

Gold's better suited to being money today

The yellow metal is a better store of value than all the major currencies, mainly because its quantity cannot be increased at will

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What is money?

It is an economic good which can be used as a general medium of exchange within an economy. Thus, anything accepted in exchange of goods and services is 'money'. Dollar, pound, euro, rupee are all money as they pass this test.

Sound money should also act as a store of value, i.e. retain its purchasing power over time. It should allow us to defer our purchases to the future and buy the same quantity of goods or services in the years to come, as we can today. So if you can buy a kilo of potatoes today using a certain amount of money, you should be able to do the same several years later.

Unfortunately, hardly a currency passes this test. In fact, the money we use today degrades in value over time due to inflation.

The purchasing power of money is a function of money supply, or the amount of money available in the economy and the quantity of goods and services available in the economy. Thus, when supply of money in an economy increases, but supply of goods does

not, the price of those goods will go up sooner or later.

The amount of money circulating in the economy, i.e. the money supply, is controlled by the government (through central banks). The standard measures of money supply usually include currency in circulation and funds held in form of demand (the money you might keep in your savings and your current account) and time deposits (your fixed deposits) with banks.

Now take the instance of the US, where money supply is measured by monetary base.

Money supply in the US has increased almost 10 times over the past 25 years, but the acceleration has really gathered pace in the last 10 years. In fact, the monetary base has rocketed to two times its size in the last 2 years, meaning money supply has doubled.

The two tools available for altering the amount of money or the money supply in the economy are interest rates and the amount of reserves banks need to maintain with the central bank of a country. If the central bank hikes interest rates, it will encourage savings, discourage borrowing and thus reduce the money in circulation. At the same time, if the amount of reserves that banks need to

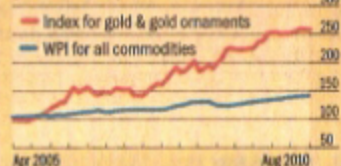
Pale shadows

Purchasing power of various currencies against gold

Comparative currency	5-year avg
Gold in British pounds	205.3%
Gold in euro	154.8%
Gold in US dollar	161.8%
Gold in Indian rupees	280.9%

Source: [Bullionbank.com](http://bullionbank.com) & Investing.com

Index numbers for wholesale prices (Base: 2004-2005)



Source: Office of Economic Adviser, Ministry of Commerce & Industry, India

maintain with a central bank is increased, money supply will go down.

Take for example the current interest rate scenario in India. India currently has negative real interest rates. There is no incentive to save because inflation is running higher (~10%) than rates at which you can invest/ save (6-7%) this money. So, deposit growth rate in the banking system has come down because people don't feel compelled to save at current interest rates.

On the flip side, if the government wants to increase money supply, it can keep reducing interest rates and keep them at low levels and print money in the hope that increased money supply will lead to increased demand.

As Milton Friedman put it, inflation can be described as "too much money chasing too few goods". Money supply and inflation go hand in hand. In-

flation is commonly defined as rising prices. However, rising prices is actually the result of inflation. The root cause of inflation is always money supply. A major reason for increase in money supply is government's unwillingness to reduce its spending plans or to raise the funds it desires by increasing taxation or by borrowing from the public. Governments would always prefer to print money over other options when it comes to funding its new spending plans. Further, the resultant high annualised rate of inflation also erodes the value of debt by eroding the value of money and credit. This makes inflation a very convenient tool to deal with massive government deficits.

Another important element to inflation is money velocity (average frequency with which a unit of money is spent in a specific timeframe) and future inflation expectations.

Money velocity is a key component because inflation is also a direct function of how fast money is moving through the system. When people expect inflation and prices to rise, they may advance their spending in order to avoid paying more for goods and services later. This can lead to increase in money velocity.

In the wake of the global credit crisis, many countries have been following expansionary monetary policies in the hope of stimulating demand. A lot of debt has been added but very little of it has resulted in real growth. This unprecedented debt expansion is already resulting in inflation. Money velocity will increase and inflation will likely pick up further. As interest rates are below the rate of inflation, and because inflation is under-reported, the previously perceived 'risk free' investment like cash in a savings account and time deposits will actually erode in purchasing power over time.

Since cash and bonds no longer offer a rate of return above the real rate of inflation, investors who wish to preserve their wealth over the medium and long-term should turn to gold.

Gold is primarily a monetary asset because it has a

high value per unit weight and is the best store of value as its quantity cannot be increased at will. In fact, gold is actually better suited to being money today than it ever has been in the past, thanks to technology that allows gold ownership to be instantly transferred without the need to physically move it.

To further exemplify the importance of gold as a store of value, we can look at the current prices of sugar and potato. In 2006, 20 mg of gold would have bought approximately 3 kg of potatoes or 1 kg of sugar. The same 20 mg of gold today will buy you 9 kg of potatoes or 1.5 kg of sugar. (Source: Spot prices on mcxindia.com)

The latest wholesale price index (WPI) data released also show how gold has retained its purchasing power:

See the chart for a comparison of the movement in composite WPI with the corresponding movement in index for gold and gold ornaments from April 2005 till August 2010. Where the composite WPI increased 1.36 times since April 2005, the index for gold and gold ornaments increased 2.6 times in the same period. Thus a unit of gold buys much more than what it could five years back.

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