

Gold and the Modern World Economy

Edited by
MoonJoong Tcha



Routledge Studies in the Modern World Economy

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Gold and the Modern World Economy

Gold is not merely an element, it has become a byword for preciousness and has been inextricably linked to currency since the long period of economic history which saw the commodity used as the main means of transaction all over the world.

This book, a comprehensive guide to the role of gold in the modern world economy, contains contributions from a wide range of leading experts in economics. *Gold and the Modern World Economy* examines such themes as:

- the role of gold throughout the history of economics
- gold as a commitment measurement
- the price of gold and the exchange rate

This important topic is addressed with style and rigour, and the book will interest students and academics involved in financial, international and industrial economics.

MoonJoong Tcha is a Senior Lecturer at the University of Western Australia.

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To Sooyoung, Kyungchae (Estelle) and Dongyoung,
who are more precious than gold to me

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Foreword

Even after the formal demonetization of gold in the early 1970s, with the breakdown of the Bretton Woods system of fixed exchange rates, gold still retains its fascination to economists for several reasons:

- The price of gold acts as an early-warning signal of future turmoil in the world economy, be it a major slump in economic activity in the large industrialized countries, war, an increase in inflation, or disruptions to other global commodity or currency markets.
- Gold still occupies a substantial share in the portfolios of many central banks. Does this represent a good investment for taxpayers in terms of risk and return?
- Gold's unique properties of durability mean that its price is governed by forward-looking considerations, such as those emphasized in asset-pricing models of modern financial economics. This perspective highlights the role of the overall outstanding stock of gold, and the key role played by expectations regarding future developments. Interestingly, the gold industry tends to emphasize a completely different set of factors that determine gold prices, viz. the flow supply of gold from current and future mines and the flow demand for jewellery and industrial uses, and for investment purposes. Is it possible to reconcile these two approaches, or are they basically incompatible? To put it another way, can the variability of gold prices be decomposed into an expectations component and a flow component?
- Gold is an important export for some countries, Australia and South Africa in particular. In Australia, there has been a major surge in gold production and exports over the last two decades, which has had a substantial impact on the national and regional economies. What is the fundamental source of this surge, and what can other industries learn from this success story?
- There are interesting public finance issues associated with gold. Although many economists favor a resource rent tax, whereby economic profits (or rents) are subject to taxation, with the distortionary impacts minimized, in practice, such a system is rarely employed. Interestingly, until the late 1980s, gold mining was the only industry entirely exempt from income taxation in Australia. And in Western Australia, the major gold-producing state of Australia, gold was

royalty free until the late 1990s. It is a challenge to economists to understand these unusual taxation arrangements pertaining to gold, and to devise better approaches.

This book deals with some of these fundamental issues, and several others. The material in the book will be of interest to those working in financial markets, policy makers, researchers, and all students of the world economy.

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If there is any value-added that I have created by editing this book, it is because of my family, my teachers at Seoul National University and the University of Chicago, and my colleagues at the University of Western Australia, all of whom have played such an important role in my personal and professional development. Therefore, I thank all of them.

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1 Gold and the world economy

Overview

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We all know that gold is precious. We also have learnt, however, that there is not necessarily a correlation between everything that we regard as being precious and what lies at the centre or at the heart of our real interests. In this sense, gold is unique not simply because of the never-ending demand for gold to make jewellery but also because it is the commodity most closely related to a variety of issues that we face every minute in our lives, especially where economic incentives and reasoning are involved. In addition to the long period when gold was used as an official means of transaction, even after the collapse of the Bretton Woods international monetary system cut the link between gold and money in 1971, gold continues to be used as part of most countries' reserve holdings. In fact, gold is the only commodity held as reserves by monetary authorities. Moreover, gold's role as a financial asset has become increasingly significant as the present system of floating exchange rates struggles to find firm ground in markets and currencies of increasing volatility (Kile, 1991). Bernstein (2000) alludes to the fact that the concept of gold as a certain and risk-free asset has been dormant in humans' behaviour from ancient times, when he states that:

... from poor King Midas who was overwhelmed by it to the Aly Kahn who gave away his weight in gold every year, from the dank mines of South Africa to the antiseptic cellars at Fort Knox, from the gorgeous artworks of the Scythians to the Corichancha of the Incas, from the street markets of Bengal to the financial markets in the City of London, gold reflects the universal quest for eternal life – the ultimate certainty and escape from risk.

(Bernstein, 2000: 5)

The history of gold as the most important part of the monetary system goes back to the sixth century BC, when the country of Lydia created electrum coins, which were an alloy of gold and silver (Mundell, 1997). Since then, gold has been at the centre of monetary systems, in spite of the frequent challenges from another metal, silver. In the modern economy, although gold no longer enjoys the prestigious status of a 'currency', it is still treated as a special commodity for a variety of reasons. Today, gold has a wide variety of uses, and is found in jewellery, electronic products and official coins and medals, as well being used in dentistry and as reserves by the