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An evaluation of gold as an inflation hedge: Empirical evidence from South Africa

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Abstract

The plague of inflation eating into investor returns is one that is experienced universally by all investors. Gold has historically proven to provide good inflationary hedging ability, due to its appreciating prices in times of high inflation. However, the recent period of price depreciation from 2012 amidst rising inflation in South Africa, has brought its usefulness as a hedge into question. The purpose of this study is therefore to thoroughly examine the use of gold as an inflationary hedge in the South African environment. In South Africa, the problem of inflation is a particularly severe one, with inflation rates reaching double figures periodically. The necessity of a hedge against inflation is therefore imperative to South African investors, to mitigate their diminishing real returns. The study extends over the period of 2000 – 2014, to incorporate for the Monetary Policy Committee in South Africa's introduction of the inflation targeting regime. In South Africa, there are two popular alternatives when purchasing gold – one is gold bullion, whilst the other is known as the Krugerrand. The Krugerrand is minted from 22 carat gold, and is a popular vehicle for private gold investment in South Africa – and therefore easily accessed by both private and institutional investors. We therefore utilized both gold and the krugerrand as possible hedges in order to evaluate whether there is any difference in their respective hedging ability, and in particular, which one is more appropriate. We also decomposed inflation into the different types, which are: actual, expected, and unexpected inflation. Testing was conducted on the data over both the short run and long run, by making use of OLS regressions for the short run analysis, and Johansen's Cointegration for the long run analysis. The results of the short run statistical tests found that whilst both gold and the krugerrand were found to be statistically significant against unexpected inflation, their sign was negative – which indicate that when unexpected inflation increases, the gold price decreases, which is contrary to the way in which a hedge should perform. The long run analysis found that both gold and the krugerrand were able to hedge against both actual and unexpected inflation, but not anticipated inflation. The

results overall also found that gold had the superior hedging ability from the two alternatives. This may indicate that for investors who are concerned with the long run effects of inflation on their portfolios, they can include gold as a potential hedge against its negative effects.

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AN EVALUATION OF GOLD AS AN INFLATION HEDGE: EMPIRICAL EVIDENCE FROM SOUTH AFRICA

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ABSTRACT

The plague of inflation eating into investor returns is one that is experienced universally by all investors. Gold has historically proven to provide good inflationary hedging ability, due to its appreciating prices in times of high inflation. However, the recent period of price depreciation from 2012 amidst rising inflation in South Africa, has brought its usefulness as a hedge into question. The purpose of this study is therefore to thoroughly examine the use of gold as an inflationary hedge in the South African environment. In South Africa, the problem of inflation is a particularly severe one, with inflation rates reaching double figures periodically. The necessity of a hedge against inflation is therefore imperative to South African investors, to mitigate their diminishing real returns. The study extends over the period of 2000 – 2014, to incorporate the Monetary Policy Committee in South Africa's introduction of the inflation targeting regime. In South Africa, there are two popular alternatives when purchasing gold – one is gold bullion, whilst the other is known as the Krugerrand. The Krugerrand is minted from 22 carat gold, and is a popular vehicle for private gold investment in South Africa – and therefore easily accessed by both private and institutional investors. We therefore utilized both gold and the krugerrand as possible hedges in order to evaluate whether there is any difference in their respective hedging ability, and in particular, which one is more appropriate. We also decomposed inflation into the different types, which are: actual, expected, and unexpected inflation. Testing was conducted on the data over both the short run and long run, by making use of OLS regressions for the short run analysis, and Johansen's Cointegration for the long run analysis. The results of the short run statistical tests found that whilst both gold and the krugerrand were found to be statistically significant against unexpected inflation, their sign was negative – which indicate that when unexpected inflation increases, the gold price decreases, which is contrary to the way in which a hedge should perform. The long run analysis found that both gold and the krugerrand were able to hedge against both actual and unexpected inflation, but not anticipated inflation. The results overall also found that gold had the superior hedging ability from the two alternatives. This may indicate that for investors who are concerned with the long run effects of inflation on their portfolios, they can include gold as a potential hedge against its negative effects.

JEL Classifications: G11, G15

Keywords: Gold, Krugerrand, South Africa, Hedging, Inflation, Inflation targeting.

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INTRODUCTION

The South African financial environment has become extremely volatile over the last decade, experiencing high levels of inflation and an unstable exchange rate mainly due to factors such as contagion, political risk and labour unrest. Inflation in particular, is an extremely important risk for investors to consider, as inflation volatility spreads to the stock and bond markets, but also because the presence of inflation reduces the

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