The Midas Touch: Gold and Its Role in the Global Economy

**Douglas R. McKay, MD, MBA, FRCSC¹,
and Daniel A. Peters, MD, MBA, FRCSC^{2,3}**

Plastic Surgery

2017, Vol. 25(1) 61-63

© 2017 The Author(s)

Reprints and permission:

sagepub.com/journalsPermissions.nav

DOI: 10.1177/2292550317696049

journals.sagepub.com/home/psg

In times of market uncertainty, investors retreat to safety and exit from equity to hold gold. Initially coveted for its malleability and resistance, gold has held a prominent place in the development and stabilization of the international economy and world currency markets. It has a fascinating history to explain its persistence in the era of modern investment.

Gold is known in chemistry circles as a noble metal. A noble metal resists corrosion and oxidation; all of the noble metals—gold, silver, and copper—have been used through history as currency, but gold rose to prominence based on its superior resistance to degradation. While the value of gold may spike and fall over time, it rises relatively consistently in the long-run skyrocketing in times of financial and political uncertainty and plunging during periods of investor confidence and overconfidence. The curve on the gold charts over the past 20 years affirms these truths. Gold hovered around US\$200 an ounce through the tech boom of the late 1990s and climbed to US\$1800 an ounce in the aftermath of the 2008 financial crisis.

The Historical Advent of Gold as Currency

Coinage or the manufacture of metal money marked the advent of the notion of standardized economic value. Commodity or metal coins were manufactured throughout the world beginning around 700 BC. Economies prior were based on barter and trade. Coins allowed merchants to ascribe standardized value to the merchandise they bought and sold. Gold-alloyed coins were first minted and circulated around 550 BC by King Croesus of Lydia, in a region now a part of modern Turkey. These coins circulated throughout neighbouring countries. Gold's reputation for preserving its value vaulted it to the top of the heap as the preferred metal for coinage throughout Europe. Simultaneously other economies grew around silver.

Gold coins were frequently struck as alloys. The technical development of a device called a touchstone allowed individuals to rapidly assess the amount of gold within a particular alloy and accurately assign value to the metal based on its percentage makeup of gold. The touchstone itself was a fascinating discovery: a black siliceous stone similar to slate that

when rubbed with gold or silver creates a streak that can be analyzed to determine relative purity.

As the gold economy grew, goldsmiths became an integral part of the economy. The goldsmith minted the coins and their business model expanded to storage for a fee. A receipt was issued to customers denoting the value of their holdings. It didn't take long for clients to realize that a piece of paper was a far easier item to pocket than coins or bars, and receipts began to circulate in lieu of the metal. Paper currency was born and goldsmiths became the first private bankers.

The Evolution of a Gold-Based Economy

Gold, silver, and copper coins circulated throughout Europe and Asia at this time. The value of the coins varied based on the weight of the coin. A standardized monetary value for a coin was still far off. Many European traders favoured gold coins over silver, whereas the opposite was true in Asia. The first fluctuation in the value of currencies was seen as gold inflated in value and flooded into Europe while silver flooded out. Simultaneously, the paper money-based economy grown out of gold holdings was flourishing. Merchants realized that by carrying paper notes on buying trips, they greatly mitigated their risk of robbery. Receipts issued by reputable goldsmiths in one country were soon accepted by merchants in other countries as currency. Goldsmiths followed suit soon after exchanging paper across borders in lieu of dealing with the hassles of gold transport. The system worked well while the number of

¹ Division of Plastic Surgery, Department of Surgery, Queen's University, Kingston, Ontario, Canada

² Division of Plastic Surgery, Department of Surgery, University of Ottawa, Ottawa, Ontario, Canada

³ Telfer School of Management, University of Ottawa, Ottawa, Ontario, Canada

Corresponding Author:

Douglas R. McKay, MD, MBA, FRCSC, Department of Surgery, Queen's University, Hotel Dieu Hospital, 166 Brock Street, Sydenham 3 S3023, Kingston, Ontario, K7L 5G2, Canada.

Email: doug.mckay@utoronto.ca

traders remained small and the reputability of receipts were easy to track. At that time, the public preferred taking their holdings to the goldsmiths over the government banks. Previously, those with large caches of gold would store them in government mints until King Charles I once seized all the private gold held in the Royal mint shaking consumer confidence and driving customers into the arms of the private goldsmith banks.

Goldsmiths realized it was rare for a client to ask for his or her gold back along; few people traded actual gold favouring the portability of receipts. So rare was it for a client to ask for gold, the goldsmiths realized that they could issue receipts for gold not held, in exchange for the interest paid. The interest paid in gold increased their holdings allowing them to lend more. Contracts required collateral and a variety of instruments for return of equity developed including land and holdings giving birth to the modern mortgage.

Gold continued to rise in popularity and its value increased. Everything worked well as long as clients didn't arrive in droves to demand their gold in exchange for their receipts simultaneously. Stop me if this sounds familiar but the banks were out on a limb lending far more gold than they had in reserve. Unfortunately, in the 1730s in a time of financial uncertainty, clients did just that and nearly collapsed the banking system. Private merchants bailed out the banks with their personal stores and the government imposed regulations obligating the banks to exchange gold at a fixed and determined rate giving rise to the gold standard.

The Gold Standard

It is a term we use daily in medicine in reference to the best we have available. We put our new treatments and advances up against the gold standard, but the origin of the expression finds its roots in finance. When coins were no longer valued based on their inherent value as a metal or mineral, individual domestic currencies grew around the world tied to the gold standard. Central banks fixed the value of domestic currency to gold.

Domestic currency could be exchanged not only for gold but also for other country's domestic currencies; domestic coins and paper circulated along with gold coins. The gold standard began in the United Kingdom and its colonies in the early 1800s, while other economies coexisted on silver or bimetallic standards. As global trade flourished, other countries adopted the gold standard to ensure their paper notes carried value backed by real assets. A decision by Germany to move to a gold standard in the 1870s and the fear of missing out on global trade motivated others to follow suit with the exception of China and handful of South American countries rich in silver.

The amount of gold bullion a country held determined the amount of domestic currency the country could put in circulation. The minimum percentage held was fixed. International trade surpluses and deficits were then settled by central banks in gold. Because everyone was in on the game trade deficits and surpluses would self-correct and in theory maintain stability for continued international trade. A country in deficit would

experience an outflow in gold limiting the amount of domestic currency in circulation, necessitating a drop in domestic pricing, and the value of goods, which in turn would make that country's goods more coveted by international buyers. International money would flow in with its exchange fixed to gold, increasing the amount of gold held by the central bank, in turn increasing the amount of domestic currency in circulation, inflating the value of domestic goods, and reinstating the value of the domestic currency. Just like today, the central banks maintained control by tailoring the discount rate. As a reminder, the discount rate is the rate at which central banks lend to the private banks for use in trade.

During the gold standard era, it was expected that central banks behaved in a manner to benefit the greater global good. A country could suspend transactions in times of crisis but would promise to return to the standard in a timely fashion. The global gold standard came to a halt with the outbreak of the First World War, and attempts at its resurrection were ultimately stifled by the Great Depression thereafter.

The Gold Standard in the Modern Era

The advantage of the gold standard lies in stability and accountability. The value of any given currency was tied to a real asset—gold bullion stores—and investor confidence in that value was high. The downside to the gold standard lies in its restrictive limitations. A central bank could not finance times of crisis through inflation and currency devaluation. During the First World War, most countries' needs exceeded their wealth in bullion and the gold standard fell into disarray. Rebuilding following disruption also placed greater demand on the world's central banks and the gold standard seemed unachievable. The Second World War buried the gold standard for good, despite some stalwart's claims that it is the key to international trade salvation. The international trade system was replaced with one of greater flexibility, but gold as an investment has remained popular as a haven of safety, and central banks still hold vast amounts of their wealth in bullion.

Gold for the Small Value Investor: Inverse Correlation

Times of market prosperity are hard on the value of gold and the opposite is true. Everyone has heard of the importance of diversity in a portfolio. Statistically speaking, diversity is a means of hedging and arises from holding assets with inverse correlations to mitigate loss. Correlated investments move in synchrony, whereas inversely correlated assets move in the opposite directions: when one goes up in value the other goes down. The rise in the value of gold at times of bear markets can be described mathematically as having a negative r coefficient or a negative correlation coefficient. Gold can be held to hedge out losses in the equity markets and provide protective stability to counter volatility.

How Do You Go About Buying Gold?

There are basically 4 ways to invest in gold: buying bullion, buying futures, buying gold mining stocks, or holding ETFs (Exchange Traded Funds) with a gold focus. These investments allow for both direct and indirect exposure to gold. For purists, owning gold is about owning security and certainty and not all of the above allow for this.

Those who want to hold the physical metal need to learn some lingo. Gold is typically measured in troy ounces, a unit of mass reserved for precious metals denoted by the symbol XAU, equivalent to 1/12th of a pound. There is a variety of bullion products available to suit an investor's needs; those in the market for larger acquisitions can purchase gold in kilobars (1 kg bars), 100 troy ounce bars, and 400 troy ounce ingots (about 28 lbs a piece). Harry Potter fans take note: the ingot is the crudely poured bar typically held by central banks in their reserves. Purchasing and storage fees can erode profits. Owning any of the above is the only way to directly hold the physical asset and some may find some security in that if they are able to figure out a way to safely store their cache.

Sophisticated traders with an understanding of the derivatives market can turn to gold futures on the commodity

exchanges. The typical contract on these markets is for a 100 troy ounce bar but these markets are not frequented by amateurs.

Indirect vehicles include owning mining stocks or ETFs with either a gold or gold mining focus. The gold mining industry seems like a very volatile way to hold what is purportedly a nonvolatile investment; likewise, ETFs with a gold mining focus share unpredictability that goes with that industry. There are ETFs designed to directly reflect the value of the gold; they hold only bullion and management fees are comparable to equity funds. Holding ETFs allow an investor to forego storage problems in exchange for management fees, but these do carry the uncertainty of contractual fulfillment during a financial crisis, if you are truly paranoid about global economic collapse.

Declaration of Conflicting Interests

The author(s) declared no potential conflicts of interest with respect to the research, authorship, and/or publication of this article.

Funding

The author(s) received no financial support for the research, authorship, and/or publication of this article.