

## All that glisters...

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**The price of gold is near a six-year high. The yellow metal seems to have regained some of its haven status thanks, in part, to weak stockmarkets and an impending war with Iraq. But its prospects are not so bright**

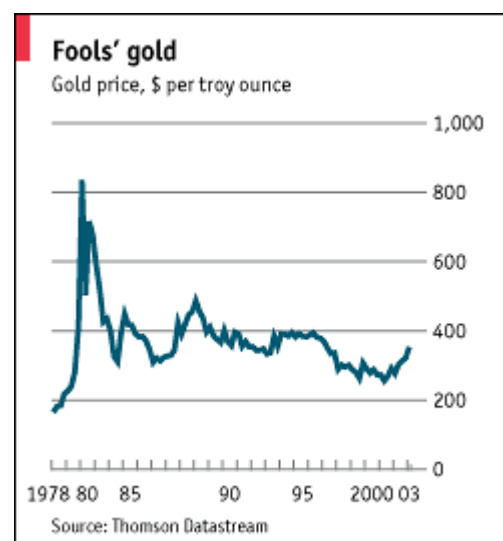
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GOLD “bugs” like to believe that the precious metal is one of the best hedges against inflation and one of the best stores of value during times of uncertainty, like war. The rise of the gold price over the past couple of years seems to bear this out. On January 6th, the price hit \$356.25 per troy ounce, a level not seen since March 1997. A looming war in Iraq, a spike in the price of oil and weakness in the dollar, the currency in which gold is traded, have all boosted demand.

Gold bugs like to stress the broader economic case for the metal, as well as the “safe haven” argument. Some argue that the case for investing in gold is just as strong now, when the world is worrying about deflation, as it is in times of inflation. This is because investors are struggling to find a happy home for their money. Shares have fallen for three years running, and some would argue that they are still relatively highly valued. Corporate bonds have lost some of their shine because of concerns about credit quality after the collapse of companies like Enron and WorldCom. And even government bonds, which typically appear more attractive in times of low inflation or deflation, are being treated with suspicion by many investors. Moreover, in India, East Asia and the Middle East gold remains in demand, not only as a store of value, but also as a form of adornment to be worn in large quantities.

In recent months, the gold market has also been given a temporary lift by producer “dehedging”. Some of the big gold-mining companies used to sell their product in advance, or hedge, so as to lock in the price. This had the effect of adding to supply on the market, and depressing the price. Thanks to the takeover of mining companies that hedge by those that do not, this process has been curtailed. The effect has been the same as if there were increased demand.

Fans of gold also like to point to the supposed limited supply of the metal—the “they’re not making it any



more" argument—to justify their faith. This is especially true for older investors who like to reminisce about the gold standard, when paper notes could be exchanged for the metal at a fixed rate. However, the notion that gold supply is fixed ignores the fact that the means of extracting it from the ground are becoming ever more sophisticated, in much the same way as with oil.

The price of gold has received support from central banks, which continue to hold the metal as a reserve. But gold does not pay interest, and the only revenue available from it (apart from selling it, of course) is the return on lending it to speculators selling it short—ie, selling gold they do not own in the hope of buying it back at a lower price. Therefore, several central banks, including those of the euro area, Britain and even Switzerland, have decided to rebalance their reserves by replacing gold with other assets. This process has a long way to go: central banks still have some 30,000 tonnes of gold in their vaults, and most have pledged to sell their stock in an orderly fashion so as not to disrupt the market.

It is worth remembering that although gold has been doing well in recent years, its price is still below the level reached during much of the 1980s and 1990s (see chart). As an indicator of what might happen to gold, pessimists point to the fate of silver. Central banks used to hoard the white metal, much as they hoard gold now. But they have long since sold their stocks, and the price of silver, at under \$5 an ounce, is back to where it was two centuries ago. Analysts reckon that if central banks ditched all their gold, its value could tumble to \$70 an ounce—a fifth of the current level.