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The economic history of gold

As the current account deficit keeps widening, the authorities seem to be far more concerned about financing it through ever larger net external liabilities, than reducing it: as for the latter, the only concrete action so far has been increasing the import duty on gold to 6%, in order to reduce imports. On the issue of blaming gold imports for our external deficits, it is as well to remember that, if gold is an idle investment, it is compensated by “unearned” resources through “private transfers”. And, there is a close relationship between gold and remittances. Administrative measures to reduce official imports may only drive them into unofficial channels like smuggling, financed by diversion of remittances though the *hawala* market. (This is exactly what happened for 40 years when we had banned gold imports.) The All India Gems and Jewellery Trade Federation representatives have recently estimated that, thanks to the imposition of import duty, something like 250 tonnes of gold was smuggled in 2012 – official imports have fallen. Surely it will be far better to accept the reality and encourage the domestic production of gold? This apart, the international gold price has softened recently – and that may well reduce the import bill.

The other side is whether the import duty would do anything to reduce the demand for gold. To me, this seems unlikely for various reasons:

- ⇒ Empirical evidence: the rupee price of gold has gone up six times in the last ten years: imports in dollar terms have gone up from $ 16.7 bn (1.3% of GDP) in 2007-08 to $ 56.2 bn (3% of GDP) in 2011-12 times. It almost seems as if the higher price increases demand, rather than curbing it! Incidentally, our central bank bought 200 tonnes of gold in 2009. (So have China and Russia on an even bigger scale.)

- ⇒ The reason for increasing imports: the demand supply curve for financial assets seems to be the reverse of the curve for real goods and services. The logic of the demand for gold (or a currency or share), is opposite to that of onions or haircuts, with price rises often increasing demand. (To be sure, gold is both, a financial asset and a consumer good, a way to display one's wealth by wearing costly ornaments, notwithstanding the physical discomfort to the wearer.)
- ⇒ Inflation hedge? The price of gold was fixed at $ 35/ounce back in 1934. After the convertibility of the U.S. Dollar into gold at a fixed price was abandoned in 1971, the price shot up to a high of $ 850 in 1980. After falling sharply thereafter, it has shot up again in recent years, to reach a high of $ 1900 in late 2011. Over the last 30+ years to the recent high, the compound rate of return is barely 2.65% p.a. in dollar terms, or just about the rate of inflation. (To be sure, one can arrive at a far higher rate of return by choosing a suitable starting point for the comparison: in fact, many financial market analysts do this regularly to support their bullish or bearish expectations.) The data in INR terms over such long periods is not really comparable because of the distortion in prices caused by smuggled gold for a third of the period. However, Nilesh Shah has recently estimated that the stock market outperformed gold over the 21 years from the beginning of 1992 (Mint, January 18).
- ⇒ Rationality of the investment in gold: whatever financial economics may postulate, the fascination for gold is perhaps more a "barbarous relic of human irrationality" (Keynes) than an example of rational decision making by the investor.

To elaborate the last point, gold has led to any number of irrationalities in human behaviour – across centuries and cultures as diverse as the American Indians, the Egyptians, the Europeans and in the east. African tribes in the middle ages were perhaps more rational: given that gold has few intrinsic uses, they were happy to part with an ounce of useless gold for an ounce of salt, without which they could not live! (Source: Peter L. Bernsteins' fascinating book "The Power of Gold: The History of an

Obsession”). No other metal, not even its cousin silver, has mesmerized human psyche so much, and for so long. But gold’s universal acceptance, however irrational, played a major role as a medium of exchange in facilitating cross border trade.

In the gold standard era, which lasted roughly from 1870 to the First World War, gold was “money” as the domestic currencies had a fixed parity with gold. The irrationality of policy-makers as regards gold was disastrously manifest in Britain’s restoration of the gold standard at the prewar rate of exchange, in 1925. Keynes, a persistent critic of the step, had then claimed that gold mining "not only adds nothing whatever to the real wealth of the world…but is the only pretext for digging holes in the ground which has recommended itself to bankers as sound finance." (The step was reversed in 1931, but only after it had inflicted huge damage to output and employment.)

But, to come back to the Indian economy, there is one law of economics which the Indian psyche’s fascination for gold is proving over the last decade: private virtue (increase in individual wealth though rise in the price of gold) is a public vice (investments of savings in unproductive assets). But Indians are hardly alone in this private virtue. China is now an even bigger importer of gold than India. Can gold demand be substituted by a financial product? I keep my fingers crossed.

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