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# The relevance and importance of Gold in the World Monetary System

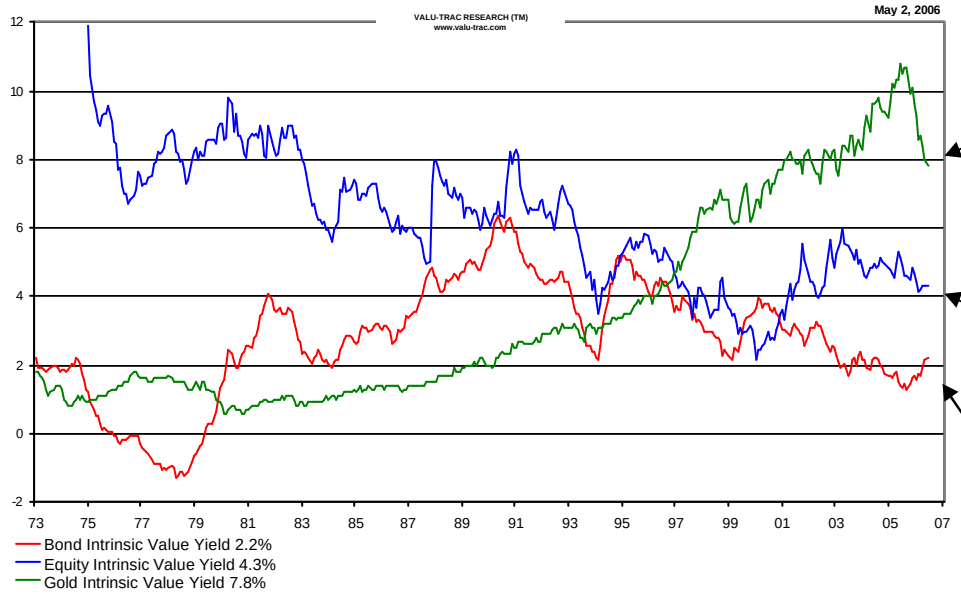
## Introduction

Most investments (equities, bonds, gold and commodities) have an "Intrinsic Value", existence of which justifies an investment. For bond and equity markets, the Intrinsic Value stems from the annual income stream, which can be valued and related to prices. Price changes occur as a result of market arbitrage between competing income streams and their Intrinsic Value yields. Knowledge of Intrinsic Value yields therefore provides a means of successful strategic and tactical asset allocation, while knowledge of the behaviour of Intrinsic Values also provides a means of timing investment decisions.

For investments which produce no income, such as Gold and other commodities, Intrinsic Value can be measured in relation to Central Bank International Monetary Reserves.

Graph 1 below shows the Intrinsic Values of Gold (green line), World Equity markets (blue line) and World Bond markets (red line):

**Graph 1: Gold, Equity and Bond Intrinsic Values**




The histories of these three Intrinsic Values show the attraction to-day of "alternative" investing, for which Gold is here used as a proxy, because of superior and declining intrinsic value.

Gold Intrinsic Value (green line) is now superior to Intrinsic Values of both the World Bond and Equity markets. It is also reducing absolutely and relatively to each in a "bull" market.

World Equity market Intrinsic Value at 4.3pc (blue line) is less competitive but at least it is not as low as it was at the end of the stockmarket "bubble" in 2000. Then it was actually lower than that of the World Bond market (red line), which is now rising in a "bear" market.

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**History of Gold in the International Monetary System**

Gold has been the foundation of monetary systems for centuries. To illustrate the importance of Gold in monetary developments over the last century, one could start with the end of the British Gold Standard in 1914 to permit inflationary financing of World War I, since when the Pound Sterling and US Dollar have lost 98% and 94% respectively of their purchasing power. As with all monetary inflations, it resulted in, and even "justified", a build-up of Debt as the public borrowed in order to spend money before loss of its purchasing power, with a view to repaying borrowings after loss of its purchasing power.

The end of monetary inflation in 1921 brought a return to stability for the UK and US with favourable effects of lower interest rates and rising Bond and Equity market prices. As prices rose, Intrinsic Values fell. In 1929, collapse of overpriced Equity markets with low Intrinsic Values produced asset deflation which, due to the high and unsustainable Debt level, resulted in deflation of consumer demand and subsequently the Depression. The cure for this came in 1935 when the burden of Debt was reduced by devaluing the paper money in which Debt was denominated. This was achieved by raising the paper money price of Gold, which increased the total World Monetary Base to well beyond the paper money level of Debt. To restore stability and to avoid giving a message in favour of possible further inflation of the World Monetary Base, Foreign Exchange Rates were then "fixed" against Gold and the US Dollar was made convertible into Gold at a set price. For this purpose, five leading Central Banks pledged to maintain the price of Gold at $35 per ounce, which they did until 1969 via the so-called London Gold Pool. The desired effect was to circumvent global piecemeal pressures of bankruptcy because of the Debt level by revaluation of the Gold part of the World Central Bank Monetary Base in relation to Debt, at the same time restoring liquidity to the World Monetary Base.

Restoration of a (US) Gold Exchange Standard in 1935 was ratified at Bretton Woods in 1944. Integrity of the US Dollar was guaranteed by the right of non-US Central Banks to convert their US Dollars to Gold if they feared that the purchasing power of the Dollar could be devalued through excess creation of money. However, in 1968 this arrangement was informally, and in 1971 formally, ended. The World Monetary system came off the US Gold Standard to permit inflationary financing of both the Vietnam War and the US welfare state (the "Great Society") which led directly to the Great Inflation of the 1970's and which as usual touched off a resurgence in Debt.

The 1970's Great Inflation of money ended in 1981, resulting in falling interest rates and strengthening Bond and Equity prices. The change in policy was a deliberate attempt by World Central Banks, led by the US Central Bank under Paul Volcker, beginning in 1981 to maintain the integrity of the means of exchange or the quality of Money by keeping the rate of change in Total International Monetary Reserves (IMR's) as close to zero as possible. This has remained official policy, but since 2000 the rate of change has accelerated in a worrying sign, as shown later.

These episodes demonstrate two occurrences during the last century of the typical monetary cycle, which has five phases. The first cycle unfolded as follows:

- Phase One: stability under a Gold standard until 1914
- Phase Two: inflation until 1921 which resulted in a build-up of Debt
- Phase Three: disinflation which brought stability and allowed asset inflation until 1929, but encouraged a further build-up of Debt
- Phase Four: instability after 1929 caused by deflation of assets from over-priced levels and exacerbated by excessive Debt levels, leading to depression of economic activity
- Phase Five: Monetary reform enabled by a revaluation of Gold to overcome deflationary Debt depression

In the second half of the twentieth century we saw a repeat of the first three phases of the same cycle:

- Phase One: stability from 1944 to 1968 under a Gold Standard
- Phase Two: inflation from 1968 to 1981, which caused and justified another build-up of Debt
- Phase Three: disinflation from 1981 until the end of the 20th Century, and maybe to the present

However, it appears that Phase Four (instability and ultimately deflation due to excessive Debt) may have started. If so, Phase Five (revaluation of the Gold price to raise the monetary value of the World Monetary Base and hence reduce the burden of Debt) becomes likely or inevitable. The extent of that revaluation would need to be major

according to our calculations, probably by a factor of at least 7 times, possibly up to 20 times the current price of Gold.

**Monetary relevance of Gold**

The present world monetary system, like its predecessors, is founded on Gold held in treasuries or Central Banks. Gold is money, and money is Gold plus credit and cash. Man can debase credit, even cash, but not Gold. Without a Gold standard, the public cannot prevent governments from pursuing destabilising monetary policies through either fiscal profligacy or attempts to escape Asset and Debt deflation.

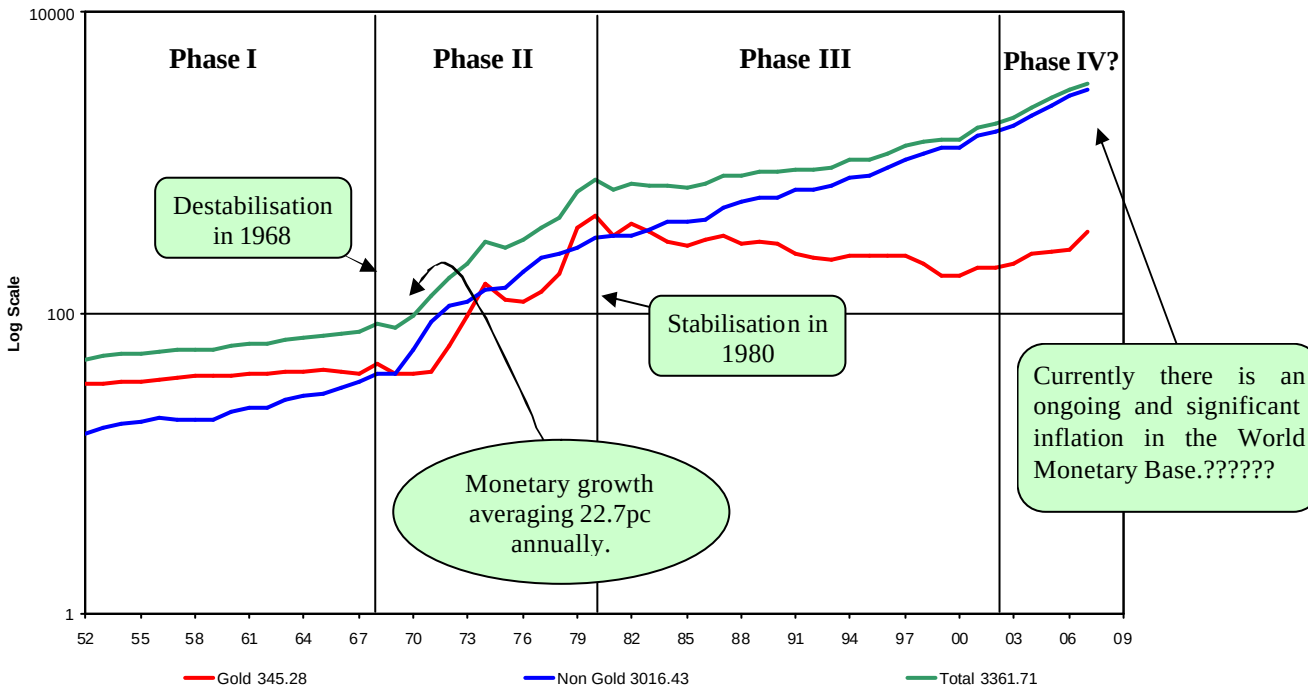
World Central Bank holdings of Gold at market price constitute one part of World International Monetary Reserves (IMRs), the base on which the world's monetary system rests. Also part of IMR Assets of each Central Bank are their holdings of Foreign Exchange and their Special Drawing Rights held in the International Monetary Fund. Total IMR Assets are equal to the net sum of the domestic components of the World Central Bank balance sheet, namely Domestic Currency Liabilities plus other Domestic Liabilities minus Domestic Assets. Measurement of changes in IMR's tells us whether the World's Central Bank Monetary Base as defined is expanding, unchanging or contracting.

At the time of Bretton Woods in 1944, Gold constituted ninety per cent of consolidated World Central Bank International Monetary Reserve assets and the USA owned ninety per cent of Central Bank Gold. Hence the US Dollar became the key currency in the International Monetary System. World Central Bank holdings of Gold remain close to 900 million ounces, similar to the level they were at sixty years ago, though the US now holds only 28 per cent with an increased proportion held by Euroland and certain governments in Asia, especially Japan.

**Analysis of International Monetary Reserves in current monetary cycle**

Graph 2 shows why examination of the phases in the development of the World Monetary system since Bretton Woods in 1944 in terms of IMRs may be a guide to the future.

**Graph 2: International Monetary Reserves (Gold at Market) Billion of SDRs**




In Phase One, total IMRs grew at an average of 2.8 per cent compound per annum (1952 to 1969). This first phase was therefore one of monetary stability via a US Dollar/Gold exchange standard where the World Monetary Base grew more or less in line with the World economy at approximately 3 per cent annually.

Phase Two followed from 1969 to 1980 when World IMRs grew on average at 23 per cent annually. It was impossible for the World economy to grow as quickly, so this was a phase of acute monetary and price inflation. To accommodate such a development, the Bretton Woods Agreement was abandoned in 1971 in favour of the

Smithsonian Agreement in which the US government ended its commitment to maintain the price of its Currency relative to Gold and all Currencies were obliged to float, thus terminating the official commitment to fixed exchange rates. Growth in World Central Bank IMR's during this period again encouraged the spending of tomorrow's money today, reflecting expected future monetary debasement, leading in turn to accelerated growth of Debt. This change in US policy arose from massive inflation of the US monetary base to provide "guns and butter" to fund both the Vietnam War and the "Great Society" welfare programme introduced by President Johnson. It culminated in 1980 with disaster for the US Dollar when it required $800+ to buy an ounce of Gold compared with $35 in 1970, and was accompanied by a leap in real US interest rates. Other countries and commodity prices, particularly oil, were affected in a similar manner.

This destructive phase was replaced by Phase Three in 1981 with a US led Central Bank commitment to "quantitative" stability in terms of the World Central Bank Monetary Base but no "qualitative" guarantee of stability through linkage to Gold at a fixed exchange rate. Since then and until recently, IMR's have grown by an average of only 6 per cent, the period characterised by broad stability but subject to occasional interruptions. Much of this period experienced a phase of general monetary disinflation, although there have been periods of misaligned exchange rates between the US Dollar and the Japanese Yen in particular.

The turn from US monetary "inflation" in 1980 to "disinflation" also meant that US nominal interest rates fell significantly as the "inflation of money premium" previously required by lenders was reduced. This made Debt cheaper so that growth in Debt has continued, even accelerated. Prolonged general absence of monetary inflation since 1980 has meant that the risk of accumulation of Debt has become a threat because monetary policies of the Central Banks no longer justify accumulation of Debt. In spite of this, Debt has grown extensively to levels which make it increasingly problematic. Deflation in Japan became a publicly admitted problem, while the US avoided deflation by massive currency devaluation, starting with the Plaza Accord in 1985 and continuing until 1995.

In the absence of a stabilising Gold Standard there is a danger of a Fourth Phase- monetary instability. This could be either inflationary or deflationary, depending on the nature of social, political and economic pressures at the time. Given the cumulative rise already observed in World Debt in relation to World IMRs, we believe that "instability" is more likely to take the form of monetary inflation as Debt burdens bear down on the World economy and take their toll. An eagerness to avoid the experience of Japan with its wave of bankruptcies in the 1990's makes inflation appear more palatable. However, although monetary inflation in the short term would be helpful to those burdened by Debt, it would raise long-term interest rates and thereby deflate Bond and ultimately Equity market prices. Such asset deflation would in turn exacerbate Debt deflationary pressures.

Following the sell-off in World Equity markets starting in 2000, Central Banks reacted to the threat of Asset deflation, especially in the US and Japan, by implementing an extreme relaxation of Domestic Monetary Policy. However, in Japan, the long-standing zero interest rate policy was insufficient to prevent Asset deflation. As far as the US is concerned, the Fed Funds policy of 1% interest rates following the bursting of the Equity "bubble" in 2000 seems to have prevented Asset deflation and has now been reversed, but has encouraged a continuation of the Debt build-up.

**Consequences of Monetary instability**

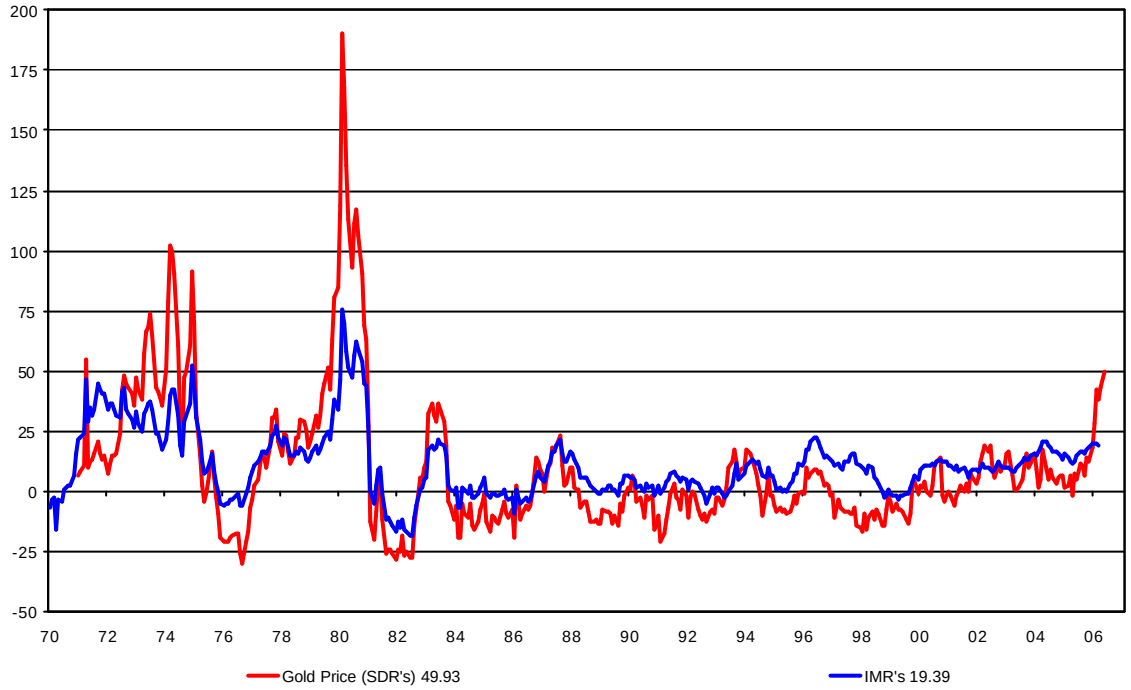
Any attempt to alleviate the Debt burden through Monetary inflation would deflate Bond markets and lead to a resumption of the "bear" market in Equities. World Monetary inflation therefore becomes impractical over time and deflation then remains the more likely form of instability, which will of course be postponed for as long as possible by World Central Bank actions. A deflationary Phase Four would be financially, economically, politically and socially destructive until remediation is organised in the Fifth Phase. A Fifth Phase could bring the World full circle back to devaluation of paper money and Debt by raising the paper money price of Gold and returning to a Gold standard to ensure continued stability of rebased money. This phase is unlikely to occur unless and until Phase Four is well advanced, which is not yet the case.

Were deflation to prevail on a global basis, all paper monetary contracts would destabilise, including Bond and Equity market contracts. This is why the risk we see in the US Equity market, which our valuation measurements show to be returning to "bubble" levels, and its parallel with the Japanese "bubble" ten years earlier are so important.. Outright collapse of the US "bubble" could lead to further Global Equity Asset deflation and attempts to offset this by Central Bank inflation could lead to Bond Asset deflation.

**Recent Monetary Developments**

Until recently, a reasonably stable price of Gold was the result of the stable Monetary background since 1980. Stable money is as benign for Bond and Equity markets as was the inflation in the 1970s malign for markets. However, the latest surge in the Gold price points to the risk of a breakdown in Monetary stability of major proportions. This is confirmed by the recent acceleration in IMRs to 19 per cent. The graph below shows the correlation between changes in the Gold price and IMRs. It is doubtful whether the World Monetary system is still in Phase Three rather than Phase Four.

**Graph 3: International Monetary Reserves vs Gold Price Annual Rates of Change**




**Summary**

If man-made money returns to being stable, it is likely that the man-made money price of Gold will also be stable. This may make Gold unattractive in terms of immediate return on investment, although insurance via Gold preserves investors' capital during times of monetary instability. If, however, the current Monetary inflation gives way to deflation because of the Debt burden, it is as certain as anything can be in the world of investment that Gold would then enjoy a secular "bull market" either in "nominal price" terms (inflation) and/or in "real price terms" (deflation). Gold, which is the only widely accepted means of exchange that cannot be destabilised by man, will adjust in price to reflect disorder in man-made money. When the Fifth monetary Phase occurs, the recent bull market in Gold will prove to be only the beginning. In these circumstances, investors in Gold would stand to profit handsomely.

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***About the author***

*Peter Millar CA founded Valu-Trac in 1985. Previously he was the Senior Investment Manager of the Bond and Equity Department of Abu Dhabi Investment Authority (1977–1984). Prior to that, he worked at Touche Remnant in London (1970-1977) and Alliance Trust in Scotland (1963-1970).*

*Valu-Trac is the name given to a systematic, valuation-based discipline for analysing and determining portfolio allocations to bond and equity markets, individual stocks, currencies, commodities and alternative investments. It focuses on measuring global market "Intrinsic Values", market behaviour and Central Bank monetary developments. Valu-Trac Investment Management manages long only and long/short portfolios. Investment research and asset allocation counselling services are distributed by ISI Group, New York*