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Mystique of gold is evergreen

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Gold is poured into an ingot at the Perth Mint, w hich refines and sells gold coins and bars to investors. Picture: Colin Murty Source: The Australian

WHEN the Spanish began shipping gold back to Europe from the Americas in the 15th century, the shimmering metal's role in the world's financial system grew inexorably. By the late 19th century, all the world's main currencies were valued in terms of gold. Almost all of the 175,000 tonnes of gold above the ground - which would make a 20m-high cube - was mined after 1875.

"For several millennia we humans have prized gold for its beauty, durability, malleability and record as a good way to store wealth," Richard Sylla, professor of monetary history at New York University, tells Inquirer.

But interest in gold waned after World War II. President Richard Nixon severed the link between the US dollar and gold in 1971, freeing governments from the need to limit the growth of their paper currencies. By the 1990s even central banks were selling; the new monetary system of paper currencies appeared to be working out so well that holding large quantities of gold in vaults appeared to be as sensible as hoarding copper or iron ore. The Bank of England and the Reserve Bank of Australia were not alone in selling a big chunk of their reserves when gold prices were about $450 an ounce.

But gold - what John Maynard Keynes derided as a "barbarous relic" - seems to be making a comeback. Its price has soared since concerns about the world's financial system arose in the years before the global financial crisis. Since 2005, the price of gold has quadrupled in US dollars. Even in more resilient Australian dollars, after oscillating in a narrow range around $500 an ounce for 25 years, the price has almost tripled over the same period to more than $1600 an ounce.

Of course, price is a relative concept; the value of gold in terms of goods and services has been remarkably stable over very long periods of time. A new study by American academics Claude Erb and Campbell Harvey compares the pay of a US army private and a Roman legionary (a similar rank). "There has been little or no income growth in military pay over 2000 years in terms of gold," they say. An ounce of gold bought 350 loaves of bread during the reign of Babylonian king Nebuchadnezzar; at the present market gold price it buys about the same number.

This is gold's appeal. For Maurice Newman, former chairman of the Australian Securities Exchange, gold is "the ultimate insurance".

"As questions are rightly raised about the way the world's fiat currencies are being run, gold, whose quantity cannot be artificially manipulated by governments, is a good place to be," he says.

It could still be a bubble waiting to pop. "When real gold prices get really high, as they are now, they often 'mean-revert', meaning there is a chance the gold price could fall," says Sylla.

"Gold is a poor inflation hedge in anything but the long run," he adds, referring to the great volatility of the gold price, especially in recent decades.

Erb and Harvey suggest the rate of return of gold since 1791 might indeed be zero - a perfect inflation hedge - but caution "the long run may be longer than an investor's investment horizon or life span".

Nevertheless, entrenched uncertainty about the longevity of the world's present financial system is prompting individuals and central banks to re-weight their investments towards gold, which pushes prices even higher.

The German government last month asked France and the US, whose central banks store gold for a fee, to return some of its gold. Germany, with 3400 tonnes of gold to its name, is the world's second biggest holder after the US, with 8100. France and Italy tie for third with about 2500 tonnes each.

Together, central banks hold about 32,000 tonnes of gold, while more than half the remaining volume is used for jewellery, with the rest for industrial use or private investment. The RBA and the Bank of England own 80 and 310 tonnes of gold, respectively.

Michael Lewis, Deutsche Bank's global head of commodities research in London, emphasises the German recall was for the purposes of an audit only.

"But it could reflect growing mistrust between central banks in these uncertain times, especially within the euro area," he says.

Lewis foresees a much higher gold price in the next few years. "They said $1000 was a bubble; now the price is much higher and we think a price between $US1900 and $US2900 is not unrealistic in coming years," he says.

"The safe haven argument is losing traction after the last round of quantitative easing in the US, but people are aware of the growing underlying demand from emerging-market central banks and the general diversification into gold from private investors," he explains.

"Brazil, India, and China are big drivers of global demand," says Jock O'Callaghan, a mining leader at PricewaterhouseCoopers. China has entrenched its position as the world's No 1 gold producer, increasing its output by 12 per cent to more than 400 tonnes last year.

Nevertheless, central banks from emerging-market countries hold only a tiny fraction of their foreign exchange reserves in gold, compared with the old rich group of countries. China's ratio is only 1.7 per cent, compared with more than 76 per cent for the US.

"If BRIC countries (Brazil, Russia, India and China), which hold around 2500 tonnes of gold, targeted the United States' ratio of gold holdings relative to GDP, they would need 6230 tonnes," Erb and Harvey conclude.

The Perth Mint buys Australia's annual gold output and most of New Zealand's too. It refines and sells gold coins and bars to investors. The mint's annual sales of gold bars and coins to domestic buyers have more than tripled to about 80,000 ounces since the GFC; at the same time, demand from international buyers has more than quadrupled to 586,000 ounces.

Nigel Moffatt, the mint's treasurer, says "the one-ounce gold coin is our biggest seller, but gold bars are increasingly popular with wealthy Chinese", pointing out foreigners make up more than half of the mint's 24,000 private depository accounts. China's annual production, bought largely by the Chinese government, isn't enough to satisfy internal demand. "Overseas investors like to buy and store their gold in Perth because it is so isolated," Moffatt adds.

Private investors, who typically own little or no gold, are conceivably very underweight in gold too. The world's total gold stock is worth about $9 trillion, a substantial 10 per cent or so of the value of global bond and share markets.

They are beginning to catch up. The biggest tradeable gold fund, run by State Street Global Investors in London, has grown from zero holdings to more than 1300 tonnes since it began in 2004.

For most goods and services, higher prices curb demand, but not gold. Over the past decade every 10 per cent increase in its price has spurred an extra 10 per cent increase in demand for gold as investment. Meanwhile, demand for gold jewellery, as one would expect, has fallen.

Don Taig, the chairman of Focus Minerals, a mid-tier Sino-Australian goldminer in Western Australia, says shareholders are increasingly asking for their dividends to be paid in gold. "Other miners, especially in China, have done it and our lawyers have been looking into it too," he says.

The sky-high gold price has failed to prompt a surge of supply. Annual gold production has consistently hovered around 2500 tonnes a year over the past decade.

Taig says "in the Australian context it would take a minimum of three years between finding gold and actually getting a mine started", pointing out the huge regulatory barriers to opening new mines and hinting that miners are not yet sufficiently confident in the high price to plunge into costly new ventures.

PwC's O'Callaghan says the risks of opening new mines are substantial, given the very fine quantities of gold in the ground.

"We are talking grams per tonne of rock," he says. "With iron ore you have key countries and key companies that can influence the price, but it's not the same with gold." If oil production ceased the world would run out within months; annual gold production is only about 1 per cent of the amount of gold above ground.

The 2011 US Geological Survey estimates about 50,000 tonnes of gold are still underground, suggesting the supply of new gold will dry up in about 20 years at current mining rates.

Gold has always been a threat to fiat currencies. President Franklin Delano Roosevelt even banned US citizens from having any of their own in 1933, a rule not rescinded until 1974.

"The mystique of gold has passed down to us from countless generations of our ancestors," says Sylla.

"We can't escape history.

"The history of fiat monetary systems is not reassuring because most of them were abused and collapsed; but in principle they are much less costly and more rational," he says, pointing out the cost of digging up gold only to intern it in vaults is wasteful.

For the time being it seems unlikely gold will regain its place at the centre of the financial system, even if it seems assured of a role in the official and private portfolios of anxious investors.