How inflation does affect gold prices economics essay

“ Inflation”- is derived from Latin word “ Inflare” means “ Blow up”. Inflation is rise in over-all cost. The price of goods and services increases, value of dollar will go down because we won’t be purchasing same amount as before. Annual inflation rate fluctuated highly over half century ranging from zero inflation to 23% inflation. Federal Reserve Bank tries to maintain specific rate of inflation which is usually 2-3% depending on the situation.

The Indian economy went through structural changes in the post 1990s; it is likely that the causes of domestic inflation too have undergone severe changes. The cause for today’s inflation is complicated. India’s average growth rate, which was close to 3. 5 percent in the fifties and sixties, went up to over 5% in the late 70’s and stayed that way for a decade. After the economic depression of 1991, growth picked up even more, clearing the 6% mark on average and actually seeing a GDP growth rate of over 7 percent for 3 consecutive years starting from 1994.

Chart – CPI inflation India 1991 (yearly basis)

Chart – inflation India 1991 (CPI)

The average inflation of India in 1991: 13. 88 %

(Taken from the site “ inflation. eu”)

Fiscal crisis of 1991, Government stated sum of money is too small and devaluated Rupee, That time inflation of 13. 66% took place on Indian economy.

#. Fiscal Crisis: The unit of Govt will be experiencing a budget crisis and will be unable to borrow finance. It is mostly due to large accumulated debt about its ability to service that debt with combination of rising public demand, failing tax revenue.

The new economic reform, popularly known as, Liberalization, Privatization and Globalization (LPG model) aimed at making the Indian economy as fastest growing economy and globally competitive.

Liberalization:

Liberalizing the Indian economy has given new dimension for India and it's billion plus population. This period of economic transition had a tremendous impact on the overall economic development of almost all major sectors of the economy, and its effects over the last decade can hardly be overlooked. Besides, it shows the real integration of the Indian economy into the global economy.

Privatization:

This period has also introduced a remarkable change in the mindset of Indians, as it deviates from the traditional values held, such as self reliance and socialistic policies of economic development, resulted in the isolation, overall backwardness and inefficiency of the economy. Despite the fact that India always had the potential to be on the fast track to prosperity.

Globalization:

India is in the process of restructuring her economy, with aspirations of elevating from her present position in the world, the need to economic development is even more obligatory. And having witnessed the positive role that Foreign Direct Investment (FDI) has played in the rapid economic growth of most of the Southeast Asian countries, India has embarked on an ambitious plan to emulate the successes of her neighbors to the east and is trying to sell herself as a safe and profitable destination for FDI.

Types of Inflation:

Inflation causes:

Extreme imbalance of Global economy.

Fuel Price hike.

Higher international farm price.

High Labor rates.

5. Increase in indirect tax by Govt.

Inflation rate is based on:

1. Consumer Price Index [CPI]

2. Producer Price Index [PPI]

#. Inflation Rate=((PI for certain year-PI for comparative year)/PI for comparative year)*100

Inflation effects:

Production.{changes in routine of economic activity}

Income distribution.-{re-distribution of wealth}

Consumption and welfare.

How Inflation does affect Gold Prices?

Gold bullion increase in price per ounce whenever the price of the currency in which it is denominated decreases in value. So, there is an inverse relationship between the price of any currency and the price of gold bullion in the reserves.

The price of gold will go up because the price of gold is always related to a currency. When the value of the currency goes down (as in inflation), the price of gold will go up, to capitalize on this, experienced investors purchase gold coins and bars- Popular gold coins which is recognized and traded world-wide.

In some currencies, the price of gold could be steady, while in others, the price of gold could be moving higher. At present, the price of gold is moving higher versus all currencies. Look at the 10 year chart for each currency and see how the price of gold has increased. This is as a result of inflation.

If we look at prices of gold versus the U. S. dollar long term, we can see that when the price of the dollar goes down, gold price increases and vice versa. Since the year 2000, the average price of gold has been increasing in terms of U. S. dollars. The fact that the U. S. and other countries are adding debt to debt to resolve their economic crisis. Traditionally, the price of gold was seen to reflect monetary inflation, i. e, inflation of the money supply. Because the fractional reserves banking system under the Federal Reserve is inherently inflationary, the total amount of money in circulation tends to expand, at times rather sharply. If monetary inflation exceeds real growth in products and services, then the result will be price inflation, which is what is measure by government measures of inflation such as the Consumer Price Index (CPI) and Producer Price Index (PPI). The balance of supply and demand for gold tends to change relatively little every year, so, for decades; changes in the price were attributed to inflation. Because rising inflation often coincides with a booming economy, a rise in the gold price is sometimes coincident with a strong economy.

How does inflation affect oil prices?

The cost of oil and inflation are often seen as being connected in a cause. As oil prices will be varying, inflation also follows in the same direction. Because oil is a major input in the economy – it is used in all major activities such as fueling transportation and heating, homes – and if input costs rise, the cost of end products. For example, if the price of oil rises, then it will cost more to produce steel, and steel company will then pass on some or the entire price to the consumer, which raises prices and results inflation.

However, this relationship between oil and inflation started to deteriorate after the 1980s. During the 1990’s Gulf War oil crisis, crude prices doubled in six months from around $20 to around $40, but CPI remained relatively stable, growing from 134. 6 in January 1991 to 137. 9 in December 1991. This detachment in the relationship was even more apparent during the oil price run-up from 1999 to 2005, in which the annual average nominal price of oil rose from $16. 56 to $50. 04. During this same period, the CPI rose from 164. 30 in January 1999 to 196. 80 in December 2005. Judging by this data, it appears that the strong correlation between oil prices and inflation that was seen in the 1970s has weakened significantly.

How does inflation affects dollar..??

The dollar value reflects the health of the US economy. In a floating currency system where the dollar is only priced relative to other floating currencies, it is very difficult to use currency movements as a measure of the economy. Still, gold is a very popular hedge for large institutions against devaluation in the US dollar. As the value of the dollar goes down relative to other major currencies, the price of gold tends to move higher, though the correlation is not always perfect. The movements in the dollar, however, can be as much related to changes in other national economies as in the US itself.

When the dollar is seen to be on the rise, investors tend to flee from gold, causing the price to drop signaling a slowing of inflation.

Co-relation:

Crude oil prices continue to hit new peaks, and the correlations between the Canadian Dollar, Euro, Australian Dollar, and US Dollar likewise trade near the top of their historical ranges.

As long as US Dollar yields remain near record-lows, we may continue to see cross-market correlations trade near historical strength across a broad range of raw materials prices. This seems particularly true for high-flying Gold and Crude Oil prices.

Looking at market, there is no direct correlation between the 3 but an external relation does exist.

Gold is an inflation Hedge. If inflation of any country increases, investors buy gold to balance their port folio. So, Gold will move up.

Crude prices directly affect the oil import bill of any country. Increase in Imports Bill will increase the Trade Deficit (Export – Imports) of countries. Higher Trade deficit would hit the value of currency of the country.

This will affect the money circulation in the economy there by leading inflation. So, If Crude price rises, Gold will also move up.

As you know most of the countries has got Foreign Reserves. And these reserves are in form of Dollars. For example, India boasts about 140 Billion Dollars of reserves. If the dollar looses value, the entire basket looses value. So, countries will look for safe heaven i. e. Gold. If Dollar looses value, Gold will move up.

As quoted by Prasenjit Chakravorty

“” Dollar is the backup currency worldwide. Price of commodities like oil and gold is quoted in dollars in the stock market every day. So when the dollar weakens against the rupee, imported items like oil, gold, etc, cost more dollars, and items we export earn more dollars.-“ That is how they are interrelated.”

As stated by Tim Duraikannan Venkatraman

“ Most of the stock market revolves around OIL price. So many metals prices are shifting with Oil shares. Gold price is controlled by dollar value/reserve too. When shares were falling GOLD was safe heaven for investors. Gold merchants always link gold with oil price (a limit set) . I think soon or later GOLD will lose its ground (how long public will buy 100dollars worth item for 400$? they will look for alternative”

#. Keynesian theory :

In the Keynesian approach potential output serves only as the notional short run maximum of feasible output. Keynesian approach, also states the excess increases in the total expenditure (e. g., investment expenditure and government expenditure) and the sources of excess demand and hence inflation.

With Keysian Theory, the result is mixed. In short term there is no any clear cause and effect relation which makes it almost impossible to state what happens to gold price when dollar down wear away.

A long term trend analysis shows negative correlation between gold prices and the value of dollar but gold price does not increase proportionately to the diminishing dollar.

As Keynes said at the later stage that there is no long term- I would go with the short term result.

How Inflation can be controlled?

Inflation cannot be measured by single step. But following steps can help in handling inflation. Those are:

Monetary measures

Fiscal measures

Other measures-To encourage for savings, Increase production, Provision of subsidies.

Monetary measure:

2. Fiscal Measures:

3. Other Measures.