

GOLD: THE ULTIMATE CURRENCY?

“Gold will be around, gold will be money when the dollar and the euro and the yuan and the ringgit are mere memories.” – Richard Russell

by Merk Investments, Nick Reece with Axel Merk



Is gold money? And if so, why? Some very smart people, Fed Chairman Ben Bernanke included, claim gold is not money. Other equally smart people call gold the ultimate currency. Here we will briefly discuss what money is, how gold compares to the dollar, and provide some practical reasons for gold's ascent as the predominant monetary commodity.

What is Money?

The classic textbook definition asserts that money serves three functions:

- Medium of exchange
- Unit of account
- Store of value

Worth its Weight?

What does this textbook definition really mean? Firstly, *medium of exchange* simply means money is something generally accepted in exchange for goods and services of value. Both gold and dollars pass this test. Secondly, there must be definable and comparable *units of account* on which relative values and interchangeability can be established. Again, both gold and dollars pass this test. Thirdly, there must be confidence

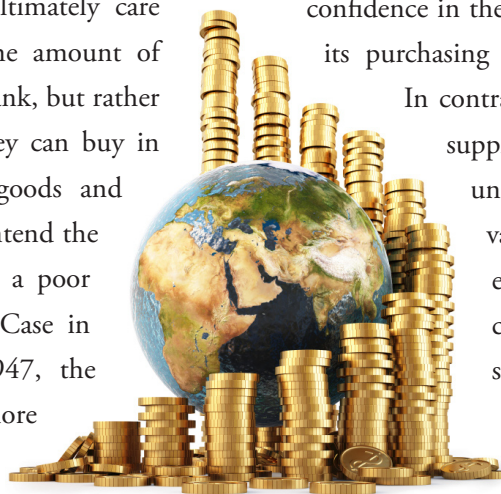
that money will hold its purchasing power as a medium of exchange over time; that it can be used as *store of value*. This is where it gets tricky...

What Money Can Buy

Indeed, of these three criteria, it is the function of money as a store of value that proves most elusive. Value is paramount. What people ultimately care about is not the amount of money in the bank, but rather what that money can buy in terms of real goods and services. We contend the dollar has been a poor store of value. Case in point: since 1947, the dollar has lost more than 90% of

its purchasing power due to inflation according to the Bureau of Labor Statistics CPI data. Meanwhile, the purchasing power of gold has remained relatively stable: an ounce of gold has been able to buy a very nice handmade suit throughout the decades, as it does today.¹ Recent rapid expansion of the monetary base may further undermine confidence in the dollar's ability to hold its purchasing power going forward.

In contrast to the dollar, gold's supply limitation and underlying commodity value may be reason to expect that gold will continue to be a reliable store of value.



¹ Known as the Gold-to-Decent-Suit Ratio, a ratio pegging the price of an ounce of gold to the price of goods.

Paper Money Grows on Commodity Value Trees

As the value of anything is determined by supply and demand, it is important to consider the potential supply growth of any form of money. As opposed to today's digitally created money, to which there is no limit, gold supply growth is physically constrained. There is an absolute limit to the amount of gold that can ever be mined; meanwhile, mining and refining gold is labor, energy and capital-intensive work, which consequently limits above ground supply growth. This hard limitation helps provide confidence that gold will preserve its value over time and was one of the key reasons the dollar was historically linked to gold. However, since the collapse of the Bretton Woods system in the early 1970s, the severing of the link between the dollar and gold has removed any previous limit on growth of the dollar money supply.



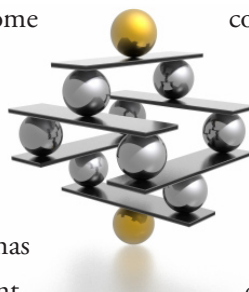
Additionally, gold has underlying commodity value, whereas dollars only have value to the extent they are accepted as money. In this respect, gold will always have intrinsic value and will therefore never become worthless, which provides support for gold's ongoing acceptance as money. Because of its perceived beauty and rarity, gold has been in demand as ornament and jewelry since at least the days of the ancient Egyptian pharaohs, and has remained a universal status symbol. In keeping, gold is commonly used as a gift to symbolize the importance of a relationship. As such, its household use as ornament and jewelry, and minimal industrial application, provides gold with a broad base of consumer demand.

On the other hand, dollars have no commodity value; without the artificial constructs of legal tender laws it is questionable whether dollars would be used as money, or indeed have any value at all. On-demand convertibility into gold is what initially gave today's paper money its legitimacy; without any convertibility into gold, that legitimacy may increasingly be questioned. As a thought exercise, it may be worth asking, in the absence of

a national currency, what would people accept as money?

Why Not Oil?

To understand why gold was chosen as a form of money over other commodities, it may be useful to recall the genesis of money.



Before money, barter was the means of attaining goods and services; exchanges only took place when there was a coincidence of wants. Barter was clearly inconvenient and gave way to a gradual process of trial and error whereby individuals sought to trade for the goods that were most readily marketable to a diverse audience of tradesmen. Some goods or commodities were more naturally suited to fulfill this role than others, and for practical reasons gold made sense. Among its most important physical characteristics, gold is portable, divisible, durable, and difficult to counterfeit.

With regards to portability, as gold is relatively scarce compared to its demand, small quantities command a relatively large amount of purchasing power that can be stored in bars transported across oceans or in coins carried in a pocket. Its high value-to-weight ratio limits gold's storage costs and allows gold to function as a convenient medium of exchange. Regarding divisibility, gold can be divided into very small units or amalgamated into much larger units

without the underlying gold content losing any of its value. This allows for acceptance of varying quantities and interchangeability, and relates to the unit of account function. With respect to durability, gold does not deteriorate over time, a key condition to gold's viability as a store of value when compared to other commodities. Additionally, gold is difficult to counterfeit due to its luster and density. Pure gold of a certain weight can be confidently determined, a key condition to people's willingness to accept money in exchange for goods of value – again relating to its suitability as a medium of exchange. Additionally, it is a globally demanded consumer commodity. Taken together, these qualities provide gold with unique marketability.

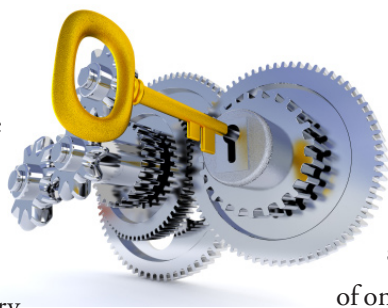
Gold: Money of the People

As outlined above, it is important to understand that gold ascended to predominance through a market-based process. Furthermore, it only left the modern monetary system through arbitrary edict when President Nixon “temporarily” suspended the dollar's convertibility into gold in 1971. It is only since then that purely fiat paper moneys have dominated the international monetary

system, not a long, nor convincing, track record compared to historical use and acceptance of gold.

Perhaps in a prescient manner, may the fiat dollar flaws implied above acknowledged in a booklet published by the Federal Reserve Bank of New York in 1977, which read:

“Regardless of what any government says, money must have certain characteristics that make it acceptable. Without those traits, even ‘legal tender’ cannot be successful as money... People’s willingness to accept money, in any form, is rooted not in the law but in money’s ability to effectively measure and hold value... When money was predominantly gold and silver coin, governments were prevented from issuing more coin by the amount of metal in their treasuries, dug out of the ground, or obtained for goods sold to other nations. Without similar restrictions on currency, governments and banks could over-issue, reducing the value of each note, and jeopardizing paper money’s acceptability by making currency a poor store of value.”²



Throughout history, gold has been used in different cultures and geographic regions, in societies that, independent of one another, found gold most



suitable to serve as money. Other forms of money may have been successful at different times and in different parts of the world, including fiat paper currency of recent decades, but none has passed the test of time or transcended as many cultures as successfully as gold. Unlike fiat currency, gold is not money because the government says so; rather, it is money because the private market says so – and it is inevitably the private marketplace that provides the most valued goods and services. Confidence in fiat currency may come and go, but for good reason there is a tacit recognition that gold is the ultimate currency. **M**

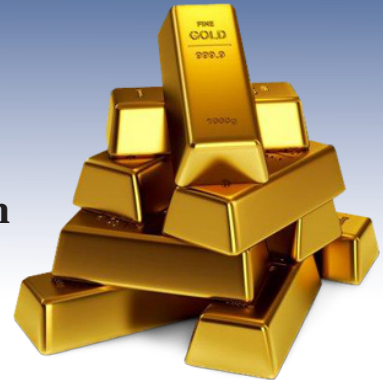
²Friedman, David H., *I Bet You Thought...* (New York: Public Information Department, Federal Reserve Bank of New York, 1977) p7, 9



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About the Authors:

Axel Merk is the President and CIO of Merk Investments, manager of the Merk Funds. Axel Merk is a sought after speaker and author on topics ranging from the economy, gold and currencies to sustainable wealth and personal finance, as well as a regular guest and contributor to the business media around the world.



Nicholas Reece is a Financial Analyst at Merk Investments, focusing on macroeconomic research and portfolio analytics. Nicholas holds a B.A. in Economics from Trinity College and he has passed the Level III exam for the CFA program.



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