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The Money Managers' Dilemma

The package of monetary policies announced in early November was consistent with the need of U.S. monetary officials to suppress the more obvious signs of a rapidly depreciating paper dollar and thereby to continue their inflating-embezzling practices. Since then the price of gold has tumbled. Unless fundamental policies have changed, and we have discerned no evidence of such to date, the drop in the price of gold is another golden opportunity for savers to protect their real wealth.

In order to understand the recent actions of the money managers in the United States and other leading nations, one must realize that those officials are confronted continually with a dilemma. On one horn of the dilemma, they must continue to embezzle the real wealth of citizens' savings, life insurance, and pensions in order to fulfill the extravagant promises made to the politicians' constituents and to maintain the solvency of leading banks. The other horn of the dilemma is the possibility that a sufficient portion of the population will "get wise" and refuse to invest their savings in forms readily embezzled, with the result that a flight from the dollar and perhaps other leading currencies will occur.

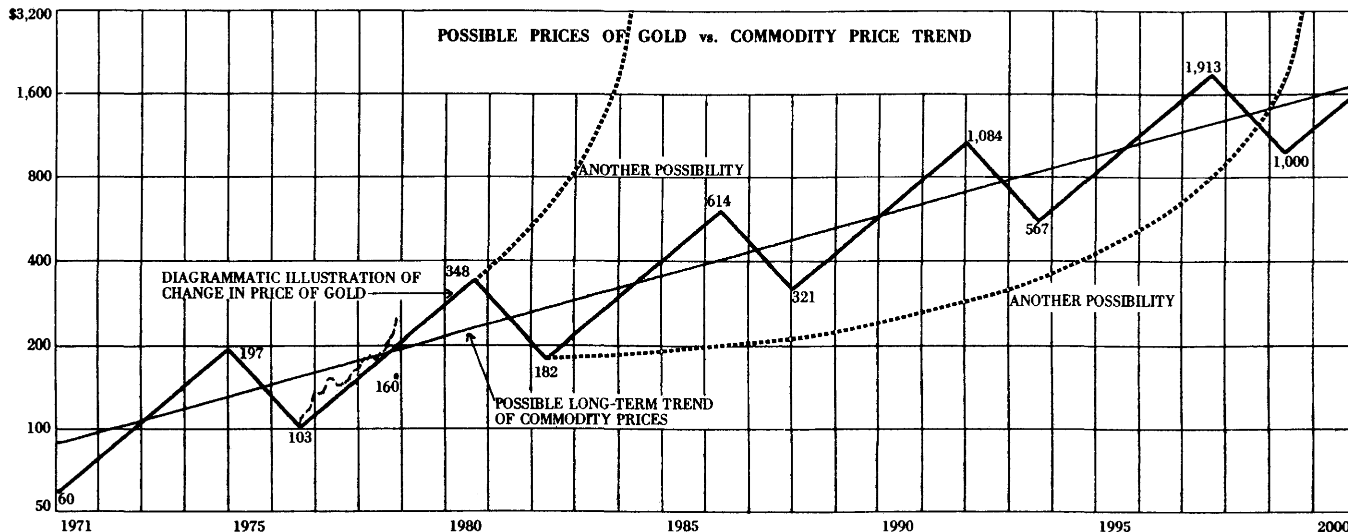
When the citizens generally refuse to continue saving in the usual ways and finally decline to accept paper money even for ordinary transactions, the inflating game will be at an end. Leading politicians then will be discredited and lose office and power. Leading bankers will be exposed for making their institutions hollow shells filled largely with the never-to-be-repaid obligations of many less developed nations, loans secured by unwanted tankers, frozen real estate loans, and other irredeemable paper promises including those of New York City. It is a situation to be avoided at any cost by those now in positions of power.

Therefore, no one should be surprised when the money managers in the government and the banks become greatly alarmed by developments such as those of last summer and early fall. Increasing worldwide distrust of the dollar was reflected in almost continually falling exchange rates for the dollar in terms of Swiss francs, Germans marks, and Japanese yen. The corresponding rise in the price of gold received a great deal of attention by the news media, and this promoted a greater public awareness of the role of gold as a protector of real wealth during times of rapidly depreciating paper currencies. It was not an impossibility that the rising price of gold reflected incipient flight from the paper dollar.

The Path of the Price of Gold

In 1974 we published evidence suggesting that an appropriate paper dollar price of gold then might be in the range of $140 to $180. During 1975 and early 1976, the price of gold fell from a high of $197.50 at the end of 1974 to $103.50 in August 1976. The halfway point, about $150, was within the range we had estimated earlier. These data served as the basis for constructing the accompanying illustrative chart of possible long-term trends in the price of gold.

The straight line extending for the 30 year period is the trend that might be followed by an index of consumer prices or some other comprehensive index of prices rising at the rate of 10 percent per year. Centuries of experience indicate that the price of gold in any currency will roughly parallel general price trends, inasmuch as the exchange value of gold for the average



price of many other things has been nearly constant *in the long run.* Of course, fluctuations in the exchange value of gold invariably have occurred around this long-term, nearly constant value when the price of gold has not been fixed by official action. Even when the price of gold has been so fixed, corrections in any marked deviations from this nearly constant exchange value of gold invariably have occurred. Officials merely could postpone, not cancel, such adjustment by manipulating the price of gold.

In the accompanying chart, the rise in the price of gold since the low of $103.50 reached in 1976 is shown by the narrow broken line. Inasmuch as the straight line extending from $103 in 1976 to a peak at $348 in 1980 reflects the rate of increase in the price of gold from 1971 to late 1974, the actual rise in the price of gold during the past two years (in other words, the depreciation of the paper dollar) has exceeded the earlier rate. This suggests, to anyone who can read ratio charts, that the possible flight from the dollar shown as a rapidly rising dotted line after 1980 might begin much earlier, indeed, might be imminent. There was good reason for the great concern of the money managers.

From the viewpoint of those in power, the only hope for continuing judicious embezzlement during their tenures lies in somehow suppressing the more obvious consequences of inflating so that most citizens would continue their usual saving and investing habits. Perhaps the rate of inflating and the resulting rise in prices (depreciation of currencies) must be held within the general range indicated approximately by the rising-steps solid line shown on the chart. Only by these means can those responsible expect to avoid most unpleasant consequences for themselves during their tenures.

Some observers believe that such astute handling of the situation is not practicable. They argue that either an accidental slide into deflationary depression or into runaway inflation, or first one and then the other, is highly probable. Our view is that those events are *possible* but not highly probable.

Near Future Possibility

As for the probable course of the price of gold in the near future, one can only guess. A conjecture based on experience in many markets over several decades might be as follows. *If* the solid line on the chart proves to be the general trend until 1980, a temporary decline to as far below that line as the recent peak of $242.50 was above the line would not be surprising. This would bring the price of gold to the vicinity of $160 per ounce before the longer-term trend would be resumed. Inasmuch as this would be within the range of a one-third to two-thirds retraction of the rise from $103.50 to $242.50, it would not be an unprecedented correction during a long-term rise. However, such guesses should not be considered predictions. What is probable is the long-term (several decades) depreciation of the dollar indicated in the chart.

The price of gold may be compared with a thermometer measuring the "fever" level of a seriously ill economy. In 1975 and early 1976, the money managers, in effect, put ice on the "thermometer" by pushing down the price of gold. That worked well for a brief period. Therefore, a repetition of that procedure was to be expected at some point when the thermometer again was rising dangerously. Now that a second effort to push down the price of gold is under way, all who desire to safeguard their long-range futures by acquiring gold are being offered another chance. Opportunity knocks again for those who did not act earlier to protect the real value of their savings.

The implications of recent actions by monetary officials would be far different were they to reflect a fundamental change in policies. However, since the early 1960's, every official act similar to the recent ones sooner or later were revealed to have masked a continuation of past pernicious policies. That the leading politicians and bankers suddenly have become "born again" sound money men stretches the imagination beyond a point we are ready to accept as sound at this writing.

RESIDENTIAL CONSTRUCTION

Construction of new residential units during this business-cycle expansion has increased to a level that is about 15 percent less than the prior peak. Single family house construction grew rapidly early in the recovery, but the number of such houses constructed has changed little during the past 18 months. Rapidly increasing costs and mortgage interest rates may sharply curtail demand for single family houses during the next few months. Although the construction of multifamily units has increased markedly in the past year, the increase has been from a low base, and it too seems vulnerable to increased mortgage costs. A cyclical contraction in residential construction activity in the near future seems probable.

Note: All data are seasonally adjusted.

According to the Department of Commerce, the value of new private housing units put in place during the 3 months ended in September was about $19.3 billion, which was 0.9 percent more than that during the preceding 3-month period and 15.8 percent more than that during the 3-month period ended in September 1977. After adjustment of these current-dollar values to reflect increased costs, the estimated physical volume of such construction put in place during the 3 months ended in September was 0.2 percent more and 1.3 percent more, respectively, than during the preceding and year-earlier 3-month periods. The constant-dollar series is shown as the top curve in the accompanying chart.

As the chart reveals, the construction of new housing units trended markedly upward from its cyclical trough in early 1975 until the spring of 1977. Between April 1975 and May 1977, the constant-dollar volume of such construction increased at a compound annual rate of more than 30 percent. Since then, however, this series has fluctuated around a level that is about 15 percent less than its all-time record high reached in early 1973.

The second curve in the chart, the number of units authorized by building permits, is a primary leading indicator of business-cycle changes. It is now appraised as contracting cyclically.

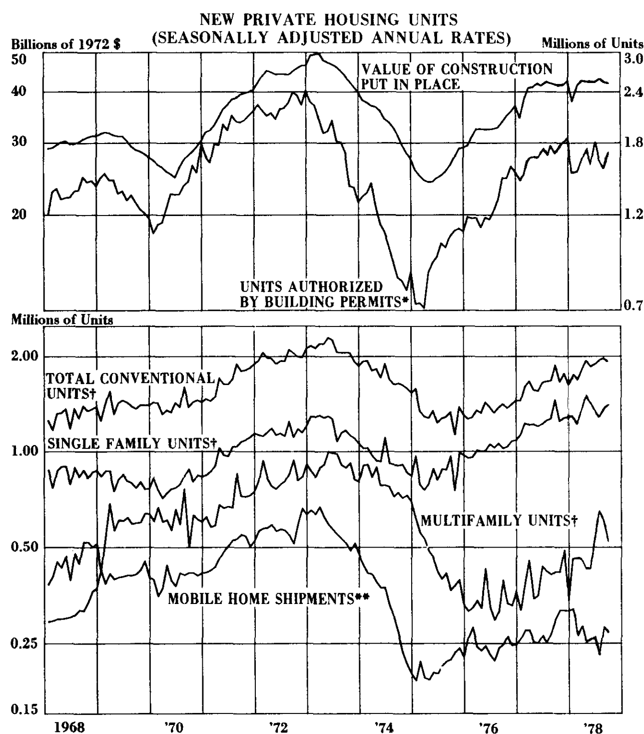
Although the physical volume of construction of new housing units has changed little on balance since May 1977, the supply of new units available has continued to expand. This is revealed by the curve for total completions of conventional units shown in the chart. That the number of conventional housing units completed has continued to expand while the value put in place of such units has changed little presumably reflects a decrease in the average real costs of the units produced and the fact that completions lag value put in place. (The "finishing touches" usually take the most time to complete even though they generally are a relatively small portion of a unit's total cost.) Moreover, builders can "stretch out" their construction schedules. In response to moderating demand, builders presumably do so in order

to put on the market only as many units as might be sold reasonably soon. Completions are delayed thereby, so that even though value put in place might peak, completions can trend upward for some time longer. In 1973, value put in place reached and remained at a high level during the first quarter, while single family units completed also reached a high level then but remained there 3 months after value put in place turned downward. With value put in place having changed little for more than a year, we expect the upward trend in total housing units completed to end soon.

The first five sections of the accompanying table are arranged in the sequence in which the various construction data series usually change cyclically. As data in the table reveal, recent marked gains in the construction of multifamily houses have offset decreases in the construction of single family houses during the past year. Multifamily housing projects usually cost less per unit than single family houses, and they take longer to build. Thus, the increasing share of multifamily units in the total has been reflected in the continuing upward trend in the number of new conventional housing units completed. It should be noted, however, that multifamily housing construction remains substantially below its earlier peak. This, and the fact that mobile home shipments have shown little recovery at all during the past 4 years suggests that less affluent households have been less able to afford to occupy new housing during the current business-cycle expansion than during earlier housing booms. However, more stringent building and zoning codes and the failure of many luxury apartment and condominium projects after the last boom in multifamily housing construction may also be involved in the recent trend of multifamily housing construction and mobile home production.

The failure of multifamily residential construction to expand significantly during this business cycle has kept the total supply of newly constructed housing units below the previous peaks. The construction of single family homes reached new record levels this year. One reason for this presumably has been changes in banking regulations designed to foster the continued availability of mortgage funds despite high and increasing interest rates. During earlier cycles, when interest rates increased markedly, deposits were diverted from the major mortgage lending institutions ("disintermediation"). This left those institutions without funds to lend to home buyers at any interest rate. During this cycle, regulatory changes have permitted "thrift" institutions to pay market-related interest rates on some types of deposits, and this has enabled those mortgage lenders to retain their deposits and to continue making new mortgage loans.

Thus, while interest rates have increased, home buyers have been able to compete with other types of borrowers and, except in states with so-called usury laws, have been constrained only by their own unwillingness or inability to pay. In this regard, the attitudes of many persons about buying a home probably have become influenced by speculative motives as well as consumption (user) motives. Because the prices of single family houses have increased markedly during recent years, and because such gains usually are highly "leveraged" and receive favorable tax treatment, many purchases of single family houses during recent years may have been made for investment or speculative purposes rather than to meet the shelter requirements of buyers. For such home buyers, rising prices well might have fostered higher demand that the



* 1968-71, 13,000 localities; beginning 1972, 14,000 localities.
† Completions.
** Excluding exports and sales to governments.

PRIVATE RESIDENTIAL CONSTRUCTION DATA

	Average During 3 Mos. Ended Sept. 1978	*Percent Change From Preceding 3 Mos.*	*Percent Change From Year Earlier 3 Mos.*
*Building permits issued (000)**			
Single family houses	1,051	–5.5	–7.3
Multifamily units	583	–3.8	+0.5
Total	1,634	–5.0	–4.7
Housing units started (000)			
Single family houses	1,453	–1.2	–1.3
Multifamily units	626	–2.8	+16.2
Total	2,079	–1.7	+1.9
*Value put in place***			
New single family houses	$63.2	–1.5	–0.8
Multifamily units	$13.6	+6.7	+12.1
Total	$76.8	–0.1	+1.3
Housing units completed (000)			
Single family houses	1,354	–5.2	+2.0
Multifamily units	594	+35.6	+43.4
Total conventional	1,947	+2.7	+11.9
Mobile home shipments	259	–2.1	–0.9
Total	2,206	+2.5	+9.5
New single family houses for sale at end of period (000)	422	+1.0	+8.5
New housing units under construction at end of period (000)			
Single family houses	788	+1.8	+11.3
Multifamily units	527	+1.0	+19.5
Total	1,315	+1.5	+14.4
Conventional mortgages on newly built houses	*During 3 Mos. Ended Oct. 1978*		
Effective interest rate (%)	9.75	+0.29†	+0.71†
Average mortgage (000)	$47.2	+4.5	+15.3
Average down payment (000)	$17.9	+9.8	+27.3
Average purchase price (000)	$65.1	+5.9	+18.4
Average monthly payment	$410	+7.1	+22.4

Note: Value put in place and number of units are shown at seasonally adjusted annual rates.
* In 14,000 permit-issuing places.
** Amounts shown in billions of current dollars, percent change calculated from constant-dollar amounts.
† Percentage points of change in 3-month averages.

initial period of increasing interest rates did not discourage.

Whatever the motives of house buyers, there no doubt is some level of required outlays that will deter demand for newly constructed homes. In view of the recent rapid increase in the required outlays for new houses (shown in the table under the category "conventional mortgages on newly built houses"), that level already may have been reached or soon may be reached. Moreover, there recently have been reports that some managers of "thrift" institutions are becoming unwilling to pay the high current short-term market interest rates to continue to attract depositors' funds because the rates they would have to pay exceed the rates they can obtain on their earning assets, largely house mortgages.

Regardless of these considerations, the construction of new single family houses seems particularly vulnerable to decreased demand at this time. The number of unsold houses at the end of October was the highest since 1973, and the number of such houses under construction then was about 21 percent more than the 1973 peak. The "overhang" of these units could depress single family house construction for some time.

This, combined with the probability that current high interest rates will also restrain multifamily construction, leads us to believe that the outlook for total residential construction is quite grim. Because the residential construction industry is a major element of the private economy in itself, but also because consumer outlays for household durables are related to new residential construction activity, a cyclical contraction in residential construction activity could well initiate a general business contraction.

DID THE ELECTION RESULTS SIGNAL A MAJOR SHIFT?

Although the November 7 election results reflected widespread voter disapproval of big government, evidence available thus far is not sufficient to warrant the expectation of a fundamental change in government policies away from large spending. The anti-government public mood would have to extend through a recession before we would be convinced that such a shift is probable.

The elections of November 7 gave the Republican Party net gains of 3 U.S. Senate seats, 12 U.S. Representative seats, 6 governorships, and perhaps 12 state legislative houses. Of the record number of initiatives on ballots across the Nation, voters approved about 80 percent of measures designed to limit or reduce taxes or government spending. The latter result probably has greater economic implications than the former, inasmuch as not all Republicans support a reduced role for government and not all Democrats support more government spending and taxes, but all politicians pay attention to the mood of the electorate.

The mood of taxpayers was dramatically thrust before politicians with the passage of Proposition 13 in California on June 6. Thereafter, most politicians competed vigorously to convince voters that they would be more fiscally frugal than their opponents. In California, Governor Jerry Brown promptly switched his opposition to tax cuts after Proposition 13 was passed, and he managed to get re-elected. In our own Massachusetts, the Democratic candidate for Governor, Edward King, promised tax cuts that his Republican opponent said were reckless and unachievable. The Democrat won. In New Hampshire, conservative Republican Governor Meldrim Thompson was defeated by Democrat Hugh Gallen, who claimed that Thompson's support of higher electric utility rates demonstrated a lack of concern for the middle-class taxpayer. Taxpayers had spoken and the candidates had heard.

Do such results represent a watershed in the trend of the past 50 years toward more government spending and taxes, larger government deficits, and the pressures to inflate generated therefrom? Although the taxpayers' revolt is a favorable development, we are not convinced by events to date that the past pernicious policies have been finally repudiated by the public or its political representatives. The public has yet to experience a substantial reduction in government services that must accompany any substantial cut in government spending; thus, the public's fervent protest against bigger government has yet to prove its staying power. Results of a New York Times-CBS News national poll of voters at polling places revealed that about half of the voters favored Government-financed national health insurance. Yet, the same poll showed that 80 percent of the voters would favor a law or amendment requiring a balanced budget. Apparently many voters do not fully realize that Government "goodies" will have to be sacrificed if Government economy is to be achieved.

Like the public, the politicians who made promises of government cuts during the campaign have still to prove their commitment to that end. When the time comes for those politicians to vote on spending programs affecting large special-interest constituent groups, there will be severe pressure for them to spend then and meet the promised cuts later. Especially would this seem to be the situation for Democrats who changed their "spots" during the recent campaign.

We focus on the probable effects of the public's anti-government mood on spending because that is the critical aspect for the economy. If taxes are reduced but government spending is not, governments will incur larger deficits that will have to be financed with more borrowing (which drives up interest rates and chokes off private-sector spending) or more inflating.

In connection with the matter of government deficits and the public's new mood, we call readers' attention to the nearly $40 billion planned Federal deficit for fiscal 1979. That deficit is based on the assumption that the current business-cycle expansion will continue into its *fifth year.* What will happen to the amount of the deficit, to the politicians' promises of a smaller role for government, and to the public's anti-government sentiment if, instead of expansion, the Nation experiences a recession?

Before we conclude that the trend toward a larger role for government has been reversed, we shall have to see the taxpayers' revolt and voters' anti-government-spending sentiment withstand the test of a recession. Not until then would we be optimistic that the role of government will diminish, that inflating will end, and that a sound economy will be restored.

PRICE OF GOLD

	1977	*1978*	
	Nov. 22	*Nov. 16*	*Nov. 21*
Final fixing in London	$156.15	$196.30	$200.20

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