National University of Singapore

Headline: Gold prices likely to stay high for now
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ASK: NUS ECONOMISTS

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Can you explain the persistent rise in the price of gold over the past year? Is it a bubble? How long will it be before the price normalises?

IN THE last year, the price of gold has risen steadily, reaching a historical high of US$1,390 last December. While the price decreased slightly to US$1,350 last month, it is still 40 per cent higher than the average price in 2009 of US$970. In addition, the annual gold price volatility also declined from $645 to $273 by February. This increase in price, together with lower price volatility, suggests the current gold price constitutes a new equilibrium.

The World Gold Council says the supply of gold increased by 12.1 per cent in 2009 and 5.64 per cent last year, while its known demand – including for jewellery, technology, gold bar and coins, and gold Exchange Traded Funds – remained stable, with the supply always exceeding the demand. So why does the price of gold continue to rise?

In economic theory, the equilibrium gold price is determined by gross supply and demand, whereas the statistics provide only net demand and supply figures. There are several factors that drove down the gross supply and increased the gross demand for gold in the past year.

Many central banks became net buyers of gold for the first time last year after being net sellers for decades. Emerging market central banks with large foreign reserves, led by China, actively diversified across different asset classes.

While central banks continue to hold the US dollar and the euro as the world's two major reserve assets, gold is catching up because the major currencies became volatile during the recent financial crisis. European central banks essentially stopped selling gold in the wake of the recent European debt crisis. In addition, individual and institutional investors sought safe investments – and many chose gold.

Going forward, what will be the important determinants of gold price? We suggest the following are:

- First, poor growth prospects and high unemployment rates in the world's leading advanced economies, and the continued strong growth in emerging economies, will make investors prefer safe assets. Treasuries, commodities and precious metal will remain attractive.
- Second, there is now a greater supply of government bonds – from the United States, Europe and Japan. For example, the total US public debt stood at US$14.19 trillion (S$18.2 trillion) last month, a 42 per cent increase since September 2008. When the supply of money is abundant, the demand for gold is likely to remain high.
- Third, political uncertainty in the Middle East and North Africa, and in some European countries, can further increase investors' fear. When the "fear factor" kicks in, people would naturally demand safe assets such as gold to safeguard their wealth.

These three factors suggest that gold prices are likely to stay high this year unless the advanced economies recover, sovereign debt issuances are cut back and the Arab world stabilises.

One word of caution though: Investors need to be aware of gold's high price volatility, especially in the short term. Based on the past two years' data, the daily gold price fluctuation can be as high as US$20 per ounce, quite a significant amount for investors.

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