How Gold Affects Currencies

By Kalen Smith Updated Feb 26, 2018

Ah, the enduring appeal – and influence – of gold. Even though it is no longer used as a primary form of currency in developed nations, the yellow metal continues to have a strong impact on the value of those currencies. Moreover, there is a strong correlation between its value and the strength of currencies trading on foreign exchanges. (For a quick primer, see "Gold: The Other Currency.")

TUTORIAL: Commodities Introduction

To help illustrate this relationship between gold and foreign exchange trading, consider these five important features of the yellow stuff:

1. Gold was once used to back up fiat currencies.

As early as the Byzantine Empire, gold was used to support fiat currencies – that is, those considered legal tender in their nation of origin. Gold was also used as the world reserve currency up through most of the 20th century; the United States used the gold standard until 1971 when President Nixon discontinued it. (For more, see "The Gold Standard Revisited.")

Until the gold standard was abandoned, countries couldn't simply print their fiat currencies *ad nauseam;* the paper money had to be backed up by equal amount of gold in their reserves (then, as now, countries kept supplies of gold bullion on hand). Although the gold standard has long fallen out of in the developed world, some economists feel we should return to it due to the volatility of the U.S. dollar and other currencies; they like that it limited the amount of money nations were allowed to print.

2. Gold is used to hedge against inflation.

Investors typically buy large quantities of gold when their country is experiencing high levels of inflation. The demand for gold increases during inflationary times due to its inherent value and limited supply. As it cannot be diluted, gold is able to retain value much better than other forms of currency. (For related reading, see "The Great Inflation of the 1970s.")

For example, in April 2011, investors feared declining values of fiat currency and drove the price of gold to a staggering $1,500 an ounce. This indicates there was little confidence in the currencies on the world market and that expectations of future economic stability were grim.

3. The price of gold affects countries that import and export it.

The value of a nation's currency is strongly tied to the value of its imports and exports. When a country imports more than it exports, the value of its currency will decline. On the other hand, the value of its currency will increase when a country is a net exporter. Thus, a country that exports gold or has access to gold reserves will see an increase in the strength of its currency when gold prices increase, since this increases the value of the country's total exports. (For related reading, see "What Is Wrong With Gold?")

In other words, an increase in the price of gold can create a trade surplus or help offset a trade deficit. Conversely, countries that are large importers of gold will inevitably end up having a weaker currency when the price of gold rises. For example, countries that specialize in producing products made with gold, but lack their own reserves, will be large importers of gold. Thus, they will be particularly susceptible to increases in the price of gold.

4. Gold purchases tend to reduce the value of the currency used to purchase it.

When central banks purchase gold, it affects the supply and demand of the domestic currency and may result in inflation. This is largely due to the fact that banks rely on printing more money to buy gold, and thereby create an excess supply of the fiat currency. (The metal's rich history stems from its ability to maintain value over the long term. For more, see "8 Reasons to Own Gold.")

5. Gold prices are often used to measure the value of a local currency.

Many people mistakenly use gold as a definitive proxy for valuing a country's currency. Although there is undoubtedly a relationship between gold prices and the value of a fiat currency, it is not always an inverse relationship as many people assume.

For example, if there is high demand from an industry that requires gold for production, it will cause gold prices to rise. But this will say nothing about the local currency, which may very well be highly valued at the same time. Thus, while the price of gold can often be used as a reflection of the value of the U.S. dollar, or any currency, conditions need to be analyzed to determine if an inverse relationship is indeed appropriate.

The Bottom Line

Gold has a profound impact on the value of world currencies. Even though the gold standard has been abandoned, gold as a commodity can act as a substitute for fiat currencies and be used as an effective hedge against inflation. There is no doubt that gold will continue to play an integral role in the foreign exchange markets. Therefore, it is an important metal to follow and analyze for its unique ability to represent the health of both local and international economies.