Gold is Still Pretty Pricey

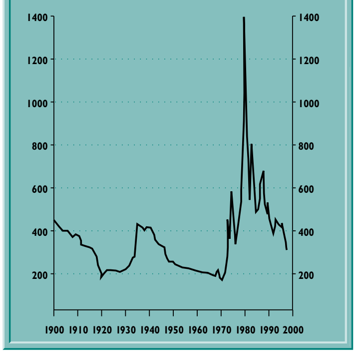
Stephen Poloz

THE PRICE OF GOLD HAS DECLINED STEADILY DURING THE past two years. It has fallen so far that even the most pessimistic observers have begun to ask whether the bottom has been reached.

Gold has traditionally been useful as a hedge against geopolitical and inflationary risks. Gold carries no default risk, making it a favourite store of value in troubled times, such as during wars. Gold also offers the perfect hedge against an unexpected surge in the general level of prices—if all prices in the economy were to double unexpectedly, so would the price of gold.

When inflation evolves as expected, bonds offer a better alternative to gold. In addition to including a component matching expected inflation, bond yields compensate investors for their loss of liquidity, the risk of default, and the risk that the inflation forecast proves inaccurate. Gold's reward potential comes from an *unexpected* surge in inflation. When that happens, bond yields will rise, actually penalising current bondholders with a capital loss. In contrast, the price of gold will usually shoot up and reward the gold bug. Gold works much like automobile insurance, paying off handsomely only under unusual circumstances.

Real Price of Gold (1997 Dollars)



The current low price of gold suggests that inflation risks are diminishing, and investors have been dropping gold from their portfolios. The global technological revolution is boosting productivity and putting downward pressure on prices world-wide. Furthermore, the crisis in Asia is causing the prices of traded goods to plummet and will produce a slowdown in the global economy. The world's central banks are carrying their traditional anti-inflationary bias through the turmoil, and their conservative policies are likely to push inflation down even further.

The downgrading in gold's investment role is not restricted to private investors. Governments have long been the biggest hoarders of gold. Under the gold standard, accumulation of the metal was viewed as the ultimate indicator of national economic strength. Accordingly, central banks possess literally tonnes of the stuff, much of it booked under the official price of US$ 35 per ounce. Thus, even today's low prices offer governments a handsome incentive to liquidate their gold holdings. Moreover, for purposes of holding international reserves, US Treasury securities offer central banks virtually the same liquidity as gold with a far superior rate of return. The upshot is that gold's popularity is declining even within its biggest fan club.

With so many sellers and so few buyers, where will the price of gold go next? It is important to take a very long perspective when answering this question. This is because the past 30 years stand out as a major inflationary episode in the long sweep of history. The surge in inflation in the early 1970s was totally unexpected. The casualties included the Bretton Woods system, which was the post-war equivalent of the gold standard. As a result, the price of gold skyrocketed in the 1970s. Gold gave investors much more than inflation protection at that time. It gave them a premium based on the increase in uncertainty about how monetary policy would be conducted in the future, given the demise of the Bretton Woods system.

A quarter-century later, the uncertainty about the outlook for the world price level has dissipated considerably. Major central banks have adopted inflation targets, either formally or informally, and have managed to get inflation back roughly to the levels of the 1950s. The bottom line is that the price of gold—expressed relative to the prices of other goods and services—could also return to around 1950s' levels. If central banks continue to shuffle their reserve holdings away from gold, the price could go even lower than that.

The accompanying chart converts the price of gold into 1997 dollars using the US consumer price index, and runs it back to 1900. The spike in the 1970s becomes nearly US$ 1400 in these terms. The major turning point in 1979 is marked by Federal Reserve Chairman Paul Volcker's declaration of war against inflation. Volcker backed up his pledge with massive increases in short-term interest rates, the war-time equivalent of a nuclear salvo. It has taken nearly 20 years to shake inflation out of the system.

During the non-inflationary 1950s and 1960s, the price of gold averaged about US$ 175 when expressed in 1997 dollars. There is very little reason to think that gold should stay much above those levels now, particularly when central banks will be selling the metal for years to come.

Sceptics will respond that the price cannot fall below approximately US$ 250, because this will put many gold mines out of business, supply will dry up and the price will rise. However, those mines were opened on the expectation that prices would remain artificially supported by the fear of inflation and the accumulation of gold by investors everywhere. Those days are gone. Mines will close to eliminate excess capacity in the gold industry.

Investors should stay clear of gold, unless they still wish to purchase insurance against another 1970s-style surge in inflation or some major geopolitical event. Gold held as insurance against calamity always holds out the promise of a huge pay-off—but one with very low probability. So unless you have inside knowledge on some impending global crisis, do not expect gold purchases to earn a positive return anytime soon. ◆

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