

Why is everyone chasing gold?

The demand for gold may turn into a run on gold as the paper gold market is many times the physical gold stock

Sashi Sivramkrishna February 25, 2025 / 09:03 IST

Highlights

- Gold prices have surged in recent months, similar to the surge seen post the 2008 financial crisis
- Dramatic rise in gold prices is due to rising uncertainties in global markets amid geopolitical tensions
- Trading in gold has been largely in paper gold market where physical gold stocks are low and are not expected to be delivered
- Paper gold trade is many times larger than physical gold and this gap could create a crisis

On February 18, 2025, Elon Musk's provocative comment on X (formerly known as Twitter) about the possibility of gold being "stolen" from Fort Knox has sent shockwaves around the globe. Musk's remark was in response to Senator Mike Lee's announcement that Fort Knox had denied his request to inspect their gold reserves without giving a specific reason, simply stating, "You can't come... Because, you can't!"

In the wake of Musk's comment, gold prices have skyrocketed, almost doubling from \$52 per 10 grams in October 2022 to a staggering \$94 currently, with the surge becoming even more pronounced since the start of this year. A similar phenomenon occurred during the Great Recession of 2008 when gold prices more than doubled from \$23 in October 2008 to \$57 by September 2012. However, the subsequent three years saw gold prices plummet to just \$33 by November 2015. This raises the question: Are we on the brink of a similar decline, or is this time fundamentally different?

The dramatic rise in gold prices is commonly attributed to several factors such as global economic uncertainty, particularly involving the US, arising from geopolitical or economic tensions. Additionally, central banks' purchase of gold due to doubts over the US dollar's stability as a reliable reserve currency, as well as inflation and inflation expectations, play a significant role. The Ukraine War, which began in February 2022, and the subsequent freezing of Russia's dollar assets triggered an initial spike in gold prices. However, prices saw a steep 20% drop between March and October 2022.

Many experts and commentators in the gold market attribute the sudden fall in gold prices in 2022 to manipulation, a historically recurring theme, especially in the paper gold market. Although gold holds no intrinsic function in the modern fiat monetary system, it continues to be viewed as a potential global alternative to fiat currencies, particularly during periods of extreme economic and geopolitical uncertainty. This perception is reinforced by the fact that many central banks persist in holding and accumulating gold reserves, even though their currencies are no longer backed by gold (or silver).

To mitigate the relentless surge in gold prices, often driven by a self-fulfilling prophecy, interventions are frequently undertaken. These increasing gold prices can lead to a preference for holding gold over financial assets, including government and private-sector securities, and can spell massive losses for significant participants in the paper gold market. Interventions aim to dampen gold prices by increasing the supply of paper gold through methods such as hypothecation and short-selling. This can be executed by financial institutions (e.g., J.P. Morgan Chase, Deutsche Bank), bullion banks (e.g., Mocatta & Goldsmid, Barclays, Goldman Sachs), as well as central banks (e.g., the Federal Reserve, the Bank of England, the Bank of Japan).

In the paper gold market—encompassing ETFs, futures and option contracts, gold certificates, and more—actual delivery of gold is rarely executed by most participants. This market has expanded so significantly that some commentators estimate a ratio of anywhere between 100x to 500x paper gold to physical gold. How does this phenomenon occur? Imagine starting with one gold coin that you lend to someone, who then lends it to another, and so forth. If ten people lend the same coin, each of them is "owed" the gold coin, though the actual physical gold coin is held by only one person. Should that person lose the coin, a problem arises when each lender demands the physical gold coin. This issue can be avoided if lenders accept a promissory note or a financial liability like currency notes or cheques. However, if all lenders insist on physical gold, the result is nothing short of a crisis.

This process in the paper gold market is known as hypothecation. A borrower pledges gold as collateral to secure a loan from a lender while retaining ownership of the gold. The lender, in turn, has the right to seize the gold if the borrower defaults. The lender may then re-hypothecate the same gold as collateral to secure its own loans or financial obligations. Consequently, the same gold is pledged multiple times to different parties. If the original borrower defaults, the lender will seize the gold. However, if the lender also defaults, multiple parties will have legal claims on the same asset, creating a complex web of claims and potential crises.

The paper gold market enables traders and speculators to capitalize on price movements in the underlying asset, gold, without actually taking delivery of the physical metal. To prevent a potential crisis stemming from claims to take delivery of physical gold, participants in the paper gold market are generally dissuaded from doing so at the expiry of futures or option contracts. This disincentive comes in the form of fees, insurance, transport, and warehousing costs, as well as minimum quantum and lot sizes.

During typical market conditions, most lenders may not demand physical gold. However, if there's even a suspicion that the last borrower has lost the gold or defaults, lenders may be tempted to request delivery. This scenario appeared to be unfolding in early February, when [reports](#) indicated a "humongous number of contracts are opting for physical delivery" on the US Commodity Exchange (COMEX). By February 5, 2025, eligible delivery requests amounted to 28% of the registered gold stocks available for delivery, prompting large shipments of nearly 400 tons of gold from London to New York between Trump's victory and early February. The spot delivery of physical gold on the Shanghai Gold Exchange (SGE) has also significantly increased demand, creating arbitrage opportunities for traders who claim physical gold in COMEX on futures contracts and sell it in Shanghai at a premium.

One international [broker](#) noted that "96% of the [paper] gold traded daily on the London and New York markets has no physical reality... [it] can never be delivered. Once the 4% of real physical gold has been

delivered, what will happen?" With Elon Musk raising doubts about the gold stock available in Fort Knox, a run on gold could trigger an avalanche of claims, driving gold prices sky-high.

This raises the crucial question: what effects will the gold market crisis have on the financial and monetary system?

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