Mills, B. (2010)

A Brief Explanation of the Relationship Between Gold and the US Dollar:

Consider *both* Gold and the dollar as global currencies. Many foreign banks hold dollars as a reserve currency (a back up), although it has been suggested that this era may be drawing to a close (Reuters, 2009). They are both considered strong and stable with regards to their price. If banks get nervous that dollar is weakening they need a hedge (and visa versa) (Zeealllc, 2004). Gold is universally accepted and is in finite supply (you cannot print more gold). So if you are worrying about dollars you could buy gold - and this is helped as we all believe the relationship is inverse. Of course buying gold and selling dollars will have the effect of moving both prices inversely anyway. As can be seen from Figure 1 - as the Dollar falls in value gold increases.

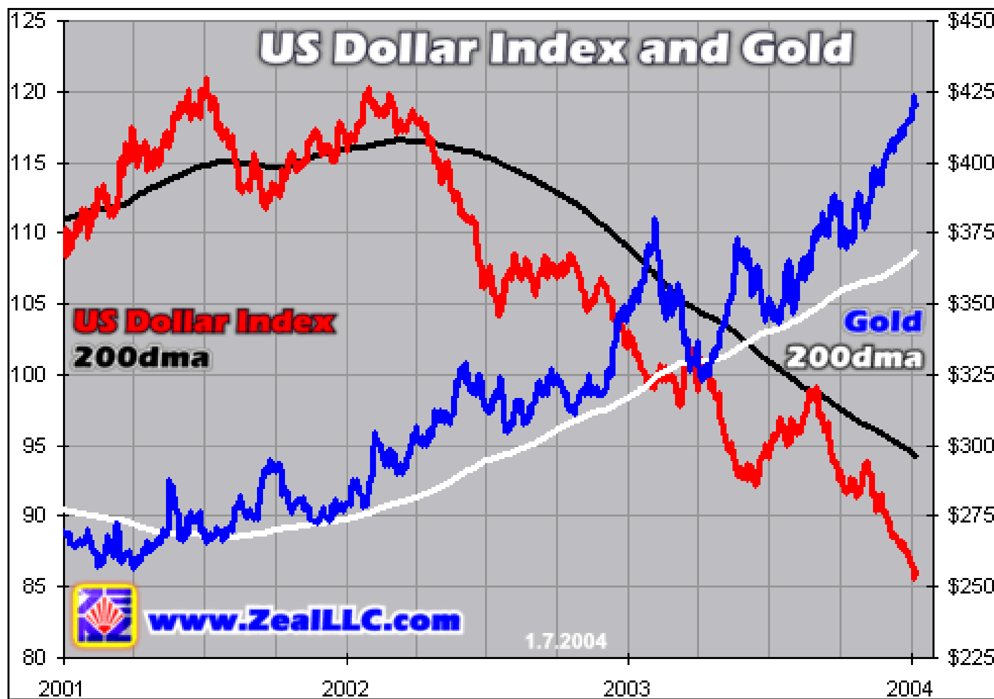

Figure 1: the inverse relationship between gold and the US Dollar (Zeealllc, 2004).

“As the dollar’s exchange value falls, it takes more dollars to buy gold so the dollar gold price rises. Conversely, when the dollar’s exchange value rises, due to a bear-market rally or any reason, it takes fewer dollars to buy gold so the dollar gold price falls” (Bullionmall, 2010).

The dollar/gold relationship is strategic, but *not necessarily* tactical. In the long run dollar weaknesses almost always translate into gold strength (Zeealllc, 2004) (strategic) but in the short term the relationship is more difficult to track. By tactical we mean that short

term both dollar and gold may rise or fall together. But long term (strategic) the relationship will be inverse as above. Markets are irrational in short time frames and return to the behaviour predicated by theoretical models in the long term.

BUT note buying gold priced in dollars using another currency is a whole different story. If Euro is strong against dollar then dollar gold will be cheaper (or perhaps even if its value has gone up by similar amount to dollar down).

Gold as anti-inflation hedge:

Gold is also an anti-inflation hedge (Asiaone, 2010). When inflation rises people buy gold -that itself puts gold's price up. If prices were rising wouldn't you want to swap your money for gold? Inflation also devalues the currency as it means you need more money to buy same stuff (so it must be getting less valuable) (purchasing power parity - the purchasing power of a currency must be maintained).

Monetary Policy and Gold:

The majority of central banks use monetarist policy (Musacchio, 2010). This means that in order to control inflation they influence the money supply. This is usually achieved by altering interest rates. Reducing interest rates to stimulate the economy may well lower the value of the currency (interest rates being the 'cost of money'). As seen above when this happens the value of gold increases.

"In plain English, when the central bank lowers the federal funds rate (interest rates), banks can lend to other banks at lower interest rates which, in turn, makes lower interest rates available to borrowers. And when rates are lower, borrowers have a greater incentive to take out loans (to start businesses, for example). This type of policy increases the supply of money in the system." (Moneyunder30, 2010).

Of course if inflation is too high the central bank may well raise interest rates which has the effect of increasing the value of the currency. This may in turn decrease the value of gold.

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