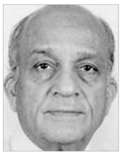
Gold glitters again



Gold bars. FILEPHOTO

By T K JAYARAMAN

Once again it is the season of gold fever.

It is worldwide, not simply confined to India, where the craze for gold jewellery is legendary. It has now spread across the continents.

As Elizabeth Browning wrote, "The plague of gold strikes far and near".

Gold price, which has been making a relentless march on each of the five trading days last week, reached the highest at US$1313 per ounce on Wednesday this week.

It is a five-time increase in the last 10 years, from a low of US$258 in 2000. However, it is still a long way from the record of US$2300 set in 1980.

Uncertain economic Conditions

Mixed economic reports have been stirring up another storm of uncertainties.

The world now looks for a "safe haven" to put their savings in.

Savers seem to have less confidence in the United States dollar, although it is being propped up by China, which is the largest creditor to the largest debtor.

How long will the life-support from China last?

Aside from China, other countries are also seeking alternatives as well.

Malaysia took the first step and began to invest in Chinese securities.

Although Malaysia justified it on the ground that it is diversifying its holdings, it is clear that one day, the Chinese Yuan would have to emerge as a safe bet, ranking along with the euro and the yen, as possible reserve currencies, dethroning the US dollar as the sole reserve currency.

It will take a real long time, as it is to dismantle capital controls and allow full convertibility.

Will the gold standard return?

Fascination for gold has been there since times immemorial.

Gold was actually used as currency. The Roman Empire and the Mughal rulers issued gold coins.

As the supply of gold could not match the demand for money, currency took to other forms; from leather to paper.

Yet the currency on demand had to be converted into gold.

The British pound was fully backed by gold and the currencies of the rest of the world were linked to the pound.

The $50 bill of the United States was 60 years ago worth 2.5 ounces of gold. The $50 bill today with the same picture of President Ulysses Grant is not worth any ounce of gold.

President Grant would be very unhappy if he were to know that the bill with his picture is not gold-worthy!

In 1971, the price of one ounce of gold was US$35. The US put an end to convertibility of the currency into gold, when it went off the gold standard in August 1971. All others followed.

Their currencies were no longer linked to gold but only to the US dollar or British pound or a basket of currencies.

Why did the nations give up gold standard?

Every nation under the gold standard had to settle each year its outstanding trade payment obligations to the other nation in gold.

If a country were to run net trade deficit, (value of imports being more than exports), gold had to be shipped out. Consequently, money supply would be automatically reduced, as the country had less gold to support its currency convertibility.

A reduction in money supply would then usher in a period of painful contraction. During contraction, the country had to experience falling prices and declining production and unemployment.

On the other hand, countries with net trade surplus, which would be receiving gold, had to adopt an expansionary path. They had to face inflation.

As prices had fallen in the contracting country relative to the other country with net gold gains, trade directions would be reversed.

Self-correction mechanism would thus set in. Countries under the gold standard thus had to push aside their own priorities and had to sacrifice price stabilty and growth, all at the altar of the goddess gold.

Soon after the end of World War II, countries with trade deficts and thus facing contraction with consequent prospects of deflation and unemployment, defied.

They did not want to go through the process of contraction and mounting unemployment.

They printed money and in the process devalued their currencies. Similarly export surplus country with more gold shipped into it, did not want to expand and bring in process of inflation as well.

They avoided an inflationary path.

So both decided to say bye-bye to the system

As the celebrated British author, Geoffrey Crowther noted, "Gold standard is a jealous goddess: she needs exclusive devotion."

If you cannot play according to the rules of the game, quit!

The US went off the gold standard in 1971 and had to value the pound from time to time.

From US$ 35 per ounce in 1971, the gold price was raised to US$38 in August 1973.

Each time gold was upvalued, the US dollar came to be devalued. Ultimately, in 1973, the dollar was de-linked from gold. It decided to float the currency. Most of the currencies of the industrialised countries followed suit. Today no currencies are convertible into gold.

Continuing glamour of gold

Although currencies are not convertible into gold and the de-link is well established, gold is still an attractive investment.

Central banks keep gold as assets against which they create currency as liabilities.

Whenever parts of the world are under stress with civil disorder, savers look to the US dollar as a safe haven.

When the US was itself involved in wars and conditions were not rosy, savers all over the world looked to gold.

For example in 1980, high inflation due to shooting oil prices, Soviet intervention in Afghanistan and the impact of the Iranian revolution, all drove investors to seek gold.

Why this time?

This time gold price rise was triggered by gloomy news about the US economy. A key US index of consumer confidence fell to 48.5 in September, a 7-month low from the figure of 53.2 in August.

That raised fears about the weak consumption, which would act as a drag on US economic recovery.

The US Federal Reserve Bank chairman announced that the Fed would continue its expansionary stance and keep the interbank-lending rate, known as the Fed Funds Rate, low: which is already at 0 to 0.25 per cent.

The Fed also announced it would purchase US Treasury Bonds and put more money into the economy and pump up liquidity, a procedure now known as quantitative easing.

Further, Bank of Japan's foreign exchange market intervention and efforts to inject more liquidity made inventors nervous about the falling value of the yen.

They now look to gold as a way to preserve capital in times of economic uncertainty.

Unlike stocks or other financial assets, gold is less likely to lose all of its value.

As a result, prices often rise when signs indicate that economic conditions are deteriorating.

Gold is considered a hedge against financial dislocation. Last two weeks witnessed no sale of gold.

Everybody wants to add to his stocks. Further, it is not hot money that flows into the gold market for short term gains. Long term investors are buying gold. As the 17th century British writer, Owen Feltham wrote: "Gold is the fool's curtain, which hides all his defects from the world."

Dr T K Jayaraman (jayaraman_tk@usp.ac.fj) teaches economics at USP. Views expressed are his own and do not reflect those of the USP or Fiji Sun.