Vol 3 Issue 4 Oct 2013

ISSN No :2231-5063

International Multidisciplinary Research Journal

Golden Research Thoughts

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RNI MAHMUL/2011/38595 **ISSN No.2231-5063**

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Golden Research Thoughts
ISSN 2231-5063
Impact Factor : 2.2052(UIF)
Volume-3 | Issue-4 | October - 2013
Available online at www.aygrt.isrj.net

ALL THAT GLITTERS : ANALYSIS OF MOVEMENT IN GOLD PRICES

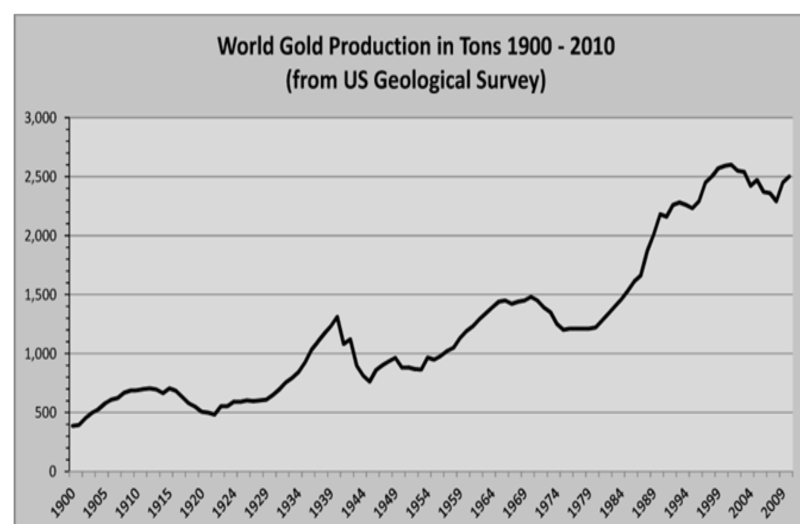
Shelly Gupta

Abstract:-The price of gold in the year 1991 was Rs. 3466 per 10 grams but in the year 2011 it was Rs. 26,400 per 10 grams. Gold prices in this period of 20 years have increased by about 661%. How did such a huge price hike take effect? The wonder of gold lies not just in its aesthetic and ornamental appeal, but also in its economic and investment appeal. Being one of the most liquid assets, it has long attracted investors and common men alike for its investment value. During the 1990s, owing to factors like liberalization of gold import, rapid economic growth and favorable gold price movements, gold consumption experienced a steep hike. Since then, gold prices in the country have been on a rise, due to both domestic and international factors.

What were these factors that lead to this price rise during this specific period of time in India? The scope of this project is to ascertain the major factors that affect gold prices in India. The time span studied is a span of 20 financial years i.e. from 1991-1992 to 2011-2012.

I.INTRODUCTION

From 1900 until 2010, that is 110 years, world gold production has steadily risen, except for four periods. See chart for historical world gold production numbers:



In the year 1900, in total 386 tons of gold was produced around the world. This is a mere 15% of gold mining in 2010, which was 2500 tons. Nowadays, within two years more gold is produced than in the one thousand years of the middle Ages. Factors contributing to increased gold mining are improved means to locate gold deposits, technological advantages regarding the construction of mines, and the excavation of gold from soil materials.

A look at the gold chart reveals four drops in gold production. During the two World Wars, gold production naturally declined. A third major decline started in 1970 and lasted for five years. Thereafter, gold production stood at a constant level of 1,200 annual tons. For the fourth decline in 2002-2008, rising production costs are responsible. In combination with low demand for gold, and consequently a low gold price, gold production became infeasible. The decline in world gold production set in when the gold price already started to rise. Mining companies were first reluctant to step up production, as it was not clear whether the greater interest in gold was only a short-term trend. Besides, increasing gold mining needs preparation and time. Thus, an immediate production expansion was not possible.

BEAR MARKET 1980-2001:

A gold investor could have made nearly 2,500 per cent profit by buying gold in 1970 for US$ 35 and selling it ten years later at US$ 850. If the same investor had bought gold in January 1980 for a rate of US$ 677 per ounce, he could have sold off his bullions a decade later for only US$ 409. A decade later, in December 2000 gold stood at only US$ 283. This constitutes a decrease of nearly 60% , not considering inflation.

What explains the gold bear market from 1980 until 2001? These two decades experienced first an end of the economic stagflation of the 1970s, with a stabilized economy and controlled inflation. Interestingly, the fall of the Soviet Union which brought down communism in most countries, and ended a bi-polar world order after 45 years, seemingly had no impact on the development of the gold prices.

BULL MARKET since 2001:

The beginning of the 21th century has witnessed a long and mostly continuous rise in the gold price from US$ 265 per ounce at the beginning of 2001 until more than US$ 1400 ten years later. This translates into a gain of 528% , which is a stark contrast to the previous 20-year long bear market.

Which factors contribute towards the steady rise of the gold rate?

First, there was a reduction in gold supply, from 2001 the global gold production fell by 10% within a decade. Still, demand in jewelry and by industry continues to increase due to India's and China's steady economic growth. Additionally, at the end of the decade central banks began to step up their gold reserves. Other important factors are the increasing US national debt and the weakening of the US dollar relative to other currencies. Further, the financial crisis of 2008, during which the US government nationalized the two biggest US mortgage lenders and the biggest US insurer, drove up demand for physical gold and exchange traded funds. SPDR Gold Trust, the biggest ETF gold fund holds currently more gold reserves than the Chinese Central Bank. To stimulate the economy, the US Treasury reduced the federal funds rate to a mere 0.25 per cent. This low interest rate also made GOLD INVESTMENTS more attractive.

RESEARCH:

The phenomenal rise in the value of gold in the decade under study has been a by-product of several factors, such as exchange rate, inflation, etc.

In this analysis, I try to study the impact and the extent of the aforementioned factors' impact on gold prices in India, during the period 1991-2011.

Based on theoretical intuitions and prior empirical work, I have expressed gold prices as a result of 6 factors-exchange rate, inflation, financial markets index, income, interest rate, crude oil prices. The model can be estimated as follows:

$$\text{Gold Prices} = 1 + \beta 2(\text{exchange}) + \beta 3(\text{CPI}) + \beta 4(\text{SENSEX}) + \beta 5(\text{PDI}) + \beta 6(\text{Interest}) + \beta 7(\text{Crude oil})$$

Estimating the linear regression form using SPSS, we obtain R2 = 0.983: This means that 98.3 % of the variation in the gold prices is explained by the explanatory variables in the model. But as suggested by the theory, this model will face the problem of high multicollinearity. This is evident from a high R2 of 0.983 and insignificant t-ratios for inflation and crude oil prices. To this, we can try dropping a variable or increase the sample size of our model. Another anomaly which could have created problem is Auto-correlation since it is a time series data but in our data as the Durbin Watson Statistic is coming to be around 2 i.e., 1.954 hence we can safely assume that there is no autocorrelation in our data.

RESULTS:

From the regression analysis, it was observed that the beta signs of all independent variables agree with our economic intuition. Exchange rate, inflation, Sensex, PDI, crude oil prices have positive impact on gold prices and

interest rate has negative impact on gold prices.

CONCLUSION:

When we see the effect of SENSEX in multiple regression positive significant relation is observed between gold prices and SENSEX reinforcing the fact that gold act as 'safe haven' on financial markets.

Personal disposable income is a factor which affects gold prices majorly. Hence increasing income push people to go for buying more gold. Income is the factor which people in India always look up to before buying gold. We find that crude oil prices and gold prices move in the same direction but do not affect gold prices significantly.

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