

[Marginal Revolution](#)

The Golden Dilemma

by [Tyler Cowen](#) on April 16, 2013 at 1:29 am in [Economics](#), [History](#) | [Permalink](#)

I've been meaning to link to [this NBER paper](#) by [Claude B. Erb](#) and [Campbell R. Harvey](#):

While gold objects have existed for thousands of years, gold's role in diversified portfolios is not well understood. We critically examine popular stories such as 'gold is an inflation hedge'. We show that gold may be an effective hedge if the investment horizon is measured in centuries. Over practical investment horizons, gold is an unreliable inflation hedge. We also explore valuation. The real price of gold is currently high compared to history. In the past, when the real price of gold was above average, subsequent real gold returns have been below average consistent with mean reversion. On the demand side, we focus on the official gold holdings of many countries. If prominent emerging markets increase their gold holdings to average per capita or per GDP holdings of developed countries, the real price of gold may rise even further from today's elevated levels. In the end, investors face a golden dilemma: 1) embrace a view that 'those who cannot remember the past are condemned to repeat it' and the purchasing power of gold is likely to revert to its mean or 2) embrace a view that the emergence of new markets represent a structural change and 'this time is different'.

There is a non-gated version of the paper [here](#).

 [19 comments](#)



Reddit



8 April 16, 2013 at 2:57 am

Gold performs best in extreme periods when there is great mistrust of the currency or financial system. If the banks or the currency are wiped out, gold infinitely outperforms those nearly 100% losses by serving as the monetary Schelling Point. The caveat is the nation needs to be large enough that it's gold buying can affect global prices, otherwise foreign currencies will serve as alternatives.

I find most of these analyses to be "eurocentric" or whatever the popular term is these days. It ultimately doesn't matter what Americans or Westerners think (unless they suddenly go crazy for gold); what matters is what Chinese and Indians think because they already are 50% of the gold market.

[Reply](#)

meicate April 16, 2013 at 4:08 am

Right.

And we can see exactly what the Chinese and Indians think of gold by the fact that gold has been going eastward for the last 10-20 years.

[Reply](#)

Doug April 16, 2013 at 4:36 am

“The real price of gold is currently high compared to history. ”

This is because there was a re-monetization from silver to gold during 1600-1850. Prior to that across Eurasia the primary monetary asset was silver, and gold was secondary. After the discovery of the New World, silver increased in abundance much more so than gold. So the price of silver fell relative to the price of gold. This prompted countries to re-monetize to the harder gold standard starting in Western Europe (who felt the silver inflation first) and eventually reaching East Asia (which suffered huge losses on the declining value of their silver reserves).

The reason gold is priced above its historical levels is primarily because gold's price relative to silver is above its historical levels. The historical mean reversion story only works if you believe the gold to silver ratio will mean revert to its pre-New World levels. Since the economics have not fundamentally changed, in fact they've moved even more so in gold's favor relative to silver, there's no reason to believe this. Current global gold reserves represent more than 100 years of current production. Silver reserves are less than 25 years of current production.

Gold as a monetary asset has a much stronger claim than silver. Supply of monetary assets must be highly inelastic to price. Gold's substantially higher reserves make it much more so than silver. I see little to no compelling reason why silver should re-claim the throne for the primary monetary metal.

[Reply](#)

Roy April 16, 2013 at 8:56 am

At current silver prices, silver is pretty much mined today as a byproduct, and thus silver reserves are grossly underestimated. I know a lot of places off of the top of my head where you could open a silver mine easily but the economics of it just aren't worth it. If there were gold deposits at small fractions of the silver yield these would all be going concerns. Of course gold is easier and cheaper to separate as well.

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Andrew' April 16, 2013 at 5:41 am

Don't buy gold now for the same reason I'm not buying bullets now. If you really need them, you may not need many.

[Reply](#)

Jonathan April 16, 2013 at 9:03 am

The only things I can think of that would hold their value for centuries are gold and Twinkies.

[Reply](#)

Andrew' April 16, 2013 at 11:52 am

And you can't eat gold.

[Reply](#)

MC April 16, 2013 at 1:57 pm

Yeah, but storing \$1,350 worth of Twinkies takes up a lot more space than one Krugerrand.

[Reply](#)

eddie April 16, 2013 at 4:50 pm

They're not making any more Twinkies.

[Reply](#)

MC April 16, 2013 at 5:21 pm

Au contraire:

<http://www.nbcnews.com/business/new-owners-hope-have-twinkies-stores-soon-1C8824840>

Vangel April 16, 2013 at 9:16 am

“The real price of gold is currently high compared to history.”

Really? Why don't we compare it to the real purchasing power of an unbacked fiat currency and see how they stand? I would argue that we can worry about the real price of gold when the Dow/Gold ratio gets to 2 or less. Until then it seems to me that over the long term gold will keep going up in value.

Let us not get distracted by action of leveraged fiat gold in the futures markets. Given the way such markets work you could have very rapid moves in both directions for long periods of time. But the primary move will come from actions in the physical markets. When central banks embrace the concept of a new era and dump their holdings we should see a decline (in some of the more 'sound' currencies) as we did from 1981 to 2000. But when they reverse and start to purchase gold we should see significant gains. In the end the central banks will fail as they have always done and at that time the markets will choose as money assets that cannot be created out of thin air.

[Reply](#)

j r April 16, 2013 at 10:07 am

The term “unbacked fiat currency” is a contradiction in terms.

[Reply](#)

meicate April 16, 2013 at 10:28 am

Depends on whether you mean 'backed' by force or 'backed' by a store of value.

CC

[Reply](#)

Yancey Ward April 16, 2013 at 10:49 am

Not contradictory, but redundant.

[Reply](#)

T. Shaw April 16, 2013 at 2:02 pm

Up until recently, Americans were woefully ignorant of economics.

Federal Reserve Notes you can exchange for goods and services are not dollars. They are not money. They are unsecured, bearer notes (short term debts/liabilities incurred by the FRB that are backed by nothing besides supplies of ink and paper) that state (left of Jackson), "This note (i.e., loan payable) is legal tender for all debts, public and private."

I recently obtained a Series of 1934 D US 20 dollar bill in an ATM cash withdrawal. Printed to the left of Jackson is "This note is legal tender for all debts, public and private, and is redeemable in lawful money at the United States Treasury or at any Federal Reserve Bank." Also, printed in bold letters under Jackson's visage is "WILL PAY TO THE BEARER ON DEMAND TWENTY DOLLARS."

All that green stuffing your pockets is is confetti. The so-called dollar lost 97% of its purchasing power since the spawning of the Federal Reserve 100 years ago. An ounce of gold buys pretty close to what it did in 1913.

You cannot eat that confetti or that smart phone.

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RR April 16, 2013 at 12:05 pm

"In the end, investors face a golden dilemma..."

How is that Investors never choose the Golden Mean?

[Reply](#)

[Floccina](#) April 16, 2013 at 5:14 pm

So when can will humans be able to control nuclear reactions enough to make gold economically? Or when will energy be cheap enough that we can start extracting it from sea water?

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www April 17, 2013 at 2:54 am

Third option: developed world countries reduce the levels of their gold holdings to those of the developing world. What's the justification for central banks to hold their reserves in negative-yield assets?

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