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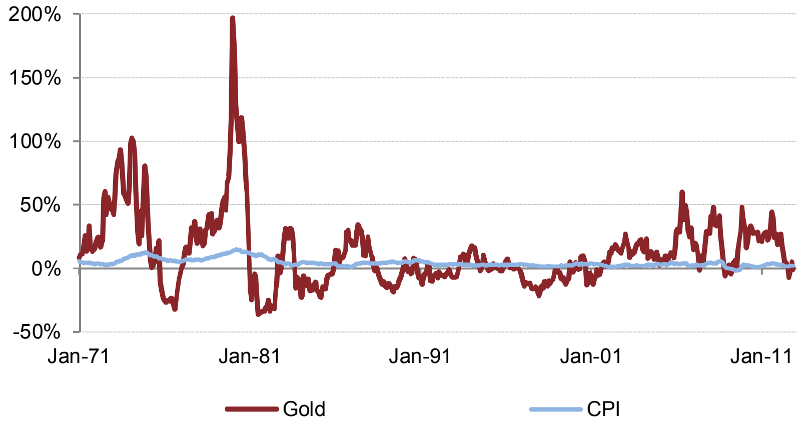
Gold in inflation and deflation

A brief explanation

Following the comment on a multi-reserve currency system published last week, I received a number of questions about the statement that gold mainly is a hedge against deflation, not against inflation. Rather than reply to each query individually, I thought I should address it in general.

This issue is addressed in Roy Jastram's book The Golden Constant.[1] Jastram shows that in times of inflation, the purchasing power of gold historically diminished; while in times of deflation, it rose. This was true both in the United Kingdom and in the United States; and both when these countries were on the gold standard and when they were not. But Jastram's book was originally published in 1977 and mainly covers the period up to and including the Bretton Woods system. For the period since then, his work was updated by Jill Leyland from the World Gold Council. While Leyland's work only goes up to 2007, the five years since then are too short a period to change the conclusions in any material way. What matters here is not short-term swings up or down in prices, but rather gold's behaviour in periods of fundamental changes in long-term price trends.

Gold prices and US consumer prices 1971-2012, 12-month change, %



Leyland shows that Jastram's conclusions are not as clear-cut in the post-Bretton Woods era as they were before 1971. The price of gold rose sharply in the inflationary 1970s, for instance, although even then there were individual years when consumer prices rose faster – as there have been since. But, overall, the price of gold has tended to fluctuate around a broadly flat trend. Basically, over a very long time, gold tends to maintain its purchasing power. That would of course imply that gold is a hedge against

[1] Roy Jastram, The Golden Constant – The English and American Experience 1560-2007; with updated material by Jill Leyland. Cheltenham 2009.

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both inflation and deflation. However, there is another reason to assume that gold is better as a hedge against deflation than against inflation. This is that inflation tends to occur as a result of overheating and an economic boom. During the boom, there will be plenty of assets that compete with gold and that have the added advantage of producing a yield – something which of course gold doesn't. By contrast, deflation or disinflation tends to occur in a bust, when concerns about the health of the financial and/or political system are on the rise. At that stage, investors turn to safe havens, such as gold, aiming primarily for return *of* capital, rather than return *on* capital. It is perhaps not a coincidence that the rise in gold prices in the last few years were the strongest when fears were expressed that the international financial system could self-destruct and central banks loudly and frequently expressed concern about threatening deflation.

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