it is not surprising that major policy changes and structural issues in these economies can potentially impact global gold demand. For instance, in the case of India, there have been three major policy changes that could have a significant impact on gold demand: various gold monetisation schemes in 2015-2016 (aimed at encouraging consumers to deposit gold in banks so they can generate some income), currency demonetisation (whereby there was a shock removal of 500 rupee (S$10.3) and 1,000 rupee notes from circulation almost overnight), and the goods and services tax (GST) which came into force on July 1, 2017.

The gold monetisation schemes thus far have been disappointing and have not had any discernible impact. While the currency crunch due to the currency demonetisation did lead to a short-term decline in gold demand (after the immediate surge as some people tried to whitewash their possibly ill-gotten rupee holdings by buying gold), over the long term it is likely that the demonetisation may bolster gold demand compared to fiat money as a store of value. To some, demonetisation has emphasised the unique character of gold compared to fiat money – it is no one else's liability.

While the imposition of the GST is expected to bring about long-run benefits, there were initial concerns about the GST rates to be levied on gold. The actual rate finally imposed is 3 per cent and after adding on other duties, gold has become only slightly costlier (around one per cent) compared to pre-GST. However, overall India lacks a coherent national gold policy and would do well to learn lessons from China and Turkey in how to monetise gold holdings and how to develop domestic currency based investment products for households.

Beyond country-specific policies, the astronomical rise of cryptocurrencies such as bitcoin and ethereum could reduce the allure for gold (some say it already has). Cryptocurrencies are often likened to gold and even called "digital gold". Much attention was paid to the nexus between gold and cryptocurrencies when the price of bitcoin surpassed that of an ounce of gold in early March 2017 and has continued to rise rapidly ever since.

MORE TRUSTED ASSET

However, while making a nice headline, it is not clear that this comparison is very meaningful since what matters is overall capitalisation. The size of the gold market far outweighs that of cryptocurrencies. Gold is also generally a more trusted asset and there is, at least for the near to medium term, a much greater tendency for cryptocurrencies to experience massive boom-bust cycles. However, both gold and cryptocurrencies are similar in the sense that there has been a penchant by their owners to hoard these assets rather than use them as a medium of exchange on a large scale. (The explosive growth of initial coin offering or ICO is more like a one-off transfer payment than a medium of exchange per se).

Uncertainties in terms of policy responses (such as the recent Chinese ban on bitcoin trading and exchange platforms) and concerns about Ponzi-type speculation make cryptocurrencies much less reliable as a store of value than gold for the time being. However, cryptocurrencies may well have a medium and long-term impact not just on gold but also on central bank policies and fiat monies in the future once they are better regulated and are more widespread in their circulation.

Indeed, central banks have already begun exploring the possibility of issuing their own digital monies. Conversely, fintech and blockchain technologies will undoubtedly provide an impetus for the development of new gold-based products and services, hence boosting gold investment demand or at least widening its appeal to a new breed of investors.

Despite intermittent headwinds, gold demand in Asia has remained highly durable and is driving global demand. It is not surprising that Singapore, which is already a major financial and wealth-management hub and has a strong ecosystem, has managed to carefully position itself as a vibrant gold bullion centre via strategic partnerships and timely policy initiatives. Singapore's embracement of fintech and the smart financial centre vision should be capitalised on by the domestic gold industry and help fortify the Republic's reputation as a safe, strategically located and innovative gold hub.

The writers are professor at Lee Kuan Yew School of Public Policy, National University of Singapore, and research fellow at the LKY School's Asia Competitiveness Institute respectively