Moneyweb

The burning question

All that glistens

The story the gold price tells us.

Felicity Duncan | 15 September 2009 07:44

Last week, the gold price breached the $1 000 per ounce level, a height it last reached at the peak of the global financial crisis in 2008, before falling back down to the upper $900s range.

Generally, when the gold price rises and tips past crucial levels, it tells us several things. First, it tells us that people are worried about inflation. Gold is generally seen as a safe haven asset, which means that when people are worried that governments are printing too much paper money, they tend to buy gold as a way to “store value”.

Inflation, in the words of legendary free market economist Milton Friedman, is “always and everywhere a monetary phenomenon”. What he meant was that inflation is the result not of rising prices, but of governments printing too much cash. There is logic to this. Let’s imagine that on day one a slice of pizza costs you R1, but on day ten, it costs you R1.50. That means that the value of your R1 has decreased, and you need 50% more rands for a set amount of pizza.

Why would that happen? Some may suggest that possibly a pizza shortage was to blame; this is the argument you hear when people talk about the inflationary effects of rising oil prices – they are saying that as oil becomes scarcer, prices automatically rise, money is diverted from other uses and the net result is a boost to inflation.

However, for Friedman and his acolytes (known variously as the Chicago School, or “freshwater” economists) the correct explanation is that there were more rands circulating and available to convert into pizza, so you need more to claim a fixed amount of pizza.

Thus, the printing of paper currencies, which has no real upper limit, tends to push up the price of gold, which is finite – it’s the old story of more money chasing a limited amount of goods. Thus, one of the things that a rising gold price suggests is that inflation is a worry.

And today, this is a pretty sensible worry given the events of the last 18 months, during which governments around the world have aggressive spending programmes in a bid to rescue the world economy. Many of these spending plans have essentially been funded by printing new cash, which means that there is a heck of lot more paper money in circulation today, hence the spectre of inflation.

A second thing that a rising gold price tells us is that people are afraid of high-risk investments like equities.

Hilton Davies the founding director of SA Bullion, explained this to ***Moneyweb Radio*** as follows: "I think the story really is that gold is a currency. In bad times gold is a currency; in good times gold is a commodity. And we're into the bad times. I think it's a generational story, and I think in these bad times we will probably see cash delivering pretty poor returns. And the expectation by gold investors is that the gold return will outperform the cash return."

In other words, people are hesitant to put their savings into things like money markets, because of the inflation problem we've touched on and the possibility of associated meagre returns, and so they are looking to gold not just as a safe haven, but also as something that will enable them to grow their wealth despite problems with "fiat" currencies, which are paper currencies that are not backed up by gold reserves.

On this front, one of the most interesting developments in gold markets over the last decade has been the worldwide emergence of gold exchange traded funds which are backed by purchases of physical gold – ETFs are investment instruments like unit trusts, but they can be backed by indices or commodities. Thus, gold ETFs are a way for investors to buy a share in a pile of physical gold without having to take possession of the metal, and, given ETF's liquidity, without having to worry about being unable to sell their holdings.

These funds have proven extremely popular in countries worldwide. In fact, in China, the government has actively been encouraging its people to purchase gold ETFs, probably in a bid to reduce China's vulnerability to devaluation in the US dollar. China is the world's biggest holder of US debt, so if the dollar depreciates in value, China will lose a lot of money on its debt investment holdings.

Gold markets and the gold price are therefore interesting to watch not simply because they give you an idea of the value of your jewellery collection, but also because they tell you a lot about the fears and hopes of people around the world. And whatever your ideological position, high gold prices are a definite sign of rocky and uncertain times.

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