Gold and the Dollar

In recent days the Canadian and Swedish central banks have joined the majority of other G10 central banks by indicating that they too may engage in quantitative easing now that the interest rates have been reduced to 25 and 50 basis points respectively. The ECB is wrestling with ways to extend its own form of quantitative easing and an announcement is likely at its next meeting on May 7th.

While some observers have focused on the potential debasement of the US dollar by the aggressive monetary and fiscal policies of both the Bush and Obama Administrations, many investors are worried about the viability of the whole universe of paper money.

As Gillian Tett, award-winning journalist at the Financial Times, put it in a column earlier this month, there has been a four-decade long experiment with fiat currencies not backed by gold or silver. This crisis is so profound that increasingly it appears to have shaken confidence in the experiment. At the same time, the crisis looks to have widened the range of possibilities.

The Special Drawing Rights that the Chinese and others have suggested to eventually replace the dollar does not get beyond paper money. The SDR is a basket of fiat currencies. It is not and cannot be a serious alternative to the US dollar.

Consider that 44% of an SDR is the dollar. The IMF's figures show that roughly two-thirds of the world's reserves are in dollars. If countries reserves were allocated according to the SDR, the dollar's share of reserves would fall by about a third. While the euro would pick up some slack the big winners would be the yen and sterling, whose share of the SDR is 11% a piece, two to three times larger than their reserve allocation.

If there has been a shift in reserve allocation over recent years, it is not away from the dollar, as so many wrongly claim, but rather away from the yen and toward sterling. And even this shift has been marginal at best. Reserve managers generally want in order of importance, security, liquidity, and yield. Japanese bonds are often seen as deficient in both liquidity and yield.

All that Glitters

Can gold return to its role as the anchor for currencies? The advocates of gold are a passionate and vocal minority which appear to be second only to Any Rand devotees in terms of intensity. Of course there is a large overlap as Alan Greenspan's 1966 essay "Gold and Economic Freedom" illustrates.

Top Gold Holders	
US	8,133.5
Germany	3,412.6
IMF	3,217.3
France	2,508.8
Italy	2,451.8
China	1,054.0
Switzerland	1,040.0
Japan	765.2
Netherlands	621.4
ECB	533.0

Data from World Gold Council and China
Figures in Metric Tonnes

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To appreciate though why gold is ill-suited today to once again back paper money, we need to consider why the gold standard ended in the first place. Simply put, the gold standard provided an economic barrier to the political agenda. That political agenda called for rapid growth to resist the spread of communism. It called for “guns and butter” in the US with the Great Society and the war in Vietnam. The European political agenda included the expansion of the welfare state—from cradle to grave

Jettisoning gold not only allowed for the pursuit of the political agenda, it helped create the conditions for the rapid and dramatic expansion of trade, capital flows and globalization. What is all too often lost amid the despair and cynicism that the crisis has wrought is the amazing success of that regime. Since 1980, for example, the world economy has grown by 145%. Taking into account the increase in the world’s population, roughly 1.6% per annum, there has been a nearly 40% increase in per capita income.

How such wealth is distributed is an important issue beyond the scope of this discussion. Yet it is interesting to note that longevity, a measure that subsumes numerous other metrics, has risen sharply in both developing and developed countries and that gap between the two has narrowed.

Not Enough

The same problem exists with a new gold standard that existed with the old. There is simply an insufficient amount of gold. Or to say the same thing, the price of gold necessary to put the international monetary regime back on a gold standard is so astronomical as to make it unworkable.

There are different ways to go conceptualizing the magnitude of the challenge. As the table above indicates, the US has more gold that Germany, France, and Switzerland combined. Given that foreign investors own about $2.5 trillion more of US assets than Americans own of foreign assets, what price of gold is necessary for the US to no longer be a debtor? Answer: More than $8,500 an ounce.

Another approach, suggested by a Swiss investment bank, is to relate the price of gold needed to cover some measure of money supply. By its reckoning, the US would need gold to be worth about $6,000 an ounce to reintroduce a gold standard. However, it may not be sufficient to simply have the US adopt a gold standard. For the US, China, and Japan, the three largest economies as measured by purchasing power parity, to back their money with gold would require a price closer to $9,000 an ounce.

The current price of gold is just above $900 an ounce. Peaking in March 2008 near $1,032, it has averaged $638 over the past five years and $473 over the past ten years. For the yellow metal to reach the kind of levels necessary to make a gold standard mathematically feasible in the present day, the protracted period of deflation necessary would not be politically acceptable.

Where Does that Leave Us?

There is no realistic alternative to the dollar. Not SDRs. Not gold. Not the euro. Not the yuan. That might not be deducible from macro-economic first principles. But it is proven by what central banks are actually doing.

This does not mean that there is no role for gold in individual portfolios, though often people seem to confuse a paper claim on gold for the actual bullion. Also, the touts for bullion often do not include the costs of storage and insurance for gold which has gone decades without appreciating and, of course, generates no income stream.

Central banks that have accumulated large holdings of foreign currencies, like those in Asian and Middle Eastern countries, tend to have relatively little gold. European central banks, which could not get enough gold during the late 1960s and early 1970s, have turned into sellers over recent years. Paradoxically, as they sold off their gold in an orderly way, the price of gold trended higher. Yet many seem to believe that it is a given that the dollar will fall if these same or other central banks sell dollars. Huh?

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On April 24th China revealed it has dramatically increased its gold holdings since 2003. In 2001, China said it had roughly 500 tonnes of gold. By 2003, it had risen to a little over 600 tonnes. Now it says it has 1,054 tonnes of gold, more than a 75% increase. Still this means that gold accounts for only about 1.6% of China's reserves.

China is the world's largest producer of gold, but it also refines scrap gold. As part of the standard arguments, gold advocates assert that all the gold that has ever been mined is still here. That is true up to a point and it is that point that it gets interesting. China is exploiting the fact that a ton of computers and cell phones contain several times more gold than a ton of gold ore has.

Central banks in Asia and the Middle East may buy more gold going forward and European sales seem set to slow (though the IMF sales will reportedly go ahead), but it will be barely noticeably in terms of the international monetary regime and the role of the dollar.

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