

**COMMENTARY - May 25, 2009**  
**Gold! Is it good for you and for the Nation?**

With all of the recent worries about the soaring national deficit and its impact on potential inflation and the value of the dollar, many Americans have in a frenzy jumped on the gold bandwagon, both for themselves as a hedge against all sorts of horror scenarios and also as a policy tool to keep the Federal Reserve Bank from flooding the nation with money, leading to high levels of inflation. Both perspectives require a closer look.

Let me first look at the virtues of a gold standard for the nation. Centuries ago, gold was a major medium of exchange. Besides its awkwardness, the risks of theft, and the untrustworthy weights of unscrupulous merchants, it worked modestly well as "money". Governments later tried to improve on the efficiency of gold as money by standardizing it into coins of a guaranteed weight, only often governments themselves were no more trustworthy than those merchants.

Gold has not always been some magical hedge against inflation. Gold prices, as is true for all goods, are relative, a ratio of the value of one good to another. With gold as the primary medium of exchange, everything was just denominated in terms of the value of gold. But the value of gold has always varied. Sometimes there was a scarcity, sometimes a glut. During the 16<sup>th</sup> century, the flood of gold and silver from the Americas into Spain produced a half century of runaway inflation.

Because of its terrible inconvenience, gold per se was eventually replaced by gold certificates or government issued money backed by gold. This movement had its origins in Europe. The United States embraced such a gold standard during much of its first century of existence when it was convenient and mostly abandoned it when it was not. For example, during the Civil War the federal government was running out of species (gold and silver) to conduct the war, so for the first time in the nation's history, the U.S. Congress approved the issuance of paper money not backed by gold or silver, but merely the full faith and credit of the federal government. Needless to say, the government printing presses, unchecked by any external constraint, created too much money and hence high inflation. Still, the government's action was not much worse than that which was occurred under state chartered banking during much of the first half of the 19<sup>th</sup> century in which banks were allowed to print their own money which was supposed to be backed by a partial reserve of species. The reality, however, was that state bank issued money was often only backed by loans, especially on inflated real estate in the 1830s. Such action resulted in the U.S. financial crisis of 1837 which was first preceded by inflation, speculation, and a real estate price bubble, and then followed by a collapse of 50% of all banks in the country and a lengthy and severe recession.

Those experiences sound like strong arguments for a gold standard, and indeed, the nation pursued the equivalent of the gold standard during much of the second half of the 19<sup>th</sup> century. The problem was that there was a world-wide shortage of gold. Basically, there was far less gold than was needed to serve as the basis for all mediums of exchange during the economic explosion of the industrial revolution and the expansion of international trade. The scarcity of gold was particularly harmful to the booming post-war American economy. The result was two decades of significant deflation and its adverse consequences on debtors who had to pay off principle and interest with higher valued dollars.

The gold standard was also partly to blame for the world's economic woes during the first half of the 20<sup>th</sup> century. The problem began with the Allies' imposition of high reparation

payments from Germany which did not have sufficient reserves (primarily of gold) to pay off those war debts. With the loss of reserves, Germany was unable to supply sufficient money for its economy and switched to the use of fiat money unbacked by gold. But excessive amounts of fiat money ultimately produced inflation and Germany found itself caught in an ever accelerating inflationary spiral.

The bottom line is that every nation needs adequate growth in money to meet the demands of economic growth without excessive growth that induces inflation. Gold often fails on both accounts. Part of the reason why most commentators cite bad monetary policy as a contributing factor to the Great Depression was that the Federal Reserve Bank was excessively fearful of the type of inflation they observed in Germany and were far too protective of the gold standard. Most of Europe abandoned the gold standard in the 1920s because of the inflationary crisis in Germany and the deflationary implications of trying to retain their old fixed exchange rates between gold and domestic currencies. Amazingly the U.S. Federal Reserve Bank went in the opposite direction, raising interest rates in the early years of the Depression, instead of lowering them, in order to try to sustain the fixed gold-to-dollar exchange rate. This greatly aggravated the economic collapse pushing a serious recession into what we now all refer to as the Great Depression.

The post WW II gold standard with the U.S. gold-backed dollar as the primary medium of international exchange was useful in the 1950s in keeping inflation in check in the U.S., but as before it was terribly inflexible. As the global economy began to gain momentum after the devastations of war, there simply wasn't enough gold to go around. The "price" of gold needed to increase relative to other goods because of its relative shortage. Fixed gold to currency exchange rates didn't make any sense. Seeing an opportunity, speculators began bidding the price of gold higher and higher in international markets (it couldn't be bought and sold in the U.S.) until the U.S. and most other major international economies were forced to abandon it in the early 1970s.

Was that a mistake? At first it looked like it might have been. During the 1970s, the U.S. suffered the longest period of inflation in decades, perhaps in its history. The problem was not so much because of the abandonment of the gold standard, but because of an unwise agreement between the U.S. Treasury and the Federal Reserve Bank to keep Treasury's interest costs low. The excessive money growth during that decade would surely have been put in check under the gold standard, but the consequences of continuing a disequilibrium price of gold would have been equally devastating.

With the Volcker monetary revolution of the 1980s, both the U.S. and most international economies enjoyed low inflation without the gold standard, something which has now lasted for the past quarter century. So why revert back to the gold standard? It would only make some sense if you felt that you could not trust world central banks to remain inflation adverse and to resist government pressures to monetize their debt. Yet that possible benefit of the gold standard is not a sufficient argument in its favor because fails to consider all of gold's shortcomings, including unpredictable supply and hence its inherent variability of value.

But what about you today? Fearful of high inflation or economic collapse, should you be buying gold? I've received many enquiries from those frightened over one doomsday scenario or another who are seeking some sort of protection against the eminent end of the world. "Why?", I ask. "If economic Armageddon is just around the corner, what are you going to do with gold? Eat it? Burn it in the fireplace to keep warm?"

Now I'm not saying that gold will plummet from here, but gold is basically useless, especially during times of an economic collapse. What would you do with gold, shave off a portion of your bullion to go to Kroger or to buy gas at Shamrock? Gold is not used for any transaction either domestically or internationally. Sure you can buy and sell Krugerrands, but you must convert them into some domestic currency to carry out transactions. I don't know of many grocery stores here or abroad that accept Krugerrands in payment for food. Even if they did, during an economic crisis there would be so few available that it would make normal commerce virtually impossible.

Gold fever is an excellent example of what fear does to us, bouncing us back and forth from one mistake to another. Consider some poor investor who in early March had lost 55% of his wealth in stocks. In a panic he decided to sell all of his stocks and buy gold at \$1,000 per ounce. Like any commodity price, gold prices won't rise forever. Did he buy at the high? In early May, the stock market was rallying and gold was selling for about \$850/ounce. Had he blown it? He'd just lost another 15% of his wealth. I can see him now selling his gold and buying back into the stock market at a price 30% higher than when he sold out.

Like almost all assets, gold has only been a good investment if you bought low and sold high. Had you been smart and bought gold in 1988 you would have tripled your money in just two years. If you had held that gold until 2001, 13 years later, you would have earned a meager 2% annual rate of return when you could have bought instead long-term treasuries in 1980 with double digit yields. But what if you had bought in September of 1980, then you would have eventually lost over 55% of your value and it would have taken you 19 years to have recovered those losses (See Graph 1). Buying gold can be a risky business!

Finally, is gold a good hedge against inflation? Graph 2 shows what has happened to the real dollar value of gold since the first of 1975, shortly after the U.S. left the gold standard and the price of gold had settled down. Remarkably, despite its high price today, the real dollar price of gold is about where it was 34 years ago. It was a decent hedge against inflation, but not nearly as good as stocks or even bonds. Yes, there were times when gold was an excellent investment, but other times when it didn't even keep up with inflation.

Let's see if we can see a pattern to gold prices over time. Gold prices spiked upward in the late 70s and in the second half of this decade. What could have explained that? The first period was a time of high and rising inflation. That seems to make sense. But this decade, inflation has remained relatively subdued, except for the first half of 2008 when oil prices pushed all prices up. So if it isn't inflation, what do these two periods have in common? The answer is low real interest rates. During times of low real rates all commodity prices tend to rise above inflationary levels and gold is no exception. What about the mid to late 80s? Why did real dollar gold values decline? They declined because of high real interest rates. And the 1990s? Gold prices remained weak because inflationary expectations continued to decline and because the Fed kept monetary policy sufficiently conservative to keep real rates up and money growth low.

So what about gold today? Either Graph 1 or 2 has to make one think twice about whether they are buying gold today at its high, though admittedly Graph 2 is much more reassuring. The real risk of gold today is a sharp rise in interest rates in 2010 and 2011. That would be a killer for gold, and that could easily push gold prices back down to where they were in 2001, a year you might have expected to see gold soar, given the scary events of 9/11. Note that despite all the fear produced by the tech crash, the beginnings of a U.S. recession, and the horrors of 9/11, gold prices fell to a 26 year low because of the Fed's move in the early part of the decade to raise interest rates. Of course, after 9/11 the Fed

dramatically lowered rates and gold took off. So when you think about buying gold today, ask yourself where you think real interest rates are headed. I'm betting that they are headed up significantly. That's why I'm not interested in having gold in my portfolio.

Graph 1



Graph 2

