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GOLD PRICE AND NEGATIVE REAL INTEREST RATES

Gold price is dependent on the demand- supply dynamics as any other freely traded commodity. However Gold is special in the sense that it is treated as a store of "real wealth" almost universally. Hence Gold becomes a competitor for printed currency as an instrument for safekeeping of the value of savings.

When inflation is high and bank deposits do not yield much, the real interest rate is negative and the more negative this real rate of interest , the higher is the price of gold. This is corroborated well by comparing real interest rates prevalent in each country with the price of gold denominated in the domestic currency of that country. Let us see data from around the world.

Chart 1. India 1998- 2008. Price of Gold Rs./10 gram vs. Real interest rate (inverted scale)*

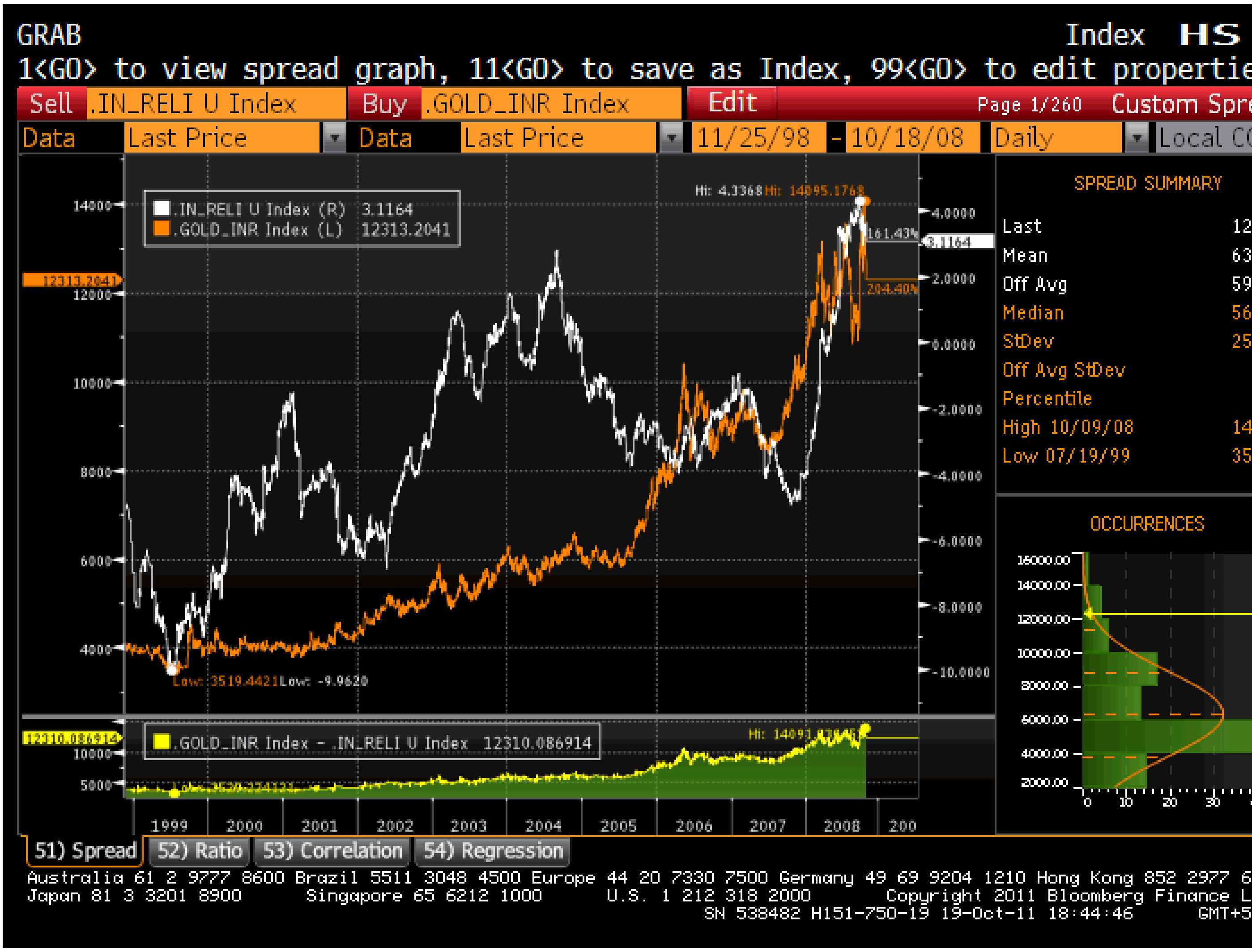

Chart 2. India 2008- 2011 (present). Price of Gold Rs. / 10 gram vs. Real interest rate (inverted scale)*

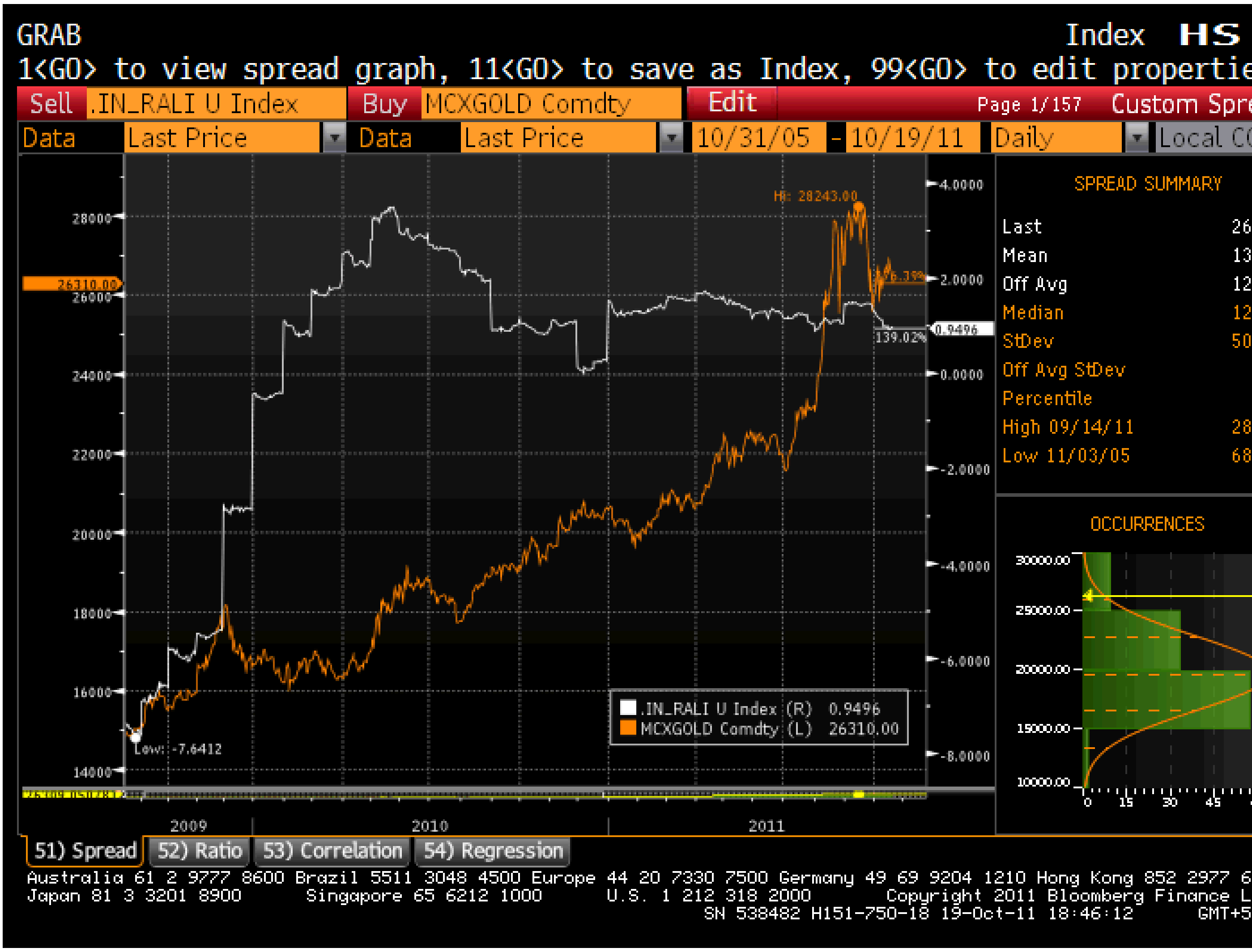

Chart 3. U.S. 1998- 2011 (Present) . Price of Gold $/Oz vs. US Real interest rate (inverted scale)*

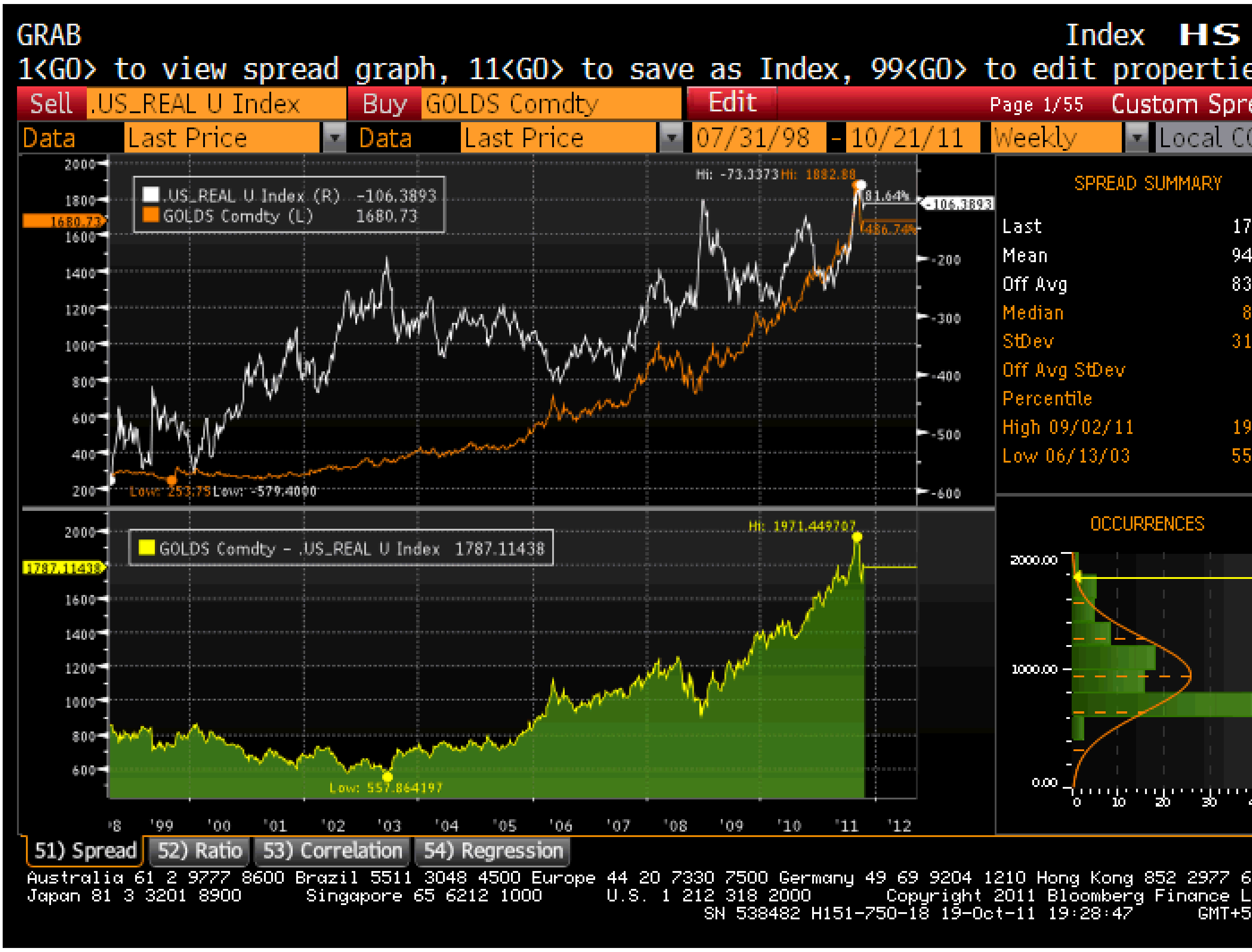

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Chart 4. China 2006 - Sep 2011. Price of Gold Yuan/10 gram vs. Chinese real interest rate(inverted scale)*

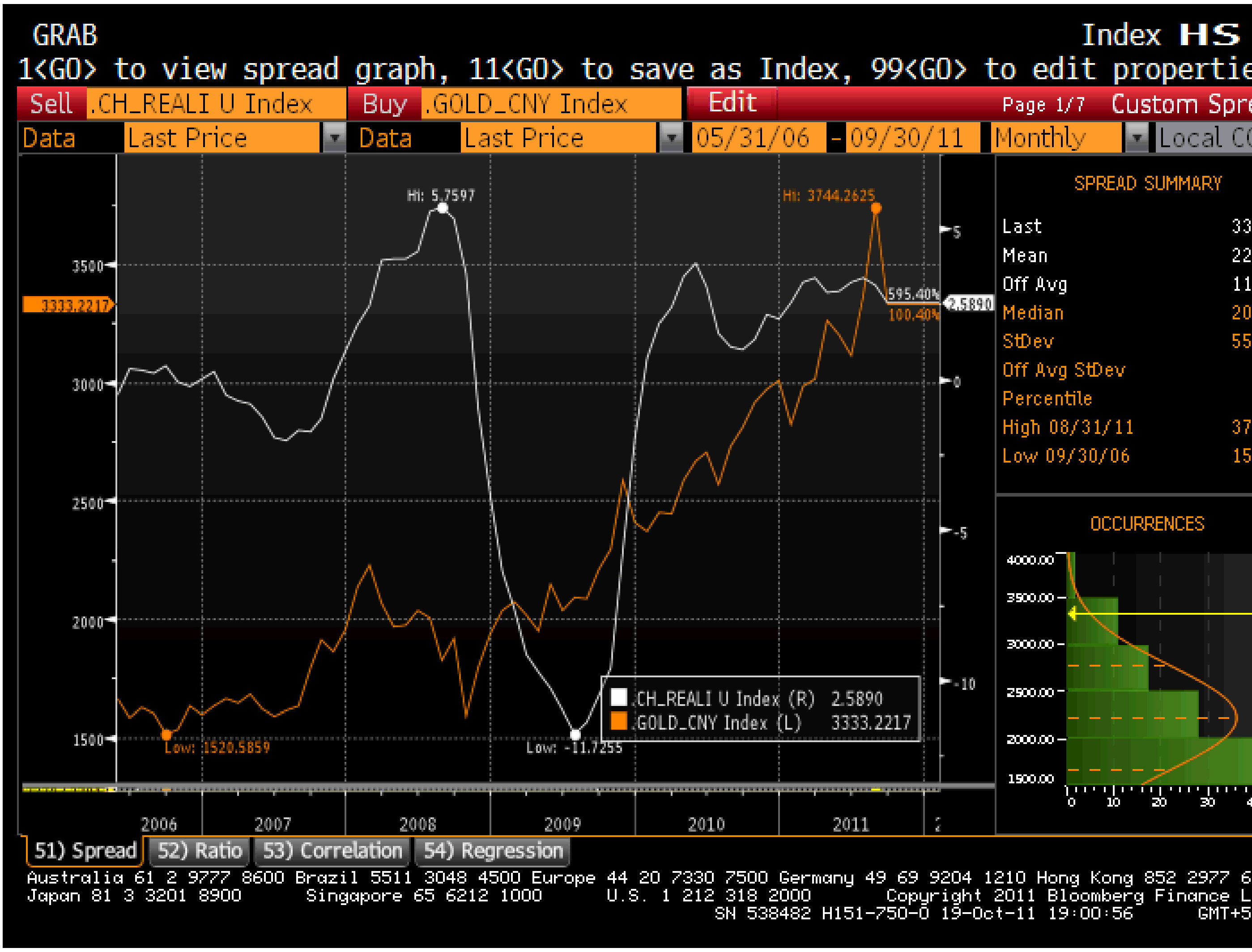

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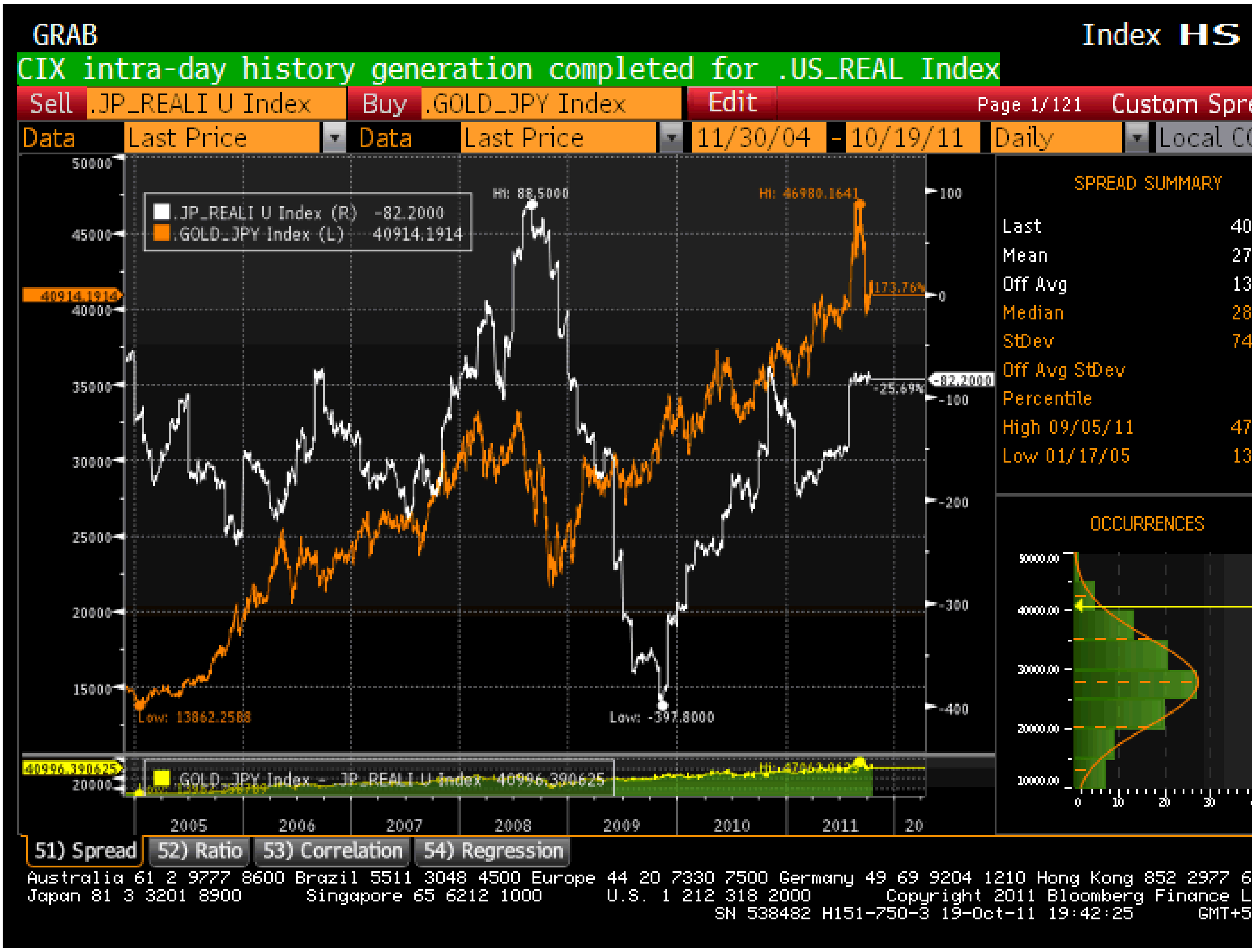
Chart 5. Japan. 2004- 2011 (Present) . Price of Gold Yen/10 gram vs. Japanese Real interest rate (inverted scale)*



So in a world of diminishing nominal returns, as long as a threat to paper currencies are viewed to be strong from debasement or from inflation, the price of gold would appreciate inspite of the fact that holding gold does not pay any interest and has storage costs associated with it.

* The real rate of interest is calculated as follows: 10 yr Sovereign yield - PPI or WPI. The graphical outputs are presented on an inverted scale by multiplying the real rate by -1.

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