India’s Accumulation of Gold Reserves

What is the issue?

- The RBI has revised its stance towards accumulation of gold reserves in the recent years.
- In this context, here is a look at the gold reserves trend and the rationale for the changes.

What is the current gold reserves status?

- The RBI has not made any move to increase its gold reserves for many years after its purchase of gold from the IMF in 2009.
- But India’s gold reserves have been increasing at a steady pace over the last 3 years.
- These purchases have added 137 tonnes to the gold reserves between December 2017 and March 2021.
- The share of gold in India’s foreign exchange reserves has increased to 7% currently, from 5% in March 2017.
- The resolve to buy gold is continuing in 2021, with purchases in the first quarter already amounting to 18.7 tonnes.
- The RBI currently holds 695.3 tonnes of gold, ranking tenth globally in gold holding.
- The quantity of holding is less than that of the US, Germany, France and Switzerland.
- However, it is far higher than other emerging economies, with the exception of China

What is the larger trend?

- India is not the only country purchasing gold.
- A few other emerging economies are also following a similar strategy.
- Countries such as Turkey, Russia and Kazakhstan have also been avid buyers of gold over the last 5 years.
- The main reason appears to be the need to reduce the risks emanating from excessive US dollar exposure.
- It is driven by a desire to reduce the dominance of the US over the global economy.

- One way to do so is to reduce the usage of US dollars in their external transactions as well as in their reserves.

What is India's rationale?

- India's desire to add gold reserves seems to be driven mainly by the fear of depreciation in dollar value causing capital loss.
- India's forex reserves have been on an upward trajectory for most part over the last three decades.
- This was because the RBI used the foreign portfolio and direct investment inflows to build its reserves.
- More than one-third of these reserves are held as US treasury securities
- In this context, the beginning of the RBI's recent gold purchases in early 2018 coincides with two events.

1. the US dollar fell sharply in 2017 as the trade war with China and crash in commodity prices led to selling in dollar assets
2. yields on US treasury bonds spiked sharply between September 2017 and March 2018

- These two happenings, taken together, would have resulted in a sharp loss in the value of US treasury securities held in foreign exchange reserves.
- Gold prices have also been in a strong up-trend since September 2018, gaining almost 48% since then.
- All these would have encouraged the RBI's resolve further.

What are the downsides to holding gold?

- There are limitations to the gold reserves that India can hold.
- One, gold prices are volatile and can result in sharp capital loss.
- E.g. gold prices crashed around 30% in 2013. A country that held over 50% of its reserves as gold would have seen its reserve deplete by 15% that year.
- One of the objectives behind building forex reserves is to create a buffer to help tide over external account crisis or to support the currency in times of extreme stress.
- So, exposing a large part of reserves to sharp swings in value is not recommended.
- Secondly, gold's property as a safe haven has been questioned quite often in recent past.
- It does provide a hedge in periods of extreme stress that last for short durations, as was seen in March 2020.

- However, over longer time-frames, gold is not an effective hedge for the portfolio.
- Another factor is that liquidity in gold is relatively lower when compared to other fixed income securities.
- Also, if central banks begin offloading large quantities of gold in the market, it tends to impact gold price adversely.
- This, in turn, affects the residual holding in the reserves.
- Also, the assets that make up the reserves should be decided based on –
  - the currency-composition of the country's external trade
  - the 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.
- Along with this, the RBI will have to decide how much exposure it wants in gold and regulate its purchases accordingly over the next 2 years.

Source: Business Line

